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SESSION THREE: BOARD COMMITTEES

Session Three of the Colloquium focused on the committee system as an organizational device to help the board of directors fulfill its responsibilities. Commentators have cited a number of advantages in using the committee system. First, because specific roles are assigned to the various committees, it is likely that continuing attention will be paid for recurring problems. This is preferable to making ad hoc responses in intermittent crises. Second, both the company and the director are made aware of the fact that an important time allocation has been made. Third, the operation of a committee makes it necessary to institutionalize a flow of information to the board. Fourth, with a committee system, it is possible to make use of the distinct abilities of individual, outside directors. In plenary board meetings, a director tends to be able only to react; in committee it is more likely that he can take personal initiative.

Despite the advantages described in the literature, not all corporations have adopted the committee system. A number of issues remain unresolved. Should all public corporations be required by law to establish committees on their boards of directors? Which committees should be required by law? Which committees, though not required by law, should a corporation adopt? How many directors should participate on each committee? How much compensation should directors receive for their participation on a committee? What is the appropriate proportion of insiders to outsiders on each committee? What should be the relationship between each committee, the board as a whole, and the officers and employees of the corporation?

Professor Noyes Leech of the International Faculty delivered the keynote remarks on board committees. Professor Leech first described the theoretical models of board organization. He then explained the role of board committees and presented an overview of U.S. practice, summarizing the legal requirements respecting board composition and board committees and reviewing the types of committees presently used.

Prior to the Colloquium, members of the International Faculty submitted brief summaries of board practices and the use of board committees in their countries. Submissions by Misao Tatsuta (Japan), Barthélémy Mercadel (France), Friedrich Kübler (Germany), Peter Lee (United Kingdom), and Alain Hirsch (Switzerland) have been appended to Professor Leech's remarks.

Professor Leech:

This session focuses on committees of the board of directors. I will first put

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the question of committee function in the context of some theoretical models of board organization. I then will describe the U.S. practice concerning board committees and conclude by briefly mentioning the use of committees in the United Kingdom, Japan, France, Switzerland and Germany.

The membership of the board of directors of a corporation generally fits one of three models. The first is a board that is composed totally of insiders, *i.e.* executive officers of the company. In the U.S. practice, public corporations no longer fit this model, although it is not uncommon in smaller, privately held corporations.

A second, more common, model is a mixed board of directors, composed of executive officers, affiliated persons (such as the firm's investment banker, lawyer, or a major stockholder who does not hold office), and possibly some totally independent outsiders, directors who have no connection with the company except for their status as a director. In this model, the board is dominated by executive officers or other insiders.

A third model is the board dominated by outsiders. Although U.S. corporations have had outsiders sitting on boards of directors in the past, that has not necessarily meant that the outsiders were exercising a particularly useful role either as participants in decision-making or as monitors. In recent years, much thought has been given to making outside directors more effective [1].

Regardless of whether a corporation has an inside board, a mixed board with insider dominance, or an outside-dominated board, the question still remains of how the board should function. The board may act in a variety of different ways. It may serve purely in a formal way, "rubber stamping" what the executive officers have already decided. It may go beyond that to exercise an advisory role, contributing to the executive officers its insights and its particular expertise in accounting, law, engineering, or banking. The board also may actively participate in managerial decisions, in fact working on day-to-day managerial problems. Another possibility, of course, is the monitoring board, the one that was described by Professor Mundheim in Session One. This type of board engages in review and surveillance; in effect, requiring the executive officers to account to it.

