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INDEPENDENT DIRECTORS

The Independent Corporate Board: A Means to What End?

Roberta S. Karmel*

I. Introduction

The American Law Institute's Corporate Governance Project has provoked intense controversy from its inception. Even its name has changed because of this controversy, from *Principles of Corporate Governance and Structure: Restatement and Recommendations*¹ to *Principles of Corporate Governance: Analysis and Recommendations*.² The evolution of provisions relating to the structure and composition of corporate boards of directors illus-

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1. PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS (Tent. Draft No. 1, 1982) [hereinafter cited as Tentative Draft No. 1].

2. PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (Tent. Draft No. 2, 1984) [hereinafter cited as Tentative Draft No. 2].

The Forward to *Tentative Draft No. 2* makes it clear that the change in the Project's title:

was made to allay the fear that courts might be misled by the traditional word "Restatement" in the title to view the entire document as purporting to restate existing law. . . . In addition, black letter recommendations with respect to corporation law are no longer preceded by the words "Corporate law should provide" because the word "provide" was thought by some to imply a call for legislative as distinguished from judicial implementation, contrary in many instances to the intention of the formulation.

Finally, in view of the concern that readers would not grasp the import of the distinction between black letter statements with respect to law and statements about "good corporate practice" and also that the possible legal significance of practice recommendations was unclear, such recommenda-

trates that underlying the controversy are questions about the very need for and purpose of the Project. These questions are unlikely to die down merely because of a name change.

This Article examines and critiques the general and specific background of the ALI's provisions on board structure. Part II traces the general historical debate on corporate governance and the development of the concepts underlying the ALI's provisions. Part III examines the history of proposals regarding board structure and director independence. Part IV discusses the development of the ALI's proposals for independent boards of directors, reviewing the provisions in *Tentative Draft No. 1*,³ then setting forth and analyzing the criticisms that led to the changed language in *Tentative Draft No. 2*.⁴ Part IV then criticizes both the provisions and the monitoring model that underlies them.

The Article concludes that there is not an adequate legal framework, nor a political consensus for proposing changes in existing corporate law that would require a board composed primarily of independent directors. Moreover, the ALI has not examined nor propounded a theoretical basis for changing corporate law to mandate the form of board structure recommended.

II. *The Corporate Governance Debate*

Two schools of thought have long been debated in American thinking about business corporations. One school views corporation law as basically private law and corporate governance as involving the definition of relationships, under theories of trust law, between corporate managers and shareholders.⁵ Another school considers corporation law as a matter of public law because the states grant charters to corporations and because managers are responsible not only to shareholders but to other constituencies as well.⁶ Competition between federal and state jurisprudence, and economic and political pressures, have caused American corporation law to ricochet between these two schools.

In the early years of the republic, state law required that corporate charters include various substantive protections for shareholders, particularly with regard to capital structure.⁷ These laws,

tions are no longer printed in black letter and even the adjective "good" has been eliminated from the formulation. . . .

Id. at vii-viii.

3. See Tentative Draft No. 1, *supra* note 1, §§ 3.03-3.08, at 71, 125.

4. See Tentative Draft No. 2, *supra* note 2, §§ 3.04-3.10, at 83-124.

5. R. HESSEN, IN DEFENSE OF THE CORPORATION xiii-xiv (1979).

6. See, e.g., R. NADER, M. GREEN & J. SELIGMAN, CONSTITUTIONALIZING THE CORPORATION: THE CASE FOR THE FEDERAL CHARTERING OF GIANT CORPORATIONS 71-73, 207-09 (1976).

7. See E. DODD, AMERICAN BUSINESS CORPORATIONS UNTIL 1860, 310-11 (1954).

however, contained no requirements for any particular board composition. The rather scanty federal jurisprudence that existed tended to analyze corporate law as a matter of contract between the state and corporate owners.⁸ In the late nineteenth century, state corporation laws requiring substantive fairness were largely repealed, probably in response to the national economic interest as well as to state needs for taxes. The charter-mongering movement of the period, sometimes denigrated as a “race for the bottom” for legal standards,⁹ permitted almost unlimited freedom in the incorporation of new enterprises. The Supreme Court’s recognition that a corporation was a “person”¹⁰ encouraged interstate companies to use state incorporation laws to further the development of large national business enterprises. Shareholder protection became primarily a matter of judicially imposed fairness or fiduciary standards. The only other law that affected corporate governance was clearly private, embodied in the listing requirements of the New York Stock Exchange.¹¹

Trust and contract law concepts were intertwined in the development of corporate law. The law viewed shareholders as the actual owners of a corporation and saw managers as their agents, entrusted with managing corporate assets for their benefit. This relationship required corporate managers to concentrate upon pecuniary gain rather than public good.¹² The same motives prevailed among boards of directors because managers generally also served as directors, and nonmanagement directors tended to be financiers or bankers. Therefore, because corporation law provided that “the business of a corporation shall be managed under the direction of its board of directors,”¹³ the law elevated shareholders’ gain over public welfare. No notion of independence as a beneficial qualification for directors had emerged.

The stock market crash of 1929 and the onset of the Great Depression of the 1930s brought more radical theories about corporations to the public’s attention. In 1931 and 1932 the Berle-Dodd

8. See, e.g., *Trustees of Dartmouth College v. Woodward*, 17 U.S. (4 Wheat.) 518, 627 (1819) (contract clause of the Constitution prohibits unilateral legislative change in public charter issued to Dartmouth College).

9. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 *YALE L.J.* 663, 666 (1974) [hereinafter cited as Cary, *Federalism*].

10. *Santa Clara County v. Southern Pac. R.R.*, 118 U.S. 394, 396 (1886).

11. The New York Stock Exchange (NYSE) first adopted its listing agreement, traditionally a principal means by which it enforces its listing standards, in 1899. That agreement and the policies set forth in the *NYSE Company Manual* have developed gradually over the years. They impose a wide variety of corporate governance requirements for initial and continued listing. Securities Exchange Act Release No. 13,346 (Mar. 9, 1977), 11 SEC Docket 1945, 1946 (1977) [hereinafter cited as SEC Release No. 13,346]. The NYSE became subject to regulation by the Securities and Exchange Commission (SEC) in 1934. In 1975, amendments to the Securities Exchange Act of 1934 gave the SEC new powers to approve, modify, and enforce NYSE rules. Securities Act Amendments of 1975, Pub. L. No. 94-29, §§ 16, 17(1)-(2), 89 Stat. 97, 146, 154 (codified as amended at 15 U.S.C. §§ 78s, 78u(d)-(e)). Whether these new powers give the SEC authority to change NYSE listing requirements is uncertain.

12. *Dodge v. Ford Motor Co.*, 204 Mich. 459, 507, 170 N.W. 668, 684 (1919).

