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CORPORATE GOVERNANCE AND THE OUTSIDE DIRECTOR — A MODEST PROPOSAL

VICTOR M. EARLE, III*

Perhaps the most controversial subject affecting American business in the past decade has been the issue of corporate governance. The subject includes a wide range of issues—corporate accountability is a prominent example—which reach the very foundations of publicly-held corporations and thus are of great interest to us all. Indeed, suggestions for reform are emanating helterskelter from every possible source. These suggestions often reflect the political demands and frustrations of a public whose understanding of the American corporation is primitive at best. Equally as often, however, they consist of thoughtful proposals advanced by leaders of business and government. The combined results are rather chaotic. It is the purpose of this article, after recapitulating the recent developments in this volatile field, to offer suggestions to relieve some of the chaos and to institutionalize a rationale process of reform.

I. RECENT DEVELOPMENTS

In the early days of the business enterprise, ownership and control were tied closely together. Gradually, businesses grew and ownership became divorced from control. Stockholders ceased to be interested in entrepreneurship and came to think of themselves as investors, interested only in profits. Control of the corporation was left to the management, with the board of directors theoretically providing an effective check. The gap between theory and reality, however, was substantial. The managers of the corporation often placed themselves on the board or filled the position with quiescent, albeit prestigious, outside directors. The function of the outside director was viewed as a sleepy one; that is, he or she was expected to stay out of the way of management in exchange for the prestige afforded or reinforced by the position. The outside directors were generally chosen by the chief executive officer, who typically sought individuals with whom he could feel comfortable. Most have been high-level business executives, usually chief executives and chairmen, as well as lawyers, bankers, and academicians.[1] The traditional quiescence of the outside director was exacerbated by a widespread lack of understanding about the precise duties of the position, even assuming the director had any interest in fulfilling them.[2] The result of all of this was that the managers of the business, the

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[1] *See* Soderquist, *Toward a More Effective Corporate Board: Reexamining Roles of Outside Directors,* 52 N.Y.U. L. REV. 1341, 1350-51 (1977) [hereinafter cited as Soderquist].

[2] *See* Estes, *The Case for Counsel to Outside Directors,* HARV. BUS. REV., July-Aug. 1976, at 127 [hereinafter cited as Estes]:

supposed servants of the shareholders, effectively became their own supervisors and the control ostensibly exercised by the board of directors became wholly formal.[3]

Today in the United States, a directorship is no longer comparable to a hot bath. Demands and expectations have increased almost daily along with a host of proposals for improving the accountability of the corporation. This change of attitude, which in its intensity and scope approaches a revolution, has occurred because of a number of recent developments. The most important developments have been certain highly-publicized corporate failures and failings, the response of the Securities and Exchange Commission (SEC) and the Congress, the increasing imposition of legal liability on directors, dissatisfaction with state regulation of corporations, and a general transformation in our cultural consciousness.[4]

A. *Corporate Failures and the Government's Response*

The revolution in attitude regarding the role of the outside director can be explained simply: revelation of widespread corporate malfeasance. To paraphrase Dr. Johnson, the revelation of wrongdoing wonderfully concentrates the mind. SEC investigations disclosed powerful evidence, including outright admissions by the corporations themselves, that many companies were engaging in outrageous conduct. These corporations admitted that they had participated in bribery or submitted to extortion abroad, kickbacks and improper political contributions at home, the creation of use of

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> Since outside directors do not bring with them special expertise as outside directors, receive no independent training for that role, and are themselves better oriented to the CEO role than any other, they do not, as a class, have much to go on except their own experience aided by such immaculate revelations as they may be blessed with as the job progresses.

See also Soderquist, *supra* note 1, at 1349-50.

[3] Douglas, *Directors Who Do Not Direct*, 47 HARV. L. REV. 1305, 1307-08 (1934) [hereinafter cited as Douglas]; Address by P. Loomis, SEC's Concern With Corporation Governance, (Nov. 20, 1978) (Before the Financial Executive Institute, Pittsburgh, Pa. at 6-7) [hereinafter cited as Loomis]. *See generally* A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932). The attitude of quiescence which all too often prevailed until relatively recently is reflected in the following oft-quoted comment of Lord Boothby:

> If you have five directorships it is total heaven, like having a permanent hot bath. . . . No effort of any kind is called for. You go to a meeting once a month in a car supplied by the company, you look grave and sage, on two occasions say 'I agree', say 'I don't think so' once, and if all goes well you get 500 pounds a year.

Chamberlain, *Why It's Harder and Harder to Get a Good Board*, FORTUNE, Nov. 1962, at 109.

[4] *See* Shipman, *The Role of the Outside Director Distinguished From the Inside Director*, *reprinted in* A. COHEN & R. LOEB, CORPORATE GOVERNANCE 259, 266 (PLI 1979). Sentiment on the question of corporate governance is not unanimous. Two commentators recently criticized various proposals being made in this area. For example, they asserted that it is doubtful whether the objectivity of outsiders will be more beneficial than the detailed knowledge of the company of those they will replace. They concluded that there is no convincing empirical evidence that change in corporate governance is necessary or that the reforms suggested will be beneficial. Russo & Wolfson, *Why Must Boards Change?*, New York Times, Jan. 21, 1979, at 16F.

slush funds, and other illegal and immoral action. Something on the order of 400 corporations acknowledged these practices. The admissions caused a storm of protest both here and in Italy and Japan.[5]

The post-Watergate discoveries followed in the wake of some spectacular bankruptcies, notably Penn Central, Equity Funding, and Sterling Homex. In each there was evidence of management fraud and, hence, the inevitable allegation that the directors were not adequately informed or sufficiently vigilant.[6]

The response of the Government was swift. In December, 1977, Congress passed the Foreign Corrupt Practices Act of 1977.[7] Sections 103 and 104 of the Act made it a crime for any United States company, public or private (the latter falling within the Act's rubric of "domestic concerns"), or any individual who is a citizen or resident of the United States, to use "corruptly" instrumentalities of interstate commerce in furtherance of an offer to bribe a foreign official or a foreign political party, party official, or candidate for foreign political office in order to assist in obtaining or retaining business for or with, or directing business to, any person. Section 102 imposes an even more direct duty upon the directors of the corporation by requiring that "issuers" who have registered securities under the Securities Exchange Act of 1934 and who must comply with regular reporting requirements, keep reasonably accurate books and records and devise and maintain systems of internal accounting controls sufficient to provide reasonable assurances that criteria in the statute intended to thwart the use of off-the-book slush funds are met.[8]

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[5] *See The Role of the Shareholder in the Corporate World: Hearings before the Subcommittee on Citizens and Shareholders Rights and Remedies of the Senate Committee on the Judiciary*, 95th Cong., 1st Sess., pt. 1 at 6-7 (1977) (statement by P. Loomis) [hereinafter cited as Metzenbaum Hearings]; Grienenberger & Harms, *Corporate Governance Project Stirs Controversy Over SEC's Authority*, N.Y.L.J., Dec. 14, 1978, at 25 [hereinafter cited as Grienenberger & Harms]; Leech & Mundheim, *The Outside Director of the Publicly Held Corporation*, 31 Bus. Law. 1799, 1801 (1976) [hereinafter cited as Leech & Mundheim]; Loomis, *supra* note 3, at 3. In testimony before the Congress, SEC Commissioner Philip Loomis responded to an inquiry about whether stricter standards for outside directors might have prevented some of these instances of corruption:

> Mr. Loomis. I think they would have been avoided to a very substantial degree. One reason for thinking that is that in the cases that we looked into, the people who were engaged in these practices were very careful to attempt to cover up what they were doing and to conceal it, particularly from the independent directors and, to the extent they could, from the accountants.
>
> This indicated that at least they felt that they probably would not have been able to do it, or, at least, their opportunities would have been reduced if the independent directors had known about it.

