Corporation Law and Securities Regulation

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The attention of this committee—and of many corporation lawyers—in the study or practice of what has been called “corporation law” has been focused almost exclusively upon state corporation statutes. The field of securities regulation is still regarded by many lawyers as a somewhat esoteric specialty concerned with the sale of new securities issues and regulation of stock exchange practices. The impact of securities regulation upon corporation law and practice and the effective taking-over, by securities regulations, of substantial areas that were previously considered the private domain of so-called “corporation law” has been too little recognized. A comparison of two modern casebooks, Baker & Cary on Corporations and Jennings and Marsh on Securities Regulation makes this point nicely. The Corporation casebook contains a substantial segment of material on proxy regulations of the Securities and Exchange Commission under the Securities Exchange Act, on the short-swing profit restrictions of Section 16(b) of the Securities Exchange Act and on fiduciary concepts and fraud prohibitions under rule 10b-5 issued pursuant to the Securities Exchange Act. The potential effect of rule 10b-5 in connection with fiduciary relations in corporate affairs (where a purchase or sale of securities is involved) and upon control over the internal affairs of corporations is indicated by the Commission’s statement that “the Securities Acts may be said to have generated a wholly new and far reaching body of federal corporation law.”1 The chairman of the Commission has also stated that “counsel must be aware of the rights and duties created by this jurisprudence and must appreciate its applicability to a two-man corporation as well as to A.T.&T.” In all probability, this federal influence will expand rather than contract.2

Thus the Corporation Law casebook recognizes the entry, in substantial significance and weight, of federal securities regulation into “corporation law.” Correspondingly, in the Securities Regulation casebook, the preface states that material with respect to Section 16(b) of the Securities Exchange Act of 1934 relating to insiders’ short-swing profits and with respect to proxy regulations under the same Act belongs in corporation law for consideration and therefore is not included in the Securities Regulation casebook. However, materials and cases related to rule 10b-5 are accorded a major place in the Securities Regulation casebook, just as they are in the Corporation Law casebook, thereby recognizing that this material is equally applicable to both fields. It is necessary for the corporation lawyer to follow the development of securities regulation insofar as it affects traditional areas of corporation law and to regard the rules, regulations, statutes and the administrative practices in the field of federal and state securities law as significant new sources of “corporation law.”

In states such as Illinois, Delaware and New York, and states which have adopted the Model Business Corporation Act, the basic theory of the statutes, in effect, is to set up enabling provisions to permit a corporation to act with considerable freedom, to forbid only certain egregious improprieties and to require only certain specified shareholder protections. Certain additional protective devices and arrangements have been imposed by the courts through fiduciary analogies and their application to corporate relationships. The trend in these corporation statutes and the decisions thereunder has generally been toward greater corporate flexibility and the reduction of restrictions and restraints; whether this is good or bad can be debated, but the existence of this tendency must be admitted.

The state securities or “blue-sky” laws were originally designed to prevent sale of securities on the basis of inadequate or fraudulent information or under terms of sale which would make their sale inequitable. The language of many statutes is broad enough to allow the administrator of the state blue-sky laws to deny a permit to sell securities within the state either (a) if the securities, or their price, is not fair, just and equitable or (b) if the sale of the securities is inequitable or fraudulent, or would tend to work a fraud. As blue-sky commission activity has, with the passage of time, become more rooted in our economic and legal structure, state commissions have begun to prohibit or restrict the sale of securities upon the finding that the sale is fraudulent or tends to work a fraud, if any significant aspect of the corporation’s internal relationships violate the commission’s standards of propriety. For example, if option warrants are granted to underwriters or if certain kinds of options are granted to officers or employees of the issuer, the existence or granting of such options is regarded as constituting a fraud or tending to create a fraud, even though there may be full disclosure of such options together with adequate disclosure of the possible impact by way of dilution upon exercise. Certain kinds of mal-distribution of voting rights may be similarly treated. Thus as the restrictions and restraints under corporation
statutes tend to be reduced, restrictions and restraints imposed through the state blue-sky laws are in the process of expanding.