Although I have described discrete models of board function, in reality a board may fulfill more than one of these roles. For example, a board may advise the chief executive officer, may actively participate in some managerial activities, and concurrently may monitor the executive officers' management of the corporation. In a large publicly owned corporation, however, boards generally cannot effectively participate in day-to-day management. It is important to remember that in the major corporations of any country, decisions on day-to-day operations are necessarily made by a limited group. Given this basic managerial fact, the issue arises: How should the board be organized in order to make the individuals who actually run the business accountable for what they do? There are a number of questions involved in focusing on the

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matter of board organization. Included among these questions is whether a director should be considered an insider or outsider. If the board is to have members whose major function is to call executive officers to account, what is needed are people who are independent of those officers. Using the phrase "outside", however, does not totally answer the question because some outsiders may have connections with the corporation that make them more or less dependent upon it. These persons may include the corporation's general counsel or investment banker. Additionally, other outsiders may be less than fully independent because of friendships with inside members of the board or management or because, although they have retired from management, they retain personal loyalties to the present executive officers.

Additional questions include the frequency with which the board of directors meets, the character and timing of information that is available to the board, and the level of compensation for work on the board. With regard to the last question, compensation should strike a balance between the expectation that a director should devote a substantial amount of time to the corporation and the need of a director to retain his independence.

The final question with respect to making management accountable is the use of board committees [2]. The board committee is used increasingly in the United States. It may be described as a small group of the board that focuses on specific tasks and makes decisions or recommendations that are then presented to the entire board. Board committees may differ with respect to their membership, selection criteria, proportion of insiders to outsiders, and their level of functioning within the corporation (*i.e.* active decision-making at the management level, advising and/or monitoring).

I would now like to present an overview of the U.S. practice, first discussing the legal requirements concerning the composition of the board and board committees. In the United States, there are two levels of law applicable to the corporation. Corporations are organized under the laws of the individual states; each state has its own legislation governing the structure and operation of corporations. Overlaid upon this state law is a body of federal law, most of which grew out of the Great Depression and was enacted during the administration of Franklin Roosevelt in the 1930s. The principal statutes are the Securities Act of 1933 [3] and the Securities Exchange Act of 1934 [4]. These statutes are aimed primarily at the issuance and trading in securities, but some portions of these statutes must be considered in dealing with the composition of the board of directors. In addition to state and federal law, those companies that are listed on a stock exchange are subject to the rules of the relevant exchange. There is no state or federal law that requires that corporations have outside directors on their boards and, with one exception, there is no state or federal law that requires board committees (the law of the state of Connecticut provides that a corporation with one hundred shareholders must have an audit committee [5]). The New York Stock Exchange and the American Stock

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Exchange require that listed companies have at least two outside directors. A company cannot be listed on the exchange unless it already has two outside directors or unless it agrees to put outside directors on the board within a short period of time [6]. The New York Stock Exchange also has a rule that companies listed with the exchange must have an audit committee [7]. The exchange does not define the role of the audit committee. That is something that has been left to the individual company to work out on a case-by-case basis, although it is required that the members of the audit committee be independent.

Finally, the Securities and Exchange Commission has a set of rules dealing with proxies [8]. The Proxy Rules provide that a corporation that goes to its shareholders to solicit their proxies for a meeting must issue a document, called a proxy statement, describing the matters to come before the meeting. In particular, the corporation that solicits proxies with respect to the selection of directors must provide certain information about the nominees. The rules mandate that the proxy statement contain information about the relationship between the corporation and the nominees, concerning, *inter alia*, family relationships and close business relationships, such as the relationship between the company and its investment banker or lawyer. Although the SEC does not require that a company set up any specific committees, it does require disclosure in the proxy statement concerning whether a company has audit, nominating, or compensation committees. This disclosure rule may tend to cause a company to set up such committees, since proper industry standards may be thought to require them and a company may not want to reveal that it is not living up to such standards.

Let us now look at some statistics about the composition of boards of directors, some of their practices and the use of committees. Korn/Ferry International, an executive search organization, publishes annual studies of boards; I will refer to their statistics in the discussion that follows [9]. Their figures for 1981 reveal that in major U.S. corporations, outsiders predominated on boards of directors. In that year, the average number of directors on boards was thirteen, of whom nine were outsiders, although the number of "outsiders" must be qualified somewhat since that designation in the Korn/Ferry figures includes people who were formerly employees of a company. These statistics disclose that boards met, on the average, eight times a year for an average number of hours of one hundred and twenty-three. The hourly figure works out to about two days a month. The most common practice with respect to compensation is the provision of a combination of an annual fee plus a per-meeting fee. Annual compensation on that basis in 1981 was $15,660.

