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The Outside Director - Selection, Responsibilities, And Contribution To The Public Corporation

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THE OUTSIDE DIRECTOR — SELECTION, RESPONSIBILITIES, AND CONTRIBUTION TO THE PUBLIC CORPORATION

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Introduction

This article treats the general topic of the outside director. It is necessary at the outset to distinguish among the classifications for directors who may serve on the board of directors of a public company. Definitions are not available in statutes or published rules. There has been very little guidance by regulatory agencies. Recently, the New York Stock Exchange wrestled with the issue in a requirement that each listed company have an Audit Committee of "independent directors."[1] The New York Stock Exchange defines an independent director as one who qualifies as an "outside director" but may include former officers of the corporation. An outside director is defined to exclude officers, relatives thereof, employees, and other persons who are compensated on a regular basis by the company for services other than directorships.[2]

The concept of independent directors suggests there may be three classes of identifiable directors. The inside director, which includes officers and employees of the company; non-independent outside directors, which includes consultants to the company such as attorneys, bankers, and investment bankers whose corporations provide the company with regular services, and relatives of inside directors; and independent outside directors who have no present direct business relationship with the corporation on whose board they serve.

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[1] Letter from William M. Batten, Chairman and Chief Executive Officer of the New York Stock Exchange, to chief executive officers of companies listed on the Exchange (Sept. 3, 1976) (letter on file at Washington and Lee *Law Review*).

[2] The term *outside director*, with respect to an Audit Committee, shall be persons who are not officers, or relatives thereof, employees, former officers, consultants, or persons who are not otherwise compensated on a regular basis by the company other than by directors' fees. The following are examples of persons who would not qualify as *outside directors* for the purposes of an Audit Committee:

> Anyone who would be classified as or represent a parent, controlling person, or affiliate under SEC usage of these terms, or anyone who would be an "associate" of such person;
> Anyone who would be classified as an associate of any officer or employee of the company;
> Outside legal counsel to the company.

The changing requirements of board membership represent a number of competing considerations, not all of which can be predicted in the current environment. Until recently, the amount of time which a member of a board of directors had to devote to the corporation was relatively limited. Compensation was also quite low. There had been little awareness of the liabilities which attach to board membership. Most public corporations devoted little time to the education of directors in the operation of the corporation of their attendant liability. Only recently have corporations begun to revise their procedures in light of pronouncements by publicly respected persons,[3] members of the Securities and Exchange Commission,[4] and in judicial decisions.[5] It is not fair to imply that the legal principles were not understood prior to recent decisions, but there had been inadequate attention given to the potential for director liability.

Another competing consideration is balance in the makeup of board membership. For a long period of time, ownership of shares in large public companies has been so diffuse that few companies had more than one or two representatives who served on the board primarily because of equity ownership. Other persons were elected to the board because of non-equity financial interests, such as representatives of banks and investment bankers. Little consideration was given to representation of community interest, balance in terms of race, color, or sex. Now there is considerable pressure to achieve representation for non-financial interests.

The increasing awareness of responsibility and liability has caused a number of persons who traditionally served on many boards

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[3] *See Corporate Rights and Responsibilities: Hearings on S-261-1 Before the Senate Committee on Commerce*, 94th Cong., 2d Sess. 60 (June 15, 1976) (statement of A.A. Sommer, Jr.); *Arthur Goldberg on Public Directors*, BUS. & SOC. REV., Spring, 1973, at 35.

[4] *See* Address by SEC Commissioner P. Loomis, Jr., *Director Responsibility—A Government View*, given at Loyola College, Baltimore, Maryland (Apr. 8, 1975); Sommer, *Directors and the Federal Securities Laws*, FED. SEC. L. REP. (CCH) ¶ 79,669 (Feb. 21, 1974); Address by SEC Chairman G. Cook, *Directors Resonsibilities*, given at Southern Methodist University (Apr. 6, 1973) *reported at* [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,302; *Corporate Governance—New Heat on Outside Director's?*, FORBES, Oct 1, 1977, at 33.

[5] *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); SEC v. National Securities, Inc., 393 U.S. 453 (1969); Sundstrand Corp. v. Sun Chemical Corp., [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,887 (7th Cir. Feb. 23, 1977); SEC v. World Radio Mission, Inc., 544 F.2d 535 (1st Cir. 1976); SEC v. Bausch & Lomb, Inc., 420 F. Supp. 1226 (S.D.N.Y. 1976); SEC v. Mattel, Inc., [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,807 (D.D.C., Oct. 1, 1974); Escott v. BarChris Constr. Corp., 283 F. Supp. 683 (S.D.N.Y. 1968).

to either limit their board membership or to withdraw *in toto.* Investment bankers are a prime example of that withdrawal. Commercial bankers have also begun to reassess their position, both under securities and trade regulation laws.[6]

The duties of boards of directors to monitor management's performance, to have access to and to utilize corporate advisers such as accountants and attorneys, and ultimately to determine integrity as well as performance of management are new phenomena. At the very time the pressure to revise board membership is increasing, there is also a dramatic increase in the responsibilities of persons serving as board members. These pressures are separate from, but must coordinate with, the three classifications noted above: inside, non-independent outside, and independent outside directors. The outside director begins to take on a responsibility far beyond that which has been historically required and well beyond that for which most directors have been adequately trained.

