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Improving Corporate Governance: Lessons from the European Community

BENJAMIN T. LO*

“Corporate governance is a means, not an end.”¹

Recently, the U.S. has witnessed bold and vigorous activity by the boards of directors of several large publicly held corporations. Within the last year, corporate boards of several major U.S. corporations have either dismissed or requested the resignation of their chief executive officers. Directors have replaced chief executives at such blue chip corporations as Eastman Kodak,² General Motors,³ Digital Equipment Corporation,⁴ Tenneco,⁵ Compaq Computer,⁶ International Business Machines Corporation,⁷ American Express Company,⁸ Westinghouse Electric Corporation,⁹ Time-Warner,¹⁰ Goodyear Tire and Rubber,¹¹ Sunbeam-Oster Company,¹² and Ames Department Store.¹³ This mass removal of chief and senior executives from several of the most prestigious corporations

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1. Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187 (1991).

2. John Holusha, *Eastman Kodak Chief Is Ousted By Directors*, N.Y. TIMES, Aug. 7, 1993, at 37.

3. Kathleen Kerwin et al., *Crisis At GM: Turmoil at the Top Reflects the Depth of its Troubles*, BUS. WK., Nov. 9, 1992, at 84.

4. Thomas C. Hayes, *Faltering Companies Seek Outsiders*, N.Y. TIMES, Jan. 18, 1993, at D1.

5. *Id.*

6. *Id.*

7. Catherine Arnt et al., *IBM After Akers: Now, A Board That Always Followed Must Lead*, BUS. WK., Feb. 8, 1993, at 22; Carol J. Loomis, *King John Wears An Uneasy Crown*, FORTUNE, Jan. 11, 1993, at 44-46.

8. Michael Janofsky, *A Surprise for Market By American Express*, N.Y. TIMES, Jan. 26, 1993, at D1; Bill Saporito, *The Toppling of King James III*, FORTUNE, Jan. 11, 1993, at 42-43.

9. John Holusha, *Westinghouse Chief Steps Down*, N.Y. TIMES, Jan. 28, 1993, at D1.

10. Thomas A. Steward, *The King Is Dead: Booted Bosses, Ornerly Owners, and Beefed-up Boards Reflect a Historic Shift in Corporate Power*, FORTUNE, Jan. 11, 1993, at 40.

11. *Id.*

12. Adam Bryant, *Sunbeam Dismisses Chairman: Analysts Shocked by Surprise Move*, N.Y. TIMES, Jan. 11, 1993, at D1.

13. Alan Farnham, *How to Stage a Coup*, FORTUNE, Jan. 11, 1993, at 41.

in the U.S. suggests that corporate boards will no longer passively tolerate poor financial performance.¹⁴ In essence, the recent activity by corporate boards strongly indicates a new era of corporate governance.¹⁵

Corporate governance is essentially concerned with the rules governing the structure of the corporation¹⁶ and the exercise of power and control of the business of a corporation.¹⁷ Of utmost interest are the roles, rights, and duties of the shareholders, the directors, and the executive officers.¹⁸ Under the traditional model of corporate governance, the board of directors manages the corporation and sets business policy.¹⁹ Executive officers act as agents of the corporate board and execute the board's decisions, while the role of shareholders, the owners of the corporation, is generally limited to electing directors and voting on major corporate matters such as amendments to corporate bylaws, mergers, and major corporate sales.²⁰ This model, however, has grown into disfavor as it is widely recognized that corporate directors do not perform management or policy making functions; rather, the operation of the corporation is an executive function.²¹ In fact, Professor Robert Hamilton has observed that "[m]odern boards of directors

14. See James Kim, *CEOs Must Get Results or Get Out*, USA TODAY, Jan. 28, 1993, at 1B-2B. See also, e.g., Holusha, *supra* note 2 ("Kay R. Whitmore, the chairman of the Eastman Kodak Company, who appeared to have survived a revolt by investors earlier this year, has been ousted by Kodak's board, apparently for not moving fast enough to improve the company's financial performance.").

15. Holusha, *supra* note 9, at D1; Kim, *supra* note 14 at 1B-2B; Steward, *supra* note 10, at 34-35.

16. Donald E. Schwartz, *Federalism and Corporate Governance*, 45 OHIO ST. L.J. 545 (1984).

17. Warren F. Grienberger, *Institutional Shareholders and Corporate Governance*, in PREPARATION OF ANNUAL DISCLOSURE DOCUMENTS 1992, at 171, 173 (PLI Corp. Law and Practice Course Handbook Series, 1992).

18. *Id.*

19. MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION—A LEGAL ANALYSIS 139 (1976). Professor Eisenberg cites former statutes such as Ill. Stat. Ann. Ch. 32, § 157.33 (1974) and N.J. Stat. Ann. § 14A:6-1 as examples of statutes embodying the traditional model of corporate governance.

20. WILLIAM L. CARY & MELVIN A. EISENBERG, CASES AND MATERIALS ON CORPORATIONS 206 (unabridged 6th ed., 1988).

21. EISENBERG, *supra* note 19, at 139-41. See also AMERICAN BAR ASSOCIATION, CORPORATE DIRECTOR'S GUIDEBOOK 9 (1978), quoted in American Law Institute, *Principles of Corporate Governance*, § 3.01, comment (a) (Proposed Final Draft, 1992) ("It is generally recognized that the board of directors is not expected to operate the business. Even under statutes providing that the business and affairs shall be 'managed' by the board of directors, it is recognized that actual operation of the board is limited to overseeing such operation"); JOHN BAKER, DIRECTORS AND THEIR FUNCTIONS—A PRELIMINARY STUDY 12 (1945) ("Under the system of directorates which has developed in this country among large, listed companies, directors are unable to 'manage' corporations in any narrow interpretation of the word Directors do not and cannot 'direct' corporations in the sense of operating them").

have practically nothing to do with the day-to-day business of the corporation."²²

Not only have legal scholars and researchers noted that corporate boards do not actively manage the corporation, but many state statutes reflect the modern practice that corporations may be managed by individuals other than corporate board members. In Delaware, where the largest number of large publicly held corporations have incorporated,²³ for example, the corporation law states that "[t]he business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation"²⁴ In addition, the American Bar Association's Committee on Corporate Law also recognizes that corporate boards do not fully manage the corporation.²⁵ Moreover, the American Law Institute's Governance Project has proposed and adopted the statement that the management functions of a corporation

should be conducted by or under the supervision of such principal senior executives as are designated by the board of directors, and by those other officers and employees to whom the management function is delegated by the board or those executives, subject to the functions and powers of the board under § 3.02.²⁶

22. Robert W. Hamilton, *Reliance and Liability Standards for Outside Directors*, 24 WAKE FOREST L. REV. 5, 9 (1989), reprinted in 1991-1992 CORP. PRAC. COMM. 285.

23. See William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 668 (1974); Peter J. Henning, *Corporate Law After the Eighties: Reflections on the Relationship Between Management, Shareholders, and Stakeholders*, 36 ST. LOUIS U. L.J. 519, 543-44 (1992) ("Delaware is the preeminent jurisdiction for defining the limits of corporate law because a disproportionate number of large companies are incorporated there.").

24. DEL. GEN. CORP. LAW § 141(a); see also CAL. CORP. CODE § 300(a) ("[T]he business and affairs of the corporation shall be managed and all corporate powers shall be exercised by or under the direction of the board"); 805 ILCS 5/8.05 (West Publishing, 1993) ("[E]ach corporation shall have a board of directors and the business and affairs of the corporation shall be managed by or under the direction of the board of directors."); IND. CODE ANN. § 23-1-33-1(b) (West Publishing, 1989) ("All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed under the direction of, its board of directors, subject to any limitation set forth in the articles of incorporation.").