Board committees are in very general use in U.S. corporations. The committees most commonly found are the executive committee, the audit committee, the compensation committee and the nomination committee. There are other committees that are less frequently used: the finance committee, the public

affairs committee, the corporate ethics committee, the planning committee, and the benefits committee, for example.

The executive committee carries on a variety of tasks for the board when the board is not in session, making definitive decisions in some cases and, at other times, making decisions to be ratified at a later board meeting. The Korn/Ferry statistics indicate that membership on executive committees was shared equally by insiders and outsiders during 1981. Outsiders predominated on the three other major committees.

As its name indicates, the audit committee is concerned primarily with the work of the outside auditor of the company [10]. You might well ask: "Why have a special committee of the board if the corporation has already hired an outside auditor to go over the company's books?" There are two major reasons. First, someone has to hire the auditor and, second, someone has to spell out the auditor's job. Thus, one of the principal tasks of the audit committee is to guarantee that the independent public accountant hired to do the audit is in fact really independent of management. The second principal task of the audit committee is to see to it that the auditor fully understands the scope of his audit and that that scope is not unduly restricted by the management. There is no formal general assignment for every auditor for every audit. An auditor can go to various depths in his audit and make various tests. He may count inventory in one part of a company one year and do it in a different part another year. He may make certain spot checks, or he may make absolute counts. Somebody has to designate what tasks are to be performed, *i.e.* to define the scope of the audit. The audit committee, a group independent of the management whose work is to be audited, defines that scope. Beyond these major tasks of selecting the auditor and defining the scope of the audit, audit committees are also frequently charged with reviewing the audit before it is published. Some audit committees are also charged with subsidiary tasks, such as reviewing the corporation's conflict of interest policies. The Korn/Ferry statistics disclosed for 1981 that the average number of members of audit committees was four and that they were all outsiders. The fact that these committees are made up of outsiders is important. The audit committee is the only one required of N.Y. Stock Exchange listed companies. It is a place where the outside directors can meet to talk with each other about the corporation's problems as they see them, problems they may not yet be prepared to bring to the full board. Committee membership affords them an opportunity to share their hopes and concerns about the company in a private way. In 1981, audit committees met an average of three or four times a year; the average payment per member for each meeting was $510.

The compensation committee is concerned primarily with the compensation of the top executive officers [11]. Its principal charge is to approve or recommend the approval of the compensation for the chief executive officer and for other leading executive officers. Some compensation committees are

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charged with other responsibilities as well, such as reviewing the company's stock option plan, engaging in management development programs, and recommending the compensation for outside directors. The executive officer is excluded from formal committee activity, but usually makes recommendations with respect to the compensation of executive officers at the top level. This committee has an average of four members, generally all of whom are outsiders. In 1981, the committees met an average of four times annually and each member received approximately $500 per meeting.

The nominating committee is used less frequently than the audit committee and the compensation committee in U.S. corporations. The SEC has encouraged corporations to use this committee, however, and an increasing number of corporations are doing so. There is no consensus among corporations as to what the role of this committee should be, or even whether there should be one. Those committees that do exist deal primarily with the following problems: qualifications for board membership; nominations to fill board vacancies between meetings of the shareholders; and nominations of the annual slate of candidates. Collateral responsibilities may include establishing criteria for the composition of the board (*i.e.* the proportion of insiders to outsiders) and recommending the successor to the chief executive officer [12]. The average number of members on nominating committees is five, usually with one insider (generally the chief executive officer) and four outsiders. In 1981 the committee met an average of twice a year and compensation per member was around $490 per meeting.

