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THE DELEGATION OF AUTHORITY TO COMMITTEES OF THE BOARD OF DIRECTORS: DIRECTORS' LIABILITIES

Charles E. M. Kolb†

Recent action by the Securities and Exchange Commission and the New York Stock Exchange make it clear that the Commission and the Exchange regard the delegation of corporate board of directors' authority to independent committees as beneficial to the public interest. In this Article, the author examines the potential for individual director liability that arises from such delegation of authority.

I. INTRODUCTION

Directors' liability for improper delegation of authority is governed primarily by a state common law and statutory framework which yields outcomes depending upon the statutory language, the specific facts pertaining to the corporation, and the director involved. The traditional "reliance liability" standard permits exculpation of a director relying in good faith upon a committee acting under authority properly delegated. Many states adopt an "ordinarily prudent person" standard which would vary according to given director's experience, expertise, and exposure to the corporation's activities. Directors who serve on committees, therefore, assume greater liabilities than those who do not.

When committees are required to be established, for example as part of a Securities and Exchange Commission (SEC) consent order or as part of the New York Stock Exchange (NYSE) listing requirements, it is unclear just how much pro forma compliance with these requirements will absolve the board as a whole from subsequent reliance liability. State common law and statutory provisions would still appear to be applicable. Nonetheless, the SEC has become more concerned in recent years that certain committees be both

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meaningfully independent and truly effective. A manifestation of this concern is a trend among recent SEC actions and statements by commissioners calling for corporations to take their own initiatives in changing their board structures so as to increase corporate accountability to their shareholders and the public at large. Although the SEC professes to favor private initiative instead of governmental fiat, there are several indications that a federal standard of fiduciary duty on the part of directors may be emerging.

This article will consider the degree of liability imposed upon members of a corporation's board of directors for actions taken by a board committee to which the board has delegated specific authority. The scope of such accountability is becoming increasingly important in light of concern by a number of SEC commissioners that management accountability would be rendered more meaningful to shareholders and society in general if key committees of the board of directors serve as independent checks on management activities. To this end, several SEC commissioners have endorsed the creation of more independent boards of directors and have urged that directors on the audit and nominating committees, for example, be wholly independent of management.¹

Both the Watergate affair and the recent international corporate bribery scandals have accentuated what many observers have recognized as a "disparity between theory and reality in corporate governance."² Referring to a "frustration of our system of corporate accountability," Professor John C. Coffee, Jr. has noted that the Subcommittee on Oversight and Investigations of the House Committee on Interstate and Foreign Commerce undertook a thorough rethinking of corporate accountability "in light of the improper payments controversy."³ One of the Congressional responses to the fact that over 400 public companies have reported making questionable or illegal foreign payments has been the enactment of the

1. See discussion in text accompanying notes 43-45 *infra*.

2. Speech by Roberta S. Karmel, former SEC Commissioner, "Politics of Change in the Composition and Structure of Corporate Boards," at 5, to the American Society of Corporate Secretaries, Chicago, Illinois (Jan. 11, 1978) [hereinafter cited as "Chicago I Speech"]. See generally, Moss, *The Crisis of Corporate Accountability: A Legislator's View*, 3 J. CORP. L. 251 (1978); Coomse, *Directors' Duties and Responsibilities: New Dimensions, New Opportunities*, 95 BANKING L. J. 634 (1978); Williams, *Corporate Accountability and the Lawyer's Role*, 34 BUS. LAW. 7 (1978); SEC's Williams, *Panelists at West Coast Institute Review Year's Developments in Corporate Accountability*, 487 SEC. REG. L. REP. (BNA) A-14 (Jan. 24, 1979).

For other commentaries on the issues of corporate governance, see Miller, *SEC to Prepare Wider Disclosure Rules*, N.Y. Times, June 8, 1978, at D3, col. 1; Goldstein, *Who Governs Corporations?*, N.Y. Times, Dec. 22, 1978, at D4, col. 1; Miller, *At Odds Over Corporate Governance*, N.Y. Times, Dec. 24, 1978, at D1, col. 3; Hubbard, *Company Boards Don't Need Uncle Sam*, N.Y. Times, June 24, 1979, § III at 14, col. 3.

3. Coffee, *Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response*, 63 VA. L. REV. 1099, 1102 n.2 &

Foreign Corrupt Practices Act of 1977.⁴ Section 30A of the Act, which is an amendment to the Securities Exchange Act of 1933,⁵ prohibits certain issuers, officers, directors, employees, agents, and stockholders from making questionable payments and imposes a \$10,000 fine or imprisonment of up to five years for willful violation by any director, officer, or stockholder.

The overall picture which emerges is one demonstrating concern over corporate accountability in general, and the responsibility of the board of directors in particular. This article will examine several responses to the corporate accountability problem as manifested in the recent debate about the structure of boards of directors. The law in this area is undeveloped as yet, and the best that one can do in most instances is to articulate the various positions in the current discussions. For example, former SEC Commissioner Roberta Karmel has noted that the SEC possesses extensive regulatory powers under section 14(a) of the Securities Exchange Act of 1934⁶ "to maintain, promote and improve fair corporate suffrage for shareholders."⁷ What is as yet unresolved is whether the SEC will be content to wait for self-reform in the direction of independent boards, or whether it will mandate changes in board structure as a matter of law. At present, the SEC has been preaching voluntary restraint, but as this article will show, its actions often demonstrate impatience with this approach. It is interesting to note that according to former Commissioner Karmel, "Our proxy powers are an intrusion of federal law into the internal affairs of corporations which could be used to affect [*sic*] changes in board structure. For example, in my opinion, the Commission could mandate the use of nominating committees under this authority."⁸

Increasing recognition and emphasis are being accorded to the view that the corporation is a quasi-public institution which must serve shareholders and the general public alike. "Corporate existence is dependent upon the government. Accordingly, in our democratic society, corporations are expected to function for the public good as well as for the private benefit of management and shareholders."⁹ Unresolved at present is whether, given the widespread perception

1129 (1977) [hereinafter cited as Coffee].

4. Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, 91 Stat. 1494 (1977) (codified at 15 U.S.C. §§ 78m, 78dd-1, 78dd-2, 78ff (Supp. II 1978)).

5. 15 U.S.C. § 77a (1976).

6. 15 U.S.C. § 78(n) (1976).

7. Karmel, Chicago I Speech, *supra* note 2, at 18.

8. *Id.* See discussion in text accompanying notes 43-50 *infra*.

9. Speech by Roberta S. Karmel, former SEC Commissioner, "The Nominating Committee as a Corporate Accountability Mechanism," at 4, to the Chicago Association of Commerce and Industry, Chicago, Illinois (Apr. 28, 1978) [hereinafter cited as "Chicago II Speech"].

that corporate management and boards of directors have been lax in their oversight, the problem requires a radical solution such as federal chartering, or whether corporations can generate the necessary and sufficient reforms internally. A middle position is Professor Cary's proposal for a Federal Minimum Standards Act specifying minimum fiduciary standards concerning directors, officers, and controlling shareholders in order to remove internal interest conflicts and improper behavior. These standards, however, would not impact directly on corporate structural reform.¹⁰ For example, Senator Howard Metzenbaum, Chairman of the Judiciary Subcommittee on Citizens' and Shareholders' Rights and Remedies, opposes federal chartering, but has established a committee charged with drafting legislation that will probably include such proposed federal minimum standards for corporate behavior, setting out uniform responsibilities and liabilities for corporate directors and allowing for shareholder enforcement.¹¹

Delegation of authority from board members to various committees is directly implicated in the accountability controversy with regard to both the nature and extent of such delegation and the characteristics of those individuals comprising particular committees. The position taken by many, that certain key committees should consist of independent or non-affiliated (with management) directors, is intended to strengthen corporate stewardship by providing that major decisions concerning a corporation's future be made by parties independent of management and its objectives.