25. See REV. MODEL BUS. CORP. ACT § 8.01(b) ("All corporate power shall be exercised by or under the authority of, and the business and affairs of the corporation managed under the direction of, its board of directors, subject to any limitation set forth in the articles of incorporation or in an agreement authorized under section 7.32 [Shareholder Agreements].").

26. American Law Institute, *supra* note 21, § 3.01 (citations omitted).

Thus, state legislatures, the American Bar Association, and the American Law Institute all recognize that corporations are managed by corporate executives, not the board of directors.

Therefore, the question remains: What is the role of the board in the modern corporation? Professor Melvin Eisenberg argues that corporate boards have four primary functions: to provide advice and counsel to the chief executive officer; to authorize major corporate actions; to provide a procedure for persons other than executives to be represented in corporate decisionmaking; and to select, dismiss, and monitor the performance of the chief executive officer and his or her senior executives.²⁷ According to the Business Roundtable,²⁸ corporate boards play an important role in corporate governance and serve five primary functions:

1. Select, regularly evaluate, and, if necessary, replace the chief executive officer. Determine management compensation. Review succession plan[s].
2. Review and, where appropriate, approve the financial objectives, major strategies, and plans of the corporation.
3. Provide advice and counsel to top management.
4. Select and recommend to shareholders for election an appropriate slate of candidates for the board of directors; evaluate board processes and performance.
5. Review the adequacy of systems to comply with all applicable laws/regulations.²⁹

Apparently, the most important function of the board of directors is to monitor or oversee executive action. Professor Eisenberg has argued that this role is "of critical importance to the corporation and uniquely suited for performance by the board."³⁰ Similarly, Chancellor William Allen of the Delaware Court of Chancery, a leading judicial scholar on corporate law, has stated that a basic responsibility of the board is "to monitor the performance of senior management in an informed way."³¹ Moreover,

27. EISENBERG, *supra* note 19, at 157-68.

28. The Business Roundtable is an association whose membership is limited to chief executive officers of major U.S. corporations.

29. Statement of the Business Roundtable, *Corporate Governance and American Competitiveness*, Mar. 1990, 46 BUS. LAW. 241, 246 (1990).

30. EISENBERG, *supra* note 19, at 162.

31. Chancellor William T. Allen, Delaware Court of Chancery, *Redefining the Role of Outside Directors in an Age of Global Competition*, presented at Ray Garrett Jr., Corporate and Securities Law

Professor Douglas Branson has argued that “[t]he heart of *Corporate Governance* has been the imposition of the so-called monitoring model.”³² However, corporate boards often perform the monitoring function either passively or ineffectively.³³ The American Law Institute admits that the oversight or monitoring role of the board of directors is usually not performed directly by active supervision of corporate executives.³⁴

Possible reasons for this inaction or ineffective oversight of executive action are numerous. First, because board members are often nominated by chief executives to serve on corporate boards, they may be reluctant to actively monitor corporate activity since they owe their appointment to the chief executive.³⁵ Quite often, chief executive officers nominate directors who “can be counted on not to rock the boat”³⁶ and who are submissive to corporate executives.³⁷ Second, directors usually do not have adequate time to carry out their assigned duties.³⁸ Boards usually meet no more than eight times per year, and when they do meet, directors are often occupied with complex management reports and other formalities.³⁹ Because scheduling of management presentations and reports is often determined by the chief executive officer, discussion time among directors may be “as elusive as the Loch Ness monster.”⁴⁰ Third, directors may be

Institute, Northwestern University, Chicago (Apr. 1992), reprinted in Martin Lipton and Jay W. Lorsch, *A Modest Proposal for Improved Corporate Governance*, 48 BUS. LAW. 59, 62 (1992).

32. Douglas M. Branson, *Countertrends in Corporation Law: Model Business Corporation Act Revision, British Company Law Reform, and Principles of Corporate Governance and Structure*, 68 MINN. L. REV. 53, 91 (1983).

33. See EISENBERG, *supra* note 19, at 140; Lawrence E. Mitchell, *A Critical Look at Corporate Governance*, 45 VAND. L. REV. 1263, 1273-74 (1992); JAY W. LORSCH & ELIZABETH MACIVER, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS 97-167 (1989); MYLES L. MACE, DIRECTORS: MYTH AND REALITY 39-42 (1986); Alfred F. Conard, *The Supervision of Corporate Management: A Comparison of Developments in European Community and United States Law*, 82 MICH. L. REV. 1459, 1472-73 (1984).

34. American Law Institute, *supra* note 21, § 3.02, comment (d).

35. EISENBERG, *supra* note 19, at 147; see also Alan Farnham, *How to Stage a Coup*, FORTUNE, Jan. 11, 1993, at 41.

36. EISENBERG, *supra* note 19, at 146.

37. Statement of the Business Roundtable, *The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation*, 33 BUS. LAW. 2083, 2092 (1978). *Contra* LORSCH & MACIVER, *supra* note 33, at 83 (stating that most corporate directors do not feel constrained by the chief executive officer, but directors do acknowledge the chief executive officer's superior power).

38. EISENBERG, *supra* note 19, at 141-43. See *supra* notes 26 and 28 and accompanying text for duties ordinarily assigned to corporate boards. For an extended discussion of the functions of a typical corporate board, see MACE, *supra* note 33, at 10-42.

39. Lipton & Lorsch, *supra* note 31, at 64. See also LORSCH & MACIVER, *supra* note 33, at 87.

40. LORSCH & MACIVER, *supra* note 33, at 87; see also MACE, *supra* note 33, at 186-87.

poorly informed about corporate matters⁴¹ or the information presented by management to the board may be too complex and unorganized to be easily comprehended.⁴² According to Professor Jay Lorsch, “[s]easoned directors recognize the complexity of the issues before them, and cognizant of their own lack of in-depth knowledge they are reluctant to speak up.”⁴³ Thus, if management and the chief executive officer fail to provide comprehensive and organized data to the board, corporate directors cannot effectively monitor the corporation.⁴⁴ Fourth, boards are unable to work as a cohesive group for the following reasons: they meet for only brief periods of time; they are often uninformed; they are unable to openly exchange ideas; they frequently have commitments outside the corporation board; and they lack a common goal.⁴⁵ The lack of a cohesive board denies directors the opportunity to work together in an effective manner. Finally, in most large publicly held corporations, the chief executive officer also assumes the role of the chairman of the board of directors.⁴⁶ As chair, the chief executive is the most influential person on the corporate board and directors tend to acquiesce to his or her decisions.⁴⁷ The chief executive officer has the power to shape agendas and select data that influence board decisions.⁴⁸

Even though many corporate boards have passively engaged in overseeing executive action, the recent removal of chief executive officers from some of the most prominent U.S. corporations strongly indicates that directors are willing to assume a more active role in corporate governance. The challenge now is to determine how to sustain active and effective monitoring by corporate boards, despite the systemic and functional problems that have hindered the oversight role in the past, while preventing

(arguing that corporate boards approve matters perfunctorily, automatically, and routinely).

41. Statement of the Business Roundtable, *supra* note 37, at 2092.

42. Lipton & Lorsch, *supra* note 31, at 65.

43. LORSCH & MACIVER, *supra* note 33, at 84-85; *see also id.* at 86-87 (“One problem a board will often have is making sure that management is able to concisely present the facts and the issues, and not just give you a stack of papers, a mile high, to sift through. A board has to depend upon management to provide information in a way the director can get his hands around. You know this isn’t a 2,000-hour-a-year-job, so you have to have some organization and brevity. Some managements are better at it than others—the good ones know how to highlight the pertinent themes.”).

44. *See* EISENBERG, *supra* note 19, at 143-44.