I would now like to mention briefly examples of practice in other countries with respect to board composition and committees. Professor Tatsuta relates that insiders predominate on Japanese boards, although some outsiders also serve. The boards, by law, are supposed not only to manage but also to monitor, although more attention is paid to the management role. Committees in Japanese corporations are not particularly well organized. There are, for example, no audit committees. One development, the increase in the powers of the supervisor, however, suggests that Japanese law is paying more attention to the monitoring role.

I will not elaborate on the picture that Mr. Bauer gave us of France, except to suggest that a monitoring role for the board has not developed and that committees of the board do not seem particularly well organized. The United Kingdom system has developed a growing interest in the use of outside directors. In Germany, the Aufsichtsrat is the prototype of a monitoring board and one would think that the monitoring role is well developed there. We are told by our German colleagues, however, that the Aufsichtsrat is really too large to engage in effectively monitoring the acts of the executive officers. Swiss practice is to appoint one major committee with significant monitoring responsibility. These various practices are described in greater detail in an appendix to this paper, in letters solicited from members of the International Faculty.

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In the United States, committees of the board have become useful tools in the development of boards that monitor managements. In other legal systems, other devices will certainly be tried. But if monitoring is to become a major board function, a conscious decision must be made, by legislatures or at the level of the corporation itself, to assign that role to the board and to organize the board to carry it out. Action must be taken to produce a monitoring board. It will not happen by itself.

Appendix: Descriptions of board practices by members of the International Faculty

Japan: *Misao Tatsuta*

(1) The board of directors is supposed both to manage and to monitor the management. This has been so since the 1950 amendment which introduced the board system modeled after the American law. The 1981 amendment explicitly provides to this effect. Commercial Code art. 260 para. 1.

Certain enumerated matters and other "important" matters must be decided by the board itself, *i.e.* they may not be delegated to other bodies. Commercial Code art. 260 para. 2.

Around 1975, in the early stage of revision discussions that led to the 1981 amendment, the Ministry of Justice suggested the introduction of outside directors. This attempt, however, was given up because of the difficulty in getting proper persons. Instead, the bill further strengthened the supervisor (*kansayaku*) system along the lines of the 1974 amendment.

(2) In large corporations it is common to have one or more committees within the board. Usually the board simply rubber stamps what a committee has decided.

The same is true with regard to the board's monitoring function. However, when it comes to an extreme situation, the board does wield its power. For instance, the board of the largest department store recently removed its president who, although extremely powerful, had committed misconduct.

(3) Most board members are employees or ex-employees. The American notion of "officers" corresponds to that of "representative directors" (*daihyō torishimariyaku*) under Japanese law. Representative directors are appointed from among the directors. In many corporations, a few members of the board are persons from other corporations, mostly from the same group. Some of them are delegated by the lead bank.

(4) As stated in (2) above, it is a common practice to have board committees. I am not sure, however, whether these committees are functioning as a means for the board to inform itself. At any rate, there is no audit committee within Japanese boards.

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The statute requires that the representative directors report to the board about what is going on at least once every quarter per year. Commercial Code art. 200 para. 3. This provision was added by the 1981 amendment. But even before then it was considered the representative directors' duty to report to the board. It is a common practice for the board to hold monthly meetings. Also, representative directors must convene an extraordinary meeting whenever an urgent problem comes up.

(5) Before the 1974 amendment, a supervisor was empowered to audit company accounts. At that time many supervisors were persons of second class, such as those who reached the age limit as employees, but were regarded as not talented enough to be a director.

The 1974 amendment changed the situation in large and medium corporations. Supervisors now have the power to request an injunction, to attend the board meeting, and to bring several kinds of actions. Since the amendment, many corporations have appointed important persons as supervisors. It is becoming more and more common that the supervisor has his own staff.

The 1981 amendment took a further step. The supervisor is now obligated to report to the board about directors' misconduct, and he is empowered to convene a board meeting for that purpose. Commercial Code art. 260-3 paras. 2 through 4. Moreover, a large corporation must have at least two supervisors, and one of them must be full time.

I would assume that many supervisors are performing their function in accordance with the statute. Otherwise, they would be held liable for large damages, jointly and severally with the directors.

