Restructuring the Corporate Board of Directors: Fond Hope–Faint Promise?

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I. Introduction

As the scope and wealth of America's large corporations has grown, federal and state governments have attempted to control corporate power through increasingly complex and comprehensive regulation. But regulation has often proved clumsy and ineffective, and reformers have also examined the distribution of power within the corporation itself in search of ways of ensuring that corporate power is responsibly wielded. As the landmark work of Berle and Means showed, management, not shareholders, controls the modern large corporation: the dispersal of share ownership has allowed management to exploit its control of information about the corporation and of the corporation's operations, including the proxy mechanism, to elect themselves or sympathetic outsiders to the board of directors. Naturally reluctant to share its authority, management has minimized the board's participation in corporate governance, and the board of directors has been reduced to an "impotent ceremonial and legal fiction."

Some, including the present Chairman of the SEC, seek to restore the corporate board's capacity to oversee and restrain management. They hope to recreate the independent board of directors—a board with the resources and will for critical judgments, a board uninhibited by deference to management and prepared to supervise it actively and assertively. This impulse has been expressed in the willingness of courts and the SEC to hold directors liable for corpo-
rate wrongdoing\(^5\) and in the pursuit by the SEC and private parties
of court orders reconstituting boards of directors or redefining their
authority and responsibilities.\(^6\) Some corporate boards have re­
formed themselves; a substantial proportion of the country's large
corporations have now adopted at least the outward forms of an in­
dependent board.\(^7\)

Nevertheless, the integrity of corporate management and of its
supervising boards of directors has been again brought under public
scrutiny by the discovery of misuses of funds in a number of large
and powerful organizations. Illegal or improper payments at home
and abroad have evoked new demands for more effective control of
corporate managers.\(^8\)

(S.D.N.Y. 1968) (outside directors subject to due diligence standard under § 11 of the Securi­
761 (3d Cir. 1976) (outside director subject to negligence standard under § 14(a) of the Securi­

6. The legal basis for judicially supervised appointment of directors is examined in Far­
rand, Ancillary Remedies in SEC Civil Enforcement Actions, 89 HARV. L. REV. 1776 (1976);
Levine & Herlihy, SEC Enforcement Actions, 10 REV. SEC. REG. 951 (March 30, 1977); Mat­
thews, Recent Trends in SEC Requested Ancillary Relief in SEC Level Injunctive Actions, 31
BUS. LAW. 1323 (1976); Comment, Court Appointed Directors: Ancillary Relief in Federal Securi­
ties Law Enforcement Actions, 64 Geo. L.J. 737 (1976); Comment, Equitable Remedies in SEC
Enforcement Actions, 123 U. PA. L. REV. 1188 (1975). For cases involving appointment of
directors by or under direction of the court, see SEC v. Charter Diversified Serv., Civ. Action
No. CV 74-2527 (C.D. Cal., filed Aug. 29, 1974), discussed in SEC Litigation Releases Nos.
6507, 6593 (Sept. 9 & Nov. 18, 1974) (additional interim directors would constitute a majority
of the board); SEC v. Clinton Oil Co., (D. Kan.), discussed in SEC Litigation Releases Nos.
5715, 5798 (Jan. 30 & March 20, 1973) (court designated five new directors, a new president
and chief executive officer; settlement also provided that all but two of the present members
of the board of directors would resign); SEC v. American Agronomics, Civ. Action No. 72-331
(N.D. Ohio, filed April 6, 1972), discussed in SEC Litigation Release No. 5667 (Dec. 11, 1972)
(board restructured to include at least a 40% independent representation); SEC v. Bio-Medical
Release No. 6700 (Jan. 28, 1975) (corporation shall use its best efforts to elect or appoint to,
and maintain on its board of directors, a majority of directors independent of association or
involvement in the activity alleged in the SEC's complaint); SEC v. Coastal States Gas Corp.,
(S.D. Tex.), discussed in SEC Litigation Release No. 6054 (Sept. 12, 1973) (court to designate
six new independent members satisfactory to the SEC and elected by the corporation's board);
SEC v. Vesco, unreported judgment discussed in International Controls Corp. v. Vesco, 490
F.2d 1334, 1338-40 (2d Cir. 1974) (International Controls Corp. consented to final judgment
providing for replacement of the board of directors by a court-appointed interim board of
directors); SEC v. Equity Funding Corp., [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶
93,917 (C.D. Cal. 1973) (court appointed an interim independent board of directors to replace
the existing board of directors).

7. See text at notes 33-38 infra.

8. See SECURITIES & EXCHANGE COMM., REPORT ON QUESTIONABLE AND ILLEGAL
CORPORATE PAYMENTS AND PRACTICES 41-42 (1976) (submitted to the Senate Banking, Hou­
ing and Urban Affairs Comm.); Solomon & Linville, Transnational Conduct of American Mul­
tinational Corporations: Questionable Payments Abroad, 17 B.C. INDUS. & COM. L. REV. 303
(1976).
Reforms, then, have been instituted, and an extensive literature on corporate reform has developed. It is time that we seriously examine the reforms and the literature to assess the accomplishments and possibilities of the corporate board of directors. This Article is a first step in that direction.

The Article begins by investigating the reasons for the impotence of corporate boards. It then examines two models of reformed boards and finds both models badly flawed. The Article proceeds to case studies of three corporations—Mattel, Inc., Northrop Corp., and Lockheed Corp.—which under court order have attempted to reform their boards by increasing the proportion of outside directors and by establishing more board committees. The case studies suggest that the problem of corporate reform is too complex and intractable to respond to so simple a solution as the reform of corporate boards. Our efforts to revive the board of directors are simply anachronistic; new methods must be devised if we are to make corporate management genuinely accountable.

