THE "INNOCENT SHAREHOLDER": AN ESSAY ON COMPENSATION AND DETERRENCE IN SECURITIES CLASS-ACTION LAWSUITS

LAWRENCE E. MITCHELL*

One of the persistent tropes in the debate over the desirability of private securities class-action lawsuits is that innocent shareholders pay the damages. The claim that shareholders are indeed innocent has rarely been examined. In this Paper, I take the assertion seriously, tracing the use of the concept from its origins as a rhetorical antiregulatory device from the 1890s through about 1920; its disappearance as the rising New Deal concern with corporate power led to a variety of academic, regulatory, and popular efforts to achieve shareholder empowerment; its reemergence in the 1970s as modern finance theory; and its separation of the shareholder from the corporation and reconceptualization of her as a passive, diversified receptacle of profit. The dominant economic thinking has been so widely accepted that rejuvenated claims of shareholder innocence are made at least as often by those in favor of regulation as by those against it.

Following my presentation of this history, I argue that the contemporary innocent-shareholder argument ignores both the reality and emerging theory of shareholder empowerment, and make some suggestions as to why and how shareholders can and should be expected to take a share of responsibility for market integrity. Damages awards in class-action lawsuits help to create the proper incentives.

* Theodore Rinehart Professor of Business Law, The George Washington University. My thanks go to Don Langevoort, Jill Fisch, Merritt Fox, Harvey Goldschmid, Theresa Gabaldon, Dalia Mitchell, Harwell Wells, and participants at a conference held by the University of Wisconsin Law Review and the Institute for Law and Economic Policy on securities class action litigation, for their thoughtful comments, and to Alexis Rose Brown for her excellent research help.

Nothing is sillier than this outcry on behalf of the "innocent shareholders" in the corporations.
—Theodore Roosevelt to Charles Bonaparte, January 2, 1908[1]

He that maketh haste to be rich shall not be innocent.
—Proverbs 28:20 (King James)

INTRODUCTION

Shareholder litigation reform is a topic that has received serious scholarly and political attention over the last several decades.[2] While the concerns are wide ranging, I have been asked, as part of this Symposium, to focus on a relatively narrow issue, but much of what I have to say is applicable to enterprise liability more generally.[3] That

1. 6 THE LETTERS OF THEODORE ROOSEVELT 886 (Elting E. Morison et al. eds., 1952).

2. *See, e.g.*, James D. Cox, *Making Securities Fraud Class Actions Virtuous*, 39 ARIZ. L. REV. 497 (1997); Michael P. Dooley & E. Norman Veasey, *The Role of the Board in Derivative Litigation: Delaware Law and the Current ALI Proposals Compared*, 44 BUS. LAW. 503 (1989); Joseph A. Grundfest, *Why Disimply?*, 108 HARV. L. REV. 727 (1995); Joel Seligman, *The Merits Still Matter: A Rejoinder to Professor Grundfest's Comment, Why Disimply?*, 108 HARV. L. REV. 748 (1995); *Keeping Shareholders in their Place*, ECONOMIST, Oct. 13, 2007, at 83; *SEC Examining Corporate Derivative Losses*, J. OF ACCOUNTANCY, July 1994, at 11.

3. The most significant distinction between securities class-action damages and many other forms of enterprise liability, such as antitrust, is that in the latter cases, actions resulting in corporate damages typically can at least arguably be defended as having been taken for the benefit of shareholders. The same cannot always be said of securities fraud. For purposes of this discussion, I date modern enterprise liability, at least in its regulatory form, from the enactment of the Sherman Antitrust Act of 1890. Despite the fact that enterprise liability has continued throughout the modern history of

issue has come to be known as the "circularity argument,"[4] and while it has received substantial attention and wide acceptance,[5] there remain significantly broader implications that have yet to be addressed. Indeed, as I will show, when one begins to unpack and examine one of the underlying premises of the circularity argument, that "innocent shareholders" ultimately, if indirectly, pay damages in securities class-action lawsuits, the foundation of the circularity argument begins to crumble.

Briefly put, the circularity argument holds that damages in class-action lawsuits are paid by the corporation (or more commonly its insurer), not its misbehaving managers, to shareholders (or former shareholders) of the corporation, the former of whom suffer indirect harm when the corporation pays. Variations on the theme include the

corporate regulation, it appears indisputable that American corporate productivity has been staggering. This ought to give us reason to hesitate before we alter a system that has produced such impressive results.

4. *See, e.g.*, Brief for Former SEC Commissioners and Officials and Law and Finance Professors as Amici Curiae Supporting Respondents at 14–16, *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761 (2008) (No. 06-43) [hereinafter *Stoneridge* Amici]; John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534 (2006) [hereinafter Coffee, *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*]; Paul G. Mahoney, *Precaution Costs and the Law of Fraud in Impersonal Markets*, 78 VA. L. REV. 623, 635 (1992) (describing the argument); Joseph P. Monteleone & Nicholas J. Conca, *Directors and Officers Indemnification and Liability Insurance: An Overview of Legal and Practical Issues*, 51 BUS. LAW. 573, 580 (1996); John C. Coffee, Jr., *Memo to Congress: Reform and Its Perils*, N.Y. LAW JOURNAL, Nov. 15, 2007, at 5 [hereinafter Coffee, *Memo to Congress*]; Hal Scott, *Let Shareholders Decide How to Resolve Disputes*, FIN. TIMES (London), July 25, 2007, at 11. The Securities and Exchange Commission (SEC) has also taken a position akin to the circularity argument with respect to seeking damages. *See* Press Release, SEC, Statement of the Securities and Exchange Commission Concerning Financial Penalties (Jan. 4, 2006), *available at* http:/www.sec.gov/news/press/2006-4.htm. A point that is important to the circularity argument is that it is the *corporation* that pays damages, not the officers (and, sometimes, directors) who committed the fraud. *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 315–52 (1991); Cox, *supra* note 2, at 509; Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 ARIZ. L. REV. 639, 646–57 (1996). The evidence seems irrefutable that individuals rarely pay damages in class-action lawsuits.

5. The one exception I could find is Ian B. Lee, *Corporate Law, Profit Maximization, and the "Responsible" Shareholder*, 10 STAN. J.L. BUS. & FIN. 31 (2005). Professor Lee looks at the obligations of the shareholder as a generalized class for corporate social responsibility. I will examine, in a more targeted yet perhaps a broader way as well, the responsibilities of shareholders for corporate governance in general. *See also* Harvey J. Goldschmid, *Capping Securities Fraud Damages: An Unwise Proposal in an Imperfect World*, 38 ARIZ. L. REV. 665, 666 (1996) (arguing that shareholders who have the power to elect and replace directors ought not to escape liability as innocent).

assertion that widely diversified shareholders, including institutions, are paying damages to themselves;[6] that long-term investors, most in need of protection, wind up suffering most by virtue of their buy-and-hold strategies;[7] and that, at its best, the whole process of assessing damages (or, more frequently, settling) in securities class-action lawsuits moves money from one pocket to another in the same coat with a substantial portion dropping off as waste in the form of transactions costs, including substantial legal fees.[8]

The circularity argument is based in part on the undisputed premise that a major purpose of class-action lawsuits is to maintain market efficiency and integrity by deterring managerial misconduct in market affairs through the compensation of shareholders for losses due to their misbehavior. Substantial evidence exists that securities class-action damages do not meaningfully compensate shareholders.[9] The

6. For an interesting argument that diversification, the generally presumed posture of rational shareholders, has shifted duties from the corporation and its managers to the shareholders themselves, see David A. Hoffman, *The "Duty" to Be a Rational Shareholder*, 90 MINN. L. REV. 537 (2006).

7. Professor Langevoort, writing a decade ago, described the plight of what he evidently perceived to be the most vulnerable of the investing class:

> The group of people who might seem most in need of insurance—the relatively inactive investors—is for that reason alone more likely to be on the losing side of the self-funding process. This group's buy and hold strategies make it somewhat more likely that they will be non-trading shareholders of an issuer defendant . . . than members of the plaintiff class who stand to gain from the settlement or judgment.

Langevoort, *supra* note 4, at 649–50. This observation, concluded Langevoort, "clinched" the argument against the compensation system developed under the federal securities laws. *See id.* at 650.

8. Professor Coffee claims that the transaction costs in securities class-action lawsuits amount to approximately 50 percent of the recovery, making it impossible even for a fully diversified investor who wins half the time and loses the other half to come close to breaking even on the proposition. Coffee, *Memo to Congress*, *supra* note 4, at 5. It is worth noting that, as with all transactions costs, these are only waste if the recipients (in this case, plaintiffs' lawyers), put the money to less good use than do the corporation and insurance companies paying damages.

For a historical look at negative attitudes toward plaintiffs' lawyers, see Lawrence E. Mitchell, *Gentleman's Agreement: The Antisemitic Origins of Restrictions on Stockholder Litigation* (The George Washington University Law Sch., Pub. Law Research Paper No. 44, 2002), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=321680.

9. For arguments that damages in securities class-action lawsuits do not adequately compensate, see Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. 1487 (1996) (proposing a shift from traditional securities litigation to a system of civil penalties to deter fraud); Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611, 641 (1985); Alicia Davis Evans, *The Investor Compensation Fund*, 33 J. CORP. LAW 223 (2007) (concluding that securities class-action lawsuits are an ineffective and poor means of compensation for defrauded shareholders); Patrick M. Garry et al., *The*

logical conclusion is that if class-action damages fail to compensate shareholders, they fail of an essential purpose. Commentators are more or less unanimous with respect to the conclusion that shareholder class-action lawsuits fail to deter managerial misconduct.[10] They note, with virtually unassailable evidence, that damages are almost always paid by the corporation or its insurers, not by the culpable managers or directors.[11] Thus, they say, deterrence also fails.[12]

As a factual matter, these conclusions seem hard to dispute, and the logic of the circularity argument in general appears to be sound. Compensation that goes from one shareholder pocket to another is, indeed, circular, whether that circle is drawn tightly around a given corporation's shareholders or more broadly around the larger class of shareholders in public corporations. It is hard to argue with the observation that managers who remain unpunished are not likely to be especially deterred by their corporation's obligations to pay damages in

Irrationality of Shareholder Class Action Lawsuits: A Proposal for Reform, 49 S.D. L. REV. 275 (2004) (claiming that shareholder litigation fails to compensate injured investors); A.C. Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925, 983 (1999) (advocating an end to securities litigation and outlining an alternative enforcement regime run by stock exchanges with no damages to be paid to victims of fraud). For arguments that damages in securities class-action lawsuits adequately compensate, or at least can adequately compensate, see Cox, *supra* note 2 (predicting that the changes wrought by the Private Securities Litigation Reform Act of 1995 will give the shareholder suit more credit with potential plaintiffs and the courts); James D. Cox, *The Social Meaning of Shareholder Suits*, 65 BROOK. L. REV. 3 (1999) [hereinafter Cox, *The Social Meaning of Shareholder Suits*]; Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, 31 J. CORP. L. 637 (2006) (stating that securities class-action lawsuits enable small investors to successfully litigate their claims).

10. *See* Ehud Kamar, *Shareholder Litigation Under Indeterminate Corporate Law*, 66 U. CHI. L. REV. 887 (1999); Mae Kuykendall, *A Neglected Policy Option: Indemnification of Directors for Amounts Paid to Settle Derivative Suits—Looking Past "Circularity" to Context and Reform*, 32 SAN DIEGO L. REV. 1063 (1995). One exception is Professor Cox. *See* Cox, *The Social Meaning of Shareholder Suits*, *supra* note 9. Professor Coffee has also tried to make the class-action lawsuit fulfill its intended purposes. *See* Coffee, *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, *supra* note 4.

11. *See* Mukesh Bajaj et al., *Securities Class Action Settlements*, 43 SANTA CLARA L. REV. 1001, 1010 tbl.4 (2003); Stephen J. Choi & Robert B. Thompson, *Securities Litigation and Its Lawyers: Changes During the First Decade After the PSLRA*, 106 COLUM. L. REV. 1489 (2006).

12. *See, e.g.*, Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691; Tom Baker & Sean J. Griffith, *The Missing Monitor in Corporate Governance: The Directors' & Officers' Liability Insurer*, 95 GEO. L.J. 1795 (2007) (concluding that, based on their empirical research, the practices of insurers actually diminish deterrence).

securities class-action lawsuits. The transaction costs of litigation are undeniable.[13]

If the circularity argument is to be effectively challenged, the challenge must come from outside the circle.[14] The debate thus far has been over whether the circularity argument, and the argument against enterprise damages more generally, is right in logic and in the facts on which it is based. I concede, at least for purposes of this discussion, that it is. A more fruitful avenue of inquiry is to ask whether the circularity argument serves as an adequate justification for modifying judicial assessments of damages or monetary settlements paid by the corporation or its insurer in securities class-action cases.

I make the case that the circularity argument fails as such a justification because it ignores an important historical, legal, and practical aspect of corporate governance: the role of the shareholders. The notion of shareholders underlying the circularity argument is nicely captured by its common description of the shareholders who ultimately indirectly pay damages for their managers' misbehavior as "innocent."[15]

I will argue that there is nothing "innocent" about the innocent shareholder. In fact, history demonstrates that the concept of the innocent shareholder consistently has been used as a rallying cry, a political argument, against corporate regulation. It began as a device of

13. Determining the systemic benefits, however, is a far more challenging enterprise.

14. Professor Cox's eloquent defenses of securities class-action lawsuits exemplify this move. *See* Cox, *supra* note 2; Cox, *The Social Meaning of Shareholder Suits*, *supra* note 9; *see also Private Litigation Under the Federal Securities Laws: Hearing Before the Subcomm. on Securities of the Comm. on Banking, Housing, and Urban Affairs*, 103d Cong. 739 (1993) (statement of Frederick C. Dunbar & Vinita M. Juneja); Arlen & Carney, *supra* note 12, at 725 (establishing that in cases of false positive announcements, "50.5% of the cases involved false positive statements designed to conceal declines in earnings, while another 17.2% of the frauds were designed to conceal bad news about the issuer"); Elliott J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053, 2083–84 (1995).

15. *See Stoneridge* Amici, *supra* note 4, at 15–16; Arlen & Carney, *supra* note 12; Editorial, *Hot Topic: A Class-Action Scheme*, WALL ST. J., Oct. 6, 2007, at A20; Roger Parloff, *Rethinking Class Actions*, FORTUNE, Nov. 12, 2007, at 26; Peter J. Wallison, *Capital Complaints*, WALL ST. J., Mar. 20, 2007, at A19. Columnist Stuart Taylor, Jr. does not use the phrase, but clearly has it in mind while bemoaning large punitive-damages payments in a broad spectrum of cases. Stuart Taylor, Jr., *When Punitive Damages Make No Sense*, NAT'L J., Oct. 27, 2007, at 15, 16. Judge Easterbrook and Professor Fischel had earlier described the shareholders trading against the injured shareholders in the open market as the "innocent beneficiaries" of the fraud. Easterbrook & Fischel, *supra* note 9. For a rare recent questioning of the notion of shareholder innocence in the limited-liability context, see Jennifer Hill, *Visions and Revisions of the Shareholder*, 48 AM. J. COMP. L. 39, 50–51 (2000).

capitalist populism, working on the assumption that shareholders were, and could be, nothing more than passive investors who needed to be protected from federal confiscation of their property caused by excessive regulation.