Metzenbaum Hearings, *supra* at 11-12.

[6] Metzenbaum Hearings, *supra* note 5, at 6.

[7] 15 U.S.C. §§ 78m(b), 78dd-1, 78dd-2, 78ff (1977 Supp. I). *See generally* Baker, *Corporate Accounting and the Impact of the Accounting Provisions of the Foreign Corrupt Practices Act of 1977*, 36 Wash. & Lee L. Rev. (1979).

[8] Section 102 provides in pertinent part:

(2) Every issuer which has a class of securities registered pursuant to section 12

The SEC was even more active than Congress. It obtained consent degrees requiring boards of directors to clean house and urged higher standards of conduct for outside directors.

An SEC staff study of the Penn Central collapse is illustrative:[9]

> Pennsylvania Railroad and New York Central directors were accustomed to a generally inactive role in company affairs. They never changed their view of their role. Both before and after the merger they relied on oral description of company affairs. They failed to perceive the complexities of the merger or the fact that appropriate groundwork and planning had not been done. After the merger they claimed to have been unaware of the magnitude of the fundamental operational problems or the critical financial situation near the end. They did not receive or request written budgets or cash flow information which were essential to understanding the condition of the company or the performance of management. Only in late 1969 did they begin requesting such information and even then it was not made available in a form that was meaningful or useful. . . .
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> The directors permitted management to operate without any effective review or control and they remained uninformed throughout the whole period of important developments and activities.[10]

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of this title and every issuer which is required to file reports pursuant to section 15(d) of this title shall—

(A) make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer; and

(B) devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that—

(i) transactions are executed in accordance with management's general or specific authorization;

(ii) transactions are recorded as necessary (I) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (II), to maintain accountability for assets;

(iii) access to assets is permitted only in accordance with management's general or specific authorization; and

(iv) the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

15 U.S.C. § 78m (1977 Supp. I).

The Commission recently issued rules to implement the Foreign Corrupt Practices Act of 1977. Securities Exchange Act Release No. 15570, [Current] FED. SEC. L. REP. (CCH) ¶ 81,959 (Feb. 15, 1979). The rules, which became effective March 23, 1979, prohibit the falsification of corporate records and prohibit officers and directors of an issuer from making misleading or incomplete statements to an accountant in connection with any audit, examination of financial statements, or filing of required reports. *Id.*

[9] SEC Staff Study of the Financial Collapse of the Penn Central Company, [1972-1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 78,931 (Aug. 3, 1972).

[10] *Id.* at 82,012-13.

In other cases, the Commission has gone to considerable lengths in insisting upon genuinely independent outside directors for corporations whose managements have engaged in fraud or other wrongdoing.[11] In certain factual contexts, the SEC has delineated extremely high standards of conduct for outside directors.

An example of the SEC's crackdown is the *Report of Investigation in the Matter of National Telephone Co.*,[12] where the Commission issued a report severely criticizing the shortcomings of National Telephone's outside directors. The *Report* chided the Company's outside directors for their inaction while inadequate information was given to the public. The National Telephone directors knew of the Company's severe cash flow problems in the fall of 1974, its need for outside capital, and its obligation to stop making new leases if the immediate future did not reveal new avenues of financing. In spite of this pessimistic outlook, the Company's public communications remained highly optimistic. The *Report* continued:

> The directors have asserted that they relied on management to make required disclosures and on company counsel to advise when disclosures were required, and that such reliance was well-placed.
>
> *In general, outside directors should be expected to maintain a general familiarity with their company's communications with the public. In this way, they can compare such communications with what they know to be the facts, and if the facts as they know them are inconsistent with these communications, they can see to it, as stewards for the company, that appropriate revisions or additions be made.*
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> *Moreover, as here, when important events central to the sur-*

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[11] In the *Equity Funding* case, the SEC charged that management had engaged in a massive and prolonged attempt to alter its books to show sales of insurance policies, receipts of premiums, and the creation of assets and reserves, all of which were in fact non-existent. Insurance policy files were set up in the names of fictitious persons, persons whose policies had lapsed, and so forth. The company, among other things, sold the false policies, obtained payments from co-insurers and re-insurers on death claims under the false policies, and issued false and fictitious financial statements. As part of the resulting consent decree, the district court was empowered to appoint an interim board of independent directors satisfactory to the SEC in place of the existing board. SEC v. Equity Funding Corp., [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 93,917 (C.D. Cal. 1973). In SEC v. Mattel, Inc., [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,807 (D.D.C. 1974), the Commission alleged that the financial statements made by Mattel in certain filings and press releases overstated Mattel's profits and understated its costs. In fine detail, the consent decree provided for a reconstituted board of directors. Among other things, Mattel was obligated to appoint such "additional directors" satisfactory to the SEC as would constitute a majority of the board. These additional directors were not to have or have had any affiliation with Mattel; they would comprise a majority of the executive committee of the board and all of the members of the financial controls and audit committee. *Id.* at 96,693-94.

[12] Securities Exchange Act Release No. 14380, [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,410 (Jan. 16, 1978).

[13] *Id.* at 88,880. *See also* Report of Investigation in the Matter of Stirling Homex Corporation, [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,219 (1975).

> *vival of the company are involved, directors have a responsibility affirmatively to keep themselves informed of developments within the company and to seek out the nature of corporate disclosures to determine if adequate disclosures are being made.* This is particularly so since there may be a tendency for corporate disclosure to lag behind developments, or, as here, there may be resistance on the part of management to make full and fair disclosure.
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> Finally, the facts developed during this investigation demonstrate the need for adequate, regularized procedures under the overall supervision of the Board to ensure that proper disclosures are being made. Such procedures could include among other things, a functioning Audit Committee with authority over disclosure matters, or any other procedure which involves the Board of Directors in a meaningful way in the disclosure process. With such procedures, the corporation's shareholders and the public should be more adequately protected from haphazard or fraudulent disclosure.[13]

B. *Increasing Legal Liability of Directors*

Although they are not insurers, directors are fiduciaries. They have a duty to avoid using inside information for personal advantage, to preserve corporate opportunities, and generally to be loyal to the corporation and its shareholders. Directors are also required to exercise reasonable care and diligence in performing their duties.[14] Affecting the extent to which a court may find that directors have fulfilled their duties is the business judgment rule, under which honest errors of judgment are immunized.[15] The application of these general principles in state courts has been the subject of controversy, with some commentators raising doubts about the resolve of those states that compete for corporations and the revenue they produce.[16]