II. BACKGROUND TO REFORM

A. The Decline of the Board of Directors

Myles Mace’s empirical studies in the late 1960s confirmed what many had long suspected: directors generally play a minor role in corporate affairs. Mace concluded that boards perform two essentially passive functions. First, they give advice when asked to do so by the chief executive officer. Second, boards fortify management’s self-discipline—executives who must periodically account to the board for their stewardship have an incentive to think carefully about that accounting and to anticipate the questions it raises. Boards do occasionally assert themselves. They have assumed managerial responsibilities when management has collapsed, and they have replaced a chief executive officer upon his death or incapacitation. But such activism is rare. As Mace has noted, in the cases in which a board fired a chief executive officer, “The leadership of the [incumbent] was so unsatisfactory that even his mother thought he ought [to go] for the good of the company—and it usually had to be that bad before the board reluctantly moved.”

9. See generally M. MACE, DIRECTORS: MYTH AND REALITY (1971) (study of corporate boards of directors in the late 1960s based on approximately 75 in-depth interviews lasting two to six hours and on several hundred shorter discussions with executives).
10. Id. at 13-27. See also J. LOUDEN, THE EFFECTIVE DIRECTOR IN ACTION 60 (1975).
11. Hearings Before the Securities and Exchange Commission (Sept. 30, 1977) (statement by Myles L. Mace). Probably the most celebrated corporate ouster was the removal of Bob R.
Management often installs on the board people who are economically and psychologically sympathetic, if not indebted, to the chief executive officer and who are therefore disinclined to challenge him. Inside directors—subordinate executives of the corporation—depend on the chief executive not only for their tenure on the board, but for their promotions and salaries. Outside directors—directors not concurrently employees of the corporation—also depend on the chief executive for their position on the board, and they frequently have personal and business reasons for agreeing with him. Outside directors are often friends and social acquaintances of the chief executive or from the upper echelons of companies and professional firms patronized by or otherwise economically concerned with the corporation. These social and professional connections may overlap; regionally and nationally, the elites who do business together also


12. Although inside directors are economically tied to and sympathetic with management, inside directors can perform useful service on corporate boards by providing information to outside directors, facilitating an appraisal of management by outside directors, preventing a chief executive officer from painting an unrealistically favorable picture of a corporation’s performance, and making decisions of the board of directors more palatable to other executives. See J. BACON & J. BROWN, supra note 2, at 64-65; Corporate Rights and Responsibilities: Hearings Before the Senate Comm. on Commerce, 94th Cong., 2d Sess. 140 (1976) (statement by Richard M. Cyert). But insiders generally find it difficult, if not impossible, to evaluate or question a chief executive officer.

13. G. William Domhoff has described a ruling elite composed of the owners and managers of large corporations and banks. They receive a disproportionate amount of income, own a disproportionate share of America’s wealth and contribute a disproportionate number of the members of key institutions and decision-making groups. G. DOMHOFF, THE BOHEMIAN GROVE AND OTHER RETREATS: A STUDY IN RULING CLASS COHESIVENESS (1974); G. DOMHOFF, THE HIGHER CIRCLES: THE GOVERNING CLASS IN AMERICA (1970). Domhoff’s empirical work assesses the institutional framework of social clubs and organizations which formulate policy, investigates the social backgrounds of individuals who control important institutions and make major decisions, and draws inferences from wealth and income statistics. Boards of directors are staffed from this elite and its satellites, including current or former chief executive officers, professionals who (with some exceptions) have corporate clients, and professors of business and law. Despite varied backgrounds, these individuals share and support the interests and viewpoints of those who manage complex hierarchical organizations; they are sympathetic to the pressures and uncertainties that confront chief executive officers. “Independent” outside directors who lead their own organizations and face their own boards especially are not anxious to create activist precedents for their boards. Although the elite may not come from a single readily identifiable stratum of society, its members generally are governed by the club’s protocol, which restrains a director from trespassing on management’s turf.

Critics of Domhoff and other ruling class theorists argue that power must be analyzed issue by issue. These critics doubt that a common class ideology exists and that Domhoff adequately defines the nature of the class’s interests, or the issues on which the class unites. They
work for the same community and charitable organizations, belong to the same social clubs, and even relax at the same camps. In the congenial atmosphere of board meetings these companionships may lead board members to be sympathetic listeners rather than determined inquirers.

Even if directors were personally independent, the position and method of corporate boards would limit their supervision of management. First, few outside directors devote to their directorial duties the substantial time needed to review comprehensively management's performance. Directors often serve on several boards, their own organizations call on their time, and the relatively modest compensation they receive is slight motivation.

Second, directors lack independent access to information: management controls the volume, quality, and timing of the information they receive. Typically, directors are given selected materials shortly before or at a board meeting, and have too little time to study it. The experience described by one director is common:

A voluminous report (100+ pages in length) on an investigation of a sensitive matter was presented at the meeting itself, after which lawyers, accountants and top management all were marched through, carefully orchestrated, to support management's desired position on the matter. The committee's acquiescence, of course, permitted perfunctory approval of the action the next day by the entire board.

Dispute Domhoff's description of the composition, size and wealth of Domhoff's ruling elite as well as his conclusion that power is monopolized by the wealthy and by corporate managers. The composition of the old board of directors of Northrop Corp., one of the companies discussed below, see text at notes 50-59, illustrates the clubbiness of some corporate boards. At least four members, including the chairman, belonged to one or both of two of California's most exclusive social clubs. G. DOMHOFF, THE HIGHER CIRCLES, supra, at 176-77, 196-97, 212-13.

14. Id. at 176-77; M. MACE, supra note 9, at 45, 89.
17. The ignorance of the board of directors of the Penn Central is perhaps an extreme example, but it suggests management's unwillingness to keep the directors informed about even massive problems, as well as the board's lack of interest in the affairs of the corporation. According to an SEC staff study, Pennsylvania Railroad and New York Central directors were accustomed to a generally inactive role in company affairs. They never changed their view of their role. Both before and after the merger [on February 1, 1968] they relied on oral descriptions of company affairs. They failed to perceive the complexities of the merger or the fact that appropriate groundwork and planning had not been done. After the merger they claim to have been unaware of the magnitude of the fundamental operational problems or the critical financial situation until near the end. [The Penn Central Co. went into bankruptcy on June 21, 1970.] They did not receive or request written budgets or cash flow information which were essential to understanding the condition of the company or the performance of management. Only in late 1969 did they begin requesting such information and even then it was not made available in a form that was meaningful or useful.

