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The Revolution in Corporate Governance, The Monitoring Board, and The Director's Duty of Care

George W. Dent
Case Western University School of Law, george.dent@case.edu

THE REVOLUTION IN CORPORATE GOVERNANCE, THE MONITORING BOARD, AND THE DIRECTOR'S DUTY OF CARE†

GEORGE W. DENT, JR.*

I. INTRODUCTION

The theory of corporate governance underwent a revolution in the 1970's. Theorists finally abandoned the myth that a public corporation[1] is managed by its board of directors, and constructed a new model under which the corporation is managed by its executive officers, and the board, dominated by outside directors, monitors management's performance.[2] This new "monitoring model" has gained wide acceptance among commentators,[3] and several of its elements have been adopted by many public corporations.[4] Even those commentators who do not enthusiastically embrace the entire monitoring model tend to agree that monitoring management is a significant board function.[5]

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* Associate Professor of Law, Benjamin N. Cardozo School of Law. B.A., Columbia College, 1969; J.D., Columbia Law School, 1973.

[1] This Article will discuss only public corporations. The role of the board of directors in closely-held corporations poses entirely different questions. For purposes of this Article, "public corporation" means a corporation whose securities are regularly traded on an exchange or over the counter.

[2] *See* notes 33-58 and accompanying text *infra*.

[3] *See* sources cited in note 49 *infra*. Many commentators insist that even more radical changes, such as federal chartering of corporations—perhaps with public directors committed to nonshareholder constituencies—or federal minimum standards for state chartering will be necessary. *See generally* M. GREEN, R. NADER & J. SELIGMAN, TAMING THE GIANT CORPORATION (1976) [hereinafter cited as R. NADER]; Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974); Schwartz, *A Case for Federal Chartering of Corporations*, 31 BUS. LAW. 1125 (1975); Solomon, *Restructuring the Corporate Board of Directors: Fond Hope—Faint Promise?*, 76 MICH. L. REV. 581 (1978). Differences of opinion about corporate governance often reflect radically different views of how corporations should function and to whom they should be accountable. Many advocates of more radical changes in corporate governance want to divert corporations from the pursuit of profit maximization to the pursuit of social goals.

[4] *See* notes 50-56 and accompanying text *infra*.

[5] *See* note 49 and accompanying text *infra*. The only major criticism of the monitoring model has been by Solomon, *supra* note 3. Solomon examines three cases of boards restructured in the wake of corporate scandals. He finds the restructuring unsatisfactory because "[n]ew directors have been drawn from the

But expositions of the monitoring model to date have been rudimentary. Its proponents have not suggested what forces will prompt corporations to adopt the model and thereby move it from theory to widely accepted reality. Nor have they described in detail what the board's duties would be under the model, much less how these duties would be discharged. Until these problems are satisfactorily resolved, the potential of the monitoring model for improving corporate governance must be considered an open question.

This Article grapples with these problems. In exploring the possible mechanisms for enforcing adoption of and performance under the monitoring model, the Article concludes that market forces alone will not suffice and that legislative solutions face insuperable political and theoretical obstacles.[6] Accordingly, special attention is given to the duty of care of directors and officers as a possible enforcement mechanism. The duty of care has been a problem child of corporate law. Its command that directors and officers perform their duties with reasonable prudence appears on its face to provide a significant constraint on directors and officers, especially in an age when control has become divorced from ownership in public corporations.[7] In practice, however, the duty of care has proved almost totally ineffectual.[8] A key question concerning the monitoring model, then, is what will be the content of the duty of care given the new role of the director that the model envisions and, more particularly, whether the duty of care can be revived and used as a tool for enforcing the monitoring model.

It will be seen that justifications for the evisceration of the duty of care are unpersuasive; accordingly, the way is open to its revitalization.[9] However, analysis of the possible duties of directors under the monitoring model will show that in many respects it will be extremely difficult or impossible to fashion legal rules for the enforcement of these duties.[10] These conclusions

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same elite as old directors," *id.* at 596 (even though he concedes that appointment of "nonestablishment" directors creates overwhelming problems, *id.* at 601-02) and because "new boards have not been notably more aggressive than unreformed boards," *id.* at 596. He does not, however, explain how or why the directors should have been more aggressive. Nor does he explain why the directors were not aggressive, except for his statement that they were drawn from "the same elite as old directors," a practice which he seems to concede is unavoidable. Nor does he consider possible approaches to make the restructured board more effective. Some commentators, though they do not criticize monitoring itself, have criticized the outsider dominated board, which is fundamental to monitoring. S. VANCE, BOARDS OF DIRECTORS: STRUCTURE AND PERFORMANCE 5 (1964); Schmidt, *Does Board Composition Really Make a Difference?*, 12 CONF. BD. REC. 38 (Oct. 1975).

[6] *See* notes 66-123 and accompanying text *infra*.

[7] *See* text following note 223 *infra*.

[8] *See* notes 131-64 and accompanying text *infra*.

[9] *See* notes 165-207 and accompanying text *infra*.

[10] *See* Section VI *infra*.

suggest that the new model's potential to improve corporate governance may be more limited than its proponents have hoped.[11]

II. The Revolution in Corporate Governance

A. *The Failure of the Old Model*

The keystone of the traditional model of corporate governance was the provision once contained in state corporate laws that "[t]he business and affairs of a corporation shall be managed by the board of directors."[12] In fact, boards of directors do not and have never managed public corporations. That task is performed by the executive officers, particularly the chief executive officer.[13] These corporate officers may also be members of the board, but their power to manage derives not from board membership but from corporate office.[14] Outside directors—directors who hold no office with the corporation—play little role in its management.[15] With few exceptions, the board quickly rubberstamps proposals drafted by the true management, the executive officers. As Myles Mace showed in his classic study, *Directors: Myth and Reality*, directors occasionally give advice and counsel at the request of the chief executive officer, provide some limited discipline over management, and replace the chief executive officer in times of crisis.[16] The

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[11] *See* text following note 302 *infra*.

[12] The Business Corporation Act of 1933, § 33, ILL. ANN. STAT. ch. 32, § 157.33 (Supp. 1974) (Smith-Hurd). *See also* DEL. CODE ANN. tit. 8, § 141(a) (1974); N.J. STAT. ANN. § 14A:6-1 (West Supp. 1968); N.Y. BUS. CORP. LAW § 701 (McKinney Supp. 1974). These statutes and most others have now been modified to provide that the corporation shall be managed by *or under the supervision of* a board of directors. *See* note 31 and accompanying text *infra*.

[13] *See* J. BAKER, DIRECTORS AND THEIR FUNCTIONS 12 (1945); H. KOONTZ, THE BOARD OF DIRECTORS AND EFFECTIVE MANAGEMENT 21 (1967); M. MACE, DIRECTORS: MYTH AND REALITY 73, 76-77, 80 (1971).

[14] This is proved not only by the impotence of directors who hold no corporate office—the outside directors—but also by the manner in which corporate decisions are made. Advice is sought and disputes are resolved among the officers before the board meeting. Proposals are generally approved unanimously by the board after a little friendly discussion. Boards rarely reject decisions reached by the controlling corporate officers. *See* M. MACE, *supra* note 13, at 43-71.

[15] *See* H. KOONTZ, *supra* note 13, at 21. This is not a new discovery. Over a century ago one committee concluded that "the very necessities of the case" made "practice ciphers" of the outside directors. REPORT OF THE INVESTIGATING COMMITTEE OF THE PENNSYLVANIA RAILROAD COMPANY 169 (Philadelphia 1874), *quoted in* A. CHANDLER, STRATEGY AND STRUCTURE 313 (1962).

[16] M. MACE, *supra* note 13, at 13. *See also* M. EISENBERG, THE STRUCTURE OF THE CORPORATION 140-41 (1976).

board does not even plan the corporation's general strategy, as some have argued it could or should do.[17]

The directors' failure to manage springs not from personal negligence but from a basic structural defect in the traditional model of corporate governance; that is, the board could not manage the corporation even if it wanted to do so. First, the chief executive officer dominates the board. Despite the trend toward more outside directors,[18] boards traditionally have been, and in many cases still are, composed largely of insiders[19]—the chief executive officer and his subordinates. The subordinates cannot flout the chief's authority when functioning as directors in his presence.[20] Outside directors, though less subject to the control of the chief executive officer, are still unlikely to be very independent. Many are either quasi-insiders whose autonomy is curbed by economic ties to the corporation and its head,[21] or else

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[17] R. GORDON, BUSINESS LEADERSHIP IN THE LARGE CORPORATION 128-29, 131 (2d ed. 1961); M. MACE, *supra* note 13, at 43, 68. *But see* C. BROWN, PUTTING THE CORPORATE BOARD TO WORK 30 (1976) ("the board of directors is the proper body for the establishment of broad policies and procedures"). Nor do the outside directors select the chief executive officer, M. MACE, *supra* note 13, at 65, 70; have a significant approval role, R. GORDON, *supra* at 128-29; or even ask significant questions, M. MACE, *supra* note 13, at 52-55, 69.

[18] CONFERENCE BOARD, THE BOARD OF DIRECTORS 84 (1977); HEIDRICK & STRUGGLES, INC., THE CHANGING BOARD 6 (1977); KORN/FERRY INTERNATIONAL, BOARD OF DIRECTORS: FIFTH ANNUAL STUDY 3, 9 (1978); Small, *The Evolving Role of the Director in Corporate Governance*, 30 HASTINGS L.J. 1353, 1356 (1979).

[19] *See* HEIDRICK & STRUGGLES, INC., THE CHANGING BOARD UPDATE 3 (1978) (ratio of outside directors remained virtually unchanged from 1971 to 1978); M. EISENBERG, *supra* note 16, at 144-45; H. KOONTZ, *supra* note 13, at 123 (arguing that recognition of a trend to more outside directors depends on a dubious definition of "outside director").

[20] M. EISENBERG, *supra* note 16, at 144-45; M. MACE, *supra* note 13, at 119-20; E. MCSWEENEY, MANAGING THE MANAGERS 105 (1978); Solomon, *supra* note 3, at 584. *See* W. CARY & M. EISENBERG, CASES AND MATERIALS ON CORPORATIONS 926 (5th ed. unabridged 1980); Leech & Mundheim, *The Outside Director of the Publicly Held Corporation*, 31 BUS. LAW. 1799, 1803-04 (1976). Although the chief executive may not have absolute power over the other officers, any differences in opinion among them are likely to be hammered out before the board meeting. Management then presents a united front at the meeting. *See* M. MACE, *supra* note 13, at 120.

[21] Moscow, *The Independent Director*, 28 BUS. LAW. 9, 11 (1972); Solomon, *supra* note 3, at 590. *See* Leech & Mundheim, *supra* note 20, at 1830. *Cf.* M. EISENBERG, *supra* note 16, at 146 ("approximately one-fifth to one-quarter of the outside directors . . . are lawyers or investment bankers [most of whom] are suppliers of services to the corporation"); KORN/FERRY INTERNATIONAL, BOARD OF DIRECTORS ANNUAL STUDY: BILLION DOLLAR INDUSTRIALS SUPPLEMENT 4 (1979) (reporting that although the average nominating committee of the companies studied had one inside and four outside directors, two of the four outsiders were

friends of the chief executive officer.[22] Moreover, most outside directors are corporate executives who expect outside directors to play a passive role on their own boards and who naturally play a passive role when they themselves are outside directors.[23] Directors who cause trouble may be fired.[24]

Outside directors lack not only the independence but also the intimate knowledge of the corporation, the time, and the information generated by an independent staff that would be necessary to manage. Most outside directors have their primary jobs with corporations in industries different from the corporations on whose boards they sit; indeed, the antitrust laws would generally prevent the use of outside directors from corporations in the same

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"affiliated" so that a majority of the average nominating committee consisted of insiders and quasi-insiders). Indeed, there is some dispute whether some directors typically classified as outsiders should be so classified. *See* H. KOONTZ, *supra* note 13, at 122; M. MACE, *supra* note 13, at 10 n.2. *But see* Lubin, *Outsiders In: Firms Adding More Independent Directors But Finding Doing So Can Mean Headaches*, Wall St. J., May 26, 1978, at 38, col. 1 (stating that recently fewer outside directors have been "quasi-insiders"). This has prompted a trend toward using different terms. The New York Stock Exchange's Audit Committee Policy, for example, uses the term "independent director," which it defines as a person "free from any relationship that . . . would interfere with the exercise of independent judgment." NYSE GUIDE (CCH) ¶ 2495H (1977). In 1978, the SEC proposed to characterize directors as affiliated and unaffiliated but later abandoned the proposal. *See* SEC Exchange Act Release No. 14,970 (July 18, 1978), [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,645; notes 93-95 and accompanying text *infra*.

[22] M. EISENBERG, *supra* note 16, at 146; M. MACE, *supra* note 13, at 95, 97-100, 108; Solomon, *supra* note 3, at 584-85; *Corporate Rights and Responsibilities: Hearings Before the Senate Comm. on Commerce*, 94th Cong., 2d Sess. 327-28 (1976) [hereinafter cited as *Senate Hearings*] (statement of Roderick M. Hills) ("outsiders . . . are all too often old friends of the chief executive officers who would rather resign from the board than severely criticize or vote to oust their old friend"). *See* J. BACON, CORPORATE DIRECTORSHIP PRACTICES 28 & Table 4 (1973). *See also* Lasker v. Burks, 567 F.2d 1208, 1212 (2d Cir. 1978), *rev'd on other grounds*, 441 U.S. 471 (1979). *But cf. Senate Hearings*, *supra*, at 140 (statement of Richard M. Cyart) ("[r]ecruitment [of new directors] is not a question of the president getting friends on the board").

[23] E. MCSWEENEY, *supra* note 20, at 106; Solomon, *supra* note 3, at 584 n.13. *See* M. MACE, *supra* note 13, at 54, 69-70 (indicating that chief executive officers consider the role of outside director a minor, passive one). *See also* note 148 *infra*.

[24] M. MACE, *supra* note 13, at 80; E. MCSWEENEY, *supra* note 20, at 106. *See also* HEIDRICK & STRUGGLES, INC., *supra* note 18, at 12 (over 36% of industrial corporations surveyed reported having "fired" directors). Some have referred to the "mushroom" concept of a good director: "Put him in a damp dark place, feed him plenty of horse manure, and when his head rises up through the pile to get attention or ask a question cut it off quickly and decisively." John T. O'Connor, An Alternative to the Goldberg Prescription, Remarks before the American Society of Corporate Secretaries 4 (March 14, 1973) *quoted in* C. BROWN, *supra* note 17, at 6.

industry.[25] Their contact with the corporation is usually limited to a meeting of a few hours' duration once a month or less frequently,[26] much too little time to learn to manage a public corporation. Information presented to the board is prepared under the chief executive officer's control and usually arrives too late to be digested by the outsiders before they must act on it.[27] The minimal pay given most directors shows how insignificant their role is in corporate governance.[28] Thus, outside directors are neither disposed nor able to play an active role in managing the corporation.

In light of the commentators' recognition that boards cannot manage, it is not surprising that courts have explicitly held on occasion that the directors are not liable for failing to do so.[29] More often, though, courts have maintained the fiction that the board must manage, but in various ways have whittled the duty down almost to nothing.[30] In either case, the board was left, so far as the courts were concerned, with no significant function. Some state corporation laws have been amended to reflect the realization that boards do not manage. The Model Business Corporation Act, for example, was revised to provide that "the business and affairs of a corporation will be managed under the direction of a board of directors," and many state

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[25] Clayton Act § 8, 15 U.S.C. § 19 (1976).

[26] M. EISENBERG, *supra* note 16, at 141-43 ("few boards spend more than thirty-six hours a year in meeting time" and "time spent preparing for meeting is roughly comparable to meeting time"); KORN/FERRY INTERNATIONAL, *supra* note 18, at 20 (median time spent is a little over 70 hours per year, "industry time on committees and expected homework"); M. MACE, *supra* note 13, at 107, 109, Mace, *Designing a Plan for the Ideal Board*, 54 HARV. BUS. REV. 20 (Nov.-Dec. 1976).

[27] M. EISENBERG, *supra* note 16, at 143-44. *See also* M. MACE, *supra* note 13, at 107 ("And to assume that company presidents [as outside directors]—busy company presidents—will spend the time to do the homework essential to understanding company problems is asking more than should be reasonably expected.").

[28] H. KOONTZ, *supra* note 13, at 147 (directors "are among the lowest-paid segments of the American managerial hierarchy"); M. MACE, *supra* note 13, at 101-04; *Senate Hearings*, *supra* note 22, at 327-28 (statement of former SEC Chairman Roderick M. Hills) ("Compensation for directors of too many large corporations is set at a figure which makes it apparent that no real work is expected."). However, this may be changing. Heidrick & Struggles' survey shows that the median compensation for companies surveyed jumped from under $8,000 in 1976 to over $12,000 in 1980. For larger corporations, compensation was considerably higher. HEIDRICK & STRUGGLES, INC., THE CHANGING BOARD: 1980 UPDATE (1980).

[29] Graham v. Allis-Chalmers Mfg. Co., 41 Del. Ch. 78, 85-86, 188 A.2d 125, 130 (S. Ct. 1963); Veasey & Manning, *Codified Standard—Safe Harbor or Uncharted Reef?, An Analysis of the Model Act Standard of Care Compared with Delaware Law*, 35 BUS. LAW. 919, 924-25 & authorities cited at 925 n.23 (1980).

[30] *See* notes 130-64 and accompanying text *infra*.

statutes followed suit.[31] Although the amendments relieve the board of the duty to manage, they give no inkling of what the directors are supposed to do.[32]

B. *The New Model: The Board as Monitor of Corporate Officers*

The old model of corporate governance having been discredited, commentators began to fashion a new model that concedes to the executive officers the authority to manage but retains a useful role for the board. Professor Melvin Eisenberg, the leading advocate of the new model, reviewed proposals intended to enable the board to manage—including ones that called for fully-staffed boards and boards dominated by professional or full-time directors—and concluded that none was likely to succeed.[33] He argued that, rather than make an unrealistic demand that the board manage the corporation, we should try to ascertain what useful functions boards can perform and then conform the model of corporate governance to that reality.[34] Examining those functions that the board can perform, he found none very important except the monitoring function.[35] He therefore proposed a new model of corporate governance that focuses on the board's monitoring function.

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[31] MODEL BUS. CORP. ACT § 35 (1976). The Committee on Corporate Laws of the Section of Corporation, Banking and Business Laws of the American Bar Association approved the revision on September 21, 1974. *Report of Committee on Corporate Laws: Changes in the Model Business Corporation Act,* 30 BUS. LAW. 501 (1975). For a discussion of identical and comparable state statutes, see MODEL BUS. ACT ANN. § 35, Par. 1, ¶¶ 3.01-.02 (2d ed. 1977 Supp.). *See also* DEL. CODE ANN. tit. 8, § 141 (1980 Supp.); N.Y. BUS. CORP. LAW § 701 (McKinney 1963); W. CARY & M. EISENBERG, *supra* note 20, at 140.

[32] *See* Leech & Mundheim, *supra* note 20, at 1799; Vagts, *Directors: Myth and Reality,* 31 BUS. LAW. 1227, 1230 (1976). The comment to the amendment of § 35 states that directors need not "become involved in the detailed administration of the corporation's affairs" but "may delegate to appropriate officers of the corporation the authority to exercise those powers not required by law to be exercised by the board itself." As to what directors *are* supposed to do, the comment says only that "the board has the power to probe to any depth but has a responsibility to do so only to the extent that the standard of care would require." *Report of Committee on Corporate Laws: Changes in the Model Business Corporation Act,* 30 BUS. LAW. 501, 504-05 (1975).

[33] M. EISENBERG, *supra* note 16, at 49-56. *See also* Eisenberg, *Legal Models of Management Structure in the Modern Corporation: Officers, Directors, and Accountants,* 63 CALIF. L. REV. 375 (1975), one of a series of articles on which the book just cited is based. The proposals rejected by Professor Eisenberg call for professional directors, full-time directors, and fully-staffed boards.

[34] M. EISENBERG, *supra* note 16, at 156.

[35] *Id.* at 156-68. The functions Professor Eisenberg deems unimportant are giving advice and counsel to the chief executive officer, authorizing major corporate functions, and providing a vehicle for exercising influence or control.