II. DELEGATED CORPORATE AUTHORITY

A. *Origins*

Initially, at common law, all corporate authority lay with the board of directors and could not be delegated. As enunciated in *Gillis v. Bailey*,¹² the board of directors' power was original and could not be delegated, its powers constituting a grant from the state. Thus, board members, having been delegated authority themselves from the state, were unable to delegate this authority any further. The board lacked common law powers, possessing only those specifically granted by statute,¹³ and the board was held to exercise its powers as a fiduciary on behalf of the stockholders.¹⁴ Yet, despite the lack of explicit statutory authorization, New York courts had upheld the

10. See *id.* at 26.

11. Crock, *Manager's Journal — Proxy Disclosures*, Wall St. J., Mar. 13, 1978, at 16, col. 3. See also note 118 *infra*.

12. 21 N.H. 149 (1850).

13. See *Town of Royalton v. Royalton & Woodstock Turnpike Co.*, 14 Vt. 311 (1842).

14. *Cook v. Berlin Woolen Mills Co.*, 43 Wis. 433, 439 (1877). Note, *Delegation of Duties by Corporate Directors*, 7 VA. L. REV. 278 (1961).

delegation of authority to executive committees of New York corporations.¹⁵

Once the principle of delegation had been recognized, the issue then focused on scope. At first, only ministerial duties of the board could be delegated.¹⁶ Courts, however, gradually began to expand the delegation concept to so-called discretionary acts as well.¹⁷ More recently, an "ultimate supervision test" has been applied under which boards are held directly responsible for matters relating to high-level control rather than for the direct supervision of every discretionary act on the corporation's part.¹⁸ Today, the scope of board delegation is still governed by applicable case law, but in most instances, this delegation is explicitly authorized by a statute which may or may not speak in detail as to the scope of delegation and the extent to which the board members remain responsible, collectively or individually.¹⁹ With delegation established both at common law and by state statute, the focus necessarily shifted to the relationship between the board and the executive committee which became the primary recipient of delegated authority.

B. *The Executive Committee*

1. Definition

An executive committee can be defined as "a group of directors established by the board to exercise its authority in the management of the corporate business."²⁰ Although delegation was permitted, there were both case law and statutory restrictions on the extent of this delegation, and it remained clear that directors were not relieved of their legal responsibilities unless otherwise provided by

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15. *Ford v. Magee*, 160 F.2d 457 (2d Cir. 1947); *Sheridan Elec. Light Co. v. Chatham Nat'l Bank*, 127 N.Y. 517, 28 N.E. 467 (1891); *Hoyt v. Thompson's Ex'r*, 19 N.Y. 207 (1859).
 16. *Sherman & Ellis, Inc. v. Indiana Mut. Cas. Co.*, 41 F.2d 588 (7th Cir. 1930).
 17. *See Yarnell Warehouse & Transfer, Inc. v. Three Ivory Bros. Moving Co.*, 226 So. 2d 887 (Dist. Ct. App. Fla. 1969); *Olcott v. Tioga R.R. Co.*, 27 N.Y. 546 (1863) (board can clothe committee with authority to conduct corporation's ordinary business; however, committee cannot delegate its authority, even to one of its members). *See also In re Lone Star Shipbuilding Co.*, 6 F.2d 192 (2d Cir. 1925) (illustrates the lack of clarity between ministerial and discretionary board duties).
 18. *See San Antonio Joint Stock Land Bank v. Taylor*, 129 Tex. 335, 105 S.W.2d 650 (1937) (dictum), *rev'g* 101 S.W.2d 868 (Tex. Civ. App. 1936).
 19. *E.g.*, DEL. CODE ANN. tit. 8, § 141 (1975 & Supp. 1978); MD. CORP. & ASS'NS CODE ANN. §§ 2-405, 2-411 (1975 & Supp. 1979); N.Y. BUS. CORP. LAW §§ 712, 717 (McKinney 1963 & Supp. 1979-80).
 20. Note, *Delegation of Duties by Corporate Directors*, 47 VA. L. REV. 278, 281-82 (1961) (citing *Steigerwald v. A.M. Steigerwald Co.*, 9 Ill. App. 2d 31, 132 N.E.2d 373 (1955)); MODEL BUS. CORP. ACT § 31(e), 9 U.L.A. 184 (1957); ABA-ALI MODEL BUS. CORP. ACT § 38 (1953, rev. 1959).

statute.²¹ Of obvious importance, then, is the extent to which the executive committee can act on behalf of the full board in committing the corporation to a given policy or decision. Any answer to this question necessarily implicates the concern for ministerial and discretionary duties already discussed.²²

2. Statutory Scope of Executive Committee Delegation

Today, the executive committee is virtually a "universal phenomenon," with some 97% of large companies having established them.²³ In every state except one (Arizona), statutes provide the basic authority for creation of an executive committee, and generally a corporation's bylaws will either "actually establish the executive committee and define its duties or permit the board to do so by resolution."²⁴ With regard to liability which may or may not fall on the board or certain of its individual members, the major issue is described as follows:

Liability when it arises is most likely to stem from financial or business decisions made by insiders sitting on the traditional executive or finance committees. Given this, questions arise as to whether liability will fall equally on committee and non-committee directors, proportionally more on committee directors, or solely on committee directors.²⁵

In many cases, the nature of the liability and the existence of any exemptions from liability for non-committee members will usually be dealt with by statute. Statutory law in Maryland, for example, provides that "[t]he bylaws of a corporation may authorize its board of directors to: (1) Appoint from among its members an executive committee and other committees composed of two or more directors."²⁶ Such committees may exercise "any of the powers of the

21. H. HENN, HANDBOOK OF THE LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES, § 212. at 425 & nn.10-11 (2d ed. 1970).

22. See discussion in text accompanying notes 9-10 *supra*. In *Tempel v. Dodge*, 89 Tex. 68, 32 S.W. 514 (1895), the Supreme Court of Texas held that a bylaw purporting to give the executive committee "all the powers of the board of directors" was invalid. For more recent cases covering the scope of executive committee authority compare *Storer v. Florida Sportservice, Inc.*, 125 So. 2d 906 (Dist. Ct. App. Fla. 1961) (corporation was bound by contract authorized by executive committee and made by the president even though bylaws say contracts must be approved by the board, if the bylaws also say the executive committee shall conduct the corporation's business), with *Doyle v. Chladek*, 240 Or. 598, 401 P.2d 18 (1965) (executive committee may not revise stock subscription agreement if the bylaws limit its authority to administrative and ministerial acts).

23. McMullen, *Committees of the Board of Directors*, 29 BUS. LAW. 755, 758 (1974).

24. *Id.* at 760.

25. *Id.* at 756.

26. MD. CORP. & ASS'NS CODE ANN. § 2-411(a) (Supp. 1979).

board of directors," except five specifically enumerated activities.²⁷ An additional provision establishes the "[s]tandard of care required of directors" which is also to apply to a director in his capacity as a member of a committee of the board on which he serves. Besides a good faith standard and the requirement that a director act in a manner in which he reasonably believes "to be in the best interests of the corporation," the Maryland statute codifies the "ordinarily prudent person" standard as it evolved from the common law.²⁸ Of particular importance is section 2-405.1(b)(iii), covering reliance on information from others, which explicitly exculpates a non-member director when he relies on "[a] committee of the board on which the director does not serve, as to a matter within its designated authority, if the director reasonably believes the committee to merit confidence."²⁹

The Maryland provisions follow the basic approach of the Model Business Corporation Act and may be compared with similar statutory approaches to director liability for board committee acts adopted in New York and Delaware. Section 712(a) of the New York Business Corporation Law provides that the board may designate "from among its members" executive and other committees "if the certificate of incorporation or the by-laws so provide."³⁰ Committees are specifically forbidden from engaging in certain activities, and it would appear that given the amendments made in 1977,³¹ a non-committee director will not be deemed under New York law to have performed an act taken by a committee for which he can be held liable without proof of direct involvement:

§ 712. Executive committee and other committees

. . . .