Third, not all directors are technically or psychologically equipped to oversee the affairs of a large corporation. Some directors lack the ability or background to analyze technical, financial, and business issues. Many directors, especially those who are corporate executives themselves, are accustomed to exercising power, not counselling it. Boards therefore progressively relinquished their complex and arcane managerial duties to the more expert officers and devoted themselves to trivia and the perquisites of their exalted status.

In sum, corporate boards form a closed club of elites sharing similar experiences and views. Directors are disinclined to criticize and lack the resources to do so. Board meetings are predictable—directors are expected to ratify management’s decisions with a minimum of delay and unpleasantness. Inquisitiveness is interpreted as distrust of the chief executive and as a violation of good corporate manners. Chief executive officers do not want to be challenged, especially if subordinate officers are present, for fear of losing the respect of their subordinates. As one experienced director noted, “[This] system breeds insularity, a tendency to make comfortable decisions, and it avoids confronting significant change in the surrounding world. It is an atmosphere in which directors reinforce, rather than challenge, each other’s opinions and ideas. In short, there is too much potential for laxity.”

B. Proposals for Reforming the Board of Directors

Directors have met mounting disapproval of their complacent relations with management, and they have increasingly found themselves vulnerable to legal action for mismanagement that occurred under their aegis. The SEC has criticized directors for their part in several recent cases of mismanagement. On the occasion of the Stirling Homex affair, the SEC admonished directors to take greater

19. M. MAC, supra note 9, at 52-54, 79-81. See also Vanderwicken, Change Invades the Board Room, FORTUNE, May 1972, at 156, 158.
initiative in ferreting out information and challenging management rather than relying on management's representation. The Commission emphasized the self-evident propositions that outside directors violate their duty to protect shareholders and others if they fail to guide the corporation.\textsuperscript{23}

The heightened public expectations of corporate behavior and the interest of the SEC and the courts in corporate governance have stimulated a reexamination of the role of the board and of the individual director.\textsuperscript{24} Efforts to redefine those roles are a prerequisite of proposals for more effective corporate governance. Without such a redefinition, it is impossible to assess the efficacy of reforms in the composition and operation of the corporate board. Perhaps more important, a consideration of the general purpose of the board can shed light on the ultimate question whether the board of directors, however reformed, is a viable instrument of corporation control.

The debate regarding the role and function of the board of directors in corporate affairs has focused on (1) the board as monitor and advisor of management, and (2) the board as an adversary of management. The first model encompasses a broad range of possibilities. At one end of the scale, a board would confine itself to measuring management's performance against fixed goals and discharging managers who failed to meet them.\textsuperscript{25} At the other extreme, a board would decide whether to accept management proposals regarding major policies and objectives of the corporation.\textsuperscript{26} In the middle of the spectrum, boards would vary the comprehensiveness of their review and of their participation in decisions.\textsuperscript{27} A board could expand its evaluations, for example, by periodically examining the corpora-


\textsuperscript{24.} For a summary of the SEC's present areas of investigation, see \textit{The Role of the Shareholder in the Corporate World: Hearings Before the Subcomm. on Citizens and Shareholder Rights and Remedies of the Senate Comm. on the Judiciary}, 95th Cong., 1st Sess., Part 1, at 608 (1977) (testimony of Philip Loomis, SEC Commissioner); see generally Conti, \textit{Boardroom Blues}, Wall St. J., Sept. 17, 1974, at 1, col. 6.

\textsuperscript{25.} For an analysis of such monitoring, see M. Eisenberg, \textit{supra note} 16, at 164-65; Corporate Rights and Responsibilities: Hearings Before the Senate Comm on Commerce, 94th Cong., 2d Sess. 62-63 (1976) (statement of A.A. Sommer, Jr.); \textit{id.} at 304 (statement of then-SEC Chairman Roderick Hills); Levy, \textit{The Search for Greater Board Effectiveness-II}, in CONFERENCE BOARD, \textit{THE BOARD OF DIRECTORS} 6-7 (1972). Professor Eisenberg sees no feasible alternative to the board as the monitoring body. The shareholders lack the cohesiveness and resources necessary to monitor management; a council of executives from a corporation would inevitably be subordinate to the chief executives; and a government agency would politicize the selection and removal of executives. M. Eisenberg, \textit{supra note} 16, at 167-68.


\textsuperscript{27.} \textit{The Role of the Shareholder in the Corporate World: Hearings Before the Subcomm. on
tion's organization and decision-making process. Conversely, a board could limit its involvement to the most general decisions, leaving more specific decisions to management, subject to the board's monitoring. However a board defines its function, it should force management to ponder its proposals and to confront issues it might otherwise overlook. The model of the board as monitor and advisor assumes that a board can promote this ideal by participating in decisions or by telling management that the board will consider these issues in assessing performance.

This first model contemplates a board working with management, the second a board acting as an adversary to management. For example, such a board might investigate management and report to the corporation's shareholders and other constituencies whether its officers have complied with legal and social demands on corporate conduct.28

Although these models may, in the abstract, be appealing, in practice they are not easily reconciled with the realities of corporate life.

It is hard to imagine how an "advisory" board could participate in corporate decisions other than those involving broad statements of the most general level of policy. Directors, with limited time to devote to the corporation and dependent on executives for access to information, probably cannot initiate or significantly shape corporate policies, even in conjunction with management.