Discussion of the monitoring model is complicated by the absence of any detailed definition of what it is or how it would be effectuated. Professor Eisenberg and others have described the new model in a rudimentary fashion only.[36] The purpose of this Article is not to define the model precisely but to inquire whether under any plausible definition the model would be enforceable. It is therefore appropriate simply to describe the areas of agreement and the undecided issues concerning the model's definition. All agree that monitoring entails selecting, evaluating, and, if necessary, removing and replacing directors and corporate executives.[37] Corollary functions include fixing management's compensation, reviewing transactions between the corporation and its insiders, and overseeing management's compliance with the law. It is an open question whether the board would select corporate accounting procedures.[38] The commentators have not suggested the methods by which the board should discharge its duties—for example, how the board could evaluate management's performance or monitor management's compliance with law, or whether the board should have an independent staff to provide it with information.

Another open question is whether the board should consider social as well as financial goals in evaluating management's performance.[39] This Article will not attempt to resolve the old and continuing debate about for whom corporate managers are trustees—the shareholders or society at large.[40] More important than the author's agreement with those who would restrict the board to representing shareholder interests is the fact that adoption of

[36] *See id.* at 162-66. According to Professor Eisenberg, monitoring is intended "to determine whether the incumbent should remain in place." *Id.* at 164. Toward this end the board must set objectives "against which to measure management's results" and then "[go] behind the result" to determine whether it has been affected by unanticipated factors. *Id.* at 166. However, he does not suggest by what structures or procedures the board will do this, how the board will determine appropriate objectives, how disputes between the board and management should be resolved, or answers to many other questions critical to the monitoring model. Professor Mace does go into somewhat greater detail, but only by way of a list of board functions without substantial discussion of how these functions are to be discharged (*e.g.*, by what standards executive compensation is to be set). Mace, *supra* note 26, at 21-22. Professors Leech and Mundheim discuss the proper functions of the board in somewhat greater depth, but without suggesting concrete standards for performance of these funtions. Leech & Mundheim, *supra* note 20. Most other advocates (*see* sources cited in note 49 *infra*) have been very vague. Mundheim, *A Time to Learn*, in COMMENTARIES ON CORPORATE STRUCTURE AND GOVERNANCE 179, 179-80 (D. Schwartz ed. 1979) ("not many . . . have gone beyond sketching the content of [monitoring] in a few specific situations.").

[37] M. EISENBERG, *supra* note 16, at 162-68; Mace, *supra* note 26, at 21-22; Manning, *Thinking Straight About Corporate Law Reform*, 41 LAW & CONTEMP. PROB. 3, 27 (Summer 1977).

[38] *See* notes 270-78 and accompanying text *infra*.

[39] Professor Eisenberg believes the board should consider social goals. M. EISENBERG, *supra* note 16, at 165.

[40] *See* notes 295-97 and accompanying text *infra*.

the monitoring model itself will not lead to abandonment of a profit orientation.[41] Accordingly, this Article will analyze monitoring from the perspective of a traditional profit orientation.

A key question is to what extent, if any, the board would retain authority to set or to review long range goals and major projects. Professor Eisenberg believes that the board is incompetent to decide these matters. Moreover, assigning these duties to the officers would facilitate development of an effective duty of care.[42] However, whether the courts will permit boards to abdicate completely their traditional authority over major corporate policy is questionable.[43] The revision of the Model Act and of many state statutes to relieve the board of the express duty to manage the corporation's business does not seem to have been intended to deny the board's authority over long range goals and major projects.[44]

If the board does retain some power over long range goals and major projects, the difference between the monitoring model and the traditional model of corporate governance is arguably a difference of emphasis only. Even if this is true, however, the difference of emphasis is significant. The traditional model has tended to view the corporate officers as mere functionaries effectuating the orders of the board.[45] Accordingly, any duty

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[41] *See* notes 298-99 and accompanying text *infra*.

[42] M. EISENBERG, *supra* note 16, at 140-41. *Accord,* Conard, *A Behavioral Analysis of Directors' Liability for Negligence,* 1972 DUKE L.J. 895, 917; Solomon, *supra* note 3, at 588. *But see* Goldschmid, *The Governance of the Public Corporation: Internal Relationships,* in COMMENTARIES ON CORPORATE STUCTURE AND GOVERNANCE 167, 174 (D. Schwartz ed. 1979).

[43] Although the board may delegate many functions, it may not delegate all of its power, or so much of it as to be inconsistent with its duty to provide general supervision of the corporation. 2 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 496 (rev. perm. ed. 1975).

[44] The *Corporate Director's Guidebook* says that the purpose of the revision was to "emphasize" the duty, *inter alia,* to "review and confirm basic corporate objectives." Committee on Corporate Laws, Section of Corporation, Banking & Business Law, American Bar Ass'n, *Corporate Director's Guidebook,* 33 BUS. LAW. 1595, 1607 (1978) [hereinafter cited as *Corporate Director's Guidebook*]. The comment to section 35 states that the 1974 amendment was intended "to eliminate any ambiguity as to the director's role in formulating management policy as opposed to direct involvement in day-to-day management." *Report of Committee on Corporate Laws: Changes in the Model Business Corporation Act,* 30 BUS. LAW. 501, 505 (1975). However, the comment does not indicate precisely what the board's role is in management policy. *See* note 32 *supra*.

[45] "Traditionally, officers are selected, and are removable, by the board of directors, which delegates to them authority to execute and administer the policies determined by the board of directors." H. HENN, HANDBOOK OF THE LAW OF CORPORATIONS § 219, at 432 (2d ed. 1970) (footnote omitted). Accordingly, officers have only such powers as are conferred on them by the board or corporate charter. 2 W. FLETCHER, *supra* note 43, § 434, at 301-03. Thus officers who are not directors are not deemed trustees, as are directors, but mere agents. 3 *id.* § 846. *See generally id.* § 1032.

to manage carefully rested with the board. Similarly, the board's duty to monitor the corporate officers was accorded little importance on the theory that the officers were mere functionaries. The monitoring model reverses this approach by placing the duty to manage primarily, if not exclusively, with the corporate officers and by elevating to major significance the board's duty to monitor.

Although the utility of outside directors has hitherto been limited,[46] the monitoring model may change this. The outside directors are not asked to manage, a task for which they are ill-suited, but only to monitor management, a task for which an outsider's perspective is well-suited, perhaps even necessary. Inside directors cannot be expected to evaluate their own performance dispassionately. Moreover, once it is candidly recognized that the board does not itself manage but rather monitors management, arguments for a board dominated by outsiders become much more persuasive.[47] Once outsiders dominate the board and control nominating procedures, they will be in a much better position to act independently of management.[48]

Many commentators have accepted Professor Eisenberg's views or ones similar to them.[49] More important, many corporations are stressing the

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[46] *See* notes 25-28 and accompanying text *supra*.

[47] One argument against the outsider-dominated board has been that outsiders are less competent than insiders to manage the corporation. *See* Bialkin, *Exaggerating the Moral Decline in Governance of Corporations*, NAT. L.J., Dec. 25, 1978, at 26, col. 1. This argument is valid, however, only if the board is indeed supposed to manage. *But see* note 254 and accompanying text *infra*.

[48] *See* notes 251-52 and accompanying text *infra*.

[49] C. BROWN, *supra* note 17, at 10, 109; Conard, *supra* note 42, at 917 (outside directors' function is "to decide whether the inside directors are doing a reasonably good job"); DUTIES AND RESPONSIBILITIES OF OUTSIDE DIRECTORS (A. Cohen & R. Loeb eds. 1978) (statement of Ralph C. Ferrara); Friendly, *Make Haste Slowly*, in COMMENTARIES ON CORPORATE STRUCTURE AND GOVERNANCE 525, 527-31 (D. Schwartz ed. 1979); Goldschmid, *The Governance of the Public Corporation: Internal Relationships*, in *id.*, at 167, 174; Mace, *supra* note 26, at 21; Manning, *supra* note 37; Mundheim, *A Time to Learn*, in COMMENTARIES ON CORPORATE STRUCTURE AND GOVERNANCE 179 (D. Schwartz ed. 1979); Werner, *Management, Stock Market and Corporate Reform: Berle and Means Reconsidered*, 77 COLUM. L. REV. 388, 412 (1977). The SEC has in speeches, enforcement actions, and explanatory releases encouraged changes in corporate governance generally consistent with the monitoring model. *See* Solomon, *supra* note 3, at 581 n.4, 582 n.6, 586-87; Weiss & Schwartz, *Using Disclosure to Activate the Board of Directors*, 41 LAW & CONTEMP. PROB. 63, 76-78 (Summer 1977).

Some commentators seek more radical changes in corporate governance, changes that would direct much of the energies of the corporation away from profit maximization toward social goals. *See* Solomon, *supra* note 3, at 610. But the monitoring model is not inconsistent with these more radical views. Under the model, the officers attempt to achieve the corporation's goals, whatever they may be, and the

director's monitoring function, as evidenced by the growing number of both outside directors[50] and oversight committees. The oversight committees are established expressly to perform various monitoring functions.[51] The most common are audit committees, which review the independent accountant's reports on auditing and accounting matters;[52] nominating committees, which review the performance of incumbent directors, suggest the removal of unsatisfactory directors, and recommend replacements for vacancies;[53] and compensation committees, which review compensation of executive officers and may evaluate management's performance as part of this review.[54] Most of these committees are composed primarily or exclusively of outside directors.[55] Acceptance of monitoring by commentators and corporations has led the *Corporate Director's Guidebook* and some other authorities to speak of a duty of monitoring as if it were established fact rather than a remote ideal.[56]

Advocates of the monitoring model hope that it will provide some meaningful check on self-serving behavior, incompetence, or complacency on the part of management, a check not always provided by shareholders or market forces. The result would be more honest and effective management—and perhaps greater faith in, and thus more legitimacy for, corporate man-

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board evaluates management's performance, a task that necessarily entails setting the corporation's goals.

[50] In 1977, 83% of manfacturing companies and 86% of nonmanufacturing companies were reported to have a majority of outside directors. J. BACON & J. BROWN, THE BOARD OF DIRECTORS: PERSPECTIVES AND PRACTICES IN NINE COUNTRIES (1977). *See also* sources cited in note 18 *supra*.

[51] W. CARY & M. EISENBERG, *supra* note 20, at 216-17, and authorities cited therein. *See generally* A.B.A. Comm. on Corp. Laws, *The Overview Committees of the Board of Directors*, 34 BUS. LAW. 1837 (1979). As to the growth of compensation, nominating, and audit committees, *see* notes 219, 252, & 265 *infra*.

[52] Under pressure from the SEC, *see* SEC Securities Exchange Act Release No. 13,346 (Mar. 9, 1977), the New York Stock Exchange adopted a rule requiring each listed company to have an audit committee composed entirely of directors independent of management. NYSE GUIDE (CCH) ¶ 2495H (1977). An independent director is defined as one "free from any relationship that . . . would interfere with the exercise of independent judgment." *Id. See generally* notes 265-78 and accompanying text *infra* for a discussion of the audit committee.

[53] *See* note 252 *infra*. *See* also notes 251-63 and accompanying text *infra* for a general discussion of nominating committees.

[54] *See* note 219 *infra*. *See* also notes 217-50 and accompanying text *infra* for a general discussion of compensation committees.

[55] A recent survey by the SEC shows that the vast majority of overview committees of the companies surveyed had a majority of outsiders and that in many cases these committees were composed exclusively of outsiders. SEC Exchange Act Release No. 17,518, SEC Docket 1551, Tables 14-18, at 1571-77 (Feb. 5, 1981).

[56] *See* W. CARY & M. EISENBERG, *supra* note 20, at 557-62; *Corporate Director's Guidebook, supra* note 44, at 1607-10.

agements.[57] Others have questioned whether the model can improve corporate governance at all.[58]

III. Prospects for Adoption of the Monitoring Model Voluntarily or as a Result of Market Forces

Despite auspicious trends, the monitoring model is far from universally accepted. Most boards remain dominated by insiders or quasi-insiders,[59] and most lack mechanisms to perform certain crucial monitoring functions.[60] Moreover, monitoring has received little judicial recognition. Unless the law imposes a duty to monitor, bureaucratic inertia and the human distaste for being judged will make many managements reluctant to adopt vigorous monitoring boards.

Outside directors alone cannot be expected to impose a monitoring board on a corporation. They may justifiably fear that voluntary acceptance of a duty to monitor will increase their exposure to personal liability, especially since the traditional posture of director passivity has avoided liability so well.[61] Active monitoring will require more time from outside directors than the traditional model requires.[62] Outsiders will not assume additional chores without additional compensation. Without some strong, external incentive they may decline to vote themselves adequate raises because the resultant fees would seem excessive in comparison with fees at corporations where directors were not required to monitor. Even with increased fees, many outside directors, being wealthy and busy executives, will hesitate to devote more time to a position they consider honorary.[63] Moreover, if they agree to monitor management aggressively they will be hard put to oppose board monitoring of their own performance in the corporations they manage. Even if outside directors were disposed to monitor, they are outnumbered by inside and affiliated directors in many corporations and thus will be unable to impose their will on the corporation.[64]

Management will not voluntarily adopt monitoring. Monitoring by the

[57] *See* Leech & Mundheim, *supra* note 20, at 1804. Most commentators have discussed monitoring in terms of dealing with existing problems rather than in terms of improving management or enhancing corporate legitimacy, *see* authorities cited in note 49 *supra*, but the two approaches are only different sides of the same coin.

[58] De Mott, *Reweaving the Corporate Veil: Management and Structure and the Control of Corporate Information*, 41 Law & Contemp. Prob. 182, 220-21 (Summer 1977); Solomon, *supra* note 3, at 588-89, 610. *See* note 3 *supra*.

[59] *See* note 19 and accompanying text *supra*.

[60] *See, e.g.*, notes 219-21 and accompanying text *infra*.

[61] *See* note 130 and accompanying text *infra*.

[62] *See* H. Koontz, *supra* note 13, at 151, 232; Goldschmid, *supra* note 42, at 175; Leech & Mundheim, *supra* note 20, at 1829.

[63] A principal reason for serving as an outside director is the prestige and honor of the position. M. Mace, *supra* note 13, at 105-09. Concerning the fee levels of directors, *see* note 28 *supra*.

[64] *See* note 19 and accompanying text *supra*.

board threatens not only criticism of management, perhaps disclosed to the public,[65] but also the discharge of managers found incompetent. Even confident managers may prefer not to submit to independent board evaluation unless managers of other corporations do likewise. Since few will want to be in the vanguard, monitoring will not be widely embraced unless required by some external forces. Even good faith efforts to install a monitoring system will be more successful if there is a legal duty imposed on directors to monitor. Finally, the initial burst of enthusiasm for monitoring cannot be expected to last forever. As the novelty of the new model wears off, commentators, the bar, and the SEC will turn their attention elsewhere; boards will feel less public pressure to monitor and will be less inclined to adopt the new model unless compelled by law to do so.

But it may be argued that enforcement of the monitoring model is unnecessary and even counterproductive because market forces alone will push corporations to the optimal type and the amount of monitoring. Market forces are believed to motivate corporate managers to perform well: their performance affects the market price for the firm's securities, thereby affecting not only their current income (through bonuses, stock options, and the value of stock already held), but also their job security (by changing the likelihood of a takeover of the firm by outsiders)[66] and the market for their services with other corporations.[67] It could be argued that market forces will similarly affect the composition and functioning of the board. If monitoring maximizes corporate profits, corporations failing to adopt the model will see the market price of their stock fall and will be threatened by takeovers in which all directors will be replaced. In addition to takeover threats, both outside directors and insiders would have positive incentives to adopt monitoring. If board evaluation of management's performance became significant to investors, management might insist on such evaluation as a means of boosting both the firm's stock price and the market for the managers' services.[68] If monitoring became widely accepted, a market would develop

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[65] *See* note 228 *infra*.

[66] Anderson, *Conflicts of Interest: Efficiency, Fairness and Corporate Structure*, 25 U.C.L.A. L. REV. 738, 784-86 (1978); Fama, *Agency Problems and the Theory of the Firm*, 77 J. POL. ECON. 288 *passim* (1980); Lorie, *An Economist's Perception I: A View on the Need to Revise Corporation Statutes*, in COMMENTARIES ON CORPORATE STRUCTURE AND GOVERNANCE 51, 56-59 (D. Schwartz ed. 1979); Werner, *supra* note 49, at 404-05 and authorities cited in 404 n.105.

[67] *See* Fama, *supra* note 66, at 292-93; Werner, *supra* note 49, at 404. "[I]n some corporations the excruciating pressure to meet profit goals is so severe that some managers have committed illegal acts to induce sales, and falsified corporate books to conceal improper accounting entries designed to improve earnings or put a better face on corporate performance." Speech by SEC Chairman Harold Williams, Adequate Information: Prerequisite to an Effective Board 16-17 (Sept. 16, 1980) (presented to the Financial Executives Research Foundation/American Society of Corporate Secretaries, Philadelphia, Pa.).

[68] *See* Fama, *supra* note 66, at 292-93. *Cf.* Burton, *Management Auditing*, in

for the services of effective outside directors, and outside directors would want to monitor effectively so as to increase the value of their services in the market.[69] If, on the other hand, the monitoring model is not the most effective way of improving management's performance, market forces will discover the most efficient way and punish corporations that adopt monitoring instead.[70] If this were the case, legal rules requiring monitoring could be counterproductive.

The argument for reliance on market forces alone has several flaws. First, even if market forces do ultimately punish corporations that fail to adopt monitoring, that punishment, when it occurs, may be visited not on the managers but on the shareholders. Even an inevitable but distant takeover may not deter managers from lining their own pockets or keeping themselves in power too long because the day of reckoning is remote and the benefits in the interim are so great.[71] The shareholders will suffer, however, from lowered dividends and a lower price for their stock when the takeover does come.[72]

Furthermore, market forces operating through the outside directors are not likely to be sufficient. First, in many corporations, genuinely independent directors are too few to be able to impose their will.[73] Second, a market for outside directors is unlikely to influence those outside directors who are highly paid executives of other corporations and who would not want careers as professional directors, even at fees considerably higher than the current mode. A sense of responsibility and concern for personal reputation will motivate outside directors to monitor in many cases, but where they do not, market forces will not oblige them to do so. Moreover, if the outsiders control the board, they may be able, subject only to a takeover threat,[74] to ignore the market for their services as outside directors and vote themselves lavish fees without providing efficient monitoring.

MODERN MANAGEMENT: ISSUES AND IDEAS 483, 492 (D. Hampton ed. 1969) (creditors, investors, and managers might insist on release of management audits).

[69] *See* Fama, *supra* note 66, at 294; Lear, *Compensation for Outside Directors*, 57 Harv. L. REV. 18, 28 (1979) (increasing competition for outside directors has caused and will continue to cause higher directors' fees).

[70] *See* Fama, *supra* note 66.

[71] *See id.* at 296; Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 273 (1977).

[72] In computing the amount per share the tender offeror is willing to pay shareholders of the target, it must subtract from the total amount the immense transaction costs of making the bid. It also must reduce the price to account for the risk that his offer may fail. Most important, the offeror will bid no more than necessary to obtain control. Since the price of shares in a mismanaged company will almost always be relatively low, the offeror may be able to gain control at a price well below what the shares would command if the company were well managed, especially if no competing bidders appear. Indeed, some believe that offerors do not attempt takeovers except at bargain prices. Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 106-09 (1979).

[73] *See* note 19 *supra*.

[74] Just as the threat of a takeover is insufficient to ensure energetic, competent,

Most important, the market for corporate control is not so efficient that a takeover will immediately (or perhaps ever) punish even the slightest deviation from maximum efficiency. Even in an ideal takeover situation—minimal government regulation, a target company with stock widely scattered among many shareholders, and little stock held by management—the takeover of a large public company involves substantial transaction costs and risks of failure.[75] Moreover, the ideal is rare. Some corporations are so huge that any attempt to take them over is unthinkable. Others, their managements wary of takeovers, have a variety of shark-repellents to deter tender offers.[76] Indeed, a servile board is an important element in any anti-takeover strategy. A servile board will approve any action by management, however outrageous, to keep itself entrenched.[77] The independent board envisioned by the monitoring model might take a neutral or even a favorable stance toward a takeover.[78] State and federal regulation of tender offers has also made them more difficult. At a minimum, disclosure requirements, such as those imposed by the SEC under the Federal Williams Act, make tender offers very expensive.[79] Many states' tender offer laws were adopted with the thinly

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and efficient management, *see* note 71 *supra* and 75 *infra,* that threat will also be insufficient to ensure energetic and competent outside directors.