It is within this framework that the search is initiated for directors who are impartial, not affiliated with management (or maybe employees), and who have no significant personal interest in the continuation or promulgation of management policies or activities. In fact, they should have no reason to protect management itself. While the issue is normally stated in terms of shareholder protection, it has become increasingly clear that the board must contend with not only shareholder interests, but the interests of the community, the employees, and others as well.

There are several companies which have made dramatic changes in the composition and operation of their boards of directors. Two which are commonly noted are Texas Instruments and Connecticut General Insurance Corporation.[7] The Texas Instruments Board is composed of a majority of non-management directors who commit to serve a minimum of thirty calendar days and as many as eighty calendar days each year. They are required to participate in all aspects of board activities including committee assignments and committee chairmanships. There are also directors who come to their positions by virtue of former association with the company. These directors must serve at least fifteen days a year in comparable types of positions. A third category is those directors who are currently

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[6] *See, e.g.,* United States v. The Cleveland Trust Co., 392 F. Supp. 699 (N.D.Ohio 1974).

[7] *See* Mace, *Designing a Plan for the Ideal Board,* HARV. BUS. REV., Nov.-Dec. 1976, at 20 (discussing Texas Instruments); *Board Power,* FORBES, July 1, 1976, at 47 (discussing Connecticut General Insurance Corporation).

serving as officers of the company or employees of the company.

The Connecticut General Insurance Corporation in 1976 adopted a definition of the role of the board of directors which expressly severs management from the board. The amendment provides that the board of directors is "the guardian of the interests of those who have a stake in the health of the enterprise . . . (including) stockholders, . . . customers, employees, suppliers, the communities in which it operates and society as a whole."

The changing environment was summarized by A. A. Sommer, Jr., when he said:

> The situation is changing dramatically and drastically. I would suggest that persons asked to join boards of publicly held companies now do so only after reflecting carefully upon the responsibilities they assume and the availability of time to perform adequately; gone are the days when it would be regarded as a badge of merit for an investment banker to be on half a hundred or more boards of directors. Corporations, aware of the necessity of greater board involvement in their affairs, have developed a number of devices to achieve that. Audit committees are becoming routine and numerous conversations with both auditors and members of boards of directors have indicated the utility, nay, the necessity, of this mechanism. Many corporations are strengthening the influence of the outside directors by involving them not only on the audit committee but other committees as well, and by expanding the number of board members without significant financial affiliations with the corporation. Many boards have added so-called "professional directors" (a term which I regard as a misnomer) who are expected, usually for additional compensation, to spend more time on the affairs of the corporation than the typical director; two significant examples of such people have been Robert Haack, formerly president of the New York Stock Exchange, now head of Lockheed, and Joseph W. Barr, formerly Secretary of the Treasury. I speak of the term "professional director" as a misappellation; rather, I think of those men commonly called that as simply directors who expend larger amounts of their time of the affairs of the corporation and thus can constitute a helpful bridge between the other outside directors and management.[8]

[8] *Corporate Rights and Responsibilities: Hearings on S-261-1 Before the Senate Committee on Commerce,* 94th Cong., 2d Sess. 60, 61-62 (June 15, 1976) (statement of A. A. Sommer, Jr.).

The Role of the Outside Director

As already noted, any discussion of the role of the outside director must take into account that the outside director may be non-independent (at least in part) or may be totally independent. In addition to determining the degree of independence of the outside director, it is necessary to focus upon the charter or code of responsibility which is to be imposed upon directors generally and the outside director specifically. That must include an analysis of the responsibility of the large public company. The business corporation has mixed social responsibilities as well as a responsibility to obtain maximum profit for the benefit of its shareholders. Obviously, the social responsibilities may impinge upon the profit motive.[9] Since 1970, there has been significant legislation adding to the social responsibility of corporations. Laws designed to protect the environment,[10] fair-employment practices,[11] and safety standards for employees[12] are examples. Directors must devote increasing attention to corporate compliance with these various statutes.

Of course, the independent director will recognize that the interests of management and shareholders are often not identical. Target companies in takeover bids as well as companies considering going private represent prime opportunities to observe the distinction between the interests of management and the interests of shareholders.

As a result of the divergence between the interest of management and shareholders, large corporations on occasion may attempt to convert their boards of directors into non-boards. The independent director may serve management better by serving only as a figurehead. The chief executive can "put his back-seat drivers to sleep."[13] While large corporations can tolerate boards which are relatively active, smaller corporations often have directors who exert too great a power. "These directors . . . keep pulling up the flowers to see how the roots are growing."[14]

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[9] For an interesting study of the development of the laws governing corporations from 1890-1970, see J. HURST, THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE LAW OF THE UNITED STATES (1970).

[10] *See, e.g.*, National Environmental Policy Act of 1969, 42 U.S.C. §§ 4321-4361 (1970); Clean Air Act, 42 U.S.C. §§ 1857-1857(h)-7 (1970); Environmental Control Act of 1972, 7 U.S.C. §§ 136-136(y) (Supp. IV 1974).

[11] *See, e.g.*, Civil Rights Act of 1964, tit. VII, 42 U.S.C. §§ 2000e-2000e-17 (1970); Age Discrimination in Employment Act of 1967, 29 U.S.C. § 621-634 (1970).