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[14] One commentator has described the duties of directors as follows:

> With respect to directors, they may be chargeable with a number of obligations some of which are fiduciary and some of which may not be, including: (a) duty to be competent; (b) duty to be reasonably informed; (c) duty to provide adequate supervision; (d) duty to disclose conflicts of interest; (e) duty to reveal to the corporation information material to its operation; (f) duty to avoid intentional misconduct; (g) duty to avoid negligent misconduct; (h) duty to act primarily for the benefit of the corporation; (i) duty to be fair in all dealings that involve the corporation; (j) duty to refrain from competing with the corporation; (k) duty to avoid seizure of corporate opportunities; (l) duty to be loyal, and honest and to act in good faith, (m) duty to devote reasonable time and effort to the performance of directional duties; (n) duty to keep abreast of the financial status of the corporation; (o) duty to investigate suspicious circumstances in the affairs of the corporation.

Kaplan, *Fiduciary Responsibility in the Management of the Corporation,* 31 BUS. LAW. 883, 887-88 (1976) (footnote omitted).

[15] *See Corporate Director's Guidebook,* 33 BUS. LAW. 1591, 1603-04 (1978) [hereinafter cited as *Corporate Director's Guidebook*]; Soderquist, *supra* note 1, at 1344-46.

[16] Some commentators assert that state courts have been reluctant to find directors

The main battleground in recent years has instead been the federal courts.

One of the provisions of section 11 of the Securities Act of 1933[17] (the '33 Act) provides for a civil cause of action by a shareholder against any director of an issuer of securities in connection with any material misstatements or omissions in a registration statement. Despite its due diligence defense, section 11 has become a subject of increasing concern to outside directors since the *Escott v. BarChris Construction Corp.*[18] decision eleven years ago. Likewise, section 12 of the '33 Act[19] provides for liability to any purchaser of a security because of material misstatements or omissions in a prospectus or oral communication offering a security. Although the Supreme Court has recently settled[20] the question whether scienter is required in an action under section 10(b) of the Securities Exchange Act of 1934[21] (the '34 Act), other generalized provisions continue to impose high standards of conduct. For example, in *Gould v. American-Hawaiian Steamship Co.*,[22] the court held that under section 14(a) of the '34 Act, regulating the use of proxies,[23] the applicable standard of conduct for outside directors is, as under section 11, negligence rather than the higher standard embodied in the notion of scienter. The court there found that an outside director was liable for negligently failing to demand disclosure of material facts in proxy materials.[24] In *Securities Exchange Commission v. Falstaff Brewing Corp.*,[25] a District of Columbia district court held that an individual, who was a director-nominee and was nominating three other directors, had a

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responsible unless there has been some form of active mismanagement. Because of this, some directors are unable to discern from the case law what their duties and functions are. A factor in this asserted reluctance has evidently been the fear of establishing disincentives to the acceptance of directorships. Soderquist, *supra* note 1, at 1349.

[17] 15 U.S.C. § 77k (1976).

[18] 283 F. Supp. 643 (S.D.N.Y. 1968).

[19] 15 U.S.C. § 77l (1976).

[20] Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976). *See* Sundstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033 (7th Cir.), *cert. denied,* 434 U.S. 875 (1977); Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973).

[21] 15 U.S.C. § 78j(b) (1976).

[22] 535 F.2d 761 (3d Cir. 1976).

[23] 15 U.S.C. § 78n(a) (1976).

[24] 535 F.2d at 778. The dissenting opinion noted that there was no proof that the outside director had been aware of the alleged misstatements and omissions and that the crucial issue was whether or not he should have noticed the very technical defects. The dissent further stated that "[a]s a non-lawyer and an outside director, Casey might easily be excused for not having his antennae so finely tuned to semantic and formal 'defects'." *Id.* at 786 (Van Dusen, J., dissenting).

[25] [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,583 (D.D.C. 1978). The court found widespread violations of various provisions of the securities laws. For example, the court found misleading a statement in proxy materials that the company had an audit committee. Even though the company did in fact have such a committee, the committee conducted no activities, held no meetings and, in short, existed in name only. *Id.* at 94,467. Despite the numerous violations found, the court rejected the SEC's request for the appointment of additional independent directors and the appointment of an audit committee to be composed of independent directors. *Id.* at 94,473-74.

duty under section 14(a) to check the validity of proxy materials and to correct statements which he knew or should have known were misleading.

Courtney Brown, retired dean of the Columbia Business School, has well summarized the present exposure of the incumbent or prospective outside director:

> In recent years, a number of judicial decisions have enlarged the requirement of prudence in a director. Federal courts have held that board members must now be fully informed, ultra-careful regarding possible conflicts of interests, and scrupulous not to use inside information for personal benefit. They must develop more than a cursory knowledge of the company and the field or fields in which it operates. They must confirm the accuracy of important reporting documents such as registration statements and proxy material. Self-dealing, inside trading, and conflicts of interest are subject to heavy penalty. Any one or several of these requirements, if violated, can be accompanied by large liability.[26]

C. *Dissatisfaction With State Regulation and the Transformation of the Culture*

A festering disenchantment with state regulation of corporations lately has broken out into the open and that, in turn, has had the effect of focusing increased attention upon corporate governance. Professor William Cary has argued that the states, in order to attract corporations as domiciliaries, have been engaged in a race for the most minimal standards of corporate regulation, citing Delaware as the leading example.[27] Because the states cannot be counted upon, Professor Cary proposed federal legislation to provide minimum standards for large corporations, including federal fiduciary standards for officers and directors and a requirement of fairness for all transactions involving interested directors.[28] Other critics have gone further and have argued for federal chartering and regulation of corporations.[29]

Finally, all of these developments have occurred against a broader canvas of general social and political change.[30] Without attempting to examine such a vast subject, it is useful to note that the convulsive social and political changes since 1960 have had their effects in the corporate world

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[26] C. BROWN, PUTTING THE CORPORATE BOARD TO WORK, 38-39 (1976) [hereinafter cited as BROWN]. *See* Estes, *Outside Directors: More Vulnerable Than Ever*, HARV. BUS. REV., Jan.-Feb. 1973, at 107.

[27] Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L. J. 663 (1974).

[28] *Id.* at 702.

[29] *See* Airlie House Symposium, *An In-Depth Analysis of the Federal and State Roles in Regulating Corporate Management*, 31 BUS. LAW. 859 (1976).

[30] *See generally*, D. BELL, THE CULTURAL CONTRADICTIONS OF CAPITALISM (1976); R. NISBET, TWILIGHT OF AUTHORITY (1975).

too. The alteration in social attitudes regarding the rights of minorities and women has had a direct impact upon the position of outside directors. There have been calls for "more representative" outside directors, and even for federally mandated constituency directors.