(c) Each such committee shall serve at the pleasure of the board. The designation of any such committee, the delegation thereto of authority, or action by any such committee pursuant to such authority shall not alone constitute performance by any member of the board who is not a member of the committee in question, of his duty to the corporation under section 717 (Duty of directors).³²

27. *Id.* § 2-411(2)(i)-(v) (Supp. 1979).

28. See discussion in text accompanying notes 19-27 *supra*.

29. MD. CORP. & ASS'NS CODE ANN. § 2-405.1(b)(iii) (Supp. 1979).

30. N.Y. BUS. CORP. LAW § 712(a) (McKinney Supp. 1979-80).

31. The 1977 amendment replaced the words "shall not alone relieve any director" with "or action by any such committee pursuant to such authority shall not alone constitute performance by any member of the board who is not a member of the committee in question."

32. N.Y. BUS. CORP. LAW § 712(c) (McKinney Supp. 1979-80).

Additionally, section 717, which deals with the duty of directors, was completely rewritten in 1977 so as to incorporate the "ordinarily prudent person" standard and to exculpate a director relying on a committee in certain specified contexts:

§ 717. Duty of directors

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 and with that degree of care which an ordinarily prudent person in a like position would use under similar circumstances. In performing his duties, a director shall be entitled to rely on information, opinions, reports or statements including financial statements and other financial data, in each case prepared or presented by:

(3) a committee of the board upon which he does not serve, duly designated in accordance with a provision of the certificate of incorporation or the by-laws, as to matters within its designated authority, which committee the director believes to merit confidence, so long as in so relying he shall be acting in good faith and with such degree of care, but he shall not be considered to be acting in good faith if he has knowledge concerning the matter in question that would cause such reliance to be unwarranted. A person who so performs his duties shall have no liability by reason of being or having been a director of the corporation.³³

Section 141(c) of the Delaware Corporation Law similarly authorizes the board to create committees which, "to the extent provided in the resolution of the board of directors, or in the bylaws of the corporation, shall have and may exercise all the powers and authority of the board of directors" in managing the corporation, with certain enumerated exceptions.³⁴ Directors and committee members are exculpated from liability for good faith reliance on books of account or reports from corporate officers, independent certified public accountants, carefully selected appraisers, or "other records of the corporation."³⁵ This section, unlike section 2-405.1 of the Maryland statute, does not specifically deal with director liability for committee action, but an argument could be made to include any such action within the concept of "other records of the corporation."

33. *Id.* § 717 (McKinney Supp. 1979-80).

34. DEL. CODE ANN. tit. 8, § 141(c) (1975).

35. *Id.* § 141(e) (1975).

Each of these statutory approaches has in common two elements: (1) express provision for the creation of executive *and other committees* either by the board, the charter, or the corporate bylaws, and (2) an attempt to articulate a standard of liability in terms of an exemption from liability for good faith reliance, or a non-committee director's being able to show that he behaved as an ordinarily prudent person, or that his behavior as a board member, through his own individual activities, did not involve him in the committee's "performance."³⁶ As is readily apparent, each of these statutory codifications of a liability standard requires fleshing out by the common law. Although the principle that delegation to an executive committee will not relieve a board, individually or collectively, of the responsibility imposed by law is well established,³⁷ the relevant factors helping to establish liability or non-liability may include the type and size of corporation involved, the scope of activity and oversight expected from its directors, the overall circumstances at a given time, and the nature of the particular problems creating the possible imposition of liability.³⁸ In other words, both inside and outside directors who are non-committee members may want to appeal to something like an "ordinarily prudent person" standard in the event that shareholders or others seek to hold them liable.³⁹ To understand how the statutory language has been implemented, it is necessary to turn to its application at common law.

36. This analysis should not be construed as implying that these three approaches are the only forms currently used by states. Each state's statute should be consulted for any given problem. Professor Folk has made the following observations:

Virtually all new statutes adopt the Model Act provision which specifies various director liabilities for improper dividends and other distributions and which grants certain defenses, among them good faith reliance on books and records and also on financial statements represented to be correct by the appropriate officer or certified independent accountants.

While most statutes follow the Model Act, which permits executive (or other) committees only if the articles or by-laws so provide, it would be preferable to authorize such committees directly if, as, and when desired. Of course, the usual limits on delegation and responsibility of the full board would remain unaffected, as would any statutory restraints on the powers which could be delegated.

Folk, *Corporation Statutes: 1959-1966*, 1966 DUKE L. J. 875, 890, 899-900.

37. Aurell, *The Corporate Executive Committee: A Dilemma for the Nonmember Director*, 17 U. FLA. L. REV. 525 (1965) [hereinafter cited as Aurell].

38. See W. KNEPPER, *LIABILITY OF CORPORATE OFFICERS AND DIRECTORS* § 506, at 118-120 (3d ed. 1978).

39. Aurell, *supra* note 37, at 529.

3. Common Law Application

The leading common law case on directors' liability for executive committee actions is *Kavanaugh v. Gould*.⁴⁰ Recognizing that a board of directors could in fact delegate authority to committees,⁴¹ the court recognized the problem arising from compelling directors to become responsible for a corporation's detailed management, namely, "it would be wholly impossible for them to accept such a trust."⁴² In explaining non-committee members' liability the court spoke as follows:

The directors generally not upon the executive committee are not supposed to have knowledge of the details of the business management of the corporation which are not submitted to them. In other words, it is not their custom to actively search the individual transactions in a bank that they may learn the responsibility of its debtors, or the nature or value of the collateral. This they intrust, *first*, to the executive officers of the bank, who are carefully chosen and paid for their services; *secondly*, to the supervision of the executive committee of their body, which is chosen with a special reference to this duty, and to which committee must be reported weekly all the transactions of the bank.

This custom, however, does not relieve directors generally of all responsibility. If the by-laws require monthly meetings, they must make diligent effort to be present thereat. They must give their best efforts to advance the interest of the corporation, both by advice and counsel and by active work on behalf of the corporation when such work may be assigned to them. If at their meetings, or otherwise, information should come to them of irregularity in the proceedings of the bank, they are bound to take steps to correct those irregularities. The law has no place for dummy directors. They are bound generally to use every effort that a prudent business man would use in supervising his own affairs, with the right, however, ordinarily to rely upon the vigilance of the executive committee to ascertain and report any irregularity or improvident acts in its management.⁴³

40. 147 A.D. 281, 131 N.Y.S. 1059 (Sup. Ct. 1911).

41. *Id.* at 288, 131 N.Y.S. at 1064 (citing *Cassidy v. Uhlmann*, 170 N.Y. 505, 516, 63 N.E. 554, 556 (1902)).

42. *Id.* at 289, 131 N.Y.S. at 1065.

43. *Id.* at 288-89, 131 N.Y.S. at 1064 (emphasis in original).