Even the modest and perhaps more realistic monitoring role raises troublesome problems.29 Acceptable, specific, and measurable standards of management performance are not easily established.30


Management theorist Peter Drucker has suggested the functions of a board which actively monitors management:

Someone must force top management to think through what the corporation's business is and what it should be, what objectives are being set and strategies being developed, look critically at corporate planning, capital-investment policy, managed-expenditures budget, monitor people decisions and organization problems, watch the organization's spirit, see to it that the corporation succeeds in utilizing the strengths of people and neutralizing their weaknesses, develop tomorrow's managers, reward its managers . . . .


29. See e.g., J. BACON & J. BROWN, supra note 2, at 26; Leech & Mundheim, The Outside Director of the Publicly Held Corporation, 31 BUS. LAW. 1799, 1805 (1976).

30. For suggestions on the development of standards and procedures for an audit of management and on the need to balance "bottom line" results and social responsibility, see J. BACON & J. BROWN, supra note 2, at 21; Leech & Mundheim, supra note 29, at 1824-25; McSweeney, A Scorecard for Rating Management, BUS. WEEK, June 8, 1974, at 12; Wilde &
Even if criteria can be set, the pace of business may render guidelines out of date, necessitating frequent revisions. Standards would be difficult to administer, and measurements might require information not supplied by management. In addition, the directors would have to decide whom to hold responsible if standards were not satisfied.31 Finally, directors would have to resolve the fundamental question: how far should they impose their judgment on management? Inevitably, in monitoring, a board would disagree with management over the meaning of the standards and the scope of the review. Thus, monitoring might disrupt the company's operations as the board assays management's performance, and might provoke directorial infringement of management's prerogatives. Even if expectations regarding management's prerogatives were to be changed, a more active board would still face the problems discussed with reference to the participatory board.

An adversary relationship between board and management is inimical to the spirit of cooperation it is widely believed the board and management must maintain. A watchdog board might stimulate divisiveness within the corporation, intimidate management, and inhibit its ability to initiate and implement programs.

In short, effective changes in the function of the corporate board cannot be achieved without significantly altering our understanding of how a large corporation works. The reforms actually instituted have typically settled for modest attempts to enhance the independence of the board of directors from management and have postponed larger, and harder, questions as to a board's function.32 These reforms have consisted of three changes in corporate boards: an increase in the proportion of outside directors; greater use of board committees, especially audit committees; and an improvement in the flow of information to directors.

Surveys suggest that many corporations, with or without external pressure, have instituted these changes in the last several years. One survey of over five hundred manufacturing companies showed a recent increase from 63% to 71% in the number of companies reporting

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31. Of course, managers of any complex organization encounter these problems in evaluating subordinates. But those managers rely on time and expertise unavailable to a board of directors.

32. See, e.g., the statement by Roderick Hills, then chairman of the SEC: "[T]he most important job we [the SEC] have to do is create a truly independent character on those boards of directors, both from a remedial standpoint, when we found the problem, and from a perspective standpoint." Corporate Rights and Responsibilities: Hearings Before the Senate Comm. on Commerce, 94th Cong., 2d Sess. 316-17 (1976).
that a majority of their board members were outsiders. Other surveys have shown that the proportion of manufacturing companies with audit committees has increased from about 20% in 1967 to 45% in 1973, with over 70% of the reporting firms with assets in excess of $500 million having an audit committee in 1972. According to one analyst, 93% of America’s largest corporations had audit committees in 1976, compared to 72% in 1973. Corporations have also kept directors better informed. In the early 1970s, a survey of 1500 large companies found that only 77% provided their directors with any information prior to board meetings. In 1976 a survey of 370 large companies found that 94% provided reports to directors before board meetings.

Unfortunately, these data are ambiguous. For example, “outside directors” are sometimes former and retired executives of the corporation or members of institutions having a business or professional relationship with the corporation, such as law firms, banks, suppliers, and customers. Such directors have an economic interest in the corporation and for many purposes are insiders. The interests of members of law firms and banks are especially likely to coincide with the interests of management. Of course, the economic interests of these institutions are not uniform. For example, firms that purchase from the corporation desire lower prices; firms that sell to the corporation are willing to see the corporation raise the prices of its products. The point is that such “outside” directors have an incentive to work closely and amicably with management and little incentive to challenge it.

33. J. BACON, CORPORATE DIRECTORSHIP PRACTICES: MEMBERSHIP AND COMMITTEES OF THE BOARD 2 (1973). The survey was conducted by The Conference Board and the American Society of Corporate Secretaries, Inc. A 1976 study by The Conference Board revealed that outsiders comprised a majority of the board in 83% of the 167 manufacturing companies surveyed. J. BACON & J. BROWN, THE BOARD OF DIRECTORS: PERSPECTIVES AND PRACTICES IN NINE COUNTRIES 84 (1977) [hereinafter cited as NINE COUNTRIES]. For nonmanufacturing companies, the percentage of companies having boards on which outside directors were in the majority remained remarkably stable at 85%, 86%, and 86% in, respectively, 1967, 1973, and 1976. J. BACON, supra, at 2; NINE COUNTRIES, supra, at 84.

34. NINE COUNTRIES, supra note 33, at 99. A study by Coopers & Lybrand indicated a rise in the percentage of respondents having audit committees from 17% in 1967 to 67% in 1972. The Coopers & Lybrand Audit Committee Guide 7, Figure 1 (2d ed. 1976).

35. J. BACON, supra note 33, at 54.


37. HEIDRICK & STRUGGLES, THE CHANGING BOARD: PROFILE OF THE BOARD OF DIRECTORS 10 (1977); Vanderwicken, supra note 19, at 159.

