TAX, CORPORATE GOVERNANCE, AND NORMS

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This paper examines the use of federal tax provisions to effect changes in state law corporate governance. There is a growing academic controversy over these provisions, fueled in part by their popularity among legislators as a method of addressing the recent spate of corporate scandals. In order to better understand and distinguish between the possible uses of tax as a tool of corporate governance, this paper takes a historical approach by focusing on two measures enacted during the New Deal – the undistributed profits tax in 1936 and the overhaul of the tax-free reorganization provisions in 1934 – and considers why the former was so much more controversial and less sustainable than the latter. While some of the difference can be explained by the different political and economic circumstances surrounding each proposal, this paper argues that the divergence in the degree of opposition can be explained in part by an examination of the extent to which each provision threatened an underlying norm, or longstanding standard, of corporate behavior. The paper goes on to test this norms-based explanation against several recent attempts to enact corporate governance-oriented tax provisions and concludes that it has modern relevance. The implication is that while Congress may use the Tax Code to reinforce existing norms of corporate behavior, it is likely to be less successful when it tries to use the Code to change existing norms or introduce new ones.

I. INTRODUCTION

President Bush's proposal to end double taxation, which was justified in part because it would increase dividends and thereby improve corporate "accountability,"[1] was only the latest example of the federal government's effort to use the Internal Revenue Code as a tool to modify corporate behavior. In recent years, Congress has enacted or introduced a number of corporate governance-motivated tax provisions – from limiting deductions for allegedly excessive executive compensation and imposing excise taxes on the receipt of so-called "greenmail" payments during takeovers to denying deductions both for stock options that have been expensed

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[1] U.S. Treasury, *Eliminate the Double Taxation of Corporate Earnings*, *available at* http://www.ustreas.gov/press/releases/docs/bluebook.pdf (last visited February 2, 2004) ("[T]he proposal will enhance corporate governance by eliminating the current bias against the payment of dividends. Dividends can provide evidence of a corporation's underlying financial health and enable investors to evaluate more readily a corporation's financial condition. This, in turn, increases the accountability of corporate management to its investors.").

for accounting purposes and for punitive damage payments.[2] In fact, almost since the inception of the corporate income tax, Congress has recognized its potential to serve as a de facto system of federal corporate law. Proponents of the earliest corporate income tax in 1894 predicted that one of its benefits would be the "salutary" influence it would have on corporations by establishing a means of federal oversight.[3] When President Taft later proposed an excise tax on corporations in 1909, he noted that one of the merits of the tax was "the federal supervision which must be exercised in order to make the law effective over the annual accounts and business transactions of all corporations."[4] Federal taxation was a means to preempt the traditional state role in the regulation of corporations without actually establishing a system of federal incorporation.[5]

Despite its long history, the attempt to regulate corporations through the tax system has had only mixed results. In many cases, Congress' corporate governance-motivated tax reform efforts have failed miserably. This is not to say that tax reform has failed to actually modify corporate behavior for at least a brief time, although this may be the case in some instances. Rather many of the tax provisions introduced or enacted as part of a corporate governance reform effort have simply failed, in the words of Mark Roe, to "survive" in the face of fierce corporate

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[2] *See, e.g.*, I.R.C. §§ 162(m) (limiting the deductibility of non-performance based executive compensation to $1 million); 5881 (levying an excise tax on the receipt of "greenmail," or above-market payments by target management to a shareholder mounting a hostile takeover bid); 280G & 4999 (disallowing deductions of certain "golden parachute" payments, or payments to departing target executives upon a change of control, and imposing an excise tax on their receipt); *Ending the Double Standard for Stock Options Act:* S. 1940, 107th Cong. (2002) (bill introduced by Senators Carl Levin (D-Mich.) and John McCain (R.-Ariz.) to only allow corporations to deduct nonqualified stock options to the extent of the amount treated as expenses for purposes of reporting earnings); *Jumpstart Our Business Strength (JOBS) Act*: S. 1637, 108th Cong. (2003) (bill introduced by Senators Charles Grassley (R.-Iowa) and Max Baucus (D-Mont.) to, among other things, end deductibility for punitive damages and to require CEO signatures on tax returns). Treasury has not always been a willing partner in Congress' decision to use the Tax Code as a tool to influence corporate governance. *See* Sheryl Stratton, *Treasury: Fix Executive Comp Abuse But Lay Off the Tax Code*, 99 TAX NOTES 191 (2003) (reporting on comments made by Assistant Treasury Secretary for Tax Policy Pamela F. Olson in opposition to efforts to use the Code to combat Enron executive's abuse of the compensation system).

The U.S. is not alone in its effort to use the tax system as a tool of corporate governance. During the post-World War II-era, the U.K. has instituted no less than four major reforms of the corporate tax system that can be traced back to the desire to influence corporate behavior. *See* MERVYN KING, PUBLIC POLICY AND THE CORPORATION 5 (1977); SVEN STEINMO, TAXATION AND DEMOCRACY: SWEDISH, BRITISH, AND AMERICAN APPROACHES TO FINANCING THE MODERN STATE 47-48 (1993).

[3] William L. Wilson, *The Income Tax on Corporations*, 158 N. AM. L. REV. 7 (1894) (Wilson was the chairman of the House Ways & Means Committee).

[4] 44 CONG. REC. 3344 (1909) (message from President Taft). *See also* Marjorie E. Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 66 IND. L.J. 3 (1990).

[5] This is not to suggest that federal incorporation itself has never been considered. Progressive-era reformers called for an explicit federal incorporation requirement in the face of a perceived decline in state corporation laws, but such proposals were defeated. *See* MARTIN J. SKLAR, THE CORPORATE RECONSTRUCTION OF AMERICAN CAPITALISM, 1890-1916 203-85 (1988); Theodore H. Davis, Jr., Comment, *Corporate Privileges for the Public Benefit: The Progressive Federal Incorporation Movement and the Modern Regulatory State*, 77 VA. L. REV. 603, 622-23 (1991). In large part, the securities laws enacted in 1933 and 1934 served as a de facto federal corporations law. *See* Robert B. Thompson & Hilary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859, 869 (2003).

resistance.[6] If they survived enactment and were not technically repealed within a few years, they have been effectively rendered useless or counterproductive and their continued existence has been the subject of much criticism.[7]

Notwithstanding such criticism, recent observers suggest that in some cases tax can be an effective ally in the fight to reform corporate governance. David Schizer, for example, argued that a variety of tax rules have served as an effective hindrance to executive hedging transactions.[8] Reuven Avi-Yonah goes further, arguing that the corporate tax, and, by implication corporate rates, can be used "to control the excessive accumulation of power in the hands of corporate management."[9] This normative conclusion draws support from recent studies in the economics literature that demonstrate the corporate governance benefits of strong tax enforcement by reducing the level of "managerial diversion" of corporate assets.[10] Given the existing political support and academic controversy surrounding the use of tax as a tool of corporate governance, the challenge is to more fully investigate whether some corporate governance-motivated tax reforms may be better positioned to succeed than others.

Perhaps the best prism through which to understand the use of taxation to modify corporate behavior is the experience of the New Deal. Not only does it have the advantage of historical distance, but the New Deal is replete with examples of corporate governance-oriented tax provisions. During a relatively brief period of time, Congress embarked on an ambitious, but ultimately unsuccessful, campaign to change corporate behavior through tax reform.[11] Thus, between 1932 and 1936, legislators enacted or attempted to enact tax provisions designed to restrict the growth of large corporations,[12] to eliminate the holding company structure,[13] to lower

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[6] *See* MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE 118 (1994).

[7] *See, e.g.*, David I. Walker, *Tax Incentives Will Not Close Stock Option Accounting Gap*, TAX NOTES 851 (2002); Susan J. Stabile, *Is There a Role for Tax Law in Policing Executive Compensation*, 72 ST. JOHN'S L. REV. 81, 90-92 (1998); Kurt Hartmann, *Comment, The Market for Corporate Confusion: Federal Attempts to Regulate the Market for Corporate Control Through the Federal Tax Code*, 6 DEPAUL BUS. L.J. 159, 199 (1993); James R. Repetti, *Corporate Governance and Stockholder Abdication: Missing Factors in Tax Policy Analysis*, 67 NOTRE DAME L. REV. 971, 974 (1992); Eric A. Lustig, *The Emerging Role of the Federal Tax Law in Regulating Hostile Corporate Takeover Defenses: The New Section 5881 Excise Tax on Greenmail*, 40 U. FLA. L. REV. 789, 792 (1988).

[8] *See* David Schizer, *Executives and Hedging: The Fragile Legal Foundation of Incentive Compatibility*, 100 COLUM. L. REV. 440, 446 (2000) (noting the corporate governance benefits of certain tax barriers to executive hedging transactions).

[9] Reuven S. Avi-Yonah, *Corporations, Society and the State: A Defense of the Corporate Tax* 65 (unpublished manuscript 2003).

[10] *See* Mihir Desai et al., *The Protecting Hand: Taxation and Corporate Governance* 2 (March 2003) (unpublished manuscript).

[11] *See* COMMITTEE ON TAXATION OF THE TWENTIETH CENTURY FUND, INC., FACING THE TAX PROBLEM: A SURVEY OF TAXATION IN THE UNITED STATES AND A PROGRAM FOR THE FUTURE 153-87 (1937) ("Twentieth Century Fund") (surveying, in a chapter entitled "Control of Business Organization and Practices," the New Deal program for the regulation of corporations through the tax laws); MARK H. LEFF, THE LIMITS OF SYMBOLIC REFORM: THE NEW DEAL AND TAXATION, 1933-1939 74-90 (1984).

[12] *See* Revenue Act of 1935, §102(a), 49 Stat. 1014 (graduated marginal rates on corporations).

[13] *See id.* at § 102(h) (reducing the dividends received deduction from one hundred to ninety percent); Revenue Act of 1936, § 26(b), 49 Stat. 1648 (reducing the dividends received deduction to eighty-five percent); Revenue Act of 1932, §

the amount of executive compensation,[14] to force the distribution of dividends,[15] and to minimize mergers, acquisitions, and other business combinations.[16] While some of these corporate governance-motivated proposals were enacted amid only mild opposition and remain a part of the Code to this day,[17] most were either rejected immediately or were repealed within a few years.[18]

As a case study on the use of tax provisions to regulate corporate governance, this Article compares and contrasts two New Deal-era corporate tax provisions – the proposed abolition and eventual overhaul of the tax-free reorganization provisions in the Revenue Act of 1934 and the enactment of an undistributed profits tax in the Revenue Act of 1936 – where managerial resistance spelled the difference between success and failure. The proposal to abolish or radically alter the reorganization provisions, which governed the tax treatment of stock and property received in mergers, consolidations, and other business combinations, aroused only limited managerial opposition and the resulting provisions have survived virtually intact to this day. The undistributed profits tax, on the other hand, was the target of a vigorous lobbying campaign and was repealed after only a few years. Although both provisions were at least partially justified on tax policy grounds, they had significant and publicly acknowledged implications for corporate governance and for the independence of managers vis-à-vis their shareholders. In the former case, elimination or tightening of the tax-free reorganization provisions as part of an effort to restrict excessive business combinations potentially limited a manager's ability to expand his business through acquisitions. In the latter case, an undistributed profits tax designed to prevent corporate "hoarding" of earnings and profits restricted the free cash flow managers' counted on for capital projects and cash acquisitions. Managerial opposition to both proposals may reflect the problems associated with the shareholders' delegation of authority to an agent – the manager – who is imbued with self-interest,[19] but agency cost theory does not entirely explain the discrepancy in the degree of opposition. The question is why managers reacted so differently to what appear to be similar threats to managerial independence.

While changes in the underlying political and economic environment played a role, this Article suggests that the divergent reactions can at least partly be attributed to the extent to which

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141(c) (additional tax of three-quarters of one percent for filing a consolidated return); National Industrial Recovery Act of 1933, § 217(e) (raising the additional tax on consolidated returns to one percent); Revenue Act of 1934, § 141 (raising the additional tax on consolidated returns to two percent for railroad corporations and abolishing the right to file consolidated returns for all other corporations).

[14] *See* LEFF, *supra* note 11, at 87-89 (describing serious proposals in 1932 and 1934 to erect tax limits on executive salaries).

[15] *See* Revenue Act of 1936, § 14(b), 49 Stat. 1648, 1656 (undistributed profits tax).

[16] *See infra* text accompanying notes 83-143.

[17] *See, e.g.*, I.R.C. §§ 368 (tax-free reorganization provision), 243 (less than 100% exemption for dividends received by some corporate shareholders), 11 (graduated marginal rate on corporations).

[18] *See, e.g.*, the abolition of the consolidated return and the imposition of an undistributed profits tax.

[19] For a general discussion of the agency cost problem in the economics and finance literature, *see* Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323 (1986); Frank H. Easterbrook, *Two Agency-Cost Explanations of Dividends*, 74 AM. ECON. REV. 650 (1984); Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

each particular proposal threatened an underlying norm of corporate behavior.[20] In the case of reorganizations, Congress sought to influence transactions that were already regulated by both a corporation's by-laws and the laws of the state of incorporation. All major acquisitions or sales were subject to unanimous shareholder approval in the early years of the corporation; by 1934, at least majority approval was still necessary. Moreover, federal antitrust laws served as an additional constraint on merger activity. Thus, there was no norm supporting a manger's unfettered discretion to engage in acquisitive transactions or to structure such transactions in the manner most suitable to the manager's needs. By contrast, dividends had always been a matter of discretion for a corporation's board of directors. While shareholders could seek redress for an abuse of that discretion, directors were given wide latitude. Under then-existing norms, it was considered prudent business practice to retain between thirty and fifty cents of every dollar earned.[21] Although some larger corporations already distributed in excess of that amount and the undistributed profits tax as passed was designed to permit corporations to retain a significant percentage of profits before the penalty tax was imposed, businesses of all sizes were concerned about the threat to their control over corporate finances. Therefore, while both provisions were opposed in part because they were potentially adverse to manager interests, one reason the undistributed profits tax was resisted much more strongly was because it threatened the long-standing norm of managerial control over a corporation's finances.

This corporate norms-based explanation of managerial resistance provides valuable insights for the use of tax as a tool of corporate governance. The implication is that tax measures may reinforce existing norms, but are less likely to be successful in establishing new ones. This may explain the fact that while most modern provisions have been nullified by managerial opposition,[22] some have been more accepted and therefore effective.[23] Analyzing the underlying norms threatened may also help provide a more reasoned basis for further use of the Code as a tool to regulate corporate governance. In Part I and II, the Article chronicles the development of the reorganization provision and undistributed profits tax proposals, respectively, considering both their legislative histories and the managerial resistance at each stage. In Part III, the Article explores the possible reasons why the two provisions took such divergent paths. While

[20] There has been a recent explosion of interest among corporate law scholars in the field of norm theory. *See Symposium: Norms & Corporate Law*, 149 U. PA. L. REV. 1607 (2001). The term "norms" in this literature is generally intended to denote non-legally enforceable conventions of behavior. *But See* Edward B. Rock & Michael L. Wachter, *Introduction, Symposium: Norms and Corporate Law*, 149 U. PA. L. REV. 1607, 1612-13 (2001) (suggesting that legal scholars have used the term to refer to both legally and non-legally enforceable arrangements and suggesting replacing the term "norms" with the phrase "nonlegally enforceable rules and standards" to end the confusion). In the context of this article, however, the use of the term "norms" is meant to convey non-tax law conventions governing the behavior of managers. Thus, it may mean both non-legally enforceable norms of manager behavior, such as those dictated by market expectations, as well as legally enforceable norms, such as judicial decisions or state and federal corporate laws governing corporate activity and manager discretion.

[21] *See* SERGEI DOBROVOLSKY, CORPORATE INCOME RETENTION 1915-1943 13 (1951).

[22] *See* Bruce A. Wolk, *The Golden Parachute Provisions: Time for Repeal?*, 21 VA. TAX REV. 125, 127 (2001); Steven A. Bank, *Devaluing Reform: The Derivatives Market and Executive Compensation,* 7 DEPAUL BUS. L. J. 301, 332 (1995) ("Devaluing Reform").

[23] *See* Schizer, *supra* note 8, at 466.

acknowledging the political and economic changes between 1934 and 1936, the Article focuses on a previously unexplored phenomenon – the nature and status of the underlying corporate behavior each proposal sought to regulate. The Article concludes by examining the possible implications this analysis may have for modern attempts to use the Code to influence corporate behavior.

II. TAX-FREE REORGANIZATION PROVISIONS

A. *Early history*

The tax treatment of the participants to a merger, consolidation, or other reorganization was an open question when the first post-Sixteenth Amendment income tax was adopted in 1913.[24] Shareholders claimed that the exchange of stock in a business combination was a change in form rather than substance, but nothing in the 1913 Act precluded their taxation.[25] Treasury officials initially appeared to side with shareholders,[26] but soon issued regulations providing that exchanges of property for stock might be taxable in certain circumstances.[27] Congress eventually resolved the issue as part of a general compromise over the timing of realization in property exchanges.[28] Under § 202(b) of the Revenue Act of 1918, reorganizations were deemed realization events, but any gain or loss was deferred until a subsequent taxable sale.[29] Although this established the principle of the tax-free reorganization, the provision was flawed in several respects.[30] Most notably, nonrecognition treatment was limited to exchanges of stock having equal par values and the provision failed to define the term "reorganization."[31]

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[24] Tariff Act of 1913, ch. 16, 38 Stat. 114.
[25] *See* RANDOLPH E. PAUL, STUDIES IN FEDERAL TAXATION: THIRD SERIES 8 (1940); Homer Hendricks, *Federal Income Tax: Definition of "Reorganization,"* 45 HARV. L. REV. 648, 648 n.1 (1931); Hugh Satterlee, *The Income Tax Definition of Reorganization*, 12 TAX MAG. 639, 639 (1934).
[26] *See* GEORGE E. HOLMES, FEDERAL INCOME AND PROFITS TAXES 262 n.20 (1920) (citing Letter from Treasury Dep't, Mar. 8, 1917; I.T.S. 1918, par. 1302).
[27] Treas. Reg. 33 (revised), arts. 101, 118, 119 (1918), 20 Treas. Dec. Int. Rev. 182, 187-88 (1918).
[28] The compromise was between proponents of the consumption and accretion models of taxation. The accretion model suggested annual taxation of increases in value, while the consumption model approved taxation only upon a sale in which the proceeds were not reinvested. Shareholders claimed that the former option would work an injustice because any gains realized were only "paper" gains, while Congress feared that the latter option would permit virtually indefinite deferral of taxation. The reorganization provisions struck a balance between these two approaches by acknowledging the paper gain problem, while recognizing that most types of property exchanges were taxable. *See* Steven A. Bank, *Mergers, Taxes, and Historical Realism*, 75 TUL. L. REV. 1, 62-63 (2000) ("Mergers").
[29] Revenue Act of 1918, ch. 18, § 202(b), 40 Stat. 1058 (1919) ("[W]hen in connection with the reorganization, merger, or consolidation of a corporation a person receives in place owned by him new stock or securities of no greater aggregate par or face value, no gain or loss shall be deemed to occur from the exchange, and the new stock or securities received shall be treated as taking the place of the stock, securities, or property exchanged.").
[30] *See* Steven A. Bank, *Taxing Divisive and Disregarded Mergers*, 34 GA. L. REV. 1523, 1550-51 (2000).
[31] Id. Treasury attempted to address the latter flaw by issuing a regulation that outlined the types of transactions that were eligible for nonrecognition treatment under § 202(b). Under Treas. Reg. § 45, nonrecognition treatment was available for transactions "where two (or more) corporations unite their properties by either (a) the dissolution of

The deficiencies in the first reorganization provision greatly limited its usefulness. As one practitioner later recalled, "[t]he 1918 provisions were impracticable in operation; the then status of the law was such as to hamper necessary business adjustments."[32] This problem did not escape Congress' attention. In his testimony before the Senate Finance Committee in September of 1921, Dr. T.S. Adams, an economic advisor to the Treasury Department,[33] noted that "the principal defect of the present law is in blocking desirable business readjustments."[34] According to Adams, "[a]ll kinds of business readjustments had been stopped" due to the fear of being subject to taxation and transaction activity would continue to stall without clarifying and liberalizing the reorganization provisions.[35]

In the context of a post-World War I economic downturn, the concerns about a threat to business reorganizations were understandable. A sharp drop in the artificially high wartime prices, especially in the agricultural sector, ushered in an economic downturn between 1920 and 1922 that has been referred to as "the last of the 'depressions' before the catastrophe of 1929 occurred."[36] During 1921 alone, approximately 20,000 companies closed and almost five million individuals were unemployed.[37] A House Ways and Means Committee Report remarked that "the exacting of the present excessive sums of taxes from the country contributes in no small degree to the depressing influences under which business and industry in general are staggering as an aftermath of the World War."[38] The Committee explained that the financial ravages of war are felt most acutely "after the cessation of hostilities, at which time the demand for war supplies terminates, with a resulting shrinkage of values. The Nation is now passing through the trying period of liquidation and readjustment. The reduction of the tax burdens is essential to business recovery."[39]

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corporation B and the sale of its assets to corporation A, or (b) the sale of its property by B to A and the dissolution of B, or (c) the sale of the stock of B to A and the dissolution of B, or (d) the merger of B into A, or (e) the consolidation of the corporations." Treas. Reg. § 45, art. 1567, 21 Treas. Dec. Int. Rev. 170, 395. This was consistent with the prevailing understanding of the term in the non-bankruptcy context. *See* Eric L. Kohler, *Reorganizations and the Federal Income Tax Law,* 4 NAT'L INCOME TAX MAG. 161, 161 (May 1926) ("The current use of the term is reflected in part by the definition offered seventeen years ago by Thomas W. Lamont: 'a decision brought about usually by a company's success, to enlarge it, to recapitalize it, or to amalgamate it with some other corporation or corporations.").