13. E.g., N.Y. BUS. CORP. LAW § 701 (McKinney Supp. 1983-84).

debate¹⁴ about corporate governance formed a backdrop for sweeping reform legislation by the New Deal, including the first federal securities laws. Professor Berle hypothesized that stockholders had surrendered control of the corporation to management. He advocated returning control of corporate affairs to the stockholders through the enforcement of fiduciary duties owed them by managers.¹⁵ By contrast, Professor Dodd took the more radical position that the state should regulate the absolute control of corporate property exercised by corporate managers not only on behalf of shareholders but for society at large. Professor Dodd felt that the passive property interests of stockholders should yield to the larger interests of society, including employees and the community.¹⁶ This "managerialist" view led some political activists to propose federal chartering of public corporations in order to compel corporations to be more responsive to labor and other constituencies.¹⁷

Both Professors Dodd and Berle argued by analogy, comparing large publicly held corporations with governmental agencies.¹⁸ Professor Dodd viewed corporations as autocratic merchant states that nevertheless derived their power from the government and therefore had to be brought under control by the government for the benefit of the populace at large.¹⁹ Professor Berle, on the other hand, stressed the analogy between corporate governance and parliamentary democracy and was more concerned with mak-

14. Berle, *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931) [hereinafter cited as Berle, *Corporate Powers*]; Dodd, *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932) [hereinafter cited as Dodd, *Corporate Managers*]; Berle, *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365 (1932) [hereinafter cited as Berle, *Corporate Managers*]; Dodd, *Is Effective Enforcement of the Fiduciary Duties of Corporate Managers Practicable?*, 2 U. CHI. L. REV. 194 (1935) [hereinafter cited as Dodd, *Effective Enforcement*].

15. Berle, *Corporate Powers*, *supra* note 14, at 1049.

16. Dodd, *Corporate Managers*, *supra* note 14, at 1156.

17. See, e.g., *Federal Licensing of Corporations: Hearings on S. 10 and S. 3072 Before a Subcomm. of the Senate Comm. on the Judiciary*, 75th Cong., 3d Sess. 351 (1938); *Federal Licensing of Corporations: Hearings on S. 10 Before the Subcomm. of the Senate Comm. on the Judiciary*, 75th Cong., 1st Sess. 1 (1937) (hearings on bills, introduced by Senators Borah and Mahoney, that would have required corporations with substantial gross assets and engaged in interstate commerce to obtain federal licensing); see also R. NADER, M. GREEN & J. SELIGMAN, *TAMING THE GIANT CORPORATION* (1976); Cary, *Federalism*, *supra* note 9, at 702; Schwartz, *A Case for Federal Chartering of Corporations*, 31 BUS. LAW. 1125 (1976). Justice Lewis Brandeis also favored the concession theory that corporations exist by virtue of a grant from the sovereign. He argued that the state should limit corporate power because large corporations threatened democracy. See *Louis K. Liggett Co. v. Lee*, 288 U.S. 517, 548-49 (1933) (Brandeis, J., dissenting).

18. Berle, *Corporate Managers*, *supra* note 14, at 1368; Dodd, *Effective Enforcement*, *supra* note 14, at 203-04.

19. Dodd, *Corporate Managers*, *supra* note 14, *passim*.

ing corporations responsive to the economic interests of stockholders.²⁰

The Securities Act of 1933²¹ and the Securities Exchange Act of 1934²² basically followed Professor Berle's theory. In federalizing state corporation law, Congress was only able or willing to require disclosure to investors,²³ independent auditors for public companies,²⁴ and improvements in the proxy machinery to promote fair corporate suffrage and to curtail management's dominance of the proxy process.²⁵

Nevertheless, many powerful voices continued to argue for the view that corporate managers should be made accountable to the public at large by controlling access to the capital markets and regulating corporate structure by federal statute. For example, Justice William O. Douglas, who exercised considerable influence upon federal corporation law jurisprudence by virtue of his position first as Chairman of the Securities and Exchange Commission and then as Justice of the United States Supreme Court, wrote:

Both prior to and during my SEC days, I had promoted the idea of having "public" directors of our large corporations. . . . The reason was that, by and large, directors tend to become subservient to the management, courteously serving its interests, which are not necessarily consistent with the interest of stockholders or compatible with the public reputation of the company. . . . [A]t least some of the directors of our large corporations must not be subservient to management. This was a policy which the SEC had power to enforce.²⁶

Although Justice Douglas and other proponents of independent boards were not, in fact, able to institute the requirement generally for public corporations through either amendments to the federal securities laws or interpretations of those laws, they injected their corporate governance ideas into discrete areas. The Public Utility Holding Company Act of 1935²⁷ imposed various substantive controls upon capital structure. More significantly for the future, the Investment Company Act of 1940²⁸ created a corporate governance structure that required a fixed percentage of independent directors.²⁹ SEC oversight of the New York Stock Exchange gave the Commission the potential power to affect corporate governance indirectly because of the Exchange's policies

20. Berle, *Corporate Managers*, *supra* note 14, at 1367-68.

21. Ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a-77aa (1982)).

22. Ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78kk (1982)).

23. 1933 Act §§ 5-12, 15 U.S.C. §§ 77f-77m.

24. 1933 Act § 12, 15 U.S.C. § 77aa; 1934 Act § 13(a)(2), 15 U.S.C. § 78m(a)(2).

25. 1934 Act § 14, 15 U.S.C. § 78n.

26. W.O. DOUGLAS, *GO EAST, YOUNG MAN* 272 (1974).

27. Ch. 687, 49 Stat. 803 (1935) (codified as amended at 15 U.S.C. §§ 79-79z-6 (1982)).

28. Ch. 686, 54 Stat 789 (1940) (codified as amended at 15 U.S.C. §§ 80a-1-80a-64 (1982)).

29. Section 10(a) provides: "No registered investment company shall have a board of directors more than 60 per centum of the members of which are persons who are interested persons of such registered company." 15 U.S.C. § 80a-10(a) (1982).

with regard to listing.³⁰ Although other federal legislation of the period contained certain negative prohibitions,³¹ there was no federal statutory control of corporate directors. This pragmatic compromise between proponents of direct federal control over corporations through chartering and those who sought to leave all regulation of corporations to the states remained in effect for the next quarter of a century. During the 1940s, 1950s, and early 1960s, business generally prospered and so did shareholders. There was little clamor for corporate reform.

In the mid-1960s and throughout the 1970s, the debate over corporate governance resumed in a context of economic and political upheaval that was different from the 1930s but certainly as disruptive.³² The Vietnam War and the Watergate scandal eroded public confidence in government. Public confidence in business also dropped precipitously because of the perceived corrupt alliance between corporate managers and politicians in the wake of federal election law and sensitive payment scandals. In addition, American business entered into a long-term restructuring that is still ongoing and therefore difficult to understand and analyze fully. Clearly, however, the country's mature smokestack industries suffered a period of relative decline just as the post World War II baby boom entered the workplace. In reaction to these events, the stock market endured a long-term bear cycle. Accordingly, stockholders became as disgruntled as the rest of the public.