If former employees are considered insiders, the percentage of manufacturing companies in the 1976 Conference Board study whose boards have a majority of outside directors falls from 83% to 60%. 39 Another tabulation of the composition of boards based on the Conference Board tables revealed that 41% of the “outsiders” were former or retired executives, partners of outside legal counsel, or executives of commercial or investment banks. 40 Similarly, the evidence of the proliferation of board committees and of the transmission of more information to board members must be more closely scrutinized before one can say that it represents significant enhancement of the independence of boards. The value of information furnished boards is difficult to evaluate—the line between too much and too little is obscure, and most information received by boards is collected and screened by management. 41

In sum, although these devices may have established themselves as commonly advocated features of large corporations, they may not represent genuine changes in corporate governance. Management has simply adopted the language and form of the restructured board in response to the pressure for “reform,” but few substantive changes have been made, as the evidence as to the effectiveness of outside directors and board committees in Part III suggests.

III. INSTITUTIONAL REFORM OF CORPORATE BOARDS: THREE CASE STUDIES

To measure accurately the value of institutional reform one must look beyond broad surveys and impressionistic commentary. To this end, I have studied reforms at three large corporations where

39. NINE COUNTRIES, supra note 33, at 85.
41. Some commentators have suggested that directors should have direct access to information from within the corporation. See, e.g., C. BROWN & E. SMITH, THE DIRECTOR LOOKS AT HIS JOB 147 (1957); Leech & Mundheim, supra note 29, at 1825; Corporate Rights and Responsibilities: Hearings Before the Senate Comm. on Commerce, 94th Cong., 2d Sess. 304, 329 (1976) (statement of then-SEC chairman Roderick Hills).

For statements of the kinds and frequency of reports directors should receive from management, as well as of other means of securing information, such as tours of corporate operations, see, e.g., Subcomm. on Functions and Responsibilities of Directors, of the Comm. on Corporate Laws, Section of Corporation, Banking and Business Law, American Bar Association, Corporate Directors’ Guidebook, 32 Bus. LAW. 5, 22 (1976); Harris, Directors of Industrial Companies: Special Problems, 31 Bus. LAW. 1235, 1238 (1976); NINE COUNTRIES, supra note 33, at 95-99; J. LOUDEN, supra note 10, at 35-36, 89-90 (1975); Berger & Donelson, What Directors Need To Know. . . and How To Get It to Them, FINANCIAL EXECUTIVE, September 1974, at 22-27; Mace, Becoming More Aware and Knowledgeable, HARV. Bus. REV., Sept.-Oct., 1975, at 18. However, chief executives are generally reluctant to allow board members direct contact with underlings for fear that their authority will be undercut. H. KOONTZ, THE BOARD OF DIRECTORS AND EFFECTIVE MANAGEMENT 161 (1967).
managerial malfeasance provoked administrative or private litigation and considerable public attention. This litigation produced remedial orders which included provisions for reform of the boards of directors. Part A recounts the events leading up to the litigation and relates the terms of the settlement. Part B examines the implementation of the orders, and Part C assesses the impact of reform.

A. An Overview

The board reforms at Mattel were mandated by a consent decree in an action brought in 1974 by the SEC against the company following the discovery that the company had issued false and misleading financial reports. Specifically, Mattel, which had suffered heavy financial reverses as a result of hasty diversification in the late 1960s and early 1970s, was accused of substantially overstating its sales and earnings.

The consent decree contained fairly detailed provisions for increasing the proportion of outside directors and for establishing board committees. The decree required Mattel to appoint, subject to the SEC’s approval, enough “unaffiliated” directors to constitute a majority of the board. The decree also required Mattel to establish three board committees: (1) an executive committee of three or more members, a majority of whom were to be unaffiliated directors

44. Part IV, Second Amended Judgment and Order of Permanent Injunction and Ancillary Relief [hereinafter cited as Second Amended Judgment], in SEC v. Mattel, Inc., Civ. Action No. 74-2958-FW (C.D. Cal., filed Nov. 26, 1974), defined “unaffiliated” as follows: Said additional directors shall not have had any affiliation with MATTEL or its subsidiaries prior to the filing by the COMMISSION of its COMPLAINT in this Action, and they shall not have any such affiliation during their tenure on the Board other than as members of the Board and/or committees thereof.

The SEC sees outsider directors as “private securities commissioners” who supplement the limited resources of the Commission. It believes that requiring the appointment of independent directors is more effective than enjoining future wrongdoing, and that that sanction is not so severe as to prevent the company from carrying on its business. Interview with Edward D. Herlihy, Branch Chief, Division of Enforcement, SEC, Washington, D.C. (Sept. 8, 1977); Interview with Theodore A. Levine, Assistant Director, Division of Enforcement, SEC (Nov. 9, 1977). See generally Loo & Ratner, The SEC’s Role in Director Selection, in PRACTISING LAW INSTITUTE, DUTIES AND RESPONSIBILITIES OF OUTSIDE DIRECTORS 144-45 (1976); Sporkin, SEC Developments in Litigations and the Moulding of Remedies, 29 BUS. LAW. 121 (1974); Comment, Equitable Remedies in SEC Enforcement Proceedings, 123 U. PA. L. REV. 1188, 1210-14 (1975).
appointed pursuant to the decree;\(^45\) (2) a financial controls and audit committee consisting of four directors, at least three of whom were to be unaffiliated directors appointed pursuant to the decree;\(^46\) and (3) a litigation and claims committee, consisting of three members selected from and designated by the new unaffiliated directors.\(^47\) A majority of the additional unaffiliated directors were required to appoint, subject to the approval of the SEC and the court, a special counsel to investigate and report on the charges against Mattel’s officers. This special counsel was empowered to institute, with board approval, legal actions on behalf of Mattel against anyone who had been or was associated with the company.\(^48\) The basic provisions of the decree were to remain in effect for five years from the date of entry unless the court decreed otherwise in the “interest of justice.”\(^49\)

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\(45\) Part V, Second Amended Judgment, SEC v. Mattel, Inc., Civ. Action No. 74-2958-FW (C.D. Cal., filed Nov. 26, 1974). See also SEC v. Coastal States Gas Corp., (S.D. Tex.), discussion in SEC Litigation Release No. 6054 (Sept. 12, 1973) (corporation’s board shall elect a new three-member executive committee which must include two new directors, one of whom shall be chairman; the executive committee (or the chairman of such committee) shall have the right, at the corporation’s expense, to retain independent legal counsel to advise them with respect to their functions as members of the executive committee).