[32] Hendricks, *supra* note 25, at 648 n.1.

[33] Adams, a professor of political economy at Yale, is sometimes called the "father of the 1921 Act." Ronald H. Jensen, *Of Form and Substance: Tax-Free Incorporations and Other Transactions Under Section 351*, 11 VA. TAX REV. 349, 383 n.117 (1991). He was the principal Treasury spokesperson before Congress on tax legislation and was considered one of the foremost tax and public finance theorists of his day. *See* Michael J. Graetz & Michael M. O'Hear, *The "Original Intent" of U.S. International Taxation,* 46 DUKE L.J. 1021, 1029-30 (1997).

[34] *Hearings on H.R. 8245 Before the Senate Comm. on Fin*., 67th Cong. 29 (1921) (statement of Dr. T.S. Adams, advisor to the Treasury Department).

[35] *Id*.

[36] CHARLES R. GEISST, WALL STREET: A HISTORY 155 (1997). *See also* PAUL, *supra* note 25, at 21; CHARLES A. BEARD & MARY R. BEARD, I AMERICA IN MIDPASSAGE 28 (1939); Jensen, supra note 33, at 386 n.126.

[37] Jensen, supra note 33, at 386 n.126.

[38] H.R. REP. NO. 350, 67th Cong., 1st Sess. (1921), *reprinted in* 1939-1 C.B. 168.

[39] *Id*.

Furthermore, merger activity began to slow during this economic downturn. Although the number and size of firms absorbed by merger increased steadily in 1919 and 1920,[40] "the pace of merger activity subsided somewhat in the depression of 1921."[41] It did not truly resume its upward slope after this interruption until the mid-1920s.[42] Sheldon Cohen, a former commissioner of the Internal Revenue Service, concluded that "[i]n this historical context it is not at all surprising that preferential treatment was accorded corporate mergers and consolidations on the assumption that the provisions would" encourage business reorganizations.[43]

Thus, in the Revenue Act of 1921,[44] Congress amended the reorganization provision to address some of business' concerns.[45] Under § 202(c)(2) of the 1921 Act, "reorganization" was defined to include "a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or of substantially all the properties of another corporation), recapitalization, or mere change in identity, form, or place of organization of a corporation (however effected)."[46] While this definition was itself flawed because it failed to specify the permissible consideration in such transactions,[47] from the perspective of business it was a vast improvement over the 1918 version. As both the House Ways and Means and Senate Finance Committees emphasized in their respective reports on the 1921 Act, the revised reorganization provision "will, by removing a source of grave uncertainty . . . permit business to go forward with the readjustments required by existing conditions."[48]

The liberalization of the reorganization provisions continued in subsequent revenue acts.[49] The Revenue Act of 1924 expanded the definition of reorganization to include spin-offs

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[40] RALPH L. NELSON, MERGER MOVEMENTS IN AMERICAN INDUSTRY 1895-1956 37 tbl. 14.

[41] J. KEITH BUTTERS ET AL., EFFECTS OF TAXATION: CORPORATE MERGERS 292 (1951).

[42] JOHN M. BLAIR, ECONOMIC CONCENTRATION: STRUCTURE, BEHAVIOR AND PUBLIC POLICY 264 (1972).

[43] Sheldon S. Cohen, *Conglomerate Mergers and Taxation*, 55 A.B.A. J. 41 (1969). The 1921 decision to create a better environment for mergers and acquisitions should be distinguished from the 1918 decision to provide nonrecognition treatment for reorganizations, which was based on the realization compromise between consumption and accretion tax visions of the income tax system. *See* Bank, Mergers, *supra* note 28, at 28-34.

[44] Revenue Act of 1921, ch. 136, 42 Stat. 227.

[45] During the debates on a proposed amendment to the reorganization provision, one senator noted that "when so much reorganization is going on in the business world, it is thought by all those interested in the upbuilding of the industries of the country at this time that this is a very helpful provision." 61 CONG. REC. 6563 (1921) (statement of Sen. Watson regarding the removal of a provision requiring stock to be of equal par value to qualify for nonrecognition treatment).

[46] *Id*. at § 202(c)(2).

[47] One commentator referred to this omission as a "blunder of draftsmanship." Valentine Brookes, *The Continuity of Interest in Reorganizations – A Blessing or a Curse*, 34 CALIF. L. REV. 1, 5-6 (1946).

[48] H.R. REP. NO. 67-350, at 10 (1921), *reprinted in* 1939-1 C.B. 168, 176; S. REP. NO. 67-275, at 11 (1921), *reprinted in* 1939-1 C.B. 181, 189.

[49] *See* Roswell Magill, Effect of Taxation on Corporate Policies, 72 U.S. L. Rev. 637, 639 (1938) ("[I]n the early twenties, Congress regarded business reorganizations as frequently desirable and often necessary. Hence, successive revenue laws contained increasingly liberal provisions, to permit corporations and stockholders to carry through tax-free, not only the kinds of reorganizations which the Supreme Court had passed upon, but a number of other kinds."); *Income Tax on Corporate Reorganization*, 2 N.Y. L. REV. 387, 390 (1924) ("The present statute, as well as that of 1921, was obviously designed to promulgate a policy more liberal to the taxpayer.").

and split-offs.[50] One member of the House Ways and Means Committee explained to Congress that this amendment was inserted "to include other usual forms of corporate reorganizations in the advance of business, such as the splitting of one corporation into two or more corporations, which I may say under the present law would not be permitted except by forming two entirely new corporations."[51] The 1924 Act also formally extended the exemption from taxation to corporations so that they received the benefit of nonrecognition of any gain.[52] Although a Treasury interpretation had concluded that corporations were exempt under the 1921 Act, the Senate Finance Committee explained that "[t]he present ruling of the Treasury Department on this question is of doubtful legality and a statutory provision is most necessary."[53] This expansion was designed to further remove any limits placed on business readjustments by the tax law. The House Ways and Means Committee explained that nonrecognition treatment was granted in order to permit "ordinary business transactions" to go forward free from tax constraints and "[i]f it is necessary for this reason to exempt from tax the gain realized by the stockholders, it is even more necessary to exempt from tax the gain realized by the corporation."[54] Finally, and perhaps most importantly, the 1924 Act refined the definition of reorganization to make it exclusive for tax purposes.[55] This helped to provide the certainty businesses sought before engaging in reorganizations.

There were two problems with the liberalization of the reorganization provisions. First, it may have worked too well in encouraging businesses to combine. One practitioner noted that reorganizations became "almost, if not actually, a fetish with many business men and certain short-sighted, so-called tax counselors."[56] This contributed to a marked increase in business combinations. Of the 92 active holding companies whose stock was listed on the New York Stock Exchange in 1928, 66 had been granted charters since 1910 and, of those companies, at

[50] Revenue Act of 1924, 43 Stat. 253 (June 2, 1924), § 203(h)(1) (the term "reorganization means (B) a transfer by a corporation of all or part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred"). A "spin-off" involves a contribution by a corporation of some or all of its assets to another corporation, followed by a distribution of the stock of that corporation to all of the first corporation's existing shareholders as a dividend. A "split-off" is the same transaction as a spin-off except instead of distributing the new corporation's stock as a dividend, the stock is distributed to certain of the first corporation's shareholders in exchange for their stock in the original corporation. The result is two separate corporations with two separate groups of shareholders. *See* 1 MARTIN D. GINSBURG & JACK S. LEVIN, MERGERS, ACQUISITIONS, AND BUYOUTS par. 1001 (2001).

[51] 65 CONG. REC. 2429 (1924) (statement of Rep. Green).

[52] *See* Revenue Act of 1924, 43 Stat. 253 (June 2, 1924), § 203(b)(3) ("No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of a plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.").

[53] S. REP. NO. 398, 68th Cong., 1st Sess (1924), *reprinted in* 1939-1 C.B. at 276. *See also* Milton Sandberg, *The Income Tax Subsidy to "Reorganizations,"* 38 COLUM. L. REV. 98, 102-03 (1938). A regulation promulgated under the 1921 Act had construed the reorganization provisions so as to exempt corporations as well as their shareholders. Treas. Reg. 62, Art. 1566(b), 24 Treas. Dec. Int. Rev. 499-500 (1922).

[54] H.R. REP. NO. 179, 68th Cong., 1st Sess. (1924), *reprinted in* 1939-1 C.B. at 250.

[55] The 1924 Act replaced the phrase "the word 'reorganization' includes . . .," with the phrase "the word 'reorganization' means . . .." 43 Stat. 257.

[56] Kohler, *supra* note 31, at 180.

least 34 had received their charters between 1923 and 1928.[57] Furthermore, during 1928 and 1929, mergers were occurring at a far more rapid pace than at the beginning of the decade or at any time during the more famous merger movement at the turn-of-the-century.[58] Of the 8500 acquisitions of formerly independent manufacturing and mining businesses between the end of World War I and the end of 1931, more than 4800 occurred between 1926 and 1930 and almost 2300 disappeared in 1928 and 1929 alone.[59]

Economic concentration accompanied this revived period of merger and consolidation. Between 1922 and 1929, there were eight mergers valued at over $100 million and at least fourteen transactions in which the target corporation had assets valued at over $50 million.[60] By 1932, Adolf Berle and Gardiner Means reported that "perhaps two-thirds of the industrial wealth of the country [has passed] from individual ownership to ownership by large, publicly-financed corporations."[61] In his famous dissent in the Louis K. Ligget case, Justice Brandeis described the extent of this economic concentration: "200 nonbanking corporations, each with assets in excess of $90,000,000, control directly about one-fourth of all our national wealth."[62] One study concluded that "the merger movement of the 1920s not only significantly increased over-all levels of concentration but did so to a substantial extent" in certain key industry groups.[63]

After the stock market crash in October of 1929, there was a tendency to place at least part of the blame for the ensuing economic crisis on the "excessive" business combinations and resulting economic concentration of the 1920s.[64] As Paul Conkin reports, this blame was probably misplaced. "Numerous corporate consolidations increased efficiency even as they narrowed participation in key managerial choices."[65] The broad impact of the crash, however, made the reality irrelevant for a Congress seeking to blunt its bitter effects. "The statutes which 'permitted necessary business adjustments' in 1921" became from the post-Crash perspective of the 1930s, "one of the major and indispensable forces in the thrust towards economic concentration which characterized the 'twenties."[66]

Second, the liberalized reorganization provisions opened the door to reorganizations motivated primarily by a desire to reduce taxes. This was primarily due to poor drafting – the reorganization provisions were overly detailed and yet still ambiguous in important ways. Although the Revenue Act of 1921 included what legislators thought to be "comprehensive" reorganization provisions, taxpayers soon took advantage of the many deficiencies and gaps in

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[57] *See* ADOLF A. BERLE, JR. AND GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 206 n. 18 (1932).
[58] BUTTERS ET AL., *supra* note 41, at 292.
[59] *Id*.
[60] *Id*. at 294.
[61] BERLE & MEANS, *supra* note 57, at vii.
[62] Louis K. Liggett Co., 288 U.S. at 566 (Brandeis, J., *dissenting*).
[63] BUTTERS ET AL., *supra* note 41, at 299 (citing industry groups such as oil, steel, and copper).
[64] Louis K. Liggett Co., 288 U.S. at 566-67 (Brandeis, J., *dissenting*) ("Other writers have shown that, coincident with the growth of these giant corporations, there has occurred a marked concentration of individual wealth; and that the resulting disparity in incomes is a major cause of the existing depression.").
[65] PAUL K. CONKIN, THE NEW DEAL 23 (2d ed. 1975).
[66] Sandberg, *supra* note 53, at 125.

drafting.[67] After extensive study, Congress concluded in 1924 that the relatively sparse reorganization provisions should be greatly expanded to specify the exact nature of each requirement for qualifying under the statute.[68] The resulting revenue act was called one of "the most detailed and precise statutes which had been evolved up to that time."[69] Randolph Paul remarked that the reorganization provisions "on their face appeared sufficient to capture the most elusive quarry."[70]

The detail of the reorganization provisions proved a mirage for those eager to stop abuse. Creative tax practitioners located loopholes in even the most explicit of clauses and openly devised transactions that complied with the letter if not the spirit of the statute. One practitioner described the wide variety of reorganizations that were used to reduce taxable income: "New corporations were established out of old with the assurance of larger deductions for depreciation; corporations on the verge of liquidation were reorganized so that earned surplus and surplus to be earned upon dissolution might be absorbed in larger issues of stock, and then dissolved without taxable profit except possibly to stockholders. Elaborate projects were evolved whereby surplus cash was to be passed on to stockholders as a partial 'liquidation' of their shares. Common law trusts were established by the score."[71] While the courts helped shut down a number of the schemes occasioned by loopholes and overly tight drafting,[72] taxpayers won a fair number of the cases and even more probably went undetected.[73]

B. New Deal

1. Subcommittee Proposal

As Roosevelt settled into the presidency in 1933, Congress was in the process of investigating the causes of the stock market crash and Great Depression. During the highly publicized Pecora hearings before the Senate Committee on Banking and Currency,[74] named after Ferdinand Pecora, the aggressive lead counsel for the Committee,[75] there were allegations of

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[67] PAUL, supra note 25, at 37.

[68] *See Id*; Satterlee, *supra* note 25, at 640.

[69] *See* Brookes, *supra* note 47, at 5. An explanation of the proposed changes from the Revenue Act of 1921 consumed almost two full pages of the *New York Times*. *See Treasury Expert Explains Tax Bill*, N.Y. TIMES, Jan. 5, 1924, at 1, 8-9. Authored by A.W. Gregg, a special assistant to the Secretary of the Treasury, the "Gregg Statement," as it came to be known, became a symbol for a style of drafting that favored leaving nothing unsaid. *See* Satterlee, *supra* note 25, at 640.

[70] PAUL, *supra* note 25, at 37.

[71] Kohler, *supra* note 31, at 180. *See* Ernestine Breisch, *Using the Stepped-Up Basis on Corporate Reorganizations*, 9 Tax Mag. 245 (1931) (describing the possibility of acquiring cost rather than carryover basis in a reorganization).

[72] *See* Steven A. Bank, *Federalizing the Tax-Free Merger: Toward an End to the Anachronistic Reliance on State Corporation Laws*, 77 N.C. L. REV. 1307, 1336-39 (1999) (describing cases) ("*Federalizing the Tax-Free Merger*").

[73] *See* PAUL, *supra* note 25, at 37 ("defeat piled upon defeat" for Treasury).

[74] *See Stock Exchange Practices, Hearings Before the Sen. Comm. on Banking and Currency on S. Res. 84*, 73rd Cong., 1st Sess. 2319-2325 (1933) ("*Pecora Hearings*").

[75] *See The Man Who Will Question Morgan*, N.Y. TIMES, May 21, 1933, § 8, at 2; ROE, *supra* note 6, at 110-11; LEFF, *supra* note 11, at 58-59.

widespread misconduct and questionable actions by investment bankers and corporate managers. Some of these accusations related to the disabling of typical corporate governance mechanisms in connection with mergers and acquisitions. In one device, the Pennsylvania Railroad financed a holding company by issuing "voting trust certificates" rather than stock so it could amass the financial resources to engage in strategic acquisitions of smaller railroad lines without being subject to stockholder oversight.[76] An investment banker involved in organizing the Pennsylvania Railroad holding company candidly testified that all such efforts to deprive stockholders of control were "inventions of the devil."[77]

Other corporate governance practices highlighted during the Pecora hearings related to the impropriety of executive compensation or dividend declarations. With respect to the former issue, several Senators grilled Albert Wiggin, the former chairman of the board of directors at Chase National Bank, about the size and source of his income, noting that "[t]hey credited you with being responsible for some of their added profits in the good years" by paying large bonuses, but "[i]n bad years [they failed to] charge you in any way with responsibility for losses."[78] As Wiggin later conceded under questioning, he alone determined his bonus and the board served as little more than a rubber stamp.[79] With respect to the latter issue, Pecora questioned the director of Fox Film Corporation over its declaration of a $4 million dividend to its principal stockholder, the General Theaters Equipment, in a year when it sustained a loss of more than $5.5 million.[80] Senator Couzens noted that this was particularly suspicious given the "very close affiliation between the General Theaters Equipment and the management of the Fox Film Corporation" and the fact that Fox was heavily in debt at the time.[81] While it is not entirely clear that the practice in either case was improper, the investigation into these cases and other similar incidents indicated Congress' heightened concern over the internal governance of the corporation.

This inquiry into Wall Street's contribution to the stock market crash and the ensuing Depression was accompanied by revelations of rampant tax evasion. According to one account, not only had the world-renowned financier J.P. Morgan paid no income taxes during 1931 and 1932, none of the partners in his investment house had either.[82] While much of this was

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[76] FERDINAND PECORA, WALL STREET UNDER OATH 58-59 (1939).
[77] *Id*. at 59 (*quoting* Otto Kahn, of Kuhn, Loeb and Company).
[78] *See Pecora Hearings*, *supra* note 74, at 2319-2325 (statement of Senator Adams).
[79] *Id*. at 2337 (statement of Albert Wiggin) ("I think I made up that list with my name on it and the board always approved it."). When he later conceded that he had suggested his $100,000 retirement pay, "he unleashed a furious reaction from public and stockholder alike (which soon forced him to decline the pension)." LEFF, *supra* note 11, at 84.
[80] *Pecora Hearings*, *supra* note 74, at 3812 (questioning Hermann G. Place). Pecora raised the same issue in his questioning of John Stalker, the president of the Union Guard Trust Co., about the corporation's decision to declare a dividend when it was not supported by earnings and when economic conditions did not justify it. *See id*. at 4407.
[81] *Id*. at 3813.
[82] LEFF, *supra* note 11, at 58-59; PECORA, *supra* note 76, at 190 (noting that Otto Kahn of Kuhn, Loeb also paid no income taxes during the years 1930, 1931, and 1932).

perfectly legal,[83] Congress was looking for scapegoats and the richer the better. Thus, against the backdrop of an investigation that "had whipped up public outrage against corporate abuses,"[84] the House authorized a thorough study of the internal revenue system in order to ferret out evasion and simplify the tax laws.[85]

The resulting House Subcommittee report issued in December of 1933 reflected these dual themes of tax avoidance and corporate excesses.[86] At the press conference to announce the release of the Subcommittee report, the *New York Times* observed that the "[c]hanges sought are aimed principally at persons whose incomes are in the higher brackets as well as at corporations now legally permitted to take advantage of what committee members said were 'unfair but legal' provisions of the revenue laws."[87] One such apparently "unfair but legal" revenue law was the tax-free reorganization provisions. In its report, the Subcommittee recommended eliminating the tax-free reorganization in order to "close the door to one of the most prevalent methods of tax avoidance."[88] Although nonrecognition treatment was premised on the principle that tax is deferred rather than exempted, the report noted that "the taxpayer is able to escape tax on these gains entirely by being permitted to elect the year in which he shall report such gain."[89]

While the Subcommittee's report prominently cited the tax avoidance rationale,[90] it also disclosed an underlying corporate governance motivation for its recommendation. In a separate memorandum attached to the report, the Subcommittee provided more detailed justification for repeal of the tax-free reorganization provisions.[91] It acknowledged that one of the rationales for liberalizing the reorganization provisions during the early 1920s was to remove the obstacles to "normal business readjustments," but concluded that this rationale was no longer salient.[92] "[T]he present provisions," the report observed, "have encouraged the injection into business structure of

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[83] LEFF, *supra* note 11, at 59 (suggesting the tax consequences were the result of capital loss carryforwards); PECORA, *supra* note 76, at 192-93 (describing a common scheme where taxpayers would sell stocks with built-in losses to members of their own families and then buy them back after thirty days).

[84] *Id*. at 85 (describing the outcry against excessive executive salaries). According to Ellis Hawley, the hearings "began to familiarize the public with a variety of sensational abuses, with speculative pools, preferred lists, corporate pyramiding, insider deals, and numerous devices for unloading worthless securities upon unsuspecting purchasers." ELLIS W. HAWLEY, THE NEW DEAL AND THE PROBLEM OF MONOPOLY 306 (1966).

[85] H.R. Res. 183, 73d Cong., 77 CONG. REC. 5701 (1933). *See* 78 CONG. REC. 2794 (1934) (statement of Rep. Welch) ("This bill (the House bill proposed as a result of the study of the internal revenue system) grew out of disclosures before the Senate Banking Committee by the money kings of America, that for years they had not contributed one dollar to the support of this Government.").

[86] SUBCOMM. OF THE HOUSE COMM. ON WAYS AND MEANS, 73D CONG., 2D SESS., PRELIMINARY REPORT ON PREVENTION OF TAX AVOIDANCE (Comm. Print 1933) ("1933 SUBCOMMITTEE REPORT").

[87] *Tax Plan Offered to Curb Evasions, Raise $237,000,000*, N.Y. TIMES, Dec. 6, 1933, at 1.