With reference to executive committee members, the court was specific:

To the members of the executive committee is assigned the duty of detail supervision. With this duty they are bound to be on their guard to detect any irregularities or improvident acts on the part of the executive officers. They are required to scan critically the detailed reports which are made to them by such officers. The diligence required of them is therefore greater and the rule of their liability more strict than that of a director not a member of that committee, for to them not only do the stockholders look for protection, but the directors themselves, and upon their fidelity to their commission all parties must rely.⁴⁴

The court concluded with the "necessary inference" that "the directors not upon the executive committee are not chargeable with knowledge of detail management which need be reported only to the executive committee."⁴⁵ Although *Kavanaugh* contains an eloquent explanation of non-committee member liability, an earlier case, *Warner v. Penoyer*,⁴⁶ may be cited for the proposition that directors of a national bank who were members of the discount and examining committees could be held liable while other non-committee directors were exonerated.⁴⁷

As already indicated, however, limitations on delegated authority and the extent to which non-committee directors will be insulated by either their ignorance or inadvertence will depend on rather fact-specific circumstances. A few cases, nonetheless, indicate that there exists a minimum requirement as to a director's basic knowledge of the corporation's activities. Thus, in *National Automobile & Casualty Insurance Co. v. Payne*,⁴⁸ the court noted that "[d]irectors may not abdicate their authority by delegating their powers of management of the corporation to other persons,"⁴⁹ and went on to add that "[a] knowledge of the basic capital structure of the corporation would appear to be a minimal requirement of the reasonable exercise of such duties."⁵⁰ Again, the precise knowledge

44. *Id.* at 290, 131 N.Y.S. at 1065.

45. *Id.* at 293, 131 N.Y.S. at 1068.

46. 91 F. 587 (2d Cir. 1898).

47. See Annot., 25 A.L.R.3d 941, 1047-52 (1969).

48. 261 Cal. App. 2d 403, 67 Cal. Rptr. 784 (1968).

49. *Id.* at 412, 67 Cal. Rptr. at 790.

50. *Id.* See also *Platt Corp. v. Platt*, 42 Misc. 2d 640, 249 N.Y.S.2d 1 (1964), *rev'd on other grounds*, 17 N.Y.2d 234, 270 N.Y.S.2d 408 (1966). In *Platt*, the Supreme Court of New York County commented that:

It is the obvious duty of directors to know what is transpiring in the business affairs of their corporation. They cannot assume the responsi-

required will depend upon the circumstances, as is illustrated by the SEC's recent decision in *In re National Telephone Co.*,⁵¹ finding that the outside directors had a duty to be aware of the need for "corrective disclosure" when the press releases prepared by management were inaccurate:

In general, outside directors should be expected to maintain a general familiarity with their company's communications with the public.

. . . .

Moreover, as here, when important events central to the survival of the company are involved, directors have a responsibility affirmatively to keep themselves informed of developments within the company and to seek out the nature of corporate disclosures to determine if adequate disclosures are being made.⁵²

As both *Payne* and the *National Telephone* release indicate, the "ordinarily prudent person" standard will depend on factors peculiar to a corporation's present difficulties which threaten imposition of liability. Directors, then, will be

[c]harged with knowledge [they] actually possessed or which [they] might have possessed had [they] diligently pursued [their] duties. . . . In other words, their duty is to be measured by what prudent men would do in similar circumstances being in possession not only of the knowledge and the information they possessed or could have possessed by diligent attention to all their duties not only as directors and officers, but also as members of the Executive Committee.⁵³

An almost inescapable inference from the above series of cases is that a director's liability will be greater in proportion to his responsibility concerning matters within the purview of the committee on which he serves. As one commentator has noted, this inference may be drawn from language in *Escott v. BarChris Construction*

bilities of their fiduciary position, then simply close their eyes to avoid the consequences by the mere failure to act. While corporate directors are not liable for errors of judgment, nevertheless, the law holds them accountable for that which they reasonably should have known or discovered in the discharge of their duties

42 Misc. 2d at 643, 249 N.Y.S.2d at 6.

51. [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶81,410 (Jan. 16, 1978).

52. *Id.* at 88,880.

53. *Syracuse Television, Inc. v. Channel 9, Syracuse Inc.*, 51 Misc. 2d 188, 196-97, 273 N.Y.S.2d 16, 27 (1966) (citation omitted).

*Corp.*⁵⁴ In *BarChris*, liability was imposed under section 11 of the Securities Act of 1933,⁵⁵ because directors either knew or failed to exercise "due diligence" in discovering certain undisclosed facts. Yet, the court undertook a detailed inquiry into the "due diligence" defenses of some ten individuals, finding that standards of liability varied in relation to an individual's knowledge, experience, professional background (for example, the lawyer, Birnbaum) as well as what could be expected of him. With regard to Auslander, a relatively new outside director, the court found that he failed to establish his due diligence defense, commenting that "Section 11 imposes liability in the first instance upon a director, no matter how new he is."⁵⁶ Grant, a director and signer of the faulty registration statement, also failed the due diligence test, and the court remarked that:

As the director most directly concerned with writing the registration statement and assuring its accuracy, *more was required of him* in the way of reasonable investigation than could be fairly expected of a director who had no connection with this work.⁵⁷

What emerges from a consideration of both state and federal common law decisions is that a director's liability for improper delegation of authority may be greater, even under a potentially exculpatory statute in state cases, if he fails to exercise that level of due care consistent with the judicially evolved criteria which provide meaning to phrases such as "good faith reliance" or "ordinarily prudent person." Membership on a committee appears to impose automatically a higher standard of care. Such an imposition is consistent with both the view that more responsibility entails more exposure to liability and the "ordinarily prudent person" standard, since more knowledge and exposure to corporate affairs through

54. 283 F. Supp. 643, (S.D.N.Y. 1968). Friedman, *Committees of the Board and Corporate Disclosure Policy*, in 2 MANAGING CORPORATE DISCLOSURE 553, 568 (1978).

55. 15 U.S.C. § 77k (1976).

56. 283 F. Supp. at 688.

57. *Id.* at 690 (emphasis added). For a more detailed analysis of *BarChris*, see Parts I and II of Folk, *Civil Liabilities Under the Federal Securities Acts: The BarChris Case*, 55 VA. L. REV. 1, 199 (1969). An assessment of the emerging federal law standards for director liability is necessarily beyond the scope of this article. For a concise survey of this law, see Wander, *Protecting Directors Against Securities Liabilities*, in PREVENTING DIRECTORS' LIABILITY UNDER THE SECURITIES LAWS 1976, Practising Law Institute Course Handbook Series No. 222, 145 (1976). There is also a series of common law decisions imposing a stricter standard of care upon inside as opposed to outside directors. See, e.g., *Bates v. Dresser*, 251 U.S. 524 (1920); *Savings Bank v. Caperton*, 87 Ky. 306, 8 S.W. 885 (1888); *Boulicault v. Oriol Glass Co.*, 283 Mo. 237, 223 S.W. 423 (1920).

committee membership is generally expected to raise the level of "prudence" expected.⁵⁸ In short, the right to rely is "inherent in the nature of a director's duty of inquiry," and the "proper inquiry relates to the degree and nature of the reliance"; however, "the standard will vary depending upon the position of the director within the corporation and his own special skills and expertise."⁵⁹ One commentator raises two questions which relate directly to these various standards:

May a director rely on the report of an audit committee without making independent investigation?

Should the reliance concept be expanded so that the director may rely upon actions by committees of the board pursuant to duly delegated authority?⁶⁰

Although the audit committee will be considered separately,⁶¹ it would seem that in light of the above discussion both of these questions can be answered by referring to the appropriate state statutory language and any accompanying common law standards fleshing out the statutory principles. What the commentator does not address, however, is the issue raised by *BarChris* and its progeny of whether the current reliance on a state statute and common law approach will be overshadowed by federally mandated standards of corporate accountability and director responsibility. It is to this area, literally on the frontier of the current legal debate, to which this article will now turn.

