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The Future of Corporate Democracy

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THE FUTURE OF CORPORATE DEMOCRACY

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Public corporations today are more than businesses. They are miniature governments[1] which even more than in the past influence the social, political and economic fabric of American life.[2] And their influence goes beyond the nation's borders to intrude into the foreign policy of the United States.[3] In other words, the problem of the status of corporations goes beyond the familiar but still unresolved question of the separation of managerial control from the economic interest of shareholders.[4] A fundamental question is raised about the place of public corporations in the American political and economic superstructure. A public corporation must operate within the law but otherwise need be responsive to no one, neither to the government, to the public at large, nor normally in practice to its own shareholders. It is a private government in a public sphere whose citizens have only the shadow of a vote.[5]

May a corporation with a large concentration of wealth and economic

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[1]Two examples will illustrate the scope of these pseudo governments. In 1973, American Telephone and Telegraph Co. had consolidated sales and revenues of $23.5 billion and 1,023,000 employees, MOODY'S PUBLIC UTILITY MANUAL 991 (1974), and Gen. Motors Corp. had consolidated sales and revenues of $35.8 billion and 810,000 employees, 1 MOODY'S INDUSTRIAL MANUAL 1066 (1974). By contrast, the 1973 gross national product of a sampling of several moderate sized European nations was: Finland, $16.5 billion; Greece, $16.4 billion; Norway, $18 billion; Portugal, $10 billion; and Switzerland, $42 billion. The 1970 gross national product of the continent of Africa was $59.7 billion, while the combined 1973 sales and revenues of GM and A.T.&T. was $59.3 billion. U.S. BUREAU OF CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES 824, 825 (95th ed. 1974).

[2]This is axiomatic. A few notorious illustrations outside the economic sphere include the problems of employment discrimination by race and sex, the environmental impact from industrial pollution to strip mining, the direct and indirect political contributions by corporations to campaigns and the molding of consumer taste. *See* Bell v. Maryland, 378 U.S. 226, 84 S. Ct. 814, 12 L. Ed. 2d 822 (1963) (Douglas, J., concurring opinion and appendix 1 thereto).

[3]A few current illustrations would be the alleged interference of International Telephone and Telegraph Co. with elections in Chile, the actions of oil companies in the Middle East, mutual landing rights of United States and foreign airlines, and arms shipments and the sale (or refusal to sell) sophisticated technological information to the Soviet Union. Historical examples would include the founding of Jamestown by the Virginia Company, and the colonization of parts of Asia by the East India Company.

[4]*See* T. VEBLEN, ABSENTEE OWNERSHIP 215, 216 (1923); and A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 7 (rev. ed. 1967).

[5]*See* Medical Committee for Human Rights v. SEC, 404 U.S. 403, 92 S. Ct. 577, 30 L. Ed. 2d 560 (1972) (Douglas J., dissenting opinion).

power and concomitant social and political power properly exist in a democracy without being subject to political control through a democratic political process, and if it does so, can that democracy long endure? Certainly there are grave risks although some commentators are less alarmed than others.[6] However, the major problem has not been one of principle but one of practice. Corporations do present the *form* of democracy, but not the *substance,* thus camouflaging the underlying reality. This article, after examining the scope of the present situation, shall make a modest proposal to modify the form in order to effectuate substantive corporate democracy.

I. Corporate Democracy—The Myth and the Reality

First, let us explore the extent of corporate democracy in America, both the myth and the reality. The examination shall be limited to corporate democracy in shareholder elections but shall exclude referendum elections such as approval of mergers, sale of assets and the like. Not that such matters are unimportant, but they raise a different and less fundamental set of problems and are worthy of separate treatment.

The election of directors by a vote of the shareholders is a natural out-growth of the concept of a business corporation and is the required procedure in every state. This philosophy was accepted by Congress[7] in enacting the proxy provisions of the Securities Exchange Act of 1934,[8] and some aspects of corporate elections are stricter than political elections.[9] Yet, Congress and the Securities and Exchange Commission (herein the "Commission") dealt mainly with procedure, to insure an honest election and a reasonably informed electorate. The substantive rights adhering to a shareholder's franchise were described by the law of the several states.

Public corporations appear to represent an economic extension of American political democracy. More than thirty million Americans owned shares in public companies in 1970 with an aggregate estimated market value of 682 billon dollars, and a substantial number of additional Americans had an indirect interest in publicly held stock estimated at 365 billion dollars, held by intermediate fiduciary institutions such as pension trust funds, mutual funds and life insurance companies.[10]

[6]*See* J. Galbraith, The New Industrial State (2d ed. 1971); Chayes, *The Modern Corporation and the Rule of Law,* in The Corporation in Modern Society 25, 40 (E. Mason ed. 1959).
[7]H. R. Rep. No. 1383, 73d Cong., 2d Sess. 5, 13-14 (1934).
[8]Securities Exchange Act of 1934 § 14a, 15 U.S.C. § 78n (1970).
[9]SEC v. May, 229 F.2d 123, 124 (2d Cir. 1956).
[10]New York Stock Exchange, Census of Shareownership 1, 24 (1970).