[88] 1933 SUBCOMMITTEE REPORT, *supra* note 86.

[89] *Id*.

[90] Indeed, it provided eight hypothetical cases in which the reorganization provisions were then used to avoid taxes. *See* id. at 39-42.

[91] *Id*. at 37, exh. D ("Memorandum on Exchanges and Reorganizations").

[92] *Id*. at 38. The rationale for the 1921 reforms has led at least one modern observer to conclude that the tax-free reorganization provisions are one "of the best examples of the Code's attempt not to let tax rules influence corporate governance." Paul B. Stephan, *Disaggregation and Subchapter C: Rethinking Corporate Tax Reform*, 76 VA. L. REV. 655, 677 (1990). This analysis, however, ignores the corporate governance motivation for the later 1934 reforms.

an unsavory stimulus, such as the organization of large holding companies and the overcapitalization of business."[93] In effect, the Subcommittee report endorsed withdrawing the reorganization provisions as a means of stemming the tide of business combination and economic concentration.

The characterization of the reorganization provisions as an "unsavory stimulus" to the creation of holding companies was part of a general attack on such forms of corporate organization. One of the Subcommittee's many recommendations was to eliminate the provisions permitting an affiliated group of corporations to file a consolidated federal income tax return.[94] As the report acknowledged,[95] this was the culmination of a continuing controversy in Congress over consolidated returns and the dangers of holding companies. Holding companies, or corporations whose assets consisted of the stock of subsidiary corporations, were often considered vehicles for the predatory activities of trusts and chain stores.[96] In 1932, after rejecting a similar proposal to abolish the consolidated return,[97] Congress levied a small tax on the privilege of filing as a consolidated group.[98] According to the Subcommittee, however, this surcharge was no longer sufficient to offset the tax advantages provided to corporate families under the consolidated return provisions. "In the past, when any corporation could carry forward a net loss from one year to another, the consolidated group did not have such a great advantage over the separate corporation. Now that this net-loss carry-over has been denied, the advantage of the consolidated return is much greater on a comparative basis."[99] Thus, the Subcommittee proposal to eliminate the consolidated return, like the proposal to abolish the tax-free reorganization, was an attack on the holding company system.[100]

At the subsequent House Ways and Means Committee hearings, corporate managers opposed the Subcommittee's recommendations,[101] but they were noticeably muted in their reaction to the proposal to abolish the reorganization provisions. James Emery of the National Association of Manufacturers generically pleaded "[w]e venture particularly at this time the suggestion that the national tax policy, for the most practical reasons, should encourage new investment rather than discourage it by radical change. The development of new or the expansion of existing forms of business, means a new or enlarged contribution to the shrunken public

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[93] 1933 SUBCOMMITTEE REPORT, *supra* note 86, at 39.
[94] *Id*. at 10.
[95] *Id*.
[96] *See* 75 CONG. REC. 7125 (1932) (statement of Rep. Cannon) (suggesting that the consolidated return allows holding companies to reduce prices and undercut the competition in one location while allowing the any tax losses suffered to be used to offset income from other more profitable locations).
[97] 1933 SUBCOMMITTEE REPORT, *supra* note 86.
[98] *Id*. The National Industrial Recovery Act subsequently increased this rate. Id.
[99] *Id*.
[100] *Cf. Tax Bill Changes Offered by Borah*, N.Y. TIMES, March 2, 1934, at 38 (characterizing Senator Borah's attempt to revive the original Subcommittee consolidated return proposal in the Senate as an effort "to strike at the holding company system.").
[101] *See generally Railroads Oppose Income Tax Change*, N.Y. TIMES, Dec. 20, 1933, at 5; *Opposes Taxation as Social Cure-All*, N.Y. TIMES, Dec. 24, 1933, at 15.

purse."[102] Although this statement could be construed as an indictment of the proposal to eliminate the tax-free reorganization provisions, Emery made no mention of this proposal.[103] Only the United States Chamber of Commerce specifically opposed the proposal to eliminate the reorganization provisions. It noted that "[e]xchanges, modifications of capital structure and consolidations undertaken in the interest of better operating conditions and as a means of expanding business activity should not be penalized but should be encouraged. This is especially true at the present time when many reorganizations are unescapable as a result of the depression. Reorganizations which are necessary to business recovery and increased employment will not be undertaken if an immediate tax liability is imposed."[104] Even this expression of opposition, however, was a part of a prepared statement submitted in lieu of live testimony.[105] No speaker actually devoted any of his allotted time to the reorganization proposal.[106]

Part of the silence on the reorganization provisions may have been due to the fact that Treasury was already doing most of the heavy labor in opposing the Subcommittee recommendations.[107] Acting Treasury Secretary Henry Morgenthau issued a statement regarding the Subcommittee report at the start of the Ways and Means hearings.[108] Morgenthau agreed with the Subcommittee that the reorganization provisions are both complex and "open to the serious objection of being overspecific,"[109] but concluded that the provisions should be "completely redrafted" rather than abandoned entirely.[110] Treasury believed that the elimination of the reorganization provisions would simply afford taxpayers an opportunity to claim losses, both immediately and over time in the former of higher bases for depreciation and depletion deductions, with the result that "the proposal would not only yield no additional revenue, but would result in a net loss."[111] While corporate managers did not reference the Treasury statement

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[102] *Hearing Before the House Comm. on Ways and Means*, 73d Cong., 215 (1933) ("*1933 House Hearings*") (Statement of James A. Emery, Taxation Committee of the National Association of Manufacturers).
[103] *Id*.
[104] *Id*. at 290-91 (statement of F.H. Clausen, Chairman of the Committee on Federal Taxation, Chamber of Commerce of the United States).
[105] *Id*. at 287 (Chester Leasure appeared on behalf of the Chamber because Fred Clausen, the Chamber's chief lobbyist on tax issues was unable to attend). The written statement was subsequently republished in edited form in the *New York Times*. *See Opposes Taxation as Social Cure All*, N.Y. TIMES, Dec. 24, 1933, at 15.
[106] Since witnesses had a limited time to speak before the committee, they presumably chose the most important issues to highlight during live testimony and reserved lesser issues for a written statement submitted sometime later.
[107] Treasury was apparently upset at its minimal role in the preparation of the Subcommittee report. *See* LEFF, *supra* note 11, at 61.
[108] *See* STATEMENT OF THE ACTING SECRETARY OF THE TREASURY REGARDING THE PRELIMINARY REPORT OF A SUBCOMM. OF THE HOUSE COMM. ON WAYS AND MEANS RELATIVE TO METHODS OF PREVENTING THE AVOIDANCE AND EVASION OF THE INTERNAL REVENUE LAWS TOGETHER WITH SUGGESTIONS FOR THE SIMPLIFICATION AND IMPROVEMENT THEREOF, 73D CONG., 2D SESS. (Comm. Print 1933) ("STATEMENT OF THE ACTING SECRETARY OF THE TREASURY"). *See also Treasury Would Alter All Taxes*, WALL ST. J., Dec. 16, 1933, at 1.
[109] STATEMENT OF THE ACTING SECRETARY OF THE TREASURY, *supra* note 108, at 9.
[110] *Id*. at 9-10.
[111] *Id*. at 10. This argument was not as persuasive after Congress adopted limits on the ability to recognize capital losses in the Revenue Act of 1934 and thereby greatly reduced the ability to use a taxable reorganization as an avenue for recognizing losses. *See* Sandberg, *supra* note 53, at 121.

in supporting their own testimony, it may have allowed them to focus on those recommendations Treasury did not choose to contest.

The problem with this explanation is that business leaders questioned a number of the Subcommittee recommendations that Treasury had already rejected in its own statement. For instance, Treasury concluded that the Subcommittee proposal to abolish consolidated returns "might well be a backward step, which would result in little, if any, additional revenue."[112] According to Treasury, full recognition of intercompany transactions would be just as likely to result in deductible losses as gains and would incur considerable administrative expenses for both the government and the taxpayer.[113] This strong repudiation of the Subcommittee recommendation, however, did not prevent a number of witnesses from raising the consolidated return issue in their own testimony. The National Association of Manufacturers noted that the consolidated return "merely recognizes the separate corporate entities which are working parts of one business created for convenience and necessity, developed out of experience, and recognized by the States of the Union."[114] Similarly, M.L. Seidman of the New York Board of Trade protested that "[t]o shut one's eyes to the position of a particular company in a group, and to insist that every corporation in that group file separate returns, would be to encourage artificial business arrangements and to distort normal and natural intercompany accounting methods."[115]

2. House

Despite the lack of public protest from business leaders and Subcommittee Chairman Hill's confident predictions that its recommendations would prevail,[116] the full House Ways and Means Committee sided with Treasury on the reorganization question. In its report submitted in February of 1934, the Committee stated that "under present conditions, the wiser policy is to amend the provisions drastically to stop the known cases of tax avoidance, rather than to eliminate the sections completely. This decision will further avoid the period of litigation and uncertainty which would necessarily follow a complete reversal of the established policy."[117]

This apparent victory for corporate managers did not mean that the Committee sought to continue encouraging reorganizations. In fact, under the Committee's proposal, the number of transactions in which reorganization status was available would be severely limited to "(1) statutory mergers and consolidations; (2) transfers to a controlled corporation, 'control' being defined as an 80 per cent ownership; and (3) changes in the capital structure or form of

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[112] *Id*. at 13.
[113] *Id*.
[114] *1933 House Hearings, supra* note 102, at 215 (statement of James A. Emery, Taxation Committee, National Association of Manufacturers).
[115] *Id*. at 173 (statement of M.L. Seidman, New York Board of Trade). *See also* id. at 290 (statement of F.H. Clausen, Chairman of the Committee on Taxation, Chamber of Commerce of the United States) ("Elimination of consolidated returns would undoubtedly force corporate mergers and consolidations solely for the purpose of avoiding an unfair tax. Mergers should be consummated only for the economic reason of increasing business efficiency.").
[116] *Stands by Committee*, N.Y. TIMES, Dec. 17, 1933, at 2.
[117] H.R. Rep. No. 73-704, at 13 (1934), *reprinted in* 1939-1 C.B. (pt. 2), at 564.

organization."[118] According to its report, "the definition of reorganization has been restricted so that the definition will conform more closely to the general requirements of corporation law."[119]

This admittedly "drastic" amendment to the reorganization provisions once again provoked little protest on the part of corporate managers.[120] In the House, this was partly because the Ways and Means Committee pushed for the passage of a special rule prohibiting all amendments other than those offered by members of the Committee.[121] According to Representative Robert Doughton, the Chair of the Committee, "[i]t is the only practical way to bring out the bill. It is a good bill, and if it is opened to amendments it won't be as good when passed as it now is."[122] The apparent rationale for the rule was to block any amendments seeking to scrap the whole income tax in favor of a sales tax,[123] but the practical result was to secure passage of the bill with little debate on the floor of the House and shift protest on individual proposals to the Senate.[124]

3. Senate

Passage of the House bill did stir corporate managers to protest, but the protest was still relatively limited. While the bill headed to the Senate Finance Committee, the U.S. Chamber of Commerce once again issued a statement decrying the proposed changes, including those to the reorganization provision. This statement, however, was only a slightly revised version of the one it submitted during the Ways and Means Committee hearings. According to the Chamber, "[n]o tax should be imposed on exchanges or reorganizations unless there is a clearly realized gain. Reorganization and mergers made necessary, in view of economic conditions, as a matter of good business policy, should not be discouraged or precluded by additional taxation."[125] The Chamber allowed for some possibility of minor changes, but argued against anything more radical: "The question of mergers and reorganizations in relation to Federal income taxes has always been a

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[118] *Id*. at 14, *reprinted in* 1939 -1 C.B. (pt. 2), at 564.
[119] *Id*.
[120] *Id*.
[121] *House Rule is Won to Speed Tax Bill*, N.Y. TIMES, Feb. 14, 1934, at 1. *See* ROY G. BLAKEY & GLADYS C. BLAKEY, THE FEDERAL INCOME TAX 356 (1940).
[122] *Id*.
[123] *See $65,000,000 is Cut From New Tax Bill*, N.Y. TIMES, Feb. 9, 1934, at 7 ("Upon such procedure agreed upon [requesting a rule to limit amendments and debate], the only opportunity for a vote on a sales tax would be on a motion to send the whole bill back to the committee with instructions to insert the levy. Since only one motion to recommit will be proposed in the rule, it is not a certainty that a vote will be afforded on the sales tax levy at all."). See *Manufacturers Association Urges Sales Tax and Flexible Liquor Levy at House Hearing*, WALL ST. J., Dec. 19, 1933, at 1 (describing the growing impetus for a sales tax).
[124] The bill passed by a vote of 390 to 7. 78 CONG. REC. 3005 (1934). *See* BLAKEY & BLAKEY, *supra* note 121, at 356 ("There was less discussion of the fundamental income tax sections than on any similar occasion. The few speeches made were in explanation of the changes. Perhaps the amendments were of such technical nature that they were not readily understood. Perhaps the members thought it futile to debate in view of the stress that had been placed on the profound study made by the subcommittee. Certainly, after the passage of the gag rule, there was no point in offering amendments.").
[125] *Tax Bill Attacked as Business Blow*, N.Y. TIMES, March 4, 1934, at 21.

complex one. The present provisions have been in the law practically unchanged since 1918 and taken as a whole are sound. Any substantial change will result in confusion and uncertainty."[126]

Corporate managers issued similar statements of opposition to the House bill's proposed treatment of reorganization provisions during the Senate Finance Committee Hearings. As in the House hearings, however, few witnesses addressed the issue and most of those who did only did so in their written statements.[127] The one exception was David Gaskill on behalf of the Cleveland Chamber of Commerce.[128] While he discussed a proposed limit on the deductibility of capital losses first,[129] he did raise the reorganization provision in his testimony. Gaskill stated that "[t]he bill, as passed by the House, took out the so-called 'parenthetical clause', and limits the definition to statutory mergers and consolidations. We take the position that with that eliminated, the bill is now indefinite and a substantial amount of litigation will be necessary in order to find out just what is and what is not a statutory consolidation or merger."[130] As Senator Harrison appeared to recognize when he questioned Gaskill about his claims,[131] and the Cleveland Chamber of Commerce implied in its written statement,[132] the predicted litigation would most likely result from managers' attempts to characterize stock and asset acquisitions – previously parenthetical clause transactions – as statutory mergers and consolidations.

Aside from the Cleveland Chamber of Commerce, no other party addressed the reorganization provision in their testimony. The United States Chamber of Commerce submitted both a prepared brief and report in which the House's reorganization provision was criticized, but much of this was essentially a repeat of the objections raised by the Cleveland Chamber of Commerce. In its brief, the Chamber warned "[t]he provision affecting mergers or consolidations of corporations will result in confusion, and will discourage mergers which, in the view of recent economic conditions should be made in the interests of good business policies, and because of the lessened number of mergers, revenues will probably decrease."[133] Its accompanying report elaborated on such concerns, emphasizing the view that the House proposal would severely limit the tax-free reorganization: "The apparent effect of this amendment will be to eliminate the most usual and important form of reorganization, leaving only comparatively restricted and technical forms permissible without tax."[134] According to the Chamber's report, the cause of the confusion

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[126] *Id*.
[127] As in the House, speakers were asked to limit their presentations and submit as much as possible in a written statement. *See Hearings on H.R. 7835 Before the Senate Comm. on Fin*., 73d Cong. 1 (1934) (statement of Chairman Pat Harrison). Thus, issues presented in live testimony were likely to be deemed more important than those only presented in a written statement.
[128] *Id*. at 1 (statement of David A. Gaskill, Cleveland Chamber of Commerce).
[129] *Id*. at 1-2.
[130] *Id*. at 2-3.
[131] *Id*. at 3 (Sen. Harrison).
[132] *See id*. at 7 (arguing that "the changes proposed will prevent the consummation of transactions which are entirely proper and which are in fact necessary and advisable during a period of reconstruction. The prevention of such transactions does not produce any revenue for the Government and creates unreasonable interference with the proper transaction of legitimate business.").
[133] *Id*. at 50 (Brief of F.H. Clausen, Chairman of Special Committee on Federal Taxation, United States Chamber of Commerce).
[134] *Id*. at 58 (Report of the Committee of Federal Taxation, Chamber of Commerce of the United States).

would be that the meanings of the terms merger and consolidation would "have to be determined in various instances by the laws of the particular State which might be applicable in the case. What would be a merger or consolidation in one State might not be in another. Instead, then, of having uniform principles generally applicable to all corporations, there would be different standards applicable to different corporations."[135]

This latter argument proved to be convincing to the Senate Finance Committee – or at least it sounded reasonable enough to use as its official justification for the rejection of the House's more radical amendments. In its report, the Senate Finance Committee noted that it was "in complete agreement with the purposes of the House Bill," but indicated that "some modifications are recommended in order to bring about a more uniform application of the provisions in all 48 of the States. Not all of the States have adopted statutes providing for mergers or consolidations; and, moreover, a corporation of one State can not ordinarily merge with a corporation of another State."[136] Since "some legitimate and desirable business readjustments would be prevented" by limiting nonrecognition treatment to statutory mergers, the Finance Committee proposed a broader definition of "reorganization."[137] Thus, in addition to the statutory merger or consolidation and other transactions proposed under the House bill, the Senate Finance Committee proposed to include the following transaction within the definition of reorganization: "the acquisition by one corporation in exchange solely for all or part of its voting stock: of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of another corporation; or of substantially all the properties of another corporation."[138] The Committee noted that "these transactions, when carried out as prescribed in this amendment, are in themselves sufficiently similar to mergers and consolidations as to be entitled to similar treatment."[139]

The Senate Finance Committee proposal provided for a more expansive reorganization definition than the one passed by the House, but contemporary observers still thought it had been "sharply modified" from the existing provisions.[140] As the Committee noted, it required the acquisition of 80% of the target corporation stock.[141] Ever since the parenthetical clause was inserted into the reorganization provision in the 1921 Act, Congress had only required the acquisition of a majority of the target corporation stock.[142] Moreover, both the asset and stock acquisitions would only be entitled to nonrecognition treatment if the property or stock were

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[135] *Id*. at 59. The Chamber further explained by providing an example: "if two corporations owned by different interests desire to consolidate and give their stockholders no cash or property, but only stock representing the same properties, they may apparently do so free of tax if they happen both to be in the same State and that State provides by law for procedure which can be called a 'merger or consolidation,' but if not, and if the transaction involves one of the corporations or a new corporation taking over the stocks or properties then a tax is seemingly payable based upon appraised or estimated values of the stocks." *Id*. at 58-59.
[136] S. REP. NO. 73-558, at 16 (1934), *reprinted in* 1939-1 C.B. (pt. 2), at 586, 598 ("1934 Senate Report").
[137] *Id*. at 599.
[138] *Id*. at 598.
[139] *Id*.
[140] Magill, *supra* note 49, at 639 n. 9.
[141] *Id*.
[142] *See* Revenue Act of 1921, § 202(c)(2), ch. 136, 42 Stat. 227, 230.

exchanged "solely for the voting stock of the acquiring corporation."[143] Not only had the former parenthetical clause not imposed a similar voting stock requirement, it had not specified the consideration at all. One commentator called this "[p]erhaps the most radical change" to the reorganization provisions.[144]

Notwithstanding the significant changes to emerge from the Senate Finance Committee, corporate managers made no protest and the measure sailed through the Senate.[145] Within a few weeks the House conferees accepted the Senate proposal on the reorganization provisions. After little debate in either the House or the Senate over the Conference Report, the bill was signed into law in May of 1934.[146] Not only did the Revenue Act of 1934, or more specifically its changes to the reorganization provision, provoke little opposition on the part of corporate managers,[147] most of its major statutory innovations have endured to this day.[148]

II. UNDISTRIBUTED PROFITS TAX

Just two years after the relatively mild reaction to a proposal to restrict a manager's ability to do a tax-free merger, there was a very different reaction to a proposal to limit their discretion over dividend policy.

A. *Early history*

Ever since an income tax was first imposed during the Civil War and Reconstruction, Congress has struggled with how to reach the undistributed profits of a corporation. During the nineteenth century, undistributed profits were taxed as a way to ensure that corporations would not evade dividend taxes by simply accumulating, rather than distributing, their earnings. Thus, in 1864, Congress used an undistributed profits tax as an enforcement mechanism for its taxation of the dividends issued by corporations in certain industries.[149] The House revived the undistributed profits tax in 1894 when it passed a bill imposing a dividends tax.[150] Such efforts

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[143] 1934 Senate Report, *supra* note 131, at 599.

[144] ROBERT S. HOLZMAN, CORPORATE REORGANIZATIONS: THEIR FEDERAL TAX STATUS 66 (1948).

[145] 78 CONG. REC. 6574 (1934) (53 to 7 with 36 not voting).

[146] *See* BLAKEY & BLAKEY, *supra* note 121, at 362.

[147] *See* Revenue Act of 1934, ch. 277, 48 Stat. 680. This is not to say that corporate managers expressed no displeasure about other aspects of the bill. *See* LEFF, *supra* note 11, at 66 (noting that one of the chief lobbyists for the U.S. Chamber of Commerce described the Act as an "ill-considered modified program.").