[75] *See* O. WILLIAMSON, CORPORATE CONTROL AND BUSINESS BEHAVIOR 99-100 (1970); Winter, *supra* note 71, at 267-70.

[76] M. LIPTON & E. STEINBERGER, TAKEOVERS AND FREEZEOUTS 263-89 (1978) and Supp. 1980 at 134-41, detailing the many measures taken by corporate managements to discourage takeovers. *See also* W. CARY & M. EISENBERG, *supra* note 20, at 1594-95.

[77] *See* Wyser-Pratte, *Takeover Panel Needed To Protect Shareholders,* N.Y.L.J., June 4, 1979, at 25, col. 5 (describing incidents in which the author believes that corporate managements have opposed tender offers that were clearly attractive to shareholders). *See* M. LIPTON & E. STEINBERGER, *supra* note 76, at vii:

> Modern corporate takeover battles resemble closely the feudal wars of the middle ages . . . . The Board of Directors is the Council. Like the feudal Council, it is often subservient to the Count [the president] . . . . Without the full support of the Council, takeover defense is almost impossible, and the Castle will be quickly lost.

[78] Even advocates of broad board discretion to oppose tender offers concede that shareholders will usually accept any tender offer at a substantial premium over the pre-offer price of the target company's shares. Lipton, *supra* note 72, at 113-14. A board more attuned to the wishes of the shareholders rather than management therefore might well be more receptive, or at least less hostile, to takeover bids. At the least, nonaffiliated outside directors do not face the same conflicts of interest as do inside and affiliated directors when weighing an unsolicited tender offer. *See* Williams, Tender Offers and the Corporate Director, (speech before the 7th Annual Securities Regulation Institute, San Diego, California, Jan. 17, 1980), *reprinted in* [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,445 (1980). Thus, strengthening the independent directors would enhance the possibility of fair treatment of shareholders.

[79] Williams Act, 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1976 & Supp. III 1979). *See* Winter, *supra* note 71, at 268-69. *See also* Jarrell & Bradley, *The Economic Effects of Federal and State Regulations of Cash Tender Offers,* 23 J. L. & ECON. 371 (1980)

veiled purpose of preventing all hostile takeovers.[80] Takeover by proxy fight is also expensive and the advantages of incumbency are so great that proxy fights are rarely attempted except in extreme cases.[81] Thus, market forces cannot be relied upon as the sole tool for encouraging the adoption of efficient monitoring.

Even if market forces induced most corporations to adopt monitoring, those corporations which are not subject to market forces would not be apt to adopt monitoring. Accordingly, some other mechanism will be necessary to require adoption of the monitoring model if it is to be fully accepted and reach its full potential.

IV. Possible Mechanisms for Requiring Adoption of the Monitoring Model

Three mechanisms for promoting the monitoring model deserve exploration: use of existing federal legislation, enactment of new state or federal legislation, and use of the duty of care, sometimes common law and sometimes statutory, that directors and officers owe to the corporation they serve.

A. *Existing Federal Legislation*

No existing federal legislation is adequate to enforce the monitoring model. Prior to 1977, the "new fraud" doctrine developed under the Securities and Exchange Commission's rule 10b-5[82] appeared to be a federal basis for attacking mismanagement of public corporations. Even at its apex, however, the doctrine was flawed for this purpose because it was limited to fraud "in connection with the purchase or sale of [a] security"[83] and because it covered only breaches of the duty of loyalty, not the duty of care. For example, although mismanagement in the purchase of property with stock would have been actionable, mismanagement in the purchase of property for cash could not have been attacked under the new fraud doctrine.[84] In any event, the Supreme Court ruled in the 1977 case of *Santa Fe Industries, Inc.*

(concluding that state and federal regulations, although they increased the premiums paid by bidders, have discouraged many takeover attempts, and that their effect on shareholders is generally detrimental).

[80] *See* W. Cary & M. Eisenberg, *supra* note 20, at 1603; Sommer, *The Ohio Takeover Act: What Is It?*, 21 Case W. Res. L. Rev. 681, 682 (1970).

[81] Williams, *Cumulative Voting*, 33 Harv. Bus. Rev. 108 (May-June 1955).

[82] 17 C.F.R. § 240.10b-5 (1980).

[83] *Id.* Although this language of the rule was often expansively construed, *see* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971); R. Jennings & H. Marsh, Cases & Materials on Securities Regulation 994-97 (4th ed. 1977), "many corporate mismanagement charges do not . . . involve any purchase or sale of securities." *Id.*, at 994.

[84] *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975); D. Ratner, Securities Regulation in a Nutshell 140-41 (1978).

v. Green[85] that a 10b-5 suit requires an allegation of deception or manipulation.[86] Although the lower federal courts have disagreed on the precise meaning of this holding,[87] it does establish that mismanagement alone is not actionable under rule 10b-5. Thus, rule 10b-5 certainly cannot be used to obligate a corporation to adopt a monitoring model for its board of directors.

The SEC proxy rules adopted pursuant to section 14 of the Securities Exchange Act[88] have been touted as a possible tool for encouraging monitoring by directors. It is contended that shareholders' influence over board conduct will be enhanced if they are provided more information about the directors' activities.[89] Consequently, directors who do not actively monitor can be removed and replaced by those who will. But it is well established that most shareholders do not want to participate actively in corporate control.[90] Moreover, even if they did, the lack of any alternative to management's slate of board nominees (except in the rare case of a proxy fight) renders their vote meaningless. Indeed, many commentators have concluded that even the existing level of corporate proxy disclosure cannot be justified on a cost-benefit basis.[91] If increased disclosure of board practices will in fact affect those practices, the cause is likely to be potential embarrassment at the disclosures, not shareholder votes. However, many have questioned the propriety of using disclosure requirements in this way.[92]

A few years ago the SEC threatened to take disclosure of board practices to new lengths by establishing guidelines for director functions and requiring corporations to disclose the extent to which their board practices departed from these guidelines.[93] The Commission eventually abandoned the effort

[85] 430 U.S. 462 (1977).

[86] *Id.* at 473-74.

[87] *See* Healey v. Catalyst Recovery, Inc., 616 F.2d 641 (3d Cir. 1980); Kidwell *ex rel.* Penfold v. Meikle, 597 F.2d 1273 (9th Cir. 1979); Goldberg v. Meridor, 567 F.2d 209 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978).

[88] SEC rules 14a-1 to 12, 17 C.F.R. § 240.14a-1 to 12 (1980).

[89] Weiss & Schwartz, *supra* note 49. *But see New Approaches to Disclosure in Registered Security Offerings*, 28 BUS. LAW. 505, 530-31 (ABA Panel Discussion) (remarks of Harold Marse, Jr.) (it is unrealistic to expect management to evaluate itself candidly).

[90] C. BROWN, *supra* note 17, at 25; Manning, *supra* note 37, at 14-19.

[91] *E.g.*, Benston, *An Appraisal of the Costs and Benefits of Government-Required Disclosure: SEC and FTC Requirements*, 41 LAW & CONTEMP. PROB. 30 (Summer 1977); Benston, *Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934*, 63 AM. ECON. REV. 132 (1973). *See also* Stigler, *Public Regulation of the Securities Markets*, 37 J. BUS. 117 (1964) (concerning 1933 Act disclosure). The criticisms apply equally to proxy disclosures.

[92] *E.g.*, H. KRIPKE, THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE 190-91 (1979). Others have defended the practice. *See* REPORT OF THE ADVISORY COMMITTEE ON CORPORATE DISCLOSURE TO THE SEC 414 (Nov. 3, 1977); Weiss & Schwartz, *supra* note 49, at 60.

[93] SEC Exchange Act Release No. 14,970 (July 18, 1978), [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,645 at 80,580. *See* Address by SEC Chairman G.

because of the difficulty of drafting the guidelines and complaints that the proposals exceeded the SEC's authority.[94] Perhaps this semi-coercive disclosure approach could have effectively compelled corporations to follow the monitoring model. The rules actually adopted by the Commission are limited, however, to added disclosures about the directors' activities,[95] and it seems unlikely that this will shame many corporations into altering their board practices significantly. Shareholders' voting certainly will not be so altered by the new disclosures as to require corporations to amend their practices.

More recently, the SEC has demanded revision of a corporation's governance structure as part of consent decrees in enforcement actions where it believes that a restructured board might help prevent future securities law violations.[96] The revisions demanded contain many elements of monitoring, including the establishment of a board with a majority of outside directors, of an audit committee, and of formal mechanisms to monitor management's compliance with law.[97] Demands by the Commission for such ancillary relief raise a number of problems,[98] but for present purposes it suffices to note that ancillary relief is of limited duration and can be obtained only in cases in which the SEC alleges that a corporation has violated the federal securities laws.[99] Even if ancillary relief is beneficial, it cannot be a tool for the general reform of corporate governance.

Bradford Cook, Southern Methodist University School of Business Administration (April 6, 1973), *reprinted in* [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,302.

[94] SEC Exchange Act Release No. 15,384 (Dec. 6, 1978), [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,766. *See* What the SEC Expects of Corporate Directors, address by SEC Chairman Ray Garrett, Jr. before Arthur D. Little Corporate Directors Conference, Washington, D.C. (Dec. 17, 1974).

[95] Item 6 to schedule 14A, 17 C.F.R. § 240.14a-101, *as amended by* Securities Exchange Act Release No. 15,384 (Dec. 6, 1978), [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,766.

[96] *E.g.*, SEC v. Mattel, Inc., SEC Litigation Release Nos. 6467, 6531, & 6532 (D.D.C. 1974). *See* Farrand, *Ancillary Remedies in SEC Civil Enforcement Actions*, 89 HARV. L. REV. 1779 (1976); Jacobs, *Judicial and Administrative Remedies Available to the SEC for Breaches of Rule 10b-5*, 53 ST. JOHN'S L. REV. 397 (1979); Note, *Ancillary Relief in SEC Injunction Suits for Violation of Rule 10b-5*, 79 HARV. L. REV. 656 (1966); Comment, *Court-Appointed Directors: Ancillary Relief in Federal Securities Law Enforcement Actions*, 64 GEO. L.J. 737 (1976).

[97] Second Amended Judgment and Order of Permanent Injunction and Ancillary Relief, SEC v. Mattel, Inc., Civ. No. 7H-2958-W (C.D. Cal. Nov. 26, 1974), *reprinted in* DUTIES AND RESPONSIBILITIES OF OUTSIDE DIRECTORS 167 (A. Cohen & R. Loeb eds. 1977). *See* Jacobs, *supra* note 96, at 442-45; Comment, *supra* note 96, at 738-40.

[98] *See generally* Comment, *supra* note 96.

[99] In general, the SEC may seek judicial relief only for violations of the securities laws and rules. Securities Act of 1933, § 19(b), 15 U.S.C. § 77s (Supp. IV 1980); Securities Exchange Act of 1934, § 21(a), 15 U.S.C. § 78u (Supp. IV 1980).

Many other weapons in the SEC arsenal might be used to influence corporate governance—the internal accounting provisions of the Foreign Corrupt Practices Act,[100] the power to impose rules on stock exchanges and the NASD,[101] the power to discipline professionals,[102] and the power to publish findings after investigations.[103] However, these powers, even taken together and even if one accepts the SEC's broad construction of its powers, are inadequate to change corporate governance in any comprehensive way. More important, Congress did not intend to confer on the SEC any general powers regarding corporate governance but to leave that power where it had always been—with the states.[104]

B. *New State or Federal Legislation*

Since existing federal legislation is inadequate to require directors to monitor, perhaps an enforcement tool should be sought in new federal or state legislation. A legislative solution has much to recommend it. Legislation could deal comprehensively with the corporate governance problem, prescribing the structure and duties of the board and its committees, the sanctions for failing to comply with the statute, and the means for enforcing the statute. More general virtues also inhere in legislation, such as its textual firmness and the legislature's capacity to investigate a problem thoroughly.[105] Moreover, a federal legislative solution would prescribe uniform national standards.[106] This would be desirable because most large

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[100] Securities Exchange Act of 1934, § 13(b), 15 U.S.C. § 78m (Supp. IV 1980).

[101] *Id.*, § 19(b) & (c), 15 U.S.C. § 78s (Supp. IV 1980). The Commission used this power in effect to force the New York Stock Exchange to adopt its rule requiring each listed company to have an audit committee. *See* note 52 *supra*; Coffee, *Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response*, 63 VA. L. REV. 1099, 1274 (1977).

[102] SEC rule 2(e), 17 C.F.R. § 201.2(e) (1980). The SEC's use of rule 2(e) has been seriously criticized. H. KRIPKE, *supra* note 92, at 198-205.

[103] Securities Exchange Act of 1934, § 21(a), 15 U.S.C. § 78u (Supp. IV 1980). Former Commissioner Roberta Karmel has dissented from the use of section 21(a) as punishment absent a charge of violation of law. Spartek, Inc., SEC Exchange Act Release No. 15,567 (Feb. 14, 1979), [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,961, at 81,408-11.

[104] H. KRIPKE, *supra* note 92, at 173-74 & 174 n.2. Even Professor Cary, a leading advocate of greater federal involvement in corporate governance, has criticized efforts to "jigsaw" corporate governance problems into existing legislation. Cary, *supra* note 3, at 702.

[105] *See* H. JONES, J. KERNOCHAN & A. MURPHY, LEGAL METHOD CASES AND TEXT MATERIALS 12 (1980); H. READ, J. MACDONALD, J. FORDHAM & W. PIERCE, MATERIALS ON LEGISLATION 318-21 (1973).

[106] It is reasonable to assume that, in the unlikely event that such legislation was enacted, it would apply only to corporations of a certain size, as do, for example, the

public corporations do not confine their activities primarily to one state but are truly national enterprises whose activities are more logically regulated by the federal government. Also, federal legislation would mitigate or avoid the so-called "race to the bottom" in which, according to some critics, states competing for chartering fees make their corporation laws attractive to managements by "watering shareholder rights down to the thin gruel."[107]

Although a legislative solution has certain advantages, it also has two major flaws. First is the political improbability of its adoption. Commentators have been arguing for nearly one hundred years for federal chartering of public corporations,[108] but the idea does not seem to have gained much momentum in all that time. Congress certainly is not eager to adopt such legislation now, and political trends are not favorable for its prospects in the near future. Professor Cary first proposed federal minimum standards for state chartering largely because federal chartering was politically implausible;[109] however, his own proposal has not gained any greater political support. Moreover, even those bills recently introduced in Congress concerning corporate governance would not impose the monitoring model on corporations.[110]

The prospects for new legislation are even dimmer at the state level. For over a century the trend in state corporation laws has been to reduce regulations and requirements to a bare minimum. Several factors have contributed to this trend. The most notorious has already been mentioned—the "race to the bottom," the alleged attempt by many states to reduce regulations in order to attract corporations to incorporate there and thus to reap a harvest of franchise fees.[111] Many have denied that this trend is harmful.[112] This race produced a feeling that new state regulation would be useless, even counterproductive, because corporations would respond simply by leaving the state and incorporating elsewhere.[113] Many have also felt,

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proxy and various reporting provisions of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78*l*-78n & 78p (Supp. II 1980).

[107] Cary, *supra* note 3, at 666.

[108] *See* R. NADER, *supra* note 3, at 65-71; Note, *Federal Chartering of Corporations: Constitutional Challenges*, 61 GEO. L.J. 123, 125-28 (1972).

[109] Cary, *supra* note 3, at 700-01.

[110] The most prominent such bill is Senator Metzenbaum's proposed Protection of Shareholders' Rights Act of 1980, S. 2567, 96th Cong., 2d Sess. (1980). The section-by-section analysis of the bill states that "[t]he duty of care provision[ ] . . . directs that the director act carefully in fulfilling the important tasks of monitoring and directing the activities of corporate management." [1980] SEC. REG. & L. REP. (BNA) F-3 (Apr. 23, 1980). The body of the bill does not bear this out. Section 4(b) states the duty of care in terms virtually identical to the Model Business Corporation Act's § 35. *See* text accompanying note 126 *infra* (quoting from the Model Act).

[111] The phrase was created by Professor Cary. Cary, *supra* note 3, at 666. The phenomenon has been noted by many authors. *See* note 152 *infra*.

[112] *See* sources cited in notes 114 & 154 *infra*.

[113] In 1969, the New Jersey Corporation Law Reform Commission stated: "It is

perhaps with considerable justification, that enactment of the federal securities laws reduced, if not eliminated, the need for state regulation of public corporations; that further regulation, if necessary, ought to be undertaken by the federal government; and finally, that minimum regulation and maximum flexibility are advisable as a matter of public policy.[114]

At neither the state nor federal level is there any organized constituency pressing for reform of corporate governance. Although investors are not indifferent about or unaffected by corporate governance, most lack large enough interests to undertake political action and are not sophisticated enough to be aware of recent developments in the theory of corporate governance. Investors prefer to display dissatisfaction with corporate management by selling their stock.[115] The best organized and most effective lobbyists on corporate governance are corporate executives; they will oppose any effort to mandate monitoring.[116]

Even if new legislation were politically feasible, an attempt to codify the monitoring model would face immense drafting problems. The monitoring model has not yet been sufficiently articulated to permit it to be prescribed by detailed legislation.[117] For example, though evaluation of management's performance is the keystone of the monitoring model, there are currently no concrete standards for such evaluations that could be incorporated into a statute mandating monitoring.[118] Detailed legislation would quickly become outdated and unduly restrictive as theory and experience evolved, and would not allow for the fact that the situation of each corporation is different.

Alternatively, Congress or a state legislature might empower an administrative agency to prescribe the duties of corporate boards.[119] On the federal level, the SEC might be authorized to define directors' duties, but this is

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clear that the major protections to investors . . . have come, and must continue to come, from Federal legislation. . . . Any attempt to provide such regulations . . . through state incorporation acts . . . would only drive corporations out of the state to more hospitable jurisdictions." REPORT OF THE CORPORATION LAW REVISION COMMISSION, in N.J. STAT ANN. tit. 14A, at xi (West 1969) and Cary, *supra* note 3, at 666. *See* Kaplan, *Foreign Corporations and Local Corporate Policy*, 21 VAND. L. REV. 433, 478-79 (1968).

[114] *See* Garrett, *The Limited Role of Corporation Statutes*, in COMMENTARIES ON CORPORATE STRUCTURE AND GOVERNANCE 95, 96-98 (D. Schwartz ed. 1979) (Delaware is preferred not for nefarious reasons but because of desirable flexibility and certainty); Manning, *supra* note 37, at 17 (liberal state corporation laws have not led to "corporate misfortune"); Winter, *supra* note 71, at 259 (liberal state corporation laws benefit shareholders by reducing transaction costs).

[115] C. BROWN, *supra* note 17, at 25; J. LIVINGSTON, THE AMERICAN SHAREHOLDER 60-61 (1958); Manning, *supra* note 37, at 14-19.

[116] *See* Anderson, *supra* note 66, at 782 & n.130 and authorities cited therein.

[117] *See Senate Hearings*, *supra* note 22, at 218-25 (statement of Professor Mundheim); notes 36-44 and accompanying text *supra*.

[118] *See* notes 233-45 and accompanying text *infra*.

[119] This position is advocated by C. STONE, WHERE THE LAW ENDS 144 (1975).

even less politically feasible than a federal statute that excluded the SEC from such power. The business and financial communities are alarmed at the Commission's recent attempts to become involved in corporate governance and other areas which have traditionally been thought to be outside its jurisdiction.[120] Any attempt to give it a blank check to define the director's duties would almost certainly meet fierce opposition, opposition which would, in light of the Commission's past performance, be entirely warranted.[121] Quite apart from the Commission's shortcomings, theoretical objections exist to delegating the power to define directors' duties to an administrative agency.[122] The current wave of deregulation reflects some of these objections.