The forms of corporate democracy are familiar.[11] Each year in advance of the annual meeting of shareholders, an annual report on slick paper containing pictures and looking for all the world like an expensive magazine is mailed to shareholders, as well as a simple black and white proxy statement printed on plain lightweight bond paper.[12] A few corporations include pictures of nominees in the proxy statement. More include pictures of existing directors in the annual report where they can be better balanced by pictorial endorsements of the company's product. A proxy form and a postage paid return envelope are enclosed so that a shareholder who does not attend the meeting may vote for the nominees of the existing management, and while his vote will have no influence on the result, it may be useful in establishing a quorum. At the meeting, if he attends, he will hopefully receive an optimistic report by the company president. If he is fortunate he may even hear some penetrating questions by fellow shareholders which may or may not be answered from the podium. Many companies put out post-meeting reports which summarize the discussions and questions at the meeting for those who do not attend. A new trend is to have an informal information meeting before or after the shareholders meeting with the two-fold purpose of allowing more time for officers' reports and shareholders' questions and minimizing stockholder participation at the formal meeting. Bond-holders and holders of debentures, even convertible debentures, cannot vote and may not even be entitled to notice of the meeting. They have an economic interest in the corporation, but only the shareholder can vote. Only the shareholder is a citizen of the corporation.[13] All this has the appearance of democracy except that voting is on a per share not a per capita basis. There appears to be majority rule, but is there? The question requires a brief look at corporate democracy in action.

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[11]They elaborate on a pattern prescribed by SEC Rule 14a-3, 17 C.F.R. § 240 (1974) and state law. The discussion in this article is limited to corporations which by reason of § 12 of the Securities Exchange Act of 1934, 15 U.S.C. § 78 (1970) have common stock subject to the proxy rule. Although proxy solicitation is not required by either state or federal law (though once undertaken it must comply with the appropriate requirements referenced in the preceding sentence), the New York Stock Exchange Listing Agreement § III ¶ 5 and the American Stock Exchange Listing Agreement § 6b require corporations with stock listed on such exchanges to solicit proxies for all meetings of shareholders. *See also* NEW YORK STOCK EXCHANGE COMPANY MANUAL A-29, A-34 and AMERICAN STOCK EXCHANGE COMPANY GUIDE 299, 300 (1973).

[12]SEC Proxy Rule 14a-3(d), 17 C.F.R. § 240 (1974) requires the company to supply additional copies of the annual report and proxy statement to brokerage houses and others who hold stocks of record for beneficial owners and pay the reasonable cost to distribute copies of this material to the beneficial owners.

[13]A few state statutes now authorize corporations to grant voting rights in their charters to holders of debt securities, *e.g.*, 8 DEL. CODE § 221 (1953) and CAL. CORP. CODE § 306 (1947). Such debt instruments are quite rare in public corporations. Their existence would expand the concept of a corporate citizen.

How is a shareholder's election for directors conducted? Some weeks before the annual meeting of shareholders a slate of nominees is selected by the existing board of directors.[14] To almost no one's surprise, nearly all of the nominees are existing directors.[15] They may be officers of the company, corporate counsel, bankers or investment bankers to the company, substantial stockholders, and may also include several unaffiliated persons presumably friendly to management.[16]

Many boards consist of directors who, even in the aggregate, own a very small portion of the outstanding stock of the company and that often acquired by stock options. In fact, generally speaking, the larger the corporation, the smaller the direct stock ownership that is represented on the board. For example, in 1975, the nominees for director of American Telephone and Telegraph Co. and their families owned in the aggregate 21,856 shares of common stock of 560,940,041 shares outstanding,[17] or 0.0039 percent of the outstanding shares. Other examples selected at random show that nominees for director owned in the aggregate the following percentages of outstanding common stock: 0.051 percent in Exxon Corp., 0.094 percent in U.S. Steel, and 0.302 percent in Caterpillar Tractor.[18] The list could go on. Moreover, a large number of the shares held by officer-directors were apparently purchased through key employee stock option plans or similar plans pursuant to which shares were purchased at an advantageous price. This is not a new phenomenon and continues the trend predicted by Professor Berle a generation ago.[19]

These directors have no constituency, yet they serve unchallenged on their boards year after year, in good times and in bad.[20] There is no way to compel a shareholder's nominee to be included in the

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[14]*See* M. MACE, DIRECTORS: MYTH AND REALITY 195 (1971).

[15]For example, a random sampling of twenty public corporations shows that only fourteen directors of an aggregate of 304 directors failed to be re-elected. If directors who were not renominated for reasons of death or retirement (as stated in the company's annual report to stockholders) are eliminated, only five directors failed to be re-elected and not more than two directors in any company. A random two-year consecutive period between 1969 and 1975 was selected for each corporation as the basis for comparison.

[16]J. BACON, CORPORATE DIRECTORSHIP PRACTICES table 6 at 29 (1973). A distinct majority of the companies surveyed in this study had boards consisting of a majority of outside (but presumably affiliated or friendly) directors, *id.*, at 2.

[17]See the 1975 Proxy Statement of American Telephone and Telegraph Co. for the 1975 Annual Meeting of Shareholders.

[18]See the 1975 Proxy Statements of Exxon Corp., United States Steel Corp. and Caterpillar Tractor Co., respectively, for their 1975 annual meetings of shareholders.

[19]Berle and Means, note 4, *supra*, at 66.

[20]Six of the companies in the survey described in note 15, *supra*, had an adverse financial report (compared to the prior year) for the fiscal year immediately preceding the election; of these six companies only three of an aggregate of ninety-six directors failed of re-election, two of whom were directors in one corporation with a twelve-man board.

management proxy, although management may recognize a substantial stock position with a place on the board. Shareholders may vote for management's nominees listed on the proxy but cannot use that proxy to vote for other candidates.[21] Except by assuming all the expenses connected with a proxy fight, there is no practical way to solicit proxies for a dissident slate or a minority director. The obstacle is not legal (except in those states where a stockholder cannot get a shareholders list sufficiently in advance of the meeting[22]), but one of cost.[23] At a minimum there is the cost of preparing, filing and processing a proxy statement through the Commission, printing and mailing the proxy statement, as well as the associated legal expenses.[24] To this should be added soliciting expenses, possible newspaper advertisements, prepaid return postage and the problem of securing a shareholders list (which frequently requires litigation). Unless control of the board is secured, even a successful candidate might have to repeat this procedure every year. Opposition nominations can be made and votes can be cast in person at the meeting for such non-management nominees but since almost all votes are cast by proxy before the meeting and few, if any, shareholders vote in person, it is an empty right. The right to solicit proxies is the right to elect.