The argument originated at a time when the middle class was first entering the stock market, and the industrial corporations and railroads whose stock they were buying were controlled by networks of bankers, thus making the claim of innocence at least facially plausible. The bankers, along with other industrialists, used the claim of shareholder innocence as a means of combating the Roosevelt antitrust program, and its populist appeal on behalf of the new, small shareholder brought it significant support. At the same time, progressive reformers who sympathized with shareholders facing corporate liability as a result of managerial misbehavior criticized those same shareholders for failing to exercise their potential power when corporate misbehavior imposed externalities on consumers and workers, whether that power could be exercised through, to use a modern expression, voice or exit. While they recognized the practical limitations on effective shareholder power, they argued that practically enforced passivity was no excuse when other Americans were hurt at the expense of capital, even if that capital was owned by average people.[16] The shareholder came to be seen as a powerful, if only potentially so, force in ensuring good and honest corporate governance.

As corporate regulation and accompanying enterprise liability became established facts during the New Deal, the argument of shareholder innocence faded as broader attempts to control corporate power and assure responsible and honest management developed as the dominant concern. Those on both sides of the debate about corporate power argued for ways that shareholders could act as a potent political force to encourage or prevent regulation. Often, but not always, related, those whose principal concern was honest and effective management developed the concept of shareholder democracy during the 1950s as a rhetorical device designed to assert the shareholder's right to participate in corporate governance. These new postures led to calls for stockholder empowerment, culminating in the shareholder-activist movement of the 1960s and 1970s.

The development of neoclassical law and economics severely damaged at least the intellectual project of constructing the activist shareholder, and returned the widespread conception of the shareholder

16. For a contemporary feminist argument that the inability or failure to exercise responsibility does not exculpate the power holder, see Theresa A. Gabaldon, *The Lemonade Stand: Feminist and Other Reflections on the Limited Liability of Corporate Shareholders*, 45 VAND. L. REV. 1387, 1429–30 (1992).

to the turn-of-the-century notion of passive investor. The effect was to reinvigorate the cry of shareholder innocence, even as deregulation became the dominant governing mode. But facts on the ground challenged the accuracy of the passive-investor model as institutions began to use their muscle. Shareholder activism of the 1990s and early twenty-first century has, for the first time, called shareholder innocence into question as a factual premise, even as cries of shareholder innocence have grown louder.

Understanding this history leads to an examination of the appropriate place of shareholders in corporate governance as relevant to, if not determinative of, the persuasiveness of the circularity justification for restricting or eliminating class-action damages. A robust model of shareholders as coordinate actors in corporate governance, such as those that support election reforms and rules that facilitate shareholder communication and shareholder proposals, might cast that argument in a very different light. And there are variations on each model that should affect the way we think about class-action damages. It is the purpose of this Paper to explore these questions.[17]

I begin with a historical account of the innocent shareholder, showing how it undermines a critical assumption underlying the circularity argument. I will conclude by arguing that *if* shareholders are to be empowered as an essential force in maintaining fair and honest capital markets, as is implicitly acknowledged by modern enterprise liability, they can no longer be thought of as innocent.

17. Let me also be clear about what I am not addressing in this Paper. I am not advocating an increased role for shareholders in corporate governance. Nor am I questioning the need for reform of aspects of shareholder litigation. As to these issues, I express no opinion, at least in this Paper. My only point is that the assumption of shareholder innocence diminishes the circularity argument as an adequate reason for reform.

Those familiar with my work will know that I am not especially sympathetic to the shareholders' role in corporate governance, at least as presently exercised. This lack of enthusiasm might, however, be altered in an environment in which the average shareholder becomes a long-term investor and takes on some of the responsibilities of ownership. *See* LAWRENCE E. MITCHELL, CORPORATE IRRESPONSIBILITY: AMERICA'S NEWEST EXPORT (2001). But ongoing research increasingly convinces me that shareholder rights ought to be very limited. Lawrence E. Mitchell, *The Legitimate Rights of Public Shareholders* (George Washington University Legal Studies Research Paper No. 461, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1352025.

I. THE INNOCENT SHAREHOLDER IN THE EARLY TWENTIETH CENTURY

A. Three Aspects of Shareholder Innocence

The notion of shareholder innocence has had a long history that presents itself in three somewhat distinct contexts. The issue of shareholders' innocence and their need for protection from poor management and directorial theft is probably the oldest concern,[18] followed closely by public outcries for shareholder protection from fraud and overcapitalization in the purchase of their securities.[19] Contests between shareholders and other corporate stakeholders, typically in bankruptcy, presented the third context.

Concern about shareholder protection was shaped by widespread norms of sympathy for vulnerable minority shareholders whose interests had been abused by financiers and those who controlled the corporations (who often were the same people). Shareholder protection provided an avenue of attack by populists and progressives against the plutocrats of Wall Street. The problem fit squarely within the broader progressive agenda of advocating increased public concern with the growing displacement of a variety of classes of Americans who were oppressed by the consequences of rapid industrialization and urbanization, including workers, children, farmers, consumers, and the poor.[20] But shareholder protection was not the exclusive province of progressives. It was also favored by the more established members of the rapidly developing investment-banking industry as well as financial

18. *See, e.g.*, *Reckless Banking*, N.Y. TIMES, Oct. 25, 1893, at 4; *That Third-Track Grab*, N.Y. TIMES, Aug. 30, 1891, at 9.

19. *See, e.g.*, *Brooklyn Elevated Road*, N.Y. TIMES, Jan. 16, 1892, at 8 (discussing fraudulent overcapitalization). Shareholders were sometimes not considered innocent when a corporation had made full disclosure of its business. *See, e.g.*, *City Ownership of Railways*, N.Y. TIMES, Apr. 22, 1897, at 4. At least one commentator argued that shareholders did not want disclosure because they did not want to hear bad news, and that the only real measure of directorial performance was the performance of the corporation's stock price. *See A Plea for the Director*, N.Y. TIMES, Jan. 12, 1890, at 6.

Of course both of the concerns noted in the text were not new in the 1890s. I begin here largely because this is the period during which American stockholding begins to become more widespread and moves beyond railroads and banks to industrial securities. *See* LAWRENCE E. MITCHELL, THE SPECULATION ECONOMY, at ch. 4 (2007).

20. For the intellectual and social context of progressivism and reform thought, see generally HENRY STEELE COMMAGER, THE AMERICAN MIND: AN INTERPRETATION OF AMERICAN THOUGHT AND CHARACTER SINCE THE 1880'S (1950); RALPH HENRY GABRIEL, THE COURSE OF AMERICAN DEMOCRATIC THOUGHT (1986); ERIC F. GOLDMAN, RENDEZVOUS WITH DESTINY: A HISTORY OF MODERN AMERICAN REFORM (1963); RICHARD HOFSTADTER, THE AGE OF REFORM: FROM BRYAN TO F.D.R. (1955); ROBERT H. WIEBE, THE SEARCH FOR ORDER: 1877–1920 (1967).

conservatives, but with very different goals. Their concern was to ensure that corporate investments were perceived by potential shareholders as sufficiently safe to induce them to part with their money in order to increase their own profits by improving the reputation of the investment-banking industry, as well as to satisfy the increasing capital needs of American industry.[21]

At the same time, and consistent with the progressive program of protecting the vulnerable, growing ideas of collective responsibility and older notions of individual responsibility led to a widely held belief that shareholders were accountable to creditors when their corporations failed and also, more generally, to the broader communities who were affected by the corporation during its lifetime like consumers, bank depositors and workers. Shareholder responsibilities were deemed satisfied when they elected honest and responsible directors, or enforced the law against those who were not.[22] This is the beginning of the third context in which shareholder innocence appears, and one in which the resolution was not so clearly in favor of the shareholder.[23]

The issue of shareholder accountability was initially grounded in widespread shareholder limited liability and addressed the resolution of disputes between shareholders and creditors. Shareholders were implicated when mismanagement led to bankruptcy, and the Depression that lasted from 1893 through 1897 presented numerous opportunities for this issue to be aired publicly. Shareholder suffering was sometimes perceived as unfair because of their vulnerability in reorganizations. But shareholder suffering was justified for the benefit of the even more vulnerable creditors on the ground that the shareholders themselves were responsible for choosing the poor corporate management that had

21. *See* V.H. Lockwood, *How To Reform Business Corporations*, N. AM. REV., Mar. 1897, at 294. The Investment Bankers Association of America, formed in 1912, served lobbying functions as well as the goal of professionalizing investment banking, and maintained on its agenda a concern to bolster the reputation of the industry in order to induce the newly emerging middle class to invest. *See* VINCENT P. CAROSSO, INVESTMENT BANKING IN AMERICA: A HISTORY, 165–71 (1970). Financial and political conservatives viewed widespread shareholdings as, among other things, a way to prevent socialism from taking root in America. MITCHELL, *supra* note 19, at 26 (noting the endorsement of securities regulation by the Investment Bankers' Association in 1919).

22. *See, e.g.*, *Small Creditors Sue*, WASH. POST, Feb. 3, 1903, at 12. This notion of shareholder responsibility persisted. *See* M.J. Fields, *The International Mercantile Marine Company—An Ill-Conceived Trust*, 5 U. CHI. J. BUS. 362, 371 (1932) (noting that the company's reorganization plan "indicates, as nothing else can, the utter irresponsibility of most shareholders in the long-range welfare of the corporation of which they are the owners, and demonstrates anew the self-seeking proclivities of the average human being").

23. I might hazard that it is in these early beginnings that modern notions of enterprise liability developed.

brought the company to ruin in the first place.[24] As one report noted, an 1894 shareholder suit for mismanagement against the directors of a bankrupt railroad was a rare occurrence, the rarity of which did not reflect well upon the shareholders: "What he [the plaintiff] did other stockholders could do, but the certainty that they won't makes possible the looting of companies . . . ."[25] At the same time, "the people responsible [for the bankruptcy] are the stockholders. The law is adequate, but no one enforces it."[26]

A committee of the Tennessee Bar Association addressed the issue in a similar manner in 1896. The occasion was the suggestion by a member of the state bar that shareholders of industrial corporations should be held harmless from liability to unpaid workers in the case of corporate bankruptcy. The committee rejected the suggestion, noting that, "while it might in some instances save shareholders from hardship, it would at the same time, in our opinion, remove an important guaranty of careful corporate management."[27]

Creditors and workers were within the corporate structure, but community interests were also of concern. Observers early on bemoaned the fact that bankruptcy robbed consumers of necessary services. Commenting on the reorganization of the Northern Pacific Railroad in 1894, *The New York Times* remarked:

> The stockholders are responsible for the whole business. It was they who armed the Directors with power to loot the company; and never since the Erie safes were emptied in the days of Fisk and Gould, has a fine property been so completely and thoroughly gutted as the Northern Pacific.[28]

Disputes in the bankruptcy context were longstanding, but the rise of the giant corporation raised other issues. Growing regulation, especially at the federal level, brought with it new threats of punishment to noncomplying corporations. As I will show later in more detail, this led business interests to use the concept of shareholder innocence to combat regulation. The regulatory fight began after passage of the Interstate Commerce Act of 1887, and the interests of shareholders were central, although its defenders came from all

24. *See, e.g.*, C.E. Gunn, Letter to the Editor, *Ambiguity of Legal Expression*, 57 ALB. L.J. 193, 207 (1898); *Union Pacific Foreclosure*, N.Y. TIMES, Jan. 24, 1897, at 6; *Where the Government Comes In*, WASH. POST, Feb. 19, 1895, at 6.

25. *The Financial World*, N.Y. TIMES, June 24, 1894, at 5.

26. *Id.*

27. J.W. Caldwell, *Law Reform*, 4 AM. LAW. 539, 540 (1896).

28. *The Financial World*, *supra* note 25, at 5.

quarters. For example, in its *Preliminary Report of 1900*, the conservative United States Industrial Commission suggested that punishment for violation of the Interstate Commerce Act should be accomplished by fining the carriers rather than imprisoning railroad officials. They were promptly criticized by progressives for advocating harm to the innocent shareholders while the "rascals" went free.[29]

The battle lines of the regulatory debate and the shareholders' place in it clarified as calls for reform of the Sherman Act began in the mid-1890s. The concern was over the allocation of rights between the innocent shareholders and third-party victims of antitrust violations.[30] Indeed, as I will discuss, the rights of the innocent shareholder became a major issue during the lead-up to the presidential campaign of 1908.[31]

It is this third context that clearly is most relevant to a critique of the circularity argument and enterprise liability more generally. For it was in the debates about these third-party issues, and especially antitrust regulation, that shareholder innocence was most commonly dismissed for the protection of the broader society, including its overall economic system, which was harmed by managerial misbehavior.

B. The Rise of the Public Corporation and the Creation of the Innocent Shareholder

In order to give some context to the issue beyond the obvious, it is worth recalling a bit of the early history of the development of the modern public corporation and its initial confrontations with the Sherman Act and antitrust reform at the very end of the nineteenth century and the first decade of the twentieth century.

Railroads and banks were the first significant American public corporations, although shareholding was not terribly widespread and debt formed the permanent capital of most enterprises prior to the 1890s.[32] Even most railroads had significant controlling shareholders. Industrial corporations were almost exclusively closely held (or in some

29. *Reports of the Industrial Commission*, 35 AM. L. REV. 147, 149 (1901) (book review).

30. *Id.* at 149. The ICC concern, which was related, was over high passenger and freight rates charged by overcapitalized railroads to enable the roads to pay dividends to their stockholders.

31. The antitrust concern continued, *see, e.g.*, Jean W. Adams, *Trustbusting and the Innocent Shareholder: 'Compensation' If Stock Prices Fall?*, 10 ANTITRUST L. & ECON. REV. 51 (1978), as it obviously continues in other contexts including securities class-action lawsuits and other forms of corporate crime. For an example of the labor context, see *The Issue in Colorado*, OUTLOOK, May 16, 1914, at 93, 101–02.

32. There were some industrial corporations that were publicly, or at least fairly widely, held, but not terribly many, and such investing class as existed in the United States was vanishingly small. MITCHELL, *supra* note 19, at 9,12.

cases, like Carnegie Steel, organized as partnerships). The public shareholder was, more often than not, a pure speculator, and the concerns of speculators did not significantly bother courts or lawmakers. To the extent that shareholder innocence or responsibility was an issue, it largely arose in the context of insolvency and reorganization when the interests of the debt holders dominated and issues of watered stock or *ultra vires* corporate behavior threatened stockholders.

The shareholding landscape changed during the great merger wave that lasted from 1897 to 1903. As I have described elsewhere, this movement, although it had a number of causes arising from a specific set of industrial, legal, social, and financial conditions, was motivated largely by the desire of trust promoters and investment bankers to combine corporations using stock as their consideration, taking stock as their fees, and selling the stock in a market characterized by a growing middle class, large capital surpluses, and a paucity of investment opportunities.[33] The upshot was that in a seven-year period, $20 billion in new capitalization was added to American corporate capital, and in a four-year period, trading volume on the New York Stock Exchange (NYSE) alone jumped from 77 million shares to 265 million shares, mostly of previously closely held industrial concerns.[34]

The merger wave had a number of consequences for the innocent shareholder. In the first place, it brought substantial numbers of middle-class shareholders into the market for the first time, and over the succeeding three decades common-stock ownership mushroomed. In this respect, it can perhaps be said to have created the innocent shareholder. Importantly, too, the merger wave added a significant new dimension to the antitrust debates that had been raging since the late 1880s. It was one thing for large industrial concerns to monopolize, or appear to be monopolizing, their industries, but their issuances of huge quantities of watered stock made overcapitalization the central issue in antitrust reform for well over a decade, and kept the issue alive well into the 1930s.