In the last few years, the boards of more and more companies have acquired a majority of outside directors.[31] The number of companies having nominating committees with non-management majorities grew significantly in 1978. Another development was the increase in the number of female directors, those from academia, and those formerly from government.[32] Directors have been devoting more time to directing.[33] A recent survey by the New York Stock Exchange and the American Society of Corporate Secretaries reveals that non-management directors constitute a majority on about 80% of the boards of directors of 993 responding companies. The survey also showed that 963 of these companies had audit committees and 834 had compensation committees, both figures substantially higher than in 1975.[34]

II. PROPOSALS FOR REFORM

A. *Actions of the SEC*

The SEC lately has been most active in the area of corporate governance,[35] both by means of speech-making and rule-making. Some members of the SEC have wondered aloud, however, about the limits of its authority.[36]

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[31] Leech & Mundheim, *supra* note 5, at 1828.

[32] Harris, *"Independent" Panels of Corporate Boards To Tap New Directors are Proliferating,* Wall St. J., Jan. 15, 1979, at 14.

[33] Mace, *Designing a Plan for the Ideal Board,* HARV. BUS. REV., Nov.-Dec. 1976, at 20-21; Soderquist, *supra* note 1, at 1352.

[34] [1979] SEC. REG. & L. REP. (BNA), No. 492, at A-1 (Feb. 28, 1979). One case in which reform was apparently lacking is reflected in the settlement between the SEC and William F. Buckley, Jr. The SEC charged Mr. Buckley and others with violations of the securities laws in connection with the affairs of Starr Broadcasting Group, of which he was chairman of the board. Mr. Buckley is reported to have said that he relied as a corporate director on materials prepared by others. Although "not always an epistemological optimist," he said, he started out "on the assumption that these things are correct." Mr. Buckley described himself as "someone who did not know until he heard the term for the first time in September 1974 that there was such a thing as '10-K'." Miller, *S.E.C. Charges William Buckley: He Agrees to a Settlement in Stock,* N.Y. Times, Feb. 8, 1979, at 1.

[35] The Commission's interest in the subject of corporate governance is not entirely new. As early as 1940 the SEC recommended the establishment of an audit committee composed of outside directors. Loomis, *supra* note 3, at 5.

[36] Unlike state corporation laws, the federal securities laws are concerned not with structure and substance but with full disclosure of pertinent facts. Thus there is a danger of going too far in trying to peg corporate governance to the policy of full disclosure. *See generally* Grienenberger & Harms, *supra* note 5. The Commission's General Counsel concluded that the SEC has ample authority to require all public companies to establish an audit committee composed of independent directors. Opinion of SEC General Counsel on the Commission's Authority to Require Public Companies to Establish Independent Audit Committees. [1978

Harold Williams, Chairman of the SEC, has made provocative reform proposals. Williams proposed that boards of directors be truly independent; that outside counsel, bankers and all suppliers of the corporation be excluded from service on the board; that the only member of management on the board be the chief executive officer; and that the chief executive not be the chairman. He warned that federal regulation would be imposed on corporations unless they voluntarily promoted a greater degree of accountability. The large corporation, he stated, "has ceased to be private property—even though theoretically still owned by its shareholders—and has become, in essence, a quasipublic institution."[37] Therefore, he concluded, corporations must assume their responsibilities.[38]

In the summer of 1978, the SEC published certain important rule changes relating to corporate governance.[39] One of the SEC proposals was that the proxy rules would be amended to require the identification of each director as a "management director", as "affiliated nonmanagement director", or an "independent director". In the case of the second of these terms, each proxy statement would contain a description of the nature of the

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Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,535 (March 2, 1978). Commissioner Loomis agreed:

> While the Commission has implemented [Section 14(a) of the 34 Act] primarily by establishing disclosure requirements, the statutory provision is by no means limited to disclosure nor have we limited it. We have, for example, provided Marquis of Queensberry Rules for proxy fights and procedures for the submission of stockholders proposals.
>
> Proxy solicitation is an essential element of the process of corporate governance in publicly-owned corporations. It is this process by which members of the board of directors are chosen. The legislative history of Section 14(a) indicates that the section was intended to provide for "fair corporate suffrage." Thus, there are a good many things which we could do under the proxy provisions which would impact upon corporate governance. . . .

Loomis, *supra* note 3, at 3-4.

[37] [1978] SEC. REG. L. REP. (BNA), No. 437, at A-23 (Jan. 25, 1978).

[38] *Id.* Other SEC Commissioners sounded the call for responsible corporate management. Commissioner John Evans argued that there is a need for greater accountability and pointed to the Penn Central, Stirling Homex, and Equity Funding failures as instances in which directors and officers had been unable or unwilling to carry out their duties. At least a majority of every board should, he stated, be independent, as should the chairman. The executive, audit, compensation, and nominating committees should be dominated by outside directors. [1978] SEC. REG. L. REP. (BNA), No. 436, at A-12, 13 (Jan. 18, 1978). Commissioner Roberta Karmel contended that the demands for corporate reform have increased because of the apparent indifference of corporate management to economic and social problems and the lack of accountability for illegal conduct. *Id.* at A-14. In August 1978, Mr. Williams repeated his proposals for reform of the board and stated: "I do not mean that all corporate boards, constituted differently than I proposed, are necessarily ineffective. But I do believe that boards can be more effective and that, in many situations, they do not discharge their responsibilities to oversee the management of the affairs of the corporation." Address to the American Bar Association, Section on Corporation, Banking and Business Law, "Corporate Accountability and the Lawyers Role," *reprinted in* [1978] SEC. REG. L. REP. (BNA) No. 465, at H-2 (Aug. 9, 1978).

[39] Securities Exchange Act Release No. 14970, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,645 (July 18, 1978).

relationship for which the director was so categorized. The definitions of these terms provided that a "management director" is an officer or employee of the issuer; that an "affiliated nonmanagement director" is a former officer or employee, a customer, a supplier, outside counsel, an investment banker, and the like; and that an "independent director" is an independent person not having any of the foregoing relationships. It was also proposed that disclosure be made of whether or not the issuer had standing audit, nominating, and compensation committees, the number of meetings held by each committee, and the identity of the committee members and their categorization under the terms discussed earlier. The Commission stated that these three standing committees should normally be composed entirely of independent directors.

These proposals evoked a storm of controversy, especially the categorization of directors. The SEC therefore adopted the proposed rules in a substantially revised form.[40] The Commission abandoned the requirement that directors be categorized. Instead, any of certain significant economic and personal relationships which may exist between the director and the company are required to be disclosed. The relationships include former officers and directors, relatives of officers, customers, suppliers, outside counsel, investment bankers, and the like. The existence or non-existence of standing audit, nominating, and compensation committees must be disclosed, together with an identification of the members, the number of meetings held, and the functions performed by the committees. The number of board meetings held during the year must also be disclosed. If during any particular year a director attended less than 75% of the aggregate of the meetings of the board and the meetings of committees on which he served, the director's name must be disclosed.