\(46\) Part VI, Second Amended Judgment, SEC v. Mattel, Inc., Civ. Action No. 74-2958-FW (C.D. Cal., filed Nov. 26, 1974). This committee was directed by the settlement order to review Mattel’s financial controls, accounting procedures and financial reports, and to discuss periodically with the auditors the company’s financial condition and statement. The order stipulated that the company could not release financial information to the public or shareholders or change the independent auditors without prior approval of the committee. Moreover, the committee was empowered to arbitrate disputes between management and the auditors. For similar orders in other cases, see SEC v. American Agronomics, Inc., Civ. Action No. 226 (S.D.N.Y., filed Jan. 16, 1973), discussed in SEC Litigation Release No. 3667 (Nov. 7, 1972) (an accounting committee of the independent directors to be established); SEC v. Lum’s Inc., [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,504 (S.D.N.Y. 1974) (as long as Caesars World, Inc. (formerly Lum’s, Inc.) has securities registered under § 12 of the Securities Exchange Act of 1934, the corporation is to continue to have a standing audit committee consisting of two or more members of the board who are not officers or employees of the corporation; SEC v. Coastal States Gas Corp. (S.D. Tex.), discussed in SEC Litigation Release No. 6054 (Sept. 12, 1973) (corporation to appoint a three-member independent audit committee with a majority of new independent directors); Wall St. J., Aug. 22, 1977, at 8, col. 1 (audit committee to be reconstituted and to have a majority of new directors, one of whom is to be the chairman).

\(47\) Part VII, Second Amended Judgment, SEC v. Mattel, Inc., Civ. Action No. 74-2958-FW (C.D. Cal., filed Nov. 26, 1974). The committee was empowered to review claims against past and present officers, directors, employees, and controlling persons arising out of their relationship with Mattel, to determine what actions the company should bring, and to approve any settlement of such claims.

\(48\) Part VIII, Second Amended Judgment, SEC v. Mattel, Inc., Civ. Action No. 74-2958-FW (C.D. Cal., filed Nov. 26, 1974). The special counsel was directed to retain a special auditor (subject to the approval of the corporation, the SEC, and the court) to verify the suspect financial statements. Part IX, Second Amended Judgment, SEC v. Mattel, Inc., Civ. Action No. 74-2958-FW (C.D. Cal., filed Nov. 26, 1974).

In contrast to the rather conventional wrongdoing committed at Mattel, Northrop fell victim to the post-Watergate sensitivity to kinds of corporate improprieties long overlooked by the public and by the regulators. Under its flamboyant president, Thomas V. Jones, Northrop had become a leading seller of military aircraft in the international arms market. In 1974, an investigation by the Watergate Special Prosecutor and later by Northrop's independent auditors revealed that the corporation had made illegal domestic political contributions and had given large subventions to "representatives" of the company abroad.\(^{50}\) Northrop and its top management were sued by a group of shareholders who claimed that the corporation, Jones, and several other officers had violated federal securities and campaign laws and had breached their fiduciary duties under state corporation law.\(^{51}\)

The Northrop litigation, like the Mattel litigation, produced a settlement restructuring the board of directors. The settlement required the company to elect four new outside directors as well as to amend the certificate of incorporation by adopting a provision which increased the size of the board and assured that outsiders would comprise a majority of it.\(^{52}\) Candidates for the new directorships

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50. The illegal political payments are discussed in Report to the Board of Directors of Northrop Corp. on Special Investigation of the Executive Committee I (July 16, 1975). Northrop and Jones pled guilty and were each fined $5,000. Criminal charges were also filed against James Allen, former Northrop vice-president and director, who pled guilty to a misdemeanor charge and was fined $1,000. *Id.* at 1. For information about the auditor's investigation, see *Multinational Corporations and United States Foreign Policy: Hearings Before the Subcomm. on Multinational Corporations of the Senate Comm. on Foreign Relations, 94th Cong., 1st Sess., pt. 12, at 147 (1975) [hereinafter cited as *Multinational Hearings*]. The corporation's independent auditors, Ernst & Ernst, in turn, engaged another accounting firm, Price Waterhouse & Co., to participate in the investigation. Report to the Board of Directors of Northrop Corp. on the Special Investigation of the Executive Committee I (July 16, 1975). For a description of the investigatory procedures used by Ernst & Ernst, see Supplement to the Report on Special Investigation of Northrop Corp. and Subsidiaries (as supplied by Ernst & Ernst), in *Multinational Hearings*, pt. 12, at 925-32.


52. Undertaking Incorporated into Final Judgment, Springer v. Jones, Civ. Action No. 74-1455-F (C.D. Cal., filed Jan. 20, 1975). "Independent outside director" was defined as an individual who had not, within a specified period, (1) received in excess of a specified dollar figure for services rendered or from the sale of material to the corporation or (2) been associ-
were to be selected by the existing board subject only to the court’s
determination that the candidates met the settlement’s vague com-
mand that they have “experience, independence, integrity and ability
to make significant contributions as directors of Northrop and to ful-
fill the special responsibilities of New Directors.”

The settlement also reconstituted the Board’s executive, audit,
and nominating committees. The executive committee was directed
to report on Northrop’s relationships with its emissaries and consul-
tants at home and abroad and to recommend reforms in the com-
pany’s organization which would prevent future wrongdoing. To
insure that the committee would distance itself from management
during the inquiry, the settlement provided that for a specified time
five of the six committee members would be outside directors and
that three of these, including the chairman, would be new outside
directors. The settlement further provided that the audit and nomi-
nating committees would permanently consist entirely of outside di-
rectors.