[148] See I.R.C. §§ 368(a)(1)(A) (statutory merger requirement) & (a)(1)(B) & (C) (solely for voting stock requirements). *See also* Bank, *Federalizing the Tax-Free Merger, supra* note 72, at 1307 (discussing the history of the statutory merger requirement).

[149] *See* Act of June 30, 1864, ch. 173, §§ 120-22, 13 Stat. 223, 283-85 (The 1864 Act taxed businesses in certain specified industries such as transportation, insurance and banking on dividends or interest paid, and on "undistributed sums, or sums made or added during the year to their surplus or contingent funds.").

[150] Section 59 of the House Bill provided, in relevant part,

> [t]hat there shall be levied and collected a tax of 2 per cent on all dividends in scrip or money thereafter declared due, wherever and whenever the same be declared payable to stockholders, policy holders, or depositors or parties whatsoever, including nonresidents, whether citizens or aliens, as part of the earnings,

were not controversial, however, because the norm was for corporations to distribute virtually all of their profits as dividends.[151]

After passage of the Sixteenth Amendment,[152] Congress once again employed the undistributed profits tax concept, but only as a penalty provision. Under the Tariff Act of 1913,[153] shareholders were subject to a tax on their undistributed profits when the corporation was found to have unreasonably accumulated profits for the purpose of evading the high surtax rates on individual income.[154] This pass-through undistributed profits tax remained in place until it was deemed to be unconstitutional under the realization requirement announced in *Eisner v. Macomber*.[155] In subsequent years, the undistributed profits tax was applied directly to the corporation when the purpose of the accumulation was to evade the surtaxes on individual income or when the corporation was formed for the purpose of evading the surtaxes.[156] Because of the tax's intent requirement, however, the provision was often not enforced during the early years of the income tax.[157]

Perhaps recognizing the inherent problems with the use of the undistributed profits tax as a penalty provision, various individuals and groups forwarded proposals to broaden the tax's scope. In 1917, Senator Andrieus Jones of New Mexico proposed to tax corporations on a certain percentage of their undistributed profits regardless of the purpose for the retention.[158] While a bill introduced by the Senate Finance Committee to adopt this proposal was rejected, the Senate eventually adopted something similar to Jones' original suggestion in an amendment to the Revenue Act of 1924 before it was removed in the House.[159] In 1928, the Joint Committee on Internal Revenue Taxation revived the undistributed profits tax proposal, but Congress rejected it amid concerns about making such a radical change during a period of business expansion.[160]

> income or gains of any bank, trust company, savings institution, and of any fire, marine, life, inland insurance company, either stock or mutual, under whatever name or style known or called in the United States or Territories, whether specially incorporated or existing under general laws, and on all undistributed sums, or sums made or added during the year to their surplus or contingent funds."

26 Cong. Rec. 6831 (1894). As passed, the 1894 Act taxed corporations directly, but the Supreme Court struck down the income tax as an unconstitutional direct tax and therefore the corporate tax was never implemented. Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429, 572 (1895).

[151] *See* Steven A. Bank, *Entity Theory as Myth in the Origins of the Corporate Income Tax*, 43 WM. & MARY L. REV. 447, 528-29 (2001).

[152] U.S. CONST. amend. XVI.

[153] Tariff Act of 1913, ch. 16, 38 Stat. 114.

[154] Id. at § II(A) 2, 38 Stat. at 166-67. At the time, all individual income was subject to a flat normal tax, but incomes above a certain level were subject to an additional surtax at gradually increasing rates.

[155] 252 U.S. 189 (1920). Prior to this case, Congress merely repeated the 1913 provision in subsequent revenue acts. *See* Revenue Act of 1916, § 3, 39 Stat. 758; War Revenue Act of 1917, § 3, 40 Stat. 301; Revenue Act of 1918, § 220, 40 Stat. 1072.

[156] *See* John B. Martin, Jr., *Taxation of Undistributed Corporate Profits*, 35 MICH. L. REV. 44, 49 (1936).

[157] *See* WALTER LAMBERT, THE NEW DEAL REVENUE ACTS: THE POLITICS OF TAXATION 273 (1970).

[158] *See* Martin, *supra* note 156, at 44; LAMBERT, *supra* note 157, at 274.

[159] LAMBERT, *supra* note 157, at 274; Note, *The Surtax on Undistributed Profits*, 50 HARV. L. REV. 332, 332 n. 2 (1936).

[160] BLAKEY & BLAKEY, *supra* note 121, at 405; LAMBERT, *supra* note 157, at 274.

B. *Revenue Act of 1936*

1. Prelude to an undistributed profits tax

Even before he was elected for the first time in 1932, President Roosevelt's advisors had urged him to consider the possibility of an undistributed profits tax. As he was campaigning for the presidency, Roosevelt's small circle of policy advisors – the "Brain Trust" as they came to be called – were hard at work developing methods of stabilizing the economy and preventing a repeat of the 1929 stock market crash.[161] In a memorandum to then-Governor Roosevelt, the Brain Trusters outlined what would become the foundation for the New Deal.[162] Although the memorandum identified many culprits for the depression, it laid much of the blame on the unreasonable accumulation of corporate profits. According to the memorandum, the prosperity of the Twenties led to "a greater accumulation of surpluses than were ever before realized in economic history."[163] This practice of "corporate hoarding," the memorandum charged, "upset the balance of production and consumption" and contributed both to the crash and the ensuing Depression.[164] Roosevelt's advisors recommended a "tax on undistributed surplus income of corporations" as a means of "forcing undistributed surplus into the general market for capital."[165]

While Roosevelt clearly endorsed the basic principles underlying the recommendation,[166] he did not push for the enactment of an undistributed profits tax until two events prompted a budgetary crisis arose at the end of his first term of office. First, the Supreme Court struck down the Agricultural Adjustment Act and consequently invalidated the processing taxes Roosevelt had counted on to finance the Act's operations.[167] Second, Congress overrode a presidential veto to

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[161] *See* DANIEL R. FUSFELD, THE ECONOMIC THOUGHT OF FRANKLIN D. ROOSEVELT AND THE ORIGINS OF THE NEW DEAL 207 (1954); RAYMOND MOLEY, AFTER SEVEN YEARS 21-22 (1939).

[162] Memorandum of May 19, 1932 of Raymond Moley and others for Franklin Delano Roosevelt outlining national program for recovery in Box 282, Folder 3, Raymond Moley Papers, Hoover Institution Library and Archives, Stanford University ("Memorandum of May 19, 1932"). The May 19 memorandum was written in response to a request by Roosevelt to keep him updated during his pre-campaign vacation trip to Warm Springs. It became the opportunity to prepare a series of specific recommendations for various aspects of the economic crisis and was the foundation of many of Roosevelt's campaign speeches and eventually his acceptance speech. *See* Moley, *supra* note 156, at 21-22; Fusfeld, *supra* note 161, at 219. Many, if not most, of the memorandum's recommendations were eventually enacted into law.

[163] Memorandum of May 19, 1932, *supra* note 162, at 1.

[164] *Id*. at 2-3.

[165] *Id*. at 3-4.

[166] In his July 1932 acceptance speech at the Democratic national convention in Chicago, for example, he attributed the Depression to heavy "corporate surpluses" used to finance "unnecessary plants" and rampant pre-crash stock market speculation. *July 2, 1932 Speech* in I THE PUBLIC PAPERS AND ADDRESSES OF FRANKLIN D. ROOSEVELT 651 (Samuel I. Rosenman, ed. 1932). He did not even suggest the possibility of enacting the specific proposal, however, until later in his term. In his message to Congress on June 19, 1935, Roosevelt declared that ultimately we might need to use taxation to "discourage unwieldy and unnecessary corporate surpluses." ALFRED G. BUEHLER, THE UNDISTRIBUTED PROFITS TAX 19 (1937).

[167] *See* United States v. Butler, 297 U.S. 1 (1936). Under the Act, the Secretary of Agriculture was empowered to pay farmers not to produce a particular commodity when prices for that commodity fell to dangerously low levels. *Id*. at 88-90.

accelerate payment on World War I veterans' bonuses from 1945 to 1936.[168] The combined result of these two events was a $620 million shortfall in the president's budget.[169] To address this shortfall, Roosevelt and his advisors once again turned to the undistributed profits tax.[170]

On March 3, Roosevelt addressed Congress in a supplemental budget message.[171] Ostensibly, the message was merely to announce the need for an additional $620 million in revenue to replace the processing taxes and fund the veterans' bonuses. Roosevelt made a point of acknowledging Congress' discretion to determine the appropriate means to raise such revenue.[172] His true aim, however, was to push his proposal for an undistributed profits tax.[173] In advocating for the undistributed profits tax, Roosevelt did not mention its potential as a check on corporate managers and a stimulus to the economy. Roosevelt instead emphasized its two more politically saleable features:[174] (1) its ability to equalize the treatment of all business owners, and (2) its promise to "stop 'leaks' in present surtaxes."[175] One particular novel aspect of Roosevelt's proposal was that it was designed not to serve as it had in the past as a penalty tax, but rather as a replacement for the corporate income tax.[176] Distributed income would be subject to one layer of tax while retained income would bear both a corporate and shareholder-level tax.

Unlike the proposal to abolish the reorganization provisions in 1934, the undistributed profits tax proposal aroused "deep opposition" on the part of corporate managers.[177] Alfred Buehler reported, "[t]he business world . . . was aghast at the proposal and shuddered at the consequences if it were adopted."[178] Under then-prevailing dividend practices, the tax could not possibly raise the required $620 million in revenue.[179] Thus, the rates would have to be set high enough to "compel[] corporations radically to alter their present dividend policy" in order to reach its revenue goals.[180] This would force many corporations to rely more heavily on expensive and intrusive external financing sources, something managers are generally disinclined to do

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[168] *See* LEFF, *supra* note 11, at 170. Although this meant an immediate cash payment of almost $2 billion, the real cost of this payment was the $120 million annual carrying charge on financing the bonuses. *Id*.

[169] *See* BLAKEY & BLAKEY, *supra* note 121, at 401; SIDNEY RATNER, TAXATION AND DEMOCRACY IN AMERICA 472 (photo reprint 1980) (1967).

[170] *See* JOHN MORTON BLUM, FROM THE MORGENTHAU DIARIES: YEARS OF CRISIS, 1928-1938 306 (1959).

[171] *See A Supplemental Budget Message to Congress (March 3, 1936) in* 5 THE PUBLIC PAPERS AND ADDRESSES OF FRANKLIN D. ROOSEVELT 102 (Samuel I. Rosenman, ed., 1938).

[172] *Id*. at 104-05 ("I leave, of course, to the discretion of the Congress the formulation of the appropriate taxes for the needed permanent revenue.").

[173] *Id*. at 105.

[174] *See* LEFF, *supra* note 11, at 175-77.

[175] *A Supplemental Budget Message to Congress (March 3, 1936) in* 5 THE PUBLIC PAPERS AND ADDRESSES OF FRANKLIN D. ROOSEVELT, *supra* note 171, at 105.

[176] *Id*. at 106 (Roosevelt stated the undistributed profits tax would accomplish its goals only "if accompanied by a repeal of the present corporate income tax, the capital stock tax, the related excess profits tax and the present exemption of dividends from the normal tax on individual income.").

[177] Arthur Krock, *Opposition is Divided Over President's Tax Proposal*, N.Y. TIMES, March 4, 1936, at 20.

[178] BUEHLER, *supra* note 166, at 23.

[179] *See The New Tax Schedule*, N.Y. TIMES, March 17, 1936, at 20.

[180] *Id*.

especially when the alternative is simply to dip into retained earnings.[181] Managers were perhaps most offended by the fact that a forced change in dividend policy would substitute "the blanket judgment of Congress and the Treasury Department, based on a general theory" for the "individual judgment of business managers, based on their direct knowledge of the needs of their particular company."[182]

2. House

Corporate managers were initially restrained in their public responses to the President's message,[183] but this quickly changed as the undistributed profits tax concept was transformed into a concrete proposal. Under the bill as it was presented to the House Ways and Means Committee, the corporate income tax would be replaced by an undistributed profits tax graduated according to the percentage of net income retained.[184] For corporations with annual net income of $10,000 or less, the rates ranged from 1% on the first 10% of undistributed net income to 29.7% on undistributed net income of 70.3% or more.[185] For corporations with annual income in excess of $10,000, the bill proposed rates ranging from 4% on the first 10% of undistributed net income to a maximum of 42.5% on undistributed net income of 57.5% or more.[186] "Undistributed net income" was defined to include adjusted net income less taxable dividends and the undistributed profits tax itself.[187] The bill exempted or provided special treatment for banks, insurance companies, corporations in receivership, foreign corporations and corporations that were contractually or legally prohibited from paying dividends.[188] Finally, the bill subjected dividends to the normal tax on individuals.[189]

Despite Internal Revenue Commissioner Guy Helvering's declaration that "[t]here is no intention or desire whatever to interfere with the internal management of business enterprises,"[190] corporate managers showed up in force at the Ways and Means hearings to testify against the

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[181] *See* Jensen, *supra* note 19, at 323 ("Financing projects internally avoids this monitoring and the possibility the funds will be unavailable or available only at high explicit prices.").
[182] *Punishing Prudence*, N.Y. TIMES, March 13, 1936, at 22.
[183] *See* George B. Bryant, Jr., *Reform Motive in Tax Program*, BARRON'S, March 30, 1936, at 13 ("The remarkable lack of visible opposition to the proposal to date can be explained easily. It does not necessarily mean that business and industry will accept it without question and opposition. The scheme, thus far, has been in a purely formulative stage, and its effects upon the interests most vitally concerned cannot be definitely appraised."); *Trade Groups Study Tax Plan*, N.Y. TIMES, March 6, 1936, at 30 ("Organized business groups are reserving any public criticism of the President's plan for taxing corporate surpluses until later, it developed in a canvas of association offices yesterday. . . . Advices received by some of the associations from Washington offices are to the effect that opposition to the measure will develop within the coming ten days.").
[184] *Revenue Act of 1936: Hearings on H.R. 12395 Before the Sen. Comm. on Fin.*, 74th Cong., 2d Sess. 5 (1936) ("*1936 House Hearings*").
[185] *Id*. at 5-6.
[186] *Id*. at 6.
[187] *Id*. at 5.
[188] *Id*. at 6-11.
[189] *Id*. at 9.
[190] *Id*. at 22.

proposal. Unlike in 1934, however, the large trade associations presented oral testimony against the undistributed profits tax rather than reserving the issue for their written statements.[191] Moreover, these trade groups often sent multiple representatives to testify against different aspects of the proposal. Three speakers, for example, represented the United States Chamber of Commerce, with their combined testimony consuming more than seventy-five pages of the transcribed hearings.[192]

Not only did the national trade associations devote a substantial portion of their allotted time to the undistributed profits tax proposal, they were harsh in their criticism. Noel Sargent, secretary of the National Association of Manufacturers, argued that the retention of corporate profits produced benefits ranging from an increase in stockholder value and industrial employment from the expansion of plant operations to the preservation of working capital and the protection against depression.[193] Fred Clausen of the United States Chamber of Commerce was even more candid in his opposition, warning that "[t]his proposal would cause corporate management to be controlled, in its decisions on fiscal policy, by fear of government exactions rather than by good business judgment."[194] Clausen predicted that the tax "would engender such uncertainties concerning the sound course to pursue as to subject the management to grave difficulties with shareholders and creditors. . . . You can well imagine the difficulties facing management and the board of directors in a company as to how to meet a situation which would exist if this proposal becomes the law of the land."[195] According to Clausen, "[i]t presents the danger that corporate management would be subject to serious criticism and even law suits if liberal dividend policies were followed to escape taxes and gave rise to charges of dissipation of assets."[196]

Many smaller national, regional, and local trade groups joined the National Association of Manufacturers and the U.S. Chamber of Commerce in testifying against the tax. The chairman of the tax committee of the Illinois Manufacturing Association warned of the "grave danger that the present highly capitalized organizations will have a continuing advantage over these small corporations" by virtue of the imposition of the tax.[197] R.C. Fulbright of the Southern Pine Association echoed this charge, stating that "[w]e consider that it would be a very great detriment to our smaller companies unless some what can be found to protect the company that is heavily indebted or the company that must in order to keep going make needed improvements."[198] As a

[191] This was in part due to the fact that the 1936 hearings were primarily devoted to the undistributed profits tax issue and therefore the trade groups did not have to pick and choose among the issues. Nevertheless, corporate managers thought it was important to testify in person against the proposed undistributed profits tax rather than send in written statements.
[192] *See id*. at 735 (Fred Clausen); *id*. at 760 (Roy Osgood); *id*. at 803 (E.C. Alvord).
[193] *1936 House Hearings, supra* note 184, at 203, 206-210 (statement of Noel Sargent, Secretary, National Association of Manufacturers).
[194] *Id*. at 737 (statement of Fred H. Clausen, Chairman of the Committee on Federal Finance, Chamber of Commerce of the United States).
[195] *Id*. at 739-40.
[196] *Id*. at 740.
[197] *Id*. at 352 (statement of G.L. Walters, Secretary, Illinois Association of Manufacturers).
[198] *Id*. at 468 (statement of R.C. Fulbright, Southern Pine Association).

representative of the Detroit Board of Commerce summarized, "a tried system of taxation is much better than a new system of taxation."'[199]

Perhaps more significant than the trade association testimony was that, unlike in 1934, business was not content to let its representatives speak for it. A parade of individual businessmen appeared before the Ways and Means Committee to testify against the tax. Some of these witnesses were from small businesses that felt threatened by the tax. The president of a bridge corporation testified "[t]he smaller companies have only grown by using their earned surplus in the building of larger facilities and in increasing their working capital the necessary amount to take care of the increased capacity."[200] Not only were such companies concerned about their ability to grow, they argued that the tax would prevent them from repaying their existing bank indebtedness.[201] Other witnesses appeared to represent the concerns of larger companies. One attorney noted that "[s]ince 70 percent of the earnings of [publicly owned companies] are distributed without regard to the tax brackets of the stockholders, and since the earnings of [privately owned companies] are distributed only after careful consideration of the tax brackets of its stockholders," the committee should distinguish between public and private corporations in applying the tax.[202]

During their testimony, Treasury representatives attempted to allay corporate managers' fears.[203] First, they pointed out that the tax would still permit accumulation of a fairly significant surplus.[204] According to Oliphant, corporations might be able to retain 20% and 30% of their earnings under the proposal.[205] Second, Treasury officials suggested corporations could satisfy their capital needs through debt and equity financing, or, where those methods were

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[199] *Id*. at 841 (statement of Raymond H. Berry, Detroit Board of Commerce). *See id*. at 857 ("The radical change in form of taxation suggested, and the serious effect of the proposed system on recovery and employment, prompts us to urge your committee to explore the effects and results with great care, giving full consideration to both practice and theory.") (statement of John W. O'Leary, President, Machinery and Allied Products Institute).

[200] *Id*. at 146 (statement of Clyde G. Conley, President, Mount Vernon Bridge Co.).

[201] *See id*. at 177 (statement of Dean Alfange, general counsel, Axton-Fisher Tobacco Co.) ("Under the tax recommended by the committee, corporations financed by banks and those that have weathered the depression by means of bank loans would be severely penalize [sic] in applying their earnings to the liquidation of these loans.").

[202] *Id*. at 92 (statement of Albert Hubschman, Hubschman & Walsh).

[203] *Id*. at 607 (statement of Herman Oliphant, General Counsel, Treasury Department). Herman Oliphant emphasized that "it is not for anybody in Washington to tell business executives how much of their earnings they shall keep back and how much they shall distribute. That is not the Government's business. . . . But it is the Government's business to see to it that those administering the affairs of a corporation shall not use it, nor permit it to be used for avoiding the surtaxes which everybody else has to pay. That is what this does." The New York Times was clearly dubious of Oliphant's statement, asking "[i]f the proposed tax is not a tax designed to control the dividend policy of corporations, one would like to know what it is. . . . Mr. Oliphant is saying to the corporations in effect: 'We are not trying in the slightest to influence your dividend policy, but we will put a thumping tax on you if you don't pay out everything, and let you off scot free from taxes if you do.'" Editorial, *The Ship and the Rats*, N.Y. TIMES, Apr. 8, 1936, at 22.

[204] *Id*. at 581 (statement of Arthur H. Kent, Acting Chief Counsel, Bureau of Internal Revenue) (it "is continually overlooked that the measure will permit retention of a substantial fraction . . . without a corporate tax burden equal to or in excess of the burden imposed by the present law.").

[205] *Id*. at 649 (statement of Herman Oliphant, General Counsel, Treasury Department). *See also id*. at 582 (Kent estimated that a corporation might be able to retain as a high as 40% of earnings without exceeding its previous income tax liability).

unavailable,[206] by retaining funds through the issuance of taxable stock dividends.[207] Recent judicial decisions had confirmed the possibility that a corporation could issue a type of stock dividend that would be considered taxable to the stockholder, but would permit the corporation to retain the underlying funds.[208]

Treasury's responses appeared sufficient to satisfy any lingering concerns on the part of most Committee members. Despite opponents' urgings to proceed slowly before pursuing such a "radical change" in the system of taxing corporate income,[209] the undistributed profits tax emerged from the Committee and quickly passed in the House with surprisingly little dissent.[210] Much of this apparent lack of interest was due to the Republicans' decision to avoid prolonging consideration of an issue that was likely to face stiffer opposition in the Senate.[211]

3. Senate

Although opponents were initially emboldened by reports that even pro-Administration members of the Senate Finance Committee were dissatisfied with the House bill,[212] the overwhelming approval of the bill in the House caused such optimism to waver.[213] Thus, even before the Senate Finance Committee began hearings on the proposed undistributed profits tax, corporate managers and their representatives redoubled their efforts to oppose the bill. The Chamber of Commerce of the State of New York issued a report sharply condemning the tax: "In practice this proposed tax involves serious Federal interference with business management. It is a scheme to force the distribution of corporate profits regardless of the policy dictated by sound

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[206] *See, e.g.*, *id*. at 761 (statement of Roy Osgood, U.S. Chamber of Commerce) (suggesting that small corporations lacked access to the debt and equity markets).