Because of the problems with drafting legislation to define directors' duties in detail or with delegating this power to an administrative agency, the best route to legislative enforcement of the monitoring model would probably be to enact a very general statute essentially commanding boards to monitor effectively. The courts would then give precise content to the statute. Although legislation could, consistent with this approach, provide a few additional useful weapons for requiring the use of the monitoring model,[123] such legislation is largely unnecessary—the director's duty of care, part of the statutory or common law of every state,[124] already gives courts authority that can be turned to the same purpose. Legislation that federalized the duty of care would also provide the procedural advantages of federal courts to plaintiffs and promote uniform national standards of care. There remains, however, the question that already exists under the state law—whether the duty of care can be made an effective weapon for enforcing the monitoring model.

V. THE DUTY OF CARE

Corporate directors and officers have long been held to owe the corporation a duty of care.[125] When stated in the abstract, the duty of care seems to

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[120] For example, the SEC's proposal to define directors' duties provoked massive criticism. *See* SEC Exchange Act Release No. 13,901 (Aug. 29, 1977), [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,296, at 81,087-89, 81,094. Other SEC proposals relating to corporate governance have provoked similar criticism. Grienenberger & McGrath, *Reduction in Credibility Stems from Commission Stand on Accountability,* N.Y.L.J., Dec. 17, 1979, at 29, col. 1. The authors conclude that the result of the SEC's forays into corporate governance "has been confusion in the private sector and a reduction in the Commission's credibility." *Id. See also* H. KRIPKE, *supra* note 92, at 28, 31 (1979).

[121] *See generally* H. KRIPKE, *supra* note 92.

[122] Indeed, in 1977 the SEC tried to define directors' duties and abandoned the task as impossible. *See* notes 93-95 and accompanying text *supra*.

[123] *See* A. CONARD, *supra* note 49, at 913-15.

[124] *See* notes 126-27 and accompanying text *infra*.

[125] For some older cases see Briggs v. Spaulding, 141 U.S. 132 (1891); Hun v.

impose a meaningful obligation on directors and officers. In practice, however, the duty has had almost no effect on corporate governance for several reasons, not the least of which is confusion over the proper functions of directors. The evolution of the monitoring model gives a clearer picture of what the board can and should do and thereby makes it possible to breathe some life into the duty of care.

A. *The Duty of Care: The Ideal and the Reality*

In every state directors and officers are held to owe their corporation a duty of care. Many states have embodied this duty in a statute such as section 35 of the Model Business Corporation Act, which provides, in relevant part, that

> [a] director shall perform his duties as a director, including his duties as a member of any committee of the board upon which he may serve, in good faith, in a manner he reasonably believes to be in the best interests of the corporation, and with such care as an ordinarily prudent person in a like position would use under similar circumstances.[126]

The common law or statutory formulation of the duty of care in most states is to the same effect.[127]

So stated, the duty of care seems fairly straightforward and rigorous. The term "ordinarily prudent person" is a classic negligence standard found in many other areas of the law, especially torts.[128] The phrase "in good faith, in a manner he *reasonably* believes to be in the best interests of the corporation," if not completely redundant with the "ordinarily prudent person" test, underscores the requirement that the director must act not only with ordinary diligence and in good faith but also reasonably. Determination of the standard's exact meaning must generally be handled on a case-by-case basis; however, this is also true in many other areas of the law and does not diminish the rule's clarity.

Given the long-recognized failure of directors to do much of anything in the governance of corporations,[129] one might imagine myriad decisions

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Cary, 82 N.Y. 65 (1880); Charitable Corp. v. Sutton, 2 Atkyns 400, 26 Eng. Rep. 642 (Exch. Ch. 1742). *See generally* 3A W. FLETCHER, *supra* note 43, §§ 1029-1064; H. HENN, *supra* note 45, § 234; Dyson, *The Director's Liability for Negligence,* 40 IND. L.J. 342 (1965).

[126] MODEL BUS. CORP. ACT § 35 (1976). As to the officer's duty of care, see note 200 and accompanying text *infra*.

[127] *Report of Committee on Corporate Laws: Changes in the Model Business Corporation Act,* 30 BUS. LAW. 501, 505 (1975); MODEL BUS. CORP. ACT ANN. § 35, Par. 2, ¶¶ 3-4 (2d ed. 1977 Supp.). *See, e.g.,* Barnes v. Andrews, 298 F. 614 (S.D.N.Y. 1924); Lutz v. Boas, 39 Del. Ch. 585, 171 A.2d 381 (1961); Selheimer v. Manganese Corp., 423 Pa. 563, 224 A.2d 634 (1966); Neese v. Brown, 218 Tenn. 686, 405 S.W.2d 577 (1964).

[128] *See* W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 32, at 150 (4th ed. 1971).

[129] *See* notes 12-17 and accompanying text *supra*. Problems with the diligence of

holding directors liable for breach of the duty of care. But the duty of care has long been moribund. As Professor Bishop expressed it, cases holding directors liable for negligence uncomplicated by self-dealing constitute "a very small number of needles in a very large haystack."[130]

B. *Reasons for Inefficacy of the Duty of Care*

There are numerous reasons for the inefficacy of the duty of care. Several courts have expressly rejected the ordinarily prudent man standard in favor of a more lenient test, and others have suggested a more lenient standard in dicta.[131] Some commentators have argued that court references to bad faith, gross negligence, and recklessness are not intended to reject the prudent man standard and that an examination of case holdings, rather than dicta, bears this out.[132] Perhaps so, but practicing lawyers and commentators give credence to dicta; judicial statements appearing to adopt lenient standards of care no doubt discourage the bringing of suits and influence the bases on which suits are settled even if lawyers have misinterpreted those statements.

Moreover, courts adhering to the prudent man standard have nevertheless mitigated the rigor through the so-called business judgment rule, a doctrine of obscure origin and uncertain meaning. It is well established that directors are not insurers or guarantors of the corporation's success;[133] indeed, no one has ever argued the contrary. Directors owe their corporation duties of loyalty and care and if these duties are observed they will not be held liable to shareholders or creditors, even if the corporation is not as successful as the latter hoped.[134] Apparently trying to say no more than this, some courts

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directors were noted as long ago as 1776, when Adam Smith wrote:

> The directors of [joint stock] companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in private copartnery frequently watch over their own. . . . Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.

A. SMITH, THE WEALTH OF NATIONS 700 (Modern Library ed. 1937). (1st ed. London 1776).

[130] Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1099 (1968). *See also* C. STONE, *supra* note 119, at 147 ("directors' liability for ordinary negligence is a dead letter, and even worse").

[131] *See* 3A W. FLETCHER, *supra* note 43, § 1029, at 12; N. LATTIN, THE LAW OF CORPORATIONS § 78, at 274 & nn.12 & 13 (2d ed. 1971).

[132] Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93 (1979).

[133] Litwin v. Allen, 25 N.Y.S.2d 667, 678 (Sup. Ct. 1940); H. HENN, *supra* note 45, § 234, at 454; Comment, *Factors That Limit the Negligence Liability of a Corporate Executive or Director*, 1967 U. ILL. L.F. 341, 345, and cases cited at 345 n.38.

[134] *See* Berman v. Gerber Prods. Co., 454 F. Supp. 1310, 1319 (W.D. Mich. 1978) (applying Michigan law); Pollitz v. Wabash R.R., 207 N.Y. 113, 124, 100 N.E. 721, 723-24 (1912); 3A W. FLETCHER, *supra* note 43, § 1039, at 38; H. HENN, *supra* note

in the last century stated that a director is not liable for mere errors of judgment.[135] The "business judgment" rule is incontestable if it is recognized that to invoke the rule the director must exercise his judgment within the scope of the duty of care—that is, his judgment must have been reasonable and exercised with the care of an ordinarily prudent person. However, courts have often described the business judgment rule without any reference to the duty of care and, more important, have often dismissed suits against directors on the ground of the business judgment rule without first inquiring whether the directors had acted reasonably and with due diligence.[136] In some cases, courts have simply ignored a statutory "prudent man" standard in favor of a fraud or bad faith standard under the business judgment rule.[137] Moreover, courts have frequently extended the rule beyond its original purpose; for example, it has been used to prevent shareholder interference with directors' decisions even though the shareholder did not seek to hold the directors liable for their actions.[138]

45, § 242; N. LATTIN, *supra* note 131, § 78, at 272-74; Note, *The Continuing Viability of the Business Judgment Rule as a Guide for Judicial Restraint*, 35 GEO. WASH. L. REV. 562, 562-63 (1967); Comment, *The Business Judgment Rule: A Guide to Corporate Directors' Liability*, 7 ST. LOUIS U.L.J. 151 (1962).

[135] Many of the early cases clearly demanded ordinary or reasonable prudence by the director as a condition to his being held not liable. *See* Percy v. Millaudon, 8 Mart. (n.s.) 68, 77-78 (La. 1829) (denying liability "if the error was one into which a prudent man might have fallen"); Hun v. Cary, 82 N.Y. 65, 70-71 (1880) ("if they act . . . using proper prudence and diligence, they are not responsible for mere mistakes or errors of judgment"); Hodges v. New England Screw Co., 1 R.I. 312, 348 (1850) ("The law requires of them care and discretion, such as a man of ordinary prudence exercises in his own affairs; and if they practice this, and nevertheless make a mistake, the law does not hold them answerable."). *See generally* Arsht, *supra* note 132, at 97-100.

[136] If the business judgment rule requires directors to act with ordinary or reasonable prudence, a complaint alleging negligence could not ordinarily be dismissed without a trial on the issue of fact of negligence. Nonetheless, many shareholder derivative suits have been dismissed on summary judgment on the basis of the business judgment rule. *See, e.g.*, Ash v. International Business Machs., Inc., 353 F.2d 491 (3d Cir. 1965), *cert. denied*, 384 U.S. 927 (1966); Stadin v. Union Elec. Co., 309 F.2d 912 (8th Cir. 1962), *cert. denied*, 383 U.S. 915 (1963); Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979); Parkoff v. General Tel. & Elec. Corp., [1980 Transfer Binder] SEC. REG. & L. REP. (BNA) A-5 (N.Y. App. Div. Mar. 11, 1980); Bennett v. Instrument Sys. Corp., 66 A.D.2d 708, 411 N.Y.S.2d 287 (1978).

[137] *E.g.*, Kamin v. American Express Co., 86 Misc. 2d 809, 383 N.Y.S.2d 807 (Sup. Ct.), *aff'd on opinion below*, 54 A.D.2d 654, 387 N.Y.S.2d 993 (1976) (suit dismissed on grounds of business judgment rule without any mention of N.Y. BUS. CORP. LAW § 717 (McKinney Supp. 1980), which requires directors to act "with that degree of care which an ordinarily prudent person in a like position would use under similar circumstances.").

[138] The most significant example is the judicial extension of the business judgment rule to the decision by a board or board committee to terminate a shareholder's

At times, judges justify abstention on the ground that the corporation is to be managed by the board, not the shareholders.[139] But many courts refuse to recognize that if the duties of care and loyalty mean anything, they must mean that courts will intervene at a shareholder's request if the board has not acted with due care or loyalty. Courts sometimes deny that they are competent to review business decisions.[140] Although courts possess no special expertise in business affairs, they also have no special expertise in medical malpractice or many other areas in which they often decide whether a defendant has acted with reasonable prudence or skill. Nor have they any special expertise to decide the complicated environmental and patent cases which they routinely face. Courts are not asked to make business policy or to decide whether the directors' decisions were the wisest that could have been made, but only to decide whether the directors acted with reasonable prudence. This question is no more difficult than many others routinely decided.

The business judgment rule's precise impact on the duty of care is impossible to determine. Where the rule is held to obviate a judicial decision whether the directors acted with reasonable prudence, whether they did so is usually unknown. Many cases would probably have been decided differently, however, if the duty of reasonable prudence had not been modified by the business judgment rule. Moreover, as with dicta suggesting a lenient standard of care,[141] even if the business judgment rule has been misinterpreted, that misinterpretation is nonetheless a fact that affects litigation and director conduct.

Also weakening the duty of care is the doctrine of reliance on corporate counsel, accountants, and officers. Section 35 of the Model Business Corporation Act provides that "a director shall be entitled to rely on information, opinions, reports or statements, including financial statements and other financial data" presented by officers, counsel, public accountants, a committee of the board, or other persons whom the director reasonably believes to be reliable and competent unless "he has knowledge concerning the matter in question that would cause such reliance to be unwarranted."[142] Statutory

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derivative suit. This application of the rule is in addition to its application to determine whether any director is liable. *See* Burks v. Lasker, 441 U.S. 471 (1979); Lewis v. Anderson, 615 F.2d 778 (9th Cir. 1979); Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979). *But see* Maldonado v. Flynn, 413 A.2d 1251 (Del. Ch. 1980). *See generally* Dent, *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?*, 75 Nw. U.L. REV. 96 (1980).

[139] *See* United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261, 263 (1917); Cramer v. General Tel. & Elec. Corp., 582 F.2d 259, 274-75 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979); Miller v. American Tel. & Tel. Co., 507 F.2d 759, 762 (3d Cir. 1974).

[140] Auerbach v. Bennett, 47 N.Y.2d 619, 631, 393 N.E.2d 994, 1000, 419 N.Y.S.2d 920, 926 (1979).

[141] *See* text following note 132 *supra*.

[142] MODEL BUS. CORP. ACT. § 35 (1976).

or common law is to the same effect in most states.[143] Courts have faced considerable difficulty in defining the scope of the director's right to rely.[144] At one extreme, it might be argued that the directors may rely on the opinions of corporate officers in deciding how to vote on any matter placed before the board. This interpretation would, of course, be absurd—it would allow the director to delegate all his duties to others, leaving him no real function at all. But a limiting principle is hard to find. Because most concede, implicitly or explicitly, that the board cannot manage the corporation, one can hardly deny directors the right to rely on the officers in approving major managerial decisions. Thus, recognizing that the directors' only significant duty is to manage,[145] it has been difficult to deny directors a right to rely.

Some courts and commentators also fear that a duty of reasonable prudence would pose such a substantial threat of personal liability that the best qualified persons would decline to serve as directors.[146] Under the old model of corporate governance this fear may have had some validity. Since outside directors cannot manage a corporation, holding them liable for failing to manage would deter many from serving as outside directors. If directors were assigned tasks they reasonably could perform, however, requiring them to perform these duties with reasonable care would not deter qualified persons from serving.[147] A more rigorous duty of care would discourage

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[143] *E.g.*, N.Y. BUS. CORP. LAW § 717 (McKinney Supp. 1980). *See generally* Hawes & Sherrard, *Reliance on Advice of Counsel as a Defense in Corporate and Securities Cases*, 62 VA. L. REV. 1 (1976).

[144] Hawes & Sherrard, *supra* note 143, at 4.

[145] For example, in addition to providing that, with certain exceptions, "[t]he business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors," DEL. CODE ANN. tit. 8, § 141(a) (1980 Supp.), Delaware General Corporation Law provides that the board may change the location of the corporation's registered office, *id.* § 133; issue shares authorized by the certificate, *id.* § 161; declare dividends, *id.* § 170(a); call special meetings of stockholders, *id.* § 211(d); fix the record date for meetings of stockholders, *id.* § 213(a); and fill vacant and newly created directorships, *id.* § 223(a). Also, both the shareholders and the board must approve amendments to the certificate of incorporation, *id.* § 242(c)(1); mergers, consolidations, and sales of all or substantially all assets, *id.* §§ 251(b) & 271(a); and dissolution of the corporation, *id.* § 275(a). However, even in the absence of such express statutes most, if not all, of these powers would probably be deemed implicit in the board's general power to manage the corporation. Thus, it is fair to say that the board has few statutory functions other than to manage or direct the management of the corporation.

[146] Smith v. Brown-Borhek Co., 414 Pa. 325, 333, 300 A.2d 398, 401 (1964); E. MCSWEENEY, *supra* note 20, at 106; Symposium, *The Greening of the Board Room: Reflections on Corporate Responsibility*, 10 COLUM. J.L. & SOC. PROB. 15, 23-24 (1973) (statement of Professor Harvey J. Goldschmid); Soderquist, *Toward a More Effective Corporate Board: Reexamining Roles of Outside Directors*, 52 N.Y.U.L. REV. 1341, 1349-50 (1977); Comment, *supra* note 133, at 343.

[147] Indeed, the many directors who resign in disgust because they serve no significant corporate role, S. VANCE, MANAGING THE MANAGERS 106 (1978), would

those who relish the current state of affairs in which "no effort of any kind is required" and in which possession of several directorships is "like having a permanent warm bath."[148] But riddance of such directors should be viewed as desirable. If a director cannot be required to perform some valuable function with reasonable prudence, the corporation would be better off saving his fees and avoiding the illusion that he was protecting the shareholders' interests.

Some have also feared that the prospect of crushing personal liability for simple negligence would force directors to become unduly cautious in order to avoid risky ventures that might result in losses to the corporation.[149] This fear flows from the erroneous assumption that boards actually manage corporations. As previously noted, boards do not manage and have little influence regarding even major corporate plans;[150] thus, they do not determine the riskiness of corporate ventures. Rather, the executive officers manage the corporation, and recent studies suggest that financial markets give management ample, even excessive, incentives to undertake risks to maximize corporate profits.[151]

A possible further reason is that a lenient standard of care is part of the race to the bottom among the states, an invitation from each state to reincorporate there.[152] If this theory were valid, it would be a serious obstacle to a revival of the duty of care. However, the theory is largely

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prefer being given meaningful functions. It might be necessary, however, to limit liability for negligence and to increase directors' compensation.

[148] TIME, Oct. 5, 1962, at 96, *quoted in* H. HENN, *supra* note 45, § 234, at 454 n.3:

> In Britain, where a company's list of directors often reads like a tear sheet from Burke's Peerage, many a titled tycoon sits on more boards than he can count. Lord Boothby, 62, a longtime Tory backbencher who is one of this happy breed himself (he has 'eight or nine' directorships), explained last week just what directors do in return for adding prestige to corporate letterheads. "No effort of any kind is called for," he told an audience of Yorkshire clubwomen. "You go to meeting once a month in a car supplied by the company. You look both grave and sage, and on two occasions say 'I agree,' say 'I don't think so' once, and if all goes well, you get $1,440 a year. If you have five of them, it is total heaven like having a permanent hot bath."

[149] *See* Veasey & Manning, *supra* note 29, at 931-32 (stressing desirability of encouraging risk taking); Comment, *supra* note 133, at 343.

[150] *See* notes 12-17 and accompanying text *supra*. However, setting goals will necessarily involve the board in management. *See* text accompanying notes 234-37 *infra*.

[151] *See* notes 66-67 *supra*.

[152] *See* Cary, *supra* note 3, at 665-66, 670, 683-84. *See also* Liggett Co. v. Lee, 288 U.S. 517, 559 (1933) (Brandeis, J., dissenting) ("The race was not one of diligence but of laxity."); Jennings, *Federalization of Corporation Law: Part Way or All the Way*, 31 BUS. LAW. 991, 992-93 (1976); Young, *Federal Corporate Law, Federalism, and the Federal Courts*, 41 LAW & CONTEMP. PROB. 146, 151 (Summer 1977). Other commentators have questioned whether the race to the bottom is undesirable, Winter, *supra* note 71, at 289-92, and even whether such a race exists at all, Manning, *supra* note 37, at 17-18.

meritless. Even in Delaware, supposedly the leading instigator of the race to the bottom, the courts have shown some zeal recently in holding directors to high standards of fiduciary duty.[153] Moreover, unreasonably low fiduciary standards would be counterproductive for a state seeking increased corporate franchise taxes through new incorporations there. Investors would avoid the securities of companies incorporated in that state, causing these securities to be valued lower in financial markets than securities of companies incorporated in states that provided reasonable protection to investors. This would induce companies to reincorporate out of the state with unreasonably low fiduciary standards.[154]

In light of the weakness of the preceding justifications for leniency in the standard of care, the best explanation is the longstanding confusion over the proper role of the board of directors. Although state corporation laws long provided that the board was to manage the corporation,[155] courts recognized that in practice boards do not do so and could not be expected to. With a few specific exceptions,[156] state law required nothing more of the board than the vague, general duty to manage. Since the only substantial task assigned to the board by state law was one the board obviously did not and could not fulfill, it is neither surprising nor unreasonable that courts refused to impose a high standard of care on directors. This confusion over the board's role, not the race to the bottom or judicial indifference to shareholder interests, best explains the courts' attitudes.[157] If the monitoring model can eliminate

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[153] *See, e.g.*, Singer v. Magnavox Co., 380 A.2d 969 (Del. 1977); Maldonado v. Flynn, 413 A.2d 1251 (Del. Ch. 1980). *See generally* Arsht, *supra* note 132.