As at Northrop, illegal payments prompted administrative and
judicial sanctions against Phillips Petroleum. The company and
several individual directors were accused of surreptitiously main-
taining a substantial cash fund for political contributions in the
United States. As a result of these payments, Phillips and several of
its officers were indicted for tax fraud and for violating the federal
election law. The SEC sued to enjoin future violations of the securi-
ated with a company or firm which received in excess of a specified percentage figure of its
gross sales from transactions with Northrop.

See Undertaking Incorporated into Final Judgment schedule A (Resolutions of the Board
of Directors Re Amendment of Articles and Re Amendment of By-Laws), Springer v. Jones,
Article II of the By-Laws of Phillips Petroleum Co. attached as exhibit M to the Stipulation of
(similar definition of outside director).

53. Undertaking Incorporated into Final Judgment, Springer v. Jones, Civ. Action No. 74-

54. Undertaking Incorporated into Final Judgment at 4 & schedule A (Resolutions of the
Board of Directors Re Amendment of Articles and Re Amendment of By-Laws), Springer v. Jones,
Article IV of the By-Laws of Phillips Petroleum Co. attached as Exhibit M to the Stipula-
tion of Settlement, Gilbar v. Keeler, Civ. Action No. 75-611-EAC (C.D. Cal., filed Apr. 22,
1976) (Undertaking approved by the court requires the board of directors to elect three new
independent outside directors).

55. Undertaking Incorporated into Final Judgment & schedule A (Resolutions of the
Board of Directors Re Amendment of Articles), Springer v. Jones, Civ. Action No. 74-1455-F

56. Notice to Stockholders of Phillips Petroleum Co. Concerning Hearing on Confirma-
22, 1976).
ties laws,57 and a shareholders’ suit was brought to obtain injunctive relief against the company and the officers responsible for the payments.58

The settlement of the shareholders’ suit required the company to institute several reforms designed to strengthen the independence of the board. As was the case with Northrop, the order directed the company to create a nominating and an audit committee and to amend its bylaws to increase the number and proportion of outside directors.59

B. The Implementation and Impact of Reform

For those who hoped that judicially mandated institutional reform would significantly change corporate governance, the results of these settlements have been disappointing. New directors have been drawn from the same elite60 as old directors; new boards have not been notably more aggressive than unreformed boards. Moreover, board committees have not given boards much more insight into or control over management activities. This section examines how the three corporations carried out the settlement provisions pertaining to the selection of new directors. Section C broadly questions the efficacy of independent directors and audit committees.

The private settlements at Northrop and Phillips gave the plaintiffs a voice in the selection of new directors. The Northrop plaintiffs suggested ten candidates who, the plaintiffs believed, would be aggressively independent and acceptable to Northrop.61 The undertaking required the company to interview and consider these candidates as it did other candidates.62 The selection of candidates was entrusted to Northrop’s nominating committee, subject to the court’s supervision. This committee, which was composed of the six outside directors then on Northrop’s board, considered candidates of its own choice as well as plaintiffs’ and announced its intention to nominate the candidates most likely to perform significant directo-

60. See note 13 supra.
61. Interview with John R. Phillips, attorney, Center for Law in the Public Interest (Nov. 11, 1977).
rial services and best able to fulfill the special responsibilities of the new directors.63

The selection was a process of "horse trading" in which each side possessed a veto power.64 According to one of the plaintiffs' lawyers, Northrop understood (without ever having been explicitly told) that if the corporation rejected plaintiffs' nominees out of hand, the plaintiffs would vigorously attack the nominees in open court.65 Although each side placed two candidates on the final slate of four, it is questionable whether this process produced different directors than the corporation would have chosen on its own.66 Both of the plaintiffs' nominees were members of the corporate club. One, William Balhaus, was in fact a former executive and director of Northrop, although since he had been a rival of Jones he might have been expected to keep a close eye on Northrop's management. Nevertheless, Northrop regarded Balhaus, the president of Beckman Industries, Inc., who had a board of directors of his own to deal with, to be "safe."67 One of Northrop's lawyers was able to say that "the plaintiff nominated [selected] many of the same people as the corporation would have."68

The Phillips Petroleum settlement provided no formal mechanism for the selection of directors; management and the plaintiffs openly bargained. Each side prepared a list of twenty candidates for the six new outside directorships. The plaintiffs' attorney, three outside directors of Phillips, the chairman, another high executive, and general counsel discussed the various candidates.69 These appar-

64. Interview with Michael Klein, partner in the Washington, D.C., law firm of Wilmer, Cutler & Pickering (Aug. 30, 1977); Interview with John R. Phillips, supra note 61.
66. Of the four nominees, two were corporate executives, one was a banker, and one had served as president of two large universities and as chairman of the board of a federal reserve bank. Memorandum of Northrop Corp. Re Nomination of New Directors at 8-10, Springer v. Jones, Civ. Action No. 74-1445-F (C.D. Cal., filed Feb. 3, 1975).
67. Id. at 8; Interview with Michael Klein, supra note 64. Evidently Northrop assumed that Balhaus would hesitate to establish, as a member of the Northrop board, any precedent upsetting the traditional management-board relationship.
68. Interview with Michael Klein, supra note 64.
ently “amicable negotiations” produced three new directors from the plaintiffs’ list, and three from management’s list.\(^{70}\)

Unlike private plaintiffs, the SEC prefers not to intrude in the selection of directors,\(^ {71}\) and it did not do so in the Mattel proceedings. SEC enforcement orders usually allow management to draw up a list of candidates and give the Commission a right to review the list before it is presented for judicial approval or put before the shareholders.\(^ {72}\) Thus, the Commission’s settlement with Mattel called for the company to select, subject to the Commission’s approval, candidates for new outside directors. Occasionally, the Commission discusses the candidates with a company or suggests possible candidates if a company has difficulty producing names.