45. Lipton & Lorsch, *supra* note 31, at 65.

46. *Id.* at 66.

47. *Id.* *See also* EISENBERG, *supra* note 19, at 144-45; Walter J. Salmon, *Crisis Prevention: How to Gear Up Your Board*, HARV. BUS. REV., Jan.-Feb. 1993, at 72.

48. *See* LORSCH & MACIVER, *supra* note 33, at 89-90.

the boards from abusing the monitoring function or overreacting to the detriment of the corporation.

This Note examines proposed models of corporate governance that attempt to ensure that board members take an active role in monitoring the activities of management in large publicly held corporations.⁴⁹ This Note concludes that the current proposals do not adequately address the problem of how to achieve effective corporate monitoring. U.S. corporations, legislatures, and scholars should look abroad and examine models of corporate governance in the European Community to decide how to best assure that corporate boards will continue to actively monitor the actions of management for the benefit of the corporation and its shareholders.

Part I briefly discusses several models of corporate governance that have been proposed by scholars, practitioners, and business executives.⁵⁰ Part II outlines the European Community's current proposal for a European Company Statute, a statute intended to regulate the creation and management of corporations within the European Community. Part III argues that the two-tier board model, one of two alternatives available to European corporations under the European Company Statute, is the most appropriate model to ensure active and effective monitoring of corporate activity. Finally, Part IV offers model legislation that articulates the powers and functions of the board of directors under a two-tier corporate board.

I. CURRENT PROPOSALS INTENDED TO INCREASE CORPORATE MONITORING

In order to improve the monitoring function of corporate boards and ensure that directors take or continue to take an active role in the

49. This paper focuses exclusively on large publicly held corporations. According to the American Law Institute, a large publicly held corporation is:

a corporation that as of the record date for its most recent annual shareholders' meeting had both 2,000 or more record holders of its equity securities and \$100 million or more of total assets; but a corporation shall not cease to be a large publicly held corporation because its total assets fall below \$100 million, unless total assets remain below \$100 million for *two* consecutive fiscal years.

American Law Institute, *supra* note 21, § 1.24 (citations omitted).

50. It should be noted that recently a United States Representative pushed for legislation that would require directors to disclose all professional commitments, limit the number of boards that individuals may serve on, and require formal reviews of board performance. Such legislation is intended to ensure that corporate boards continue to act assertively. See Stephen H. Wildstrom, *Corporate Governance*, BUS. WK., Apr. 19, 1993, at 43.

corporation, many legal scholars, practitioners, and corporate executives have proposed or argued for various models of corporate governance. This section briefly reviews some of the more recent proposals for increased oversight of corporate activity by boards of directors.

A. Separate the Job of Chief Executive Officer and the Chairman of the Board of Directors

In most corporations, the chief executive officer of the corporation also holds the position of chairman of the board of directors.⁵¹ As chairman of the board, the chief executive officer has at his or her disposal substantial influence and power over the nonexecutive members of the board.⁵² Outside directors⁵³ are usually selected by the chief executive,⁵⁴ and, due to the selection, they often support the proposals of the chief executive.⁵⁵ In fact, “unwilling to show a lack of confidence in the CEO, [an outside director] often feels awkward voicing concerns about the agenda.”⁵⁶

To overcome the influence and power of a chief executive officer over outside directors and to insure that corporate boards act as effective monitors, it has been proposed that corporations split the position of chief executive and chairman.⁵⁷ James E. Heard, president of Institutional Shareholder Services, recently remarked: “Look at a poorly performing company. Who’s running it? Mr. CEO. And who’s he accountable to? The chairman. And who is he? Mr. CEO. Huh? An autonomous,

51. Salmon, *supra* note 47, at 72.

52. Lipton & Lorsch, *supra* note 31, at 66. As an example of the substantial influence of the chief executive officer over the board of directors, consider the current situation regarding the future of Paramount Communications. The board of directors, which consists of ten independent directors out of a total of fifteen board members, is considering which bid for the company to accept. Many of the independent members owe their seat on the board to Martin S. Davis, the chief executive officer of Paramount Communications. As a result, they may be inclined to follow the desires of management. See Leslie Wayne, *A Board Facing Special Pressures*, N.Y. TIMES, Sept. 21, 1993, at C2.

53. An “outside director” is one who is not a member of the management team and who only devotes a portion of his or her time to board responsibilities. See Statement of the Business Roundtable, *supra* note 37, at 2107; Statement of the Business Roundtable, *supra* note 29, at 249; American Law Institute, *supra* note 21, § 1.13 & § 1.15. As used here, “outside director” is synonymous with “independent director.”

54. EISENBERG, *supra* note 19, at 146.

55. *Id.* at 147; see also Kim, *supra* note 14, at 2B.

56. Salmon, *supra* note 47, at 72.

57. *Id.*; see also Grienerberger, *supra* note 17, at 178; Roberta S. Karmel, *Is It Time For a Federal Corporation Law?*, 57 BROOK. L. REV. 55, 59 (1991).

effective board is more likely if it has its own chairman."⁵⁸ By denying the chief executive the right to serve as the chairman of the board of directors, outside directors may overcome their hesitancy to act and may effectively monitor the corporation.⁵⁹ If the chief executive officer is not the leader of the corporate board, his or her influence may be reduced. In addition, taking the title of the chairman of the board away from the chief executive will allow more diverse thinking in the board room.⁶⁰

Several corporations have recently separated the role of chief executive officer and chairman of the board. After the board of directors at General Motors accepted the resignation of its former chief executive, Robert C. Stempel, the next chief executive was not given the title of chairman of the board. Instead, an outside board member, John G. Smale, assumed the role of chairman of the board.⁶¹ At the American Express Company, the board ousted James D. Robinson as chief executive officer, but the board did permit him to serve as chairman of the board.⁶²

However, separating the role of chief executive from the position of chairman of the board appears to be more of a symbolic change rather than an effective change in structure. Although the chief executive officer under this model no longer leads the board, outside directors may still be heavily influenced by the presence of senior executives who sit on the board.⁶³ Not only is the separation merely symbolic, but the separation of the role of chief executive officer and chairman may also lead to more problems than expected. The relationship between the board and the chief executive officer could be contentious. Philip Cadwell, the retired chairman and chief executive officer of the Ford Motor Company recently remarked that "[i]f you have to resort to that kind of organizational change, you have the wrong relation between the board and the CEO."⁶⁴ Also, the nonexecutive who

58. Steward, *supra* note 10, at 40.

59. See Judith H. Dobrzynski, *A GM Postmortem: Lessons for Corporate America*, BUS. WK., Nov. 9, 1992, at 87.

60. Grienberger, *supra* note 17, at 178.

61. Kerwin et al., *supra* note 3, at 84-86; see also Steward, *supra* note 10, at 40.

62. Janofsky, *supra* note 8, at D1; see also Allen R. Myerson, *American Express: Try, Try Again*, N.Y. TIMES, Feb. 1, 1993, at D1 (Robinson resigned as chairman of the board of directors on Jan. 30, 1993, six days after being removed as chief executive officer.).

63. See MACE, *supra* note 33, at 80. (That the president possessed the complete powers of control was also communicated to, and generally accepted by, directors. Those members of the board who elected to challenge the president's powers of control were advised, usually outside the board meetings, that such conduct was inappropriate, or they were asked to resign.)

64. Steward, *supra* note 10, at 40.

assumes the role of chairman may be ill-equipped to run the monitoring function of the board because of his or her unfamiliarity with the operations of the corporation.⁶⁵ Thus, separating the position of chief executive officer and chairman of the board will not overcome the problem of director inaction and ineffective monitoring of management functions.