Even after enactment of these new rules, Chairman Williams has continued to exert pressure for change. In January 1979, Mr. Williams repeated his call for a reconstituted board of directors.[41] He asserted that his original proposals were not an arbitrary governmental directive, but a signal of the need for change in order to forestall just such government action, which political pressures might otherwise generate.[42]

Mr. Williams repeated his suggestion that the board be composed entirely of independent, outside directors, save only the chief executive.[43] In

[40] Securities Exchange Act Release No. 15384, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,766 (Dec. 12, 1978) [hereinafter cited as Directors Release].

[41] Address to the Sixth Annual Securities Regulation Institute, "Corporate Accountability—One Year Later" (San Diego, Cal. Jan. 18, 1979) [hereinafter cited as Williams].

[42] Mr. Williams observed that a result survey showed shareholders generally are interested only in profits. Therefore, some other body, presumably the board of directors, must assume responsibility for the actions of the corporation in terms of other than short-run economic growth. *Id.* at 6.

[43] The Chairman stated that:

> Members of management cannot be expected, as a general rule, to assess objectively the performance of the management of which they are a part, the adequacy of the performance of their superior, the chief executive, and similar issues which

response to critics who contend that other management points of view are needed on the board so that the chief executive does not intentionally or mistakenly color the facts, Mr. Williams said that other management personnel should attend board meetings and make factual presentations, but should not be actual members or participate in the decision-making process.[44] He went on to observe that it was especially important that the chief executive officer not serve simultaneously as the chairman of the board in order that control over the agenda, which is a powerful tool for domination of the board, be kept out of the hands of management.[45] He also emphasized the importance of functioning committees to effective corporate accountability and proposed that there be a nominating committee composed entirely of non-management directors.[46]

Even more recently, Chairman Williams urged securities analysts to express their willingness to advise institutional investors on matters of corporate governance that might affect their proxy voting decisions.[47] They should tell the investors, who are increasingly reconsidering their adher-

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> entail an evaluation of their own fitness. They cannot realistically be expected to measure and reward their own performance, ask themselves embarrassing questions, or fire themselves or the president who hired them.

Id. at 16-17.

[44] *Id.* at 18-19.

[45] The importance of control over the agenda "is analogous to the internal control system's pivotal role in management's exercise of authority over the affairs of the corporation itself." *Id.* at 22.

Professor Courtney Brown, like SEC Chairman Williams, argues that no members of management should serve on the board except for the chief executive officer, who should never serve as chairman. BROWN, supra note 26, at 109. Joseph W. Barr, a distinguished business leader, opposes Professor Brown's suggestion. Mr. Barr believes that it reduces a director's effectiveness to be also the board chairman because the chairman is associated with management. *The Professional Director: A Conversation with Joseph W. Barr,* DIRECTORS & BOARDS 48, 63 (Fall 1977) [hereinafter cited as *Conversation*]. Other authorities, including the *Corporate Director's Guidebook, supra* note 15, oppose Professor Brown's position and prefer a board with a majority of outsiders. The reasoning is that some management representation is essential and that the outside directors should be exposed to management personnel who might become candidates for higher office, including that of chief executive. *Corporate Director's Guidebook, supra* note 15, at 1624-25; Statement of the Business Roundtable, *The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation,* 33 BUS. LAW. 2083, 2107-09 (1978) [hereinafter cited as Business Roundtable]. *See* Cohen, *The Outside Director—Selection, Responsibilities, and Contribution to the Public Corporation,* 34 WASH. & LEE L. REV. 837, 850-52 (1977) [hereinafter cited as Cohen].

[46] Mr. Williams stated that "a nominating committee, by which potential directors are selected, is in itself a key element of accountability. In my view, this committee could become the single most effective force in improving corporate governance because of its impact, over time, on the composition of the board and on the succession of management." Williams, *supra* note 15, at 23.

The SEC Chairman also noted that, although the American Institute of Certified Public Accountants recently decided not to compel public companies to establish audit committees as a pre-condition to certification, it nevertheless repeated its support for the committee. *Id.* at 28-29.

[47] Address by Chairman Williams to the New York Society of Securities Analysts, [1979] SEC. REG. L. REP. (BNA) No. 489, at A3 (Feb. 7, 1979).

ence to the "Wall Street Rule",[48] what they think about board membership and structure.

The SEC has thus become deeply involved in the subject of corporate governance and can be expected to continue its efforts to effect change in board composition and performance.[49]

B. *The Work of the Senate Subcommittee*

The Subcommittee on Citizens' and Shareholders' Rights and Remedies of the Senate Judiciary Committee, chaired by Senator Howard Metzenbaum of Ohio, has held hearings on the question of corporate governance. A wide variety of views were expressed on the general subject and on the role of outside directors.[50] The position of the Subcommittee has not yet become clear, but it has been reported recently that the Subcommittee staff has prepared draft legislation.[51] Apparently, the proposed bill, which applies only to certain large corporations, outlines a director's duties and specifies that directors may be found negligent if they fail to exercise proper care in making inquiries when and if they have suspicions about corporate conduct. A majority of the board would be composed of independent directors, which would exclude former employees, outside counsel, investment bankers, suppliers, and the like.[52]

C. *Other Proposals*

1. The Functions of the Board

State corporate statutes are notoriously vague as to the duties of directors. A few specific subjects are left to them and they are generally admonished that the affairs of the corporation are to be managed by or under their discretion. Outside directors are not expected to involve themselves in the daily operation of the enterprise.[53] Under these conditions, ensuring the accountability of the corporation is difficult. Many have therefore sought to define useful yet realistic functions for the board.[54]

As a matter of tradition and theory, the functions of the board have been to establish corporate policies and strategies, allocate resources in

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[48] The Wall Street Rule provides that investors should go along with management or sell out.

[49] *See* Interview with Harold Williams, [1979] SEC. REG. L. REP. (BNA) No. 493, at AA-2-AA-4 (March 7, 1979). The Commission has stated that it intends to issue a staff report on corporate governance which will address important issues, including additional proposals for rules or legislation. *See* Directors Release, *supra* note 40.

[50] *See generally* Metzenbaum Hearings, *supra* note 5.

[51] Miller, *At Odds Over Corporate Governance: Leaders Fail to Achieve a Compromise on Legislation,* N.Y. Times, Dec. 24, 1978, at F-1.

[52] Senator Metzenbaum reportedly set up an informal advisory body composed of members of various interested groups, but these individuals were unable to agree on the proposed bill. *Id.*

[53] Soderquist, *supra* note 1, at 1343.

[54] *Id.* at 1358-59.

major corporate projects, select the corporate officers, and generally manage the corporation.[55] In truth, directors do not and cannot "manage" or "direct" the operations of corporations in the strict sense.[56] Management runs the corporation. The fact is that, as Professor Myles Mace noted a few years ago, the selection of officers and even of board members, the formulation of policy, the allocation of resources and the evaluation of personnel are all functions under the control of management.[57] What boards in fact do is give advice to the chief executive, serve as a kind of disciplining force, and act in a crisis, for example, when the chief executive unexpectedly dies.