The SEC played a key role as a catalyst for corporate governance reform throughout the 1960s and 1970s. The first SEC case to address the issue of management integrity, afterwards utilized as a precedent for the Commission's management fraud program, was *In re Franchard Corporation*.³³ Franchard involved a stop order suspending the effectiveness of registration statements that the SEC deemed materially deficient because of failure to disclose the use of company funds for the personal benefit of the issuer's chief executive officer. In a statement that became a keystone of

30. Securities Exchange Act of 1934 §§ 6, 19, 15 U.S.C. §§ 78f, 78s. See *supra* note 11; see also *An In-Depth Analysis of the Federal and State Roles in Regulating Corporate Management*, 31 BUS. LAW. 863, 1096 (1976) (assertion by symposium participant that the Act may give the SEC full authority to establish federal law for those corporations listed on the New York Stock Exchange and the American Stock Exchange).

31. See, e.g., Banking Act of 1933 § 32, 12 U.S.C. § 78 (1982), which provides that no director of any corporation "engaged in the issue, flotation, underwriting, public sale, or distribution . . . of stocks, bonds, or other similar securities" shall also serve as a director of a member bank of the Federal Reserve Board.

32. See generally SUBCOMM. ON INTERGOVERNMENTAL RELATIONS, SENATE COMM. ON GOVERNMENT OPERATIONS, 93D CONG., 1ST SESS., CONFIDENCE AND CONCERN: CITIZENS VIEW AMERICAN GOVERNMENT (Comm. Print 1973); T. H. WHITE, BREACH OF FAITH: THE FALL OF RICHARD NIXON (1975).

33. 42 S.E.C. 163 (1964).

future SEC programs, the SEC asserted that disclosure of the chief executive officer's continual diversion of funds to the use of his wholly owned corporation was "germane to an evaluation of the integrity of his management. This quality is always a material factor."³⁴

However, the *Franchard* decision did not depart from traditional state law fiduciary concepts.³⁵ Furthermore, because of the egregious breach of duty involved, the SEC could claim that failure to disclose constituted a material omission under federal securities laws. These laws had long been used to make disclosure a prophylactic for corporate reform without any claim that the SEC could regulate the substantive conduct of corporate affairs by corporate managers. At this time, however, the federal judiciary seized upon Rule 10b-5,³⁶ promulgated under the Securities Exchange Act of 1934, as a mechanism for developing a federal corporation law. Utilizing an implied private right of action,³⁷ the Court strengthened the fiduciary obligations of managers to shareholders. The SEC participated in this process through administrative rulings, injunctive actions, and amicus curiae briefs.³⁸ These developments did not affect corporate governance as such, but nevertheless provided a foundation for the view that a federal law regulating the conduct of managers of large publicly held corporations was appropriate.

In 1973, as a result of the work of the Watergate special prosecutor, several corporations and executive officers were charged with using corporate funds for illegal domestic political contributions.³⁹ The SEC first published a statement that nondisclosure of these

34. *Id.* at 172.

35. *See id.* at 176 (the diligence of directors is to be evaluated in the light of standards established by state statutory and common law).

36. 17 C.F.R. § 240.10b-5.

37. *Scherk v. Alberto Culver Co.*, 417 U.S. 506, 513-14 (1974); *see also* *J. I. Case v. Borak*, 377 U.S. 426, 431-35 (1964) (implying a private cause of action under rule 14a).

38. One SEC critic, writing in 1965, justified these developments as follows: The growth of the federal law of corporations . . . has been necessary and its direction predictable. The legislative history demonstrates that the federal securities laws were intended to have a strong and pervasive impact. Congress acted in 1933 and 1934 at a time of grave national economic crisis and widespread abuses in the securities markets. A federal law was required to cope with the interstate operations of business and the securities markets if workable rules were to be developed. The preamble to the Exchange Act proclaims that a healthy securities market is important for the economy and the national well-being. The securities laws were designed to produce fair and honest markets, and to restore investor confidence by requiring high standards of conduct in securities transactions.

Fleischer, *Federal Corporation Law: An Assessment*, 78 HARV. L. REV. 1146, 1174-75 (1965) (footnotes omitted).

39. *See Abuses of Corporate Power: Hearings before the Subcomm. on Priorities and Economy in Government of the Joint Economic Comm.*, 94th Cong., 2d Sess. 2-38 (1976) (testimony and prepared statement of Roderick M. Hills, Chairman, Securities and Exchange Commission) [hereinafter cited as *Joint Hearings*]; *See also* SEC. & EXCH. COMM'N REPORT ON QUESTIONABLE AND ILLEGAL CORPORATE PAYMENTS & PRACTICES, SUBMITTED TO SENATE COMM. ON BANKING & URBAN AFFAIRS, 94th Cong., 2d Sess. (Comm. Print 1976) [hereinafter cited as SEC REPORT ON QUESTIONABLE PAYMENTS].

matters might involve violations of the federal securities laws, then brought enforcement actions against nine corporations that made illegal political contributions.⁴⁰ These investigations in turn led to the "questionable foreign payments" cases, which involved various payments to foreign government officials to obtain or keep business abroad.⁴¹

Because of the magnitude of the cases uncovered and the questions raised as to the legality of these payments under either the federal securities laws or the laws of the foreign countries involved, the SEC adopted a program of "voluntary" disclosure. Under this program, the SEC indicated it would not prosecute issuers who voluntarily disclosed reports of investigations into sensitive payments. The SEC took the position that corporations had to disclose sensitive payments regardless of the amount involved on the grounds that these matters related to management integrity.⁴² In some of these cases, the SEC obtained consent injunctions that resulted in the restructuring of particular corporate boards.⁴³

Against this backdrop and the general post-Watergate hysteria that prevailed in Washington, the corporate governance debate of the 1930s was resurrected. The SEC played a major role in its rebirth. The Commission's Division of Enforcement set the stage through its widely publicized program regarding sensitive payments⁴⁴ and its long series of injunctive actions requiring corporations to conduct internal corporate investigations and to structure their boards.⁴⁵

Consumer activist Ralph Nader also advocated the concession theory. He led the school that viewed corporations as state agencies that enjoy special privileges in order to achieve social or na-

40. *E.g.*, *Securities & Exch. Comm'n v. ITT Corp.*, 1979 FED. SEC. L. REP. (CCH) ¶ 96,948 (D.D.C. Aug. 8, 1979); *Securities & Exch. Comm'n v. Lockheed*, [1975-76 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,509 (D.D.C. Apr. 13, 1976); *See Joint Hearings, supra* note 39, at 13-15.

41. *E.g.*, *Securities & Exch. Comm'n v. ITT Corp.*, 1979 FED. SEC. L. REP. (CCH) ¶ 96, 948 (D.D.C. Aug 8, 1979); *Securities & Exch. Comm'n v. Lockheed*, [1975-76 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,509 (D.D.C. Apr. 13, 1976); *See Joint Hearings, supra* note 39, at 13-15; *See generally* Note, *Disclosures of Payments to Foreign Officials under the Securities Acts*, 89 HARV. L. REV. 1848 (1976) (discussing legal history of "questionable foreign payments" cases and possible legal standards and their rationales).

42. *See Joint Hearings, supra* note 39, at 16-18. According to the *SEC Report on Questionable Payments*, over one hundred corporations responded under this program. *See* SEC REPORT ON QUESTIONABLE PAYMENTS, *supra* note 39, tables attached at end.