This proposal fails to consider that which is essential—a board that responds and works hard to actively oversee the corporation—not who should lead the board. Separating the two roles also does not appear to be gaining any popularity. According to executive search firm Korn/Ferry International, in 1979, twenty-six percent of the largest United States industrial and service corporations had separated the jobs of chief executive officer and chairman of the board. In 1992, however, only twenty percent of the largest corporations continued to have separate chairmen.⁶⁶

B. Employ Professional Directors on Corporate Boards

Another proposal to ensure that directors effectively monitor management decisions and performance and actively participate in board meetings is to hire a core of professional directors.⁶⁷ These directors would serve full time on the corporate board⁶⁸ and would sit on no more than six boards.⁶⁹ A potential candidate for professional director may be a professor of finance at a graduate school of business, a partner at a Big Six public accounting firm or major management consulting firm.⁷⁰ These individuals are “likely to have the skills to monitor the management of a public corporation.”⁷¹

65. See generally Grienberger, *supra* note 17, at 178-79.

66. Steward, *supra* note 10, at 40.

67. See Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863 (1991); John C. Coffee Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1360-61 (1991); Grienberger, *supra* note 17, at 178-79; Nell Minow, *Shareholders, Stakeholders, and Boards of Directors*, 21 STETSON L. REV. 197, 231-32 (1991); A. A. Sommer, Jr., *Corporate Governance: The Search for Solutions*, 26 U.S.F. L. REV. 695, 711 (1992); EISENBERG *supra* note 19 at 150-52; Christian J. Meier-Schatz, *Corporate Governance and Legal Rules: A Transitional Look at Concepts and Problems of Internal Management Control*, 13 J. CORP. L. 431, 471-73 (1988).

68. See EISENBERG, *supra* note 19, at 150-53.

69. Gilson & Kraakman, *supra* note 67, at 885.

70. *Id.*

71. *Id.*

Not only would professional directors possess the requisite skills to oversee management decisionmaking, but they could completely devote themselves to their work and spend more time familiarizing themselves with their corporations than typical outside directors.⁷² In addition, these professional directors would be elected exclusively by shareholders and thus remain financially independent of management.⁷³ Essentially, these directors would become "specialists in monitoring."⁷⁴

Employing professional directors appears to solve the problem of passive corporate monitors. First, since these directors would devote themselves exclusively to the boards on which they serve, they would have the time, skills, and motivation to actively and effectively monitor the corporation.⁷⁵ Second, since professional directors would be exclusively elected by shareholders as opposed to being nominated by management, the directors would not be afraid that they would be dismissed for questioning corporate activity.⁷⁶

Unfortunately, a number of barriers would hinder the implementation and employment of professional directors. First, shareholders and investors would have to overcome regulatory barriers before they could elect professional directors to serve on corporate boards. For example, to elect a professional director, shareholders would have to vote in a cooperative fashion, which would require the solicitation of votes.⁷⁷ Such solicitations, however, would require a filing under the federal proxy rules with the Securities and Exchange Commission,⁷⁸ and the filing would be subject to review under the antifraud provisions of Rule 14a-9.⁷⁹ Second, the number of individuals who could actually meet the proposed minimum requirements of a professional director is exceedingly low compared to the number of professional directors needed to serve on the corporate boards of every large publicly held corporation.⁸⁰ If few people could serve as professional

72. *Id.*

73. *Id.* at 886; Sommer, *supra* note 67, at 711.

74. Coffee, *supra* note 67, at 1360.

75. See Gilson & Kraakman, *supra* note 67, at 888; EISENBERG, *supra* note 19, at 150.

76. See Meier-Schatz, *supra* note 67, at 472.

77. Gilson & Kraakman, *supra* note 67, at 894.

78. *Id.*

79. *Id.* For a more detailed discussion about how the federal proxy rules and other regulatory barriers such as the Securities Exchange Act and the Hart-Scott-Rodino Antitrust Improvement Act of 1976 hinder the election of professional directors, see *id.* at 894-904.

80. EISENBERG, *supra* note 19, at 151.

directors, they “would form an interlocking communication network tying the country’s major corporations together in a wholly undesirable way.”⁸¹ Finally, by regulating the composition of the corporate board through the placement of professional directors completely independent of management, an adversarial relationship may be created between senior executives and the professional directors.⁸² An adversarial relationship may arise because professional directors would be hired exclusively to second guess management decisions, but professional directors would have limited responsibility for the results.⁸³ Thus, the proposal to elect a core of professional directors appears sound, yet the election of a number of qualified professional directors is problematic and may impair effective monitoring and oversight.

C. Permit Corporate Boards to be Dominated by a Majority of Outside Directors

A third proposal that may lead to more active and effective board oversight over corporate affairs is to elect a majority of outside directors to serve on the corporate board.⁸⁴ The most current draft of the American Law Institute’s *Principles of Corporate Governance* proposes that “[t]he board of large publicly held corporations should have a majority of directors who are free of any significant relations with the corporation’s senior executives.”⁸⁵ Similarly, in its 1974 statement, the Business Roundtable endorsed the position that “it is desirable that the board be composed of a majority of non-management directors.”⁸⁶ In its revised statement in 1990, the Business Roundtable again suggested that corporate boards should be

81. *Id.*

82. Meier-Schatz, *supra* note 67, at 472.

83. *Id.*

84. See Donald E. Pease, *Outside Directors: Their Importance to the Corporation and Protection From Liability*, 12 DEL. J. CORP. L. 25, 31-40 (1987); EISENBERG, *supra* note 19, at 174-77; James D. Cox & Nis Jul Clausen, *The Monitoring Duties of Directors Under the EC Directives: A View From the United States Experience*, 2 DUKE J. COMP & INT’L L. 29, 31 (1992); Lipton & Lorsch, *supra* note 31, at 67-69; Salmon, *supra* note 67, at 69; Statement of the Business Roundtable, *supra* note 37, at 2107-08; Statement of the Business Roundtable, *supra* note 29, at 248-49.

85. American Law Institute, *supra* note 21, § 3A.01.

86. Statement of the Business Roundtable, *supra* note 37, at 2108.

predominately composed of "independent directors who do not hold management responsibilities within the corporation."⁸⁷

Members of the legal and academic community have also offered support for this view. Martin Lipton, a prominent corporate attorney, argues that boards should consist of "a maximum of ten directors . . . with a ratio of at least two independent directors to any director who has a connection with the company, either as management or substantial customer or supplier of goods or services."⁸⁸ Walter Salmon, a business school professor and a corporate director, has also asserted that management should have a limited role on corporate boards and that only the chief executive officer, the chief operating officer, and the chief financial officer should sit on the corporate board.⁸⁹

A board that consists predominately of outsiders has many advantages. By limiting the number of executives on the board, outsiders may competently and objectively analyze corporate performance.⁹⁰ Outsiders will feel less dependent on the advice of senior management⁹¹ and less influenced by their presence.⁹² Furthermore, boards dominated by outsiders also tend to bring in neutral counsel and advice.⁹³ Often, inside directors are committed to old ideas and company traditions, but outsiders can bring in independent sources of information and unique perspectives to the corporation.⁹⁴ Through outside directors, corporations can adapt to changes in consumer tastes, competition, technological advances, and economic shifts.⁹⁵

One company, the Dayton Hudson Corporation, a retailer, is a prime example of a corporation with a board consisting of primarily outside directors. Out of a total of fourteen directors, twelve are outsiders.⁹⁶ The outsiders are mostly corporate executives, not lawyers or investment

87. Statement of the Business Roundtable, *supra* note 29, at 249.

88. Lipton & Lorsch, *supra* note 31, at 67.

89. Salmon, *supra* note 47, at 69.

90. American Law Institute, *supra* note 21, § 3A.01, comment (c).

91. *See* Meier-Schatz, *supra* note 67, at 471.