[12] *See, e.g.*, Occupational Safety and Health Act of 1970, 29 U.S.C. §§ 651-678 (1970).

[13] R. TOWNSEND, UP THE ORGANIZATION 49 (1970).

[14] *Id.* at 51.

While historically directors were thought to be entitled to rely upon the honesty and integrity of executives until something occurred to raise their suspicion,[15] more recent cases indicate that the level of responsibility is significantly higher.[16] The Securities and Exchange Commission, as well as the courts, has stirred a revolution in the thinking as to the responsibility of outside directors. The Commission has insisted that there be committees to handle problems of disclosure, of questionable payments,[17] and, of course, to review the audit and related procedures. The Commission has suggested in numerous written materials on the subject that directors are expected to be active and deal with management at arm's length.[18]

Section 11 of the Securities Act of 1933[19] represents the most awesome exposure to possible liability for outside directors. It requires that these directors have significant legal, financial, and operational knowledge of the corporation whenever a registration statement is filed. The registration statement normally is prepared by specialized legal counsel in conjunction with management. Management's function is to provide the basic necessary knowledge of the company's operations. The outside director is by statute placed in an arm's-length position where he must establish that he has independently checked the written product in order to protect investors. A similar responsibility arises under the Securities Exchange Act of 1934 in connection with the preparation of proxy statements.[20] The responsibility which the SEC defines for the outside director has been dem-

[15] *See, e.g.*, Graham v. Allis-Chalmers Mfg. Co., 41 Del. Ch. 78, 188 A.2d 125, (1963).

[16] SEC v. Mattel, Inc., [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,807 (D.D.C., Oct. 1, 1974); Gould v. American Hawaiian S.S. Co., 351 F. Supp. 853 (D. Del. 1972); Escott v. BarChris Constr. Co., 283 F. Supp. 643 (S.D.N.Y. 1968).

[17] SEC v. Mattel, Inc, [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,807 (D.D.C., Oct. 1, 1974).

[18] *See, e.g.*, C. BROWN, PUTTING THE CORPORATE BOARD TO WORK, (1976); C. STONE, WHERE THE LAW ENDS, (1975); Cabot, *Louis W. Cabot On An Effective Board*, HARV. BUS. REV., Sept.-Oct. 1976, at 40; *Arthur Goldberg on Public Directors*, BUS. & SOC. REV., Spring, 1975, at 35; Mann, *A Program Enabling Non-Management Directors to Comply With Their Responsibilities for Ensuring Adequate Disclosure*, in PLI FIFTH ANNUAL INSTITUTE ON SECURITIES REGULATION, (Fleischer, Mundheim, Schupper 1974); Sommer, *Directors and the Federal Securities Laws*, FED. SEC. L. REP (CCH) ¶ 79,669 (Feb. 21, 1974); Stone, *Public Directors Merit a Try*, HARV. BUS. REV., Mar.-Apr. 1976, at 20; Address by SEC Commissioner P. Loomis, Jr., *Director Responsibility—A Government View*, given at Loyola College, Baltimore, Maryland (April 8, 1975).

[19] 15 U.S.C. § 77k (1970).

[20] *See, e.g.*, Gould v. American Hawaiian S.S. Co., 351 F. Supp. 853 (D. Del. 1972).

onstrated in the recent report on the Sterling-Homex Corporation.[21] The Commission alleged that the company's financial statements were fraudulent. It did not specifically allege that the outside directors knew that the statements were fraudulent. Instead, the SEC took the position that the inside directors misled the outside directors. Yet, the outside directors were included in the consent injunction because at the board meetings there had been little interrogation or questioning of management. Interestingly, there had been no written agenda for board meetings. It would seem that by this time most public corporations would circulate an agenda prior to the meeting, and in no event would have a meeting without circulating an agenda at the meeting.

The Board of Directors of Sterling-Homex had in essence delegated its decisionmaking powers to the Executive Committee. The Executive Committee was apparently the only operating committee of the Board. The corporation did not provide board members with memoranda to assist them in their decisionmaking responsibility, did not provide opportunity to test accounting principles, and did not provide timely, accurate, or complete information with respect to the business operations of the company. As it became more apparent that the corporation was in financial difficulty, the outside directors did not involve themselves to a greater extent in the company affairs. In short, the SEC concluded that the outside directors "did not provide the shareholders with any significant protection in fact, nor did their presence on the board have the impact upon the company's operations which shareholders and others might reasonably have expected."[22]

Securities and Exchange Commission v. Shiell

In December, 1976, the SEC filed an action in the United States District Court for the Northern District of Florida, Tallahassee Division, entitled *Securities and Exchange Commission v. Shiell.*[23] The action is one seeking an injunction against various officers, directors, and professionals who had been associated with The Commonwealth Corporation (TCC) prior to its filing a Petition for Reorganization under Chapter X of the Bankruptcy Act. Included in the allegations of the Complaint is the charge that the directors "exercised or should have exercised control over" the corporation. The Complaint notes that the president of the company "was the sole office of TCC . . .

[21] FED. SEC. L. REP. (CCH) ¶ 8219 (1975).

[22] *Id.*

[23] No. 76-204 (N.D. Fla., filed Dec. 2, 1976).

reporting directly to the directors."