Unless there is an election contest, brokerage firms which own stock in street name are permitted by the New York and American Stock Exchange rules to cast proxies for the election of management's nominees.[25] This enables management to readily secure a quorum. On the other hand, if there is an opposing slate the brokerage house must solicit instructions from the beneficial owners of securities (at the company's or soliciting parties' expense, as the case may be). Brokerage firms may not vote their own wishes except for securities of which they are beneficial as well as record owners.[26] The information furnished to shareholders in the proxy statement generally consists of a nominee's

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[21] An examination of the form of proxy of several hundred companies indicates this to be the universal practice. The management proxy form for the 1975 annual meeting of the shareholders of the Proctor and Gamble Co., in what may be a singular example, allows shareholders to vote for some nominees and withhold their votes from others.

[22] The shareholders list is useful for personal solicitation but may not be essential if time is not of the essence and the insurgents can contest the election exclusively by mail and advertisements. *See* SEC Proxy Rule 14a-7, 17 C.F.R. § 240 (1956).

[23] *See* Eisenberg, *Access to the Corporate Proxy Machinery*, 83 HARV. L. REV. 1489, 1500-01 (1970).

[24] Compliance with SEC Rule 14a-11, 17 C.F.R. § 240 (1968) is required.

[25] Rules 450-60 of the Rules of the New York Stock Exchange, 2 CCH NEW YORK STOCK EXCHANGE GUIDE §§ 2450-60 and Rules 575-85 of the Rules of the American Stock Exchange, 2 CCH AMERICAN STOCK EXCHANGE GUIDE §§ 9526-37. These rules apply to securities held by member firms of the exchanges regardless of whether a stock is listed on the exchange.

[26] *Id.*

principal occupation (and if he is being elected by shareholders for the first time, his principal occupation for the past five years), his ownership of equity securities of the company and of securities of any class of which he and his associates own ten percent, the compensation of any directors or nominees who received more than $40,000 a year, and certain transactions between the company and its directors or nominees since the beginning of the company's last full fiscal year.[27] There is no statement reflecting a nominee's position on any matters concerning the company, from dividend policy to plant expansion, from ecology to diversification to doing business with Russia. Finally, it is the company, not the nominee, which pays the cost of management solicitation.

There can be, and in rare instances still are, proxy fights. When one group of investors decides that it would like to replace the management with its own nominees and has accumulated enough shares to make an effective challenge, it must, if it wishes to solicit proxies, file its own proxy statement with the Commission[28] and solicit proxies from the shareholders at its own expense. If the challengers win they can sometimes be reimbursed by the company.[29] Win or lose, the company will normally bear management's costs.[30] Usually, it is a "winner takes all" contest; *i.e.,* one entire slate or another is elected. Occasionally a single seat on a board of a corporation with cumulative voting will be contested. These fights can be prohibitively expensive and are not undertaken except in unusual circumstances. The larger the company, the less the likelihood there is of a proxy fight.[31] As a result, tender offers appear to have become the preferred "take over" technique.[32]

An examination of files of the New York Stock Exchange disclosed that during the twenty-one month period beginning January 1, 1972 and ending September 30, 1973, there were only five companies which had proxy fights for the election of directors among the approximately 1,500 companies listed on the Exchange.[33] One of these corporations (with cumulative voting) had two contests in this period by the same

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[27]SEC Proxy Rule 14a-101, 17 C.F.R. § 240 (schedule A) (1974).

[28]SEC Proxy Rule 14a-11, 17 C.F.R. § 240 (1968).

[29]Rosenfield v. Fairchild Engine and Airplane Corp., 309 N.Y. 168, 128 N.E.2d 291 (1955); L. Loss, SECURITIES REGULATION 857 (2d ed. 1961).

[30]*Id.*

[31]Fleisher & Mundheim, *Corporate Acquisition By Tender Offer,* in SELECTED ARTICLES ON FEDERAL SECURITIES LAW 815, 818-19 (H. Wander & W. Grienenberger eds. 1968). Some examples of the costs of proxy fights are set forth in the footnotes to Eisenberg, note 23, *supra.*

[32]Aranow & Einhorn, *State Securities Regulation of Tender Offers,* 46 N.Y.U. L. REV. 767 (1971).

[33]This period included two annual meetings of shareholders for the election of directors for most of the companies surveyed.

insurgent for one seat on the board, but not for control. In a country where a local schoolboard cannot be elected without a contest, these statistics clearly suggest that corporate democracy is moribund if not extinct.

The situation in most corporations may be analogized to a one-party government whose citizens may vote for management, or not vote at all. The corporations are often controlled by men who are more concerned with their jobs and the company *qua* company than with a powerless electorate. The "government" may no longer even feel compelled to maximize earnings, but only to avoid loss and its destructive effect on the technostructure[34] and their security.[35]

What is missing? *The opportunity to dissent.* The opportunity for shareholders who are not part of management to be represented on the board or at least a chance to appear on the ballot. A program to establish meaningful shareholder democracy is outlined in part III of this article. However, the scope of the problem is even broader because an estimated twenty-eight percent of all stock shares are held by mutual funds, banks, pension plans, universities, nominees and the like.[36] These shares are routinely voted for management. The governing philosophy appears to be that if one is unhappy with management, then he should sell; otherwise vote for the incumbents.[37] Of course, as has been noted, this discussion is more often than not a theoretical one, since alternative slates are rare. To have meaningful, functioning democratic capitalism, a way of giving impact to the indirect votes of the beneficial owners of these interests must be found.