92. *Id.* at 468.

93. *Id.* at 467-68.

94. *See* Pease, *supra* note 84, at 33; Salmon, *supra* note 49, at 69.

95. *See id.*

96. Julia Flynn, *Giving the Board More Clout: Dayton Hudson Directors Run the Show*, BUS.

bankers.⁹⁷ Because of the sheer number of outside directors, the board has developed into a powerful and independent board.⁹⁸ The Dayton Hudson board does not merely rubber stamp the decisions of the chief executive officer; rather, the board thoroughly reviews the performance of the chief executive officer on an annual basis.⁹⁹

Although a board dominated by outside directors has many advantages, such a model also deters active and effective corporate monitoring. A board that is comprised primarily of outsiders may be unable to work together because of the various backgrounds and interests of the directors.¹⁰⁰ Also, outside directors often have commitments unrelated to the corporation and thus are unable to devote as much time and energy to their monitoring duties.¹⁰¹ According to Professor Christian Meier-Schatz, “[a]n effective policing of management requires still more time and energy, and a more sophisticated infrastructure than that which the average independent American director has at hand.”¹⁰² Finally, a board of directors made up of a majority of outsiders may lack the knowledge to effectively oversee management decisions.¹⁰³ In fact, the American Law Institute has stipulated that senior executives should not be prohibited from serving on corporate boards because such executives can ensure that the board will engage in knowledgeable and detailed board discussions.¹⁰⁴ Thus, although several legal scholars, practitioners, and corporate executives have argued for a corporate board dominated by non-executive or outside directors, such a board may in fact impair the board’s basic and primary oversight function.

D. Allow Representatives of Institutional Investors to Serve on the Corporate Board

The amount of equity held by institutional shareholders has skyrocketed within the last decade.¹⁰⁵ Institutional shareholders include private and

97. *Id.*

98. *Id.*

99. *Id.*

100. *See* Lipton & Lorsch, *supra* note 31, at 65.

101. Meier-Schatz, *supra* note 67, at 468.

102. *Id.* at 469.

103. *See* Pease, *supra* note 84, at 33.

104. American Law Institute, *supra* note 21, § 3A.01, comment (c).

105. Coffee, *supra* note 67, at 1291; *see* Bernard S. Black, *Agents Watching Agents: The Promise*

public pension funds, investment companies, insurance companies, bank trusts, and foundations.¹⁰⁶ In 1950, institutional investors owned merely eight percent of the equity in U.S. corporations.¹⁰⁷ By 1980, institutions held thirty-three percent of all publicly held shares, and by 1988, institutional holdings owned forty-five percent.¹⁰⁸ As of 1990, institutional shareholdings have reached fifty-three percent in the one hundred largest corporations in America.¹⁰⁹ In some cases, institutions hold over seventy percent of all of the equity in the corporation. For example, institutional shareholders own seventy-one percent of the shares in Eli Lilly & Company, seventy-four percent in the Mobil Corporation, eighty-two percent in the General Motors Corporation, and eighty-six percent in the Amoco Oil Company.¹¹⁰

As a result of the enormous holdings of institutional investors, several legal scholars have proposed that institutional shareholders or representatives of institutional investors should be represented on the corporate board.¹¹¹ Such representatives, or, more appropriately named, institutional directors,¹¹² will be less influenced by corporate executives, will react more quickly to declining corporate performance, will expeditiously attempt to replace a weak chief executive officer, and will swiftly question executive compensation.¹¹³ Already, several major United States corporations such

of Institutional Investors in Corporate Governance, 39 UCLA L. REV. 811, 827-29; Paul L. Davies, *Institutional Investors: A U.K. View*, 57 BROOK. L. REV. 129, 131 (1991); Henning, *supra* note 23 at 601; A. A. Sommer, Jr., *Corporate Governance in the Nineties: Managers vs. Institutions*, 59 U. CINN. L. REV. 357, 361 (1990); John H. Matheson & Brent Olson, *Corporate Law and the Longterm Shareholder Model of Corporate Governance*, 76 MINN. L. REV. 1313, 1354-55 (1992); Richard M. Buxbaum, *Institutional Owners and Corporate Managers: A Comparative Perspective*, 57 BROOK. L. REV. 1, 13 (1991); Grienenberger, *supra* note 17, at 175; Karmel, *supra* note 57, at 68-69; Thomas Christian Paefgen, *Institutional Investors Ante Portas: A Comparative Analysis of an Emergent Force in Corporate America and Germany*, 26 INT'L LAW. 327 (1992).

106. Karmel, *supra* note 57, at 69-70. Institutional shareholders engage in large block transactions and trading of shares, usually ten thousand or more.

107. Coffee, *supra* note 67, at 1291.

108. *Id.*; Karmel, *supra* note 57, at 68.

109. Coffee, *supra* note 67, at 1291.

110. See Sommer, *supra* note 105, at 361; Coffee, *supra* note 67, at 1291.

111. See, e.g., Black, *supra* note 105, at 842-44; LOUIS LOWENSTEIN, WHAT'S WRONG WITH WALL STREET: SHORT-TERM GAIN AND THE ABSENTEE SHAREHOLDER 205-18 (1988); Jayne W. Barnard, *Shareholder Access to the Proxy Revisited*, 40 CATH. U.L. REV. 37 (1990).

112. Black, *supra* note 105, at 842-44.

113. *Id.*; see also Bernard S. Black, *The Value of Institutional Monitoring: The Empirical Evidence*, 39 UCLA L. REV. 895, 925-27 (1992) for detailed studies of the utility of institutional investors as monitors of corporate performance.

as Lockheed and Cleveland-Cliffs have agreed to permit institutional directors to serve on their corporate boards.¹¹⁴

Even though institutions do hold a majority of the equity in large publicly held corporations, institutional shareholders or their representatives may not be the most effective monitors of management decisions and corporate activity. First, institutional investors are merely managers of large sums of money and it is unclear how well institutions can monitor corporate performance.¹¹⁵ As Professor Bernard Black has stated, “[t]o date, the institutions haven’t done much monitoring. Their people aren’t trained to do it, and might not do it well.”¹¹⁶ Second, as institutions grow in dominance through their shareholdings, they may concentrate their power to the detriment of the corporation.¹¹⁷ For example, institutions could potentially “embrace [market] fads en masse” or even deny capital to the corporations for new ideas.¹¹⁸ Such concentrated institutional power could be highly dangerous. Third, if institutional shareholders are able to extensively review a corporation’s financial data or oversee major decisions, the institutions could trade shares based on the nonpublic information they possess.¹¹⁹ Fourth, institutional shareholders are far from homogenous and typically only public pension funds such as the California Public Employees Retirement System (CalPERS) have been active in corporate governance.¹²⁰ CalPERS has been prominently involved in challenging management decisions, offering proposals to restructure the composition of corporate boards, and fighting for increased shareholder voice.¹²¹ Yet, the majority of institutional groups have never demonstrated interest in taking an active role on the board.¹²² Fifth, institutional investors, when faced with the choice between exercising control over corporate management or maintaining liquidity, have traditionally preferred liquidity to control.¹²³ Professor John Coffee asserts that some institutional shareholders such as

114. Black, *supra* note 105, at 842-43.

115. *Id.* at 852.

116. *Id.*

117. *Id.* at 866.

118. *Id.*

119. *Id.* at 868-69. It should be noted that trading on inside information would violate the Securities Exchange Act.

120. Sommer, *supra* note 67, at 714-15.

121. *Id.* at 715.