43. *See* SEC REPORT ON QUESTIONABLE PAYMENTS, *supra* note 39, at 3-5.

44. *See supra* notes 39-42 and accompanying text.

45. Treadway, *SEC Enforcement Techniques: Expanding and Exotic Forms of Ancillary Relief*, 32 WASH. & LEE L. REV. 637 (1975).

tional ends.⁴⁶ According to Mr. Nader, the consensual economic cornerstone for corporate privilege had crumbled because of the breakdown of controls that historically legitimized corporate power. These controls⁴⁷ were to insure that corporations efficiently and responsibly served the public interest. However, they all had failed to prevent irresponsible and unlawful conduct by corporate executives, and therefore giant multinational corporations had become private governments, exercising a detrimental influence on the quality of life for which they were not being held accountable.⁴⁸ Mr. Nader prescribed federal chartering of corporations to restructure the board of directors, to redefine its relations with managers, employees, shareholders, and the community, and to regulate corporate disclosure and conduct in certain areas of social concern.⁴⁹

The Nader school blamed corporations for virtually all of the ills of our post-industrial, technological society ranging from pollution to unemployment. The remedy advocated was sweeping reform at the federal level to give the government direct power to control and perhaps even to appoint corporate managers who would work for the public interest.⁵⁰ New York Congressman Ben Rosenthal introduced legislation to further this objective in the House of Representatives: the Corporate Democracy Act of 1980.⁵¹ Although the bill proposed to increase shareholder and director participation in company decision making, it also served constituencies other than, and sometimes in conflict with, shareholders. However, the bill attracted almost no interest in Congress and died.

Another school of reform advocates focused upon the poor economic performance of American business and perceived abuses of trust by corporate managers. Their inquiry addressed discrepancies between theoretical models of corporate law and actual conditions. Professor Melvin Eisenberg, one of this school's foremost legal theorists, comprehensively analyzed corporate structure in *The Structure of the Corporation*.⁵² Professor Eisenberg observed that virtually all state corporation laws provide that the board of directors owe a duty to manage the business and affairs of the corporation. He then focused on the differences he perceived in large corporations between the statutory legal model and the actual working model. Under the statutory model, the board takes an active hand in selecting officers, setting business policy, supervising and monitoring corporate executives, and generally managing

46. R. NADER, M. GREEN & J. SELIGMAN, *TAMING THE GIANT CORPORATION* 62-71 (1976).

47. Mr. Nader specifically listed state chartering, competition, remedial law, federal regulation, labor unions, shareholders, and the board of directors. *Id.* at 63-64.

48. *Id.* at 63-64.

49. *Id.* at 75-236.

50. *Id.* at 247-49.

51. H.R. 7010, 96th Cong., 2d Sess. (1980).

52. M. EISENBERG, *THE STRUCTURE OF THE CORPORATION* (1976).

the corporation. Under the working model, the board is only in a position to supervise and monitor and, for the most part, does neither effectively. In today's large and complex corporations, which require substantial time and effort to manage, the board takes no active hand in directing the operation of the corporation.⁵³

Professor Eisenberg therefore formulated a model for reform, the monitoring model. He argued that because a corporate organ comprised substantially of nonexecutives can rarely either manage the corporation's business or make policy, the board should primarily advise management, approve of major corporate projects and, most importantly, supervise, monitor, and select executive management. Professor Eisenberg concluded that the legal rules governing the structure of corporate management should ensure the effective performance of these functions by the board. Thus, he argued, the rules must make the board independent of the executives whose performance they monitor, and assure that the board receives adequate and objective information to enable it to execute its monitoring function.⁵⁴

Another influential voice in the recent corporate governance debate was that of Harold M. Williams, Chairman of the SEC from 1977 to 1981. Chairman Williams recommended that corporations "explore" the role and number of inside directors on corporate boards because "directors who have business links to the corporation impose a cost on the accountability process, and we need to consider carefully in each situation whether that cost is a necessary one to incur, and whether the benefits can be achieved in other ways."⁵⁵ Chairman Williams further asserted that the chief executive officer should not serve as chairman of the board because managers should not control the substance and purpose of the board's deliberations. He recommended that at least the board's nominating and audit committees, key elements in corporate governance, should be composed of independent directors.⁵⁶

It has been persuasively argued that Chairman Williams came out "four square for [Professor Dodd's] managerialist point of view."⁵⁷ He believed that although large corporations are theoretically owned by their shareholders, they have ceased to be private

53. *Id.* at 137-48.

54. *Id.* at 149-70.

55. Williams, *Corporate Accountability and Corporate Power*, in THE 1979 BENJAMIN F. FAIRLESS MEMORIAL LECTURES: POWER AND ACCOUNTABILITY: THE CHANGING ROLE OF THE CORPORATE BOARD OF DIRECTORS 8 (1979).

56. *Id.* at 18-19.

57. Kripke, *The SEC, Corporate Governance, and the Real Issues*, 36 BUS. LAW. 173, 183 (1981). See *supra* notes 15-19 and accompanying text.

property and have become quasi-public institutions.⁵⁸ Yet, the difference between Professors Berle and Dodd as to the public obligations of large corporations is not as great as it probably appeared at the time,⁵⁹ and Chairman Williams did not favor federal chartering legislation.⁶⁰ Rather, he argued that a more long-term public perspective on the part of corporate managers furthered the short-term interest of investors and shareholders.⁶¹

The real distinction between the Eisenberg-Williams perspective on corporate governance and the Nader perspective involves the role of the federal government. Chairman Williams advocated the use of independent directors as an alternative to federal chartering.⁶² Like Professor Berle, Chairman Williams and Professor Eisenberg believed that strengthening the procedural mechanisms for controlling corporate managers would allow corporation law to remain primarily a matter of private property interests.⁶³

Somewhere in the middle between Ralph Nader, on the one hand, and Harold Williams, on the other, were Professor William Cary, a former SEC Chairman, and Professor Donald Schwartz. Both urged passage of a federal minimum standards act to protect shareholder rights without federal chartering.⁶⁴

III. *Proposals Regarding Board Composition and Director Independence*

It was in this atmosphere of intellectual ferment — necessarily summarized briefly and perhaps only simplistically here — that the corporate governance debate turned to the question of board composition and director independence.

Neither federal nor state law in the United States has ever dictated the composition of boards of directors, nor has the law attempted to define necessary qualifications for directors of publicly held corporations.⁶⁵ To the extent that public boards moved in the direction of having outside directors, they have done so not in response to any legal requirement. Rather, this development has been the result of business practice that appears appropriate in the light of present economic and political circumstances. Nevertheless, the trend towards independent directors has not occurred in a vacuum. Especially during the past ten years, the SEC, the New York Stock Exchange, the American Bar Association, and the

58. Williams, *supra* note 55, at 12.

59. See Weiner, *The Berle-Dodd Dialogue on the Concept of the Corporation*, 64 COLUM. L. REV. 1458, 1465 (1964).

60. Williams, *supra* note 55, at 21.

61. *Id.* at 23-24.

62. *Id.* at 19.

63. *Id.* at 20.