[207] *Id*. at 582.

[208] *Id*. at 593. In 1935, for instance, the Sixth Circuit held that a dividend of common stock to preferred stockholders constituted a taxable stock dividend because it meaningfully changed the preferred stockholders' interest in the corporation. *See* Commissioner v. Tillotson Mfg. Co., 76 F.2d 189, 190 (6th Cir. 1935).

[209] *Id*. at 857 (statement of John W. O'Leary, President, Machinery and Allied Products Institute). *See also id*. at 841 (statement of Raymond H. Berry, Detroit Board of Commerce) ("I believe a tried system of taxation is much better than a new system of taxation, which to me presents many difficulties.").

[210] *See $803,000,000 Tax Bill Wins by Vote of 267-93 in House; Business Attacks New Deal*, N.Y. TIMES, Apr. 30, 1936, at 1; *see House Gets New Tax Bill, But Yield is Still in Doubt; Quick Passage Forecast*, N.Y. TIMES, Apr. 22, 1936, at 1 (House Ways and Means Committee voted 15 to 8 in favor of reporting the bill to the full House). At times, fewer than 10% of the Representatives were present for the debates over the bill, and, according to the *New York Times*, "not more than half [of those present] were listening to the discussion." Turner Catledge, *Democrat Lines up with Tax Bill Foes in Attack in House*, N.Y. TIMES, Apr. 25, 1936, at 1, 4; 80 CONG. REC. 6009 (statement of Rep. Rich).

[211] *See Republicans Bar Tax Amendments*, N.Y. TIMES, Apr. 28, 1936, at 12.

[212] *See* Alfred F. Flynn, *Finance Committee Questions Tax Bill on Two Grounds*, WALL ST. J., Apr. 24, 1936, at 1.

[213] *See* George B. Bryant, Jr., *Tax Bill Speeded as Opposition Wanes in Senate*, WALL ST. J., Apr. 29, 1936, at 1, 1-7; Turner Catledge, *$803,000,000 Tax Bill Wins By Vote of 267-93 in House; Business Attacks New Deal*, N.Y. TIMES, Apr. 30, 1936, at 1 ("Because of the tremendous House majority in today's vote and the ease with which the bill was shoved through the amending stages in that body yesterday, prospective opposition in the Senate was felt to be cooling perceptibly. Republican senators indicated they might follow the lead of their House colleagues and merely make their record against the whole new tax proposal, without attempting to amend it.").

business judgment."[214] Similarly strong statements emerged from the annual meeting of the United States Chamber of Commerce, where it adopted a resolution decrying the undistributed profits tax as an attempt "to regulate the management of corporations."[215]

Once the Senate Finance Committee hearings began, business leaders appeared in even greater numbers than during the House Ways and Means Committee hearings to testify against the undistributed profits tax. Whereas fifty-one non-governmental speakers testified on the bill during the House hearings, nearly double that number – ninety-four – testified before the Senate Finance Committee.[216] The Senate Finance Committee also received letters from another forty-three individuals or organizations, while the House Ways and Means Committee received only fourteen such written statements or letters.[217] Some of the increase in the number of people testifying on the bill was attributable to the Senate's consideration of a proposal to impose a new processing tax.[218] Nevertheless, the primary topic for most witnesses was the undistributed profits tax. Although they advocated relegating the tax to a subordinate role if Congress insisted on adopting it,[219] they maintained a steadfast opposition to the entire concept. The principal complaint was that the tax would interfere with normal business operations. Managers' concerns ranged from the specific concern that the tax would upset the "regularity of dividend" to the more general worry "over the uncertainty produced by the constant changing of our tax laws."[220] The United States Chamber of Commerce summarized such complaints:

> The plan would tend to provide substitution of public control for private management in important fiscal operations of business. It would promote improvident and unstable dividend policies in many companies. In others it would engender such uncertainties concerning the sound course to pursue as to subject the management to grave difficulties with shareholders and creditors. It presents the danger that corporate

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[214] *New Tax Law Unsound Says the Chamber*, N.Y. TIMES, Apr. 28, 1936, at 37. *See Chamber Attacks Tax Bill*, WALL ST. J., Apr. 28, 1936, at 1.

[215] Thrust at Tax Bill Winds up Chamber, N.Y. Times, May 1, 1936, at 1. The Chamber's annual meeting was widely covered in the press and its rhetoric was portrayed as a symbol of business' growing distrust of the New Deal. *See Wide Rift Shown Between Business and New Deal*, WALL ST. J., Apr. 29, 1936, at 2; *Chamber Talks Caustic*, N.Y. TIMES, Apr. 30, 1936, at 1; *Chamber Speakers Assail Profits Tax*, N.Y. TIMES, Apr. 30, 1936, at 10; Felix Belair, Jr., *Business and the New Deal Still Far Apart*, N.Y. TIMES, May 3, 1936, § 4, at 3.

[216] *Compare 1936 House Hearings, supra* note 184, at III-IV (index of statements) *with Revenue Act, 1936: Hearings on H.R. 12395 Before the Sen. Comm. on Fin.*, 74th Cong., 2d Sess. III-VI (1936) ("*1936 Senate Hearings*").

[217] *Compare 1936 House Hearings, supra* note 184, at IV *with 1936 Senate Hearings, supra* note 216, at V-VI.

[218] *See 1936 Senate Hearings, supra* note 216, at 3 (statement of Henry Morgenthau, Secretary of the Treasury) (urging consideration of the President's proposed new processing tax, which was not considered by the House, to replace the one struck down by the Court).

[219] One particularly effective argument in this respect was to question the tax's ability to raise the necessary revenue by itself. *See 1936 Senate Hearings*, *supra* note 216, at 682 (statement of James A. Emery, general counsel, National Association of Manufacturers) ("it is not . . . a reliable source of revenue, for it is subject to the variations of business policy rather than the net income of the business itself"). *See also id*. at 220, 221 (statement of Fred H. Clausen, United States Chamber of Commerce) ("The added revenue to be derived is highly uncertain and insufficient. It is less than the budgeted increase in ordinary expenditures for the next fiscal year.").

[220] *Id*. at 75 (statement of Franklin Spencer Edmonds, Philadelphia Chamber of Commerce); 101 (Statement of M.L. Seidman, New York Board of Trade). *See also id*. at 143 (statement of Paul H. Wilson, Graton & Knight Co.) (concerned about replacing a system we have had for many years for one "that we do not know what it will produce).

> management would be subject to serious criticism and even lawsuits if liberal dividend policies, followed to escape taxes, give rise to charges of dissipation of assets.[221]

The constant themes running throughout managers' testimony was that the tax constituted an unwarranted interference with their ability to run the corporation.

Not only were there more people protesting the undistributed profits tax bill, they were more direct in complaining about the potential interference with corporate management. Noel Sargent of the National Association of Manufacturers warned that "[a]ny attempt to substitute the judgment of commissions or legislators for that of industrial executives as to the percentage of earnings which can be properly distributed as dividends is economically unsound and fraught with dangers alike to employers, stockholders, and the public."[222] Herman Lind of the National Machine-Tool Builders Association echoed such concerns, suggesting that the management/shareholder and other conflicts engendered by the tax "will deflect the energies of management from the aggressive production and sale of goods and services which are its main function, to attempts to cope with a tangled mass of administration problems and uncertainties."[223]

Although managers preferred to cut the undistributed profits tax out of the bill entirely, they tried to influence the Finance Committee's consideration of several compromise proposals. In one prepared with the substantial assistance of the United States Chamber of Commerce, the undistributed profits tax would become a mere temporary supplement to the corporate income tax.[224] In another, the undistributed profits tax rate would be set at exactly same rate as the normal tax on dividends, thereby effectively nullifying its effect on dividend policy.[225] When the Senate Finance Committee Chair, Pat Harrison, proposed a modest three percent spread between the normal (4%) and undistributed profits tax (7%) rates, corporate managers howled,[226] but it was eventually adopted by both the Committee and the full Senate.[227]

As the bill proceeded to a conference committee to resolve the differences between the radically different House and Senate versions, corporate managers took their case to shareholders

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[221] *Id*. at 225 (statement of Fred H. Clausen, United States Chamber of Commerce).
[222] *Id*. at 651 (statement of Noel Sargent, National Association of Manufacturers).
[223] *Id*. at 520 (statement of Herman H. Lind, General Manager, National Machine-Tool Builders Association). *See id*. at 724 (statement of H.W. Story, Allis Chalmers Manufacturing Co.) ("But with the normal pressure upon management by stockholders for the payment of larger dividends, it would become more difficult for management to pursue a conservative policy of utilizing a large proportion of it earnings for the purpose of promoting the growth of the company.").
[224] *Senate Group Plans Complete Tax Bill Revision*, WALL ST. J., May 9, 1936, at 2. Under this proposal, the corporate income tax would be retained at rates ranging from 17.5% to 20% and dividends would be subject to the normal tax, but the undistributed profits tax would remain a part of the bill for only three years. *Id*.
[225] *See* Editorial, *A Compromise Tax Bill*, N.Y. TIMES, May 15, 1936, at 18.
[226] The United States Chamber of Commerce issued a statement denouncing Harrison's compromise. *See* Turner Catledge, *New Tax Program is Held Adequate by the Treasury*, N.Y. TIMES, May 17, 1936, at 1 According to the Chamber, "[t]he introduction of that principle [the undistributed profits tax] into our tax system in any form whatever is opposed by business on the justifiable ground, among others, that it would inject government into the management of private enterprise." *Id*. at 27.
[227] Turner Catledge, *18% Corporate Income Tax and 7% on Undivided Profit Agreed on by Senate Group*, N.Y. TIMES, May 22, 1936, at 1; *Tax Bill is Passed by Senate, 38 to 24; Conference to Act*, N.Y. TIMES, June 6, 1936, at 1.

directly and to the public at large. The president of General Motors, Alfred Sloan, sent a letter to shareholders with the regular quarterly dividend in which he warned that it "would be little short of a catastrophe" for the government to interfere with "the employment of accumulated profits by aggressive and intelligent management."[228] The National Association of Manufacturers issued a statement declaring that

> [b]oth the Senate Finance Committee and House bills accept the principle of taxation of undistributed profits. Such a proposal is economically unsound, since it repudiates the policy of industrial reinvestment of earnings upon which expansion and employment have been based for over 100 years, and because it seeks to substitute government judgment as to the desirable amount of corporate reserves for that of directors elected by corporate stockholders.[229]

Managers hoped that these public relations efforts would pressure Congress to abandon the undistributed profits tax entirely, but they ultimately proved unsuccessful. The conference committee successfully pushed through a compromise proposal. Thus, under the Revenue Act of 1936, Congress retained the corporate income tax, subjected dividends to the normal tax, and imposed an undistributed profits tax at rates ranging from 7% to 27%.[230]

C. *The campaign to repeal the tax in the Revenue Act of 1938*

1. Aftermath of the 1936 Act

In the immediate aftermath of the passage of the 1936 Act, business opposition to the undistributed profits tax did not subside. According to Alfred Buehler, national and regional business associations "continued to direct broadsides of criticism against the measure because of its alleged complexities, inequalities, and unfortunate effects on corporations."[231] John Morton Blum recounted that, "[b]ecause that tax tended to return to stockholders the decision about how to spend or invest their money, it challenged the power of professional managers of large corporations. These managers, their lawyers, and accountants, in all an able, articulate, and influential group, were aggressive opponents of the tax."[232] Republicans also helped sustain opposition by highlighting it during the 1936 election campaign as an example of the administration's anti-business stance.[233] Alf Landon, the Republican candidate for president,

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228 *Decreed Dividends Opposed by Sloan*, N.Y. TIMES, June 12, 1936, at 33.

229 *Heated Debate on Taxes Forces Recess in Senate; Rise in Surtaxes Voted*, N.Y. TIMES, June 4, 1936, at 1, 4.

230 Revenue Act of 1936, ch. 690, § 14(b), 49 Stat. 1648, 1655.

231 BUEHLER, *supra* note 166, at 35. *See* LAMBERT, *supra* note 157, at 409 ("Business representatives continued to complain that the law impaired the financial strength of corporations, imposed unreasonable penalties upon expansion, and retarded economic recovery. Business executives, lawyers, and economists gloomily predicted that the levy on undivided corporate surpluses would lead to industrial stagnation, increased unemployment, and a financial collapse."). For a typical expression of such sentiments, *see, e.g.*, *Executives Sound Confident Keynote*, N.Y. TIMES, Jan. 4, 1937, at 55 (year-end statement of W.G. Carey, president of Yale & Towne Manufacturing Co., assailing undistributed profit tax).

232 BLUM, *supra* note 170, at 321.

233 *Id*. at 36; HAWLEY, *supra* note 84, at 356.

vowed to eliminate "this vicious method of taxation," calling the undistributed profits tax "the most cockeyed piece of tax legislation ever imposed in a modern country."[234]

Where managers were forced to increase their dividend distributions as a result of the 1936 Act,[235] they used it as another opportunity to publicly assail the undistributed profits tax. The National Association of Manufacturers spearheaded a campaign to send letters to shareholders explaining that a desire to avoid the tax, and not the exercise of business judgment, forced the extra dividends.[236] In one example, a prominent oil company declared a special dividend with an accompanying explanation stating

> This special dividend declaration is made in order to reduce the company's liability for the new Federal tax on undistributed earnings. Because of the company's needs for capital expenditures and debt payments, the directors would prefer to retain in the business the cash represented by this special dividend. In any event, they would not ordinarily declare any dividend at this time with respect to earnings for the present calendar year, as such earnings cannot be known with sufficient exactness in the usual course of business for some time after year's end.[237]

Similar statements accompanied announcements of other changes necessitated by the undistributed profits tax. For example, the president of a public electric company explained that the directors voted in favor of a stock split with a reduction in stated par value because the tax would potentially interfere with plans for capital expenditures,[238] and a steel corporation executive sent a letter to stockholders blaming the undistributed profits tax "for abandoning its old policy of financing expansion and improvements out of earnings."[239]

Some corporate managers complemented their public activism against the tax by passively resisting its underlying principles. Thus, they continued retaining profits either by resorting to taxable stock dividends or by agreeing to incur the undistributed profits tax penalty. The former method, although specifically recommended by Treasury officials during the hearings,[240] was only used by a miniscule percent of the companies subject to the tax because of legal uncertainties.[241] By contrast, a substantial number of managers simply chose to pay the tax

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[234] Alf M. Landon, *Federal and Family Finances*, II VITAL SPEECHES OF THE DAY 763 (Sept. 15th, 1936).

[235] *See* GEORGE E. LENT, THE IMPACT OF THE UNDISTRIBUTED PROFITS TAX 1936-1937 33 (1948) (concluding that the undistributed profits tax was responsible for an increase of dividends by one-third); E.J.H., Jr., *Some Economic Aspects of the Surtax on Undistributed Profits of Corporations*, 25 GEO. L.J. 423, 435 (1937) ("During the last few weeks of 1936 announcements have been made of extra dividend, of bonuses, and of wage increases, running into millions of dollars. Each day brings announcement of further actions of this character, and when the statistics are finally compiled for the calendar year 1936, the total of these disbursements will probably reach, if not pass, the half billion mark").

[236] *See* LEFF, *supra* note 11, at 249 (noting the advent of "NAM sponsored shareholder letters in 1936").

[237] M.L. Seidman, *The Stockholder Holds the Bag*, 59 THE MAG. OF WALL STREET 156, 157 (1936). For other examples, *see Profits-Tax Levy Avoided By Trust,* N.Y. TIMES, Jan. 15, 1937, at 31 ("Distribution of extra and special dividends before the end of 1936 enabled Supervised Shares, Inc., to avoid liabilities under the tax on undistributed profits, Merrill Griswold, chairman, and Mahlon E. Traylor, president, said in a quarterly report issued yesterday.").

[238] *See Will Balance Effect of Federal Surtax*, N.Y. TIMES, Aug. 6, 1937, at 24.

[239] *Financing Planned by Ludlum Steel*, N.Y. TIMES, Aug. 26, 1937, at 31.

[240] *See supra* text accompanying notes 202-03.

[241] *See* William G. Christie & Vikram Nanda, *Free Cash Flow, Shareholder Value, and the Undistributed Profits Tax of 1936 and 1937*, 49 J. FIN. 1727, 1753 n.19 (1994) (one-third of one percent of all corporations subject to the tax

rather than distribute their free cash flow. According to one recent study, a surprisingly high percentage of corporations paid marginal rates of 22% or more under the tax.[242] Thus, managers in these corporations chose to incur the penalty either because of the deficiencies of shareholder monitoring or because shareholders implicitly or explicitly consented.

2. Recession of 1937

In the spring of 1937, a severe economic downturn opened a window of opportunity for managers to begin a campaign to repeal the undistributed profits tax.[243] Critics blamed the tax either partially or completely for a variety of economic ills,[244] including the decline of retail credit,[245] delay and termination of expansion plans,[246] lagging employment,[247] the onset and aggravation of stock market volatility,[248] and what the president of General Tire and Rubber Company called, "strikes by capital," where a lull in business confidence caused both large and small-time capitalists as well as corporate financiers to keep their money on the sidelines rather than to invest in business.[249] Horace Stoneham, the president of the New York Giants professional baseball team, even went so far as to blame the undistributed profits tax for his team's inability to sign a high profile star like Joe Medwick of the St. Louis Cardinals.[250]

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issued taxable stock dividends); Godfrey N. Nelson, *Law Still is Hazy on Stock Dividends*, N.Y. TIMES, Nov. 1, 1936, sec. III, at 1.

[242] *See* Charles W. Calomiris & R. Glenn Hubbard, *Internal Evidence and Investment: Evidence From the Undistributed Profits Tax of 1936-1937*12 -13 (1993), in NATIONAL BUREAU OF ECONOMIC RESEARCH WORKING PAPER SERIES (Working Paper No. 4288) (between 17 and 23% of small to medium-sized corporations).

[243] "Before the economy picked up in the late spring of 1938," Mark Leff observed, "industrial production fell by a third, durable-goods production and stock prices slipped by half, and profits skidded to one-fifth their 1937 highs. Unemployment, always a tragic embarrassment to the New Deal, shot up by nearly 4 million." *See* LEFF, *supra* note 11, at 209.

[244] Another tax provision cited as a cause of the economic downturn was the capital gains tax. *See Tax Modification Asked as Trade Aid*, N.Y. TIMES, Aug. 4, 1937, at 28.

[245] *See Profits Tax Slows Recovery, He Says*, N.Y. TIMES, Aug. 28, 1937, at 20.

[246] *See Levy on Profits Halts Expansion*, N.Y. TIMES, Aug. 27, 1937, at 24.

[247] *15 Criticisms Made of the Profit Tax*, N.Y. TIMES, Sept. 26, 1937, at 24 (U.S. Chamber of Commerce study); *Surplus Tax Repeal Held Labor Benefit*, N.Y. TIMES, Oct. 31, 1937, § III, at 8 (National Association of Manufacturers Study).

[248] *See* Editorial, *A Tax Theory Demolished*, WALL ST. J., Oct. 22, 1937, at 4; *Our Taxes Too High, Periling Business, Tremaine Asserts*, N.Y. TIMES, Oct. 1, 1937, at 1 ("[New York State Controller] Tremaine blamed the stock market slump directly upon the Federal Capital Gains and Losses Tax, and the Undistributed Profits Tax."); *Ballantine Finds New Deal Harmful*, N.Y. TIMES, Oct. 20, 1937, at 10 (highlighting the undistributed profits tax among New Deal programs "as responsible for the current stock market slump").

[249] *Capital 'Strikes' Laid to Tax Laws*, N.Y. TIMES, Oct. 23, 1937, at 25; *Profits Tax Held Bar to Confidence*, N.Y. TIMES, Nov. 8, 1937, at 33.

[250] *Unfair to Baseball*, BUS. WEEK, Dec. 11, 1937, at 44. According to Stoneham, "[i]f you wanted to spend your surplus on ball players, the government would step in and stop you. That sort of thing is inimical to baseball. If you make a lot of money you want to make more by strengthening your club. But you cannot do what you please. You've got to distribute a large part of your profits to stockholders." *Id*.

Although economists refuted claims that the undistributed profits tax was responsible for starting the recession,[251] corporate managers blamed the tax on creating "a climate of fear and uncertainty" that both contributed to the recession and made recovery more difficult.[252] Prominent business leaders such as the president of Chemical Bank advocated repeal "as a means of restoring confidence among business men."[253] The American Institute of Accountants issued a report declaring that in order for business "to face the future confidently" Congress must return to "fixed principles of taxation" and abandon the failed undistributed profits tax.[254]

3. Revenue Act of 1938

The combination of the recession and business' steady campaign against the tax sealed its fate. The only question in 1938 was whether it would be repealed outright or merely nullified by reducing its rate so low that it no longer acted as an incentive to distribute profits.