The problem, as it was perceived at the time, was the widely held belief (including among economists, congressmen, presidents, and others) that overcapitalization caused monopoly. Since the newly created combinations had productive assets in very small proportion to their outstanding capitalizations, the idea was that they had to overcharge consumers in order to earn enough money to pay dividends to their common stockholders. Monopoly was seen as a means whereby the new class of public stockholders profited at the expense of the

33. *Id.* at chs. 1, 4.
34. *Id.* at 13.

consumer. The point was driven home when the hugely overcapitalized U.S. Steel had to miss a dividend two years after its creation and its stock price, as well as those of many of the new combinations, simply tanked.[35] U.S. Steel responded by engaging in a policy of retaining earnings which allowed it to "grow into" its capitalization, although the process took almost twenty years.[36]

In any event, the political stage was set for a battle between the consumer (represented by Democrats and progressive Republicans in Congress) and big business, backed largely by the major banking firms of J.P. Morgan, First National Bank, National City Bank, Lee Higginson, and Kidder Peabody, among the leaders. Controlling trusts meant controlling capitalization. In addition, because these banks and many wealthy industrialists were seen as the principal beneficiaries of the merger wave, the conflict between capital and the ordinary American, including not only consumers but workers, railroad shippers, and the purchasers of watered stock, was dramatized as a class struggle. While some degree of sympathy existed for the ordinary shareholders, when it came to disputes between capital (represented by the giant combinations) and the rest of America, the innocent shareholders often were classified with the former and their interests were frequently subjugated to the interests of others.[37]

C. The Culpable Shareholder in the Capitalist Class

As I noted earlier, populists and progressives were happy to defend the interests of the innocent shareholder when the issue was financial fraud or oppression by promoters and managers. But their priorities changed as the financial effects of the merger wave placed shareholders, as capitalists, firmly against the interests of the rest of society. As members of the "capital class," shareholders ultimately were responsible for their corporations, even as proponents of this view understood the vulnerability of most shareholders to plutocratic bankers and captains of industry.[38] For example, Senator "Pitchfork Ben" Tillman of South Carolina, arguing in favor of strict railroad-securities regulation in order to keep rates low, noted:

35. *Id.* at 95.

36. *Id.* at 303 n.39.

37. This was not always the case. In 1900, *The Brooklyn Daily Eagle* quoted Professor Clark in calling for investor protection as noting, "There is no antagonism, but complete harmony, between the practical policy that stands guard over honest capital that has been lured into the trust and the one that protects the purchasing public and the workman." *How to Tame the Trusts*, BROOKLYN DAILY EAGLE, Mar. 27, 1900, at 15.

38. MITCHELL, *supra* note 19, at 186–87.

> There can be no justice in compelling the people as a whole to pay dividends on watered stock primarily for the purpose of increasing the fortunes of men already too rich. The poor dupes who have been led to invest their savings in such stocks can better afford to lose them than to have the labor of the country saddled with the burden of paying perpetual tribute in the shape of dividends on dishonest valuations . . . .
>
> . . . .
>
> All issues of railroad securities in the future . . . should be under the control of the Interstate Commerce Commission and there should be a speedy readjustment of capitalized values . . . while protecting, as far as possible, the innocent holders of watered stock. It may be that these can not be protected under the law and that the holders of [senior securities], who will be found in the end to be multimillionaires who have perpetrated the scheme of injustice, will retain their advantage, while the poor dupes who have been led to buy the products of railway printing presses will lose what they have invested.[39]

A populist like Tillman, even from a state where shareholders were scarce and plutocrats reviled, could at least express some degree of sympathy for innocent shareholders who were, after all, the "little guy" in the capitalist hierarchy, while still privileging the interests of farmers, small businessmen, and consumers over capital. But some progressives, especially those from states where shareholding was more prevalent, showed no sympathy at all.[40]

Those who were sympathetic to the plight of minority shareholders often had relatively little desire to support the cause of innocent shareholders against other interests. While it is historically inaccurate to use the word apathetic in terms of their relationship to the corporation, it was clearly the case that they were rendered powerless in public corporations, either because of the presence of a control block of stock

39. S. REP. NO. 59-1242, at 8–9 (1906). It is worth noting here, as Professor Tsuk Mitchell points out, that the principal internal corporate conflict during this era was not between management and shareholders, but between controlling shareholders (and creditors) and minority shareholders. Dalia Tsuk Mitchell, *Shareholders as Proxies: The Contours of Shareholder Democracy*, 63 WASH. & LEE L. REV. 1503, 1520 (2006).

40. *See* HOFSTADTER, *supra* note 20, at 92–93, 232–33.

or, more commonly, as a result of interlocking directorates and the deployment of devices like voting trusts and dual-class shares that maintained control in the hands of financiers and founders.[41] Nevertheless, reformers were unwilling to exculpate shareholders when they had at least the theoretical possibility of controlling corporate behavior through their election of directors. Their acknowledged powerlessness brought forth calls, from progressives in particular, for shareholders to assume the responsibilities of ownership.[42]

The possibility of shareholder empowerment held out the hope not only for managerial responsibility to shareholders, but also for shareholders to exercise meaningful civic responsibility by holding their directors accountable for compliance with the law.[43]

Yet there were powerful voices that traded on the practical powerlessness of shareholders—their status as passive investors—to push a different political agenda. Business and financial interests were alarmed by the increasing intensity of Theodore Roosevelt's antitrust campaign. They had already managed to co-opt the administration's regulatory program by battling significant antitrust reform in the form of the federal incorporation movement, forcing progressives and the president to settle for a watered-down compromise in the form of the Department of Commerce and the Federal Bureau of Corporations. But as Roosevelt neared the end of his term, having proclaimed upon his 1904 election, much to his regret, that he would not run again, his efforts to control the trusts intensified. Not only did antitrust

41. As to powerlessness, see EDWARD DUDLEY KENNA, THE HELPLESS SHAREHOLDER: A PHASE OF THE RAILWAY QUESTION IN THE UNITED STATES (1911). As to the use of control devices, see ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932); Gardiner Means, *The Separation of Ownership and Control in American Industry*, 46 Q.J. ECON. 68 (1932).

42. *See* William Horace Brown, *Public Ownership and Popular Government*, 12 AM. J. SOC. 328, 331 (1906); Lewis C. Williams, *Responsibility of Corporate Control*, 12 VA. L. REV. 563, 571 (1926).

43. Professor Dunlavy provides evidence that there was a broader concern with minority-shareholder rights during this period, citing reports in prominent newspapers as evidence. *See* Colleen A. Dunlavy, *Social Conceptions of the Corporation: Insights from the History of Shareholder Voting Rights*, 63 WASH. & LEE L. REV. 1347, 1362 (2006). Indeed Dunlavy's fascinating article shows how earlier in the nineteenth century, concern with corporate power and a fear of plutocracy led a substantial proportion of corporations to be governed by a one-shareholder-one-vote rule. By the turn of the twentieth century, a "plutocratic conception" of the corporation had emerged, facilitated by the dominance of the one-share-one-vote rule, the wide dispersal of corporate shares resulting from the merger wave of 1897–1903 (Dunlavy dates it from 1895 to 1904), and the corresponding ability of larger shareholders to overpower small individual shareholders, leading to calls for minority protection. *Id.* at 1384–86. For a discussion of discrepancies in the periodization of the merger wave, see MITCHELL, *supra* note 19, at 283–84 n.12.

prosecutions become more frequent, but Roosevelt was able to achieve the enactment of more effective railroad regulation with the Hepburn Act of 1906, and in 1907 began to push hard for a federal corporation bill that would significantly restrict corporate freedom and put powerful regulatory tools in the hands of the president.[44] While business had been willing to work with the president to produce palatable regulation for the sake of calming public opinion and preventing more intrusive regulation, their cooperation turned to strong opposition as Roosevelt became increasingly aggressive in his regulatory approach.[45]

D. The Innocent Shareholder and the Battle Over the Trusts

The issue came to a head during the spring and summer of 1907, as stock-market volatility around the world, including the United States, began to lead up to the Panic of 1907. Blame for the turmoil came to be heaped upon the head of Roosevelt, who was accused of creating or at least exacerbating the problem with his growing war on the trusts, the most dramatic result of which was Judge Kenesaw Mountain Landis's August 7 assessment of a $29 million fine against Standard Oil for multiple violations of the Elkins Act.[46] With demands for a presidential response growing, Roosevelt made a speech on August 20 at Provincetown, Massachusetts, where the cornerstone of the Cape Cod Pilgrims Memorial Monument was being laid, in which he sought to make his position clear. In the speech, in which he coined his famous phrase, "malefactors of great wealth," Roosevelt characteristically threw caution to the wind in the face of mounting criticism and strongly reiterated his administration's position.[47] Beginning with an apparently conciliatory tone, after speaking of other matters, he said, "During the present trouble with the stock market I have, of course, received countless requests and suggestions, public and private, that I should say or do something to ease the situation."[48] And so he did:

44. *See generally* MARTIN J. SKLAR, THE CORPORATE RECONSTRUCTION OF AMERICAN CAPITALISM, 1890–1916: THE MARKET, THE LAW, AND POLITICS (1988); HANS B. THORELLI, THE FEDERAL ANTITRUST POLICY: ORIGINATION OF AN AMERICAN TRADITION (1954).

45. *See* GABRIEL KOLKO, THE TRIUMPH OF CONSERVATISM: A REINTERPRETATION OF AMERICAN HISTORY, 1900–1916 (1963); MITCHELL, *supra* note 19, at 153.

46. *United States v. Standard Oil Co.*, 155 F. 305, 306, 321 (N.D. Ill. 1907).

47. A characteristically thoughtful and nuanced evaluation both of the speech and the financial situation preceding it was provided by the dean of financial journalists, Alexander D. Noyes. *See* Alexander D. Noyes, *The Fall in the World's Markets*, 39 FORUM 186 (1907).

48. *No Change in the President's Policy*, INDEPENDENT, Aug. 29, 1907, at 474.

> Once [and] for all let me say that as far as I am concerned, and for the eighteen months of my administration that remain, there will be no change in the policy we have steadily pursued, no let up in the effort to secure the honest observances of the law, for I regard this contest as one to determine who shall rule this Government—the people, thru their governmental agents, or a few ruthless and determined men whose wealth makes them particularly formidable because they hide behind the breastworks of corporate organization.[49]

While it might appear that the president's attempt to "ease the situation" had thrown fuel on the fire, and indeed the full-blown Panic remained two months away from that late August afternoon, he did express words of conciliation: "But I desire no less emphatically to have it understood that we have undertaken and will undertake no action of a vindictive type, and, above all, no action which shall inflict great or unmerited suffering upon the innocent stockholders and upon the nation as a whole."[50]

According to the next day's *Washington Post*, the market reacted positively, and the *Post* suggested that it was Roosevelt's conciliatory remarks that made all the difference.[51] Stockbroker J. S. Bache approved.[52] So did famous, respected, and prodigiously gossipy stockbroker, Henry Clews, who, while he disapproved of corporate fines, also wrote:

> When public hysteria has subsided, the effect of past agitation and present action will result in higher standards of corporate management and a keener sense of honor and responsibility. Let the stockholders of the various corporations join hands in demanding the punishment of the guilty individuals without causing the suffering of innocent investors, and Mr. Roosevelt will accept them as allies in this work of reform.[53]

49. *Id.*

50. *Id.*

51. *Wall Street Gossip*, WASH. POST, Aug. 21, 1907, at 10. The positive reaction, however, was not universal. *See, e.g.*, W.R. Givens, *[Untitled]*, INDEPENDENT, Aug. 29, 1907, at 482.

52. *See Wall Street View of Speech*, N.Y. TIMES, Aug. 21, 1907, at 2.

53. Henry Clews, *President Roosevelt and Wall Street*, INDEPENDENT, Aug. 21, 1907, at 481, 481–82. Leading investment banker Henry Lee Higginson was more critical of Roosevelt, and agreed with Clews's view of punishing the individual officers,

But this immediate reaction was short lived, at least in New York. In October of that year, a survey of newspapers in the periodical *Current Literature* noted that the New York newspapers generally were up in arms about the speech, and accused Roosevelt of destroying, or at least attempting to destroy, the economy.[54] On the other hand, it noted, "Such intensity of feeling appears but rarely outside New York."[55] New York, which by that time had fully assumed its financial prominence, was, needless to say, the epicenter of antiregulatory sentiment.

But Roosevelt did not mean it, at least not the words of conciliation. Stockholders, he thought, were responsible for the conduct of the directors they chose, and if those directors chose to break the law, the stockholders should suffer for their bad choices. Even if they lacked enough control to choose the directors, they made the choice to invest in the corporation in the first place and should be held responsible. As he wrote to Attorney General Charles Bonaparte on January 2, 1908:

> The stockholders have the control of the corporation in their own hands. The corporation officials are elected by those holding the majority of the stock and can keep office only by having behind them the good will of these majority stockholders. They are not entitled to the slightest pity if they deliberately choose to resign into the hands of great wrongdoers the control of the corporations in which they own the stock. Of course innocent people have become involved in these big corporations and suffer because of the misdeeds of their criminal associates. Let these innocent people be careful not to invest in corporations where those in control are not men of probity . . . . But if these honest innocent people are in the majority in any corporation they can immediately resume control and throw out of the directory the men who misrepresent them.[56]

And despite this apparent about-face from his August speech, Roosevelt did not hesitate to make his less conciliatory views public. In his January 31, 1908 special message to Congress, he wrote:

not the stockholders through the corporation. *See Justice to Corporations*, OUTLOOK, Jan. 18, 1908, at 118.

54. *A Review of the World*, 43 CURRENT LITERATURE 351, 352 (1907).

55. *Id.* at 353.

56. 6 THE LETTERS OF THEODORE ROOSEVELT, *supra* note 1, at 886.

> That stockholder is not innocent who voluntarily purchases stock in a corporation whose methods and management he knows to be corrupt; and stockholders are bound to try to secure honest management, or else are estopped from complaining about the proceedings the Government finds necessary in order to compel the corporation to obey the law.[57]

Unsurprisingly, in light of Roosevelt's strong position and the public's (or at least the business community's) reaction to it,[58] the fate of the innocent shareholder or, to put it differently, the question of corporate versus individual responsibility, became an issue in the presidential election of 1908. William Taft, naturally, agreed with his friend, mentor, and chief promoter for the nomination. New York Governor Charles Evans Hughes, who attained his first fame conducting investigations into the gas and insurance industries and who made his first bid for the Republican presidential nomination in 1908, reacted immediately.[59] As the *Washington Post* reported on February 1, Hughes staked out his own independent position despite Roosevelt's potentially strong support for his candidacy by arguing that the appropriate locus of punishment fell on corporate officials, not innocent shareholders, as did Ohio Republican Senator Joseph Foraker, a perennial candidate.[60] Judge Judson Harmon of Ohio, a frequently mentioned Democratic candidate, agreed with Hughes, as did more

57. *Special Message of the President of the United States Communicated to the Two Houses of Congress on Jan. 31, 1908*, THEODORE ROOSEVELT PAPERS 17–18 (Lib. Cong.).

58. As an example, the idea of punishing the individuals rather than the corporation was defended at the annual Washington's birthday dinner of the Society of the Cincinnati in 1908. *See Million Men Needed, Gen. Grant Declares*, N.Y. TIMES, Feb. 23, 1908, at 10.

59. Hughes had heavily discounted talk of his potential gubernatorial run in 1906 because of the highly negative reaction among financiers and conservatives, as well as his own party machine in New York. *See* MERLO J. PUSEY, 1 CHARLES EVANS HUGHES 170 (Columbia Univ. Press 1963) (1951). His progressive and principled performance as governor had not helped his presidential candidacy. *Id.* at 206, 216.

60. *See Hughes in a Larger Field*, WASH. POST, Feb. 1, 1908, at 6; *Hughes' Platform*, WASH. POST, Feb. 1, 1908, at 1, 4; *Permanent Prosperity*, OUTLOOK, Feb. 22, 1908, at 380–81. *The Outlook* was well known for its consistent positions in favor of the Roosevelt administration, and in fact Roosevelt was a frequent writer for the journal. *The Outlook* was also a fan of Hughes.