64. Cary, *Federalism*, *supra* note 9, at 700-04; Schwartz, *The Paradigm of Federal Chartering*, in COMMENTARIES ON CORPORATE STRUCTURE AND GOVERNANCE, THE ALI-ABA SYMPOSIUMS 1977-1978 325, 336 (D. Schwartz ed. 1979).

65. *But see* Investment Company Act of 1940, 15 U.S.C. § 80a-10(a) (1982) (requiring at least 40% of Board members be disinterested).

Business Roundtable have encouraged companies to employ outside directors.

The SEC recommended that corporations form committees composed of independent directors as early as 1940.⁶⁶ However, no regulatory action on the subject was taken until 1972, when the SEC issued a release that concluded with the statement that "the Commission endorses . . . the establishment by all publicly-held companies of audit committees composed of outside directors. . . ."⁶⁷ A year later, the New York Stock Exchange strongly recommended that each listed company form an audit committee, preferably composed exclusively of independent directors.⁶⁸ In 1974, the SEC restated its support for independent audit committees by amending its rules to require disclosure in proxy statements of the existence or absence of an audit committee.⁶⁹ In 1976, in response to the SEC's investigation into questionable corporate payments and practices and in particular to the uncovering of falsified corporate records and the use of slush funds, the Chairman of the SEC suggested that the New York Stock Exchange "take the lead in this area by appropriately revising its listing requirements, thus providing a practical means effecting . . . important objectives without increasing direct government regulation." On March 9, 1977, the SEC approved the new Exchange rule requiring all listed domestic companies to "establish . . . and maintain audit committees comprised solely of directors independent of management and free from any relationship that . . . would interfere with their exercise of independent judgment as a committee member."⁷⁰

In April, 1977, when Harold Williams became Chairman of the Commission, the SEC announced that it would hold public hearings concerning shareholder communications, shareholder participation in the corporate electoral process, and corporate governance in general.⁷¹ These hearings, held in four cities around the country, lasted for many months. Following the hear-

66. *In re McKesson & Robbins, Inc.*, [Accounting Series Release Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 72,020, at 62,104, 62,108 (Nov. 19, Dec. 5, 1940).

67. *Standing Audit Committees Composed of Outside Directors*, [1971-1972 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 78,670, at 81,424 (No. 9548, Mar. 23, 1972).

68. See SEA Release No. 13,346, *supra* note 11, at 1946 n.9.

69. *Notice of Amendments to Require Increased Disclosure of Relationships Between Registrants and Their Independent Public Accountants*, 40 Fed. Reg. 1010 (1974), reprinted in [Accounting Series Release Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 72,187, at 62,394 (No. 11147, Dec. 20, 1974).

70. Letter from Roderick M. Hills to M. Balten (May 11, 1976), reprinted in SEC REPORT ON QUESTIONABLE PAYMENTS, *supra* note 39, at Exhibit D. The rule appears in SEA Release No. 13,346, *supra* note 11, at 1945. The requirement took effect June 30, 1978.

71. *Re-examination of Rules Relating to Shareholder Communications, Shareholder Participation in the Corporate Electoral Process and Corporate Governance*

ings, the Commission engaged in a number of rulemaking proceedings concerning the proxy rules. Although these rules required increased public disclosure of board composition and board committees, none of the SEC's rulemaking proceedings endeavored to regulate the substantive composition of the board.⁷² The staff report on the hearings concluded: "The board of directors has come to be viewed by many as the center of efforts to enhance corporate accountability. With an increased number of truly independent directors and an effectively functioning committee system, an institutionalized process for holding management accountable will be created."⁷³ Nevertheless, the report did not include any legal recommendations as to whether or how to create a board composed of independent directors controlling the nominating process.

During this period, the SEC's disclosure policies strongly encouraged public corporations to create boards composed of independent directors and establish committee systems in which independent directors predominated. In a rulemaking proposal in 1978, the Commission expressed its view that boards should be composed of independent directors, as strictly defined.⁷⁴ The proposal also would have mandated disclosure of whether the issuer had standing audit, nominating, and compensation committees composed of independent directors. The rules eventually issued by the Commission differed in certain significant respects from the original proposal on the definition of "independent" director.⁷⁵ Nevertheless, they were intended to move corporations in the direction of independent boards.

In reaction to the SEC's corporate governance hearings and to threats of corporate chartering legislation, the business community and corporate lawyers began considering voluntary measures that might ward off federal legislation. A number of high level conferences were held in the late 1970s, and two significant statements were issued. In November 1976, a subcommittee of the Corporation, Banking, and Business Law Committee of the American Bar Association issued the *Corporate Director's Guidebook*,

Generally, 42 Fed. Reg. 23,901 (1977), reprinted in [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,130, at 87,889, 87,890 (No. 13482, Apr. 28, 1977).

72. Indeed, it is highly questionable whether the SEC has any authority to do so.

73. *SEC Staff Report on Corporate Accountability*, printed for use of the Senate Comm. on Banking, Housing and Urban Affairs, 96th Cong., 2d Sess. 579 (Sept. 4, 1980) (footnote omitted).

74. *Proposed Rules Relating to Shareholder Communications, Shareholder Participation in the Corporate Electoral Process and Corporate Governance Generally*, 43 Fed. Reg. 31,945 (1978), reprinted in [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,645, at 80,574, 80,578 (No. 34-14970, July 18, 1978). "Independent director" was defined as "any person who is neither a 'management director' nor an 'affiliated non-management director.'"

75. Rather than adopting specific categories, the rules required a brief description of significant economic and personal relationships between the director and the issuer. *Shareholder Communications, Shareholder Participation in the Corporate Electoral Process and Corporate Governance Generally; Final Rules*, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,766 at 81,086 (No. 15384, Dec. 6, 1978) (codified at 17 C.F.R. § 240.14a-1 (1977)).

designed to assist corporate directors in performing their duties.⁷⁶ The *Guidebook* included a proposed model for the boards of directors of publicly owned corporations that distinguished between management and nonmanagement directors.⁷⁷ However, it stated that the model did not represent a "definitive recommendation for board structure such that continuance or adoption of differing procedures would or should place in question compliance with legal norms or contemporary practices."⁷⁸

Under the *Guidebook's* model, a director was classified as a management director if he devoted substantially all of his attention to the affairs of the corporation, one of its subsidiaries, or any subsidiary. This definition included former officers or employees. The *Guidebook* classified all other directors as nonmanagement directors, then as affiliated or unaffiliated nonmanagement directors.⁷⁹ The *Guidebook* recommended that nonmanagement directors constitute a majority of the full board of directors.⁸⁰ It advocated formation of at least three working committees to exercise the most common recurring needs for disinterested oversight: a nominating committee composed exclusively of unaffiliated nonmanagement directors, a compensation committee composed of nonmanagement directors, a majority of whom should be unaffiliated, and an audit committee composed of nonmanagement directors, a majority of whom should be unaffiliated.⁸¹

The Business Roundtable issued a report on the composition of corporate boards of directors in 1978.⁸² This report's perspective, as might be expected, was more pragmatic and less legalistic than the *Guidebook*. The report contended that economic and political power have been separated in the United States and that corporate legitimacy stems from economic success, not "some royal franchise."⁸³ Directors needed the critical qualities of integrity, independence, an inquiring mind, vision, an ability to work with others, and broad experience. Managerial experience in other businesses was particularly relevant because of corporations' status as primarily economic instruments. Directors from outside the

76. American Bar Association Comm. on Corp. Laws, *The Corporate Director's Guidebook*, 32 BUS. LAW. 5 (1976).

77. *Id.* at 31-32.