[154] Lorie, *supra* note 66, at 57; Winter, *supra* note 71, at 256-58. *See* R. LARCOM, THE DELAWARE CORPORATION 14-15 (1937) (footnote omitted):

> West Virginia had a reputation . . . for being the home of irresponsible corporations. It may have been this reputation which was responsible for the impression which one of the gentlemen testifying before the United States Industrial Commission had that "corporations organized in West Virginia have considerable difficulty in placing their stocks and bonds.

See also Hyman, *Do Lenient State Incorporation Laws Injure Minority Shareholders?*, in THE ATTACK ON CORPORATE AMERICA 166, 168-69 (M. Johnson ed. 1978) (prices of a corporation's stock do not drop when the corporation changes its place of incorporation to Delaware). Professor Cary himself has recounted the story of a South American ambassador in whose country public investors lacked confidence in corporations because management considered itself to owe loyalty only to its relatives. Cary, *supra* note 3, at 671. But Professor Cary does not conclude from this story that since shareholders were not fleeing Delaware corporations, Delaware's corporation laws must not be detrimental to shareholders' interests.

[155] *See* note 12 *supra*.

[156] *See* note 145 *supra*.

[157] *See* C. BROWN, *supra* note 17, at 5 ("A well-known corporate officer recently observed in public discussion, 'Most boards of directors I have been on don't know exactly what they are supposed to do.' "); H. KOONTZ, *supra* note 13, at 225. *See*

confusion over the board's role and provide directors with an important and workable role, courts could reasonably require a more rigorous standard of care in their performance.

Even if the courts had been willing to impose a more stringent director duty of care, major obstacles remained to the imposition of personal liability. First is the problem of proof of proximate cause. A plaintiff must show not only that a director breached his duty of care, but also that this breach led to an identifiable loss to the corporation.[158] Not surprisingly, plaintiffs have rarely been able to prove proximate cause in cases not involving board approval of specific transactions. Because directors are expected to do little or nothing, proof that their failure to act with due care caused the corporation some identifiable loss is quite difficult. Although proof of proximate cause is a rational requirement and deeply embedded in our jurisprudence,[159] it has weakened the director's duty of care.

Even if it can be shown that a director failed to act with due care and that this failure caused a corporate loss, he may still be able to circumvent personal liability through indemnification or insurance. Insurance policies protect most directors and officers of public corporations against liabilities arising out of their position, and most of the premiums for these policies are paid by the corporation.[160] When suits are settled or in those rare cases in which a director is held liable for negligence, resort to insurance may not even be necessary. Some state indemnification statutes are so broad and vague that they might be construed to permit indemnification by the corporation even for amounts paid in settlement, thus placing on the shareholders the burden of paying for a loss incurred by the director's failure to perform a

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also C. STONE, *supra* note 119, at 141 ("there is almost no authoritative guide as to what, exactly, the directors are supposed to be doing"); Leech & Mundheim, *supra* note 20, at 1803 ("The confusion as to the role and responsibility of the corporate director has precipitated serious debate.").

[158] Briggs v. Spaulding, 141 U.S. 132, 151 (1891); Barnes v. Andrews, 298 F. 614, 616 (S.D.N.Y. 1924) (L. Hand, J.); H. HENN, *supra* note 45, § 234, at 456-57. This requires proof not only that the board's act or omission caused a specific loss, but also perhaps that each individual defendant-director could have prevented the loss if he had acted with due care. *See* Allied Freightways, Inc. v. Cholfin, 325 Mass. 630, 91 N.E.2d 765 (1950) (director held not liable because, being unskilled, she could not have discovered and prevented the misdeeds); 3A W. FLETCHER, *supra* note 43, § 1063.1 ("he is liable only for a loss that results from his negligence"); Dyson, *supra* note 125, at 363-65; Comment, *supra* note 133, at 342 and cases cited in 342 n.12. *But see* Coffee, *supra* note 101, at 1213 n.408.

[159] *See* F. BACON, MAXIMS OF THE LAW, Reg. I, *quoted in* W. PROSSER, *supra* note 128, § 42, at 244 n.63.

[160] "[T]he common practice has been for the corporation to pay 90 per cent of the total premium and the director the remaining 10 per cent." Bishop, *supra* note 130, at 1090. Today, it is common for the corporation to pay the entire premium. W. CARY & M. EISENBERG, *supra* note 20, at 970.

duty owed to them![161] Although no court has embraced this absurd and shocking result, insurance is really little different because it too places the ultimate burden on the shareholders by having the corporation pay policy premiums.[162] These results negate the deterrent effect of liability for failure to act with due care and, more importantly, they may well contribute in an unmeasurable way to the judicial reluctance to impose stricter standards of care by instilling a feeling that more rigorous standards would only stir up more litigation for the benefit of lawyers with no corresponding benefit to shareholders.

The duty of care has been further weakened by procedural obstacles to its enforcement. Unless the director violates the federal securities laws, thereby bringing the SEC into action, no public agency is likely to be willing or able to sue. Of course, the directors are not likely to sue themselves either. Thus, enforcement of the director's duties is relegated almost entirely to shareholder derivative suits.[163] But an alleged fear of strike suits—that is, suits brought not to benefit the corporation but for the purpose of being bought off in a settlement from the defendants or the corporation solely to avoid the nuisance of the suit—has prompted state legislatures and courts to erect many barriers to the bringing of such suits.[164] These barriers discour-

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[161] *See* W. CARY & M. EISENBERG, *supra* note 20, at 1083-84. DEL. CODE ANN. tit. 8, § 145(a)-(b) (1974) specifically permits indemnification of attorneys' fees and, in nonderivative suits, amounts paid in settlement, judgments, and fines if the director "acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the corporation." Moreover, this indemnification right is not exclusive. *Id.* § 145(f). Section 145(b) says nothing about indemnification of amounts paid in settlement of derivative suits. Thus, the question is still open in Delaware. For an opinion that indemnification is not permitted in such cases, see E. FOLK, THE DELAWARE GENERAL CORPORATION LAW 100 (1972). The SEC has opposed indemnification of directors and officers for violations of the federal securities laws. Note to SEC rule 460, 17 C.F.R. § 230.460 (1980).

[162] Bishop, *supra* note 130, at 1090-91.

[163] Dean Rostow has called the derivative suit "the most important procedure the law has yet developed to police the internal affairs of corporations." Rostow, *To Whom and For What Ends Is Corporate Management Responsible?,* in THE CORPORATION IN MODERN SOCIETY 48 (E. Mason ed. 1959). Justice Jackson called it "the chief regulator of corporate management." Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 548 (1949). *See* Surowitz v. Hilton Hotels Corp., 383 U.S. 363, 371 (1942); N. LATTIN, *supra* note 131, § 115, at 457 ("The derivative suit is the minority shareholders' one effective remedy against management's abuse of its trusteeship.").

[164] These obstacles include the following requirements: ownership of stock at the commencement and during the pendency of the suit; ownership of stock at the time of the alleged wrong (the so-called contemporaneous ownership requirement); allegation with particularity of the facts constituting the corporate cause of action (often interpreted to require the plaintiff in effect to plead evidence); demands on the board and the shareholders to take action with respect to the alleged wrong or a showing that such demands would be futile; fair representation of the shareholders by the

age potential plaintiffs from bringing even meritorious derivative suits.

In sum, the duty of care has hitherto been an ineffective tool for requiring directors to perform a meaningful function within the corporation. This ineffectiveness has gone hand in hand, however, with the failure of the received model of corporate governance to prescribe any meaningful role for the board of directors. Thus, the question arises whether the duty of care can be revamped and revived under a monitoring model that in theory provides a sound role for the board.

C. *The Monitoring Model and Reviving the Duty of Care*

By abandoning the unrealistic demand that the board manage the corporation and substituting for it the feasible demand that the board monitor management's performance, the monitoring model eliminates most logical objections to a rigorous duty of care. The illogical objections should follow suit. Although legislation may be desirable on a few specific points, in most respects the courts can easily eliminate the obstacles to a more rigorous duty of care.

The claim that courts are incompetent to decide issues of business policy has already been rejected in light of the many complicated issues courts decide in other areas of the law.[165] The fear that a rigorous duty of care would discourage qualified persons from serving as outside directors should dissipate considerably if directors are given workable tasks instead of the vague, unrealistic mandate the law now gives them. We are better off without those directors who will serve only if "no effort of any kind is required."[166] Because monitoring requires more effort than directors have traditionally exerted,[167] the directors may demand higher fees,[168] but the benefits of monitoring should exceed its costs. Future boards may have to be

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plaintiff; provision by plaintiff of security for expenses of the corporation (including attorneys' fees); indemnification of corporate personnel for litigation expenses; bringing of suit within the period of a short statute of limitations for certain actions against directors, officers, and shareholders; and reimbursement of defendants' expenses. H. HENN, *supra* note 45, §§ 359, 361-367, 372, 378; N. LATTIN, *supra* note 131, §§ 105-06.

[165] *See* text following note 140 *supra*.

[166] *See* note 148 *supra* (quoting TIME, Oct. 5, 1962, at 96, *quoted in* H. HENN, *supra* note 45, § 234, at 454 n.3)).

[167] H. KOONTZ, *supra* note 13, at 151, 232; Goldschmid, *supra* note 49, at 175; Leech & Mundheim, *supra* note 20, at 1829.

[168] *See* C. BROWN, *supra* note 17, at 80 (suggesting that directors' compensation "should be, in most cases, much higher than at present" and should be ratably equivalent to the corporation's senior executives); H. KOONTZ, *supra* note 13, at 243; Lohnes, *The Selection and Compensation of Outside Directors*, in DUTIES AND RESPONSIBILITIES OF OUTSIDE DIRECTORS 67, 73-74 (A. Cohen & R. Loeb eds. 1978); Mundheim, *supra* note 49, at 181. Some corporations are now paying much higher directors' fees. Dean Brown reported in 1976 that Texas Instruments was paying some directors about $1,000 per day. C. BROWN, *supra* note 17, at 33.

smaller because of the limited number of qualified directors,[169] but this is no problem—boards are now unnecessarily large.[170]

Under the monitoring model, a stringent duty of care should not produce unduly cautious corporate policies. Since the board will not make corporate policy, it will not be in a position to discourage reasonable risktaking; the board will merely monitor the performance of management, and management will continue to have ample market incentives to take reasonable risks.[171] Moreover, if they do have any influence over corporate policies, outside directors themselves will have certain market incentives to encourage the corporation to take reasonable risks.[172]

The purported competition among states for chartering fees should not cause hesitation in state courts to impose a substantial duty of care. Indeed, if monitoring truly helps protect shareholder interests and improve corporate performance, states would have a motivation to adopt the model in order to induce corporations to incorporate there.[173]

The monitoring model would also substantially mitigate the problem of director reliance on officers, accountants, counsel, and others. With the board limited to monitoring management, the reliance issue will only arise with respect to monitoring, not company management or any other matter. As to monitoring, the board would still have some right to rely on factual data provided by management, but in reaching its ultimate decisions the board obviously could not rely on the very management it was supposed to evaluate. By limiting the scope of the board's duties to monitoring, courts will be in a better position to impose a more stringent duty to inquire. Courts have been reluctant to require directors to go beyond information presented to them by management because outside directors lacked the time and staff to investigate all matters independently and because independent investigations would interfere with orderly management.[174] By restricting the duty to inquire to matters of monitoring, this problem would be greatly reduced.

[169] HEIDRICK & STRUGGLES, INC., *supra* note 18, at 4; H. KOONTZ, *supra* note 13, at 151-54. *Cf.* C. BROWN, *supra* note 17, at 88-90 (supply of outside directors is inelastic only in short run); H. KOONTZ, *supra* note 13, at 228, 236-37 (shortage is largely a product of too narrow a view of what makes a good director). *But see* Friendly, *supra* note 49, at 529 (there are enough qualified outside directors).

[170] C. BROWN, *supra* note 17, at 92; H. KOONTZ, *supra* note 13, at 121 (the ideal board should have no more than 13 directors). *See* HEIDRICK & STRUGGLES, INC., *supra* note 18, at 4. Committees should be small, generally with no more than three or four members; C. BROWN, *supra* note 17, at 65.

[171] *See* notes 66-67 and accompanying text *supra*.

[172] *See* notes 66-69 and accompanying text *supra*.

[173] *See* Winter, *supra* note 71, at 255-58.

[174] *See* Barnes v. Andrews, 298 F. 614, 617, (S.D.N.Y. 1924) (L. Hand, J.), in which the court said a director "had no right to interject himself personally" into a dispute between officers that helped lead to the corporation's demise. *See also Corporate Director's Guidebook*, *supra* note 44, at 1603 ("[A]ctual operation is a function of management. The responsibility of the board is limited to overseeing such operation.").

The monitoring model will not solve the problem of proof of proximate cause. Indeed, although the problem may be somewhat mitigated by the reduction of the scope of directors' duties, it may also be exacerbated because it will be extremely difficult to prove that an identifiable corporate loss resulted from a failure to monitor. For example, failure to replace an incompetent management will damage the corporation, but to prove the extent of the loss by showing how much better a different, more competent management would have done will usually be impossible. However, effective enforcement of the monitoring model does not necessarily require frequent imposition of personal liability on the directors. Both market forces[175] and suits for equitable relief can motivate directors to act prudently and these can be at least as effective as holding directors liable for negligence. A derivative suit seeking an injunction avoids not only the issue of loss causation but also the problem of ultimately shifting liability back to the shareholders through indemnification or insurance.[176] It also avoids the potential problem of damages being excessive in relation to the magnitude of the director's sins.[177] Furthermore, suits for equitable relief promote a dialogue between the courts and corporate boards about the boards' proper functions, a dialogue that is especially desirable while the monitoring model is in its formative stages.

Stressing injunctive actions would not, if combined with a more rigorous duty of care, eviscerate sanctions for breach. First, the prospect of being sued is itself a substantial deterrent for many corporate executives who serve as outside directors.[178] The further prospect of being enjoined for failure to perform one's duties increases the deterrence.

More important, courts can use their injunctive powers in imaginative ways to improve corporate governance. So far, courts have barely scratched the surface of these powers. For example, courts have occasionally enjoined defendants from serving as directors, but more often they have held that they lack the power to remove directors, except perhaps for fraud.[179] Such

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[175] *See* note 69 and accompanying text *supra*.

[176] *See* note 162 and accompanying text *supra*.

[177] In the case of any substantial public corporation engaged in transactions worth millions of dollars, a damage action for mere negligence could result in crushing liability. Hawes & Sherrard, *supra* note 143, at 3 n.1 (examples of excessive damage cases).

[178] *See* W. CARY & M. EISENBERG, *supra* note 20, at 562 ("His reputation and prestige in his community may be injured by the bringing of the action alone."); Cary, *Corporate Standards and Legal Rules*, 50 CALIF. L. REV. 408, 418 (1962) (corporate managers are very responsive to public opinion).

[179] Some courts have removed directors pursuant to their inherent equitable powers. Brown v. North Ventura Rd. Dev. Co., 216 Cal. App. 2d 227, 30 Cal. Rptr. 568 (1963). Some courts have suggested in dicta that they have such powers. Feldman v. Pennroad Corp., 60 F. Supp. 716 (D. Del. 1945), *aff'd*, 155 F.2d 773 (3d Cir. 1946), *cert. denied*, 329 U.S. 808 (1947) (no removal unless directors guilty of fraud); Gettinger v. Heaney, 127 So. 195 (Ala. 1930) (no removal unless other

passivity is unwarranted. Indeed, even if courts feel they cannot or should not order reform of a corporation's governance structure where no violation of fiduciary duties has been shown, such reform should be considered and, where appropriate, mandated when fiduciary duties have been violated.

Consider, for example, the well-known case of *Graham v. Allis-Chalmers Manufacturing Co.*[180] The Delaware Supreme Court held that the director defendants had not breached their duty of care in failing to discover antitrust violations by several corporate officers. Commentary on the case has focused on whether the court erred in failing to assess damages.[181] The more fruitful inquiry would be whether the court erred in declining to order appropriate injunctive relief. If failure to discover the officers' misdeeds resulted from the directors' incompetence or lack of time or independence, the court could have enjoined the directors from continuing in office and taken steps to see that their replacements would be more effective. If the solution was "an internal control system to prevent repeated antitrust violations,"[182] rather than holding the directors liable for failure to install such a system (perhaps only to see the directors then made whole by indemnification or insurance),[183] the court should have ordered the board to install such a system. Such injunctions could provide both guidance to corporate boards and practical experience on the basis of which courts might then issue injunctions where the corporation had not yet suffered any loss.[184]

Precedents for this approach are found in the corporate governance reforms the SEC has obtained as ancillary relief in many consent decrees.[185] It

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remedies inadequate); De Garmo v. Goldman, 19 Cal. 2d 755, 123 P.2d 1, 4 (1942); Nahikian v. Mattingly, 265 Mich. 128, 251 N.W. 421 (Mich. 1933) (no removal unless directors guilty of fraud); *see* Brudney, *Fiduciary Ideology in Transactions Affecting Corporate Control,* 65 MICH. L. REV. 259, 281 (1966); Annot., 124 A.L.R. 364 (1940). In some states the power to remove directors has been conferred by statute. CAL. CORP. CODE § 304 (Deering 1977); N.C. GEN. STATS. § 55-27(g) (1975); N.Y. BUS. CORP. LAW § 706(d) (McKinney 1976); PA. CONS. STAT. ANN. tit. 15, § 1405(c) (Purdon 1967). Other courts have held that they lack power to remove directors. Neall v. Hill, 16 Cal. 146 (1860); *In re* Burkin, 1 N.Y.2d 570, 136 N.E.2d 862, 154 N.Y.S.2d 898 (1956). Professor Stone has recommended removal of directors for breach of their fiduciary duties, but he contemplates removal pursuant to a federal statute or rules of a new Federal Corporations Commission. C. STONE, *supra* note 119, at 149. The view of the author of this Article is that state courts already have the power not only to remove directors but to order further corporate governance reforms. *See* note 187 *infra*.

[180] 41 Del. Ch. 78, 188 A.2d 125 (S. Ct. 1963).

[181] Cary, *supra* note 3, at 683.

[182] *Id.*

[183] *See* notes 160-62 and accompanying text *supra*.

[184] Of course, breach of some duty would have to be shown, but failure to institute monitoring mechanisms may, in light of future experience, be deemed to violate the duty of care even though no loss has yet occurred.

[185] *See* notes 96-99 and accompanying text *supra*.

may be questioned whether obtaining these decrees is beyond the Commission's statutory powers,[186] but this criticism could not be leveled at state courts granting similar relief.[187] Moreover, the SEC has acted in part because the states have declined to act. If the SEC is not to preempt state law in corporate governance,[188] it may be necessary for state courts to play a more active role.

Although injunctive actions should be stressed in enforcing the duty of care, damage actions should not be abandoned altogether. The rules pertaining to damage actions, however, should be revised to make them more effective and reasonable. Professor Conard wisely suggests that derivative suits against directors for breach of the duty of care would be more effective if insurance and indemnification against liability were eliminated,[189] and if damages were limited, perhaps, to a director's compensation from the corporation for one year.[190] This reform would eliminate the prospect of Draconian damages for mere carelessness and with it some of the reluctance of courts to impose damages at all. It would also prevent directors from shifting to the shareholders, the persons to whom they owe the duty of care, the burden of liability for breach of the duty. Although forbidding insurance and indemnification would tend to discourage even competent persons from serving as directors,[191] limits on personal liability would have the opposite effect.

Limiting damages might occasionally leave insufficient funds to pay for the plaintiff's attorneys' fees, the customary practice in derivative suits,[192] but such cases would probably be rare.[193] Moreover, an award of

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[186] H. KRIPKE, *supra* note 92, at 189, 197-98; Comment, *supra* note 96.

[187] Although courts have been reluctant to order broad injunctive relief in derivative suits (which are proceedings in equity), there is no doubt that the power to order such relief exists. 3A W. FLETCHER, *supra* note 43, §§ 6027-6042; H. HENN, *supra* note 45, § 375. This power permits a court to install a receiver or to order dissolution. *See* note 179 *supra*. *A fortiori*, courts have the power to require corporations to institute the changes necessary to enable the directors to fulfill their duty of care.