While it might seem odd that an argument in favor of punishing corporate officials would help Hughes gain the support of the financial interests, punishing corporate executives was, at that time, even rarer in fact than it is now, but punishing corporations could, as the *Standard Oil* ruling demonstrated, significantly damage their financial claimants as well as bring disarray to the markets.

distant potential candidates like Woodrow Wilson.[61] Editorializing in 1908, the Democratic *New York Times* expanded on Wilson's call for individual responsibility, noting, "Whoever has admired or envied Captains of Industry is responsible for a distributive share of the acts of the Captains, for our Captains are what we have made them."[62] If one took individual responsibility seriously, then not only shareholders, according to the *Times*, but "the Average Man" was responsible for corporate malfeasance.[63]

E. Progressive Individualism and the Innocent Shareholder

Progressive thought was complex and varied as it evolved over the first two decades of the twentieth century. The strands were hardly distinct, and the political affiliations I will describe hardly constant, but the errors of too stark a classification may be forgiven for the clarification of views.

One strand, associated politically with the Republican party and later taken up by legal realists, identified and celebrated the increasing collectivism and associationalism of American society, illustrated most prominently by labor unions and corporations but also by the growth of cities themselves, with collective housing in the form of apartment buildings and collective life within a constrained geographical space.[64] Corporate liability was not troubling for this group of thinkers. The collective was the reality, and it was the collective that was liable for its actions. This notion was well expressed by Louis Brandeis, a progressive who came to be most identified with the individualist strand, in a 1902 debate with labor-union leader Samuel Gompers. Brandeis and Gompers debated whether labor unions ought to incorporate in order to make their members collectively liable for damages caused by union activity, most prominently labor strikes. Brandeis argued in favor of such liability as enhancing public acceptance of union accountability and legitimacy.[65]

61. *[Untitled]*, LIFE, Jan. 16, 1908, at 70. The concern that innocent shareholders should not be made to bear the burden of official corporate misconduct through enterprise liability was increasingly widespread as a popular matter in all contexts. *Indicting a Corporation After Criminal Directors Are Out of Office*, 71 CENT. L.J. 437, 437–38 (1910). Democratic support for individual accountability was consistent with that party's general preference for individualism to the collectivism that enterprise liability implied.

62. Editorial, *Finding the Individual*, N.Y. TIMES, Jun. 9, 1908, at 6.

63. *Id.*

64. ROBERT H. WEIBE, THE SEARCH FOR ORDER, 1877–1920, 123–32 (1967).

65. *See* Louis D. Brandeis & Samuel Gompers, *The Incorporation of Trade Unions: "No, Thank you!" Says Gompers*, 1 GREEN BAG 306, 308 (1998).

The second strand, associated more typically with Wilsonian progressivism, of which Brandeis was a principal expositor, was Democratic and thus more conservative. This Wilsonian progressivism worked to restore individual responsibility while accepting the collective society that America had become.[66] I have already described Wilson's 1908 position that corporate liability could only be imposed on individual actors, not the collective itself, and this remains a nice illustration of the point.[67]

The individualist strand, at least in political thought, became more prominent in the second decade of the twentieth century with the election of a Democratic House of Representatives in 1910 and Wilson's election to the presidency in 1912. Popular morality also supported the notion of punishing wrongdoing corporate executives rather than levying penalties on the corporation itself. The *Christian Observer* argued in 1910 that morality could only be individual, and that corporations could not be used to shield corporate executives from having to account for their acts. Innocent shareholders should not be made to pay the penalties.[68]

Despite the significant public airing of views on the matter in 1907 and 1908, the fate of the innocent shareholder remained a hot issue in 1910. This time the debate was set off by the government's prosecution of the American Sugar Refining Company after the allegedly wrongdoing officers were "dead or displaced."[69] An editorial in the *Central Law Journal* celebrated its own foresight:

> This editor . . . urged that it was illogical in principle, impolitic in law . . . confusing in morals and unjust, that corporations should be held, by imputability, for crime. We scarcely hoped, that . . . it would be heralded over the land that there was a question of inherent justice in the prosecution of one of the great trusts for any one of the reasons advanced by our contributor.[70]

While business continued to object to regulation, it incorporated an individualistic, populist cast to the argument, an argument that had a ring of truth when increasingly large numbers of average Americans

66. MITCHELL, *supra* note 19, at 211–17.

67. *See, e.g.*, *Finding the Individual*, *supra* note 62 (reporting on an address given by Wilson).

68. *Corporate Morality*, CHRISTIAN OBSERVER, Feb. 23, 1910, at 3.

69. *Indicting a Corporation After Criminal Directors Are Out of Office*, *supra* note 61, at 437.

70. *Id.*

had become stockholders. The *Central Law Journal* made clear, with approval, how the Sugar Trust formulated its argument in defense of the innocent shareholders:

> As to these shareholders, it is said they "are generally trustees, executors, administrators, guardians of orphans, banks, trust companies, mortgage and investment companies, churches, Roman Catholic religious orders, hospitals, domestic and foreign missionary societies, schools, colleges, homes for the aged, asylums, libraries, lodges, athenaeums, Young Men's Christian Associations and other charitable associations."[71]

And if that were not a complete enough list of the needy and deserving (leaving aside perhaps the banks and investment companies who, after all, were also holding stock on behalf of the little people), "[i]n addition to this remarkable list appear the names of 9,870 women who have purchased stock as an investment."[72] Punish the corporation, and you were punishing the most vulnerable and worthy citizens of the United States.

While it was clear that some who advocated a reemphasis on individualism in the face of the collectivist thought that gained prominence in the Progressive Era were sincere in their long-standing beliefs, others, like the Sugar Trust, whose very existence and power depended on the new collectivism of the giant corporation, used the cry on behalf of the innocent shareholder in a more cynical way. James B. Dill was one of the most successful trust lawyers in the late nineteenth and early twentieth centuries, the acknowledged creator of New Jersey's 1896 corporation law that permitted the merger wave to occur, and a complex man. While known for his legal and business prowess as a midwife to giant corporations, he often spoke out publicly against trust abuses, and even his most long-standing interlocutors had difficulty judging the sincerity of his corporate critiques.[73] As a member of New Jersey's highest court, the Court of Errors and Appeals, he gave an interview in 1910 to *The Washington Post* in which he said, "I have never looked with patience on the fining of a corporation.

71. *Id.*

72. *Id.*

73. *See* MITCHELL, *supra* note 19, at 128. Based upon Dill's later conversations with his friend and critic, journalist Lincoln Steffens, it appears more likely than not that, while Dill was not completely insincere, he clearly sided with the trusts. *See* LINCOLN STEFFENS, THE AUTOBIOGRAPHY OF LINCOLN STEFFENS 193–96 (1931).

Inflicting a fine as penalty is inflicting punishment on the innocent stockholders. Penalties should be laid upon persons responsible."[74]

While corporate theory was not the stuff of dinner-table conversation, important legal philosophers intervened and suggested that the tide of legal thought was on the side of collectivism and therefore group liability. *The New York Times* reported that journalist Arthur W. Machen, Jr. opined in 1911:

> The old theory that corporations have no soul and no mind was giving way, especially in Continental Europe, to the idea that the corporation is a real, not an artificial, person, not created by the State, but recognized by it as existing. It was regarded by these jurists as a group-person, responsible and punishable as such. The fact that this punishment involved the suffering of innocent persons was held to be no more an evil than that the wife and family of a murderer suffered when he was executed. The Anglo-Saxon mind, however, would not accept a theory inconsistent with the conception that guilt is personal. The tendency, however, was to accept the group-person idea and to reject the other, leading to the punishment of the guilty persons in the corporation when they can be found and the fining of the corporation, affecting innocent and guilty shareholders alike, when the guilty could not be found.[75]

Despite the practical application of corporate theories that supported group liability, solicitude for innocent shareholders was demonstrated in practice as, for example, in *United States v. American Tobacco Co.*,[76] where the Court insisted on a remedy that harmed the shareholders as little as possible.[77]

74. *Dill Talks on Trusts*, WASH. POST, Jan. 23, 1910, at 8.

75. *Our Judges Lack Power, Says Taft*, N.Y. TIMES, May 14, 1911, at 16. Machen had just published two famous articles on the subject of corporate personality in the *Harvard Law Review*. *See* Arthur W. Machen, Jr., *Corporate Personality*, 24 HARV. L. REV. 253 (1911); Arthur W. Machen, Jr., *Corporate Personality (continued)*, 24 HARV. L. REV. 347 (1911). The real entity theory of corporate personality had unleashed a "flood of articles . . . after the turn of the century," MORTON J. HORWITZ, THE TRANSFORMATION OF AMERICAN LAW, 1870–1960: THE CRISIS OF LEGAL ORTHODOXY 103 (1992), and the theory dominated corporate thinking during the Progressive Era. *See* Gregory A. Mark, *The Personification of the Business Corporation in American Law*, 54 U. CHI. L. REV. 1441 (1987); Dalia Tsuk, *Corporations Without Labor: The Politics of Progressive Corporate Law*, 151 U. PA. L. REV. 1861 (2003).

76. 221 U.S. 106 (1911).

77. *Id.* at 184–88 (holding that in fashioning relief for a violation of the Sherman Act, a court must, among other things, show "a proper regard" for the

F. Reconciling the Individual Shareholder with Corporate Responsibility

Individual responsibility could cut both ways. The regard for individualism and individual responsibility shown by the more conservative progressives not only argued in favor of protecting the innocent shareholder but, at least as important, acknowledged the responsibilities of the shareholders for the behavior of their corporations when appropriate. President Taft, among the most conservative, encountered serious criticism from financial quarters for fully approving of the Supreme Court's decisions in the *Standard Oil* and *American Tobacco* cases.[78]

Brandeis, as I noted earlier, was one of the best-known individualists of the progressive movement. His famous 1914 book, *Other People's Money and How the Bankers Use It*, was on one level an argument in favor of protecting innocent shareholders, or at least potential shareholders, from banker's predations, and a call for disclosure to permit shareholders to act. But while Brandeis focused on the market for shares, this was also a time when bankers indisputably controlled many of the large, newly public corporations.[79] As Brandeis put it:

> The large army of small investors, constituting a substantial majority of all security buyers, are entirely free from banker control. Their submission is undoubtedly due, in part, to the fact that the bankers control the avenues to recognizedly safe investments . . . . But the investor's servility is due partly, also, to his ignorance of the facts. Is it not probable that, if each investor knew the extent to which the security he buys from the banker is diluted by excessive underwritings,

interests of innocent shareholders); *see also* Frederic R. Coudert, *The Record*, 194 N. AM. REV. 32 (1911); *Tobacco Trust Decision Epitomized*, WASH. POST, May 30, 1911, at 5.

78. One financier, while supporting the idea that shareholders had some responsibility in ensuring corporate compliance with the law, decried the absence of a federal corporations law that would have protected shareholders from paying the price for their managers' abuses and noted the lack of sympathy that Taft had shown toward shareholders like those of American Tobacco, who would be punished for that corporation's violation of the Sherman Act. *See Lauds Taft's Speech*, WASH. POST, Sept. 21, 1911, at 12. Taft was so unconcerned with the plight of the innocent shareholder that none other than Teddy Roosevelt had to coach him to show some compassion during the 1908 presidential contest. *See* MITCHELL, *supra* note 19, at 183.

79. *Money Trust Investigation: Investigation of Financial and Monetary Conditions in the United States Before the H. Subcomm. of the Comm. on Banking and Currency*, 63d Cong. (1913), *available at* http://fraser.stlouisfed.org/publications/montru/issue/3642/download/53821/montru_pt16.pdf.

> commissions and profits, there would be a strike of capital against these unjust exactions?[80]

While modern securities-disclosure laws had not yet reached the federal legislative agenda, calls for investor protection were heard from time to time,[81] and state legislatures had begun the process of enacting blue-sky laws for shareholder protection.[82]

At the same time, Brandeis's individualism accommodated a strong acknowledgment of shareholders' responsibility for corporate misconduct, at least when it caused harm to third parties. Best known to corporate lawyers for his arguments in favor of corporate disclosure as a means of shaming management from misbehaving, Brandeis also meant disclosure to serve as a means by which shareholders could restrain managers' irresponsible use of corporate power and thus exercise their role as a coordinate branch of corporate governance.[83] As Professor Tsuk Mitchell points out, by the time the federal government had made disclosure the centerpiece of federal securities legislation in the 1933 Act, it conceived of shareholders more in the nature of consumers than actors in corporate governance.[84] Brandeis's views of disclosure were adopted, but not Brandeis's broader concerns with the role of minority shareholders as a counterweight to corporate power. Yet the Securities Exchange Act of 1934 did incorporate some notion of stockholders as corporate actors by authorizing the SEC to adopt proxy rules.[85]

Brandeis balanced his concern for shareholders with their responsibility to the broader society in a manner consistent with his notions of individual accountability. The balance shifted when the interests of shareholders clashed with the interests of other, more vulnerable corporate stakeholders. Testifying before the Commission on Industrial Relations in 1915, he was questioned about "the

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80. LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT 99 (1914). It is interesting to note that Brandeis used the terms *investor* and *shareholder* interchangeably, presumably because he was talking principally about excessive underwriting fees. But in the larger context both of this book, which was based on the revelations of bankers' corporate control emerging from the Pujo Committee, and Brandeis's other work, his concern with minority shareholders within the corporation is clear.

81. To the extent that the federal government was interested in securities regulation at this time, it had to do with controlling monopolies, speculation, and the stock of common carriers. MITCHELL, *supra* note 19, at 209–44.

82. *See* LOUIS LOSS & EDWARD M. COWETT, BLUE SKY LAW 3–10 (1958).

83. *See* Tsuk Mitchell, *supra* note 39, at 1518–19.

84. *Id.* at 1541; *see also* MITCHELL, *supra* note 19, at 245–68.

85. Securities and Exchange Act of 1934, § 14(a), 48 Stat. 881, 892 (codified as amended in scattered sections of 15 U.S.C.).

responsibility of these so-called absentee owners of industries for conditions, wages, and other conditions existing in the corporations in which they are financially interested."[86] His response is worth quoting at length:

> They must be held absolutely responsible. There is no such thing, to my mind, applying it in this connection, as an innocent stockholder. He may be innocent in fact, but socially he cannot be held innocent. He accepts the benefits of a system. It is his business and his obligation to see that those who represent him carry out a policy which is consistent with the public welfare. If he fails in that, so far as a stockholder fails in producing a result, that stockholder must be held absolutely responsible, except so far as it shall affirmatively appear that the stockholder endeavored to produce different results and was overridden by a majority. Of course, stockholders may be innocent if they have been active and have been outvoted; but stockholders cannot be innocent merely by reason of the fact that they have not personally had anything to do with the decision of questions arising in the conduct of the business. That they have personally selected gentlemen or given their proxies to select gentlemen of high standing in the community, is not sufficient to relieve them from responsibility.[87]

Of course Brandeis acknowledged the reality that most stockholders had virtually nothing to do with management. But it was, he said, their obligation as stockholders to accept the "obligations which go with stockholdership" rather than to shirk them, and their failure to do so left them morally culpable.[88]

It was during the Wilson administration, which quickly came around to accepting both the inevitability and virtues of big business, that individual shareholder rights began to receive a sympathetic hearing.[89] The Capital Issues Committee, formed in 1917 to oversee the allocation of capital between private industry and a federal government

86. THE CURSE OF BIGNESS: MISCELLANEOUS PAPERS OF LOUIS D. BRANDEIS 74 (Osmond K. Fraenkel ed., 1935).

87. S. DOC. NO. 64-415, at 7660 (1916); THE CURSE OF BIGNESS, *supra* note 86, at 75.

88. THE CURSE OF BIGNESS, *supra* note 86, at 75. The perspective that, as between innocent shareholders and the rest of the world, the innocent shareholders should bear the financial burden of corporate misconduct, continued. *See, e.g.*, *Stockholder Levy Upheld in Detroit*, N.Y. TIMES, Mar. 9, 1934, at 29.