4. An Evolving Federal Standard of Directors' Liability?

Although *BarChris* was the first case to interpret section 11 of the Securities Act of 1933⁶² and result in the imposition of liability, its holding cannot be restricted to the confines of federal securities law. The liability standards articulated in *BarChris* are one bit of recent evidence indicating the evolution of a federal due care standard which would impact upon the current pattern of what might be called directors' "reliance liability." In 1974, even before the revelations of corporate slush funds and illegal foreign payments, it was evident that the SEC favored enlistment of the board of directors to help prevent corporate wrongdoing: "It expects the board of directors to pay close attention to the functioning and indepen-

58. See text accompanying notes 25-53 *supra*.

59. Ruder, *Satisfaction of Directors' Liability by Reliance on Others*, in PREVENTING DIRECTOR'S LIABILITY UNDER THE SECURITIES LAWS 189, 196 (1974).

60. *Id.* at 200.

61. See text accompanying notes 32-43 *supra*.

62. 15 U.S.C. § 77k (1976).

dence of the outside auditors through audit committees comprised entirely of outside directors."⁶³ The calls for establishing independent boards of directors have been heard with increasing frequency, but as yet, aside from the audit committee requirement imposed by the NYSE as a listing prerequisite,⁶⁴ no corporate structural changes have been mandated. Nonetheless, many large corporations such as Coca-Cola, Citicorp, and Allied Chemical have established ethical guidelines for their officers, directors, and employees.⁶⁵ Yet, as Leonard Silk has recognized:

The corporate reformation will be enduring only if statements of ethical standards are matched by the building of institutions and procedures within the corporation to insure that the standards are enforced. This will involve strengthening the independence and oversight powers of boards of directors and their audit committees. It will involve improving the flow of information to the board and up and down the organization. It will also require establishing oversight and review committees at different levels.⁶⁶

The entire reliance structure, however, could be radically changed in the event that corporations move in the direction of more independent boards of directors. Both the Business Roundtable, an association of 190 chief executive officers which takes positions on public policy issues, and SEC Chairman Williams have endorsed the "strong tendency" of large United States corporations to have boards consisting of a majority of outsiders.⁶⁷ Williams, however, stressing again the "quasi-public" character of the corporation, has called for an independent board of directors "from which outside counsel and both investment and commercial bankers would be excluded. In his view, the only member of management who should sit on a corporation's board of directors is the chief executive — and that officer should not act as chairman."⁶⁸ Although most of these suggestions are still at the "talking" stage, there is evidence that individuals such as Stanley Sporkin, Director of the SEC's Enforcement Division, favor a legislated investors' bill of rights which would

63. Caplin, *Outside Directors and Their Responsibilities: A Program of Due Care*, 1 J. CORP. LAW 57, 71 (1975) (referring to Securities Act Release No. 5550, FED. SEC. L. REP. (CCH) ¶ 72,187 (Dec. 20, 1974)) [hereinafter cited as Caplin].

64. See text accompanying notes 35-38 *supra*.

65. Silk, *Ethical Guides for Companies*, N.Y. Times, June 15, 1978, at D2, col. 1.

66. *Id.*

67. 437 SEC. REG. & L. REP. (BNA) A-21 (Jan. 25, 1978).

68. *Id.* at A-22.

have the net effect of "reopening the federal courts to our shareholders."⁶⁹ Furthermore, Sporkin claims that the SEC "or another agency" has the authority to set qualifications for corporate directors as well as to disqualify those who fail to discharge adequately their fiduciary responsibility.⁷⁰

One example of the SEC's increased activism in this area — of its greater willingness to look over the directors' shoulders — is the 1977 Consent Order filed with respect to the Zale Corporation. In *SEC v. Zale Corp.*,⁷¹ the SEC used evidence of the company's half-hearted investigation of certain inside directors as proof of a securities law violation. Specifically, an independent committee of outsiders charged with conducting the investigation was adjudged by the SEC to have failed to "conduct a meaningful independent investigation."⁷² Eventually, the board of directors abolished the committee leaving the investigation to be conducted by the chairman's son. As Professor Coffee has observed, at present there is very little "judicial interest in piercing the veil of formalism to achieve a meaningful definition of board independence."⁷³ To the extent that corporations attempt to meet the criticisms voiced by Chairman Williams with token reform, they "[invite] SEC activism to fill the void, resulting in an overexpansion of that agency's jurisdiction that may well be undesirable."⁷⁴ What this entails for the entire "reliance liability" structure is obviously the interjection of federal standards into areas currently left to state court assessment, such as the degree of expertise of a director, his experience with and knowledge of the corporation, and the other more or less "fact specific" elements taken into consideration by the "good faith" and "prudent person" standards.

Insofar as the executive committee is concerned, the current debate has focused on the need to staff it with outsiders who are independent of management. As of the present, the debate has been just that — a debate. In the area of the audit committee, however, a long-standing debate has materialized into a concrete rule to be imposed by the NYSE on all listed companies.

69. 402 SEC. REG. & L. REP. (BNA) A-1 (May 11, 1977).

70. *Id.*

71. SEC v. Zale Corp., SEC Litigation Release No. 8081 (Aug. 24, 1977).

72. *Id.* at 2.

73. Coffee, *supra* note 3, at 1236.

74. *Id.*

III. THE AUDIT COMMITTEE

A. *History*

The idea of an audit committee was suggested by the SEC in 1940 in its report on the McKesson & Robbins investigation.⁷⁵ Very little activity, however, occurred with regard to audit committees until 1967 when the American Institute of Certified Public Accountants (AICPA) recommended appointing a committee of outside directors to nominate and work with independent auditors.⁷⁶ In 1972, the SEC endorsed the creation of corporate audit committees.⁷⁷ A year later the New York Stock Exchange made a similar endorsement.⁷⁸

In light of the revelations concerning corporate bribery and illegal payments which surfaced after the Watergate affair, the audit committee took on even greater importance. Specifically, an audit committee on financial accounting was seen as a means of providing a direct channel of communications between the board and the corporation's auditors:

It lessens the outside auditors' direct reliance on management and helps the outside directors meet their obligations of due care. Generally, it recommends the auditors to be selected by the company, reviews reporting policies and practices, reviews the scope and results of an audit, and reviews the adequacy of the company's accounting and financial controls.

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Since 1972, the SEC has indicated its broad support for the creation of an audit committee. Corporations have been urged to form these committees so as to increase the independence of the auditors. On December 20, 1974, the SEC took steps to implement its position by amending the proxy rules to require inclusion in proxy materials of (a) information concerning the existence and composition of the audit committee and (b) if none exists, a statement to that

75. 5 FED. SEC. L. REP. (CCH) ¶ 72,020 (Dec. 5, 1940). See Mautz & Neumann, *The Effective Corporate Audit Committee*, 48 HARV. BUS. REV. 57, 59 (Nov.-Dec. 1970); Feller & Loo, *The Audit Committee*, in 2 MANAGING CORPORATE DISCLOSURE 633, 635 (1978) [hereinafter cited as Feller & Loo]; Greene & Falk, *The Audit Committee — A Measured Contribution to Corporate Governance: A Realistic Appraisal of its Objectives and Functions*, 34 BUS. LAW. 1229 (1979); 3 J. CORP. L. 400 (1978).

76. AICPA *Executive Committee Statement*, 124 J. OF ACCOUNTANCY 10 (Sept. 1967).

77. 5 FED. SEC. L. REP. (CCH) ¶ 72,145 (Mar. 23, 1972).