[188] One commentator has opined that "[d]uring the past few years, the SEC has been carefully laying the groundwork for extending its jurisdictional reach to preempt the state corporation laws." Rosenfeld, *Corporate Governance*, 7 SEC. REG. L.J. 171, 172 (1979).

[189] Conard, *supra* note 42, at 913-15.

[190] *Id.*

[191] *See* C. BROWN, *supra* note 17, at 38 (threat of personal liability now deters many from serving as directors); Conard, *supra* note 42, at 899, 903; note 146 and accompanying text *supra*. *Contra*, E. MCSWEENEY, *supra* note 20, at 106 ("it is widespread frustration [with "the impotence of their positions"], more than fear of liability suits, that is most responsible for the decline in the number of persons willing to accept directorships.").

[192] *See* W. CARY & M. EISENBERG, *supra* note 20, at 938-39; H. HENN, *supra* note 45, § 377.

[193] If courts limit damage awards as Professor Conard suggests, a major source of

damages will often be accompanied by an injunction benefitting the corporation; this would warrant the payment of attorneys' fees by the corporation if damages are insufficient.[194] Although requiring the corporation to pay plaintiff's attorneys' fees in effect shifts fees to the shareholders, these fees will be much cheaper than indemnification or insurance of the directors against liability.[195]

The procedural obstacles to plaintiffs in derivative suits that exist today will remain under the monitoring model.[196] It is beyond the scope of this Article to propose a comprehensive solution to the problem of permitting meritorious derivative suits without encouraging frivolous strike suits. Legislation will be necessary to remedy some problems.[197] However, revamping the duty of care under a monitoring model of corporate governance should make the duty more rational from the perspective of both shareholders and directors and thereby reduce the fears of abuse that have prompted creation of many obstacles to derivative suits.[198] For example, by giving directors a feasible set of duties, the monitoring model may enhance judicial belief that derivative suits to enforce these duties are not merely strike suits brought for the benefit of plaintiffs' attorneys.

By expressly relieving directors of the duty to manage, the monitoring model facilitates imposing this duty on the officers. Not only will the duty to manage be placed squarely on the executive team, but the board will also have an incentive to assign specific managerial tasks to each executive, or at least ensure that such an assignment has been made by the chief executive officer.[199] Although courts and commentators have long recognized that corporate officers owe a duty of care,[200] the officers have rarely been held

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contention will be eliminated, making settlements more likely and trials less time-consuming. Plaintiffs' attorneys already have strong incentives to settle. Alleghany Corp. v. Kirby, 333 F.2d 327, 347 (Friendly, J., dissenting), *aff'd en banc by an equally divided court*, 340 F.2d 311 (2d Cir. 1964), *cert. dismissed*, 384 U.S. 28 (1966). Prohibiting insurance of directors and officers would increase the incentive for defendants to settle unless they were confident of exoneration at trial.

[194] Most states now authorize such payments. *See* W. CARY & M. EISENBERG, *supra* note 20, at 939; H. HENN, *supra* note 45, § 377, at 795-96.

[195] Insurance, for example, will often cover both plaintiffs' and defendants' attorneys' fees, and perhaps amounts paid in settlement or judgment as well. *See* Lloyd's Open Market Form of Directors' and Officers' Liability Insurance (ALS (D5)) § 2(c), *reprinted in* W. CARY & M. EISENBERG, *supra* note 20, at 966.

[196] *See* note 164 *supra*.

[197] Many of the obstacles—including the requirements of security for expenses, contemporaneous ownership, and demand on the board—are imposed by statute and therefore can only be removed by statute. *See, e.g.*, N.Y. BUS. CORP. LAW § 626(b) & (c) (contemporaneous ownership and demand on board) and § 627 (security for expenses) (McKinney 1976).

[198] *See* A. CONARD, CORPORATIONS IN PERSPECTIVE § 525, at 399-400 (1976) (abuses led to imposition of many procedural obstacles to derivative suits).

[199] *See* notes 284-86 and accompanying text *infra*.

[200] 3A W. FLETCHER, *supra* note 43, § 1032; H. HENN, *supra* note 45, § 234. *See*

liable for breach of this duty[201] because under the received model of corporate governance the board was supposed to manage and the officers merely carried out the board's orders. The courts were also reluctant to hold the board liable for mismanagement, however, because the board was incapable of managing.[202] By assigning the officers the duty to manage and ensuring that specific management tasks are delegated to specific officers, the monitoring model remedies this problem.

Moreover, by requiring the officers to manage, the monitoring model eliminates many justifications for the evisceration of the duty to manage carefully. Under the received model, the courts insisted on a common standard of care for both inside and outside directors; rather than selecting a high standard that would have been appropriate for inside directors, they invariably adopted a low standard appropriate for outside directors.[203] With management delegated to the officers, there is no reason not to insist on a higher standard of care. A review of the factors that have contributed to the weakening of the duty to manage carefully make this apparent. The defense of reliance on information and opinions of others[204] makes sense with respect to management by outside directors because they lack independent sources of information and the time and expertise to form opinions on difficult management questions. Not so with the officers; their right to rely should be strictly circumscribed. Another justification for avoiding a stringent duty to manage carefully was that it would deter the best outside directors from serving—directors' fees have never been large enough, in and of themselves, to induce the best to serve, and the position's honor could quickly be outweighed by any substantial threat of liability. However, these concerns are much less compelling, if applicable at all, when officers are involved; a stringent duty of care will not prompt officers to resign to become something other than corporate executives. If outside directors were required to manage, a rigorous duty of care might force them to be too cautious because no potential reward would offset the potential liability for

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N.Y. BUS. CORP. LAW § 715(h) (McKinney 1976). Section 35 of the Model Business Corporation Act did not include officers within the statutory duty of care because of problems in an officer's right to rely, though the Comment to section 35 noted that "a non-director officer may have a duty of care similar to that of a director as set forth in section 35." MODEL BUS. CORP. ACT. ANN. § 35, Par. 1, at 256 (2d ed. 1977 Supp.).

[201] 3A W. FLETCHER, *supra* note 43, § 1032 ("Most of the decisions involving the question as to the required degree of care are expressly limited to directors, and there is very little law as to the degree of care required of other officers.") *See also* 3 *id.* § 991, at 522.

[202] *See* notes 18-29 and accompanying text *supra*.

[203] This has been particularly evident with respect to the board's duty to supervise, where the courts have based standards of care on the outside director who devotes little time to the business. *See Graham*, 41 Del. Ch. at 84-86, 188 A.2d at 130-31.

[204] *See* notes 142-45 and accompanying text *supra*.

taking substantial risks. The officers, however, would not be too cautious because they have large potential rewards for risk-taking in the form of bonuses, larger salaries, enhanced value of stock and stock options, greater job security, and greater value in the job market if ventures succeed.[205]

Proof of proximate cause has created major problems under the received model.[206] The monitoring model can ameliorate these problems if not eliminate them completely. Since all managerial tasks rest with the entire board under the traditional model, a director's duty as to any single task is necessarily spread thin. If each managerial task were assigned to a specific officer, this problem would diminish. Even a reasonably diligent outside director cannot be held to a high standard of effort or expertise in making management decisions, but an officer can be.

Although obstacles to derivative suits will remain under the monitoring model, the rationalization of liability outlined above should help persuade courts and perhaps legislatures to reduce those obstacles.[207] Derivative suits could then become an effective tool, working in tandem with monitoring by the board, toward the desired end of effective corporate governance.

D. *Summation*

The courts' refusal to impose a rigorous duty of care is best explained by the confusion generated by the traditional model of corporate governance. The monitoring model of corporate governance removes this confusion and thereby eliminates most objections to a rigorous duty of care. It remains to be determined, however, to what extent a court could in practice require and enforce monitoring.

VI. Toward Enforceable Standards for Monitoring

Although adoption of the monitoring model of corporate governance clears the way for a shift in judicial attitudes towards the duty of care, courts cannot effectively enforce the duty unless there are workable, enforceable standards for monitoring. Without such standards, the monitoring model may become little more than a pious wish that the directors do something good, with no penalty if they persist in doing virtually nothing.

An initial question is where courts can find authority to require directors to monitor. The command, now contained in many state statutes, that the corporation shall be managed "under the direction of" a board of directors[208] could be easily construed to require monitoring once courts concede that this is the one important function that the board can perform.[209] In the

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[205] *See* notes 66-67 and accompanying text *supra*.

[206] *See* notes 158-59 and accompanying text *supra*.

[207] *See* note 198 and accompanying text *supra*.

[208] *See* note 31 and accompanying text *supra*.

[209] *See* M. Eisenberg, *supra* note 16, at 156-68 (discussion of importance of monitoring as main board function).

few states in which statutes still provide that the board shall manage the corporation, it may be a bit harder for the courts to reach this result—but not unduly so, because of the general agreement that boards do not and cannot manage. Indeed, court-imposed duties already anticipate certain aspects of monitoring. For example, courts often recognize a directorial duty to supervise subordinates[210] and to inquire when put on notice that the corporation is being mismanaged.[211] If the courts can fashion a duty to supervise and to inquire about mismanagement, they should be able, supported by recent developments in corporate governance theory, to fashion a duty to monitor.[212] Whether this broad duty can lead to concrete, enforceable rules will be discussed below.

Most proponents of monitoring identify discrete duties the board would perform and advocate the discharge of these duties through a system of board committees.[213] Corporate practice has recently moved in a similar direction.[214] Accordingly, the remainder of this section will be organized into discussion of these duties—evaluation of management's performance and determination of management's compensation; evaluation of incumbent directors and nomination of new directors; overseeing corporate accounting practices and audits; monitoring compliance with the law; allocating managerial duties to officers; and reviewing interested transactions. In practice, much board work must be delegated to committees if, as is contemplated by the monitoring model, part-time outside directors are to dominate the board.[215] To perform any single major monitoring function effectively will require a greater time commitment than outside directors have previously given.[216] Without committees, no director could properly perform all these functions and yet serve only part-time.

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[210] *See* H. HENN, *supra* note 45, § 234.

[211] *See* Bates v. Dresser, 251 U.S. 524, 529-30 (1920); *Graham*, 41 Del. Ch. at 84, 188 A.2d at 130 (S. Ct. 1963) ("[D]irectors are entitled to rely on the honesty and integrity of their subordinates until something occurs to put them on suspicion that something is wrong."); 3A W. FLETCHER, *supra* note 43, § 1078.

[212] *See* C. BROWN, *supra* note 17, at 21 ("The dictum in state charters that the corporation 'shall be managed by the board of directors' can only mean that general control and direction of corporate affairs and the supervision of the corporate officers, to whom the day-to-day management is delegated, belongs to the board."). *Cf.* Mundheim, *supra* note 49, at 181 (courts might hold that ordinary prudence requires directors of a public corporation to have or establish an audit committee).

[213] C. BROWN, *supra* note 17, at 62, 64–65; H. KOONTZ, *supra* note 13, at 170-71; Harris, *Directors of Industrial Companies: Special Problems*, 31 BUS. LAW. 1235, 1239-40 (1976).

[214] *See* notes 51-56 and accompanying text *supra*. As to the frequency of compensation, nominating, and audit committees, see notes 219, 252, & 265 *infra*.

[215] *See* C. BROWN, *supra* note 17, at 62, 64-65; H. KOONTZ, *supra* note 13, at 170-71; Harris, *supra* note 213, at 139-40; Leech & Mundheim, *supra* note 20, at 1807-09.

[216] *See* notes 26 & 167 *supra*.

A. *Evaluation of Management's Performance and Determination of Management's Compensation*

The core concept of the monitoring model is that the board, though incapable of managing the corporation, can and should monitor management's performance.[217] Accordingly, the key function of the monitoring board is to evaluate management's performance. Corollary duties include rewarding superior management with increased compensation, discharging incompetent managers, and filling management vacancies. Many corporations have recently established compensation committees,[218] but few have authority to suggest the discharge of managers, to fill vacancies, or even to evaluate management's performance.[219] Moreover, existing compensation committees often include inside directors.[220] Thus, outside directors now rarely evaluate management's performance and, except in extreme emergencies,[221] do not discharge managers or fill managerial vacancies.

Business commentators discussing evaluation of management's performance have generally advocated management by objectives and appraisal by results. Management by objectives entails the establishment of quantifiable goals against which the managers' performance will be measured. Appraisal by results is the subsequent evaluation of the managers' performance, taking into account not only success or failure in meeting the established goals but also external factors affecting that success or failure but not anticipated when the goals were set.[222] Some have objected that quantifiable goals may

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[217] C. BROWN, *supra* note 17, at 26, 30; E. MCSWEENEY, *supra* note 20, at 105; Conrad, *supra* note 42, at 917; Mace, *supra* note 26, at 21; Manning, *supra* note 37, at 27-28.

[218] One study showed that between 1973 and 1977, the proportion of surveyed corporations that had compensation committees grew from 76.1% to 87.6%. KORN/FERRY INTERNATIONAL, *supra* note 18, at 11.

[219] The duty traditionally assigned to the compensation committee is to determine whether the corporation's executive compensation is adequate to attract and retain highly qualified management and to encourage "extraordinary effort through incentive awards." ABA Committee on Corporate Laws, *The Overview Committees of the Board of Directors*, 34 BUS. LAW. 1837, 1848 (1979). A few corporations do, however, encourage board evaluation of management. *See* R. MUELLER, BOARD COMPASS 73 (1979) (discussing Pillsbury Co. and Massachusetts Mutual Life Ins. Co.); R. MUELLER, NEW DIRECTIONS FOR DIRECTORS 48 (1978) (discussing Continental Telephone Corp.). Most boards do not, however, evaluate management's performance in any depth. C. BROWN, *supra* note 17, at 26.

[220] In a recent survey by the SEC, over 40% of the companies with compensation committees had at least one committee member with a relationship listed in Item 6(b) of Schedule 14A. SEC Exchange Act Release No. 17,158, Table 15, SEC Docket 1551, 1573 (Feb. 5, 1981).

[221] M. MACE, *supra* note 13, at 65, 70. *But see* Bauer, *Why Big Business Is Firing the Boss*, N.Y. Times, Mar. 8, 1981, § 6, at 22, col. 1, indicating that dismissal of high-level executives is becoming more common.

[222] H. KOONTZ, APPRAISING MANAGERS AS MANAGERS 80 (1971); H. SMITH

work well at lower echelons, where more tangible tasks are performed, but not at the level of top management; nonetheless, they argue that management can be evaluated as to its qualitative performance of more nebulous tasks, such as planning, staffing, and discharging corporate social responsibilities.[223]

This approach to evaluating management's performance arguably has much to recommend it. Evaluation of lower level managers by top management is an inherent part of any but the smallest business. In fact, a central feature in the evolution of the modern multidivisional public corporation was the creation of an executive management divorced from operations and devoted solely to long range planning and to evaluating the performance of operating units.[224] One problem not solved by the multidivisional form is that executive management may be incompetent or may pursue nonprofit goals, such as growth, with no restraint other than the threat of takeover[225]—a threat inadequate by itself to ensure competence or pursuit of maximum profits.[226] Evaluation of management by nonmanagement directors is a logical extension of the multidivisional form and may help solve this problem.[227]

The existence of an independent board committee which would evaluate management and mete out appropriate reward or punishment and which might announce its conclusions publicly[228] should itself motivate manage-

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& P. BROUWER, PERFORMANCE APPRAISAL AND HUMAN DEVELOPMENT 77 (1977); Wikstrom, *Management by Objectives or Appraisal by Results*, in MODERN MANAGEMENT: ISSUES AND IDEAS 436 (D. Hampton ed. 1969).

[223] H. SMITH & P. BROUWER, *supra* note 222, at 81 ("A simple, quantitative approach to 'management by objectives' may work well at lower echelons . . . but it is likely to be inappropriate at higher levels in the organizations."); Burton, *supra* note 68, at 486.

[224] A. CHANDLER, THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS 6-12 *passim* (1977). *See generally* A. CHANDLER, *supra* note 15, at 1-17.

[225] O. WILLIAMSON, *supra* note 75, at 165-66.

[226] *See* notes 71 & 75 and accompanying text *supra*.

[227] Another approach to evaluating management is the management audit. Commentators do not completely agree on what this is. Most see it as an evaluation to be conducted by independent certified public accountants, but whether this audit would be intended primarily to rate management or merely to give it advice is not clear. *See* M. EISENBERG, *supra* note 16, at 210-11; H. KOONTZ, *supra* note 222, at 179 and authorities cited at 179 n.6; Burton, *supra* note 68; Campfield, *Management Auditing: Pathway to Efficient, Economical Operations*, 35 INTERNAL AUDITOR 33 (Apr. 1978). Others see the management audit as being performed or commissioned by outside director. *See* Smith, *Performance Audits by Outside Directors*, in CORPORATE DIRECTORS CONFERENCE, THE CORPORATE DIRECTOR: NEW ROLES, NEW RESPONSIBILITIES 65 (1975); Wilde & Vancil, *Performance Audits by Outside Directors*, 50 HARV. BUS. REV. 112 (July-Aug. 1972).

[228] Public disclosure of board evaluations of management might increase management's hostility to the board and opposition to monitoring. There is also the danger that public disclosures of corporate goals might be deemed predictions that

ment to perform better. It should also improve management's planning and control, and help to clarify organization roles.[229] The benefits of board evaluation of management will be greatest in those companies in which competition in product and capital markets is least effective, because it would furnish rewards and punishments that these markets ordinarily provide. If securities analysts believe the board to be truly competent and independent, the board's evaluation could become a significant piece of market information.[230] Management compensation structures and the capital market's preoccupation with short-term performance currently force management to stress short-term results.[231] However, the board can encourage management to give greater emphasis to long range goals, especially if capital markets come to rely on board evaluations so that stock prices and takeover threats do not depend so heavily on short-term profits.[232]

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would give rise to securities law violations unless carefully framed. On the other hand, disclosure might serve as an additional incentive for management to perform well. Moreover, board evaluations cannot become market information, *see* text accompanying note 230 *infra*, unless publicly disclosed. If the board's evaluation becomes material information, SEC rule 10b-5 would prevent insiders from trading in the corporation's stock until the evaluation was disclosed. *See, e.g.*, SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). In fact, disclosure might be required even if the insiders were not trading in the stock. *See* R. JENNINGS & H. MARSH, *supra* note 83, at 949-50.

[229] H. KOONTZ, *supra* note 222, at 81-83.

[230] This is because the board, as part of the corporate governance structure, has better access to corporate information and can get better cooperation from management than market analysts. Therefore, it can make a better informed evaluation. O. WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS 146-47 (1975). The importance of the evaluation of management in investment decisions cannot be doubted. Franchard Corp., 42 S.E.C. 163 (1964); *New Approaches to Disclosure in Registered Security Offerings*, 28 BUS. LAW. 505, 530-31 (1973) (ABA Panel) (remarks of Harold Marsh, Jr.). It is not far-fetched to imagine that markets would rely on outside directors. Shareholders and underwriters have insisted that public companies add outsiders to their boards. H. KOONTZ, *supra* note 13, at 130-32.

[231] Indeed, the obsession of American corporate managers with short-term profits has itself become an obsession with commentators on American business. During just a few weeks while this Article was in preparation the author noted the following in the New York Times: Hayes, *Managers Adopting Long-Term Outlook*, Jan. 11, 1981, § 12, at 40, col. 1; Arenson, *Economists: Influential But Erratic*, Jan. 11, 1981, § 12, at 42, col. 3; Thurow, *Productivity: Japan Has a Better Way*, Feb. 8, 1981, § 3, at 2, col. 4; *Interview with Reginald H. Jones, How to Improve Management*, Jan. 27, 1981, § D, at 2, col. 1; Bauer, *supra* note 221, at 86, col. 4 (quoting an expert on executive compensation: "Contracts have, more and more, called for bonuses tied to short-term performance . . . .").

[232] *See* C. BROWN, *supra* note 17, at 6 (boards may take a longer range view than does management). Professor Williamson notes the possibility that internal auditors may, because of their superior access to information and cooperation, be better able

Corporate governance would improve substantially if board evaluation of management produced all these benefits and if the duty of care or some other legal norm required boards to evaluate management effectively and independently. Unfortunately, many problems exist with both the theory of board evaluation and the enforcement of a duty to evaluate.