The gap between the theory and reality of corporate direction is the result of several factors. Because of time constraints alone, the typical board is in no position to "manage" the affairs of a large corporation. Board members have no staffs of their own and have limited access to information. In the past, there has been a distinct tendency for boards to include individuals who are economically or psychologically connected with management, especially the chief executive.[58]

Many commentators have therefore turned their attention to identifying the functions outside directors can realistically perform while enhancing the prospect of corporate accountability.[59] It should come as no surprise that the single function most emphasized is the monitoring role.[60]

Unlike various other functions, monitoring can be achieved without requiring an inordinate time commitment.[61] Monitoring requires that there be an adequate flow of information and that the outside directors be truly independent of management.[62] Thus, directors can provide advice to the chief executive, authorize major corporate actions, provide a means for the inclusion in decision-making of persons other than top management and,

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[55] *See* Eisenberg, *Legal Models of Management Structure in the Modern Corporation: Officers, Directors, and Accountants*, 63 CALIF. L. REV. 375, 376 (1975) [hereinafter cited as Eisenberg]; M. MACE, DIRECTORS-MYTH AND REALITY (1971) [hereinafter cited as MACE].

[56] MACE, *supra* note 55, at 178-90; Eisenberg, *supra* note 55, at 376. Traditionally, state statutes have provided that the business and affairs of a corporation shall be managed by a board of directors.

[57] MACE, *supra* note 55, at 184-90; Soderquist, *supra* note 1, at 1355. Professor Mace himself has recognized the signs of improvement which others have observed. He pointed out recently that chief executives and directors have increasingly become concerned about their responsibilities and their attitudes have demonstrably been changing. Mace, *The Changing Role of Directors in the 1970s*, 31 BUS. LAW. 1207, 1208-09 (1976).

[58] Eisenberg, *supra* note 55, at 378-84.

[59] *See, e.g.*, Leech & Mundheim, *supra* note 5, at 1803-04.

[60] *See* Lanza v. Drexel & Co., 479 F.2d 1277, 1306 (2d Cir. 1973); Riger, *The Lawyer-Director—A Vexing Problem*, 33 BUS. LAW 2381, 2385 (1978); Soderquist, *supra* note 1, at 1356.

[61] Commentators always must consider the effect their reform proposals would have upon the time pressures facing outside directors. To increase drastically their time commitments would be to change the nature of the position or to deter many qualified candidates from accepting the position. *See* Soderquist, *supra* note 1, at 1357-58.

[62] Eisenberg, *supra* note 55, at 438.

most important, choose top management and monitor the performance of the corporation under their direction.[63] Professor Mace has proposed a charter of duties which, although slightly more specific, likewise stresses the monitoring role.[64]

A rule requiring independence of only a clear majority of the board is preferable to one requiring total, or virtually total, independence. The definition of independence, however, must be strict. Officers, relatives of officers, suppliers, and the like would be excluded. Some thought has been given to the implementation in the United States of the two-tiered system used in Germany. Under this system, one board concerns itself with management and the other with supervision. Professor Eisenberg argues that a truly independent board with control over the proxy mechanism is preferable.[65]

2. Creation of Working Committees

In the past, committees, when they existed at all, too often tended to be mere empty shells. An excellent example is the case of National Telephone Co., which had an audit committee that never met. Attention has thus centered on what committees a board should create, what the committees should do, and who should serve on them.[66]

The latest SEC rules require the disclosure of information about standing audit, nominating, and compensation committees. In June 1978, the New York Stock Exchange, at the behest of the SEC, implemented a rule requiring all listed companies to establish an audit committee composed entirely of directors independent of management.[67]

In terms of corporate accountability, the most important committees appear to be audit, nominating, and compensation. The *Corporate Director's Guidebook* recommends that these "overview" committees be composed exclusively of outside directors and, to varying degrees, unaffiliated non-management directors, *i.e.*, those who are not outside counsel, investment bankers, or suppliers.[68] One commentator has argued that the nominating committee should take control of the proxy process in order to

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[63] *See id.* at 391-92.

[64] Professor Mace suggests that directors should be responsible to shareholders, select the chief executive, evaluate the work of top management, review and approve major corporate policies and projects, monitor the corporate financial structure, monitor top management monitor, review and approve employee relations, manage the board, including selecting new members, setting up committees and choosing outside auditors, and ensure compliance with all applicable laws. Mace, *Designing a Plan for the Ideal Board,* HARV. BUS. REV., Nov.-Dec. 1976, at 21-22. *See* Business Roundtable, *supra* note 45, at 2096-103.

[65] *See* Eisenberg, *supra* note 55, at 404-14. *See also* Douglas, *supra* note 3, at 1314-17.

[66] For a description of the advantages of effective board committees, see Leech & Mundheim, *supra* note 5, at 1809.

[67] N.Y.S.E. COMPANY MANUAL, at A-29 (1978). *See* Business Roundtable, *supra* note 45, at 2109-10.

[68] *Corporate Director's Guidebook, supra* note 15, at 1625-27.

protect the independence of the outside directors.[69] The audit committee is intended to monitor the integrity of the corporation's financial information used in decision-making and reporting to the public. The audit committee performs this function by reviewing significant financial information, inquiring into the corporation's internal control and accounting practices, consulting with the inside and outside directors, and reviewing changes in accounting principles.[70]

3. Orientation and Information Flow

Certain authorities have urged that new directors undergo a thorough orientation process. A new director would, for example, review the financial statements, meet with corporate officers, attend some meetings of committees on which he does not serve, meet with the outside auditors and regular corporate counsel, and assure himself that board meetings will be held regularly. A new director should also satisfy himself that an agenda will be circulated in advance, that dissent is acceptable, and that minutes of meetings are kept and circulated.[71]

When Arthur Goldberg resigned from the board of TWA in 1972, he suggested that outside directors be given a staff in order to avoid dependency for their information on the management they are attempting to monitor. He repeated and amplified his proposal at hearings of the Senate Subcommittee on Citizens' and Shareholders' Rights and Remedies.[72]

The Goldberg proposal has been widely opposed on various grounds, including cost, impairment of morale, and legal uncertainties. Its principal weakness is the likelihood that a staff for the board would lead to dissension and divisiveness.[73] Outside directors should instead obtain assistance from the corporate staff and, perhaps when necessary in specific instances, be able to employ their own counsel, accountants, and other experts.[74]

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[69] BROWN, *supra* note 26, at 48-49.

[70] *See Peat, Marwick, Mitchell & Co., The Audit Committee* (1977). *See also* Cohen, *supra* note 45, at 856-57.

[71] A new member of the board should always review the most recent financial data. A thorough financial review would include inspection of the Form 10-K, Form 10-Qs filed with the SEC, and a meeting with a company's financial officers. *See* Cohen, *supra* note 45, at 852-54; *Corporate Director's Guidebook,* supra note 15, at 1604-06.

[72] Metzenbaum Hearings, *supra* note 5, at 98-118.