Although Congress initially aimed for the latter option,[255] business leaders were not satisfied. They argued that maintaining even the nominal undistributed profits tax proposed in the subcommittee report was unacceptable. During hearings before the House Ways and Means Committee in January of 1938, the United States Chamber of Commerce recommended "[r]epeal[ing] the thoroughly discredited undistributed profits tax and openly abandon[ing] the 'principle.'"[256] As one railroad executive noted, nothing short of repeal would be sufficient: "The continuation of this tax, even in the modified form proposed, will continue to hamper business and destroy the confidence of business management in its ability to look ahead and to plan and enter into long-time commitments, which constitutes the very essence of recovery. This

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[251] *See Eased Income Tax Urged By Tremaine*, N.Y. TIMES, Dec. 15, 1937, pt. 1 at 1, 12 ("Dr. Willard L. Thorp, director of economic research for Dun & Bradstreet, said there was 'danger in saying that the undistributed profits tax was responsible for the recession.' He declared there would have been a slump if there had been no such tax.").

[252] LAMBERT, *supra* note 157, at 414. *See* Lewis H. Kimmel, *Experience Under the Undistributed Profits Tax*, 11 CONF. BOARD BULL. 105, 105-15 (1937) (survey of 360 corporate executives revealed that many corporate expansion plans were delayed by fear of the tax's effect on surpluses); Godfrey N. Nelson, *Loss of Confidence Laid to Tax of 1936*, N.Y. TIMES, Feb. 20, 1938, § III, at 1 ("[T]he results of research show that the undistributed-profits tax is one of the major causes of the loss of business confidence.").

[253] *F.K. Houston Urges Repeal of Two Taxes*, N.Y. TIMES, Oct. 22, 1937, at 33.

[254] *Taxation Found 'Bugaboo' of Corporations; Accountants Advocate Nonpartisan Study*, N.Y. TIMES, Sept. 23, 1937, at 41.

[255] A subcommittee of the House Ways and Means Committee proposed merging the undistributed profits tax with the corporate income tax so that the corporate rate would rise or fall between 16 and 20 percent depending upon the percentage of profits distributed. *See* Steven A. Bank, *Corporate Managers, Agency Costs, and the Rise of Double Taxation*, 44 WM. & MARY L. REV. 167, 239-40 (2002). The net effect would be to make the 4 percent pressure to distribute identical to the 4 percent tax on dividends, and thus pressure not to distribute.

[256] *Revision of Revenue Laws 1938: Hearings Before the House Comm. on Ways and Means,* 75th Cong. § 104, at 468 (1938) (prepared statement of Ellsworth C. Alvord, Chamber of Commerce of the United States). *See also id*. at 155 (statement of M.L. Seidman, New York Board of Trade) ("The undistributed profits tax stands before the country today thoroughly convicted as an undesirable tax and as harmful to business and to confidence. It has earned its execution. Let it die.").

tax should be repealed in its entirety."[257] While corporate managers spoke of the hardships still imposed under the revised tax, the principal concern appeared to be that retaining the principle would invite the reintroduction of more meaningful rates in subsequent years.[258]

The proposal to retain the undistributed profits tax principle received an equally chilly reception in the hearings before the Senate Finance Committee. The chair of the committee, Senator Pat Harrison, issued a statement announcing his intent to secure the tax's repeal: "While the House retained only the skeleton of the undistributed profits tax . . . the remains will haunt business, and its complete removal and return to a sufficient flat corporation tax is preferable."[259] This echoed the sentiments of most business leaders. A representative of the Brooklyn Chamber of Commerce warned that retaining the principle would make it "an ever-constant threat,"[260] while M.L. Seidman of the New York Board of Trade predicted that "it would remain to haunt business, not only for what it is, but also for what it may eventually grow into if permitted to remain as a permanent part of our tax structure."[261] Ellsworth Alvord of the United States Chamber of Commerce asked "if you impose 3½ percent this year . . . what is there to assure a businessmen that you will not boost that penalty to 42½ percent as was proposed two years ago?"[262]

As expected, both the Senate Finance Committee and the Senate heeded business' complaints and overwhelmingly voted to repeal the undistributed profits tax altogether.[263] Only a last-ditch effort by President Roosevelt led to what one conferee called a "face-saving compromise" in the Conference Committee.[264] The tax was retained at the very low rate of 2.5 percent, but it was scheduled to expire after 1939.[265] While Roosevelt hoped to revive it at a later date, the opposition was still too great. As Robert La Follette, the lone senator who publicly challenged the repeal, observed the undistributed profits tax "has been the object of one of the

[257] *Id*. at 401 (statement of George Houston, president Baldwin Locomotive Works).
[258] *See, e.g., Tax Bill Sent to Conference, House Not Yielding on Changes*, N.Y. TIMES, April 13, 1938, at 1 (Rep. Lamneck of Ohio "declared that the business interests were absolutely opposed to the undistributed profits tax theory, as retained in the House bill, 'not because it is going to levy a high tax on them, but because they fear we may use the principle to raise the rates and change the schedule.'").
[259] *Harrison Demands End of Profits Tax to Help Business*, N.Y. TIMES, Mar. 13, 1938, at 1.
[260] *Revenue Act of 1938: Hearing on H.R. 9682 Before the Sen. Comm. on Finance*, 75th Cong. 183 (1938) ("*1938 Senate Hearings*") (statement of J.W. Hooper, Chairman of the Federal Tax Committee, Brooklyn Chamber of Commerce).
[261] *Id*. at 257 (statement of M.L. Seidman, Chairman of Taxation Committee, New York Board of Trade).
[262] *Id*. at 469 (statement of Ellsworth Alvord, U.S. Chamber of Commerce). *See also id*. at 19 (statement of Henry H. Heimann, National Association of Credit Men) ("We think that the present undistributed profits tax will not constitute the menace, the penalty that it has in the past, but nevertheless we still believe the principle of the tax is dangerous, and there is no assurance at any time that the law may not be changed with respect to rates so that the same danger that was inherent in the 1936 bill will again become included in the bill.").
[263] *See* Lauren D. Lyman, *Profit Tax Eliminated, Gains Levy is Modified by Senate Finance Group*, N.Y. TIMES, Mar. 25, 1938, at 1 (17-4 vote); *Senate Approves Most of Tax Bill*, N.Y. TIMES, Apr. 8, 1938, at 13 (41-27 vote).
[264] *Profits Tax Looms as Election Issue*, N.Y. TIMES, Apr. 24, 1938, at 4.
[265] *Modified Surplus Tax for Two Years Retained in Senate-House Compromise*, N.Y. TIMES, Apr. 23, 1938, at 1.

most widely organized and most successful propaganda campaigns in the history of tax legislation."[266]

III. A CORPORATE NORMS-BASED EXPLANATION

What accounts for the difference in corporate managers' reactions to the two proposals? Both appeared to be attempts to restrict behavior in ways that under traditional agency cost theory analysis managers were likely to oppose. In the case of tax-free reorganizations, the elimination or restriction of this option would likely decrease a manager's ability to expand his empire and pursue pet projects. In the case of the undistributed profits tax, the crimp on managerial discretion over dividend policy and resulting decline in free cash flow would either reduce their ability to pursue individual projects or force them to be subjected to the scrutiny of the capital markets.

Some of the difference in reaction may have been the result of the peculiar political and economic circumstances of the day. During President Roosevelt's first term, when the Revenue Act of 1934 was introduced and the stock market crash was still a recent memory, business may have been inclined to be more cooperative in its dealings with the administration.[267] By the time the undistributed profits tax was enacted, however, the political climate had changed. Roosevelt was perhaps at the height of his power in 1936, but in reaching that point he had sabotaged any possibility of working together with business.[268] The fact that Roosevelt himself had initiated the undistributed profits tax proposal while the recommendation to abolish the tax-free reorganization came from a Congressional subcommittee may have heightened the stakes from

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[266] *1938 Senate Hearings, supra* note 260, at 4932 (statement of Senator La Follette). La Follette's Investigating Committee in the Senate found that the National Association of Manufacturers had spent almost $1 million a year fighting the undistributed profits tax since its passage. In conjunction with the efforts of other groups such as the U.S. Chamber of Commerce, "every known medium of reaching the public with their propaganda has been used, including advertising in the daily and weekly newspapers, and colored news articles. The [La Follette Investigating Committee] records show they have also used direct mail, booklets, leaflets, bulletin board posters, 24 sheet posters for outdoor boards, pay envelope slips, sound slide films, moving picture slides, plant publications and house organ service, nation-wide radio programs, including the "American Family Robinson" cartoon service and the "Uncle Abner" series and under many other names." W.D. McFarlane, *Weekly Newsletter*, WICHITA BANNER, March 11, 1938, *in* William Doddridge McFarlane Papers, 1919-1981, Box No. 3U265, Center for American History, University of Texas.

[267] *See* LEFF, *supra* note 11, at 133 ("Earlier in the New Deal, with economic survival and political stability hanging in the balance, businessmen had good reason to go along with the New Deal's 'concert of interests' theme."); BEARD & BEARD, *supra* note 36, at 244 (observing that during the spring and summer of 1933, "[p]owerful business leaders cooperated with the administration in a spirit of cheerful compliance contrasting sharply with the hostility which they had displayed toward Bryanism, Progressivism, and the New Freedom."). This conciliatory position may have been adopted out of necessity. As Richard Hofstadter observed, "the coming of the depression and the revelation of some of the less palatable business practices of the 1920's brought about a climate of opinion in which the leadership of business, and particularly of big business, was profoundly distrusted and bitterly resented. Its position certainly was, in these respects, considerably weaker than it had been twenty-five years before." RICHARD HOFSTADTER, THE AGE OF REFORM 312 (1955).

[268] *See* CONKIN, *supra* note 65, at 81 (describing Roosevelt's campaign for presidency in 1936 as "a much more aggressive, even provocative campaign than in 1932, with angry jabs at economic autocracy, organized money, economic tyranny, and forces of selfishness and lust for power.").

the perspective of business leaders. By 1937-38 when the country was in the throes of another economic downturn, the tide had turned and business leaders had more leverage to use in the fight against purportedly anti-business measures.[269]

While the timing factor is not insignificant, it should not be overstated. Business started to criticize the administration as early as the fall of 1933 and the beginning of 1934.[270] A temporary truce was not declared until after the elections in 1934, which was well after the reorganization provisions had been amended.[271] Moreover, even if business leaders had resisted opposing the reform because of their pledge to cooperate with the recovery program, it should not have prevented them from repealing the restrictions once they felt their compact with the administration had been broken. They did this not only in their battle over the undistributed profits tax, but also in reversing the abolition of the consolidated return.[272]

It is also possible that the difference in reaction was in part a reflection of the extent of the underlying changes in the current tax law. Ever since 1918, managers had been subject to a fairly strict set of requirements in order to qualify their transactions as tax-free reorganizations. Moreover, the final changes enacted, while considered substantial by tax practitioners, still left intact the basic scheme for such transactions. In that sense, the changes might not be described as "revolutionary." By contrast, there was no undistributed profits tax prior to 1936. President Roosevelt's proposal to eliminate the corporate income tax and the dividend exemption, while subjecting undistributed profits to a high levy, would have been a sharp change from the corporate tax system that had developed during the preceding two decades.

Cutting against the merit of a degree-of-change-based argument is that the undistributed profits tax also was not altogether new. From the beginning of the income tax in 1913, managers had been subject to an accumulated earnings tax on earnings retained for the purpose of evading the surtax rates. While this provision was often not enforced because of the difficulty of proving intent, its use had been upheld in a 1936 Board of Tax Appeals case,[273] which was eventually affirmed by the Supreme Court in 1938.[274] In 1934, Congress adopted a personal holding company tax for smaller companies that omitted an intent requirement.[275] While neither of these

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[269] *See* LEFF, *supra* note 11, at 231 ("Until 1937, the Roosevelt administration set the terms of debate on taxation. But the recession changed that, allowing the business community to take charge.").

[270] *See* HAWLEY, *supra* note 84, at 151; BEARD & BEARD, *supra* note 36, at 245.

[271] *Id*. at 153.

[272] Starting in 1918, corporations that were considered "affiliated" under the tax laws because of their common stock ownership or parent-subsidiary relationship were permitted to file a single return that reflected the consolidated income of the group. In 1932, Congress began to impose an additional tax for the privilege of filing a consolidated return and in 1934, the consolidated return was abolished completely except for railroads. *See* TWENTIETH CENTURY FUND, *supra* note 11, at 177-78. This repeal was justified as part of an attack on the holding company structure. *See Tax Bill Changes Offered by Borah*, N.Y. TIMES, Mar. 2, 1934, at 38; Daniel C. Schaffer, *The Income Tax on Intercorporate Dividends*, 33 TAX LAW. 161, 165 (1979). By 1942, Congress revived the consolidated return, although it still subjected the return to an additional tax. *Id*. at 168-69.

[273] Nat'l Grocery Co. v. Commissioner, 35 B.T.A. 163, 167 (1936).

[274] Helvering v. Nat'l Grocery Co., 304 U.S. 282, 291 (1938).

[275] 48 Stat. 751 (1934).

provisions approached the expansive reach of the undistributed profits tax proposal,[276] they did introduce corporate managers to the concept of a tax limitation on dividend policy.

The full legislative histories of the two provisions further weaken the substantive argument regarding the extent of the change. From an ex ante perspective, the original proposal to abolish the reorganization provisions was just as radical as the undistributed profits tax proposal and yet it was not subject to nearly as much active opposition from business leaders. Moreover, from an ex poste perspective, business leaders were eager to eliminate all traces of the undistributed profits tax in 1938, notwithstanding the reduction of the rate to a level that would make it a non-factor in dividend decisions, while there was no similar attempt to further reduce the restrictions on tax-free reorganizations after the 1934 Act was passed.

Thus, while a variety of historical and statute-specific factors may have influenced the different reactions to the two proposals, they do not, either individually or in the aggregate, offer a complete explanation. There is one potential factor, however, that has not been explored -- the underlying norms that governed the behavior Congress sought to regulate through the tax laws. In the case of reorganizations, mergers and acquisitions were historically subject to the oversight of both shareholders and the state legislature and managers were not accustomed to free rein in this area. By contrast, dividend policy had always been the exclusive province of directors. This distinction may have affected managerial attitudes toward the government's attempt to regulate those areas through the tax laws.

A. *Mergers and Acquisitions*

During the nineteenth and early twentieth centuries, managers were subject to heavy constraints on their ability to cause the corporation to engage in a merger or acquisition. First, such transactions were subject to a shareholder vote, often one that required unanimous or near-unanimous consent. Second, for most fundamental corporate changes such as mergers and consolidations, managers had to secure the approval of the state, either by statute or via a provision in their corporate charter. Third, the passage of the Sherman Anti-Trust Act in 1890 introduced federal oversight on mergers and combinations. The combined effect of these constraints was to undercut any notion of managerial primacy on the issue of mergers and acquisitions. Thus, it is not surprising that managers responded to the proposed changes with relatively muted rhetoric.

1. Shareholder approval

There is a long tradition of shareholder primacy in the context of a fundamental corporate change. During the mid-to-late nineteenth century, almost all courts required the unanimous consent of shareholders before a corporation could pursue transactions such as a merger,

[276] *See* Paul Marcuse, *Taxation of Undistributed Profits*, 15 N.Y.U. L.Q. REV. 1, 8 (1937) (recounting the history and deficiencies of the two provisions).

acquisition, or sale of assets.[277] Thus, while corporate managers could initiate these and other similar transactions, shareholders were empowered with the ability to block such transaction simply by withholding their consent.

The theory underlying the unanimous consent requirement was that a fundamental corporate change constituted a breach of the shareholder's contract and a violation of his property rights.[278] As to the former justification for unanimity, the argument was that a shareholder entered into a contract with the corporation when he purchased its stock. This contract, deriving some of its content from the *ultra vires* doctrine,[279] implied that the corporation had a duty to continue in operation under roughly the same terms as it had done at the time of purchase. By merging with another corporation or selling all of its assets, the corporation effectively abandoned its former charter and thereby breached the contract.[280] As to the latter justification for unanimity, the concern was that the shareholder's property interest in the business' assets would be taken through a transfer of the assets.

In 1890, the U.S. Supreme Court relied on the unanimous consent requirement to invalidate a transaction in *Mason v. Pewabic Mining Company*.[281] In the case, the taxpayer's charter had expired and the company was in the process of winding up its affairs.[282] The directors and a majority of the stockholders sought to transfer the assets to a new corporation, of which they would be directors and stockholders, in exchange for shares of stock in the new corporation or their equivalent value.[283] The Court upheld the dissenting stockholders' right to block the transfer. According to the Court, "there is no superior right in two or three men in the old company, who may hold a preponderance of the stock, to acquire an absolute control of the whole of it, in the way which they may think to be for the interest of the whole. . . . [W]e know of no reason or authority why those holding a majority of the stock can place a value upon it at which a dissenting minority must sell, or do something else which they think is against their interest, more than a minority can do."[284]

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[277] *See* MORTON J. HORWITZ, THE TRANSFORMATION OF AMERICAN LAW, 1870-1960 87 (1992); VICTOR MORAWETZ, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS § 54, at 49 (1882); GEORGE W. FIELD, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS 168 (1877); Kean v. Central Railroad Co., 9 N.J. Eq. 401; 1800 WL 2297, 1, 5 (N.J. Ch., 1853).

[278] HORWITZ, *supra* note 277, at 87.

[279] *Id*. at 86-87.

[280] *See, e.g*., Kean, 1800 WL 2297, at 9 ("That the majority should have the power claimed for them, does not seem to me to be the contract between the stockholders, for there *is* a contract, as already shown in the case of every corporation, between them. That contract is, that their joint funds shall, under the care of specified persons, generally called directors, be employed, and that for certain specified purposes."). The modern concept of dissenter's right to the value of his shares was not considered satisfactory under the unanimous consent requirement. *Id*. at 10 ("It can hardly, therefore, I think, be argued with justice, that a majority of the stockholders had a right, upon principle, to sell out all the property of the company from which its profits were to be realized and abandon the business, and that the minority's rights are satisfied by a division to them of the value of their stock.").

[281] Mason et al. v. Pewabic Min. Co., 10 S. Ct. 224 (1890).

[282] *Id*. at 224-25.

[283] *Id*. at 225.

[284] *Id*. at 226.

This principle of unanimity continued to be the common law rule well into the twentieth century.[285] According to the 1927 edition of a contemporary treatise, "[i]n the absence of statutory authority the consent of every stockholder is absolutely essential to a consolidation; and dissenting stockholders can not be compelled to give their assent."[286] Even where a charter provided that in the absence of specific direction the company shall have the greatest rights and privileges accorded to a corporation of its type, the courts refused to approve a consolidation with less than unanimous shareholder approval.[287]

While the unanimous consent requirement could be and was relaxed by state statute in some jurisdictions by the 1930s,[288] directors were still subordinated to the shareholders on the issue of fundamental corporate change. As William Meade Fletcher explained in the 1919 edition of his *Cyclopedia on the Law of Private Corporations*, "[c]onsolidation cannot be effected by the action of the boards of directors but must be consented to by at least a majority of the stockholders."[289] The same rules were in place for a sale of all of the assets of a corporation, where, according to one contemporary commentator nearly half of the state statutes had abandoned the unanimous consent requirement, but all still required at least a majority.[290] Sometimes this meant a majority of the stock ownership, so that in practice a few stockholders could still control,[291] although occasionally it simply meant a majority or more of the stockholders present at a duly called meeting in which at least a quorum was present.[292] Typically, the requirement for "majority" approval meant considerably more than that, often requiring two-thirds or even three-quarters or four-fifths of the shareholders to consent to the transaction.[293] When there were multiple classes of voting stock present, each class was required to approve the transaction by the minimum percentage.[294]

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[285] The use of the phrase "common law" here is not to suggest that the merger was possible under the common law, but rather that in the absence of statutory direction in a jurisdiction where a merger was permitted, unanimous consent was required.

[286] SEYMOUR D. THOMPSON & JOSEPH W. THOMPSON, 8 COMMENTARIES ON THE LAW OF CORPORATIONS 93 (3d ed. 1927).

[287] *Id*. at 95 (*citing* Botts v. Simpsonville &c. Tpk. Rd. Co., 88 Ky. 54).

[288] *See* HORWITZ, *supra* note 277, at 88 (citing Delaware, New York, and New Jersey among those states permitting mergers with less than unanimous consent). The requirement had actually been relaxed by state statute in some jurisdictions early on in the nineteenth century. *See, e.g.*, Mass. Acts & Resolves, ch. 223, § 11 (1849) (majority); N.J. Acts, § 1, at 124 (1831) (seven-eighths); Pa. Laws, No. 197, § 3 (1856) (two-thirds).

[289] See WILLIAM MEADE FLETCHER, 7 CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS 8326 (1919).

[290] *See* Kenneth Field, *Nature of a Procedure for Direct Property Owning Consolidations*, 5 ROCKY MTN. L. REV. 230, 242 (1933).

[291] FLETCHER, *supra* note 289, at 8329 ("where each share of stock is entitled to one vote the per cent is to be figured on the number of shares and not the number of holders.").