Some commentators contend that the proper function of blue-sky laws is to supplement, amplify and repair the laxness of corporation laws. California has done so, in effect, and many other state blue-sky securities commissioners are beginning to veer toward the same philosophy, either by avowed action or by indirection.

Primarily through the expansion and application of rule 10b-5, as indicated by the Cady Roberts & Co. decision by the Securities and Exchange Commission, and by such court decisions as the Kardon case, a new presence, namely the federal securities laws, has been brought into the field of corporation law and a whole new set of standards and restraints have been imposed. Similarly, the proxy requirements of Section 14 and the short-swing insider profit rules of Section 16(b) of the Securities Exchange Act of 1934 have intervened directly in corporate activities and have created a new set of rules and requirements.

In addition to witnessing the advent of important new sources of corporation law, several interesting cross-currents and divergent movements in the corporate field are also discernible. At the same time there has been a reduction of restrictions and restraints in the corporation statutes, there has been an expansion and extension of restrictions and restraints in corporate rulings outside the statutes themselves. This latter expansion is taking place

1. through the growth of fiduciary concepts,

   (i) partly through the S. E. C.'s enforcement of the acts administered by it,

   (ii) partly through court decisions, and

   (iii) partly through the adoption of S. E. C. and trust fiduciary standards by courts, lawyers and businessmen, through analogy and example, even where such S. E. C. or trust fiduciary standards are not mandatorily applicable, and

3 See, Jennings, "The Role of the States in Corporate Regulation and Investor Protection," 23 Law and Contemporary Problems 193, at 207 (1958): "... Another method which has not been given the recognition which it deserves is that of using the state securities acts or 'blue-sky' laws as instruments of corporate regulation. The chief interest of the state in these matters is that of protecting its shareholders against unfair and inequitable share structures loaded in favor of promoters and managers. The time to check these arrangements is when the corporation proposes to issue or sell securities. Even a lax corporation statute may be strengthened by a strong 'blue-sky' law, and a more regulatory corporation statute can be buttressed by a fair but effective state securities statute. In this connection, it is important to consider the various types of blue-sky laws and their strengths and deficiencies as instruments for providing a greater measure of protection for shareholders against potential management abuses."


Corporation law is no longer only the law found in the corporation act to which a corporation is subject and the decisions thereunder; it must include the rules and regulations of the Securities and Exchange Commission, court decisions under the acts administered by the S. E. C. and also the rules and regulations of the state blue-sky commissioners of the various financial centers in which a corporation's securities may now, or later, be presented for sale.

In the case of the small company whose securities will never be sold to the public, the "corrective" effect of blue-sky laws will never be felt; in the case of the small or medium sized company whose securities will be presented to the public in a small offering in a limited area, the extent of such "corrective" effect will depend on the views and attitudes of the securities commissioners in the particular area involved; in the case of a nation-wide offering this "corrective" effect will cumulate all restraints imposed by any states whose business importance makes it mandatory that registration or qualification of the securities issued be effected therein.

Several further observations occur from those just stated. First, the so-called "corrective" effect of blue-sky laws in supplementing corporation laws has no effect on the small, closed corporation whose securities will not be sold to the public; correspondingly it has its greatest remedial effect upon companies whose securities are going to be offered widely to the public. This is suggestive of another trend in corporation law, namely, the trend toward providing different standards and rules for closed corporations as contrasted with publicly held corporations. It could well be argued that such "corrective" controls as the blue-sky laws afford should properly be limited to companies whose stock is offered to the public but should not apply to the closed corporation, where the general public is not involved. Second, this so-called "corrective" effect is infrequent, haphazard and fortuitous, because it is imposed only when securities offerings are made, which is very infrequent in almost all companies. Third, this so-called "corrective" effect is inapplicable (even with respect to large companies whose securities are offered to the public) where the corporate action, which would have been forbidden had it been taken prior to public sale of the securities, is instead taken subsequent to the public sale and after the state blue-sky laws are no longer applicable. An example is a subsequent amendment to the charter to modify a preferred stock right.