The position of the SEC is spelled out in great detail in an accompanying affidavit filed with the Complaint signed by a staff accountant and senior investigator. The affidavit quotes directly from the testimony of two directors as follows:

> In the late 1960's, the Board of Directors were concerned about the rapid growth of the construction loan department. With this thought in mind, a limit was voted on the amount of construction loans that the Company could be involved in at one time. The president was strongly opposed to this limitation, feeling that this was the most lucrative part of the Company's business.
>
> From time to time the president would show the Directors a record of the construction loan business, which showed constantly increasing income and few, if any, losses. He accompanied this with his strong recommendations that limitations on construction lending be lifted. With his continued success in this area, the Board removed the limitation on construction lending. This limitation was lifted sometime in 1971.
>
> The Directors monitored the construction lending fairly closely for a short period thereafter and, having received assurances that the Company's management was proceeding prudently, allowed the further expansion of construction lending thereafter.
>
> As time went on, the Directors felt that Mr. Shiell's continued success in handling these construction matters was ample proof that he was right and that construction lending was a good idea for the Company. . .

The charge against the outside directors continues in affidavit form as follows:

> (c) The minutes and agendas [sic] of the Board of Directors meetings starting at least in 1972 reflect that the directors had in effect relinquished substantial control over Shiell. The directors, as "outside" directors, relied upon Shiell as their sole source for all information regarding the activities and operations of TCC. The minutes do not reflect that any other officers of TCC were present at any meetings nor did the directors require any other officer to report to them regarding the activities of TCC to any significant extent.
>
> The testimony of the directors indicates that they did not deem it necessary to have other officers present at the meetings for they believed (by accepting Shiell's reports at face value)

that they were getting accurate and complete information from Shiell. Additionally, they felt that questioning other officers about TCC's activities or, in fact, requiring other officers to report to them independently of Shiell would "constitute an intrusion into the functions of management". . . .Even when the directors visited the TCC offices from time to time, and encountered other key officers, there were few discussions regarding TCC's activities . . . .
(d) An examination of the minutes and agendas [sic] of the meetings of the Board indicates that from at least 1972 on, the directors would receive financial reports, monthly reports as to ratios of foreclosures and rates of delinquency regarding the permanent mortgages serviced by TCC; opening of new bank lines by TCC; changes in personnel; budget forecasts, and production reports of loan closings which included both C&D loans and permanent loans. The minutes and agendas [sic] reflect that the information that the directors received was voluminous but examination reveals that much of this information was general and in some instances lacked specific information as to certain material aspects of TCC's activities. For example, the monthly reports of rate of foreclosures and delinquencies submitted by Shiell at the board meetings dealt exclusively with defaults of residential mortgages that TCC services for permanent investors who owned these mortgages and who bore all risk of loss. There was no risk of loss to TCC other than a possible diminution of TCC's service fees if there was a foreclosure. Conversely, where TCC had a real liability and possible loss of income stemming from the C&D loans, the directors did not receive nor did they request regular reports of foreclosure, defaults, delinquencies, or arrearages other than general oral assurances from Shiell, who indicated that TCC was not encountering difficulties . . . . The directors accepted these assurances without any independent verification. While TCC avoided foreclosure of C&D loans, the evidence clearly indicates that TCC carried builders who were failing to pay their loans at maturity or who were in arrears for as long as six months. The directors have testified they did not request any report as to the status of outstanding C&D loans. In addition, while the directors knew of the tremendous expansion of the C&D activity and the resultant effect of increased earnings for the years 1972 and 1973, the directors admitted that they never specifically requested any of the following information with respect to C&D loans:

> (1) Who the largest borrowers from TCC were;
> (2) What was their financial condition;
> (3) The number of projects that TCC was financing for a particular builder and what financial exposure TCC faced thereon;
> (4) The progress of particularly large projects;
> (5) The delinquencies or arrearages of C&D borrowers from TCC and what direct or indirect exposure faced TCC, and
> (6) Whether TCC had granted more than one mortgage loan on the project . . . .

With respect to disclosure in the financial statements, the affidavit states the following:

> (f) Further, the directors did not review the unconsolidated audited and unaudited statements for TCC and its wholly owned subsidiaries. The TCC files reflect that for each annual and semi-annual audit of TCC performed by the accounting firm of John W. Hosford and Co., TCC was audited both on an unconsolidated and consolidated basis and likewise each subsidiary was audited separately. The accountants supplied the officers of TCC with all of these statements. Nevertheless, the unconsolidated statements were never given to the directors by Hosford or by the officers, nor were they ever asked for by the directors. According to Teague . . . the directors relied on the consolidated audited statements and, based upon this reliance, assumed they were getting all appropriate information and, accordingly, saw no need to examine the unconsolidated statements. These statements, particularly the unconsolidated audited and unaudited statement of TCC up to July 31, 1973, contained numerous schedules, some of which indicated the name of each borrower from TCC and the amount so borrowed.

The affidavit finally sums up the charge of neglect on the part of the directors as follows:

> While the facts in paragraph "50" above indicate a failure by the directors to adequately inquire into the activities of TCC, a failure to exert sufficient control over management and a *failure to require responsible reporting from management,* the focal point of the charges against the directors is that both just prior and subsequent to the offering of May 6, 1974, the directors were on notice of TCC's deteriorative financial condition

> and *failed to take timely affirmative action* to withdraw the offer and sale of the investment certificates and common stock covered in the May 6, 1974 public offering. [Emphasis added.]