II. Non-Traditional Alternatives

It has been assumed thus far that corporate democracy is a necessary economic manifestation of a political democracy—that capitalism in a democracy should mean democratic capitalism or else political democracy itself will be endangered. There are nevertheless several possible alternatives to traditional corporate democracy, not all of which are democratic, not all of which are capitalistic.

Eliminate the Election of Directors

The first possibility would be to carry the present system to its

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[34] *See* text at note 40, *infra.*

[35] Galbraith, note 6, *supra,* at 168-169.

[36] The stock referred to includes both common and preferred issues. Note 10, *supra,* at 24.

[37] *Wharton School Study of Mutual Funds,* H.R. Rep. No. 2274, 87th Cong., 2d Sess. 12, 26 (1962); Eisenberg, *The Legal Roles of Shareholders and Management in Modern Corporate Decision-making,* 57 Calif. L. Rev. 1, 49 (1969).

logical conclusion and eliminate all annual meetings for the election of directors. An annual report to shareholders and a statement in lieu of a proxy statement would presumably still be required as it is now for companies whose managements do not solicit proxies.[38] However, shareholders would recognize that they were not corporate citizens of a democracy so much as investors in an autocracy.[39] Some money might even be saved. Shareholders owning at least ten percent of the outstanding voting stock could be allowed to demand that an annual meeting for the election of directors be held to allow for the violent eruption of a proxy fight. Such suggestions lead in turn to managerialism. Or to put it another way, managerialism now exists in fact if not in form and the election of directors has been all but eliminated in fact if not in form.

Managerialism[40]

In a large and complex corporation, not only are the stockholders without power but as Professor Galbraith has observed, ". . . the Board of Directors is normally the passive instrument of the management."[41] The entrepreneur has been replaced by management[42]—by the somewhat larger number of individuals who bring specialized knowledge, talent or experience to group decision making and who compose what Galbraith calls the technostructure. Moreover, "Given the deep dependence of the industrial system on the state and the nature of its motivational relationship to the state, *i.e.*, its identification with public goals and the adaptation of these to its needs, the industrial system will not long be regarded as something apart from government. Rather it will be seen as part of a much larger complex which embraces both the individual system and the state,"[43] one which is leading to the socialization of the mature corporation.[44] It is "socialism" with two major distinctions. First, the allocation of capital, the investment risk of the venture and a return on the investment are basically (though not entirely) private rather than public; and secondly, the board of directors

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[38]SEC Proxy Rule 14c-1, 17 C.F.R. § 240 (1974).

[39]*Cf.* Manning, Book Review, 67 YALE L. J. 1477, 1485-88 (1958).

[40]A summary of the general theories which might be classified as managerialism is contained in Eisenberg, note 37, *supra*, at 20. This approach has been refined and modified by Professor Galbraith and this discussion is based on his analysis, Galbraith, note 6, *supra*.

[41]Galbraith, note 6, *supra*, at 149.

[42]*Id.*, at 70.

[43]*Id.*, at 395.

[44]*Id.*, at 397.

(and through them the technostructure) has no responsibility to a body politic, be it shareholders or the government.[45]

It would appear that the model of the technostructure is a good descriptive model of corporate power and decision making in a contemporary corporation. There is little doubt as to the ability of the industrial system to serve man's physical needs, but as Galbraith asks, is it consistent with his liberty?[46] Not, he replies, if we continue to believe that "the goals of the industrial system . . . are coordinate with life," but only if aesthetic goals are strongly asserted.[47] And this would hopefully be accomplished because the demands of the industrial system in contrast with its economic antecedents are intellectually demanding and will bring forth a technostructure which will reject the goals of the industrial system which has bred it.[48] This is indeed a slender reed upon which to trust our freedom. That may be why, despite Plato, there are still poets in our Republic. A large public corporation or an industrial state is not an economic entity alone and the inherent political needs of freedom cannot be guarded solely by economic arrangements or wistful entreaties to the future character of man. Liberty and freedom are political rights and can best be enhanced as they have always been, by reliance on democratic political processes, if appropriate ones can be found. Only if that search fails should efforts be bent in another direction.

Client-Group Participation

Another suggestion which has been put forth is to allow client-groups of the corporation to participate in decision making. These would include employees, customers including consumers, and suppliers and distributors at the expense of or even to the exclusion of the shareholders.[49] Except in the case of employees, this would probably raise an insuperable task of selecting representatives as well as countless instances of conflict of interest. How would directors be allocated among the several groups, who would have a right to vote, and how many votes might they cast? In any event, if this is the desired result might it not be

[45]Galbraith finds economic power under democratic socialism in the non-communist world to also be lodged with the technostructure and removed from the reach of social (political) control but that public ownership may increase the amenability of the public corporation to social goals. *Id.*, at 98, 104. It is unclear whether political control of enterprises has disintegrated as far in the Soviet Union. *Id.*, at 106-07. Certainly in theory it has not done so. E. LIBERMAN, ECONOMIC METHODS AND THE EFFECTIVENESS OF PRODUCTION 44 (1970).

[46]Galbraith, note 6, *supra*, at 399.

[47]*Id.*, at 401-2.

[48]*Id.*

[49]Eisenberg, note 37, *supra*, at 16.

better achieved by an ombudsman or direct state ownership?