78. *Id.* at 31.

79. A director was regarded as an affiliated nonmanagement director if he engaged in material transactions with the corporation or if he had close family ties to a member of key management. *Id.*

80. *Id.* at 33.

81. *Id.* at 35-36.

82. Statement of the Business Roundtable, *The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation* (January 1978).

83. *Id.* at 2.

business community, however, also served some purpose.⁸⁴ The Business Roundtable Statement rejected any rule disqualifying all members of operating management except the chief executive officer as directors,⁸⁵ but recommended instead that outsiders should have a substantial impact on the board's decision making process: "We note the strong tendency of U.S. business corporations to move toward a board structure based on a majority of outside directors — and we endorse it."⁸⁶

IV. *The ALI's Proposal And Its Critics*

During this debate over corporate governance and reform, the ALI authorized a corporate governance project, under the leadership of former SEC Chairman Ray Garrett, Jr.⁸⁷ Chairman Garrett's articulation of the Project's methodology paved the way for the furor that developed over *Tentative Draft No. 1's* black-letter requirements for an independent board of directors:

Where there is no judicial authority, or where the cases are unsatisfactory by modern standards — either because of their antiquity, or absence of compelling analysis, or because they just seem wrong — resort must be had to other sources. These may include the literature on the subject, the better corporate practice in the view of those experienced in the field, not limited to lawyers, and ultimately the judgement of the Institute, aided by the Reporter and his Advisers. Where the project is not in fact restating the cases, the Institute's views should take the form of recommendations, which may include recommended statutory provisions, state or federal.⁸⁸

Board structure, however, is not a matter that has been, or by its nature can be dictated by judicial decisions. State law does not require a particular kind of board composition. Neither, generally, does federal law, with the peculiar exception of the Investment Company Act.⁸⁹ Thus, the board structure sections fall squarely into the grey area where the Project does "not in fact restat[e] the cases." Yet, *Tentative Draft No. 1* clearly established black-letter requirements.⁹⁰ Critical attacks upon the draft by the Business Roundtable and counsel to many large public corpora-

84. *Id.* at 17.

85. *Id.* at 19.

86. *Id.* at 20.

87. Kripke, *supra* note 57, at 175.

88. *Tentative Draft No. 1*, *supra* note 1, at viii.

89. *See supra* note 65.

90. The "black letter" law of *Tentative Draft No. 1* stated:

§ 3.03. Composition of the Board of Directors

(a) Corporate law should provide that at least a majority of the directors of a large publicly held corporation [§ 1.15] shall be free of any significant relationships [§ 1.24] with the corporation's senior executives [§ 1.23], unless a majority of the corporation's voting securities [§ 1.27] are owned by a single person [§ 1.18] or a family group [§ 1.13].

(b) As a matter of good corporate practice, a publicly held corporation [§ 1.21] that is not required, under subdivision (a), to have a majority of directors who are free of any significant relationships with the corporation's senior executives, should have at least three such directors.

tions⁹¹ and heated debate within the ALI and consultants and advisors to the Project led not only to a title change for the entire Project,⁹² but also to substantially toned-down *recommendations* for board structure in *Tentative Draft No. 2*.⁹³

The comment to *Tentative Draft No. 2*, section 3.04, traces the sources of the board composition sections in legal precedent and theory.⁹⁴ It readily concedes that present law generally makes no provisions for the composition of the board. It refers to the Investment Company Act, which requires that forty percent of the directors of a registered investment company not be "interested" persons,⁹⁵ to the New York Stock Exchange requirement that at least two independent directors for listed companies sit on the board,⁹⁶ to the Business Roundtable's Statement, and to the *Corporate Director's Guidebook*.⁹⁷ The comment provides that voluntary corporate action would implement section 3.04.

The ALI's proposals seek to enhance the oversight function of the board; this goal in turn has two prerequisites: a board that can objectively evaluate the performance of the senior executives, and an accurate and reliable flow of information to the board concerning executive performance.⁹⁸ This reasoning, which applies both to independent directors and particularly to independent audit committees,⁹⁹ is consistent with Professor Eisenberg's monitoring

91. See *infra* notes 108-111 and accompanying text.

92. See *supra* notes 1-2 and accompanying text.

93. § 3.04. Directors Who Have No Significant Relationship to the Senior Executives.

It is recommended as a matter of corporate practice that:

(a) The board of every large publicly held corporation [§ 1.16] should have a majority of directors who are free of any significant relationship [§ 1.26] with the corporation's senior executives [§ 1.25], unless a majority of the corporations's voting securities [§ 1.29] are owned by a single person, a family group [§ 1.13], or a control group [§ 1.06].

(b) The board of a publicly held corporation [§ 1.23] that does not fall within Subsection (a) should have at least three directors who are free of any significant relationship with the corporation's senior executives.

See *Tentative Draft No. 2*, *supra* note 2.

94. See *id.* at 84.

95. *Id.* (discussing 15 U.S.C. § 80a-10(a) (1981)).

96. *Id.* This is related to the Exchange's policy on audit committees. See *supra* note 68 and accompanying text.

97. *Tentative Draft No. 2*, *supra* note 2, at 84. See *supra* notes 76-80 and accompanying text.

98. *Tentative Draft No. 2*, *supra* note 2, § 3.04 comment, at 85.

99. The provisions concerning audit committees were developed and regarded as a mechanism for overseeing and strengthening the audit process. *Tentative Draft No. 2* specifically provides that every large corporation should have an audit committee composed of at least three significant directors, a majority of whom have no significant relationship with the corporations senior executives. *Id.* § 3.03, at 76. The comment to this section recognizes that an audit committee is not now required as a matter of state law, with one exception. *Id.* (The exception is Connecticut). However, the NYSE requires listed companies to have an audit committee composed of in-

model for corporations.¹⁰⁰

However, many prominent scholars have rejected the monitoring model of corporate structure requiring a board of independent directors to protect shareholders by limiting the power of corporate managers. Professor Daniel Fischel argues that the monitoring model is based on the premise that corporations have failed to meet their responsibilities to shareholders and the public, but that, in fact, no empirical evidence supports this conclusion:

Despite the near consensus that improved corporate governance is necessary, critics have proffered no evidence to demonstrate that any problem exists. Many reformers, as their proposals reflect, either ignore or misunderstand the economics of the corporate form of firm organization and the market forces that limit the divergence of interest between managers and investors. It is difficult to escape the conclusion that the corporate governance movement, despite its durability and widely held support, is much ado about nothing.¹⁰¹

Professor Walter Werner criticizes the monitoring model as based on the incorrect view that shareholders once participated in the control of public corporations and should be restored to such control by revitalized shareholder democracy:

Shareholders are seen as citizens of a state, determining the destiny of the enterprise through directors, the corporate legislature, whom they elect to operate it on their behalf. Corporations grew large, according to this doctrine, because the law's constraints on corporate scope and shareholder constraints on directors' power were eroded. Since the law did not distinguish between close and public corporations, the erosion doctrine also makes no distinction. It therefore ignores the effect of securities markets on the ownership and governance of public corporations as though those markets had never existed.¹⁰²

Professor Werner argues that in fact "public corporations have always pursued a goal of profitability and have always been owned by shareholders chasing their own private gain."¹⁰³ These profit-oriented shareholders are not interested in the credentials of directors or corporate democracy. Instead, they rate the performance of management and vote by purchasing and selling shares.