The Complaint in the *Shiell* case along with the Sterling-Homex Consent Decree noted earlier are ample evidence that the SEC is not only prepared to talk about the responsibility of directors, but to enforce liability in connection therewith.

Stanley Sporkin, head of the SEC's Enforcement Division, stated in a speech before the Business League Conference on Corporate Directors that "our corporate managers over the years learned that they in effect had unfettered control of the corporation to do exactly as they pleased and not too many questions would be asked as long as they showed an upward earnings trend."[24] He suggested several massive reforms which included the following:

> (1) Give non-insider public shareholders board representation even though it might be disproportionate to their holdings;
> (2) Establish a mechanism to take the selection process for directors-at-large and the board's audit committee out of the hands of management, to ensure board independence;
> (3) Find a way to sanction directors who do not perform their functions;
> (4) Enable the independent director to assure the appointment of adequate and disinterested counsel, who will represent only the corporation's interest;
> (5) Provide the audit committee with adequate powers and high-calibre, independent directors; and
> (6) Appoint a "Business Practices Officer" to ferret out improper business practices within the corporation and bring them to the attention of the Board.

Directors Appointed With Court Consent

In recent years a new phenomenon has developed in the election of outside directors. This is most often demonstrated by the consent appointment of independent outside directors in connection with the entry of a consent decree in an action brought by the SEC.[25] These

[24] As reported in EXECUTIVE DISCLOSURE GUIDE, (CCH) SEC Compliance, Vol. 2, No. 14 (July 7, 1977).

[25] *See, e.g.*, International Controls Corp. v. Vesco, 490 F.2d 1334 (2d 5.082

directors have had no previous material contact with the company on whose board they will then serve. There is no present statistical base to ascertain whether the presence of such directors results in materially more information being made available to the board, differences in board votes, or even subsequent changes in management (excluding those changes which may be part of the consent decree).

It is highly probable that the presence of these appointed independent directors causes the management of the corporation to provide more significant information to the board before seeking board approval of material alterations in the company's course of conduct. Their presence may also encourage greater disclosure to the board of the nature of the corporation's activities.

It is basic to the federal statutory scheme that responsibility for greater disclosure brings better critical thought to the decisionmaking process. It is all but impossible to prove that fewer mistakes occur because of careful thought processes, but our planning processes accept care as an axiom for better performance.

While the jury must remain out for some time on the contribution of appointed outside directors, there have been a number of proposals for the utilization of public directors for large public corporations.[26] In an atmosphere where so many corporations of size, magnitude, and historic high reputation have admitted engaging in various illegal and/or immoral activity, it is not surprising that there are pressures to place on boards of directors persons who do not have pre-existing relationships with management. The "old boys club" is in serious and proper jeopardy. Although agreeing that independent outside directors should include persons who are not close friends, relatives, or other business associates of management, it is hard to understand why these persons should be unknown to management. It is not a

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Cir.), *cert. denied,* 417 U.S. 932 (1974); SEC v. Tilco, Inc., [1971-1972 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 93,240 (D.D.C. Oct. 15, 1971); SEC v. Bio-Medical Services, Inc., SEC Lit. Release No. 6700 (Jan. 28, 1975); SEC v. Chapter Securities Management Corp., SEC Lit. Release No. 6593, (Nov. 21, 1974); SEC v. Charter Diversified Services, SEC Lit. Release No. 6507 (Sep. 9, 1974); SEC v. Mattel, Inc. (D.D.C. 1974), SEC Lit. Release No. 6467, (Aug. 8, 1974), No. 6431, (Oct. 2, 1974), and No. 6532 (Oct. 3, 1974); SEC v. Westgate-California Corp., SEC Lit. Release No. 6142 (Nov. 9, 1973); SEC v. Canadian Javelin, Ltd. SEC Lit. Release No. 6054 (Sep. 12, 1973); SEC v. Coastal States Gas Corporation, SEC Lit. Release No. 6054 (Sep. 12, 1973); SEC v. International Controls Corp. (IOS-Vesco-ICC), SEC Lit. Release No. 5643 (Nov. 27, 1972).

[26] Stone, *Public Directors Merit a Try,* HARV. BUS. REV., Mar.-Apr. 1976, at 20.

recommendation of this article that public directors be appointed to the boards of directors of corporations by anything other than the elective process. However, it would be wise to provide independent outside directors several very important tools for effectiveness:

1. Compensation should be adequate to allow the director to devote considerable time to his undertaking.
2. The independent director should have available to him staff from the corporation and within reasonable limitations be empowered to retain outside experts as needed.
3. Each significant corporate committee should include these persons as directors. To the extent they are not included in the committee, they should be entitled to attend committee meetings.

Reclassifying the Board

In determining who should serve on the board of directors and what the appropriate balance of persons should be, the following are suggested guidelines that ought to be attempted by publicly held corporations. First, it must be recognized that corporations of differing size will have differing abilities to attract quality outside directors. There are several crude, but not inaccurate, measuring sticks. In the current legal-economic environment in which relatively few companies are "going public" and relatively few public companies are seeking to change their trading markets from over-the-counter to listing on an exchange or from listing on one exchange to another, we have a fairly static working model from which to experiment.