[73] Blough, *The Outside Director at Work on the Board,* 28 RECORD OF N.Y.C.B.A. 202, 203-09 (1973); *Conversation, supra* note 45, at 62. Professor Eisenberg contends that the Goldberg proposal is unsound:

> Notwithstanding its logic, however, the Goldberg proposal is both unsound and unworkable. Stripped of its trappings, it would create a shadow staff with an institutionalized obligation to second-guess the management, but with very limited responsibility for results. Assuming that the directors are part-time, in cases where the recommendations of staff and management diverged they would have little choice except to adopt one set of recommendations or the other. Yet absent self-dealing on the part of management, the board's staff could normally be expected only to decide again—with much more limited facilities and feel for the business, and at the price of additional expense and time—issues which management and the

4. The Full-Time Director

Some believe that many of the problems facing the outside director today can be alleviated, or at least diminished, if large corporations were to rely upon "full-time" or "professional" directors. These directors would be experienced individuals with no ties or obligations of any kind except to serve several corporations as directors. The professional director is experienced, often a former executive, and yet has more time than most active chief executive officers. Since he is not allied with management, he can afford to be independent.[75] In any event, however, it is unlikely that an adequate supply of professional directors is available or sufficiently diverse to make such a proposal workable.[76]

5. Representativeness

A persistent criticism of the outside director has centered upon his background. Essentially, the criticism relates to the "old boy network," the feeling that outside directors are chosen by the chief executive primarily from among his friends or colleagues. Plainly, a broader group than that must be tapped. The Business Roundtable has identified the desirable qualifications to be "integrity, independence, an inquiring mind, vision, an

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> corporate staff have already once decided. If the conclusions of management and staff are the same, nothing will have been gained for this price. If they differ, it is far from clear how the board will choose between them. In short, the proposal would add a further and unnecessary level of decision-making to corporations which already tend toward overbureaucratization; would add immensely to the difficulties of running the corporation's business; and would produce a wholly undersirable diffusion of responsibility as among the executives, the shadow staff, the overseeing committee, and the board itself.

Eisenberg, *supra* note 55, at 390.

[74] Cohen, *supra* note 45, at 849; *Corporate Director's Guidebook, supra* note 15, at 1627. Robert M. Estes, former General Counsel, Secretary and Senior Vice President of General Electric, has suggested that outside directors should have counsel to assist them. Mr. Estes believes that counsel could provide significant assistance to outside directors as they attempt to deal with such complex matters as economic measurements of performance, accounting standards, environmental performance, occupational health and safety performance, pension legislation, and the structures of anti-trust law. However, he opposes the idea of a special staff for outside directors on the ground that it would be divisive. Estes, *supra* note 2, at 128-31.

[75] Barr, *The Role of the Professional Director,* HARV. BUS. REV., May-June 1976, at 18; *Conversation, supra* note 45, at 48. The outside director should be put in the position where he spends a good deal of time at his job as a director, but not so much time that he is identified with management. *See* Vagts, *The Governance of the Corporation: The Options Available and the Power to Prescribe,* 31 BUS. LAW. 929, 932 (1976).

[76] Eisenberg, *supra* note 55, at 385-86. The board of Texas Instruments, Inc. has attracted considerable attention. The TI board has as members the Chairman and the President and three categories of directors; general directors, officers of the board, and directors. The second title refers to employees who devote the principal amount of their time to their duties as directors. The general directors devote at least 30 days a year and receive in compensation $30,000. The directors make a 15-day commitment for which they receive $15,000. *See* Mace, *supra* note 64, at 36.

ability to work with others, and broad experience."[77]

The notion of broad experience has begun to take on a political connotation, that is, that the board should in some sense "represent" the society at large. Indeed, some critics argue that directors should be appointed to represent certain constituencies, such as minorities and women. This proposal is widely opposed, however, in the business world[78] on the ground that such constituency directors cannot most effectively promote the development of the total enterprise.[79]

In 1977, a commission on "industrial democracy" issued the Bullock Report, which urged substantial reform on the boards of British companies. The Report recommended that there be unitary boards (2x+y) with equal numbers of union and shareholder representatives (2x), who together would choose a set number of outside directors (y). Participation on the boards by workers was to be through union channels only and the government would spend over £3 million to train union activists for service on the boards.[80] After a season of intense political battling and maneuvering,[81] the Labor Government issued a compromise proposal.[82]

Worker participation—either in its original or modified form—is unsound and, in any case, antithetical to the traditions of labor-management relations in the United States.[83] Whether "industrial democracy" is the wave of the future for this country is, at this point, unclear. But it is another on the growing list of suggestions for reforming the board of directors.[84]

III. INSTITUTE OF CORPORATE GOVERNANCE

As noted earlier, the proposals for reform are reaching the level of a flood. They are eclectic and often contradictory. Harold Williams' proposal for the ideal board has prompted considerable debate which Chairman Williams says he welcomes. To conduct such a debate in a more institutionalized fashion, however, would be preferable. Today, what we have is

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[77] Business Roundtable, *supra* note 45, at 2105. *See Brown, supra* note 26, at 59-60; *Corporate Director's Guidebook, supra* note 15, at 1621.

[78] Business Roundtable, *supra* note 45, at 2106. *See Corporate Director's Guidebook, supra* note 15, at 1621.

[79] BROWN, *supra* note 26, at 93-94.

[80] THE ECONOMIST, Jan. 29, 1977, at 74-75, 81-83.

[81] The Bullock Committee was heavily influenced by the Trades Union Congress. THE ECONOMIST, Feb. 12, 1977, at 109-10. The Confederation of British Industry, on the other hand, was vigorously opposed to the plan. THE ECONOMIST, Feb. 19, 1977, at 103-04. Neither faction was willing to compromise. *See* THE ECONOMIST, May 14, 1977, at 125.

[82] The Government issued a white paper which was considerably less radical than the original Report. The Government preferred voluntary participation plans over a universal formula, rejected parity (2x) for union representatives and permitted both unitary and two-tier board structures. *See* THE ECONOMIST, May 27, 1978, at 77-78.

[83] *See* Business Roundtable, *supra* note 45, at 2106-07.

[84] *See generally* Solomon, *Restructuring the Corporate Board of Directors: Fond Hope—Faint Promise?*, 76 MICH. L. REV. 581 (1978).

a process whereby government officials make proposals and various members of the business community make responses, usually ad hoc and postprandial. Mr. Williams had advanced a number of provocative suggestions regarding corporate governance, all of which plainly call for thoughtful discussion. But there is no permanent forum in which to initiate and carry forward that discussion. Nor is Mr. Williams going to be Chairman of the SEC forever; his successor might disagree strenuously, shift the Commission's attention elsewhere, or offer proposals of a wholly different nature.

If the objective is effective corporate governance, then how do we train directors and how do we develop a rational body of law and custom in which they should operate? The answer is rudimentary: we send them to school.[85]

The advantages of a school for directors are many. Conceptually, they would fall into two categories: first, the benefits to be gained from specific vocational teaching as at any professional school and, second, the incremental development, in a scholarly atmosphere, of a body of corporate governance jurisprudence.

The school environment creates continuity while building a system of thought and custom exegetically, particularly where the Socratic method is employed and scholarly articles are published. In the absence of such schools, we have been subjected to an episodic development of thought, in part based on randomly negotiated settlements ("the common law of consent decrees"),[86] together with administrative or legislative fiats—witness the Foreign Corrupt Practices Act of 1977—which too often are hastily conceived.