89. MITCHELL, *supra* note 19, at 209–44.

embroiled in war, noted in its final report the need to protect shareholders who were victimized by fraudulent issuance schemes, and helped to introduce the first modern federal securities-disclosure bill in Congress (with the endorsement of the president).[90] But the Capital Issues Committee, understandably in light of its role, had nothing to say about the position of existing minority shareholders.

Constraining corporate power, principally through the antitrust laws, was a central theme from the end of the nineteenth century through the 1930s. But as New Deal regulation imposed a greater variety of corporate liabilities and enterprise liability had become an accepted fact, the dominant issue shifted from corporate liability in litigation to empowering shareholders to control their corporations from within, a topic that would continue to dominate through the rest of the century.[91] Shareholders as a group were seen as the logical lever to restrain corporate power by ensuring that managers complied with the law, and Brandeis's individualistic ideas gradually disappeared into the collectivist progressivism of thinkers like Adolf Berle, William Ripley, Eustace Seligman and, eventually, into the thinking of William O. Douglas.

Nothing had changed with respect to the reality of shareholder powerlessness, and it is safe to say that the notion of shareholder as passive investor had become entrenched. But reformers continued to recognize that shareholders had the potential to be a countervailing force in corporate governance. Although varying in form, these reformers saw the solution in creating shareholder organizations, analogous to labor unions, to counterbalance managerial power.[92] These shareholder organizations would, had they been formed and successful, likely have transcended the simple role of shareholder voting and perhaps have played a role similar to that now being played by activist institutional investors and hedge funds, although with a broader public-interest orientation in addition to their corporate-governance agendas.[93] The dominant reform vision of shareholder power during the middle of

90. *Id.* at 245–68.

91. Tsuk Mitchell, *supra* note 39, at 1535.

92. *Id.* at 1528–35.

93. *See* Douglas M. Branson, *Corporate Social Responsibility Redux*, 76 TUL. L. REV. 1207, 1219 (2002) (citing how institutional activists monitor corporate social responsibility of the companies in which they invest); Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1062–69 (2007) (discussing the nature of hedge-fund monitoring); Joel Seligman, *The Case for Federal Minimum Corporate Law Standards*, 49 MD. L. REV. 947, 955 (1990) (noting that the current trend of activist institutional investors will impact the composition of the boardroom and how businesses run themselves).

the century became one that saw shareholders as having broad civic responsibilities in addition to their own economic self-interest.[94]

II. THE POWER OF THE SHAREHOLDING CLASS: FROM PUBLIC CITIZEN TO SHAREHOLDER VALUISM

A. The Innocent Shareholder During the Depression

The problems of the Depression changed the focus of public concern. Debate about the plight of the innocent shareholder had dropped significantly during the hyper years of the 1920s, and had virtually disappeared by the 1930s, except in two contexts. The first was investor protection from fraud in securities offerings and market manipulation embodied in the 1933 and 1934 Acts. As I noted earlier, this legislation, originating late in the Wilson administration, adopted the vision of the shareholder as largely a consumer whose need for information was critical to the buying decision but little else.

The other context arose in response to the Depression and, as had been the case during the Progressive Era, used the innocent shareholder argument to attempt to oppose New Deal business regulation. Fred N. Oliver, general counsel for the Security Owners' Association, used this argument in testimony against the 1932 Rayburn Bill, which was designed to control railroad holding companies, a device which had imposed significant damage on the industry after the 1929 Crash. The bill would have authorized the Interstate Commerce Commission to compel holding companies to divest their railroad stocks. Arguing that the legislation would depress railroad stock prices, Oliver said, "That necessarily would result in a loss not only to the holding companies but to innocent stockholders generally—stockholders of the companies in which the holding companies are interested."[95]

Not surprisingly given the state of the economy, the bankruptcy argument reappeared, but this time in defense of shareholders against creditors. Railroad counsel Charles Franklin called for Congress to pass a law limiting courts' abilities "to aid unscrupulous bankers throwing solvent corporations into receivership for the purpose of wiping out innocent stockholders spread throughout the land."[96] Former U.S. Ambassador to Germany, James W. Gerard, argued in favor of the creation of a national shareholders' organization "to protect their own interests" and stave off New Deal regulation,[97] and his call was

94. Tsuk Mitchell, *supra* note 39, at 1564–72.

95. *Security Owners Hit Rayburn Bill*, N.Y. TIMES, Mar. 25, 1932, at 32.

96. *Franklin Letter on I.R.T.*, N.Y. TIMES, Feb. 24, 1934, at 7.

97. *Gerard Would See Investors United*, N.Y. TIMES, Apr. 29, 1934, at N9.

followed by a lengthy response by Russell B. Kingman, an industrialist, founder of the New Jersey Symphony Orchestra, and President of the U.S. Lawn Tennis Association and the International Lawn Tennis Club. This exemplar of the business establishment elaborated upon Oliver's suggestion, noting that American shareholders "could readily make [themselves] the most powerful organization in the country," and calling upon them to use their political muscle to stop regulation.[98] It is interesting to note that Kingman, a corporate president, did not suggest that shareholders use their power to improve corporate governance (although Gerard did).

The economic environment of the time continually raised questions of who was responsible for what. Journalist Robert Quillen, writing in 1933 in *The Washington Post*, noted the degree to which overcapitalized corporations were overcharging consumers to pay dividends to their shareholders, even as those innocent shareholders numbered among them "the usual old people, widows and orphans," and asked, "Shall the corporations reorganize and let the stockholders take their loss, or shall the public pay and pay to make watered stock worth something?"[99] Quillen gave no answer, but recognized that someone would be hurt. In that same year, Richard Whitney, president of the NYSE and still at the height of his popularity, announced that the NYSE would delist Allied Chemical unless its board provided its shareholders with "what the Exchange deems to be 'adequate information' concerning the position of the company."[100] Both Allied's management and the NYSE were reported to have seen the action as putting the matter squarely in the hands of Allied's stockholders, leaving it to them to decide whether they would continue to support the nondisclosing management and suffer the consequences of delisting, or throw them out in favor of a new management that would comply with NYSE rules.[101] It is especially interesting to note in the context of this Paper that the NYSE, in effect, expected the shareholders to take action to protect themselves (by demanding disclosure) and their stock (by preventing delisting) through the processes of corporate elections.

98. Russell B. Kingman, Letter to the Editor, N.Y. TIMES, May 20, 1934, at E5.

99. Robert Quillen, *They Rob Peter to Pay Paul Because Paul Was Robbed*, WASH. POST, Nov. 22, 1933, at 6.

100. *Ultimatum Given to Allied Chemical*, N.Y. TIMES, May 25, 1933, at 29.

101. *Id.* at 29, 32.

B. The Intellectual Construction of the Activist Shareholder

1. BUSINESS PARTNER OR LEGAL ANTAGONIST?

While most of the voices decrying shareholder innocence were in favor of business regulation, and many calling for protection of the innocent shareholder opposed it, idealized views of the shareholders' role in American society continued to develop. In 1929, John H. Sears, a New York corporate lawyer and frequent commentator, published his book, *The New Place of the Stockholder*,[102] a paean to the virtues of stockholders and stockholder involvement in business. The tone of the book is, to modern ears, almost laughably upbeat,[103] and in hindsight Sears comes across as utopian. But his views were taken seriously.[104] He argued that shareholders had something besides cash to contribute to the corporation, and saw the increased managerial control of the proxy machinery as depriving the corporation of its shareholders' input. He envisioned shareholders as taking pride in their corporations, as enjoying the "romance of business," of which pleasure their inability meaningfully to participate deprived them.[105] He wrote that shareholder apathy arose because the shareholder expected nothing from the corporation, and that was because the corporation failed to provide anything to expect. As a consequence, shareholders needed to develop a "new positive attitude," and it was the job of business to cultivate that attitude in its shareholders.[106] He announced as a recognized fact that "the dawn of a new era, of better understanding between management and stockholders and greater cooperation on the part of stockholders, appears on the horizon."[107] Regrettably for Sears's vision of a brave new business world, what was really on the horizon was the Crash of 1929, which took place only a month after his book was published.[108] Shareholders had other things to worry about.

Adolph Berle and Gardiner Means's argument, published three years later, was the one that took hold. Regardless of their intent, they convinced the general public that the shareholder was a passive investor, and that legal remedies against misbehaving directors in the

102. JOHN H. SEARS, THE NEW PLACE OF THE STOCKHOLDER (1929).

103. One reviewer described it as reading like the unedited diary of a busy corporate lawyer. Robert L. Masson, *The New Place of the Stockholder*, 5 ACCT. REV. 324, 325 (1930) (book review).

104. *Id.*

105. SEARS, *supra* note 102, at 29.

106. *Id.* at 28.

107. *Id.* at 34.

108. Sears died in 1929 and therefore did not live to see the passage of the securities disclosure laws he advocated.

form of fiduciary-duty actions brought through shareholder suits (largely unused before the 1940s)[109] were the most effective potential means of redress. But Berle's notion of fiduciary control never quite made it off the ground and, instead, the 1930s and 1940s saw an increase in the shareholder-democracy debate. The innocent shareholder began to be replaced by the activist shareholder, in theory as well as in practice. The problem was that there was no resolution of the bipolar view of the shareholder as owner and as apathetic investor.[110] As a result, shareholder activism had, as it still has, an uncertain theoretical basis and, as a consequence, a less than successful history.[111]

2. UNITED WE STAND: THE ASSOCIATIONAL CONCEPT OF THE ACTIVIST SHAREHOLDER

Even as Sears saw the shareholder as asserting her individuality by participating in business, and Berle settled for shareholder litigation to maintain managerial accountability, the intellectual trend favored the notion of shareholder associations as both corporate and political actors. The distinctions came in identifying what it was that shareholders were to accomplish. Some continued the progressive view that shareholders had broad political and social responsibilities. While this attitude persisted throughout the century, exemplified by the political shareholder activism of the 1970s, by the beginning of the second half of the century there was a marked shift in the purpose of shareholder activism from a progressive notion of social responsibility to what we have come to call shareholder activism.

William O. Douglas, who would join the SEC in 1936 and become its chairman in 1937, maintained the progressive view of the activist shareholder while bowing to what he saw as the reality of its existence. In his classic article, *Directors Who Do Not Direct*,[112] he built on the observations of Berle and Means that management controlled the board, self-perpetuated in a manner that foreclosed meaningful monitoring, and allowed management to serve itself rather than the shareholders. Shareholders, according to Douglas, were responsible in some part for their own self-protection, as well as for protecting the integrity of the

109. Dalia Mitchell, *Status Bound: The Twentieth-Century Evolution of Directors' Liability*, 5 N.Y.U. J.L. & BUS. (forthcoming 2009).

110. Tsuk Mitchell, *supra* note 39, at 1543.

111. *See id.* at 1560; *see also* Dunlavy, *supra* note 43 (commenting on the theoretical conflict in models of shareholder voting).

112. William O. Douglas, *Directors Who Do Not Direct*, 47 HARV. L. REV. 1305 (1934).

capital markets. The problem, he wrote, was to find a way of mobilizing "scattered and disorganized stockholders and other investors into an active and powerful group so that there may be a competent and respectable patrol of the field of finance."[113]

One of Douglas's primary solutions to overcoming the problem of entrenched and self-serving boards was to reconstitute the board by requiring that a majority consist of independent stockholders.[114] But empowering stockholders to ensure that this representation would be meaningful was blocked by a seemingly intractable reality. Shareholders themselves had changed through a shift in their investment goals. "Stockholders moved more and more from an entrepreneurial to an investment position . . . . They have bought with a view towards increments of value other than control."[115] The notion that shareholders were owners in any meaningful way, which was at least plausible from the merger wave through the mid-1920s when investors bought primarily to hold a corporation's stock and profit by receiving dividends, had, as a result of changes in their investment behavior, shifted to the idea that all they were concerned with was capital gains, a position consistent with apathy and short-term holdings.[116] While Douglas advocated reforms like eliminating nonvoting shares, the adoption of "cumulative voting, pluralistic voting, or division of stock into blocks, each block electing a specified number of directors,"[117] he well recognized that these reforms by themselves could not overcome shareholder apathy, although they could provide tools for empowerment.

The solution he proposed for "mobilizing scattered and lethargic stockholders into action"[118] was, in a way, an end around the problem. He suggested the creation of a federally incorporated, although nongovernmental, shareholders' protective association that "would assume the primary responsibility for devising the type of procedure" appropriate to each monitoring situation and for mobilizing shareholder

113. *Id.* at 1307. He discussed two other problems "of primary importance" needing reform which are not of relevance here. *Id.*

114. *Id.* at 1314–15.

115. *Id.* at 1307–08, 1316; *see also* Tsuk Mitchell, *supra* note 39, at 1509–10 (describing the historical conflict between shareholders as participants and shareholders as investors).

116. MITCHELL, *supra* note 19, at 205–08. In the parlance of the time, shareholders were not investors but were speculators. *See* BENJAMIN GRAHAM & DAVID L. DODD, SECURITIES ANALYSIS 307–09 (1934).

117. Douglas, *supra* note 112, at 1330.

118. *Id.* at 1333.

votes.[119] "The association rather than the management might at times gain real control over the proxy machine."[120]

As with earlier reformers, like Brandeis and Berle, Douglas's concerns were broader than simple shareholder protection, although they certainly were that. He shared with Brandeis a belief that concerned and mobilized shareholders would play a significant role in ameliorating "the amazing absence of social consciousness on the part of directors and business executives and . . . their lack of any awareness of the implications and results of many practices which flourished in recent years."[121] While Douglas's concerns were broad, his primary interest was to ensure that corporate finance was conducted in an honest, open, and respectable manner. Shareholder activism, whether through direct democracy in the voting process or by means of an intermediate representative organization, would provide the solution. As he said in a 1936 speech at the University of Chicago, "I feel that the solution of current industrial and financial problems is to be found in large measure through democratization of industry and finance,"[122] and active shareholders were a key to this solution. "[T]he fact that there is at last a Securities and Exchange Commission in Washington should not lull investors and business into forgetfulness of the fact that the problem of what happens to their capital is still their concern."[123] Organized shareholders, acting as a political class, would help to prevent irresponsible management and help to ensure the integrity of the market. If such a vision had been realized, one might not speak plausibly today about the innocent shareholder.

To some degree, the SEC responded as a coordinator for shareholder activism. The 1940s saw the enactment of its shareholder proposal rule which acknowledged the increasing calls for greater shareholder involvement in business.[124] Although it underwent various iterations and modifications over the years, sometimes withdrawing shareholder power and sometimes expanding it, it nonetheless acknowledged that shareholders were entitled to a greater voice than the

119. *Id.* at 1330–33.

120. *Id.* at 1333.

121. *Id.* at 1329.

122. DEMOCRACY AND FINANCE: THE ADDRESSES AND PUBLIC STATEMENTS OF WILLIAM O. DOUGLAS 7 (James Allen ed., 1940).

123. *Id.* at 10.

124. *See* JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 270 (1982); Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1497 (2007); Lee, *supra* note 5, at 62; Tsuk Mitchell, *supra* note 39, at 1547–53.

stark limitations of proxy voting generally gave them.[125] Shareholder activists like the Gilbert brothers and Wilma Soss were quick to seize upon the opportunity to attempt to compel management to adopt governance proposals that permitted greater shareholder involvement, and their efforts were sometimes successful.[126] These efforts laid the groundwork for a continued vision of shareholder participation in corporate affairs, which was later built upon by the socially motivated shareholder proposals of the 1970s and the shareholder value-oriented proposals of the 1990s and early 2000s.[127]

3. PEOPLE'S CAPITALISM AND THE RISE OF SHAREHOLDER DEMOCRACY

Despite the prominence of the discussion over shareholder rights and responsibilities that had begun with the creation of the public shareholder during the merger wave, shareholders constituted a small proportion of the American population. The potential for shareholders to become a powerful corporate constituency only really developed after World War II. Beginning in the 1950s, shareholding became a much more widespread activity. Overlapping the development of the shareholder-democracy movement, then, was the development of

125. *See* Tsuk Mitchell, *supra* note 39, at 1547–53; Philip A. Nicholas, Jr., The Securities and Exchange Commission and the Shareholder Proposal Rule: Agency Administration, Corporate Influence, and Shareholder Power, 1942–1998 (2002) (unpublished Ph.D. dissertation, University at Albany) (on file with author).