122. *Id.*

123. Coffee, *supra* note 67, at 1287.

mutual funds, banks, and insurance companies prefer to have liquidity, rather than control, chiefly "because their shareholders, depositors, or policyholders can withdraw their funds on short notice."¹²⁴ Because of the need for liquidity, this group of institutional investors is most unlikely to oppose corporate management and would be unable to effectively monitor the corporation.¹²⁵ Thus, the use of institutional investors as corporate monitors, although sound in theory, is highly problematic in practice.¹²⁶

E. The Quinquennial Proposal

A final proposal to consider for improving the monitoring function of corporate boards is Martin Lipton and Steven A. Rosenblum's recommendation for a quinquennial approach.¹²⁷ Lipton and Rosenblum, two corporate attorneys, assert that it is necessary for shareholders, managers and directors in the United States and the United Kingdom to take a long term view in order for corporations to "invest in the future, maintain their vitality, and compete in the world economy."¹²⁸ Under the quinquennial system, the corporation would undergo a thorough review every five years.¹²⁹ Control of the corporation would be under the responsibility of management for five years without shareholder interference, and such decisions will lead to the long term health of the corporation.¹³⁰ Directors would serve five year terms and would be required to carefully monitor the corporation against the corporation's long term plan.¹³¹ If a director seeks to be reelected at the end of the five year period, reelection would be based on the performance of the corporation.¹³²

A five year approach removes many barriers to effective monitoring by corporate directors. First, in order to be reelected, directors must ensure that corporate performance improves over the preceding five years.¹³³

124. *Id.* at 1318.

125. *Id.* at 1318-21.

126. For additional problems with the idea of institutional investors as corporate monitors, see *id.* at 1324-36; Mitchell, *supra* note 33, at 1290-91; Lipton & Lorsch, *supra* note 31, at 64-67.

127. Lipton & Rosenblum, *supra* note 1, at 187.

128. *Id.* at 216.

129. *Id.* at 225.

130. *Id.*

131. *Id.*

132. *Id.* at 226. For a more detailed discussion of the quinquennial approach, see *id.* at 229-53.

133. *Id.*

According to Lipton and Rosenblum, directors seeking reelection “would stand on the corporation’s record for the past five years and its strategic plan for the next five years. Stockholders would base their determination of whether to oppose incumbent directors, and focus any challenge they determined to mount, on the same issues.”¹³⁴ Second, since the corporation will only be critically evaluated every five years, directors will not be pressed for time when monitoring and reviewing corporate information.¹³⁵ Third, because of the five year time frame, managers and outside advisors will have the opportunity to frequently consult with outside directors on the corporation’s performance and direction.¹³⁶ Finally, since directors will serve five year terms, shareholders cannot interfere with the board’s monitoring duties by trying to remove and replace directors at will.¹³⁷

Although the quinquennial approach has many advantages, the proposal may not efficaciously overcome the problem of ineffective board oversight of corporate activity. Because Lipton and Rosenblum’s plan would require shareholders and corporate boards to critically evaluate the corporation only once every five years, directors may actually become ineffective monitors during the years the corporation will not be reviewed. Lipton and Rosenblum’s approach would require a majority of outside board members,¹³⁸ but as argued, outside board members often have commitments unrelated to the corporation. Since an evaluation occurs only once every five years, directors may be inclined to spend less time overseeing the corporation between the evaluation periods. While such a plan would allow corporations to test or sample various plans without substantial shareholder protests, directors may be slow to realize that a plan is ineffective because shareholders cannot voice their complaints until the year the corporation is critically evaluated. Moreover, since directors have more time to consult with management and outside advisors, directors may become overly reliant on such consultations. If boards frequently seek outside counsel, board decisions may be prolonged and such delayed action

134. *Id.* at 225.

135. *Id.* at 227.

136. *Id.*

137. *Id.* Note, however, that Lipton and Rosenblum would allow shareholders to remove a director during the five year term if such director engaged in “personal illegal conduct or willful malfeasance, or if the corporation were guilty of such conduct.” *Id.* at 225.

138. *Id.* at 226-27.

may harm the corporation. Lipton and Rosenblum's quinquennial approach may in fact encourage shareholders, directors, and management to work toward the long term, but the monitoring role of the corporate board may still be ineffective.

II. THE EUROPEAN COMMUNITY'S PROPOSAL FOR A EUROPEAN COMPANY STATUTE

Given that the current proposals for improving the monitoring or oversight function of the modern corporate board are either inadequate or problematic, United States corporations, legal academics, and state legislatures should consider looking to Europe to decide which model of corporate governance will ensure that boards will maintain an active monitoring role. In particular, the European Community's Proposal for a European Company Statute should serve as a model for improving the corporate governance structure in American corporations.

A. *History of the Proposal for a European Company Statute*

The European Community (EC) is currently debating whether to enact the European Commission's proposal for a European Community Statute (ECS).¹³⁹ The ECS consists of both a regulation and a directive. The regulation "provides detailed rules for setting up, financing, and operating a European company, or 'Societas Europea' (SE)."¹⁴⁰ The directive "addresses the difficult problem of employee participation in the SE's decisionmaking."¹⁴¹ The EC determined it was necessary to create a single European statute for the entire community in order "to avoid distortions in the market which may result from the differences in each Member State's economic development and the varying corporate

139. See *Company Law*, Coopers & Lybrand EC Commentaries, Sept. 9, 1993, at 1, 2, & 6; *Building a Eurocompany*, FIN. TIMES LTD., Sept. 7, 1993, at 19. A major reason why the European Company Statute has not been adopted is due to opposition to the provision that allows labor unions and other special interests to be represented on the supervisory board. See Terrence L. Blackburn, *The Societas Europea: The Evolving Corporation Statute*, 61 FORDHAM L. REV. 695-704 (1993); *Company Law*, Coopers & Lybrand EC Commentaries, at 6.

140. David C. Donald, *Company Law in the European Community: Toward Supranational Incorporation*, 9 DICK. J. INT'L L. 1, 24 (1991).

141. *Id.*

requirements of their national company laws."¹⁴² Also, without a single corporation law, corporations would potentially seek to incorporate in the Member State with the "least restrictive company laws."¹⁴³ To avoid the so called "Delaware syndrome" or a "race to the bottom" in the European community, the harmonization of each Member State's company law was necessary.¹⁴⁴ The EC needed a uniform statute to handle mergers and joint ventures between corporations from different states.¹⁴⁵ Corporations that maintained their own national laws were more inclined to break the joint venture apart.¹⁴⁶

The proposal for an SE and an ECS originated from a series of lectures given by Professor Pieter Sanders in 1959.¹⁴⁷ Professor Sanders, a Dutch scholar and distinguished professor of corporation law,¹⁴⁸ and a panel of experts from the member states of the EC drafted the first ECS in 1967.¹⁴⁹ Professor Sanders had in mind "an additional, novel organizational form which would coexist with companies incorporated under national company laws, thus offering a choice."¹⁵⁰ Sanders and his panel submitted its first proposal in 1970 and revised it in 1975.¹⁵¹ Both versions were abandoned, however, due to their cumbersome nature and hotly contested provisions regarding worker participation.¹⁵²

142. Johan de Bruycker, *EC Company Law—The European Company v. The European Economic Interest Grouping and the Harmonization of the National Company Laws*, 21 GA. J. INT'L & COMP. L. 191, 193 (1991); Donald, *supra* note 140, at 26-27.

143. de Bruycker, *supra* note 142, at 193.

144. *Id.* For a more detailed discussion of the "Delaware syndrome" and "race to the bottom" theory, see Cary, *supra* note 23, at 663. For a general survey of the potential for a "race to the bottom" in the European Community, see Clark D. Stith, Note, *Federalism and Company Law: A "Race to the Bottom" in the European Community*, 79 GEO. L.J. 1581 (1991).