The definition of directors should be divided into three categories suggested above: inside director, non-independent outside director, and independent outside director. The inside director is a person who receives material compensation or devotes the most significant portion of his time to the corporation in a capacity other than as a director. The non-independent outside director is a person who is either related to an inside director, is an employee of the inside director, or receives directly or indirectly material compensation for services other than board membership. Thus, lawyers, business consultants, or even the company's commercial bank representative would be considered a non-independent outside director. The independent outside director is a person who receives no material compensation directly or indirectly from the corporation for services other than board membership.

It is necessary to recognize that the availability of qualified persons for boards of directors will vary. The rules cannot be the same for all corporations. The boards of directors of corporations listed on the New York Stock Exchange over a period of no more than five years should alter their composition so that no less than one-third of their total membership includes independent outside directors and no less than one-third includes non-independent outside directors. All other companies listed on any exchange should require themselves to have no less than 25 percent of their board memberships made up of independent outside directors and no less than 25 percent of non-independent outside directors. Only a minority of the board should be management directors. Although companies listed on the National Association of Securities Dealers Automated Quotation should strive to achieve the breakdown suggested for listed companies, many of these companies will find it difficult to entice 25 percent of their board membership from independent outside persons. Under all circumstances, their boards should contain a majority of non-management ("outside") directors. Other publicly held companies should strive for the attainment of significant independent and significant non-independent representation on the board of directors, but should not be held to the same standards.

Having composed the board on a basis of three major classifications, it is now desirable to view who should be included within those classifications. Independent outside directors should not be persons who have had any previous relationship with the company. While it is desirable that they be shareholders, it does not seem that that should be a necessary element in their qualification. To have persons buying insignificant numbers of shares so the proxy statement will indicate ownership does not make any real economic sense. It must be acknowledged that to some degree the independent outside director may represent interests adverse to those of the main body of shareholders. In part, the independent outside director is the review person for such things as integrity of management, compliance with regulatory schemes, and, most important, the community conscience. This is not to say that the independent outside director should not be concerned with earnings and profits or other types of economic progress. To ignore these realities would eventually be the downfall of the corporation.

To the extent possible, the independent outside director should bring to the corporation special expertise. Experience within the industry, general management experience, expertise in areas in which the corporation from time to time needs guidance are all desirable elements in the selection of the independent outside director.

Corporations should have significant opportunities to recruit this type of independent outside director since the average age of all directors is currently fifty seven and outside directors average fifty eight.[27] As directors grow older, both death and retirement will assist in the turnover of board membership so that the objectives stated above can be achieved.

The selection of the independent outside director should not be in the exclusive domain of the chief executive officer. It would probably be helpful to utilize present outside directors as a nominating committee. It is more comfortable to have current board members developing the selection process than government agencies or courts. Anticipating that individuals will accept fewer board positions, it will not be easy to find persons with experience who are also willing to serve on many additional boards. Each position will require greater attention, and few candidates can devote significant attention to many boards. It will be necessary to engage in research beyond normal circles to find appropriate persons; for example, there is a growing pool among women and minority groups who have historically not been selected for board membership. It is not being suggested that prospective independent directors should be disqualified because they are known to present board members, graduates of the same universities, members of the same clubs, or if they live in the same neighborhoods. It is being suggested that the search for directors should not be contained within these parameters.

A significant source of independent outside directors can be found among senior management of other companies. Historically, only the top officers of corporations became board members of other major corporations. It is both necessary and desirable to make use of a broader base of senior management in the selection of independent outside directors. These persons should be allowed to serve on other company boards so long as there is no conflict of interest.

The selection of a non-independent outside board member is considerably less complicated. These persons already have some contact with the corporation. They may even have intimate knowledge of certain or all phases of the corporate activity. Attorneys and retired officers are probably the most representative persons in this group, but many other persons can be added without difficulty. Bank officers and investment bankers should be included. The independence which these individuals exercise will vary based in part upon their personal standards. Because these persons are working with the corporation in other capacities, they will from time to time have insight

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[27] HEIDRICK & STRUGGLES, INC., THE CHANGING BOARD—PROFILE OF THE BOARD OF DIRECTORS (1977).

not generally available to the other outside directors. In both the *Sterling-Homex* consent decree and the complaint in the *Shiell* case discussed above,[28] the SEC criticized the lack of contact of the board members with corporate personnel other than top management.

At least one member of management in addition to the chief executive officer should serve on the board of directors. That person represents an additional conduit to the board on corporate activity as well as a conduit from the board to the organization. Unless there is such a source of information, the board is in a less tenable position in the event that it wants to review the capability of its chief executive officer or consider the possibility of replacing that executive.

The large shareholder who serves on the board of directors who has no other capacity within the corporation may well be considered in a special capacity unrelated to any of the three categories above. Large shareholders who are not part of management normally are in that position for one of three reasons: (1) the founding family continues to own large amounts of stock but has no family members continuing in the business; (2) the large block has been acquired as an interest adverse to present management; or (3) the large block has been acquired either to assist or place management in its present position. If it is clearly established that the large shareholder is essentially adverse to management, that board representative should be considered as an independent outside director. Otherwise, it is suggested that the large shareholders should be considered as non-independent outside directors.