Law schools teach students how to think like lawyers. A school for directors would do roughly the same, that is, it would inculcate a *sense* of being a director. Independence is the key to being an effective outside director, and independence is an attitude that can only be instilled; it cannot be legislated. Independence must be cultivated and developed, preferably in a scholastic environment centered on the case method that is currently used in most law and many business schools. The case studies, naturally enough, would consist of past corporate failures and failings, as well as successes, combined with discussions of hypothetical extensions and role-playing.

The issues studied would include: When and for what grounds does a board remove a chief executive officer? Can bribes or submitting to extortion overseas ever be tolerated? How much knowledge of auditing and accounting is required to serve on an audit committee and what are its tasks? To what extent can the board as a whole rely on the work of committees? How much executive compensation, including perquisites, is too much? How do you motivate managers, and is a compensation commit-

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[85] *See* Earle, *A Stop at School on the Way to the Boardroom*, FORTUNE, June 2, 1979, at 102.

[86] Cohen, *supra* note 45, at 838.

tee necessary? How much time each year, at a minimum, must an outside director devote to his job? May he, must he, own stock in the corporation? From what ranks should directors primarily be drawn? Are full-time outside directors necessary or desirable? Should the board undertake a management audit, that is, appoint an operations committee to rate management's performance, or does that go beyond the monitoring function? What are the telltale signs of management fraud? Is a nominating committee of outside directors essential to avoid self-perpetuating oligarchies? How does a board balance its desire that the corporation be a "good citizen" with the desire of the shareholders for profits when those two interests appear to collide?

At the same time, the directors' schools would be forging new ideas and shaping old ones into the "law" governing the role of directors generally. Such schools would develop "a theory of the board of directors".[87] The curriculum would encompass the major current issues underlying the subject, *e.g.*, Arthur Goldberg's suggestion that directors have staff; the labelling concept identifying management, affiliated non-management, and unaffiliated non-management directors; the validity and cost effectiveness of overview committees, particularly within the boards of smaller companies; whether the board should have its own counsel or designated "officer"; whether a conflict of interest exists when a director sits on the boards of two companies one of which is contemplating a takeover of the other; whether some sort of public or group representation is appropriate, either through a public issues committee as at General Electric or more directly; plus all of the comprehensive questions involved in giving direction to a complex business enterprise. Classes in independence could profitably draw analogies to the role of the outside auditor, explaining the importance of the appearance as well as the fact of independence.

Over time, as the curriculum is expanded and refined, as experience with the educational process deepens and after more and more directors graduate, a consensus will gradually emerge answering or sharpening many of the various questions that have been posed by Mr. Williams and others, as well as those that are as yet unasked. That consensus would naturally evolve from the give and take between the students and faculty and, in turn, as the matriculated directors got on the job. Such a consensus might occasionally be stimulated or even created by articles on leading-edge subjects. The law of privacy, by way of comparison, essentially originated in a law review article written at the turn of the century.[88]

Professional schools for directors should be established at two or three major universities around the country primarily on the basis of private funding, with tuition paid by those companies sponsoring candidates. They could be adjuncts to the business and law schools at those universities and be called, for example, Institutes of Corporate Governance. These

[87] Eells, *Foreword* to C. BROWN, PUTTING THE CORPORATE BOARD TO WORK xxiii (1976).
[88] *See* Warren & Brandeis, *The Right to Privacy*, 4 HARV. L. REV. 193 (1890).

institutes could make use of the existing university faculties by giving intensive two to five week courses over the summer. The faculty would be selected from the business and law schools on campus, augmented by visiting distinguished lecturers from all fields, including business and government. The institutes could issue degrees for candidates successfully completing the course.

Recruitment of the student body would work essentially as the selection of directors does today, except that, when Company A invited the chairman of Company B to serve on its board, the new member would enroll at the nearest institute at Company A's expense. Both companies, as time permitted, would send along their sitting directors as well. Two weeks or ten days of instruction would be the minimum, even for experienced directors. A series of additional one-week courses would be available depending on the candidate's background and areas of interest. One asks a great deal of a busy executive, prominent lawyer, or tenured professor to give up part of a summer, and of their respective employers to donate the director's time. But even our existing, limited body of seasoned and sophisticated outside directors could profit from such instruction. Many of these directors were severely taxed during the questionable payments saga. This time commitment is analogous to the continuing education requirements now imposed by most professions, and is a comparatively small extension of the public service already performed by those organizations whose key employees sit on the boards of others.

The Parker School of International Law at Columbia, the School of Foreign Service at Georgetown and the schools for trial judges, trial lawyers, and state governors have all been successful. Even more similar to this proposal is the Advanced Management Program offered by the Graduate School of Business Administration at Harvard University. The Program, which is for senior executives, runs for thirteen weeks, either with a fall and spring session in one year or a summer session over two years. Similarly, the Harvard Business School offers an International Senior Managers Program, an eight-week program for senior-level executives from around the world on the problems of international business. If these examples can succeed and even flourish, there is no reason why Institutes of Corporate Governance cannot as well. Indeed, if the idea were to catch on, the waiting lists would soon be long.[89]

IV. CONCLUSION

Much has been said about the animosity in the public mind toward the business community. However unfair some of that attitude may be, it is

[89] In June, 1977, Stanley Sporkin, Director of Enforcement of the SEC, suggested that perhaps directors should be sent to school. *See* Metzenbaum Hearings, *supra* note 5, at 94-96. Two months earlier, on April 20, 1977, this author made the same suggestion, as outlined above, in a speech in London on the responsibility of outside directors, sponsored by the International Bar Association.

attributable in part to the "private fiefdom" form of corporate rule that was once so prevalent. Some of those chief executives, of course, made enormous contributions to their particular organizations, whether as a result of invention, innovation, vision, leadership, or the like. Only a truly disinterested leader, however, can identify and reasonably accommodate all of the ways in which his or her corporation affects the various communities in which it exists. The days of one-man domination ("his board") are numbered and, in most cases already ended. Their demise should reduce the temptations leading to management fraud or excessive pressure on outside auditors and counsel.

Corporate governance and corporate accountability are thus issues whose time has come. Given their importance to our way of life, surely their continued examination must be accomplished in a more systematic way. If Institutes of Corporate Governance are not feasible, then perhaps there is some other solution. The commercially oriented directors' newsletters, checklists, and seminars that lately have become popular are not the answer. Something is needed both to train directors in a comprehensive and serious manner—to establish a whole profession, a discipline—and in the process develop the policies and customs governing their responsibilities. What is ultimately at stake, in no small measure, is the viability and legitimacy of corporate self-regulation or, even more generally, that of the private sector itself.

Only twenty years have passed since the London Times published an advertisement for a "titled person required to add distinction to the board of directors of a wine company." And even today in the United States there are still some fiefdoms that have survived the aftermath of Watergate. It may not be that full-time professional directors are necessary, but it is time for directors who are professionals.