Employee representation is at least mechanically feasible since there is a well-defined group, usually with a union, and established voting procedures under the supervision of the National Labor Relations Board. This attempt at codetermination with employees has apparently worked reasonably well in Germany but may be peculiar to the continental climate.[50] Codeterminism is inconsistent with the American tradition of labor management relations and American commentators have been suspicious about its applicability or acceptability on these shores.[51]

Even if one accepts the principle of codeterminism there remains the question of how to select the shareholders' representatives to the board, so at best and a doubtful best at that, codeterminism will complicate the problem of democracy, but will not solve it.[52]

Ombudsman

Would the creation of an ombudsman at the state or federal level promote corporate democracy? It is certainly an alternative to client-group participation and the government might appoint separate ombudsmen as watchdogs for labor's rights, consumers' rights, etc. An ombudsman might attend and speak out, but not vote at directors' meetings. Many of these functions are now more or less allocated to the Federal Trade Commission, the Securities and Exchange Commission, the Environmental Protection Agency, etc. The concept of giving the public at large or interest groups a voice in the direction of the corporation, considering the corporate influence on society, may have considerable merit. However, an ombudsman might appear to be more of a spy than a spokesman and there are already an abundance of regulatory agencies.

Presidential Directors

A more useful approach than an ombudsman and a variation of client-group participation might be to authorize the President of the United States to appoint an ex officio member of the board at large for each public interest. This will not solve the problem of democratically electing directors but in its absence would give some political base to the board. However, the establishment of a representative corporate gov-

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[50]See Vagts, *Reforming the Modern Corporation: Perspectives From the German*, 80 HARV. L. REV. 23 (1966-67) for an extended treatment of the German experience with codeterminism.

[51]*Id.*; Eisenberg, note 37, *supra*, at 20-21.

[52]*Cf.* Vagts, note 50, *supra*, at 87-89.

ernment might by itself furnish a sufficient political body to obviate the need for this indirect representation of the public. It would be a supplemental not a basic reform. However, if electoral reforms are not instituted, such an appointee system might prove a worthy experiment before the ultimate political alternative of socialism.

The Government as the Sole Stockholder

The Government is already an equal economic partner with the shareholders through taking fifty percent of the profits by way of taxes. The Government is often a direct or indirect source of business,[53] and by means of the investment credit, tax depreciation and depletion allowance, an indirect source of equity capital. The Government also greatly influences the cost and availability of credit. Then, of course, there is the whole panoply of governmental standards and regulatory agencies, and in the Tennessee Valley Authority, the Government has completed the circle and is the sole owner. On the other hand, the communist countries of the Soviet bloc have been adopting capitalistic management techniques to the ordering of the productive and distributive aspects of their economy by decentralization, reliance on the market and the use of profit-based incentive systems.[54] Coming to a first flowering in Hungary, this approach has been expounded in the Soviet Union since the early 1960's by E. G. Liberman and others who have expostulated the essential role of commodity-monetary relations in the system of planned economic management,[55] and who have reached the further conclusion that the form of profit under socialism is similar to profit under capitalism.[56] The tools of financial planning of both the Soviet centrally planned system and the divisional systems of large American corporations have become similar.[57] In fact it has been suggested that Soviet enterprises should pay into the state budget out of their profits a certain percentage of the value of their assets as a payment for use of plant, *i.e.,* a return on capital.[58] However, under capitalism, Liberman asserts, profit is the goal of private enterprise while the goal in the Soviet Union is the satisfaction of the social and personal needs of the people.[59] The Soviet enterprise is in fact run by a technocracy not unlike the technostructure of American corporations except that instead of being theoretically responsible to its shareholders it is in fact polit-

[53]*See* Berle and Means, note 4, *supra,* at xvi; Galbraith, note 6, *supra,* at 395.
[54]THE LIBERMAN DISCUSSION (M. Sharpe ed. 1966).
[55]Liberman, note 45, *supra.*
[56]*Id.,* at 57.
[57]B. HORWITZ, ACCOUNTING CONTROLS AND THE SOVIET ECONOMIC REFORMS OF 1966 (1970).
[58]*Id.,* at 23-36. *See* Liberman, note 45, *supra,* at 57.
[59]Liberman, *id.*

ically responsible to the state through the Gosplan (State Planning Committee).[60]

Is there then a convergence or at least a converging of the economic systems of European Communism and American capitalism? With some reservations and still marked differences, the answer would appear to be in the affirmative, or at least that there is a serious mutual flirtation.[61] Yet, even a casual observer of the social and political systems of the Soviet Union and the United States could not help but be struck by the marked and continuing differences.

These are, then, clearly political not economic questions[62] and there must be political solutions consistent with American democratic traditions. While totalitarian socialism would not be tolerable in this country, nations such as Great Britain and Sweden with traditions of democracy and freedom have opted for an increasing element of "democratic" socialism. But because of the size and complexities of its economy, the Soviet Union may be the only comparable model. There is, then, the danger that if the economic circle is completed, the political circle may be completed. There is an equal danger that a powerful social and economic force in the country which has no political obligation may also lead to totalitarianism.

III. A Proposal to Further Corporate Democracy

The search for or apology for non-democratic solutions for corporate democracy has been conducted perhaps not so much from a lack of faith in democracy as from despair as to how it might practically be achieved. The proposals set forth below apply a number of democratic institutional models to the corporate setting to further a concept of corporate democracy and furnish a political foundation for public corporations.

Shareholders' Candidates

The cornerstone of corporate democracy must be to allow shareholders (as well as management) a reasonable opportunity to elect directors in fact as well as in theory. This includes the right to nominate a director to appear on the ballot, and the right to vote and have

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[60]Horwitz, note 57, *supra*, at 3-9; N. LUBINTSEV, BASIC PRINCIPLES AND EXPERIENCE OF INDUSTRIAL DEVELOPMENT PLANNING IN THE SOVIET UNION 12-18 (1965).