Orientation of Board Members

No person should stand for election to the board of directors of a publicly held corporation without certain minimal investigation. The investigation is not to determine whether the company has problems, which most companies do, but to be knowledgeable as to problems and opportunities.

The orientation of members of the board of directors should include an opportunity to review current financial data. This should include the Form 10-K filed with the SEC and subsequent Form 10-Qs as well as recent financial information circulated to the board of directors. The new member of the board should have available the consultation of financial officers of the company who should be able to explain the financials in depth. In addition, new board members should have an opportunity to view some of the corporate facilities,

[28] *See* text accompanying notes 14 & 16 *supra*.

meet with corporate officers, and an opportunity to meet with corporate advisors such as the outside attorneys and accountants.

There is some danger in setting designated minimal standards by which a new board member is considered adequately educated to commence board service. It does not seem wise to set absolute standards of liability based upon inadequate orientation. Experience as to the reasons that outside board members have not performed adequately does not indicate elements in the orientation process which would have protected against inadequate performance. Ongoing diligence is the touchstone for success.

Those corporations which have operations at varying locations should from time to time have board meetings at or near such locations so that the board members may view the facilities. As will be discussed, the care and planning of a board meeting is of critical importance to successful board contributions.

Although membership on committees will give certain board members special expertise, it cannot and should not be forgotten that liability extends to all board members and that it is therefore necessary that all board members have input from committees as well as the opportunity to make contributions to the various committees of the board. New board members will be well advised occasionally to attend meetings of committees on which they do not serve. A more delicate question with respect to orientation is the access which board members should have to company personnel on an informal or otherwise unregulated basis. Many chief executive officers would find regular visits by members of the board of directors to company operations and inquiries of company personnel to be disruptive. The objective of a free flow of information may best be handled by providing the outside board members (both independent and non-independent) with special staff who would handle visits and questions on a formal and scheduled basis. The objective of providing a free flow of information should not overshadow the equally important objective of maintaining smooth operation of the business enterprise.

Some special recommendations for the new board member are as follows: at the time of accepting the nomination, the board member should determine that the following procedures are followed by the corporation or will be initiated:

1. Board meetings will be held on a regular basis.
2. An agenda will be circulated within a reasonable period prior to each meeting.
3. There will be a continuous flow of information to directors.
4. There will be an opportunity to meet with outside experts as well as management persons who do not serve on the board.

5. Major proposals will be submitted as soon as reasonable in advance of action.
6. It is socially acceptable within the board to dissent and/or to present philosophical differences.
7. Minutes of both the board meetings and committee meetings are to be maintained and circulated.

Committees

Naturally, the board of directors cannot focus its attention on all of its obligations as a committee of the whole. Recent pressures, particularly from the New York Stock Exchange and SEC would indicate that some committees of the board are expected to serve in a very special capacity somewhat independent from the board of directors. The Audit Committee is the prime example. The Audit Committee will on occasion make judgments which are not in accord with those most desired by management. It is therefore necessary that care be exercised in selecting the membership of that committee.

Historically, the most important committee of the board of directors has been the Executive Committee. While it may now have lost some of its importance to the Audit Committee, it continues to be the committee with the greatest flexibility for power. There are no rules as to persons who may or must serve on the Executive Committee. Normally, the Executive Committee consists of a minority of the board. The chief executive officer, one or two inside directors, and one or two outside directors are commonly on the Executive Committee. Unlike other committees, the Executive Committee is frequently recognized by state statute. The board may delegate to the Executive Committee certain powers which would otherwise be powers of the board itself. Most corporations provide for the existence of an Executive Committee within their corporate by-laws and/or charter or articles of incorporation. The responsibilities of the Executive Committee are designated by the board of directors. Some executive committees have broad ranges of power, while others possess fairly narrow authority.

The Executive Committee should include outside directors. Both the independent outside directors and non-independent outside directors should be included. It is a personal observation that most executive committees have a majority of inside directors. It is recommended that executive committees draw a majority of their membership from among the outside directors, to serve the same function, in essence, as is served by those directors on the board as a whole.

Generally, the Executive Committee is charged with the responsibility of acting between board meetings. For some executive committees, meetings are scheduled on a regular basis between board meetings, while other executive committees only meet irregularly. It is recommended that regular meetings be held.

Certain powers should not be delegated to the Executive Committee. The Executive Committee should not have the power to amend or recommend for shareholder action amendments of corporate charters, and should neither create nor fill vacancies among officers who are elected by the board. Certain financial matters such as the declaration of dividends should not be acted upon by the Executive Committee. While the Executive Committee may make recommendations on the compensation of officers, the final determination should be a matter for the board of directors. Of course, the Executive Committee should not act contrary to, rescind, or otherwise nullify action taken by the board of directors. The Executive Committee should also be limited in its power to dispose of property or other assets of the corporation. There should also be limitations on the amount of debt which the Executive Committee can incur on behalf of the corporation.

On the other hand, the Executive Committee can handle many of the problems which arise from time to time. It is also in a position to refine and then make definitive recommendations to the board of directors with respect to issues that are appropriate for board action only. The Executive Committee is the natural committee for the assignment of special projects or topics. The Executive Committee should relieve the board of many of the routine tasks which boards of directors have. For example, the committee should be able to review budgets, lower-level salaries, leases, bank agreements, and may even be charged with the responsibility of allocating corporate contributions. Long-range planning and other major decisions should be reviewed by that committee before going to the board of directors.