145. The recent merger between Renault of France and Volvo of Sweden is a prime example of the need for a common legal corporate structure such as the European Company Statute. Because of the differences in company law in France and Sweden, it has been difficult and costly to merge the corporate structure of the two companies. See *Building a Eurocompany*, *supra* note 139, at 19.

146. *Id.*

147. See Pieter Sanders, *The European Company*, 6 GA. J. INT'L & COMP. L. 367 (1976).

148. See Detlev F. Vagts & Thomas Waelde, *The Societas Europaea: A Future Option for US Corporations*, 29 BUS. LAW. 823 (Apr. 1974).

149. Barbara E. Hoecklin, Comment, *European Company Statute: Company Structure and Employee Involvement Across EC Borders*, 16 N.C.J. INT'L & COM. REG. 587, 590 (1991).

150. ERIC STEIN ET AL., *EUROPEAN COMMUNITY LAW AND INSTITUTIONS IN PERSPECTIVE* 647 (1976).

151. Hoecklin, *supra* note 149, at 590.

152. *Id.*

The effort to revive the creation of a European company arose again in June 1985.¹⁵³ By June 1988, the Commission of the EC adopted a memorandum proposing an SE.¹⁵⁴ The Commission's efforts resulted in a new proposal for a "Statute for a European Company."¹⁵⁵ In January 1991, the European Parliament held a reading of the proposed statute and amended the statute.¹⁵⁶ The Commission adopted many of the European Parliaments amendments and drafted an amended ECS statute in May 1991.¹⁵⁷ The May 1991 proposal is still under consideration by the EC.¹⁵⁸

B. *The Two-Tier Board Model*

Of the proposals contained within the ECS, the most relevant provision which U.S. Corporations, legal scholars, and corporate executives should consider in improving the American scheme of corporate governance is Title IV entitled "Governing Bodies."¹⁵⁹ Under Title IV, an SE must adopt one of two types of governing structures—a two-tier board or a single tier system.¹⁶⁰ To ensure that corporate directors will actively monitor executive functions and decisions, corporate America should adopt the European two-tier board model.¹⁶¹

In the two-tier board model, corporations will have two separate boards, a supervisory and a management board.¹⁶² The latter manages and represents the company under the direction of the former.¹⁶³ The members

153. de Bruycker, *supra* note 142, at 201.

154. *Id.*

155. *Proposal for a Council Regulation on the Statute for a European Company*, 1989 O.J. (C 263) 41; *Proposal for a Council Directive complementing the Statute for a European Company with regard to involvement of employees in the European Company*, 1989 O.J. (C 263) 69.

156. Hoecklin, *supra* note 149, at 593.

157. *Amended Proposal for a Council Regulation on the Statute for a European Company*, 1991 O.J. (C 176) 34 [hereinafter *Proposal for a European Company Statute*]; *Amended Proposal for a Council Directive complementing the Statute for a European Company with regard to the involvement of employees in the European Company*, 1991 O.J. (C 138) 34.

158. See sources cited *supra* note 139.

159. *Proposal for a European Company Statute*, *supra* note 157, arts. 61-100.

160. *Id.* art. 61-80.

161. The two-tier board model is essentially a German creation. The model has been in existence since 1861. For an extensive review of German corporation law, see Detlev F. Vagts, *Reforming The "Modern" Corporation: Perspectives From The German*, 80 HARV. L. REV. 23 (1966).

162. *Proposal for a European Company Statute*, *supra* note 157, art. 61.

163. *Id.* art. 62(1).

of the management board are appointed and may be removed by the supervisory board at any time.¹⁶⁴ It must also provide the supervisory board with information and respond to inquiries.¹⁶⁵ No member may serve on both the management board and the supervisory board at the same time, except if a vacancy arises on the management board.¹⁶⁶ The supervisory board is primarily responsible for supervising the duties of the management board.¹⁶⁷ This board may not engage in management functions and may not represent the company in dealings with third parties.¹⁶⁸ The members of the supervisory board are appointed and removed at the general meeting of shareholders.¹⁶⁹

III. CORPORATE AMERICA SHOULD ADOPT THE TWO-TIER BOARD MODEL

Although the Proposed European Company Statute and the two-tier board model have not yet been adopted by the European Community, the model is still an appropriate model to consider for improving the monitoring function of the modern American corporate board.¹⁷⁰ The two tier board model is unique in the sense that it “creates a clear institutional and personal separation of monitoring and management organs and, accordingly, realizes a distinct distribution of responsibilities and powers within the corporation.”¹⁷¹ Not only does a two-tier board lead to a distinct division

164. *Id.* art. 62(2).

165. *Id.* art. 64.

166. *Id.* art. 62(3).

167. *Id.* art. 63(1).

168. *Id.*

169. *Id.* art. 63(2).

170. The late Professor William L. Cary hinted as early as 1973 that the two-tier board model may be appropriate for American corporations. See William L. Cary & Sam Harris, *Standards of Conduct Under Common Law, Present Day Statutes and the Model Act*, 27 BUS. LAW. 61, 66 (1972). On the other hand, some legal scholars have argued that a two-tier board model would not be feasible in American corporations. See EISENBERG, *supra* note 19, at 183-85; Cox & Clausen, *supra* note 84, at 44-52; Thomas J. Schoenbaum & Joachim Lieser, *Reform of the Structure of the American Corporation: The “Two-Tier” Board Model*, 62 KY. L.J. 91, 115-19 (1973); Meier-Schatz, *supra* note 67, at 464-67; Stith, *supra* note 144, at 1596-97.

171. Meier-Schatz, *supra* note 67, at 464; see also EISENBERG, *supra* note 19, at 183; Schoenbaum & Lieser, *supra* note 170, at 118. Jayne W. Barnard, *Institutional Investors and the New Corporate Governance*, 69 N.C. L. REV. 1145, 1147 (1991).

in corporate responsibilities, but also allows directors to supervise and act completely independent of management.¹⁷²

Because of these unique attributes, the two-tier model is able to overcome many of the factors that have traditionally hindered effective corporate monitoring. Unlike the current model of corporate governance in the United States, under the two-tier board model, the chief executive officer and other senior executives will be unable to influence or dominate the board meetings as they cannot be present or represented on the supervisory board.¹⁷³ Also, the members of the supervisory board will not owe any loyalties or feel obligated to support the decisions of the managing board since managing directors will be appointed by the supervisory board. Thus, a two-tiered board will allow the supervisory board to act independent of the managing board and thus lead to effective monitoring of the corporation.

The two-tier board of directors will afford sufficient time to discuss and carry out assigned duties. Under the two-tier board, the chairman of the supervisory board, who is not and cannot be the chief executive officer, will schedule which reports to hear and when to hear the reports of management. In the United States, the chief executive officer often dictates the schedule at board meetings and he or she is able to limit the amount of time for discussion so that board members will be inclined to acquiesce to the decisions of management.¹⁷⁴ Since the supervisory board will conduct its own meetings, the board can schedule enough time to fully analyze and discuss how the corporation is performing. It may focus on the relevant or most pressing issues instead of what the chief executive officer wants to report.

The two-tier board will also reduce the problem of board members who are ill-informed about corporate matters. In the United States, management often presents information that is too complex or unorganized.¹⁷⁵ Under the two-tier board, however, management will be more inclined to present information to the supervisory board in a clear and organized manner as the

172. Alfred F. Conard, *The European Alternative to Uniformity in Corporation Laws*, 89 MICH. L. REV. 2150, 2184 (1991); Richard D. English, *Company Law in the European Single Market*, 1990 B.Y.U. L. REV. 1413, 1503 (1990); Meier-Schatz, *supra* note 67, at 464; Guenter H. Roth, *Supervision of Corporate Management: The "Outside" Director and the German Experience*, 51 N.C. L. REV. 1369, 1378 (1973).