[61]Liberman, *Are We Flirting with Capitalism?* in Sharpe, note 54, *supra*, at 304; Linnemann, Pronk & Tinbergen, *Convergence of Economic Systems in East and West*, in THE SOVIET ECONOMY 441 (3d ed., M. Bornstein & D. Fusfeld eds.); Wiles, *Convergence: Possibility and Probability*, in A. BALINSKI, A. BERGSON, J. HAZARD & P. WILES, PLANNING AND THE MARKET IN THE U.S.S.R.: THE 1960's (1970).

[62]As Dr. Gardiner Means has observed, "[T]he real difference between the system operating in Russia today and that in the United States is concerned with power and who makes what decisions." Berle & Means, note 4, *supra*, at xxxvii.

others vote for such nominee by proxy without undue effort or cost. Since management controls elections by control of the proxy machinery, this machinery must be opened equally to all shareholders. There must be the opportunity to nominate candidates to appear along with management's nominees in the company's proxy statement and on a single company ballot; furthermore, companies should be required to solicit proxies.

There are undoubtedly many constructs which can be created to accomplish this objective. For purposes of this paper only a procedure suggested by the present provisions in the proxy rules for submitting proposals to meetings of security holders will be discussed.[63] Under this method a nomination could be made by any shareholder by sending the name of his nominee, together with the candidate's consent to serve and the necessary background information required by the proxy rules,[64] to the secretary of the corporation a reasonable time before the election is to be held.[65] The candidate would have to be responsible for complying with such rules and for the accuracy of the information furnished. If the company had any reservations about such accuracy or compliance its obligation would be limited to so advising the Commission. For practical purposes the number of such non-management nominees should be limited to certainly no more than the number of vacancies on the board and perhaps less. There is the danger that too many nominees might dilute the votes of insurgents thus dooming any attempt to have non-management representation on the board. Hence, a smaller number of nominees might be preferable. In fact, this proposal might find quicker acceptance in the business community if shareholder nominees were limited to one less than a majority of the board, thus not threatening incumbent management with a change in control. This requirement, as with most of the details of these procedures, should be within the rule-making authority of the Commission so that they can be modified with experience. If there are more nominees than places, those nominees having the greatest number of shares supporting their nomination petitions would be selected to appear in the proxy statement. A candidate would not be permitted to run for more than two consecutive years unless he received ten percent of the votes necessary to elect one director at the most recent meeting.[66] A can-

[63]SEC Proxy Rule 14a-8, 17 C.F.R. § 240 (1972). Section 14a-8(a) of this rule now specifically excludes any application to corporate elections.

[64]*See* items 6 and 7 of schedule 14a, 17 C.F.R. § 240 (1974).

[65]The nominating shareholder would presumably have to be a shareholder on the date of the nomination and the record date for the meeting. This procedure is consistent with state law (although the proposals may supercede certain by-laws). *See* Eisenberg, note 23, *supra*, at 1502.

[66]*See* the section entitled *Cumulative Voting*, *infra*, at 54.

didate should be allowed to count the votes he received in the last election towards his qualification as a nominee. Rules governing the soliciting of support for nominating petitions might be required.

The proxy statement should allow each of the nominees named in the proxy statement (management nominees and shareholders' nominees) to furnish a short (one hundred word) summary indicating among other things whether or not he agrees with management policies. Shareholders will then have something more than a director's principal occupation and share ownership on which to base a decision. Nominees, of course, would have to disclose if they have any direct or indirect affiliation with any competitor, supplier or customer, and nominees whose election to the board might be illegal because of the antitrust laws or otherwise could be omitted from the proxy statement, again under appropriate Commission rules or guidelines. The names of all nominees listed in the proxy statement should be included in the management proxy which would then be a company proxy. If there were more nominees than vacancies on the board, shareholders would vote for each of the directors they support. The proxy committee would be bound to vote in accordance with the proxy instructions in the same way proxies under the current rules follow such instructions in casting negative votes against a management-supported merger.[67] "Bullet" or slate voting would not be allowed as it would only encourage the one-party system these proposals are designed to eliminate, and candidates' names should be listed in alphabetical order. Shares held in street name by brokerage houses would, as now, be voted on instructions from their beneficial owners when there is a contest.[68] Companies listed on the major stock exchanges are required to solicit proxies for shareholder's meetings[69] and even unlisted corporations which choose not to solicit proxies must furnish information to their shareholders comparable to that which would be included in a proxy statement.[70] The cost of these proposals to the corporation and the effort necessary to implement them would be minimal, totaling little more than a small increase in printing charges from the addition of proxy material prepared by the candidates.

The concept of shareholders' candidates will certainly be resisted by many who enjoy the status quo. Their position will likely focus on the argument that a board of directors should represent all the company's shareholders as a group, and the supposition that a minority director

[67]SEC Proxy Rule 14a-4(b)(1), 17 C.F.R. § 240 (1968).
[68]Note 25, *supra*.
[69]Listing Agreements of the New York Stock Exchange § III ¶ 5, NEW YORK STOCK EXCHANGE COMPANY MANUAL B-95, B-101 and American Stock Exchange § 6b, AMERICAN STOCK EXCHANGE COMPANY GUIDE 299, 300 (1973).
[70]SEC Proxy Rule 14c-2, 17 C.F.R. § 240 (1969).

will introduce dissent into an otherwise harmonious board.[71] Many boards go through a full year of meetings without a single dissenting vote. An abstention (except because of a conflict of interest) is often considered to be the harshest of criticisms.[72] If this situation could be changed, boards with minority directors might cease being "the passive instrument of management."[73] A minority director owes the same fiduciary duty to the corporation and its shareholders as do all other directors. He will at least have a true constituency among the shareholders and his interest in their welfare will be inherently no less than an inside director with job and compensation conflicts. But efficiency is always the oligarch's argument against democracy. The resolution must be based on political philosophy not economic pragmatism.