In most large corporations division presidents are usually not represented on the board of directors and only appear at such meetings for special occasions. The Executive Committee is in a position to meet with heads of divisions on a regular basis and have a better understanding of the operations of those divisions. As a result of these meetings the Executive Committee is in a better position to review corporate budgets and policies before presentation to the board. A conscientious Executive Committee should reduce the exposure of both the members of the Executive Committee and other members of the board of directors.[29]

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[29] Syracuse Television, Inc. v. Channel 9, Syracuse Inc., 51 Misc.2d 188, 273

The other highly important committee of the board of directors is the Audit Committee. This is a committee which, as noted above, should be structured to include primarily or exclusively outside directors.[30] When possible, members of the Audit Committee should have a financial background. An outside director, preferably an independent outside director, should act as chairman of the committee. The Audit Committee is a committee which will not meet as regularly as the Executive Committee, but will have a period during the year when it will meet with greater intensity. The duties and responsibilities of the Audit Committee should be carefully outlined and adopted by the board of directors. These duties must include a review of the financial statements with the independent auditors. During this review the Audit Committee must make inquiry into the financial practices of the corporation. Areas of special interest will include changes in accounting principles and practice, sensitive reporting, adjustments in financial statements from period to period, evaluation of both the understandability and readability of the financial statements as well as a review of the total disclosure encompassed in the financial statements.

It is difficult, if not impossible, for non-professionals to keep abreast of pronouncements of the various accounting standards promulgated by both the accounting profession and the SEC. Yet, the Audit Committee must make a detailed effort to determine that the standards are being met.

All of the large accounting firms have published guides directed to the Audit Committee to assist them in their function. No Audit Committee should operate without having reviewed the guide published by an auditing firm other than that which audits the corporation.

In addition to reviewing the audit, to a degree the Audit Committee is also reviewing the auditor. The Audit Committee must have confidence that the independent accountants have maintained some continuity of staff while at the same time rotating staff. There must be adequate services available to the corporation from the independent accounting firm to perform the audit effectively and to make

N.Y.2d 16 (1966); Litwin v. Allen, 25 N.Y.2d 667 (Sup. Ct. 1940); Goff v. Emde, 32 Ohio App. 216, 167 N.E. 699 (1928). For an informative discussion of boards of directors see Address by SEC Commissioner P. Loomis, Jr., *Director Responsibility—A Government View*, given at Loyola College, Baltimore, Maryland (Apr. 8, 1977). *See also* Mace, *Designing a Plan for the Ideal Board*, HARV. BUS. REV., Nov.-Dec. 1976, at 20.

[30] For a discussion of management's role with the Audit Committee see Lam, *Management Representation on Audit Committees*, THE C.P.A. J., Nov. 1975, at 33.

recommendations for improvements in the financial reporting of the corporation. Of course, the Audit Committee must also end its work with confidence that the management of the corporation has cooperated adequately in the audit process.

The Preparation of a Philosophy for Board Activity

The public corporation should define in writing the duties which its directors undertake. Working with the management, the board of directors should articulate its functions and duties. Having defined its task, the board will be in a better position to review its membership, to make plans for retirements, attrition, and additional memberships on the board.

There must be a regular flow of written materials from the corporation to the board of directors to inform the board of the operation of the company and to periodically and regularly update the board on the results which the company is achieving. The objectives ought to be stated for the board and ought to be utilized as measuring tools for management performance. It is for the board to determine if management's goals are appropriate, if the goals are being met, and if not, why not.

It is very difficult for the board of directors to define its constituency. At least until such time as laws are amended, no board member can defend with confidence on the basis that his constituency is more narrowly defined than other board members. In today's world, the constituency includes not only shareholders, but also employees and the communities in which the corporation has significant operations. The investing public is also part of the constituency.

> A corporate director stands in a position of trust and confidence with respect to the corporation he serves and its stockholders. While he is technically not a trustee, he does have responsibilities of a fiduciary nature. He must not only protect the interests of the corporation committed to his charge, but must also refrain from doing anything to work injury to the corporation or to deprive it of the profit or advantage that his skill and ability might properly bring to it.[31]

Diligent attendance at directors' meetings, at meetings of committees on which the director serves is highly important. It is also important that directors be keenly aware of potential conflicts of

[31] W. KNEPPER, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS 1 (1969).

interest. This is particularly so with outside directors who may be serving on other boards or have other capacities where a conflict may develop. Directors also have a responsibility to maintain a current understanding of developments in the industry. This can probably best be accomplished by reading trade journals and business periodicals which affect the industry. Being too busy is not an excuse.[32]

Summary

The philosophy presented above is not a panacea for the operation of boards of public companies. It is instead an outline of a method which should bring boards of directors to a higher level of service and at the same time bring management more effective boards of directors.

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[32] *See, e.g.*, Boddy v. Theiling, 129 Ga.App. 273, 199 S.E.2d 379 (1973) (director, too busy to attend meetings, found liable as having participated in an illegal sale under the Georgia Blue Sky Laws).

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