In addition, Professor Werner points out that the major example of governance failure given by the reformers — the sensitive payments scandals — was an instance where management and shareholder interests coincided but conflicted with society's inter-

dependent directors. See *supra* note 70. The comment to section 3.03 of *Tentative Draft No. 2* states "[S]ection 3.03 would be an appropriate subject for legislative action in connection with a general modernization of a state's corporation statute." *Id.* at 77.

100. See *supra* notes 52-54 and accompanying text.

101. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1291-92 (1982).

102. Werner, *Corporation Law in Search of its Future*, 81 COLUM. L. REV. 1611, 1643 (1981).

103. *Id.*

ests.¹⁰⁴ Accordingly, boards of independent directors would not have achieved greater shareholder protection. Indeed, Professor Werner opines that the monitoring model's emphasis on the interests of society may result in reforms inimical to shareholders' interests.¹⁰⁵

Professor Victor Brudney attacks the independent-director model on the ground that the very quality of directorial independence makes directors ineffectual instruments for enforcing management integrity or performance.¹⁰⁶ Outsiders simply do not have the time, knowledge, or incentive to perform that role, according to Professor Brudney. Furthermore, when "the independent director seeks to monitor corporate social responsibility, he faces larger difficulties and smaller likelihood of overcoming them than in matters of assuring managerial integrity or efficiency."¹⁰⁷

The most acrimonious objections to the Project's formulations concerning board structure and composition have come from the Business Roundtable, which prepared a statement in opposition to *Tentative Draft No. 1*.¹⁰⁸ In the Roundtable's view, the Project proposes significant changes in current law, while using the form of a traditional Restatement. The Roundtable's Statement emphasizes that the Project recommends new law and formulates black-letter rules in spite of conflicting case law and that the Reporter's model imposes duties not required under current law.¹⁰⁹

The Roundtable also attacks the Project's choice of one model of corporate governance, the monitoring model, to the exclusion of all others, and criticizes the Project's failure to consult and rely upon disciplines outside the law, especially business school research and economic data.¹¹⁰ Regarding the merits of the Project's theories on board composition, the Roundtable's Statement criticizes the Project for imposing "new rules and regulations on United States corporations which will serve only to decrease the risk-taking and flexibility critical for corporate survival."¹¹¹

Some in the ALI have taken umbrage at the Roundtable's attack on legalistic and regulatory solutions to corporate govern-

104. See Werner, *Management, Stock Market and Corporate Reform: Berle and Means Reconsidered*, 77 COLUM. L. REV. 388, 409-13 (1977).

105. See Werner, *supra* note 102, at 1663-66.

106. See Brudney, *The Independent Director — Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 616-22, 642-59 (1982).

107. *Id.* at 639.

108. Statement of The Business Roundtable on the American Law Institute's Proposed "Principles of Corporate Governance and Structure: Restatement and Recommendations" (Feb. 1983) [hereinafter cited as Statement of the Business Roundtable (Feb. 1983)].

109. *Id.* at 2.

110. *Id.* at 20-27.

111. *Id.* at 35.

ance. Yet, the Project presumes the existence of a conflict of interest between management and shareholders, to be resolved by independent boards. This adversarial approach to corporate governance, although appropriate for political bodies, is simply not consonant with normal corporate culture. Corporate boards generally act by consensus, led by the chief executive officer. Corporations value efficiency and profit rather than equity and fairness. Whether the accountability mechanism of an independent board is worth the economic cost is a question that the corporate governance debates on the Project have given short shrift.¹¹²

Perhaps this question has not been explored because proponents of the monitoring model generally advocate an amelioration of the corporate objective to pursue profit.¹¹³ For this reason, critics of the monitoring model have expressed the view that its most serious defect is the notion that independent directors can reconcile business and social goals. According to Professor Homer Kripke, the recommended corporate governance reforms are directed toward "the preemption of state corporate law in the enforcement of the [SEC's] managerialist program."¹¹⁴ Professor Kripke attacks this program as, in the final analysis, inimical to shareholders:

The crucial choices for our future are economic: how to deal with union efforts to protect jobs against automation, new products, imported products, beginners who cannot earn the minimum wage, runaway shops; when to adopt a cold-turkey cure for losses by abandoning a product or closing a plant; when to manufacture in overseas low-wage platforms. These will be agonizing choices. There is no reason to think that present managements and boards can make these choices less well than

112. See generally Butler & Baysinger, *Revolution Versus Evolution in Corporation Law: The ALI's Project and the Independent Director*, 53 GEO WASH. L. REV. 557.

113. The Project itself is somewhat ambiguous on the question of whether and to what extent business corporations should exercise social responsibility. Nevertheless, it rejects the notion that managers and directors are only obligated to maximize investor wealth without balancing in social or moral responsibility. *Tentative Draft No. 2* provides:

§ 2.01. The Objective and Conduct of the Business Corporation

A business corporation should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain, except that, whether or not corporate profit and shareholder gain are thereby enhanced, the corporation, in the conduct of its business

(a) is obliged, to the same extent as a natural person, to act within the boundaries set by law,

(b) may take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business, and

(c) may devote a reasonable amount of resources to public welfare, humanitarian, educational, and philanthropic purposes.

Tentative Draft No. 2, supra note 2, at 25.

The controversy over this provision is not surprising, and the ALI's reluctance, frequently exhibited since the Project began, to debate fully the Project's premises and purposes seems inappropriate. After all, the monitoring model is only a mechanism. The real question is whether the Project is designed to protect shareholders or society. As Professor Brudney states, "the argument for the independent director rarely disentangles his possible roles — as a monitor of integrity, efficiency, or social responsibility — or the logic supporting each of them." Brudney, *supra* note 106, at 658.

114. Kripke, *supra* note 57, at 204.

outsiders who can cheaply make themselves momentary heroes to the community at stockholders' expense.¹¹⁵

Some critics of the monitoring model, like Professor Brudney, take the position that independent directors constitute a poor substitute for government regulation because independent directors will probably provide less protection for consumers, suppliers, workers, and the general public.¹¹⁶ Others, like Professor Fischel, argue that the marketplace will appropriately discipline business corporations, and that requiring boards to consist primarily of independent directors to compel socially responsible behavior "has the effect of obliterating the distinction between a firm — a nexus of contracts voluntarily and lawfully entered into by individuals to maximize their joint welfare — and a public body serving the public interest. . . ."¹¹⁷ Together, the critics suggest that the independent board as a surrogate for the legislature in determining public policy is likely to do a poor job, both economically and politically.