78. Feller & Loo, *supra* note 75, at 635.

effect. Among other things the SEC believes that the audit committee "would lessen the accountants' direct reliance on management and would put them directly in touch with outside members of the Board whose performance was less specifically being reported on in financial statements, thus increasing the accountants' independence."⁷⁹

Thus, the audit committee was viewed as a key feature of corporate structure, having become endowed with a stature second only to the board of directors itself because of the New York Stock Exchange's requirement after 1977 that all listed companies establish audit committees by June 30, 1978. Even before 1977, however, the required use of audit committees in several SEC consent settlements became increasingly common.⁸⁰

B. *The 1977 New York Stock Exchange Rule*

Once an audit committee was established, it was a different matter altogether as to who could or should serve on the committee. For instance, the extent to which the committee should include management participation or remain independent of senior management involvement continues to be debated.⁸¹

With respect to companies with common stock listed on the NYSE, however, this uncertainty was resolved on March 9, 1977, with the adoption of the NYSE's Audit Committee Policy requiring establishment of such a committee by June 30, 1978.⁸² The Exchange required that the committee be "comprised solely of directors independent of management and free from any relationship that, in the opinion of its Board of Directors, would interfere with the exercise of independent judgment as a committee member."⁸³

79. Caplin, *supra* note 63, at 77-78 (quoting Securities Act Release No. 5550, FED. SEC. L. REP. (CCH) ¶ 72,187, at 62,427 (Dec. 20, 1974)).

80. See, e.g., SEC v. Mattel, Inc. [1974-75 Transfer Binder] FED. SEC. L. REP. (CCH), ¶ 94,504 (Oct. 1, 1974); SEC v. Lum's, Inc. [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH), ¶ 94,504 (Apr. 11, 1974); SEC v. Coastal States Gas Corp., SEC Litigation Release No. 6054 (Sept. 12, 1973); SEC v. Zale Corp., SEC Litigation Release No. 8081 (August 24, 1977); SEC v. Killlearn, SEC Litigation Civil Action No. TCA-75-67 (May 2, 1977). See also J. BACON & J. BROWN, CORPORATE DIRECTORSHIP PRACTICES: ROLE, SELECTION AND LEGAL STATUS OF THE BOARD 117-27 (1975); THE COOPERS & LYBRAND AUDIT COMMITTEE GUIDE (2d ed. 1976).

81. Compare Lam, *Management Representation on Audit Committees*, THE CPA J. 33 (Nov. 1975) (recommends that if management is to be represented on audit committee, it should comprise a minority of its members) with Lovdal, *Making the Audit Committee Work*, 55 HARV. BUS. REV. 108 (Mar-Apr. 1977) (opposes management involvement). See also 3 J. CORP. L. 400, 420-21 (1978).

82. NYSE GUIDE (CCH) ¶ 2495H (1978).

83. *Id.* at ¶229.

The SEC was clearly pleased with the Exchange's listing requirement. In a letter to Exchange President William Batten dated May 11, 1976, then SEC Chairman Hills had suggested an amendment of the Exchange's listing policies in order to increase the role and percentage of outside directors on publicly listed companies.⁸⁴ In testimony later that year before a Senate Committee, Hills stated that he favored a majority of outsiders on the board.⁸⁵ Additionally, on January 19, 1977, the Commission proposed a series of rule amendments requiring registered and reporting issuers under the Securities Exchange Act to maintain accurate corporate books and records as well as an "attendant system of internal accounting controls."⁸⁶ As with the current fabric of common law liability, standards of effective control systems will depend on particular circumstances:

Systems of control will, of course, vary from company to company. The size of the business, diversity of operations, degree of centralization of financial and operating management, amount of contact by top management with day-to-day operations, and numerous other circumstances are factors which management must consider in establishing and maintaining an internal accounting controls system.⁸⁷

Director liability would be implicated under new rule 13b-2 which requires management to devise and maintain a system of internal auditing controls.

As of June 30, 1978, creation of an audit committee became a listing requirement for the NYSE. There have been no legal opinions as to the degree to which creation of such committees entails a higher standard of director due diligence. Director liability for reliance on an audit committee's report would seem to be subject to the prevailing common law and statutory approach discussed earlier in connection with executive committees.⁸⁸ Under the common law standards, audit committee members would appear to assume greater liability than non-audit committee directors. The extent to which such delegation of authority is required, however, may tend to complicate the analysis, especially in light of the fairly rigid requirements as to who can and cannot serve on the audit

84. SENATE BANKING, HOUSING, AND URBAN AFFAIRS COMM., 94TH CONG. 2D SESS., REPORT OF THE SECURITIES AND EXCHANGE COMMISSION ON QUESTIONABLE AND ILLEGAL CORPORATE PAYMENTS AND PRACTICES, Exhibit D. (Comm. Print 1976).

85. [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,611 (June 21, 1976).

86. *Id.* at ¶80,896 (Jan. 19, 1977).

87. *Id.* at 87,379.

88. Securities Exchange Act of 1934, 15 U.S.C. § 78m(b)(2)(B) (1976).

committee.⁸⁹ At the same time, a showing of pro forma compliance with the NYSE Rule may itself be enough to constitute a director's "due diligence" in relying on an audit committee. Although no new

89. The New York Stock Exchange Audit Committee Policy provides as follows:
Audit Committee Policy

Each domestic company with common stock listed on the Exchange, as a condition of listing and continued listing of its securities on the Exchange, shall establish no later than June 30, 1978 and maintain thereafter an Audit Committee comprised solely of directors independent of management and free from any relationship that, in the opinion of its Board of Directors, would interfere with the exercise of independent judgment as a committee member. Directors who are affiliates of the company or officers or employees of the company or its subsidiaries would not be qualified for Audit Committee membership.

A director who was formerly an officer of the company or any of its subsidiaries may qualify for membership even though he may be receiving pension or deferred compensation payments from the company if, in the opinion of the Board of Directors, such person will exercise independent judgment and will materially assist the function of the committee. However, a majority of the Audit Committee shall be directors who were not formerly officers of the company or any of its subsidiaries.

Supplementary Material

In order to deal with the complex relationships that arise, the following guidelines are provided to assist Boards of Directors to observe the spirit of the policy in selecting members of the Audit Committee.

A director who has, or is a partner, officer or director of an organization that has customary commercial, industrial, banking or underwriting relationships with the company which are carried on in the ordinary course of business on an arms-length basis may qualify for membership unless, in the opinion of the Board of Directors, such director is not independent of management or the relationship would interfere with the exercise of independent judgment as a committee member.

A director who, in addition to fulfilling the customary director's role, also provides additional services directly for the Board of Directors and is separately compensated therefor, would nonetheless qualify for membership on the Audit Committee. However, a director who, in addition to his director's role, also acts on a regular basis as an individual or representative of an organization serving as a professional advisor, legal counsel or consultant to management, would not qualify if, in the opinion of the Board of Directors, such relationship is material to the company, the organization represented or the director.

A director who represents or is a close relative of a person who would not qualify as a member of the Audit Committee in the light of the policy would likewise not qualify for the committee. However, if the director is a close relative of an employee who is not an executive officer or if there are valid countervailing reasons, the Board of Directors' decision as to eligibility shall govern.

While SEC Rule 405 may be helpful to the Board of Directors in determining whether a particular director is an "affiliate" or a close relative for purposes of this policy, it is not intended to be so technically applied as to go beyond the spirit of this policy.

NYSE GUIDE (CCH) ¶ 2495H (adopted by the Exchange March 9, 1977).

For a general discussion of the liability of committee members and noncommittee directors, see 3 J. CORP. L. 400, 416-17 (1978).

standards of liability have as yet evolved, as with executive committees, the law may be in flux at the fringes, especially when one considers the SEC's recent actions in light of corporate misconduct as a possible model for corporate reform.