The authority granted to the Commission by sections 14(a) and 23(a) of the Securities Exchange Act of 1934[74] appears sufficiently broad to permit the Commission to adopt implementing regulations. Over the years the contents of proxy statements and annual reports have had their scope expanded and companies' obligations under the rules enlarged so that management is now required to mail proxy statements and other communications for security holders,[75] shareholders are allowed to submit proposals which must be included in the management proxy statement,[76] and an increasing quantity of public financial information is being made available to stockholders, particularly in the annual report to shareholders.[77] As late as 1966 shareholders who wished to vote at an annual meeting on any matter presented to shareholders (other than the election of directors), for all practical purposes, also had to vote for management's nominees for directors. Today a stockholder may vote for a merger and abstain from voting for management's nominees.[78] It would appear that the proposals put forth here could be adopted by the Commission within the authority granted to it to make rules with regard to the solicitation of proxies.[79]

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[71]*Cf.* Bacon, note 16, *supra,* at 9.
[72]*See* Mace, note 14, *supra,* at 46-7, 54-5. This is true although many companies have boards with a majority of outside directors, *see* Bacon, *id.,* at 2. However, their constituency is too often the board which selects them rather than the shareholders who nominally elect them.
[73]Galbraith, note 6, *supra,* at 149.
[74]15 U.S.C. § 78n(a) (1970); 15 U.S.C. § 78w(a) (1964).
[75]SEC Proxy Rule 14a-7, 17 C.F.R. § 240 (1956).
[76]SEC Proxy Rule 14a-8, 17 C.F.R. § 240 (1972).
[77]SEC Proxy Rule 14a-3, 17 C.F.R. § 240 (1974).
[78]SEC Proxy Rule 14a-4(b)(2), 17 C.F.R. § 240 (1968).
[79]Note 63, *supra.* The last sentence of Rule 14a-8(a), 17 C.F.R. § 240 (1972) would have to be correspondingly deleted and its inclusion in the rule would appear to be an acknowledgement by the Commission that this area is within its rule-making competence.

Cumulative Voting

However, changes in the election procedure are only the beginning. For it must be assumed that management with the cooperation of institutional investors, will as it always has, still normally control a majority of the votes cast. An occasional minority director might be elected, but it would be the exception. Fifty-one percent of a quorum at a stockholders' meeting would still typically elect one hundred percent of the board. Something more is needed. The traditional manner of assuring broad representation in the election of directors is by compulsory cumulative voting. It has been relatively successful in private corporations but has not led to significant minority representation in public companies[80] because alternative candidates are not listed in the proxy statement or on the proxy card. The proposed amendments to the proxy rules in the preceeding section would remedy that defect. The effectiveness of cumulative voting is further diminished by the practice of classifying directors.[81] A nine-man board might be divided into three classes of three directors each, elected for three-year terms. A minority will thus require many more votes to elect a director than if all nine seats were being filled at the same time,[82] thereby defeating the effect of cumulative voting. Twenty-one states have mandatory cumulative voting provisions.[83] However, it is unlikely such provisions will be generally adopted by the remaining states because of the competition among most states to enact liberal corporate codes in order to attract large companies as domestic corporations.[84] Since Congress has moved to regulate corporate elections through the 1934 Act, this proposal is a natural and necessary outgrowth of that legislative scheme. Although cumulative voting has been governed by state law, it is a provision that concerns the state of incorporation little, if at

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[80]Bacon, note 16, *supra*, at 8.

[81]*See* Wolfson v. Avery, 6 Ill.2d 78, 126 N.E.2d 701 (1955), which held a statute allowing classification of directors inconsistent with a State constitutional requirement of cumulative voting; *contra*, Janney v. Philadelphia Transp. Co., 387 Pa. 282, 128 A.2d 76 (1956).

[82]For example, if a corporation had cumulative voting, a board of nine directors, and 1,000,000 shares of voting stock represented at an annual meeting, then 100,000 shares would be required to elect one director; if the board were divided into three classes of three directors each, then 250,000 shares would be required to elect one director. The New York Stock Exchange refuses to authorize the listing of stock where the board is divided into more than three classes. NEW YORK STOCK EXCHANGE COMPANY MANUAL § A15, at A-280.

[83]As of 1972, seventeen states had mandatory provisions on cumulative voting, and four states had mandatory cumulative voting on request. Twenty-six states had permissive provisions and three states had no provision on cumulative voting. Bacon, note 16, *supra*, at 8.

[84]Carey, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L. J. 663 (1974).

all, with respect to a public corporation. Corporate elections in public companies are, as Congress has already determined,[85] of national concern. Such elections affect the interstate commerce of this country in many ways, not to mention the nation's basic political democracy.[86]

In addition to the proxy regulations, the federal government has already intruded directly into the state voting requirement in several other areas. For example, section 424c of the *Internal Revenue Code of 1954* makes shareholder approval a condition of a qualified stock option plan although not required by state law, and the Investment Company Act of 1940[87] directs that at any time less than a majority of directors of a registered investment company are elected by shareholders, a shareholder's meeting must promptly be held to fill vacancies on the board. A federal law of corporations is not being proposed,[88] but the time has come for Congress to put a roof on the edifice it has long since erected.

Institutional Stockholders

Finally, we come to what has been perhaps the most cumbersome stumbling block to effective corporate democracy—the concentration of large blocks of funds in the hands of trusts, union pension funds, mutual funds and the like, which for the balance of this article shall be called institutions. However, two complementary suggestions, a pass-through vote and a Committee on Shareholder Responsibility, present reasonable and practical solutions.