126. *See* LEWIS D. GILBERT, DIVIDENDS AND DEMOCRACY 128–32 (1956); Tsuk Mitchell, *supra* note 39, at 1547–53; John Bainbridge, *The Talking Stockholder–II*, NEW YORKER, Dec. 18, 1948, at 33–34; Nancy Fraser, *Queen of Corporate Gadflies*, LIFE, Mar. 18, 1966, at 115; Nicholas, *supra* note 125, at 212–14. For an argument that while the individual stockholder had been disempowered, the class of stockholders had become an important force thanks to disclosure, regulation like the securities laws, and market power, see J.A. LIVINGSTON, THE AMERICAN STOCKHOLDER (1958). For an earlier attempt to argue that the stockholder should behave like a business owner, see SEARS, *supra* note 102.

127. *See, e.g.*, *Med. Comm. for Human Rights v. SEC*, 432 F.2d 659, 676–81 (D.C. Cir. 1970); *Lovenheim v. Iroquois Brands, Ltd.*, 618 F. Supp. 554 (D.D.C. 1985); *State ex. rel. Pillsbury v. Honeywell, Inc.*, 191 N.W.2d 406 (Minn. 1971); American Telephone and Telegraph Corp., SEC No-Action Letter, [1993–1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,820 (Jan. 24, 1994). While it certainly is the case that shareholder proposals aimed at profit maximization have proliferated in recent years, socially oriented shareholder proposals have also grown. Lee, *supra* note 5, at 62. A brief history of the rise in institutional investor activism is provided in LAUREN TALNER, THE ORIGINS OF SHAREHOLDER ACTIVISM 38 (1983). Perhaps the most influential writing in the 1970s on the shareholder-responsibility movement was JOHN G. SIMON ET AL., THE ETHICAL INVESTOR: UNIVERSITIES AND CORPORATE RESPONSIBILITY (1972).

"People's Capitalism," which gradually contributed to a shift in shareholder activism from social concerns to investment returns.

The NYSE got into the act of shareholder empowerment for the purpose of stimulating widespread shareholding in the late 1940s, but intensified its efforts in 1952 when it received the results of its commissioned study of American shareholding.[128] Its goal in undertaking this study was to demonstrate the widespread shareholdings of the American people, with the ideological understanding that broad common-stock ownership would prevent socialism from growing in America, and the not-inconsistent political motive of showing that increased corporate regulation would hurt ordinary Americans. The NYSE was disappointed in the relatively small number of shareholders.[129] It found that approximately 6.5 million individuals, only 4.2 percent of the American population, owned any stock.[130]

As a result, it commissioned a new study several years later in which it found material, although not overwhelming, additional growth in share ownership. The results prompted it to launch an advertising and public-relations campaign, heralding a democratic and widespread "People's Capitalism," under the slogan, "Own Your Own Share of American Business."[131] For a variety of reasons, including the NYSE's efforts, stock ownership increased rapidly in the 1960s.[132] By 1965, over 20 million individuals, 10 percent of the population, owned stock.[133]

The NYSE studies and People's Capitalism campaign prompted financial columnist, Joseph A. Livingston, not known as "one to pull his punches,"[134] to publish *The American Stockholder*, a book in which

128. The study was published as LEWIS H. KIMMEL, SHARE OWNERSHIP IN THE UNITED STATES (1952).

129. Bayless Manning, 67 YALE L.J. 1477, 1477–78 (1958) (reviewing J.A. Livingston, THE AMERICAN STOCKHOLDER (1958)).

130. KIMMEL, *supra* note 128, at 89. Interestingly, the demand for stock, which was a primary driver of increased equity offerings in the late 1940s, came from investors in "the middle and lower income brackets who are less affected by high personal income tax rates." Jules I. Bogen, *The Importance of Equity Financing in the American Economy*, 5 J. FIN. 170, 174 (1950). By 1967, the average shareholder had relatively high income. *See* CARTER F. HENDERSON & ALBERT C. LASHER, 20 MILLION CARELESS CAPITALISTS 231–32 (1967). It is interesting to speculate what, if any, effect the demographic changes in shareholding suggested by this data had on shareholder activism, but the answer to this question awaits future work. Institutional ownership was negligible at this point. KIMMEL, *supra* note 128, at 89.

131. LIVINGSTON, *supra* note 126, at 24; Manning, *supra* note 129, at 1478.

132. Wyatt Wells, *Certificates and Computers: The Remaking of Wall Street, 1967 to 1971*, 74 BUS. HIST. REV. 193, 194 (2000).

133. NEW YORK STOCK EXCHANGE, SHAREOWNERSHIP 1985, at 3 (1986).

134. S. Oliver Goodman, *Livingston Scalpel Prods Stockholders*, WASH. POST, Mar. 12, 1958, at A25.

he sought to provide a clear-eyed view of the role of stockholders in American society and "[put] the stockholder in his proper place."[135] The picture was not especially attractive: "They are suckers like the parasite that hangs on to the shark and, thereby, gets free transportation. Most purchasers of stocks know what they are doing. They are absentee owners who let somebody else work for them."[136] And, lacking political power, they did not have much chance to change the situation through governmental intervention.[137]

At the same time, Livingston sought to describe and analyze the newly emergent concept of "corporate democracy,"[138] which he defined as "the shareholder's right to speak, congregate, communicate with other shareholders, and to know what is going on."[139] Despite several well-publicized proxy contests; the dogged integrity of Lewis Gilbert and the well-publicized antics of Wilma Soss; the creation of shareholder organizations like B. C. Forbes's Investors League, Benjamin Javits's United Shareholders of America, and Soss's Federation of Women Shareholders in American Business; corporate democracy remained a faint hope and, in general, stockholder-parasites had abrogated any sensible responsibility they could be said to have had.[140]

What was to be done? Livingston, anticipating the creation of the Investor Responsibility Research Center by twenty years, initially hoped to encourage the creation of "some independent, objective organization [that] undertook to appraise—rate—the managements of various companies each year."[141] But this organization would be very

135. LIVINGSTON, *supra* note 126, at 16.

136. *Id.* at 13.

137. *See id.* at 25.

138. *Id.* at 20.

139. *Id.* at 76; *see also* Manning, *supra* note 129, at 1486–90. Reviewing Livingston's book, Professor Manning applied his characteristically sardonic yet beautifully expressed realism to conclude that corporate democracy was not only a fallacy and that Livingston's book had shown its unreality, but that, as "a shimmering conception fusing good old American free enterprise with good old American Jacksonianism," it posed serious dangers to responsible corporate management. Manning, *supra* note 129, at 1486.

140. *See* LIVINGSTON, *supra* note 126, at 119–28.

141. *Id.* at 237. Livingston described the creation, in the late 1940s, of the American Institute of Management which purported to serve this purpose. He despaired of its effectiveness, however, largely because he found inconsistencies in its ratings and appears to have disagreed with several of its judgments. *Id.* at 238. In contrast to Livingston's proposal of management rating, the Investor Responsibility Research Center initially undertook to evaluate corporate behavior in a variety of social contexts. TALNER, *supra* note 127, at 45–46. Management rating in the sense Livingston envisioned it would await the work of Bob Monks and Nell Minow, and Institutional Shareholder Services, among others.

different from the association envisioned by Douglas. Whereas Douglas's call was for shareholders to exercise the broader responsibility to the market and society inherent in their position, Livingston's answer was a call for institutional-investor activism for the sake of improved performance, a solution that might make corporate democracy actually mean something. In this respect, institutional investors, as Livingston described them, were "trustees for all shareholders."[142] Livingston was prescient, but his solution lay far in the future.[143]

Calls for shareholder activism continued to be issued, even as proxy contests made occasional headlines. In 1967, Carter Henderson (a corporate public-affairs manager) and Albert Lasher (a corporate public-relations manager) published *20 Million Careless Capitalists*. Although they were evidently unaware of John Sears's earlier work, the parallels are quite astonishing, including their encouragement of shareholders to experience the joys of business through their shareholdings. While they certainly acknowledged the profit motive of owning stock, their message was clear: "But owning a share in American business can also be an experience that holds the potential—whether or not it is ever realized—of enabling every stockholder to make his small contribution to improving the society of which he is a part."[144] And the shareholder who ignored this call did so at his peril:

> The whole point is that a very serious dialogue about the future of American business and what it will produce is underway. One that makes it more imperative than ever for you to understand your power and responsibilities as a stockholder, power and responsibilities that are yours if you care enough to exercise them.[145]

While they recognized that many shareholders conformed to the picture Livingston had described, Henderson and Lasher had a deeper faith in the potential of individual shareholder power and corporate democracy. Proxy fights had significantly increased in the fifteen years since Livingston wrote, and tender offers had begun to appear with some frequency by the mid-1960s. "What has really made even the

142. LIVINGSTON, *supra* note 126, at 246.

143. In what I consider to be a rare failure of foresight on Professor Manning's behalf, he dismissed the possibility of institutional-investor activism (he referred, probably accurately for the time, to "*mutual funds*," whereas Livingston used the broader "*institution*"), noting that Livingston's book implicitly undercut his own claims for institutional activism. *See* Manning, *supra* note 129, at 1486.

144. HENDERSON & LASHER, *supra* note 130, at 13.

145. *Id.* at 14.

smallest stockholder a potential force, however, is a new breed of business personalities who appeared on the scene in the early 1950s. These are the rank outsiders, often called 'raiders,' who set out to capture some of America's biggest and oldest companies."[146] Henderson and Lasher put their hope in men like Norton Simon, Louis Wolfson, and Victor Muscat, who they saw as the ultimate guardians of shareholder interests.[147]

But that was not all. In contrast to Livingston's pessimism (amplified in Bayless Manning's review of the book), and drawing back on a line of thought that traced at least to James Gerard's 1934 ideas, Henderson and Lasher described cases in which shareholders asserted political power on behalf of their corporations, as for example, during the Federal Communication Commission's investigation into AT&T's rates, where a shareholder "Committee of 100,000" led the company's shareholders in exerting pressure on the Commission to conclude the hearings favorably to the company, as well as more numerous examples of stockholders buying, and encouraging others to buy, company products, and even engaging in soliciting new stockholders for their corporations.[148] They concluded:

> The willingness of America's 20 million stockholders to act in their companies' behalf either economically or politically represents one of the greatest untapped reservoirs of power in our country's history. If it could be harnessed as effectively as the union movement has organized the power of the laboring man, it could alter the shape of our capitalistic society forever.[149]

But who, they asked, would "organize" investors? Their prediction was less accurate than Livingston's. It was crusaders, like Gilbert and Soss, in whom they put their faith to organize the shareholders behind the raiders. It was, Henderson and Lasher wrote, becoming clear that management was beginning to follow some of the governance reforms advocated by the shareholder activists entirely on their own.[150] But, as

146. *Id.* at 203.

147. *Id.* at 200–03, 207.

148. *Id.* at 223–26, 229–30. The very interesting doctoral dissertation by Kenneth Paul Uhl, examining the extent to which corporations drew upon their shareholders not only as customers, but as volunteer sales forces for company products and stock also deals with this matter. Kenneth Paul Uhl, Stockholders as Customers for Their Corporations' Products (1960) (unpublished Ph.D. dissertation, Iowa State University) (on file with author).

149. HENDERSON & LASHER, *supra* note 130, at 232.

150. *Id.* at 251.

with Livingston only more so, Henderson and Lasher were far more interested in improving corporate profits than with the corporate-control concerns that had motivated Brandeis, Berle, and Douglas. Indeed, the book was marketed as an investment guide.[151]

4. THE POLITICAL ERA OF SHAREHOLDER ACTIVISM

Even as Henderson and Lasher predicted a brave new world for shareholders, events were conspiring to make it reality, if not in the way they had imagined. The 1970s brought turmoil in the market. The go-go years collapsed into history,[152] the Penn Central Transportation Company declared bankruptcy, and the war in Vietnam intensified, fueled with the products of American industry. Corporate management was under fire, and politics, not economics, became the driving force. Community organizer Saul Alinsky had used shareholders to pressure Eastman Kodak's management to improve its hiring of African Americans as early as 1966, bringing into the fight institutions like private foundations and TIAA-CREF.[153] The Medical Committee for Human Rights's first communication with Dow Chemical's management took place in 1968,[154] the same year that saw the formation of the Honeywell Project which, in 1969, would lead Charles Pillsbury to buy a single share in the company in order to mobilize shareholders.[155] The Project on Corporate Responsibility, which conducted Campaign GM, was organized in 1970,[156] and various church groups began to engage in shareholder campaigns on issues as diverse as environmental and social concerns and apartheid in South Africa, with the National Council of Churches forming the Corporate Information Center in 1969 as an information clearinghouse.[157]

While social responsibility filled the agendas of annual meetings in place of the corporate power concerns of earlier decades and the immediately preceding (and following) concerns of improved shareholder-primacy based corporate governance, the political shareholder activism of the 1970s serves as another demonstration of the potential influence of shareholders when they choose to exert their dormant power.

151. See, for example, a half-page ad appearing on page 22 of the October 15, 1967 issue of *The New York Times Book Review*.

152. *See* Joseph W. Bishop, Jr., *Review: The Bursting of the Bubble*, 83 YALE L.J. 1100, 1100 (1974). *See generally* JOHN BROOKS, THE GO-GO YEARS (1973).

153. TALNER, *supra* note 127, at 4–8.

154. *Id.* at 8–9.

155. *Id.* at 10–11.

156. *Id.* at 12.

157. *Id.* at 28–29.

5. SHAREHOLDER VALUE—THE RETURN OF THE INNOCENT SHAREHOLDER

By the late 1970s, the rise of institutional ownership of a substantial proportion of American stock had become an established fact and a topic of investigation.[158] In this new environment, the Twentieth Century Fund commissioned a study by two Wharton professors to examine the role of individual stockholders.[159] Shareholder activism and corporate democracy were none of their concern. Instead, the book marked a growing and decisive shift in interest to the investing and trading habits of individual investors and the effects of institutional growth on market efficiency. No longer were shareholders seen as a potentially powerful force in maintaining the business and social integrity of corporate America. As Livingston, Carter, and Lasher had foreshadowed, they instead were seen as pure investors, unconcerned with corporate behavior except insofar as it increased the value of their investments. The turn to shareholder valuism had taken firm hold[160] and, with it, a shift in the goals of shareholder activism that would begin to manifest clearly almost twenty years later.

A similar view was evident in the growing work of legal scholars working with the new tools of neoclassical law and economics. The shareholder was no longer any kind of an owner, but simply a capital provider whose contract promised her the corporation's residual

158. DIV. OF CORP. FIN., SEC, 96TH CONG., REPORT ON CORPORATE ACCOUNTABILITY 199–200 (Comm. Print 1980) (questioning the proper relationship of the holders of institutions' stock to the political process); Victor Brudney, *Business Corporations and Stockholders' Rights Under the First Amendment*, 91 YALE L. J. 235, 258 (1981); Donald E. Farrar & Lance Girton, *Institutional Investors and Concentration of Financial Power: Berle and Means Revisited*, 36 J. FIN. 369 (1981).