C. *An Emerging Federal Standard?*

If the outside directors on an audit committee were to prove to be "shams," would the directors as a whole be liable? What if the trend toward outsider boards were simultaneously undercut by the fact that many such directors were hand-picked by the chief executive officer?⁹⁰ In discussing the possible creation of a federal duty of due care for directors, Professor Coffee refers to the somewhat unusual *SEC v. Shiell* complaint brought by the Division of Enforcement in which "directors (including outside directors) who failed to control management adequately could be found to violate the federal securities laws, because implicitly they falsely represented the material fact that they were in control of the company."⁹¹ As further evidence of a federal due care standard, Coffee points to proposed (now effective) rule 13b-2,⁹² and the NYSE audit committee rule.⁹³ In the case of sham compliance with the audit committee rule, it is even possible that a court might imply a private right of action on the basis that the rule was a substitute for direct federal regulation or served to support an "'evidence of negligence' approach."⁹⁴ Although such a duty might be unknown to common law, it could be regarded as intended to protect the shareholder-plaintiff, and Judge Friendly has stated that an implied private right of action could be found when an Exchange rule served as a "substitute" for SEC regulation and imposed a duty unknown at common law.⁹⁵ In the case of the *Shiell* complaint, the theory advanced by the SEC would clearly undercut the reliance on management holding of state cases such as *Graham v. Allis-Chalmers Mfg. Co.*⁹⁶

A fourth indication of expanded federal standards in the area of corporate management is the recent legal opinion of the SEC's general counsel on the Commission's authority to require public

90. Professor Coffee cites a study indicating that in 46.5% of the companies surveyed, the chief executive officer was the "initial decision maker regarding a prospective director." Coffee, *supra* note 3, at 1233.

91. Coffee, *supra* note 3, at 1249; *SEC v. Shiell*, SEC Litigation Release No. 7763 (Jan. 31, 1977).

92. Although a private litigant would lack standing, the SEC could require restitution to the corporation as "an ancillary equitable remedy." Coffee, *supra* note 3, at 1273.

93. *Id.*

94. *Id.* at 1274.

95. *Colonial Realty Corp. v. Bache & Co.*, 358 F.2d 178, 182 (2d Cir.), *cert. denied*, 385 U.S. 817 (1966).

96. 41 Del. Ch. 78, 188 A.2d 125 (1963). Coffee, *supra* note 3, at 1249.

companies to establish independent audit committees.⁹⁷ In this opinion, Harvey L. Pitts, the SEC's former General Counsel, explained the statutory grounds on which the SEC had "ample authority" to promulgate such a requirement. An indication of the SEC's readiness to bootstrap its position is Pitt's reference to the SEC's approval of the NYSE audit committee rule⁹⁸ and the enactment of new section 13(b)(2)(B) of the Securities Exchange Act of 1934.⁹⁹

Cutting against this heightened SEC activity, however, is a recent United States Supreme Court decision, *Santa Fe Industries, Inc. v. Green*,¹⁰⁰ which may serve to limit the ability of lower courts to imply a private cause of action in circumstances in which "the cause of action [is] one traditionally relegated to state law."¹⁰¹ The Court's limiting language in *Santa Fe* was expressed as follows:

Absent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden. As the Court stated in *Cort v. Ash*, "Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation."¹⁰²

Interestingly enough, the director of the SEC's Enforcement Division, Stanley Sporkin, has already gone on record as opposing *Santa Fe*.¹⁰³

As noted above, the law in this area is unsettled with regard to both the likely de facto emergence of a federal standard and the expectations to be accorded audit committees. While welcoming the initiatives taken by the stock exchanges, the National Association of Securities Dealers, and the AICPA in compelling the creation of audit committees, SEC Chairman Williams noted that:

97. [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,535 (Mar. 2, 1978).

98. *Id.* at 80,177.

99. *Id.* at 80,181.

100. 430 U.S. 462 (1977).

101. *Id.* at 478 (quoting *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1, 40 (1977) (quoting *Cort v. Ash*, 422 U.S. 66, 78 (1975))).

102. 430 U.S. at 479 (emphasis in original). See *St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 562 F.2d 1040 (8th Cir. 1977).

103. *Wall St. J.*, May 5, 1977, at 3, col. 2.

These efforts are important, but the next question which must be faced is the definition of the audit committee's responsibilities. At present, many audit committees are, undoubtedly, not working effectively, and may serve more to provide windowdressing than to add substance to the accountability process. . . . But no consideration of the role of directors is complete without underscoring the importance of an effective audit committee.¹⁰⁴

In terms of substantive liability, the mandated use of audit committees may directly impact upon the current status of director liability for delegated authority. At this time, however, one can only reconstruct the continuing dialogue, as legal certainties have not yet emerged.

IV. OTHER IMPORTANT COMMITTEES OF THE BOARD OF DIRECTORS: NOMINATING AND COMPENSATION COMMITTEES

A. *Nominating Committees*

Apparently, the focus by the SEC, at least during the past six years, on corporate restructuring and management accountability has been primarily on promoting the appointment of outside directors in the hope of achieving a more independent board and in the establishment of audit committees which, in theory, will reduce the instances of illegal bribes and corporate slush funds. With most of the attention going to audit committees, the nominating committee has not been as carefully considered; however, as already noted, at least one SEC commissioner believes the Commission has the authority to compel the use of nominating committees through its proxy regulations. In its proposed model board and committee structure for a public corporation, the Section on Corporation, Banking and Business Law of the American Bar Association published a *Corporate Director's Guidebook*,¹⁰⁵ which recommended a minimum of three working committees, namely the audit, nominating, and compensation committees. The guidebook recommends that the audit and compensation committees be staffed with non-

104. Speech by SEC Chairman Harold M. Williams, "The Role of the Director in Corporate Accountability," to the Economic Club of Detroit, Detroit, Michigan (May 1, 1978).

105. *A Corporate Director's Guidebook*, 32 BUS. LAW. 5 (1976). See also *The Overview Committees of the Board of Directors*, 34 BUS. LAW. 1837 (1979), for a discussion of the roles played by nominating, compensation, and audit committees.

management directors, a majority of whom should be unaffiliated, while the nominating committee be made up entirely of unaffiliated non-management directors.¹⁰⁶ Thus far, the ancillary measures required by the SEC (creation of independent compliance and executive committees) have not included creation of nominating committees; however, as a logical outgrowth of the SEC's general corporate accountability concerns, the best way to ensure an independent board and effective executive or audit committees is to have candidates independently chosen.¹⁰⁷

Former Commissioner Karmel focused directly on the role of the nominating committee as a means by which the SEC can broaden its approach to corporate management in order to focus more on "general issues of social significance" and less upon shareholders' concerns.¹⁰⁸ She argued that the nominating committee is neither a radical device nor a costly one. It can, however, become "the single most effective force in improving corporate governance because of its impact over time on the composition of the board and, accordingly, the succession of management."¹⁰⁹ Yet, despite her enthusiasm for nominating committees, she remains "unpersuaded that the Commission should require or urge all public companies, or request the exchange to require their listed issuers to establish nominating

106. *Id.* at 33-35. A "management" director is one devoting "substantially full time and attention to the affairs of the corporation, one of its subsidiaries, or any other corporation controlled by the corporation." An "affiliated non-management director" is one who has "since the beginning of the last fiscal year of the corporation engaged in, or proposes in the future to engage in, transactions with the corporation which are material to the corporation or to the director (or to his affiliated corporation), or if he has close familial ties to a member of key management." *Id.* at 31.