Institutions whose portfolios are composed of relatively few stocks (five or less) could pass through the vote in these companies to their shareholders or other beneficial owners, comparable to the manner in which brokerage houses request instructions from beneficial owners on how to vote stock held in street name when there is a proxy fight.[89] This approach might also be followed for any security in a portfolio which constitutes more than ten percent of the outstanding stock of

[85]Note 7, *supra;* and Securities Exchange Act of 1934 § 14a, 15 U.S.C. § 78n (1970).

[86]A survey of 855 public corporations by The Conference Board, reported in 1973, showed that 273 companies (32%) had specifically provided for cumulative voting in their by-laws or certificates of incorporation or both. Almost two-thirds had done so in response to a legal requirement, but the remainder instituted the provision as a matter of choice. Bacon, note 16, *supra,* at 7.

[87]Investment Company Act of 1940 § 16a, 15 U.S.C. § 80a-16a (1940).

[88]*But see* Schwartz, *The Case for Federal Chartering of Corporations,* 8 Bus. & Soc. Rev. 53 (1973-74).

[89]Note 25, *supra.* The New York Stock Exchange has for some time had an informal policy of requiring a company pension trust which has significant holdings of its own company's stock to solicit voting instructions from the beneficiaries of the trust. *Cf. Restrictions on Voting Rights Through Voting Trusts or Similar Arrangements,* New York Stock Exchange Company Manual § A15, at A-280.

any class of securities entitled to elect a director regardless of the number of different securities in its portfolio. Copies of the proxy material would be mailed to the stockholders or beneficial owners of the securities at the cost of the soliciting corporation.[90] Voting would not be on an all or none basis but would be in a pro rata manner to reflect the instructions of the institutions' shareholders or other beneficial owners based on their proportionate beneficial interest in the portfolio. These rules should not apply to investments in subsidiaries, but to investments by subsidiaries in outside corporations and should be consolidated with such investments by the parent corporation for these purposes. Investments of industrial companies or utilities as part of their normal business activities or investments of any institution in non-public companies should be exempt from such requirements. However, this procedure will become too cumbersome for institutions with a large portfolio of stocks, each representing a relatively small voting position.

The second suggestion, applicable to all other situations, is the selection for each institution of a Committee on Shareholder Responsibility which would have the authority to vote the stock held by the institution.[91] The Committee would be charged with the duty of making a specific determination on how to vote the stock held by the institution in any contested election, and the institution would cast its vote in proportion to the vote of its Committee members.

Since most institutions vote unfailingly for the management slate, evidencing disapproval by selling the security of the portfolio company rather than by attempting to sponsor or participate in movements for management reorganization,[92] the separation of the voting decision from the investment decision is justified in practice, and moreover would be a decision and not merely a clerical act.[93] The boards of directors

[90]*Cf.* note 12, *supra.*

[91]An interesting example of a comparable but more restricted committee in a noncommercial situation is the Advisory Committe on Shareholders Responsibility at Harvard University which studies proposals which will come before shareholders' meetings of corporations in which Harvard owns stock and makes voting recommendations to the governing body of the university.

[92]Wharton Study, note 37, *supra.*

[93]Investors apparently are generally concerned with the social as well as economic impact of the investments made by institutions in which they have an interest. A survey was conducted in 1971 by the Wellington Management Co. which then managed four mutual funds with assets of $3.5 billion. The survey showed that 82% of the stockholders agreed a fund should emphasize investments in socially responsible companies since such qualities tended to be indicative of management ability and responsiveness to changing trends in other areas, and 56% agreed that a fund should invest only in socially responsible companies *even if* other companies offered better investment opportunities. As noted in editorial comment following Doctors, *Who Uses Social Criteria in Institutional Investing,* 2 BUS. & SOC. REV. 98 (1972).

historically have not actively made such choices, nor are they necessarily inclined to devote the required energy to what would become a time consuming task. They are interested in running their institutions, not making decisions on the management of other companies.

There are several alternatives for selecting the Committee, including the election of the Committee by the shareholders at the annual shareholder's meeting, selection of the Committee by the board, or by the outside directors on the board. A combination of these suggestions might best achieve a broad representation with a maximum of expedience. The Committee could be composed of the outside (non-management) directors plus any nominee for director who received at least ten percent of the votes necessary to elect him as a director (under cumulative voting) at the last annual meeting, but in no event should the Committee be larger than the board. The Committee should also be authorized to select an Advisory Group which could make recommendations to the Committee. The members of the Advisory Group would not be employees of the institution and provisions would have to be incorporated in any legislation to assure that the Advisory Group would be independent, although they might be compensated. While admittedly the Committee vote is not a direct vote by the shareholders, it is likely to be reasonably reflective of their views. Concededly, this is not a perfect system, but it will compel a political and economic input by institutions, and the institutional vote will not necessarily be an automatic vote for management.[94]

The implementation of these proposals would require amendments to the Investment Company Act of 1940 and the Securities Exchange Act of 1934. Since the implementation of these proposals will be a new corporate experience, legislation should be broadly drafted, giving extensive regulatory authority to the Commission.

IV. Conclusion

The present industrial and financial complex in America is composed principally of public corporations whose management is responsive in the normal course to itself alone, a situation perpetuated by the current complexion of federal and state law. The states have avoided the problem or left it to a Congress which since the 1934 Act has relied on the proxy rules alone to foster democracy in corporations. That solution was a vital first step. Forty years later it is clear that it is not enough.

[94] A much less satisfactory but possible alternative would be to disenfranchise shares while held by institutions.

Despite the possible alternatives to democratic capitalism, it is submitted that the only realistic alternative to corporate democracy is socialism, possibly democratic, not impossibly a form of national socialism. As the economic operation of capitalism and communism converge, it becomes apparent that in the long view the principal difference between these systems may not be which can best deliver goods and services to the people but which system is most consistent with liberty. And liberty will only persist where the political system and the economic system which support it are both rooted in democratic principles.