159. MARSHALL E. BLUME & IRWIN FRIEND, THE CHANGING ROLE OF THE INDIVIDUAL INVESTOR (1978).

160. Professor Gordon marks this period as a shift to shareholder valuism resulting in large part from the newly created institution of the independent monitoring board, as do I. We differ in our evaluation of the causes of the latter, as well as the normative implications we draw from this development. *Compare* Gordon, *supra* note 124, *with* Lawrence E. Mitchell, *The Trouble with Boards*, (George Washington University Legal Studies Research Paper No. 159, 2005), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=801308. Professor Tsuk Mitchell marks the intellectual shift to shareholder valuism as dating to the work of academic Henry Manne in the early 1960s, even as she evaluates later shareholder political efforts as a fading dream of shareholder empowerment. Tsuk Mitchell, *supra* note 39, at 1562–64.

wealth.[161] The fiduciary duties owed to these capital providers were limited to those necessary to ensure corporate efficiency, and voting rights were a vestigial instrument that gave some opportunity for shareholders to protect their contract rights by choosing who was to manage their money.[162] The market for corporate control had become the recognized medium for managerial discipline, and in light both of market incentives and those provided by the structure of corporate law, the aim of managerial discipline came to be seen as increasing shareholder value.[163]

While these arguments alone were sufficient to reduce the shareholder to the status of passive investor, modern finance theory helped to further separate the shareholder from any meaningful concern with particular corporations by establishing the dominance of portfolio theory and the capital-asset-pricing model. Corporate law responded accordingly. Shareholders were largely to self-protect, and the way they could do so was by holding a diversified portfolio of securities. The deracinated shareholder had become the completely passive investor. As an intellectual matter, after more than five decades of efforts to empower shareholders, the innocent shareholder had been recreated to resemble her counterpart at the turn of the twentieth century.[164]

161. The theory is thoroughly discussed in a symposium published by the *Columbia Law Review* in 1989. Symposium, *Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989).

162. *See* P. John Kozyris, *Corporate Wars and Choice of Law*, 1985 DUKE L.J. 1, 6; Larry D. Soderquist & Robert P. Vecchio, *Reconciling Shareholders' Rights and Corporate Responsibility: New Guidelines for Management*, 1978 DUKE L.J. 819, 833.

163. *See* Allan Kaufman, *Managers' Double Fiduciary Duty: To Stakeholders and to Freedom*, 12 BUS. ETHICS Q. 189, 190–91 (2002); Thomas A. Smith, *The Efficient Norm for Corporate Law: A Neotraditional Interpretation of Fiduciary Duty*, 98 MICH. L. REV. 214, 214 (1999).

164. A LEXIS search shows approximately 650 law-review articles published since 1970 discuss the innocent shareholder and regulation. Prior to 1970, only nineteen articles did so. While it is hard to conclude terribly much from this information, it is consistent with my argument that the concept of the innocent shareholder was used largely as a political device and only became a scholarly concern when the model of shareholder passivity became generally accepted with the rise of law-and-economics scholarship, as I discuss later. The conclusion can, of course, only be correlative, not causative, but it is interesting nonetheless.

I should note that the passive-investor model has become so generally accepted that for the past thirty years, the innocent-shareholder argument has been used more to argue for regulation than against it, as the foregoing LEXIS search readily demonstrated. This makes sense in light of the fact that deregulation in securities law has restored a level of shareholder vulnerability that, while not as dramatic as the turn of the century, is greater than existed after the passage of the New Deal securities acts.

In addition to an increase in shareholder proposals aimed at improving corporate governance for the purpose of increasing shareholder value were calls, beginning in the 1990s, to alter the 1934 Act disclosure rules to permit shareholders to communicate with one another in order to resolve the collective-action problem that had traditionally prevented meaningful stockholder action.[165] While the arguments in favor of permitting increased shareholder communications were broadly articulated, their motivating force was to facilitate greater shareholder pressure on management for improved corporate performance.[166] Much of this, again, was aimed at influencing the composition of management or business policy,[167] and provides a further example of stockholders' struggles to increase their influence in the boardroom and beyond.

Despite the return of a dominant view of shareholders as rationally apathetic passive investors—in other words, innocent shareholders—the institutional activism that began in the 1990s and grew following the corporate scandals of 2002, as well as the rise of activist hedge funds, demonstrates that even, if not especially, on this model of shareholder as investor, American shareholders have been more vigorously

165. *See* Cracker Barrel Old Country Store, Inc., SEC No Action Letter, [1992–1993 Transfer Binder] Fed Sec. L. Rep. (CCH) ¶ 76,418 (Oct. 13, 1992); *see also* ABA Section of Business Law, *Annual Review of Federal Securities Regulation*, 62 BUS. LAW. 1065, 1090 (May 2007) (detailing disclosure standards for related-persons transactions); Christine L. Ayotte, *Reevaluating the Shareholder Proposal Rule in the Wake of* Cracker Barrel *and the Era of Institutional Investors*, 48 CATHOLIC U. L. REV. 511 (1999); Robert C. Illig, *What Hedge Funds Can Teach Corporate America: A Roadmap for Achieving Institutional Investor Oversight*, 57 AM. U. L. REV. 225, 253–58 (2007) (detailing briefly the historical context in which the shareholder-communications rule emerged, and the response to the promulgation of the rule); Maya Mueller, *The Shareholder Proposal Rule: Cracker Barrel, Institutional Investors, and the 1998 Amendments*, 28 STETSON L. REV. 451 (1998); Paul M. Neuhauser, *Facilitating Shareholder Communications*, 17 J. CORP. L. 213, 213 (1991); Beth-ann Roth, *Proactive Corporate-Shareholder Relations: Filling the Communications Void*, 48 CATHOLIC U. L. REV. 101 (1998); Norma M. Sharara & Ann E. Hoke-Witherspoon, *The Evolution of the 1992 Shareholder Communication Proxy Rules and Their Impact on Corporate Governance*, 49 BUS. LAW. 327 (1993). While it certainly is the case that shareholder proposals aimed at profit maximization have proliferated in recent years, socially oriented shareholder proposals have also grown.

166. Myron P. Curzan & Mark L. Pelesh, *Revitalizing Corporate Democracy: Control of Investment Managers' Voting on Social Responsibility Proxy Issues*, 93 HARV. L. REV. 670 (1980); Leila Sadat-Keeling, *The 1983 Amendments to Shareholder Proposal Rule 14a-8: A Retreat From Corporate Democracy?*, 59 TUL. L. REV. 161, 169 (1984) (outlining a history of calls for increased shareholder communications).

167. George W. Coombe, Jr., *Directors' Duties and Responsibilities: New Dimensions, New Opportunities*, 95 BANKING L.J. 634 (1978) (detailing the changes directors must make to their boardrooms to accommodate a "shareholder democracy").

searching for ways to influence corporate behavior, if only for the limited purpose of increasing the value of their shares.[168]

The result has been a demonstrated increase in shareholder influence. It does not require extended discussion to observe the way that, in recent years, the innocent shareholder has become the activist investor.[169] Despite the growing corporate social-responsibility movement that began to take off in the mid-1990s,[170] the conclusion that the midcentury notion that a nation of shareholders could somehow keep America safe for responsible business is all but dead as shareholder activism has shifted to an almost unrelenting concern with increased corporate profits.[171] Scholarly debates have moved from a focus on the shareholder proposal rule and improved corporate democracy as tools to hold corporate managements socially accountable to demands for greater shareholder corporate involvement for the purpose of ensuring greater management attention to shareholder wealth.[172]

168. It is worth reiterating Professor Werner's 1977 observation of managerial sensitivity to the stock market. Walter Werner, *Management, Stock Market and Corporate Reform: Berle and Means Reconsidered*, 77 COLUM. L. REV. 388, 389 (1977).

Probably the most visible proponent of improved shareholder democracy, Professor Bebchuk, is quite explicit that his goal is to improve shareholder value. Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 678 (2007).

169. INV. & FIN. SERV. ASS'N OF AUSTL., SHAREHOLDER ACTIVISM AMONG FUND MANAGERS: POLICY AND PRACTICE 1–3 (July 2003), *available at* http://www.ifsa.com.au/documents/2003_Publications_Shareholder%20Activism.pdf; Stuart L. Gillan & Laura T. Starks, *Corporate Governance Proposals and Shareholder Activism: The Role of Institutional Investors*, 57 J. FIN. ECON. 275 (2000) (measuring the success of shareholder activism in the 1990s through voter outcomes and short-term market reactions conditioned on proposal type and sponsor identity).

170. Douglas M. Branson, *Corporate Governance "Reform" and the New Corporate Social Responsibility*, 62 U. PITT. L. REV. 605, 611 (2001) (recounting a history of the corporate social-responsibility movement); Kellye Y. Testy, *Linking Progressive Corporate Law with Progressive Social Movements*, 76 TUL. L. REV. 1227, 1228 (2002) (distinguishing the "new" corporate social responsibility from the 1970s version).

171. Randall S. Thomas & James F. Cotter, *Shareholder Proposals in the New Millennium: Shareholder Support, Board Response, and Market Reaction*, 13 J. CORP. FIN. 368, 372 (2007) (describing shareholder proposal types from 2002 to 2004, namely, (1) auditor independence, (2) compensation, (3) environmental/social, (4) external corporate control/governance, (5) internal corporate control/governance, and (6) other social responsibility); Sarah Mulholland, *Shareholder Proposals Hit Record High*, INVESTMENT MGMT. WKLY., Aug. 18, 2003 (showing an increase in shareholder proposals from 529 received in 2002 to 775 as of August 18, 2003, with a full 41 percent of the proposals dealing with executive pay, 23 percent dealing with poison-pill provisions, and 15 percent dealing with calls to companies to expense stock options).

172. Bebchuk, *supra* note 168, at 678.

Some observers might wish for a shareholder activism that more broadly increases managements' attention to issues of corporate social responsibility. But there is no doubt that shareholders have been working to find ways to influence corporate management for their own benefit. While one might have greater sympathy for liability imposed upon shareholders whose interest in their corporations was directed toward the kind of responsibility envisioned by Roosevelt and Brandeis, it is hard to have compassion for the deflowered shareholder who has begun to find his voice and use it to assert an evidently insatiable demand for profit. Indeed, the increase of annual turnover on the NYSE[173] suggests that American shareholders have virtually conceded their lack of interest in the corporations whose stock they own.

But while shareholders may no longer be seen as potential "partners" in their corporations' businesses, or as a political force for the betterment of society, their legal powers persist, as they have increasingly demonstrated. With power, even inchoate power, comes responsibility, and the notion that shareholders are somehow innocent, either because they have chosen not to exercise their power or because their efforts have not yet been entirely successful, concedes too much to the alleged owners of corporate America.

6. THE RESPONSIBLE SHAREHOLDER

Recall that the circularity argument holds that securities class-action lawsuits fail of their essential purpose because the damages recirculate between the sources and recipients and rarely, if ever, come from the pockets of the culpable corporate actors. The innocent shareholder pays the damages.

But the argument fails to account for the role of shareholders. It fails to examine their actual and potential role in the corporate-governance structure that puts misbehaving managers in office. By considering only the payment of damages by specific corporations, it fails to consider the systemic ways in which shareholders might serve as instruments in maintaining market integrity. And by assuming shareholder innocence it fails to consider the extent to which shareholders themselves bear responsibility for the system we have created.[174]

173. Turnover increased 123 percent in 2007. NYSEData.com, NYSE Group Turnover, 2008, http://www.nyxdata.com/nysedata/asp/factbook/viewer_edition.asp?mode=table&key=3027&category=3 (last visited Feb. 8, 2009).

174. *See* Goldschmid, *supra* note 5, at 666.

History shows us that the role of the shareholder has been a debated issue ever since industrial public shareholding began.[175] It also reveals that the innocence of shareholders in corporations that have been penalized for violating the law was a significant issue around the time of the giant public corporation's birth, often as an antiregulatory trope, and faded with the general acceptance of enterprise liability, even as shareholder empowerment became the principal theme in the 1930s and has retained that prominence ever since. Finally, the story traces the shift in the concept of shareholder activism full circle, from the helplessness of the innocent shareholder at the turn of the century, to the shareholder as mid-century business partner and public servant, to the innocent shareholder whose sole concern is the performance of her investment. The history of the innocent shareholder calls us to ask whether such a concept can sustain an argument against enterprise liability.

Much of the history of the innocent shareholder pitted the shareholder as a responsible (or potentially responsible) actor in corporate governance against third parties who had been damaged by the corporation's behavior. In this story, the innocent shareholder might well be regarded as the appropriate indirect source of fines for corporate legal violations, like antitrust or environmental laws, or corporate torts. But when it comes to issues of securities fraud, the question is more complex. No longer is the violation an externality that is internalized by penalty. Rather, damages awarded in securities class-action lawsuits ensure that both the violation and the penalty are internalized by the corporation and its shareholders. Thus, it seems that if any circumstance were to call for the protection of the innocent shareholder, the securities-fraud context would be appropriate.

The recent renewal of cries on behalf of the innocent shareholder is peculiar. Modern finance theory and neoclassical law and economics treat the shareholder as little more than a rationally apathetic, diversified provider of funds. But recent work has attempted to revive an older notion of shareholders as active participants in corporate governance.[176] And the facts are on the shareholders' side. The last

175. The modern public corporation as we have come to know it dates from the great merger wave of 1897–1903. MITCHELL, *supra* note 19, at 8–13.

176. *See, e.g.*, Bebchuk, *supra* note 168, at 682; Sharon Hannes, *Corporate Stagnation: Discussion and Reform Proposal*, 30 J. CORP. L. 51, 75 (2004); John H. Matheson & Brent A. Olson, *Corporate Law and the Longterm Shareholder Model of Corporate Governance*, 76 MINN. L. REV. 1313, 1370 (1992); J.W. Verret, *Pandora's Ballot Box, or a Proxy with Moxie?: Majority Voting, Corporate Ballot Access, and the Legend of Martin Lipton Re-Examined*, 62 BUS. LAW. 1007 (2007). Professor Tsuk Mitchell explores the foundational understandings of the modern stockholder in *Shareholders as Proxies: The Contours of Shareholder Democracy*, *supra* note 39.

decade and more has witnessed a substantial body of scholarship attempting to reinvigorate shareholder rights by providing opportunities for increased shareholder participation in corporate management.[177] For almost the past two decades, there has been significant and increasingly effective growth in pressure brought to bear on corporate management by institutional investors, particularly in the wake of the scandals of 2002.[178] Scholars and business practitioners have raised substantial concerns about the powerful pressure that stockholders, acting through the stock market, exert on corporate managements to act in the interests of short-term profit maximization.[179] The increasing empowerment of institutional investors and the rise of activist hedge funds, along with steps by the SEC to facilitate shareholder participation in corporate governance,[180] have demonstrated new possibilities not only for shareholder determination of managements' composition, but for its policies as well.[181] Institutional investors and activist hedge funds have had a significant impact on board and management composition and sometimes the business strategies of large public corporations.[182]

177. *See supra* note 166.

178. Lawyers Andrew Brownstein and Igor Kirman provide a thoughtful and detailed analysis of the significant growth of shareholder corporate-governance resolutions under SEC Rule 14a-8, as well as other forms of institutional pressure on corporate boards and management, noting that such efforts have had clearly observable results on board behavior. *See* Andrew R. Brownstein & Igor Kirman, *Can a Board Say No When Shareholders Say Yes? Responding to Majority Vote Resolutions*, 60 BUS. LAW. 23, 23–24 (2004).

179. MITCHELL, *supra* note 17, *passim*; MATTEO TONELLO, REVISITING STOCK MARKET SHORT-TERMISM (2006); MITCHELL, *supra* note 19, at 278; John R. Graham et al., *The Economic Implications of Corporate Financial Reporting*, 40 J. ACC. ECON. 3 (2005).