An initial problem is determining who will set management's goals. Management, not the outside directors, currently sets goals and performs other important functions.[233] Professor Eisenberg believes that the board should set goals and denies that this would involve the board in the corporation's long-range planning. In his view, "it is one thing, for example, to demand a certain return on capital; it is another to decide on the strategy and tactics which promise to yield that return."[234] The dichotomy between setting goals and choosing means to attain those goals is not, however, as clear as Professor Eisenberg suggests. Management can be expected to argue that the board has set goals too high.[235] Disagreements between the board and management over corporate goals could not only disrupt the firm but also diminish market reliance on the board's evaluation by raising questions about its validity. Independent objective standards to which the board or management could refer in setting goals or evaluating performance are quite rare. Two or more firms are seldom so similar that a useful comparison of their results is possible.[236] Information about competitors, especially concerning long-range plans, may be difficult to obtain at all or, at least, in time to make useful comparisons.[237] Even comparisons with a competitor will not be very helpful if the quality of the competitor's management is unknown—that is, outperforming a competitor means little if the competitor is incompetently managed.

Professor Eisenberg's dichotomy also ignores risk factors in setting

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to encourage risk-taking than the capital markets. But he also notes some doubt whether these "potential advantages . . . actually induce more aggressive risk-taking." O. WILLIAMSON, *supra* note 230, at 146 n.10.

[233] *See* note 17 and accompanying text *supra*.

[234] M. EISENBERG, *supra* note 16, at 165.

[235] *See* H. KOONTZ, *supra* note 222, at 86 ("[T]here is a natural tendency for subordinates to build padding into goals to assure they will exceed them."); E. MCSWEENEY, *supra* note 20, at 107 ("Even with a very cooperative CEO to work with, setting up a specific table of performance standards is likely to be a touchy, complex and unpleasant job."); H. SMITH & P. BROUWER, *supra* note 222, at 77 ("There is always potential for conflict in the process of setting objectives."). Although management's self-interest makes such objections suspect, management's superior knowledge of the company would lend credibility to its arguments.

[236] *See* Wilde & Vancil, *supra* note 227, at 113. *See also* Speech by SEC Chairman Harold Williams, *supra* note 67, at 10 ("It is, of course, impossible to generalize the appropriate performance standards applicable to every corporation. Nor can standardized check-lists adequately meet the individual needs of particular enterprises.").

[237] *See* Friendly, *supra* note 49, at 530.

financial goals. Higher goals require taking greater risks.[238] In setting goals, the board would thus profoundly influence corporate policy and perhaps lead the corporation to ruin if, for example, unreasonably high goals forced management to pursue unduly risky policies. High short-term profitability goals could force management to pursue unwise policies regarding research and development, maintenance and repair, accounting procedures, or other matters that would be very detrimental in the long-term.[239] If the board does not want management to disregard the future completely, it must set goals for product, plant, and market development and similar matters in addition to short-term profit. But selecting matters which management must concentrate on involves the board even more deeply in corporate planning. In sum, setting goals will invite disputes between management and the board. Moreover, it will necessarily require the board to make policy, in contradiction of the tenet that the board is competent only to evaluate management, not itself to manage.

The requirement to set goals also creates a tendency to stress quantifiable, short-term factors in order to facilitate a quick objective determination whether the goals have been met.[240] The tendency is understandable for several reasons. First, it is difficult to verify that nonquantifiable objectives have been met.[241] Second, setting long-range goals is difficult because long-term conditions are much harder to predict than are short-term conditions. And finally, both the evaluators and the evaluated need regular, fairly frequent evaluations if either is to benefit thereby. Nonetheless, the tendency to stress short-term quantifiable factors negates some important presumed benefits of monitoring. It not only defeats the goal of encouraging fair consideration of long-range and nonquantifiable objectives but actually further diverts management from these objectives—that is, it prompts management to concentrate on matters which will be evaluated, at the expense of other objectives.[242]

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[238] To accept greater risk investors demand higher expected returns. J. VAN HORNE, FINANCIAL MANAGEMENT AND POLICY 63-65 (4th ed. 1977). It follows that to aim for higher returns one must accept greater risk.

[239] *See* Bauer, *supra* note 221, at 86-87, for a description of how a CEO can boost short-term profits at the expense of long-run profits.

[240] *See* H. KOONTZ, *supra* note 222, at 86, 89-90, 96; Speech by SEC Chairman Harold Williams, *supra* note 67, at 16 ("In many corporations the board relies exclusively on current performance figures to determine the corporation's position, as well as to evaluate and reward management. This situation compounds management's own frequent tendency to have a short-term, bottom-line oriented focus—a myopia which could have a severely negative impact on the corporation's future."). Meaningless financials complicate the problem. *But see* R. SLOMA, HOW TO MEASURE MANAGERIAL PERFORMANCE 3-4 (1980); Wilde & Vancil, *supra* note 227, at 115-16.

[241] *See* H. KOONTZ, *supra* note 222, at 95-96, 104-05, 110-11; Burton, *supra* note 68, at 490.

[242] *See* H. KOONTZ, *supra* note 222, at 87-89; Wikstrom, *supra* note 222, at 439-40.

Evaluation of results is invariably complicated by conditions unforeseen when the goals were set.[243] When goals are not met, management is especially likely to blame unexpected conditions. This places the board in an awkward position: if it rejects this plea, squabbles between the board and management will follow; if it makes concessions, market reliance on its evaluations may be undermined by doubts as to the board's independence, vigor, or competence. If goals are not quantified, the board must still determine whether the goals have been met, which raises the possibility of further disputes between board and management.

To enforce the duty to monitor, courts may be able to impose some procedural standards on directors with respect to evaluating management. For example, a court might hold that the duty of care, including the duty to monitor, requires that the board establish formal mechanisms to evaluate management and perhaps even establish goals as part of these mechanisms. By requiring evaluators both to spend a reasonable amount of time evaluating management and to have no conflicts of interest, the court could in effect require boards to establish evaluation committees composed entirely of outside directors. These requirements might substantially improve board behavior. Independent-minded directors may now hesitate to evaluate management for fear that this may be deemed adversarial and therefore inappropriate.[244] A legal requirement that boards evaluate management would overcome this reluctance. Directors too timid to monitor might decide to resign. Most directors are competent businessmen who, if they are to do a job at all, want to do it well; therefore, if courts require boards to establish mechanisms to evaluate managements, many boards will perform the task as energetically and competently as possible. Despite the difficulties with evaluating that were discussed above, these evaluations will be preferable to the current total absence of independent evaluation of management.

But the problems courts will face in trying to impose any substantive standards on board evaluations will probably limit the benefits described above. As we observed, there are no objective standards for setting goals, determining whether they were met, or, if they were not, why not.[245] If a board will not evaluate management carefully and objectively, it can nonetheless produce a large paper record of its activities, thereby conveying the appearance of a good faith effort. Unless the directors are so careless as to leave evidence of bad faith in the record, a court will find it almost

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[243] *See* H. KOONTZ, *supra* note 222, at 87-88; Wilde & Vancil, *supra* note 227, at 114.

[244] *Corporate Director's Guidebook: Comments Submitted by the American Society of Corporate Secretaries*, 33 BUS. LAW. 321, 322, 326-27 (1977). "The monitoring posited by the *Corporate Director's Guidebook* could lead to an atmosphere of suspicion and distrust," "of caution and hostility." *Id.* at 326-27.

[245] *See* H. KOONTZ, *supra* note 222, at 110-11, 179; E. MCSWEENEY, *supra* note 20, at 106-07; Burton, *supra* note 68, at 486, 490; Wilde & Vancil, *supra* note 227, at 114.

impossible, except in the most extreme cases, to hold that the board has acted negligently in its evaluations.

The problem of establishing substantive judicial standards will also afflict judicial review of executive compensation. Indeed, this has long been the case in both the corporate and tax law areas. Since managements control most public corporations,[246] and thus set their own salaries, one would expect such salaries frequently to be excessive. Although all courts agree that compensation must be reasonable,[247] and although the cases enumerate factors relevant to reasonableness,[248] courts almost invariably refuse to hold compensation excessive.[249] Some courts have expressly despaired of finding any satisfactory yardstick by which to measure the reasonableness of compensation.[250] Independent boards as envisioned by the monitoring model could make executive compensation more reasonable on their own initiative. Courts could encourage this by demanding the procedures described above, but it would probably be unworkable to force boards to scale back executive compensation by imposing substantive limits.

In sum, although evaluation of management and determination of its compensation by an independent board or board committee may somewhat improve corporate governance, the benefits are unlikely to be great. The difficulties are considerable in both effectuating the directors' tasks and enforcing the duty to evaluate and to set compensation.

B. *Nomination of Directors*

For a board to function effectively, its members must be both competent and independent of management. Although monitoring adds no problems to the issue of determining who is independent, it increases the importance of

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[246] *See* notes 13-28 and accompanying text *supra*.

[247] *See* H. HENN, *supra* note 45, § 245, at 487-88 and cases cited in 488 n.16.

[248] *See* 5 W. FLETCHER, *supra* note 43, § 2133, at 576-77, and cases cited therein; 2 G. WASHINGTON & V. ROTHSCHILD, COMPENSATING THE CORPORATE EXECUTIVE 855-63 (3d ed. 1962) (listing factors considered in close corporation cases). The issue has been litigated most frequently in the federal income tax area in connection with the deduction of alleged salaries. *See* authorities cited in H. HENN, *supra* note 45, § 245, at 488 n.16.

[249] "In reading the cases, it is impossible to escape the conclusion that the courts will go to almost any length to avoid a clear holding on the reasonableness of compensation. They seem bold in pronouncing amounts unreasonable only when they have already found some other basis for decision." 2 G. WASHINGTON & V. ROTHSCHILD, *supra* note 248, at 866-67; *accord*, 5 W. FLETCHER, *supra* note 43, § 2133, at 575 ("The Courts are loath to interfere even though the amount may appear to be in excess of the value of the services rendered."). Moreover, the trend seems to be toward greater reluctance to hold compensation unreasonable. *See* 2 G. WASHINGTON & V. ROTHSCHILD, *supra* note 248, at 862.

[250] *See, e.g.*, Heller v. Boylan, 29 N.Y.S.2d 653 (Sup. Ct.), *aff'd without opinion*, 263 A.D. 814, 32 N.Y.S.2d 131 (1941).

independence by giving the board the quasi-adversarial task of overseeing and evaluating management. The model does pose additional problems regarding the competence of directors, however, by giving them new tasks to perform. At the same time, it increases the importance of competence because for the first time directors will play a significant role in corporate governance. Securing competent directors and ensuring their independence has been a perennial problem. This Article will next consider the functioning of the monitoring model with respect to the selection of competent, independent directors and discuss whether courts can, under the duty of care, develop enforceable rules to improve the process.

The problem of securing independent directors begins with the chief executive officer's leverage over director retention and selection.[251] Although the monitoring model does not directly affect the selection of directors, it may reduce this leverage in several ways and thereby promote the selection of more independent directors. The creation of a nominating committee composed primarily or, preferably, exclusively of outside directors helps insulate the selection process from the chief executive officer, at least if the chief is not a committee member. In the last few years many corporations have established such nominating committees.[252]

Can a court require a corporation to have a certain percentage (perhaps a majority) of outside, independent directors? Under the monitoring model, one can cogently argue the affirmative. The model divests the board of the duty to manage, a duty for which insiders are well suited, and instead commands the board to monitor insiders, a task for which outsiders are not only better suited but necessary if conflicts of interest are to be avoided. A court could reasonably hold that the duty of the board is to monitor management; that the insiders, as members of management, cannot monitor themselves; and, therefore, that the ordinary prudence demanded by the duty of care requires the board to select and retain a majority of outside directors.

At least for the next several years, however, no court is likely to adopt this position. Until recently, a board with a majority of insiders was the rule, and many boards are still dominated by a combination of inside and affiliated directors.[253] Moreover, some studies have concluded that inside boards are more effective than outside boards.[254] To demand a majority of independent

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[251] *See* M. MACE, *supra* note 13, at 94-95; Solomon, *supra* note 3, at 605.

[252] A survey by the American Society of Corporate Secretaries showed that of 993 responding companies the number with nominating committees grew between 1975 and 1978 from 111 to 297. American Society of Corporate Secretaries, *The Overview Committees of the Board of Directors*, 35 BUS. LAW. 1335, 1361 (1980). Of over 1,000 public companies recently surveyed by the SEC, 68.4% had compensation committees. SEC Exchange Act Release No. 17,518, SEC Docket 1551, 1567 (Feb. 5, 1981).

[253] *See* note 19 and accompanying text *supra*.

[254] S. VANCE, BOARDS OF DIRECTORS: STRUCTURE AND PERFORMANCE 5

directors, then, will probably be too radical a change for the common law to take.

Nonetheless, courts may well use the duty of care to require that oversight committees, central to the monitoring model,[255] be created and staffed entirely or predominantly by independent directors. Since oversight committees are a fairly new development, this would not be so radical a departure from time-honored practices. A nominating committee should have authority to nominate directors for committee membership. New directors could then be selected with a view to their ability to serve on specific committees. This approach would ensure that important monitoring functions will be performed by independent committees without abandoning the ancient and revered fiction that the board manages the corporation.

Requiring outsider-dominated oversight committees while permitting insider-dominated boards would be a step forward but would not ensure effective monitoring. The action of any board committee would probably be subject to revision by the entire board.[256] Moreover, insiders who dominate the entire board would be free to select and remove the committee members, thereby ensuring favorable composition of these committees. The constant threat of removal or nonreelection could compromise the independence of outside directors and help preserve current boardroom etiquette, which dictates that outsiders not rock the boat.

Because directors have traditionally done little of importance for the corporation,[257] their competence has generally been unimportant. Although

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(1964); Schmidt, *Does Board Composition Really Make a Difference?*, 12 CONF. BD. REC. 38 (Oct. 1975). *But see* H. KOONTZ, *supra* note 13, at 129-32, disputing Vance's position and noting that virtually every study confirms the desirability of having outside directors, and that shareholders and underwriters have insisted on outside directors to protect against "myopia" and "the abuse of powers."

[255] *See* notes 213-16 and accompanying text *supra*.

[256] Several states expressly provide that the committee shall serve at the pleasure of the board, N.Y. BUS. CORP. LAW § 712(c) (McKinney Supp. 1980); OHIO REV. CODE ANN. § 1701.63(c) (Anderson 1978), or that a majority of the full board may "(c) abolish any such committee at its pleasure; and (d) remove any director from membership on such committee at any time, with or without cause," N.J. STAT. ANN. § 14A:6-9(2) (West Supp. 1980), or that the committee shall be subject to the direction and control of the board, MINN. STAT. ANN. § 301.28(4)(8) (West Supp. 1979). *See also* 7 F. WHITE, NEW YORK CORPORATION ¶ 712.03 (13th ed. 1979). If the statute does not grant and the full board does not expressly reserve such power, whether the board may dissolve or overrule a committee is unclear. Several courts have held, notwithstanding the literal language of the relevant statutes, that the board is limited in the powers it can delegate to a committee. *E.g.*, Hayes v. Canada, Atl. & Plant S.S. Co., 181 F.289 (1st Cir. 1910); *see* Note, *Executive Committees—Creation, Procedures, and Authority*, 1967 WASH. U.L.Q. 42, 59-63. One commentator has suggested that because the committee is created by the board to assist in management, "there should be no question that the board may control the executive committee." *Id.* at 47.

[257] *See* notes 15-17, 23, & 26-27 and accompanying text *supra*.

most outside directors are corporate executives[258] and no doubt competent businessmen, the law has not often required directors to possess any special skills.[259] The *Corporate Directors' Guidebook*, for example, refers to such vague attributes as prudence and practical wisdom.[260] Monitoring may, however, require particular skills for the effective functioning of the oversight committees. For example, evaluation of a given management's performance by an evaluation and compensation committee will require considerable sophistication. This will also be true for membership on an audit committee, especially if that committee is to review accounting procedures as well as guard against misuse of corporate funds.[261]

Competence is a more nebulous quality than independence, but courts might nevertheless impose some meaningful limits in this area. Although courts have not traditionally required that directors possess any particular skills,[262] they might indirectly impose such a requirement by holding that the duty of care requires the board to nominate as new directors only persons who possess some minimum skills.[263] Requirements would be easier to impose if the director will be nominated for a committee that requires some expertise. For example, a court could well hold that a reasonably prudent person would not agree to sit on an audit committee, and that reasonably prudent directors would not elect one of their number for an audit committee, unless the candidate had substantial acquaintance with auditing and accounting procedures.

In addition to demanding competence and independence, monitoring also requires outside directors to devote more time to their positions than they traditionally have given. Few outsiders spend more than thirty-six hours per year attending meetings; moreover, many receive little information about the meeting prior to their attendance.[264] Although courts might not be able to fix the amount of time that a director must devote to his directorship, they could increase the time actually devoted. The courts could insist that the duty of care requires that the directors who perform the nominating function

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[258] *See* note 298 and accompanying text *infra*.

[259] *See* Barnes v. Andrews, 298 F. 614, 618 (S.D.N.Y. 1924); 3A W. FLETCHER, *supra* note 43, § 1061; MODEL BUS. CORP. ACT ANN. § 35, Comment at 257 (2d ed. 1977 Supp.); Stern, *The General Standard of Care Imposed on Directors Under the New California General Corporation Law*, 23 U.C.L.A. L. REV. 1269, 1276-77 (1976).

[260] *Corporate Directors' Guidebook*, *supra* note 44, at 1601.

[261] *See* notes 273-75 and accompanying text *infra*.

[262] *See* note 259 and accompanying text *supra*.

[263] Such a requirement can hardly be deemed radical since directors are already required to exercise due care in the selection and retention of officers. 3A W. FLETCHER, *supra* note 43, §§ 1079-1080; H. HENN, *supra* note 45, § 211, at 342; *Corporate Director's Guidebook*, *supra* note 44, at 1607. Query whether there is an adequate supply of competent outside directors. *See* note 169 and accompanying text *supra*.

[264] M. EISENBERG, *supra* note 16, at 141-43; *see* note 26 *supra*.

ascertain that nominees will be able to devote an adequate amount of time to their positions and recommend that current directors not be renominated if they do not devote sufficient time.

In sum, although a court cannot, under the duty of care, require the selection of the most independent and competent board possible or the commitment of specific amounts of time to directorships, it could impose some meaningful demands in these areas.

C. *Corporate Audits and Accounting Procedures*

The most common oversight committee is the audit committee.[265] The New York Stock Exchange requires listed companies to have audit committees composed solely of independent outside directors.[266] Until now audit committees have been intended primarily to prevent misuse of corporate funds by management. A principal question is whether they can go beyond this beneficial but limited function to the broader task of monitoring corporate accounting procedures.

Advocates of the audit committee conceived of it as a device to bring the board and the independent auditor together, giving the board an independent source of information about misuse of corporate funds and giving the auditor an outlet for reports of management's misconduct. Although audit committees help to deter and discover some questionable payments, their effect is probably limited. Accountants concede that an audit often cannot uncover skillfully disguised misuse of funds.[267] Even when auditors do discover questionable payments, they may be reluctant to report them to the audit committee. Management may retaliate and make life difficult for the auditors even if it cannot directly fire them. Also, auditors may fear that the board will identify with and be more concerned about protecting management than supporting the auditors.[268] An auditor might reasonably believe that the risks of disclosure exceed the risks of nondisclosure. Furthermore, the importance of deterring or discovering and punishing most questionable payments is debatable. Some have argued that many questionable payments are made in countries where such payments are standard practice and therefore American law should not prohibit them; there is some sympathy for restricting the scope of the Foreign Corrupt Practices Act.[269]

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[265] A survey by the American Society of Corporate Secretaries showed that in 1978, 963 of 993 responding companies had audit committees. American Society of Corporate Secretaries, *supra* note 252, at 1361.

[266] *See* note 52 *supra*. In 1977, Connecticut enacted a law in effect requiring every domestic corporation with 100 or more shareholders to have an audit committee. CONN. GEN. STAT. ANN. § 33-318(b)(1) (West Supp. 1980).