France: *Barthélémy Mercadal*

The movement toward active monitoring or supervisory boards

In private companies, Ghertman's study demonstrates that in certain cases there is active intervention by the board of directors, or at least by certain of its members. The study by Bauer and Cohen, however, asserts that real power belongs to the president who organizes a team around himself from which a successor emerges; the board of directors has only a very limited role in the choice of officers; the board tends to become a mere "rubber stamp"; in the extreme case, it does not even exercise supervisory functions.

This is the role that has been assigned to the boards of some companies that have been nationalized since 1946. However, in the case of recent nationalizations, attempts have been made to restore the board to a position of effective management. The most striking position is taken by the CGT (a labor union that is communist oriented and close to the PCF, the French Communist party) which claims that the board of directors should be very active. This

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position collides with a principle of company law to which nationalized companies are subjected unless an express exception applies. This principle (the so-called principle of the hierarchic organization of corporations) forbids each organ of the company (president, board of directors, shareholders) from encroaching upon the powers that the statute confers on the other organs. Since the statute confers on the president the management of the company, it is inferred that the board of directors cannot intervene in the conduct of the company's business by taking charge of its management. Thus, the Cour de Cassation in one case annulled a very severe restriction that a board of directors had imposed on the powers of a president. Nevertheless, in spite of that example, it is not possible to state where "management" ends and "direction" begins.

Practice of the board of directors

In France, only the board of directors can set up committees of inquiry. The board has complete liberty to determine the composition of committees. Members of committees may be, but need not be, directors or shareholders.

Also, the board determines a committee's charge, which must be limited to inquiries. Moreover, committees can play only an advisory role. Within the jurisdiction of each committee, questions to be considered can be submitted either by the board of directors or by the president.

In practice, the advantage of these committees is often to allow the payment to directors of supplementary compensation, because the statute authorizes exceptional compensation for separate and occasional tasks.

Furthermore, there are no rules with respect to voting procedures within the board of directors. There occassionally arise questions on that subject: for example, can a single member of the board be given a veto right?

Germany: *Friedrich Kübler*

In the following paragraphs I shall cite our Aktiengesetz (stock corporation law) the way we normally do in Germany (§ = art.; roman figures stand for sections; S. = Satz = sentence).

Your basic assumption that "outside directors" can best be compared to the Aufsichtsrat (AR) is correct. Hiring and supervising the Vorstand (V = managing board) are the main responsibilities of the AR (see §§ 84 I and 111 I). Apart from the workers' representatives, the members of the AR are elected at the shareholders' meeting (§ 10) and at any time can be removed by a three-fourths majority (§ 103 I).

(1) The (nonworker) members of the AR should be "outsiders" in the sense that they are not institutionally dependent on the V. For this reason:

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– they cannot be a member of V or a top executive of the corporation (§ 105 I). But a retired member of V can be elected as a member of AR (in our big banks the chairman of V after retiring often becomes chairman of AR);
– a member of V of A corporation cannot become a member of AR of B corporation if B "dominates" A, for instance, by holding a majority of shares (§ 100 II No. 2);
– a member of V of A corporation cannot become a member of AR of B corporation if a member of V of B corporation already holds a seat in the AR of A corporation (§ 100 II no. 3).

Employees other than top executives are not formally excluded from the AR. (The general in-house counsel would often be a top executive.) But normally the AR of a public corporation is composed of top managers of other big companies. Practicing lawyers may be found on the AR of a close corporation (representing owners being their clients) but only recently on the AR of a public corporation.