[292] Under the Michigan statute, for example, directors needed to secure the consent of two-thirds of the stockholders constituting a quorum. *See* THOMPSON & THOMPSON, *supra* note 286, at 95; Comment, *Statutory Merger and Consolidation of Corporations*, 45 YALE L. J. 105, 113 n. 43 (1935) ("As a general rule the required proportion must be of the total capital stock outstanding, though the Virginia statute seems to require only that their be approval by a majority of the votes cast.").

[293] *See* ROBERT S. STEVENS & ARTHUR LARSON, CASES AND MATERIALS ON THE LAW OF CORPORATIONS 985 (1947); Comment, *supra*, note 292 at 107 n. 8 ("At the present time statutory provisions in forty states authorize sales of entire corporate assets on the consent of proportions of stockholders varying from a majority to four-fifths."); Field, *supra*

Even where the decision to merge was approved by at least the required percentage, the merger could still be overturned by the courts if it was deemed unfair to the minority. In New Jersey, for example, the court of chancery enjoined the merger of five public utility companies into the Public Service Electric and Gas Company despite the fact that Public Service owned more than two-thirds of the capital stock of the merging companies and could therefore satisfy New Jersey's minimum approval requirement.[295] The minority shareholders complained that the preferred stock they were to receive in exchange for their common stock was actually less secure than their previous holdings. The court held that "the merger, in effect, is nothing less than a forced sale by the majority stockholders to itself at a price fixed by it and payable at its pleasure. The preferred stock is but the equivalent of a six per cent. promissory note payable in three years at the option of the buyer. The merger legislation countenances no such perversion of the contractual obligations of stockholders inter sese. Continued membership, until dissolution is an inherent property right in corporate existence."[296] The court thus effectively limited the majority's right to engage in a "freeze out" merger.[297]

2. Legislative approval

Although corporations could generally sell and acquire large amounts of assets under the common law,[298] there was no implied right to merge or consolidate with another company.[299] Corporations needed to secure the consent of the legislature in order to engage in a merger or consolidation.[300] As William Meade Fletcher put it, "[l]egislative authority is just as essential to a valid consolidation or merger of existing corporations as it is to the creation of a corporation in

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note 290, at 230 ("The most common requirement is that the holders of two-thirds of the outstanding stock vote in favor of the consolidation; but there is no uniformity from state to state -- the amounts varying from a mere majority of the votes cast to 100 per cent of the stock outstanding.").

[294] *See* Comment, *supra* note 292, at 114.

[295] Outwater v. Pub. Serv. Corp. of N.J., 103 N.J. Eq. 461, 143 A. 729 (1928).

[296] *Id*., 103 N.J. Eq. at 466.

[297] *See* CHESTER ROHRLICH, LAW AND PRACTICE IN CORPORATE CONTROL 137 (1933).

[298] *See* Field, *supra* note 290, at 242 ("In the absence of express restrictions, business corporations have the implied power to convey any or all of their real or personal property."). Some authorities suggested that such a right was limited to a sale required by the exigencies of the business. *See* HENRY WINTHROP BALLANTINE, BALLANTINE ON CORPORATIONS 209 (1927) ("A purely private business corporation, like a manufacturing or trading company, which is not given the right of eminent domain, and which owes no special duties to the public, may sell and convey absolutely the whole of its property, when the exigencies of its business require it to do so, or when the circumstances are such that it can no longer profitably continue its business."); WILLIAM W. COOK, THE PRINCIPLES OF CORPORATION LAW 437 (1931) ("Neither the directors nor the majority of the stockholders have power to sell all the corporate property as against the dissent of a single stockholder, unless the corporation is in a failing condition.").

[299] See FLETCHER, supra note 284, at 8313; FIELD, *supra* note 277, at 461.

[300] *See* WILLIAM L. CLARK, JR., HANDBOOK OF THE LAW OF PRIVATE CORPORATIONS 191 (3d ed., I. Maurice Wormser, ed., 1916) ("A corporation has no power to consolidate with another corporation, unless the power is expressly conferred upon it.").

the first instance."[301] This could either come from a specific grant of authority in the corporation's original charter or via a general grant of authority by state statute.[302]

In many states, the principal problem was that there was no merger or consolidation statute that blessed such transactions. At the time that the tax-free reorganization provision was being considered in 1934, only thirty-three states and the Territory of Hawaii had general statutes authorizing corporations to merge or consolidate.[303] The fourteen remaining states, plus Alaska, the District of Columbia, the Philippine Islands, and Puerto Rico had no special provisions for conferring such authority.[304] Thus, in the absence of a charter provision or special act of the legislature, corporations in those states where not eligible to participate in such transactions.[305]

Even where a state merger statute existed, it was often limited in scope. Most of the early state law merger statutes restricted mergers based on the powers granted to the corporations under their respective charters. The concern appeared to be that an activity that would be *ultra vires* under the charter of one corporation would suddenly become acceptable by virtue of the more permissive charter of the combined enterprise. Thus, for example, in New Jersey, the right to merge or consolidate was restricted to corporations organized to undertake "any kind of business of the same or similar nature," the nature of the business being determined by the charter or certificate of incorporation.[306] Under this provision, the New Jersey courts denied permission for the consolidation of the United States Leather Company and the Central Leather Company because, even though the companies were generally engaged in the same line of business, the charter of one contained broader powers than the charter of the other.[307]

During this same period, there were other similar examples of purpose and geographical restrictions. New York only permitted the consolidation of corporations incorporated "for kindred purposes." [308] Connecticut limited its statute to parties "carrying on business of the same or a similar nature."[309] Illinois only permitted consolidation of "corporations of the same kind and engaged in the same general business and carrying on their business in the same vicinity."[310] Moreover, while most such purpose restrictions had been removed or weakened by the 1930s,[311] many statutes still restricted a corporation's ability to merge or consolidate with a corporation from another state, either by denying the power to engage in the transaction altogether or by a

[301] FLETCHER, *supra* note 284, at 8313.
[302] CLARK, *supra* note 300, at 192; FLETCHER, *supra* note 284, at 8315.
[303] *See* Bank, *Federalizing the Tax-Free Merger*, *supra* note 72, at 1355.
[304] *Id*.
[305] As one commentator notes, parties frequently got around this limitation by engaging in a sale or similar transaction that had the same result as a merger or consolidation. *See* Comment, *supra* note 292, at 110 n.24. In that case, the transaction would still be subject to the restrictions governing shareholder approval on fundamental corporate changes and to other restrictions on sales of assets. *See infra* text accompany note 299.
[306] FLETCHER, *supra* note 284, at 8322.
[307] *See* Colgate v. United States Leather Co., 75 N.J. Eq. 229, 239-40 (1909).
[308] *See* FLETCHER, supra note 284, at 8323.
[309] Conn. Public Acts, ch. 157 (1901).
[310] Ill. Rev. Stat. ch. 31, §§ 50, 52 (1895).
[311] *See* Comment, *supra* note 292, at 110 (purpose restrictions were still relevant, though, for public utilities, insurance companies, banks, and trust companies).

requirement that the surviving party be a domestic corporation.[312] In some cases, the merger or consolidation even had to be approved by a state regulatory board or corporation commission to be effective.[313]

While sales of large amounts of corporate assets were permitted under the common law, they were often subject to many of the same statutory restrictions as mergers or consolidations. According to one contemporary commentator, "[a]lthough merger and consolidation is strictly statutory and a sale of assets is essentially contractual, as a practical matter in a given case it may be extremely difficult to decide whether the device employed was merger and consolidation or a sale of assets inasmuch as today, the latter also usually follows a statutory procedure."[314]

3. Federal oversight

In addition to the oversight exercised by state legislatures, fundamental corporate changes were subject to federal oversight. The earliest and most prominent source of this oversight was the Sherman Anti-Trust Act. Adopted in 1890, this act held that "every contract, combination, in the form of a trust or otherwise, or conspiracy, in restraint of trade or commerce among the several states or with foreign nations" was illegal.[315] Vague language, the failure to provide for an agency to implement the Act, and the Supreme Court's narrow interpretation of the law hampered its effectiveness,[316] but it provided the basis for later federal challenges of merger activity during Theodore Roosevelt's administration.

In 1902, Roosevelt directed his attorney general to revive the then-dormant Sherman Act by pursuing an antitrust action against the Northern Securities Company.[317] Two years later, the Court ordered the company's dissolution. Emboldened by his success, which earned him the "trust-buster" label, Roosevelt set his sights on even bigger targets. Thus, Roosevelt brought separate federal antitrust actions against the Standard Oil Company and the American Tobacco Company. After protracted litigation, in 1911 the Supreme Court issued opinions ordering that both Standard Oil and American Tobacco be broken up into several smaller companies.[318] While

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[312] Bank, *Federalizing the Tax-Free Merger*, *supra* note 72, at 1355.

[313] *See* Comment, *supra* note 292, at 114.

[314] *Id*. at 107 (noting, however, that the statutes governing sales of entire corporate assets differed in form and substance from those governing mergers or consolidations); BALLANTINE, *supra* note 298, at 210 ("In recent years statutes authorizing such disposition [of the entire property of the corporation] by the consent of a majority, or two-thirds or three-quarters of the stockholders of a solvent, going concern have become common.").

[315] Act of July 2, 1890, ch. 647, 26 Stat. 209.

[316] *See* LAWRENCE M. FRIEDMAN, A HISTORY OF AMERICAN LAW 465 (1985); HORWITZ, *supra* note 277, at 84; GEISST, *supra* note 36, at 104-05; JOHN MICKLETHWAIT & ADRIAN WOOLDRIDGE, THE COMPANY: A SHORT HISTORY OF A REVOLUTIONARY IDEA 73 (2003). The Supreme Court held that the Sherman Act was inapplicable to manufacturing companies because they did not engage in "commerce." *See* United States v. E.C. Knight Co., 56 U.S. 2 (1895).

[317] *See* ROBERT L. HEILBRONER & AARON SINGER, THE ECONOMIC TRANSFORMATION OF AMERICA: 1600 TO THE PRESENT 212 (2d ed. 1984).

[318] The Standard Oil Co. of New Jersey et al. v. U.S., 221 U.S. 1, 79-80 (1911); U.S. v. Am. Tobacco Co., 221 U.S. 106, 187-88 (1911).

these victories were far from complete, they did mark a departure from "the uncritical approval of business expansion" that characterized the early-to-mid nineteenth century.[319]

Perhaps more importantly, the results may have chilled some transactions. According to one 1913 edition of a practitioner's treatise, "the general result of the federal decisions in the Tobacco, Standard Oil, and other similar cases has been to leave the situation in perplexing uncertainty. At the present time it is not possible for counsel to advise what can be safely done in forming industrial combinations."[320] The same treatise noted that "[a]t present few new combinations are being formed. The Sherman Anti-Trust Law, after many years of more or less innocuous desuetude, finally became a live law. The business world, which had considered its provisions negligible, was dismayed to find that it really meant something and that it could be enforced against the largest and most firmly entrenched combinations."[321]

Soon after the resolution of the Standard Oil and American Tobacco cases, Congress enacted the Clayton Antitrust Act in 1914 to further buttress Federal oversight in this area.[322] By outlawing interlocking directorates, Congress sought to prevent indirect combinations of companies that were in restraint of trade.[323] Unlike the Sherman Act, this measure was accompanied by the creation of an enforcement agency, the Federal Trade Commission, which served to investigate unfair trade practices and issue cease and desist orders.[324]

While neither the Sherman Act nor the Clayton Act posed serious obstacles to business combinations,[325] they had established the specter of federal oversight. The threat of antitrust enforcement action meant that even directors of corporations with willing shareholders and permissive state merger statutes did not have a free hand to engage in transactions as they saw fit.

B. *Dividend Policies*

While managers were accustomed to strict limitations on their abilities to engage in mergers, acquisitions, and other fundamental corporate changes, it was a different story when it came to dividend policy. There were some limitations on the source of a dividend payment, but these related to the source of funds, rather than the decision to issue a dividend. The decision whether to issue a dividend or retain the profits for other uses was committed to the discretion of the board of directors by well-established law. Moreover, this legal right to retain earnings was buttressed by the business custom, which took hold around the turn-of-the-century, of retaining a significant percentage of earnings each year. Thus, it should not be surprising that corporate

[319] HEILBRONER & SINGER, *supra* note 317, at 213.
[320] THOMAS CONYNGTON, A MANUAL OF CORPORATE ORGANIZATION 350 (3d ed. 1913). Part of the uncertainty was the Court's use of the "rule of reason" approach, which meant that some combinations in restraint of trade could be permitted if they were reasonable under the circumstances.
[321] *Id*. at 357.
[322] 15 U.S.C. § 12 (1914).
[323] *See* GEISST, *supra* note 36, at 143-44.
[324] 15 U.S.C. § 41 (1914).
[325] Indeed, the great merger movement at the turn-of-the-century followed the passage of the Sherman Act.

managers mounted an all-out assault against the undistributed profits tax and its threat to their continued discretion over dividend policy.

1. Early history

In the infancy of the corporation, dividends were essentially unregulated.[326] This was in part because during the days of the joint stock trading company, a corporation would distribute all of its assets at the completion of each voyage.[327] There was little need to impose significant limits on the distribution of profits in these essentially single-purpose enterprises. This era of unregulated dividends, however, soon came to an end because of two developments in corporate law and finance. First, the advent of the concept of fixed, or permanent, capital from which a corporation's earnings would flow meant that there had to be some method of distinguishing between that part of the corporation's assets that was available for distribution as a dividend and that part of the assets that constituted its capital and would remain within the corporation. Second, the development of limited liability for corporate stockholders elevated the importance of both the distinction between capital and income and the distinction between the assets in the hands of the corporation and the assets in the hands of its stockholders. The former was important because under a system of limited liability creditors would often decide to extend credit based upon the value and availability of the fixed or permanent property of the corporation. If this property were subject to division prior to the liquidation of the corporation, the creditors would have virtually no protection at all. The latter was important because, unlike the general partnership where partners remained personally liable for the partnership debts even after a distribution, the creditors' only recourse for repayment of the debts was to look to the assets while held in the corporation. A dividend would permanently remove those assets from the corporate solution. These two developments led to a spate of statutory and non-statutory limitations on the distribution of profits in a corporation.

2. Dividends paid out of "profits"

The first limitation on dividends was the requirement that dividends be paid exclusively from the profits of the corporation, as distinct from the "capital," or the money originally contributed by the stockholders.[328] Initially, companies followed such a rule by custom. Thus,

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[326] *See* Donald Kehl, *The Origin and Early Development of American Dividend Law*, 53 HARV. L. REV. 36, 37 (1939).

[327] *Id*. at 37-38. This was true even in the colonies, where a non-chartered joint stock company, Plymouth Adventurers, provided that after seven years "the capitall and profits, viz. The houses, lands, goods and chattels be equally divided amongst the adventurers." *Id*. at 43.

[328] *See* VICTOR MORAWETZ, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS § 435 410 (2d ed. 1886) ("It is a fundamental rule, that dividends can be paid only out of profits or the net increase of the capital of a corporation, and cannot be drawn upon the capital contributed by the shareholders for the purpose of carrying on the company's business."); Cyrus LaRue Munson, *Dividends*, 1 YALE L.J. 193 (1891) ("It is fundamental that dividends are payable only from the profits of the corporation, and that they cannot be paid from any portion of the capital stock, from compensation for property taken under the power of eminent domain, from a penalty recovered from a contractor for a failure to complete his work, or from the sale of forfeited stock.").

after the British East India Company established a permanent joint stock in 1657, dividends were henceforth issued "out of profits leaving the capital untouched."[329] Before long, however, the Crown began to impose such a "profits" limitation through the charters of the corporations it authorized. The 1694 charter of the Bank of England provided that "no dividend shall at any time be made by the said governor and company save only out of the interest, profit or produce arising by or out of the said capital stock or fund, or by such dealing, buying, or selling as is allowed by the said Act of Parliament."[330] This type of limitation continued during the special charter era in America, although the provisions tended to be ad hoc in nature.[331] In 1825, New York enacted the first general dividend statute in the country, which limited dividends to "surplus profits arising from the business of such corporations."[332] This became the model for nineteenth century general corporation law provisions governing dividends.[333] There was still little agreement as to how to distinguish between profits and capital, but it was well established that such a distinction itself was important.[334]

2. Penalties for dividends paid out of capital

A second rule imposed penalties on the directors and stockholders for any distribution of dividends out of capital. When Parliament authorized an increase in the capital stock of the Bank of England in 1697, it provided that if the corporation issued a dividend that reduced its capital stock without first reducing its outstanding debt, the stockholders "shall be severally liable" to any creditors of the Bank.[335] A similar rule was imported to America, where a commonly cited Massachusetts statute provided that "[i]f the directors of any such company shall declare and pay any dividend, when the company is insolvent or any dividend, the payment of which would render it insolvent, they shall be jointly and severally liable for all the debts of the company" in an amount not to exceed the amount of the dividend.[336] The New York statute was even broader, imposing liability on the directors if a dividend reduced the capital stock of the company, even if it did not induce insolvency.[337] By the end of the century, New York had gone one step further, making it a misdemeanor to declare a dividend out of the capital stock of the corporation.[338] In general, these director liability statutes were made necessary by the conferral of limited liability on corporate stockholders. As one early observer noted, "if limited liability was to survive, a rule

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[329] Kehl, *supra* note 326, at 38 nn.12-13 (*citing* COURT MINUTES OF THE EAST INDIA COMPANY 1660-1663 xx-xxi, 131 (1922)).
[330] J.W. GILBART, I THE HISTORY, PRINCIPLES, AND PRACTICE OF BANKING 32-33 (revised and edited by A.S. Michie 1882).
[331] Kehl, *supra* note 326, at 43-51.
[332] N.Y. Laws chap. 325, § 2 (1825).
[333] Kehl, *supra* note 326, at 61.
[334] *See* MORAWETZ, *supra* note 328, §§ 437-39, at 411-414.
[335] Kehl, *supra* note 326, at 42.
[336] Mass. Rev. Stat, chap 38, par. 331, § 23 (1836).
[337] N.Y. Laws chap. 325, § 2 (1825).
[338] *See* Munson, *supra* note 328, at 193.

against impairment of corporate capital by dividends or other repayments to stockholders was inevitable."[339]

3. Dividends under the sole discretion of the board of directors

A third rule, which followed naturally from the first two, was that a corporation's directors had the sole discretion to determine whether to declare a dividend. This was made clear early on in the development of dividend limitations in this country. Alexander Hamilton drafted a charter for the Bank of North America that authorized the directors to "make from time to time such dividends, out of the profits, *as they may think proper*."[340] A similar provision in the Bank of United States' charter permitted as much dividends out of profits "as shall appear to the directors advisable."[341] As one commentator affirmed, by the early 1890s there was little doubt as to the board of directors' power over whether to declare a dividend: "The directors, being the agents of the corporation, alone have the power to determine the amount and to declare a dividend from its earnings – a power resting in their honest discretion, uncontrollable by the courts, when not exercised illegally, wantonly or oppressively."[342]

Under this highly developed legal infrastructure, a stockholder had little legal recourse in the event the directors of a corporation chose not to distribute a dividend. There were some cases that appeared to support a stockholder's right to petition for the division of surplus profits,[343] but these cases relied primarily on exceptions, rather than alternatives, to the rule. Henry Ballantine wrote that "there must be bad faith or a clear abuse of discretion on their part to justify a court of equity in interfering" in the directors' determination of dividend policy.[344] The right to a dividend

[339] Kehl, *supra* note 326, at 41.
[340] *Id*. at 46 (italics added).
[341] *Id*.
[342] Munson, *supra* note 328, at 196. There were occasional exceptions, but these were rare. *See* ARTHUR STONE DEWING, I THE FINANCIAL POLICY OF CORPORATIONS 91 n. dd (5th ed. 1953) ("In rare cases the dividends are declared by the stockholders, in accordance with a provision of the bylaws. Among early corporations the stockholders' control over dividend disbursement was quite usual. Such a reservation of power is now very rare; it runs counter to the generally accepted theory of the powers and responsibilities of directors.").
[343] *See* Scott v. Eagle Fire Co., 7 Paige ch. 198 at 125 (1838) "should they without reasonable cause refuse to divide what is actually surplus profits, the stockholders are not without remedy, if they apply to the proper tribunal before the corporation has become insolvent."); Smith v. Prattville Manufacturing Co., 29 Ala. 503, 507-08 (1857) ("They may be compelled to exercise that discretion, if they improperly fail or reuse to exercise it. But when they have exercised it, without any violation of the charter or constitution of the company, their action cannot be disregarded or controlled by any court, at the instance of a stockholder, unless it is shown to have been a willful abuse of their discretion, or the result of bad faith, or of a willful neglect or breach of a known duty.").
[344] BALLANTINE, *supra* note 298, at 507. Ballantine further explained

> The mere fact that a corporation has surplus profits out of which a dividend might lawfully be declared is not of itself sufficient ground for a court of equity to compel the directors to make a dividend, for they have a right to use surplus profits to extend the business of the corporation, or to make improvements, and to establish various reserves, if it is to the interests of the corporation to do so, and a court of equity will not interfere with or control their discretion in determining what the interests of the corporation require in this respect, unless there is a clear abuse of discretion.