[267] *See* DeMott, *supra* note 58, at 212-13; Harris, *supra* note 213, at 1239; Solomon, *supra* note 3, at 609.

[268] Many factors compromise the independence and effectiveness of directors. *See* notes 15-28 and accompanying text *supra*.

[269] [1981] SEC. REG. & L. REP. (BNA) A-1 (Jan. 21, 1981) (President Reagan's

Courts could construe the duty of care to require a group with a majority of outsiders—either the entire board or a committee thereof—to work with the firm's independent auditors to prevent misuse of corporate funds. Indeed, it seems likely that some court will so hold before long, considering that the New York Stock Exchange has adopted a rule requiring an independent audit committee and that even public companies not listed have widely accepted it. However, the possibility of retaliation or board identification with management will remain to some extent, and the difficulty of uncovering misuse of funds will also remain.

If audit committees are to play a significant role in corporate governance, they must venture beyond the limited task of deterring and discovering questionable payments to the broader function of overseeing corporate accounting practices. Financial statements are the heart of corporate disclosure, yet an intensifying debate questions the adequacy of the generally accepted accounting principles (GAAP) used to compile those statements.[270] Under GAAP, companies retain broad discretion in the accounting treatment of many important financial matters.[271] Traditionally, management has selected corporate accounting procedures; but GAAP currently allows management to select procedures with a view to its own interests rather than to candid disclosure. For example, managers often seek to maximize short-run profits,[272] and toward that end they may try to accelerate the reporting of income and defer the reporting of expenses, thereby distorting reports of the corporation's financial performance.

However, an audit committee composed of outside directors would probably not choose accounting procedures materially different from those selected by management. Most audit committees will face severe constraints of time and competence. Accounting is an extremely complex discipline;[273] monitoring a large public company's accounting practices will require much time. The existing difficulty of finding competent directors with a willingness to serve[274] and sufficient time to do so will become especially acute with respect to an audit committee appointed to monitor accounting procedures.[275] Rules of most major accounting firms that bar both current and

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transition team recommends amendment of the Foreign Corrupt Practices Act to remove its criminal penalties); *G.A.O. Urges Easing of Corrupt Practices Act,* N.Y. Times, Mar. 5, 1981, § D, at 8, col. 5.

[270] *See* H. KRIPKE, *supra* note 92, at 144-48; Benston, *The Effectiveness and Effects of the SEC's Accounting Disclosure Requirements,* in ECONOMIC POLICY AND THE REGULATION OF CORPORATE SECURITIES 23, 28-29 (H. Manne ed. 1969); Speech by SEC Chairman Harold Williams, *supra* note 67, at 11, 14-15.

[271] M. EISENBERG, *supra* note 16, at 189-94, and authorities cited therein.

[272] *See* note 231 *supra*.

[273] Kripke, *The SEC, The Accountants, Some Myths and Some Realities,* 45 N.Y.U. L. REV. 1151, 1167-68 (1970).

[274] *See* note 169 and accompanying text *supra*.

[275] Membership on an audit committee will require a substantial amount of time. J.

retired members from sitting on audit committees exacerbate the shortage.[276]

Even if the audit committee has the time and competence to monitor accounting practices, it will be subject to many of the same pressures which influence management. Stock market prices tend to follow short-term performance[277] and do not always reflect a sophisticated understanding of complex accounting questions.[278] With the board playing an expanded role in the corporation, the directors may very well identify their own success with the corporation's success and be tempted to stress short-run performance in order to inflate the price of the corporation's stock. Moreover, if the board selects accounting methods that do not magnify short-term profits, it will have to face the unpleasant choice of either removing a management team that is performing well or explaining to disgruntled shareholders that the corporation's health is rosier than its financials suggest. The audit committee may well consider emphasis on short-term results preferable to either of these alternatives. Failure to choose accounting methods that maximize short-term profits and thus stock market price will also invite a tender offer by a raider whose understanding of accounting may be more sophisticated than the stock market's. The threat of a takeover, which if successful would result in the loss of corporate positions for not only management but the directors themselves, will pressure the audit committee to stress short-run results.

BACON, CORPORATE DIRECTORSHIP PRACTICES: THE AUDIT COMMITTEE 53-54 (1979).

[276] Professional standards of the accounting profession prevent an accountant, and perhaps even a retired accountant, from serving on the board of a corporation audited by his firm or former firm. AICPA Code of Professional Ethics Rule of Conduct 101(B)(1), 2 AICPA PROFESSIONAL STANDARDS (CCH) § 101.01; AICPA Interpretation of Rules of Conduct 101-2, 2 AICPA PROFESSIONAL STANDARDS (CCH) § 101.03. Several of the AICPA's Concepts of Professional Ethics also suggest the avoidance of conflict with other members of the profession. AICPA Concepts of Professional Ethics, 2 AICPA PROFESSIONAL STANDARDS (CCH) §§ 55.01, .05-.06 (1979). To avoid such conflicts, an accounting firm might bar incumbent and even retired members from serving on audit committees even if the firm is not the corporation's auditor.

[277] *See* note 231 *supra*.

[278] Commentators have disagreed whether accounting changes that do not affect cash flow affect stock price. Some believe that they do. Collins & Dent, *The Proposed Elimination of Full Cost Accounting in the Extractive Petroleum Industry: An Empirical Assessment of the Market Consequences*, 1 J. ACCOUNTING & ECON. 3 (1979); Lev, *The Impact of Accounting Regulation on the Stock Market: The Case of Oil and Gas Companies*, 54 ACCOUNTING REV. 485 (1979). *But see* Dyckman & Smith, *Financial Accounting and Reporting by Oil and Gas Producing Companies: A Study of Information Effects*, 1 J. ACCOUNTING & ECON. 48 (1979); Ball, *Changes in Accounting Techniques and Stock Prices*, J. ACCOUNTING RESEARCH 1 (Supp. 1972, *Empirical Research in Accounting: Selected Studies*).

From the shareholder's perspective, this may not be undesirable. Although investors generally and the public at large may want accounting procedures that most accurately portray corporate performance, existing shareholders will often prefer financials that exaggerate profits and thereby boost current market price. Moreover, the board arguably owes its allegiance to the shareholders and thus ought to choose whatever permissible accounting method will maximize the market price of the corporation's stock.

In short, delegating the selection of accounting procedures to an audit committee of outside directors rather than to management will probably not substantially change the methods selected. Nor does it seem likely that a rule of law can be fashioned that will require an audit committee to select specific accounting procedures different from GAAP or from those management would choose. Demanding superior accounting procedures will certainly become possible as accounting theory develops, but this demand could as easily be imposed on management as on an audit committee. Thus, the monitoring model is not apt to produce significant improvements in the accounting practices of major corporations.

D. *Monitoring Compliance with the Law*

Scandals over illegal corporate activities have led to suggestions that a major board function should be monitoring compliance with the law.[279] Both the evaluation of management performance and the audit committee discussed above are intended in part to monitor management's compliance with the law, but neither is designed comprehensively to seek out and prevent illegality. A legal compliance committee, similar to the audit committee but with access to the company's inside and outside counsel, could be useful because it would allow counsel to report management transgressions to someone other than management.

Assigning the board a general duty to monitor compliance with the law, however, poses several problems. Just as an audit committee may share the same attitudes that cause management to make illegal bribes and political contributions,[280] so outside directors may share the attitudes that cause management to break other laws. If the board sympathizes with management, it will not relieve counsel's fear of retaliation for whistleblowing. Moreover, counsel is likely to be even more ignorant of corporate illegality than auditors are of misuse of funds.

To require the board continuously to investigate the firm's compliance with the law would be unduly costly and impractical for a board dominated

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[279] *See Corporate Director's Guidebook*, *supra* note 44, at 1610; *The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation: Statement of the Business Roundtable*, 33 BUS. LAW. 2083, 2101 (1978). *See generally* Coffee, *supra* note 101.

[280] *See* note 268 and accompanying text *supra*.

by outsiders. If the board does act as a vigorous watchdog, management will view the directors as spies and keep as much information from them as possible.[281] Managements often break the law not to line their own pockets but to increase profits,[282] and in such cases one might question whether the board, as the elected representatives of the shareholders, should be assigned the task of preventing such breaches.

Nonetheless, monitoring compliance with the law is a promising board function. Although the board may sympathize with efforts to increase profits by breaking laws, it will also be anxious to avoid personal liability for failure to perform its duties. The board will therefore have an incentive to monitor compliance with the law to the extent that the law requires it to do so. Even if management attempts to keep the board ignorant of illegal activities, these attempts will not always succeed and incentives can be devised to induce management to keep the board well informed.[283] Although shareholders might sometimes prefer that laws be broken in order to increase profits, public policy need not give any weight to that preference.

E. *Allocating Managerial Duties to Corporate Officers and the Officers' Duty to Manage Carefully*

The monitoring model of corporate governance demands a candid recognition that a public corporation can only be and therefore must be managed by the corporate executives, not the board of directors.[284] As part of its monitoring, however, the board should allocate management chores among the corporate officers, or at least ensure that the chief executive officer has made such an allocation. Even the advocates of monitoring, who recognize the officers as the true managers of the corporation, have ignored the legal duties and liabilities of the officers. Courts will find it difficult to fashion concrete standards of care for many of the infinitely variable problems that corporate officers face, but shifting managerial burdens does clear the way for imposing on the officers a more rigorous duty to manage carefully.[285] Considering the almost complete ineffectiveness of the director's duty to manage carefully under the traditional model of corporate governance,[286] this would be a very significant change.

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[281] "[T]o get the outsiders poking around more than they are doing at present . . . is exactly what [inside managers] don't want." C. STONE, *supra* note 119, at 143. As a result, the board "was always the last group to hear of trouble in great business catastrophes of the century." P. DRUCKER, MANAGEMENT: TASKS, RESPONSIBILITIES, PRACTICES 628 (1973).

[282] *See* Werner, *supra* note 49, particularly at 388-89.

[283] *See* Coffee, *supra* note 101, at 1147-56 (advocating a "mini-board" structure and other devices for improving the flow of information to the board).

[284] *See* notes 18-24 and accompanying text *supra*.

[285] *See* notes 199-205 and accompanying text *supra*.

[286] *See* notes 131-64 and accompanying text *supra*.

F. *Reviewing Interested Transactions*

Most state corporation laws provide that noninterested members of the board may review a transaction in which any corporate officer or director is financially interested.[287] This board review constitutes a long-established form of monitoring. The growing significance of arguably interested transactions in anti-takeover efforts and board termination of derivative suits has increased the importance of the law of interested transactions.[288] To date, the interested director's influence over the noninterested directors has rendered board review ineffective to protect the corporation from unfair transactions. The monitoring model increases board independence[289] and thus may improve review of interested transactions, but the improvement will probably be slight, especially if inside and affiliated directors remain a board majority.[290] Directors will still tend to favor the insiders. The value of board review perhaps could be enhanced by increasing the liabilities of noninterested directors who approve unfair transactions. However, courts are unlikely to impose such liability except in the rare case in which bad faith can be shown;[291] moreover, the threat of liability could be counterproductive if the board were made so cautious that it refused to approve even beneficial transactions. A standard that required proof of the reviewing directors' bad faith would probably lead not to more effective board review but to the ritual building of a large, essentially meaningless, paper record designed to show the board's diligence and good faith.[292]

More important than the standard of the directors' liability for approving interested transactions is the question of the effect of that approval on a subsequent shareholders' derivative suit seeking to set aside the transaction or to hold the interested persons liable for damages. State law is unclear on this point: some statutes and cases suggest that noninterested director approval constitutes a complete defense to such a suit; others suggest that it does not prevent a court from deciding whether the transaction was fair to the corporation.[293] If board review became a substantial

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[287] *See, e.g.*, DEL. CODE ANN. tit. 8, § 144 (Supp. 1980); N.Y. BUS. CORP. LAW § 713 (McKinney Supp. 1980); MODEL BUS. CORP. ACT § 41 (1976). *See generally* W. CARY & M. EISENBERG, *supra* note 20, at 604-06.

[288] *See* M. LIPTON & E. STEINBERGER, TAKEOVERS AND FREEZEOUTS 294 (1978); Dent, *supra* note 138; Leech & Mundheim, *supra* note 20, at 1819-21.

[289] *See* note 47-48 & 251-52 and accompanying text *supra*.

[290] *See* note 19 and accompanying text *supra*.

[291] *See* notes 130-41 and accompanying text *supra*.

[292] Conard, *supra* note 42, at 903-04.

[293] *See* statutes cited in note 287 *supra*. *Compare id. with* Scott v. Multi-Amp Corp., 386 F. Supp. 44, 67-68 (D.N.J. 1974) *and* Kennerson v. Burbank Amusement Co., 120 Cal. App. 2d 157, 170, 260 P.2d 823, 831-32 (1953) *and* Remillard Brick Co. v. Remillard-Dandini Co., 109 Cal. App. 2d 405, 418, 241 P.2d 66, 74 (1952) *and* Fliegler v. Lawrence, 361 A.2d 218, 222 (Del. 1976) (all holding that an interested transaction must be reviewed for fairness, even though the statutory language read

barrier to shareholders challenging interested transactions, its overall effect on corporate law would be pernicious indeed. But if it did not create such a barrier, independent director review may be beneficial. The prospect of board review, especially if the board is substantially independent, may be a better inducement to insiders to design their transactions with the corporation more fairly than the threat of a derivative suit which may never be filed and which, if filed, will face numerous procedural obstacles.[294]

G. *The Monitoring Board and Social Goals*

In the 1930's, Professors Berle and Dodd began what has become an ongoing debate over the extent to which corporate decisionmakers should weigh the social impact of their actions.[295] Some have argued that a social conscience can and must be instilled in the corporation by changes in corporate governance;[296] others contend that the corporation's social responsibility is solely to maximize its profits.[297] This Article will not attempt to resolve this debate, but it is appropriate to consider the effect of monitoring on the corporate social conscience. The monitoring model is apt to produce a board committed to financial rather than social goals. By tradition, most outside directors are businessmen[298] who generally share the profit orientation of management. It is hard to imagine that any board

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literally suggested that approval by a majority of disinterested directors or shareholders is sufficient by itself). *See generally* H. HENN, *supra* note 45, § 239, at 375-76; N. LATTIN, *supra note* 131, at 290-94; Israels, *The Corporate Triangle—Some Aspects of the New Jersey, New York and Delaware Statutes*, 23 RUTGERS L. REV. 615, 627-28 (1969); Note, *"Interested Director's" Contracts—Section 713 of the New York Business Corporation Law and the "Fairness" Test*, 41 FORDHAM L. REV. 639, 648 (1973) and authorities cited therein; Note, *The "Unfair" Interested Directors' Contract Under the New York Business Corporation Law*, 16 BUFFALO L. REV. 840, 841-43 (1967) and authorities cited therein.

[294] *See* note 164 *supra*.

[295] The debate began with Dodd, *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932), and the response in Berle, *For Whom Corporate Managers* Are *Trustees: A Note*, 45 HARV. L. REV. 1365 (1932). For a continuation of the debate see Engel, *An Approach to Corporate Social Responsibility*, 32 STAN. L. REV. 1 (1979); Weiner, *The Berle-Dodd Dialogue on the Concept of the Corporation*, 64 COLUM. L. REV. 1458 (1964).

[296] *See* R. NADER, *supra* note 3; Nader, *The Case for Federal Chartering*, in CORPORATE POWER IN AMERICA 67 (R. Nader & M. Green eds. 1973).

[297] Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. Times, Sept. 13, 1970, § 6 (Magazine), at 33, *reprinted in* M. FRIEDMAN, AN ECONOMIST'S PROTEST 177-84 (1972). Professor Kripke has recently discussed the dangers of a board dominated by outsiders and committed to social rather than financial goals. *See* Kripke, *The SEC, Corporate Governance, and the Real Issues*, 36 BUS. LAW. 173 (1981). The author tends to agree with Professor Kripke's analysis.

[298] J. BACON, CORPORATE DIRECTORSHIP PRACTICES: MEMBERSHIP AND COM-

would deliberately depart from this tradition or that new directors not sharing the profit orientation would be nominated in large numbers by accident. Moreover, even if a board wanted substantially to abandon profit maximization, it probably could not do so for long because such action would attract takeover bids, proxy fights, and derivative suits for corporate waste.[299] If successful, any of the above would quickly reorient the corporation toward profit maximization.

H. *Other Monitoring Functions*

Other monitoring functions will probably not be as important as those previously discussed. The board will continue to be an occasional source of advice and counsel to management, but this will remain an insignificant function.[300] The board will still be required by state corporation laws to approve certain transactions, such as mergers and declarations of dividends.[301] Perhaps the more independent board envisioned by the monitoring model will play a more active role in such situations than the traditional board has, but for the most part the board will continue to rubber stamp management's proposals. Indeed, this is consistent with the philosophy that the board's function is to monitor, not to manage.

VII. CODA

A. *The Duty of Care vs. Other Possible Enforcement Mechanisms: A Recapitulation*

This Article earlier concluded that the duty of care could be at least as effective a tool for enforcing the monitoring model as any new or existing legislation.[302] In light of the subsequent conclusion that the duty of care is a deeply flawed tool for this purpose, it is appropriate briefly to reconsider the earlier conclusion. New legislation could overcome some problems noted with respect to the duty of care. For example, new legislation could require a majority of outside directors and even define the size of the required majority. However, most problems, especially the problem of providing sub-

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MITTEES OF THE BOARD 29, 39 (1973); M. MACE, *supra* note 13, at 87, 96-97, 106; Nutt, *A Study of Mutual Fund Independent Directors*, 120 U. PA. L. REV. 179, 217 (1971); Soderquist, *supra* note 146, at 1350-51; Solomon, *supra* note 3, at 584 & n.13.

[299] Although none of these devices is completely effective, *see* notes 71-81 & 164 and accompanying text *supra; see generally* notes 130-64 and accompanying text *supra*, they do in many cases constitute a substantial constraint on the ability of the board to abandon the goal of profit maximization. *See* Manne, *Mergers and the Market for Corporate Control*, J. POL. ECON. 73 (1965); note 163 *supra*.

[300] M. EISENBERG, *supra* note 16, at 157-58.

[301] *See* note 145 *supra*.

[302] *See* text accompanying notes 123-24 and text preceding note 165 *supra*.

stantive standards for the board's duty to evaluate management's performance, are inherent in monitoring and are thus not subject to legislative solution. In light of the tremendous political obstacles to new legislation, efforts to require adoption of the monitoring model and to enforce duties thereunder will be better focused on the duty of care despite its shortcomings. It follows *a fortiori* that existing legislation, none of which was designed to enforce the monitoring model, is also less promising than the duty of care.

B. *Conclusion*

The common law duty of care can, with minor exceptions, accomplish as much as new or existing legislation toward mandating and enforcing the monitoring model of corporate governance and is preferable thereto because of the political improbability of enacting effective legislation. Most of the considerations that have led the courts to eviscerate the duty of care disappear under the monitoring model. The time is propitious for persuading the courts to reinvigorate the duty of care—the American Law Institute (ALI) has undertaken a project on corporate governance[303] and, if it adopts an approach to the duty of care similar to that proposed in this Article, the prestige of the ALI will induce many courts to follow suit just as they have in the past followed the ALI's Restatements of the Law.

A far greater problem than convincing the courts to breathe life into the duty of care will be articulating specific, enforceable substantive standards for the discrete functions to be performed by the board under the monitoring model. Although the courts can impose effective substantive standards in some cases and at least require boards to follow certain procedures in others, they will usually find it impossible to articulate substantive standards. Thus, the monitoring model will be a largely unenforceable ideal, and will probably be so even if legislation is enacted to enforce it.

This does not mean that the monitoring model is useless. The combined weight of the law's moral force, of court-imposed procedural requirements, and of outside directors' good faith will lead to some effective monitoring. Certainly, the impact on corporate governance should be more beneficial than abolition of the board of directors, the only alternative if one rejects monitoring: if the board cannot monitor, there is no useful function it can perform. But there should be no unrealistic expectations about the magnitude of the benefit. Long traditions of directorial passivity must be overcome if boards are to monitor effectively, and neither market forces nor the law are adequate to the purpose.

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[303] *See Kaplan Named Chief Reporter for Corporate Governance Project*, 2 ALI REPORTER 1 (April, 1980).