(This assumes that the action in question was not planned
before sale of the securities which would raise a problem of non-disclosure.) This kind of impropriety or unfairness, after sale of the securities, is controlled by California, which requires administrative approval of all such actions, but in other states it is left to the corporation act itself and to the courts. It would be possible for blue-sky commissioners in other states to deal with the possibility of such future unfairness by requiring, as a condition prerequisite to blue-sky registration, that the corporation shall commit itself to a series of stipulations as to future conduct. This of course emphasizes the fact that what is really being done is to impose a supplemental corporation act, by administrative fiat. Such action appears to me to raise the question of avoiding or undermining customary democratic legislative process. Many blue-sky commissioners are operating either under vague statutes which do not clearly give them all of the powers which they are actually exercising or which do not fix any meaningful standards for the exercise of such powers as are granted. Consequently extensive regulatory control is being exercised over the securities which may be offered to the public and over corporate practice by officials whose views cannot, as a practical matter, be reviewed by any court or appellate agency and who are undertaking to exercise powers which are either ambiguously granted to them or in some cases are arguably not conferred upon them at all. In the exercise of such powers they are in effect amplifying or expanding state corporation acts, by rules or by ad hoc determinations which are never considered by the legislative body which enacted such corporation acts. In many cases, such rulings remain unpublished or are not submitted to public scrutiny so that the building of a body of general doctrine and the ability of the Bar to comment upon such doctrine is impeded. When corporate practice is so controlled and so directed, by governmental action, it seems appropriate that such action should be done openly, publicly, and in customary legislative fashion, with public hearings and open consideration.

If it is desired to authorize the supplementing of corporation acts, perhaps it would be best to do so directly, clearly, and intentionally. If it is desired to distinguish between public and private corporations, perhaps it would be best to do so consciously and explicitly, in an appropriate manner, by official corporation act amendment. If it is desired to authorize the use of securities acts for the purpose of promulgating and enforcing regulation which is ancillary or supplementary to the corporation act, probably it would be best to discuss such matters in the legislature and, expressly and clearly, to enact provisions for such practices, after customary public legislative consideration. Although I personally look with a good deal of sympathy upon the adoption of such a system, I also personally feel that the integrity of the democratic process indicates that such a system should be authorized and adopted in the customary and formal fashion for decision of such matters, that is, by express legislative enactment after public scrutiny, hearing, and legislative action. I don't think that such a system—or even a federal law of corporations—should just grow "like Topsy" or should develop and ramify from language in a statute which may not have been intentionally directed to such an end, though it is agreeably susceptible of such interpretation. The corporation statutes, which purport to provide for specific permissible and impermissible structures and procedures, have a primary and important purpose. In most instances, securities acts are directed at different practices and other purposes; where a securities act, such as the Securities Exchange Act of 1934, is expressly directed at such problems as insider short-swing trading prohibitions or proxy regulations it is quite explicit, direct and circumscribed. Unless it is quite clearly the public legislative decision to commit the promulgation of "corporation" rulings to the hands of a securities agency, state or federal, then there is much reason to doubt the wisdom of allowing such action to be taken in an indirect manner, disconnected from corporation statutes, however beneficent, wise or desirable the actual rulings may be.

I do not want, by these remarks, to imply any personal disagreement with the specific results of various securities rulings by either federal or state agencies. I usually find myself a strong supporter of such rulings. I do, however, want to call attention to the fact that the field of securities regulation is now providing important new sources of law in the area of traditional corporation law and also to raise the question of the legal and political desirability of the present manner of promulgating such new "corporation" law.