173. See *supra* notes 35-37 and accompanying text.

174. See *supra* notes 38-40 and accompanying text.

175. See *supra* notes 41-44 and accompanying text.

members of the management board are directly accountable and owe their position to the supervisory board. Since the supervisory board nominates and appoints those individuals who serve on the managing board, the management board has a greater incentive under the two-tier model to provide accurate and organized reports and data to the supervisory board in a timely manner.

Finally, even though the members of the supervisory board may have different backgrounds and commitments unrelated to the corporation, the board may still act as a cohesive body. In many corporate boardrooms in the United States, the directors are unable to work efficiently and effectively because they lack a common purpose.¹⁷⁶ Under the two-tier board, however, the duties and purpose are statutorily defined and there is a clear line of demarcation separating those individuals who serve on the supervisory board and those who are managing directors. Most corporation codes in the United States express that the management of the corporation shall be conducted by or under the supervision of the board of directors.¹⁷⁷ As such, the duties and functions of the board are ambiguous. Under the two-tier board, supervisory directors know, by statute, that they have been elected to monitor the corporation. Their role is not ambiguous, and since they have a common purpose, they effectively monitor the corporation despite their varying backgrounds.

Not only does the two-tier board overcome the problems that have hindered the effectiveness of corporate monitoring in the modern American corporation, but it is also more effective and overcomes the problems identified in the five proposed models of corporate governance discussed above. First, a two-tier board will lead to more effective corporate monitoring than separating the position of chairman and chief executive officer. Since no managing executives may sit on the higher board in the two-tier system, the executives cannot influence the monitoring role of the supervisory board. Also, since managing directors know that the supervisory board's main role is to supervise or oversee the activities of management, managing directors may not grow contentious if the supervisory board continually second-guesses the decisions of the managing directors. Finally, even though the chairman of the supervisory board may not be familiar with all of the intricate day-to-day operations of the

176. See *supra* note 45 and accompanying text.

177. See *supra* notes 24-25 and accompanying text.

corporation, the purpose of the supervisory board is to oversee management decisions, not to make the daily decisions.

The two-tier board also is more effective than electing professional directors on the corporate board. Under the two-tier board, the number of individuals who may be elected to serve on the supervisory board is not limited to individuals with special qualifications. Unlike professional directors, individuals such as retired executives or executives from other corporations may serve on the supervisory board. Although an adversarial relationship may develop between directors and managers due to the presence of professional directors, such a hostile relationship may not develop under the two-tier board because the managing directors are aware that it is the duty of the supervisory board to review their decisions. Further, the supervisory board is not elected to exclusively challenge the decisions of management. Rather, it is empowered to supervise for the benefit of the corporate shareholders.

A board with two tiers of directors is also more effective than a board that consists primarily of outside directors. Under the two-tier model, the supervisory board has a defined agenda that directs the members of the board toward a common goal. Also, the board will be able to determine its own schedule: it will decide *when* it will hear what types of reports. By dictating its own schedule, the board will not lack the time to discuss important corporate issues.

The two-tier board model is also a more effective model than allowing representatives of institutional investors to serve on the corporate board. Under the two-tier board, the supervisory board members will act for the benefit of the corporation. Institutional representatives have a greater incentive to work for the interest of the institution because of its large share holdings. Supervisory board members, instead of being accountable to an institution, are responsible to the shareholders.

Finally, the quinquennial approach is less effective than the two-tier board because the quinquennial approach is only critically evaluated every five years. Under the two-tier approach, the corporation is reviewed once a year, but the managing directors are expected to provide progress reports at least once every three months. As identified earlier, the quinquennial approach may breed a group of directors who become disinterested because they evaluate the corporation infrequently. The two-tier board model will force directors to continuously monitor the corporation or face removal by the shareholders.

Since the two-tier model overcomes many of the problems that have plagued corporate monitoring in the modern American corporation and since the model is more effective than the proposed models of corporate governance, corporate America should consider adopting a two-tier approach in large publicly held corporations.

IV. SAMPLE LEGISLATION

In order to assure that corporate directors actively and effectively engage in monitoring the activities of the corporation, each state should adopt the two-tier board model. To assist states in the development of a two-tier model, I propose the following as sample legislation.

CORPORATE STRUCTURE, FUNCTIONS, AND DUTIES

§ 1 Structure of the Corporation

(a) All large publicly held corporations incorporated within the State of [insert name] shall be governed under a two-tier board model. The corporation shall consist of two separate and distinct boards, a management board and a supervisory board.

(b) The executives of the corporation will serve on the management board. The supervisory board will be comprised of corporate directors who have no significant relationships with the executives of the corporation.

(c) No individual may sit on both the management board and the supervisory board at the same time. If a vacancy occurs on the management board, however, a member of the supervisory board may serve on the management board until a replacement has been named.

§ 2 Functions and Duties of the Management Board

(a) The management board is solely responsible for the day-to-day management of the corporation. The management board has the exclusive and unrestricted authority to represent the corporation in dealings with third parties.

(b) The supervisory board shall appoint members of the management board, and an appointment may be revoked with cause, or without cause by a majority vote of the supervisory board.

(c) The members of the management board are required to act with the due diligence and care of an orderly and conscientious manager.

(d) Individuals appointed to the managing board may serve for a term not exceeding six (6) years, and the term is not automatically renewable.

§ 3 Functions and Duties of the Supervisory Board

(a) The main function of the supervisory board is the supervision of management activity. The members of the supervisory board must appoint and replace members of the management board, approve major transactions, and approve annual financial statements.

(b) Members of the supervisory board are nominated and appointed by shareholders at the annual general meeting. Supervisory board members may be removed for cause, or without cause by a majority of votes cast at the annual general meeting.

(c) The management board must report to the supervisory board at least every three months on the progress of corporate activity. The supervisory board may demand additional information from the management board or require the management board to prepare any special reports.

(d) The supervisory board may request the assistance of experts outside of the corporation.

The majority of the sample legislation is derived from the Proposed European Company Statute. There are, however, two sections which are not reflected in the European statute. First, the ECS does not discuss the relationship between individuals on the managing board and the supervisory board other than that an individual may not ordinarily serve on both boards at the same time. The sample legislation under section (1)(b) proposes that members of the supervisory board shall have no significant relationships with the members of the executive board. This language is similar to that found in the American Law Institute's recommendations for corporate practice in large publicly held corporations.¹⁷⁸ The phrase "no significant relationship" ensures that the functions of the supervisory board are carried out independently of the managing directors. In addition, this requirement underscores the fact that the supervisory board cannot objectively monitor or supervise the corporation if the supervisory board is influenced by the managing board.

178. American Law Institute, *supra* note 21, at § 3A.01(a). For a definition of the term "significant relationship," see *id.* at §1.34.

Under the ECS, a managing director may only be removed by the supervisory board for cause. In section (2)(b), the sample legislation permits the removal of an individual from the managing board with cause or without cause if a majority of directors deems it necessary. This permits removal without cause to remind the managing directors that they are completely accountable to the supervisory board, and that they must work with, not against, the supervisory board to ensure that it may effectively monitor the corporation. Hopefully, this proposed legislation will prove beneficial to individual states.

V. CONCLUSION

The time is ripe for American corporations to seriously consider improving the current model of corporate monitoring. Recent activity by corporate boards of some of America's largest publicly held corporations suggests that corporate directors are willing to take a more active role in corporate governance. The ability of corporate directors to actively and effectively oversee corporate performance, however, is seriously impeded by systemic and functional problems inherent in the way corporate boards function. To overcome the problems that corporate boards face today, American corporations should adopt a two-tier board model. Such a model will allow corporate boards to actively, independently and effectively monitor the decisions of management. Such a model will also assure that corporate boards will not overact to the detriment of the corporation.