180. *See* Shareholder Communications Rules, 17 C.F.R. §§ 240, 249, 274 (2007); Electronic Access Rules, 17 C.F.R. §§ 232, 270 (2007). But on November 28, 2007, the SEC amended Rule 14a-8(i)(8) to make it clear that shareholder proposals to create proxy-access procedures were excludable by management from its proxy materials, although Chairman Christopher Cox, who supported the amendment, stated that he "favors shareholder access in the long term," treating the amendment as a temporary stop-gap measure to cover the 2008 proxy season. *Divided SEC Acts to Allow Exclusion by Firms of Shareholder Access Proposals*, 76 U.S.L.W. 2331 (2007).

181. *See* Aaron Bernstein, *Power to the Shareholders*, DIRECTORSHIP, Oct/Nov. 2007, at 18; Brownstein & Kirman, *supra* note 178, at 68 (describing managerial responses to shareholder pressure); *Hail, Shareholder!*, ECONOMIST, June 2, 2007, at 65; Hillary Jackson, *Raising Its Profile by Raising Its Standards*, INSTITUTIONAL INVESTOR, Dec. 2007, at 1; Louis Lavelle, *So That's Why Boards Are Waking Up: The Prospect of More Voting Power for Investors Has Companies Listening at Last*, BUS. WEEK, Jan. 19, 2004, at 72.

182. James J. Angel & Douglas M. McCabe, *The Ethics of Managerial Compensation: The Case of Executive Stock Options*, 78 J. BUS. ETHICS 225, 231 (2008); Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism:*

Perhaps ironically, the increasing tendency of institutional investors to opt out of class-action lawsuits and pursue remedies on their own suggests the ability of at least some shareholders to bring powerful influences upon corporate management.[183] Finally, the Delaware courts have made it crystal clear that, effective or not, shareholder voting is the aspect of corporate governance that legitimates the separation of ownership from control.[184] If public-corporation shareholders ever can sensibly be considered to have been innocent, these developments suggest that perhaps that innocence finally has been lost.

It appears that shareholders can be, and in some cases already are, a powerful force in corporate governance.[185] If one takes seriously even the narrowest shareholder role in electing boards, the case for the innocent shareholder begins to fade.[186] It diminishes further if one treats the class of shareholders as the primary, if not the sole, beneficiaries of managerial profit maximizing, the sole class of actors legally empowered to determine the composition of corporate boards and, through them, the sole class of actors that can select the management of

An Empirical Analysis, 32 J. CORP. L. 681 (2007); *see also* James D. Cox & Randall S. Thomas, *Does the Plaintiff Matter? An Empirical Analysis of Lead Plaintiffs in Securities Class Actions*, 106 COLUM. L. REV. 1587, 1605 (2006) (noting the desire of public pension funds, among other things, to improve financial reporting through corporate-governance reforms); James MacGregor & Ian Campbell, *Dealing with Investor Activism: Investors Seek Cash Returns from Pushing Your Buttons—There Are Things You Can Do to Prepare for an Attack*, 5 INT'L J. OF DISCLOSURE & GOVERNANCE 23 (2008) (describing how companies can circumvent activist proposals); Lawrence C. Strauss, *A Blueprint for Growth*, BARRON'S, Oct. 22, 2007, at 46 (predicting that companies will offer alternative assets to accommodate institutional investors); Warren de Wied, *New Year's Resolutions for Boards*, DIRECTORSHIP, Dec. 2006/Jan. 2007, at 44 (stating institutional investors are reluctant to wholly change board composition).

I am not here making the argument that such activism necessarily has been positive; only that it illustrates the power shareholders are capable of exerting.

183. Jonathan W. Miller et al., *Changing Face of Class Actions*, N.Y. L.J., July 9, 2007, at 10.

184. *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 659 (Del. Ch. 1988).

185. Brownstein & Kirman, *supra* note 178, at 23; *see also* MITCHELL, *supra* note 17, at ch. 7; Aaron A. Dhir, *Realigning the Corporate Building Blocks: Shareholder Proposals as a Vehicle for Achieving Corporate Social and Human Rights Accountability*, 43 AM. BUS. L.J. 365 (2006); Theresa A. Gabaldon, *Milberg Weiss: Of Studied Indifference and Dying of Shame*, 2 MD. J. BUS. & TECH. L. 207 (2007) (examining the problem with a particular focus on the law-firm context); Ian B. Lee, *Citizenship and the Corporation*, 34 LAW & SOC. INQUIRY (forthcoming 2009) (suggesting a significant, if limited, role for shareholder "citizenship" as a deliberative component of the corporate polity); Lee, *supra* note 5, at 31.

186. This is less so with respect to the possibility that those shareholders benefit from the corporation's fraud, a possibility the SEC has recognized in its decision to pursue damages against the corporation only when there has been an "improper benefit to shareholders." Press Release, SEC, *supra* note 4.

the most powerful private actors in our society. Those who are the principal beneficiaries of an institution and have the sole right to determine the governance of that institution, even by simple election of the board, cannot rightly be said to be innocent when governance fails, either because they have chosen to abdicate their power or because they have exercised it badly.[187] The innocent shareholder is, in fact, the irresponsible shareholder.

CONCLUSION

Shareholders can be seen as part of the mechanism by which managerial frauds are deterred, and seeking corporate compensation for these frauds is one tool by which they can operate.[188] A historical perspective of our views of the potential and reality of shareholder activism reveals the possibility that shareholders, through their governance potential, become part of the very enforcement regime designed to maintain market integrity.[189]

187. Goldschmid, *supra* note 5, at 666. I can think of no instance in American jurisprudence in which the abdication of, or misuse of, power by an empowered beneficiary leads us to treat that person as innocent. The opposite tends to be true. What follows is just a small sample of the cases that illustrate my point. For corporate directors: *Diedrick v. Helm*, 14 N.W.2d 913, 919 (Minn. 1944) (ruling on the accountability of corporate directors and officers for misuse of business information received by reason of their position in the corporation). For insurance law: *Van Riper v. Equitable Life Assur. Soc'y. of U.S.*, 561 F. Supp. 26, 33 (E.D. Pa. 1982) (ruling that an insurer may recover payments to the insured made as a result of fraud by the insured). For contract law: *Guarantee Title & Trust Co. v. Willis*, 297 P. 445, 448 (Ariz. 1931) (ruling that a decision of a person given certain powers under the contract may be challenged and set aside for fraud); *see also* E. Merrick Dodd, 9. U. CHI. L. REV. 538, 546 (1942) (reviewing MARSHALL E. DIMOCK & HAROLD K. HYDE, BUREAUCRACY AND TRUSTEESHIP IN LARGE CORPORATIONS (1940)) (stating that in the context of corporate managers, "[i]n any society which deserves to be called a civilization, power implies responsibility"); Joseph L. Weiner, *The Berle-Dodd Dialogue on the Concept of the Corporation*, 64 COLUM. L. REV. 1458 (1964).

188. Professor Langevoort has noted that my argument holds the purchasing shareholder, who might have been injured by fraud, to the same level of responsibility of the existing shareholders, and in this he is correct. While these shareholders might be doubly harmed, both from fraud in their purchases and the corporation's payment of damages, I believe that such a result would only heighten the incentives of shareholders to be attentive to the quality and integrity of corporate management.

189. My point is different from the standard argument that shareholders and their lawyers act as private attorneys general. It is instead a broader structural point about the allocation of responsibility both within individual corporations and the larger market deriving from the position and power of the actors. It no longer is legitimate to conceive of shareholders, any more than other powerful social forces, in a manner that allows them to abrogate their responsibilities. *See* Werner, *supra* note 168, at 389, 397 (noting the failure of corporate reformers to "recognize how significantly managers are

In addition to the compensation and deterrence rationales for stockholder class-action damages that underlie the circularity argument, we can perhaps add a new justification: the enhancement of shareholder responsibility. If the public corporation is to be treated as a private legal actor, it is the shareholders who benefit from its actions who hold the key to responsible corporate behavior, both in finance and in other matters as well. It is shareholders themselves who have the power and thus the responsibility to protect the integrity of our financial markets through their voting and trading. To deny this is, at best, to infantilize shareholders and, at worst, to let them off the hook for abdicating responsibilities that go with their privileges and indeed may be inseparable from their privileges. Finally, the role of the shareholder, and his or her presumed motivations for action, has important implications for the resolution of recent debates regarding corporate social responsibility.[190]

It may not yet be apparent how this reconciles the notion of innocent shareholders, doubly harmed by their own managers and the imposition of enterprise liability, with shareholder responsibility for their own fate, but such reconciliation is easy once one steps back from the problem. For the role of the shareholder, even more in our current market environment than at any time perhaps in our history, is to play a critical part in ensuring the integrity of our capital markets. The shareholder's participation in ensuring the integrity of our capital markets is in her careful election of directors and her monitoring the corporation's performance as a participant in the broader market.

influenced by the financial markets, particularly the stock market" and describing Berle's belief that "the market became the key to shareholder protection").

190. Lee, *supra* note 5, at 31. To be sure, I have not been an advocate for increased shareholder participation in corporate governance. My position has been based not only on my view of the superiority of directorial management, as others have well articulated, *see* Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735 (2006), but even more upon the adverse effects on business policy of an emasculated and unaccountable shareholder body subsumed into an increasingly irresponsible market. *See* MITCHELL, *supra* note 17, Chs. 6 & 7; Lawrence E. Mitchell, The Legitimate Rights of Public Shareholders (Mar. 2, 2009) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1352025. I am not here arguing for, nor do I suspect I would argue for, shareholder involvement in the actual management of the corporation. But a shareholder body that took even its limited responsibilities seriously and was held to account by law and society for its behavior might well be a class of shareholders that, at a minimum, deserved more say in the election of their corporations' directors. In any event, the current state of corporate law suggests that, regardless of my views or the views of others, shareholders are indeed gaining power. This development is sufficient in and of itself to call into question the shareholder paradigm on which the circularity argument is built.

This is not a role that would have been ascribed to shareholders in the 1930s. The shareholder- and market-protective laws passed during that decade were designed to rectify the circumstances in which shareholders regularly were defrauded by their managers, and especially their brokers. Such powerlessness as had been attributed to shareholders had been exacerbated by growing perceptions of managerial control, as well as the behavior that helped to bring about the Great Crash of 1929. But, even in those laws, one can see a role carved out for the responsible shareholder.

Antifraud protection was important. But front and center of the New Deal legislation was the notion that had developed at least since the latter part of the Wilson administration that fully informed shareholders could and would take care of themselves. As Wilson himself noted, endorsing a predecessor bill of the 1933 Act in his penultimate message to Congress, "The purchaser can often take care of himself if he knows the facts and influences he is dealing with; and purchasers are not disinclined to do anything, either singly or collectively, that may be necessary for their self-protection."[191]

Obviously fraud by its nature is not among the facts of which purchasers can be aware. But, and especially since the introduction of the proxy rules in 1943, purchasers and stockholders can be well aware of the men and women they elect to oversee the business of their corporations. Two men as different as Teddy Roosevelt and Louis Brandeis would agree; shareholders' failure to exercise their rights does not excuse them from responsibility for the consequences.

But there is another reason to see shareholders as the principal protectors of market integrity. Shareholders are the market. Thus, the corporate-governance power of appointing corporate overseers lies within the hands of the very same people who are to be protected from those corporate overseers. The greatest assurance of investor protection can therefore be seen to come from the shareholders themselves.

Modern finance theory has occluded this reality, even as it has played a substantial part in leading corporate law and, to an increasing extent, securities law, to leave shareholders to their own self-protection, reinforcing the notion that responsibility for the integrity of the market lies in the market. The problem is that finance theory largely has separated the shareholder from the corporation that issues her shares. Beginning with the notion that shareholders can self-protect through diversification, we have come to rely upon diversification as

191. Woodrow Wilson, *An Address to a Joint Session of Congress*, Aug. 8, 1919, *in* 62 WOODROW WILSON, THE PAPERS OF WOODROW WILSON 209, 214 (Arthur S. Link et al. eds., 1990).

the principal mode of shareholder protection.[192] At the same time, portfolio theory teaches shareholders not only to be indifferent about the corporations that have issued the shares they hold, but tells them that it is efficient for them to be so.[193] Finally, with the widespread acceptance of beta as a measure of risk, modern finance theory effectively cuts off the share from the corporation issuing it.[194] Portfolios are assembled as collections of betas, not as collections of corporations.[195]

Once we observe the effect of finance theory on our thinking about corporations, it is no surprise that we have so readily dismissed the idea of enterprise liability that harms innocent shareholders, and accepted arguments like the circularity argument that with such facility reject the wisdom of assessing damages against corporations. For our acceptance of modern finance theory has, in the ancient Greek sense, transformed the stockholder into an idiot. The shareholder is a nonparticipant in corporate society. This, perhaps, is why recent calls for greater shareholder participation in corporate affairs have been met with such puzzlement and even contempt.[196]

The path of reform is redirected if we accept the shareholder as responsible for the election, and therefore the conduct, of her corporation's directors and if we see that the real promise of increased market integrity is not in a larger SEC budget but in sustaining incentives, like corporate damages, to make shareholders assume this responsibility of which they are more capable perhaps than any other corporate actor. Rather than eliminate or cap securities class-action damages, we should enhance disclosure to be more revealing of who it is the shareholders are electing. At the moment, the identifying details of candidates are sterile. This could change if we were, for example, to require each director to include with the corporation's proxy materials a one-thousand word statement, written solely by the candidate (under pain of liability for fraud), describing that director's reasons for wanting to serve, perhaps some ideas about corporate direction, or even perhaps a few sentences on her ideas about the role of the director. If the director stands for reelection, the statement would be required to discuss the director's views on the corporation's progress over the last year. This would be far more personally revealing of the director and

192. *See Joy v. North*, 692 F.2d 880, 886 (2d Cir. 1982).

193. Lawrence E. Mitchell, *The Morals of the Marketplace: A Cautionary Essay for Our Time*, 20 STAN. L. & POL'Y REV. (forthcoming 2009).

194. Simply put, *beta* measures the relatively volatility of a stock's price in relationship to the market as a whole.

195. *Id.*

196. *See generally* Bebchuk, *supra* note 168.

would put her under a greater degree of public scrutiny than current disclosure obligations. I have no doubt that there are other processes to accomplish the same goal. Then, far more than now, shareholders will be able to elect real human beings and, in the next election, hold them accountable for their behavior in light of their statements. With significantly enhanced meaning in the kinds of disclosures that tell shareholders who their corporate directors are, shareholders will be increasingly less able to hide behind the idea that they somehow are innocent when directors misbehave and damages are assessed.

Such rethinking carves out a special place for the nontrading investors, the investors whose innocence Professor Donald Langevoort claimed "clinched" the argument against heavy corporate damages.[197] For it seems that the "buy and hold" investor, who might also be called the long-term shareholder, is for that reason even less innocent than the in-and-out investor or pure speculator. It is that class of shareholders who presumably has the greatest stake in managerial behavior, that class of shareholders who presumably has most carefully evaluated the investment, and that class of shareholders whose interest in, and attention to, the corporation should be greatest. It is for those reasons that this class of shareholders should be given the greatest incentives for ensuring the integrity of the market by the pain of corporate damages.

The market is only as good as its participants, and corporations, through their managers and shareholders, are the market's central participants. The managers, through the board of directors, serve at the sufferance of the market itself, constituted with respect to each corporation as the shareholders. Businessman Warren Buffett famously noted that managers get the shareholders they deserve.[198] The inverse is equally true. Shareholders get the managers they deserve, and the market they deserve as well.

197. Langevoort, *supra* note 4, at 650.

198. Landon Thomas, Jr., *Investment Banker and Client: A Bond Deepens*, N.Y. TIMES, Jan. 26, 2005, at C1.