Id.

was, in effect, not a right at all. As one contemporary commentator described it, "[t]he right of a stockholder to share in the surplus of profits is in the nature of an inchoate right, until a distribution or dividend has been actually declared by the proper officers of the corporation."[345] Justice Thomas Cooley, writing on behalf of the Michigan Supreme Court, explained "until the dividend is declared . . . the dividend is only something that may possibly come into existence."[346]

4. Business custom

Corporate managers used their legal discretion to justify adherence to a corporate finance norm favoring retained earnings. While the conventional wisdom during much of the nineteenth century had been to distribute all or almost all of a corporation's earnings as dividends and raise expansion capital through the debt or equity markets,[347] by World War I the conventional wisdom was that a corporation should "plow back" a substantial percentage of its earnings to fund expansion, protect against downturns, maintain regular dividend policies, and provide for unexpected expenses.[348] In his 1917 treatise on business finance, William Lough noted that "[i]t is generally agreed that regular dividends combined with large -- or at least adequate -- savings out of annual income should be features of the financial management of most corporations."[349] A few years later, one observer reported that "[t]oday it is taken for granted that no corporation shall pay out more than a fraction of its earnings."[350]

The available data suggests that this development in corporate finance theory was followed by a majority of companies. While dividends hovered around 80 to 90 percent of earnings prior to the turn-of-the-century, they had dropped to approximately 50 to 60 percent of earnings during the first few decades of the twentieth century.[351] According to one study, the majority of companies retained as much as fifty-five percent of their earnings during the period between 1922 and 1930.[352]

This retained earnings norm was bolstered by a corresponding norm in favor of regular dividends, rather than dividends that fluctuated with earnings. In the 1926 edition of his

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[345] H.W.R., *Dividends*, 9 CENT. L.J. 161, 163 (1879).
[346] Lockhart v. Van Alstyne, 31 Mich. 76, 78 (1874).
[347] *See* Steven A. Bank, *Is Double Taxation a Scapegoat for Declining Dividends? Evidence from History*, 56 TAX L. REV. 463, 467-68 (2003).
[348] KENNETH S. VAN STRUM, INVESTING IN PURCHASING POWER 24 (1926) ("A corporation often invests a part of its income in new plants and in equipment, which means that instead of paying out all of its income in dividends it 'plows back' into the company some of its earnings for the future benefit of the stockholder.").
[349] WILLIAM LOUGH, BUSINESS FINANCE 477 (1917).
[350] Oswald W. Knauth, *The Place of Corporate Surplus in the National Income*, 18 J. AM. STAT. ASS'N 157, 164 (June 1922).
[351] *See* COWLES COMMISSION FOR RESEARCH IN ECONOMICS, COMMON-STOCK INDEXES 2 (2d ed., 1939) ("COWLES COMMISSION"); Jack W. Wilson & Charles P. Jones, *An Analysis of the S&P 500 Index and Cowles's Extensions: Price Indexes and Stock Returns, 1870-1999*, 75 J. BUS. 505, 527-531, Appendix: Table A1 (2002) (standardizing and updating the data originally compiled by the Cowles Commission for the period 1871 through 1939).
[352] *Id*. at 35 (sample size was seventy-two companies).

corporate finance treatise, Arthur Dewing noted that "[t]he regularity of dividend payments helps the corporation in two very important respects. It creates a loyal group of stockholders who hold their stock for investment and not for speculation. It also creates a strong credit to be utilized for borrowing in the open market."[353]

The demand for regular or level dividends was in part a byproduct of the introduction of preferred stock. The early American corporation only had one class of stock and each shareholder had the same right to dividends as any other shareholder.[354] Starting around the middle of the nineteenth century, however, transportation companies, particularly in the railroad industry, began to offer a preferred level of stock as a method of attracting equity capital.[355] These securities had characteristics of both debt and equity. They provided for guaranteed dividend rates similar to interest payments on debt, but the holder could not foreclose on the instrument if his dividends fell in arrears.[356] Toward the end of the century, the preferred stock method expanded to industrial securities,[357] where the guaranteed dividend rate was attractive in unregulated industries with little or no financial disclosure. For the individual who formerly invested exclusively in debt securities, preferred stock was a middle ground between the risk of common stock and the relative certainty of debt.[358]

Although a board of directors could refuse to issue any preferred dividend at all, there was significant pressure to distribute the promised amount. The fact that most early preferred stocks appeared to have been issued on a cumulative basis only increased this pressure.[359] The cumulative feature meant a board of directors deciding against declaring a dividend in a particular year first would have to pay the preferred stockholders for all past and current dividends due before paying any dividend to the common stockholders. While this provision helped attract capital by making the equity instrument seem more debt-like, it further increased

[353] ARTHUR STONE DEWING, THE FINANCIAL POLICY OF CORPORATIONS 549 (rev. ed. 1926).
[354] *See* George Heberton Evans, Jr., *The Early History of Preferred Stock in the United States*, 19 AM. ECON. REV. 43, 43 (1929) ("*Early History*").
[355] *Id*.; JONATHON BARRON BASKIN & PAUL J. MIRANTI, JR., A HISTORY OF CORPORATE FINANCE 152 (1997); George Heberton Evans, *Preferred Stock in the United States 1850-1878*, 21 AM. ECON. REV. 56, 56 (1931).
[356] BASKIN & MIRANTI, JR., *supra* note 355, at 152. Some corporations even allowed the preferred stock holder to participate in dividends beyond the guaranteed rate in certain circumstances, but this was the exception rather than the rule. *Id*.; W.H.S. Stevens, *Stockholders' Participations in Profits. I*, 9 J. BUS. U. CHI. 114, 121-22 (1936) (noting with respect to a 1902 issuance of preferred stock by the American Brake Shoe and Foundry Company in which the preferred stock received all the residual profits after the common stock was paid a fixed dividend, that "[t]his type of issue is so rare, however, as to constitute something of a curiosity, although one would be rash to assert that no other such issues have been made.").
[357] *See* George Heberton Evans, Jr., *Early Industrial Preferred Stocks in the United States*, 40 J. POL. ECON. 227, 227 (1932); Thomas R. Navin & Marian V. Sears, *The Rise of a Market for Industrial Securities, 1887-1902*, 34 BUS. HIST. REV. 105, 116 (1955).
[358] BASKIN & MIRANTI, JR., *supra* note 355, at 152.
[359] *See* Evans, *Early History*, *supra* note 354, at 56; ARTHUR STONE DEWING, THE FINANCIAL POLICY OF CORPORATIONS 124 (1919) (noting that while early preferred stock was often non-cumulative because of the speculative nature of industrial enterprises, by 1897, when many businesses were on more stable ground, the preferred dividend rate was commonly made cumulative). Even when a charter was ambiguous on this point, courts generally found the preferred stock to be cumulative on the grounds that the preferred stockholder implicitly contracted for a certain rate of dividends regardless of the profits of the corporation. Evans, *Early History*, *supra* note 354, at 61-62.

the pressure to meet the preferred dividend payment.[360] Managers could avoid the binding nature of the cumulative provision by inducing the preferred shareholders to agree to a recapitalization,[361] but in practice they paid dividends whenever possible.[362]

The advent of preferred stock not only introduced the notion of a guaranteed dividend rate for preferred stockholders, but also created the climate for a quasi-guaranteed, regular dividend for all stockholders. Although a corporation could continue to pay the preferred dividend while choosing to pass on dividends for holders of the common stock, discriminating between the classes of stock was often difficult. This was especially true when promoters had promised that the common stockholders would receive a regular dividend. One observer noted that "to the holders of common stock it seemed unreasonable and unjust that, in such prosperous times, a discrimination should be made in favor of the preferred stock. The reputation of the management of many of the industrial combinations was seriously injured by their failure to redeem their promises of dividends on the common stock."[363]

As stock ownership spread, the demand for regularity in dividend payments increased.[364] Whereas fewer than 4.5 million individuals owned stock in 1900, more than triple that number -- almost 14.5 million -- owned shares by 1922.[365] The growth in stock ownership not only increased the size of the stockholding population, it changed the face of the typical stockholder. For example, by World War I stock ownership had spread to middle income individuals.[366] This new type of stockholder viewed dividends as a one of his or her primary sources of income. One economist, writing in 1924, noted that over the last twenty-five years, "[t]he tendency toward a more democratic distribution of beneficiary interests in the corporations of the country has been attended by an increase in the number of people who are getting a portion of their income from their accumulated savings."[367] Although stockholders may have been worse off in the long term

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[360] As one commentator noted in chronicling the rise of the United States Steel Corporation, "[n]o matter how necessary the passing of their early dividends and accumulation of large reserves by the steel trusts may be judged to have been, so far as the preferred stock was concerned, in view of the cumulative provisions included in the contract with this class of stockholders, it was impossible." Edward Sherwood Meade, *The Genesis of the United States Steel Corporation*, 15 Q. J. ECON. 517, 524 (1901).

[361] *See* DEWING, *supra* note 359, at 125-26 ("if a considerable amount of the unpaid dividends accumulate, and the company meets with more prosperous conditions, the managers, who probably control the common stock, will often try to induce the preferred shareholders to surrender their claims on the plea of some equitable adjustment.").

[362] *Id*. at 125 ("If the corporations earns the dividend on the preferred it will probably be paid; if it does not earn the dividend and the directors 'adjust' the books so that they may pay the dividend, lest the obligation accumulate, the preferred stockholders are not only deceived, but also have lasting injury done to their interests."); Meade, *supra* note 360, at 524.

[363] Meade, *supra* note 360, at 525.

[364] *See* Donald E. Wilbur, *A Study of the Policy of Dividend Stabilization*, 10 HARV. BUS. REV. 373, 373 (1932) ("With the expansion of the stock market and the wide distribution of equities among the American public, new significance has been placed upon the importance of maintaining regular dividends year in and year out.").

[365] H.T. Warshow, *The Distribution of Corporate Ownership in the United States*, 39 Q. J. ECON. 15, 15 (1924).

[366] *Id*. at 17. It also spread to new demographic groups such as women. LOUGH, *supra* note 349, at 441 (noting, for example, that "[a]pproximately half the stockholders of the New Haven Railroad are women.").

[367] Warshow, *supra* note 365, at 15. Joseph Kennedy, writing a few years later, concurred in this assessment, observing that "millions of people have become investors in securities and count upon continuity of their dividend returns in budgeting their living expenses. Anything that would interrupt the continuous flow of dividends will rob the

by the more conservative dividend policies,[368] regularity was important both for stockholders who depended upon the dividends for monthly expenses and for those who saw dividends as a signal of a stable financial company.

Corporations took advantage of this demand for regularity by publicly announcing their shifts in dividend policy.[369] The United States Rubber Company, for example, had been characterized by wildly erratic earnings and dividends since its founding in 1892.[370] In 1911, after an eleven-year drought in dividend payments, the company announced that it would commence paying a four percent regular annual dividend on its common stock.[371] As a result of this move, United States Rubber's stock rose twelve points in less than two weeks, underscoring the importance of regularity for common stockholders.[372]

The problem with regular dividends was that the earnings of all companies fluctuated to some extent. During down years, a corporation would not be able to pay out the dividend and the goal of regularity would be defeated. As Dewing observed "[a] regularity of dividend payments must therefore be superimposed on an irregularity of earnings."[373] To achieve this result, experts advised companies to retain a certain amount of their earnings each year as a cushion. Lough warned that "dividends must not be allowed to rise, even in the most prosperous periods, above a conservative estimate of the minimum earnings of the company."[374] While corporations did sometimes deviate from this conservative dividend policy to distribute additional amounts in a particularly profitable year, they maintained a policy of regularity by referring to such amounts as an "extra" or "special" dividend paid on top of the regular dividend.[375]

IV. CONCLUSION

The influence of legal and non-legal norms of corporate behavior on the fate of corporate tax initiatives may have significant relevance for modern tax policy. In the New Deal examples

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thrifty American investor of part of his livelihood." Joseph P. Kennedy, *Big Business, What Now?*, THE SATURDAY EVENING POST, Jan. 16, 1937, at 80.

[368] *See* O.J. Curry, *Utilization of Corporate Profits in Prosperity and Depression*, 9 MICH. BUS. STUD. 1, 17 (1941); BENJAMIN GRAHAM & DAVID L. DODD, SECURITY ANALYSIS: PRINCIPLES AND TECHNIQUE 375-76 (2d ed. 1940).

[369] In 1907, for example, the American Telephone and Telegraph Company announced an $8 per year regular dividend. *See* DEWING, *supra* note 342, at 763 n. ee.

[370] *Id*. at 548 n. j.

[371] *Dividend on Rubber Common*, N.Y. TIMES, Oct. 6, 1911, at 15. In an announcement regarding the move, the company's president explained "notwithstanding the fact that for some years past the surplus net earnings have been considerably in excess of the sum required for dividends upon the preferred stocks, the Directors have felt it for the best interests of the company to defer payments on the company." *Id*. He attributed the current move to a substantial gain from their automobile tire line. *Id*.

[372] *Id*.

[373] DEWING, *supra* note 353, at 547.

[374] LOUGH, *supra* note 349, at 444.

[375] *See, e.g., Dividends*, N.Y. TIMES, April 9, 1907, at 13 ("At a meeting of the Board of Directors of the New York Produce Exchange Bank, held this day, a semi-annual dividend of Three (3%) Per Cent was declared and an extra dividend of One (1%) Per Cent payable April 15th."). *See also* DEWING, *supra* note 353, at 561 (noting that it is called an "extra" dividend to signal to the shareholders that it is not permanent).

described in this paper, corporate managers fiercely resisted a measure that attempted to impose a new norm of corporate behavior – a norm of higher dividends and limited managerial discretion over dividend policy. By contrast, corporate managers only offered minimal resistance to a measure that merely reinforced an existing norm of corporate behavior – the norm of state, federal, and shareholder oversight for mergers and acquisitions – and those changes have essentially endured to the modern day. While there is no evidence whether either tax measure did have, or could have had, the effect on the underlying corporate behavior that Congress intended to regulate, the difference in the fate of each measure is a cautionary tale for corporate reformers seeking to enact governance measures through the tax code. If the New Deal examples are not atypical -- an important qualifier in determining the modern relevance of any historical study -- the implication is that Congress can reinforce existing norms through the Code, but it will have more difficulty if it seeks to initiate such norms through the tax laws.

Far from being atypical, the New Deal examples studied in this piece have modern analogies. For instance, the corporate norms-based explanation may help explain the outcome of recent attempts to use the tax code to regulate corporate governance in the area of executive compensation. In 1993, Congress enacted Section 162(m) in an attempt to control excessive executive compensation.[376] Under this provision, corporations are subject to a $1 million cap on the deductibility of compensation provided to any of its top five executives, subject to an exception for "any remuneration payable solely on account of the attainment of one or more performance goals."[377] In this case, the exception was designed to swallow the rule. As one Treasury official explained, Section 162(m) "was not intended to be a revenue raising provision, but a behavior-shaping provision. The exception for performance-based compensation 'is not a loophole.'"[378] The intention was to encourage corporations to switch from guaranteed salary arrangements to more performance-based executive compensation packages, including those centered around company stock and stock options in order to better align pay with performance.[379]

While Section 162(m) has survived, it has been undermined through managerial resistance and avoidance. According to one observer, the rule is "completely inoperative" as a limit on executive compensation.[380] It has failed to stem the growth of executive compensation packages and business leaders and tax lawyers believe that it has actually "encouraged bloated executive pay" by creating a $1 million minimum wage for executives and a push for large stock option grants.[381] According to one report, "'executive pay actually rose at a 29 percent faster rate in the first year after the law took effect than in the previous 14 years after the service had

[376] Omnibus Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 469 (codified at I.R.C. § 162(m)).
[377] I.R.C. § 162(m)(4)(C).
[378] Megan M. Reilly, *Former Treasury Official Discusses Executive Compensation Cap*, 62 TAX NOTES 747 (Feb. 3, 1994) (quoting Catherine Creech).
[379] *See* Bank, *Devaluing Reform, supra* note 22, at 305-06 (1995).
[380] Tom Herman, *Tax Report, Congress Should Repeal a 1993 Tax-Law Change on Executive Pay, Business Leaders Say*, WALL ST. J. ONLINE, Sept. 19, 2002 (quoting Gail Fosler of the Conference Board's Commission on Public Trust and Private Enterprise).
[381] *Id*. *See* John A. Byrne, *That Eye-Popping Executive Pay*, BUS. WK., April 25, 1994, at 57.

collected comparable information.' From 1994 to 1995, corporate deductions for executive pay increased more than 9.1%, compared with an average increase of 7% between 1980 and 1994."[382] Moreover, early on corporate managers found ways to subvert the original goal of aligning pay with performance by resorting to the derivatives market.[383] Many prominent investors and former government officials have now admitted defeat and are calling for the provision's repeal.[384]

When viewed from the perspective of the underlying corporate norm at stake, this outcome should have been quite predictable. While early charters sometimes fixed the corporate managers' salaries or made them subject to a vote of a majority of the stockholders,[385] executive compensation has long been the exclusive province of the board of directors. As the author of one treatise observed in 1933, "[s]alaries paid to officers must bear some reasonable relation to the value of their services. But courts will not review salaries voted by the board unless they are so clearly excessive as to amount a fraud upon the corporation."[386] Recently, securities laws have attempted to impose various disclosure requirements for executive compensation,[387] but shareholders still have no say in the compensation process under state laws and they tend to remain quite passive even when the information is disclosed.[388] Thus, managers are likely to resist attempts to indirectly control compensation through the tax code and shareholders are not going to view such resistance as in violation of existing norms.

This attempt to override existing corporate norms is what distinguishes tax provisions such as Section 162(m) from those tax provisions that have been praised for their corporate governance benefits by modern scholars. David Schizer, for instance, has argued that taxation is an ally in the corporate governance arena by providing constraints on executives seeking to reduce the incentive effects of their options to purchase employer stock.[389] Through rules governing exit strategies with respect to options, such as the disincentive to exercise under Section 83 and the disincentives to hedging resulting from both the constructive sale rules and the mismatch between capital and ordinary rates in a hedge, the tax system helps to bolster the incentive effects.[390] Schizer concedes, however, that "[a]lthough Congress sometimes

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[382] *See* Susan J. Stabile, *Is There a Role for Tax Law in Policing Executive Compensation?*, 72 ST. JOHN'S L. REV. 81, 88 (1998) (*quoting* David Cay Johnston, *Executive Pay Increases at a Much Faster Rate than Corporate Revenues and Profits*, N.Y. TIMES, Sept. 2, 1997, at D4)).
[383] *See* Bank, *Devaluing Reform*, *supra* note 22, at 320-23. Some of these attempts were subsequently limited by tax and securities law provisions. *See* Schizer, *supra* note 8, at 466.
[384] *See* Herman, *supra* note 375 (*citing* Warren Buffett, former Federal Reserve Board Chair Paul Volcker, former Securities and Exchange Commission Chair Arthur Levitt, and former Commerce Secretary Peter Peterson).
[385] *See* THOMAS CONYNGTON, THE MODERN CORPORATION: ITS MECHANISM, METHODS, FORMATION AND MANAGEMENT 67 (3d ed. 1908).
[386] ROHRLICH, *supra* note 297, at 116. *See* BALLANTINE, *supra* note 298, at 408 (noting that while directors cannot fix their own salaries, "[i]t is within the powers of the directors to fix the salaries of other officers appointed by them, although from their own number, unless there is some provision to the contrary, and to fix the compensation to be paid officers for extraordinary services which they engage or authorize.").
[387] *See* STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 482 (2002).
[388] *Id.*
[389] *See* Schizer, *supra* note 8, at 466.
[390] *See id*. at 466-94 (describing the various tax barriers to exercise and hedging).

deliberately uses the tax code to pursue corporate governance objectives, the tax constraints on exercising and hedging options do not fall into this category."[391] Some of the advantage in this case may be that the rules in question did not appear to constitute a threat, but the distinction runs deeper.

The corporate benefits in this case may be more than a mere indirect benefit of provisions adopted on tax policy grounds, but may in fact be the direct benefit of tax provisions that support existing corporate norms of behavior rather than trying to install new ones. In the case of hedging, Schizer found that firms either banned the practice directly or raised its costs indirectly by preventing executives from pledging their option grants.[392] While he considered such constraints to be ineffective or incomplete,[393] they suggest that executive hedging of option grants are disfavored under corporate law and practice. Schizer confirms this by predicting that if the tax limitations were repealed, shareholders and executives would likely cooperate in erecting contract and securities law barriers to fill the gap.[394] Thus, the use of tax law in this instance was merely to reinforce this existing norm of corporate behavior rather than to change it altogether. This appears to help explain why tax may have been an ally of corporate governance measures in limiting executive hedging while being either ineffective or counterproductive in controlling executive compensation more generally.

Thus, at least in these examples norms appear to have some relevance in distinguishing between corporate governance-oriented tax provisions. While more study may be beneficial on this point, the basic premise is intuitively appealing. Provisions that help reinforce existing norms may be better received, which will aid in their prospects for long-term success. By contrast, those provisions designed to initiate new norms or overturn existing ones are much more likely to face opposition and fail. The implication of the historical evidence seems clear: Tax can be considered an ally of corporate governance, but not a de facto system of federal corporate law.

[391] *Id*. at 466.
[392] *Id*. at 460.
[393] *Id*.
[394] *Id*. at 495.