107. Former Commissioner Karmel noted that "[n]ormally, board committees required to be established must maintain an independent majority acceptable to the Commission." Karmel, Chicago I Speech, *supra* note 2, at 16. She also notes that section 10(a) of the Investment Company Act of 1940, 15 U.S.C. § 80a-10 (1976), requiring at least 40% of the board of a registered investment company to be filled with unaffiliated persons or independent directors, may prove an indirect influence over corporate structure: "Although in practice the independence of unaffiliated directors has not always been achieved, the Commission has substantial authority under the 1940 Act to require a board model which would insure the statutory standards of independence." *Id.* at 17. At present this standard of independence is not fully defined, although Ms. Karmel notes that the Commission's statements on independence of accountants may influence the concept of independence as it pertains to membership on corporate boards. *Id.*

108. Karmel, Chicago II Speech *supra* note 9, at 9.

109. *Id.* at 10. In fact, during the two years since Ms. Karmel's speech, "nominating committees dominated by outside directors have become fixtures on most corporate boards." Harris, *Survey Finds Board Nominating Panels Help Determine Management Succession*, Wall St. J., Jan. 28, 1980, at 21, col. 4.

committees."¹¹⁰ Favoring governmental self-restraint, she nonetheless

endorse[s] a requirement that registrants state in their proxy material or their annual report to shareholders whether there is a nominating committee on the board and, if so, who the members are. In the view of the Advisory Committee on Corporate Disclosure it would be reasonable to require this type of disclosure because registrants are required already to identify the members of the Executive and Audit Committees.¹¹¹

Curiously enough, though, this approach is precisely that followed by the SEC in the case of audit committees, when the Commission anticipated that corporations would prefer to create such committees rather than disclose that they did not have them. Although one can only predict on the basis of the SEC's prior behavior, former Commissioner Karmel's approach sounds like a warning that despite her faith in the "innovative capability of the private sector . . . corporations which ignore the voices clamoring for corporate governance reforms do so at their peril."¹¹² SEC Chairman Williams has already been quoted to the effect that "regardless of the number of management directors, committees composed exclusively of independent directors for audit, nomination of directors, executive compensation, and conflict of interest are essential."¹¹³ One of the indications of the possible effect this SEC prodding may have, is a survey by Korn/Ferry International, an executive research firm, which shows that although most of the 1500 NYSE companies have had audit committees for some time, only nineteen percent of the 501 companies surveyed had nominating committees. Eight years ago, however, practically none of the companies surveyed had nominating

110. *Id.* at 11.

111. *Id.* at 12. Former Commissioner Karmel specifically wanted disclosure relating to nominee selection procedure and criteria:

Companies would be required to discuss the process by which the committee selects new nominees for election as directors and determines whether to renominate sitting directors. They would be required to state whether the committee solicits or reviews shareholders' recommendations for nominees to fill Board vacancies or for removal of Board members and to describe the committee's screening criteria and procedure to enable more informed and appropriate shareholder participation.

Id. at 14.

112. *Id.* at 15.

113. Speech by SEC Chairman Harold M. Williams, "The Role of the Director in Corporate Accountability," to the Economic Club of Detroit, Detroit, Michigan, May 1, 1978.

committees.¹¹⁴ The same survey also noted a decline in the percentage of commercial and investment bankers as well as attorneys sitting as "outside" directors. Nonetheless, some eighty percent of the boards surveyed were headed by a chairman who also served as chief executive officer.¹¹⁵

The overall climate relating to mandated SEC disclosure has been one of continued escalation. The possibility that the SEC will amend its proxy rules so as to make it easier for shareholders to support their own nominees for election to corporate boards is already being discussed.¹¹⁶ Within the past few years, the SEC has told its staff to begin drafting rules which will require disclosure of:

—the existence, composition and function of committees of directors that nominate other directors and executives, set pay, oversee the company's financial records or perform similar functions.

—the existence of personal or business relationships between directors and management. Directors would have to be classified as management directors, affiliated nonmanagement directors, such as the company's outside lawyer, and unaffiliated nonmanagement directors, that is, someone who doesn't have anything to do with the company.¹¹⁷

Although revisions in the proxy rules to permit greater shareholder involvement in the nominating process will probably not occur in the near future, such revisions are likely, and the proposed requirement to disclose the existence *vel non* of nominating committees may be regarded as a step in that direction. As Chairman Williams has stressed, only voluntary changes in corporate board structures can retard "the accelerating rush to federal corporate governance legislation."¹¹⁸

114. Schorr, *Corporate Directors Scored For Lax Scrutiny of Managements' Acts*, Wall St. J., Apr. 10, 1978, at 1, col. 6. More recent statistics, however, demonstrate a dramatic increase in the number of corporations which have established overview committees. *The Overview Committees of the Board of Directors*, 34 BUS. LAW. 1837, 1863 (1979).

115. *Id.*

116. *Id.* Schorr writes that: "To foster more audit committees composed of nonmanagement directors, especially at companies not listed on exchanges, the SEC is pressing accountants not to accept as clients any public corporations that lack such committees." *Id.* at 1, col. 6.

117. Wall St. J., June 8, 1978, at 8, col. 2.

118. Wall St. J., Jan. 19, 1978, at 3, col. 1. Just one example of this trend may be seen in legislation proposed by Senator Metzenbaum which would address directly the duties and roles of audit and nominating committees. 503 SEC. REG. L. REP. (BNA) A-2 (May 16, 1979). A description of the proposed changes in proxy rules which would mandate greater disclosure may be found at 462 SEC. REG. L. REP. (BNA) A-18 (July 19, 1978).

B. *Compensation Committees*

In comparison with those committees already discussed, there is very little literature available on compensation or salary committees.¹¹⁹ Most of the references to such committees have been in conjunction with calls for greater use of other board committees, such as executive, audit, and nominating committees. Thus, Chairman Williams has been quoted to the effect that, "given a lesser number of independent directors, then committees composed exclusively of independent directors for audit, nomination of directors, executive compensation, public policy, and conflict of interest, become essential."¹²⁰ Compensation committees will figure prominently in any effort to increase corporate accountability, because salaries set by an independent committee would reduce the chance of dominance by corporate management. The spotlight so far has been primarily on the audit committee, but the new SEC disclosure rules currently being drafted will certainly have the effect of increasing the number of compensation committees being established,¹²¹ again because corporations will prefer to create such committees rather than disclose their nonexistence.

V. CONCLUSION

The status of director "reliance liability" is presently in a state of flux. Although one can rely on the state common law and statutory approach, there are ever-increasing signs of the arrival of federal fiduciary standards for corporate management and director liability. Of the four committees considered in this article only the executive committee is susceptible of extensive commentary, primarily in light of the long history of delegation to that committee. As has been explained, the remaining three committees have been the subject of increasing attention by the SEC, yet no clear liability rules have emerged to displace the current common law and statutory approach.

119. For a general treatment of compensation committees, see J. BACON & J. BROWN, *CORPORATE DIRECTORSHIP PRACTICES: ROLE SELECTION, AND LEGAL STATUS OF THE BOARD* 127-34 (1975).

120. Speech by SEC Chairman Williams, "Corporate Accountability," to the Fifth Annual Securities Regulation Institute, San Diego, California, Jan. 18, 1978.

121. Wall St. J., June 8, 1978, at 8, col. 2.

Focusing for a moment on current corporate committee practices, one cannot help but ask whether all of this concern over committee creation is only a tempest in a teapot, especially in view of the fact that most large corporations already have audit committees and close to twenty percent have nominating committees. One might be tempted to dismiss the SEC's concerns as an overly dramatic reaction to the corporate bribery scandals; however, there is sentiment both within the Congress and the SEC that if voluntary changes are not forthcoming in corporate board structures, federally mandated changes will be created and imposed. The issue at the moment is just how much corporate compliance is enough to satisfy the SEC. The answer may well depend on whether the SEC can be bought off by "big" corporations' compliance so that smaller, less visible corporations receive, in effect, shelter from further SEC disclosure requirements. In advising a public corporation in light of the current trends articulated in this article, an attorney should seriously consider suggesting the creation of audit, nominating, and compensation committees in instances in which they do not presently exist.