(2) In order to perform its task of supervision, the AR has access to the books kept by the corporation and to other sources of information (§ 111 II S. 1). The AR can ask individual members or hired experts (accountants) to collect this information (§ 111 II S. 2). The Vorstand has to report regularly to the AR (for details see § 90 I and II). The AR can ask for additional reports at all times (§ 90 III S. 1). Even an individual member of the AR can ask for more information, although the V can refuse to give it if the demand is not supported by at least one other member of the AR (§ 90 III S.). Section 107-III authorizes the AR to form permanent or ad hoc committees. Their main functions are to help the AR to make decisions (*e.g.* the nomination of new members of V and the evaluation of risks connected with big loans made by banks). As the AR as a whole (apart again from workers' representatives) is conceived to be "outside" the corporation, these committees do not seem to have the same importance as in the United States. Of course, the AR normally is much too large to adequately perform the supervising function. Very often the main responsibility remains with the chairman of the AR (*e.g.* in the banks he is informed daily and therefore resides inside the main office).

United Kingdom: *Peter Lee*

I believe that much more is now made of nonexecutive directors by U.K. public companies than was the case five years ago. There is a general feeling that boards should include a number of them and their inclusion in boards is gradually becoming more common. I also believe that there is a realization that they should be people with something worthwhile to contribute; that these nominations should not merely be a case of "jobs for the boys" or nepotism as perhaps has sometimes been so in the past.

I think that the use of board committees is probably on the rise; *e.g.* the audit committee which a number of larger companies have created. Board committees remain a key feature in certain areas; *e.g.* in the case of a tender offer a board committee is almost always appointed to deal with the matter.

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Switzerland: *Alain Hirsch*

(1) Swiss public corporations do in fact appoint outside directors. Formally, they are really outside and unaffiliated directors. In fact, they are often directors or managers of other important Swiss companies, lawyers, members of the Swiss Parliament or other public bodies, university professors, etc. Indeed, these people would very often be the majority of the directors in important Swiss companies.

(2) Normally, in an important company the board of directors would appoint one committee only. On average, this committee would meet probably once a month. This committee generally is a "monitoring" committee and not a management committee. However, it also may make some important decisions upon delegation by the board or assist the board in making decisions.

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Notes

[1] *See, e.g.*, N. Leech and R. Mundheim, The Outside Director of the Public Corporation (Korn/Ferry International 1976), *reprinted in* 31 Bus. Law. 1799 (1976).

[2] *See generally* Committee on Corporate Laws, American Bar Association, *The Overview Committees of the Board of Directors*, 35 Bus. Law. 1335 (1980); Kolb, *The Delegation of Authority to Committees of the Board of Directors: Directors' Liabilities*, 9 U. Balt. L. Rev. 189 (1980).

[3] SEC Staff Report on Corporate Accountability (Committee Print, Senate Committee on Banking, Housing and Urban Affairs, 96th Cong., 2d Sess. 1980). 15 U.S.C. section 77a-aa (1982).

[4] 15 U.S.C. section 78a-kk (1982).

[5] Conn. Stock Corporation Act, 33 Conn. Gen. Stat. Ann. section 33-318(b)(1) (Suppl. 1983).

[6] Although the listing requirements of both the NYSE and the AMEX only recommend that listed companies have two outside directors, in practice both exchanges require that companies either have or agree to put outside directors on the board as a condition of listing. *See* NYSE Company Manual, 2 New York Stock Exchange (CCH) ¶2495 G; American Stock Exchange, Requirements and Procedures for Original Listing (1983).

[7] New York Stock Exchange, Audit Committee Policy, 2 New York Stock Exchange (CCH) ¶2495 H (1977).

[8] *See generally* section 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. section 78n(a) (1981), and Regulation NA and Schedules 14A and 14B, 17 C.F.R. section 240.14a-1-240.14a-102.

[9] Korn/Ferry International, Board of Directors Ninth Annual Study, February, 1982.

[10] *See* J. Bacon, Corporate Directorship Practices: The Audit Committee (Conference Board Report No. 766, 1979): The Emergence of the Corporate Audit Committee (Practising Law Institute 1978).

[11] *See* J. Bacon, Corporate Directorship Practices: The Compensation Committee (Conference Board Report No. 829, 1982).

[12] *See* J. Bacon, Corporate Directorship Practices: The Nominating Committee and the Director Selection Process (Conference Board Report No. 812, 1981).

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