The most stringent of the board composition and structure provisions of the Project are aimed at the large publicly held corporation, defined as a corporation with 2000 or more holders of record and \$100 million in total assets.¹¹⁸ While such companies probably adhere to the independent board model more frequently than smaller, newly emerging companies, it is ironic that mature public enterprise is the sector of the American economy that is in the most difficulty today. This should give proponents of the monitoring model some pause.

Reformers generally assume that new procedural mechanisms will push public bodies in directions that are politically compatible with their views. To the contrary, governance changes are just as likely to be used by corporate managers for their own ends as to further the ends of shareholders or society. For example, taking employee and community needs into account could be used by some managers as a justification for resisting tender offers that would have been in the best interests of shareholders. Similarly, an independent board structure, in conjunction with the business judgment rule, could be used aggressively to dispose of possibly meritorious litigation.

The formulation of the monitoring model in *Tentative Draft No. 2* is essentially statutory. Although the ALI proposes that cor-

115. *Id.* at 206.

116. Brudney, *supra* note 106, at 654. See also E. HERMAN, CORPORATE CONTROL, CORPORATE POWER 283-89 (1981) (the benefits to society at large from independent board representation are not likely to be great, because of a "tendency of outsiders to accept the board/management concept of the function of the corporations").

117. Fischel, *supra* note 101, at 1285.

118. Tentative Draft No. 2, *supra* note 2, § 1.16, at 9.

porations voluntarily follow the provisions regarding independent boards, the ALI views its provisions regarding audit committees as normative standards for legislatures to adopt by statute. The comments to *Tentative Draft No. 1* suggest that because statutes normally dictate the requirements, if any, concerning the composition of the board, full implementation of the provisions regarding board composition would require legislative action. Pending legislative action, *Tentative Draft No. 1* suggested that appropriate self-regulatory organizations adopt a counterpart of the project's provisions for large publicly held corporations within their purview.¹¹⁹

Tentative Draft No. 2 represents a significant retreat from this position because of its reliance on voluntary adherence rather than statutory compulsion. However, this retreat appears more as an accommodation of the criticisms of *Tentative Draft No. 1* rather than because of a belief that the provisions of *Tentative Draft No. 2* could become law through voluntary corporate action. While in many situations good corporate practices can become law through subsequent judicial decision making that elevates such practice to a standard of care, it is hard to foresee how this could happen with regard to the requirements concerning board composition and structure set forth in *Tentative Draft No. 1*. Although the SEC has obtained the appointment of independent directors by consent in order to settle certain enforcement cases,¹²⁰ the propriety of board restructuring by the federal courts under the securities laws is highly questionable.¹²¹ One wonders then why the ALI calls for voluntary change in board structure in the context of a document that takes traditional restatement form and that admittedly is the proper subject of legislative enactment. It would appear that this is simply the best the ALI can presently get. *Tentative Draft No. 2* is, in fact, a statement of principles for future legislative enactment at a more politically opportune time.

V. Conclusion

As suggested above, despite a decade of clamor for reform of corporate governance, a political consensus for legislation mandating structural reform of corporate entities has not materialized. Perhaps more troubling, in the context of the ALI's Project, is the lack of an articulated theoretical predicate for the structural reforms advocated.

Some have criticized the ALI's deliberations as too legalistic and not sufficiently practical, and challenged the Project's formulations as too precise and inflexible at a time of dynamic change in the corporate community.¹²² A more telling criticism of the Pro-

119. *Tentative Draft No. 1*, *supra* note 1, at 73.

120. *See supra* notes 43-45 and accompanying text.

121. Dent, *Ancillary Relief in Federal Securities Law: A Study in Federal Remedies*, 67 MINN. L. REV. 865, 933-41 (1983).

122. *See, e.g.*, Statement of the Business Roundtable (Feb. 1983), *supra* note 108, at

ject is that virtually the entire debate has involved specific provisions rather than basic conceptual matters.

The question of what objective the independent board should serve as a matter of legal theory has not received adequate attention. Is such a board intended to enforce the fiduciary duties of corporate managers to shareholders, thereby encouraging greater efficiency and integrity? Or, should it expand the horizons of the public corporation so that boards weigh social needs against purely business or economic needs? While this topic has been discussed in connection with the Project's provisions on objectives and conduct of the public corporation, the relationship between the provisions on corporate objectives and the provisions on the monitoring model has not been clearly articulated. Furthermore, the debate has ignored whether state law — which has deliberately permitted free incorporation with only minimal structural requirements — should continue to regulate matters of corporate structure. If, as the Project implicitly suggests, an established national standard should preempt state law for at least large publicly traded corporations, what public interest would that standard serve?

Professor Schwartz observes that: "Largely as a result of the competitive federal system, the striking fact about corporation law in the United States is that it lacks policy content. Even as to the internal relationships among competing interests in the corporation, by and large, corporation law does not act as a regulator."¹²³ He believes the "policy content of corporation law should seek to balance the economic goals and social responsibilities of the corporation."¹²⁴ It appears that the ALI has determined to advocate the monitoring model as a means of injecting a new policy content into corporation law without calling for any discussion of the necessity or propriety of the change.

A discussion of big questions can bog down a deliberative body like the ALI so that it settles or accomplishes nothing and produces no principles of corporate governance. However, the ALI has refused to confront basic, real questions about the desirability of structural reform of the modern corporation. Furthermore, the ALI does its Project a disservice by denying that despite its watered-down language, *Tentative Draft No. 2*, like *Tentative Draft No. 1*, seeks to prescribe changes in corporation law. Perhaps such change is necessary and appropriate, but perhaps it is not. Surely this question is sufficiently significant to our economic

4 (given the dynamic climate of corporate governance, there is "insufficient experience in which to base a mandatory, black-letter model of corporate structure and junction").

123. Schwartz, *supra* note 64, at 333.

124. *Id.* at 338.

and political system to warrant open debate. Instead, the ALI has presumed that change is required and the project has proceeded accordingly.

Business corporations should be judged by their economic viability, according to the values of the marketplace. If one can demonstrate that an independent board will improve their ability to provide jobs efficiently and deliver goods and services, thereby increasing the total return to investors, then the monitoring model deserves serious attention. This standard, however, is probably best enforced by the marketplace rather than by legislation. Furthermore, social responsibility is the job of government, not business.

If reformers advocate structural changes in order to orient public corporations towards social goals, such reforms should be seriously questioned. Corporations represent particular economic interests and not the public interest. If a board of independent directors is legally required to take into account noneconomic objectives, it is likely these objectives will be more compatible with the social and political ideas of the business community than with the aspirations of the general public affected by business corporations. On the other hand, if reformers advance the monitoring model as a means to protect investors, its proponents should explicitly articulate this purpose so that the validity of the independent board model can be utilized and tested in connection with the future work of the project on duty of care, business judgment, and changes in corporate control.