C. What Reform Has Wrought

1. The Composition of Boards

As the foregoing description of the selection procedures in three recent cases in which the board was a major subject in the remedial order suggests, reform-minded settlements have not transfigured the corporate board of directors. In each case, the traditional concept of the board was unaffected, and directors were drawn from the elites that have traditionally stocked corporate boards.\(^ {73}\)


\(^{71}\) Interview with Edward D. Herlihy, supra note 44; Interview with Theodore A. Levine, supra note 44. Helpful background was also provided by responses of new independent directors to a questionnaire. But cf. Loo & Ratner, supra note 44, at 148-49. Loo and Ratner describe the usual process as follows: the SEC and the corporation each propose candidates (the SEC selections coming from resumes on file with the Commission, volunteers, or individuals with outstanding achievements in a particular field) and then negotiate, often supervised by a federal district court judge. The SEC’s rigor and effectiveness are uncertain, however. The SEC seemingly approved Lockheed’s original special review committee, which included two “implicated” outside directors, Jack K. Horton and Dwight M. Cochran, who as members of the Lockheed audit committee received information in 1972 about payoffs to Japanese government officials which, because of pressure from Lockheed’s president and chairman, they did not report until 1974. Interview with John R. Phillips, supra note 61. See also Bus. WEEK, April 26, 1976, at 39.

\(^{72}\) The Commission ascertains whether the nominees meet the nonaffiliation requirement and whether any of them have ever violated the securities laws.

\(^{73}\) The experience of these three corporations is not atypical, as a review of reconstituted boards of four other corporations that were subject to remedial orders suggests. Of the thirty new outside directors appointed at the seven corporations, twenty-one were business executives, four were professionals, and five were from academic institutions. Only one of the new directors was a woman. The four additional companies are American Agronomics Corp., Bio-Medical Sciences, Inc., Coastal States Gas Corp., and Lockheed Aircraft Corp. Background information on the directors was drawn from various proxy statements, reports, and miscellaneous statements issued by the companies from 1973 through 1977.

SEC and private settlements produce individuals of substantially the same background.
This continuity in the board’s ethos is perhaps symbolized by the retention of the chief executive officers by all of the reconstructed boards. The boards at Phillips Petroleum and Mattel were perhaps justified in retaining their chief executives since the allegations of wrongdoing against the executives were never substantiated, much less confirmed in court. W. F. Martin, chairman of the board and chief executive officer of Phillips Petroleum, was indicted along with the corporation by a federal grand jury for tax fraud. Martin pleaded not guilty; the charges were eventually dropped as a violation of an earlier plea bargaining agreement. At Mattel, the new board declined to relieve Arthur Spear of his duties as chief executive officer though he had been a high-ranking executive during the time the alleged fraud occurred.

The boards at Phillips and Mattel could have concluded that Martin and Spear either knew or should have known of the wrongdoing. Had the boards done so, they might have considered more carefully the chief executive’s ethical standards. Yet, dismissal would have been drastic in the absence of proved malfeasance, and each man had served his company’s and his shareholders’ business interests well.

Doubts about his guilt played no part, however, in the retention of Thomas Jones as chairman and chief executive of Northrop. In its report on Northrop’s improper business practices, the special executive committee squarely blamed Jones for many of the corporation’s derelictions. The committee found that Jones had promoted improper transactions and had fostered an irresponsible attitude among many of Northrop’s executives. The committee recom-

Though the samples are too small to provide meaningful statistics, in both circumstances 70% of the new directors were business executives.

74. See Phillips Petroleum Co., Form 8-K, Sept. 1976, Item 3. The indictment charged that the defendants had violated I.R.C. § 7206(1) by conspiring to make false accounting entries on the company’s books for the purpose of creating and concealing a fund for illegal political contributions. Martin was also indicted under I.R.C. § 7206(2) for aiding in the company’s preparation and submission of inaccurate tax returns.

75. Spear had been executive vice-president of operations from 1967-1972. The report of the special counsel appointed under the settlement order exonerated Spear of all wrongdoing. Mattel, Inc., Reports of Special Counsel and Special Auditor 38 (1975). The husband and wife who had led Mattel at the time of the securities violations, Eliot and Ruth Handler, resigned their positions as directors and officers shortly after the entry of the SEC’s consent decree. Mattel Inc., Annual Report (1975).

76. Following release of the special report by Northrop’s executive committee concerning Northrop’s irregular payments and transactions, Jones resigned as chairman. About six months later the board reinstated him. Northrop Corp., Proxy Statement, Annual Meeting of Stockholders To Be Held May 11, 1976, at 9-10.

77. Report to the Board of Directors of Northrop Corp. on the Special Investigation of the Executive Committee 57-58 (1975).
mended that the board replace Jones as chairman, but, since there was no suitable replacement, that it retain him as president and chief executive officer. The board followed the committee's recommendation to leave Jones in his managerial capacities but rejected the recommendation to remove him from the board. The board explained that it had forgiven Jones because his contribution to the reform of the affairs of the company had demonstrated that his presence on the board best served the interests of security holders. In reality, Jones remained in power because he had done "a good job" with his contacts abroad and his phenomenal profit record, Jones was simply too valuable to let go.

In light of the circumstances, the continuity in management at the three corporations is not surprising or, except perhaps in Northrop's case, disturbing. The boards were in a difficult, if not impossible, position. Had they vindicated their sense of morality by firing the top officers, they would probably have harmed the corporation and innocent members of the corporate constituency, such as shareholders and employees. The difficulty of their position suggests that we are dealing with problems which will not be resolved by tinkering with the board of directors. The decision to retain the three chief executive officers illustrates the difficulties involved in controlling and managing large organizations, difficulties a reformed board is not specially suited to resolve. Problems such as the complexity of the moral issues, the diffuseness of responsibility in the corporation, the tyranny of the "indispensable" person, and the uncertainty as to how to represent the interests of groups which are affected by the corporation but which neither own nor manage it, remain perplexing and intractable. The difference between what the restructured boards did and what hypothetical "insider" boards would have done in similar circumstances is probably imperceptible. As Richard W. Millar, a long-time director of Northrop, remarked at the time of the settlement of the Northrop litigation, "[The settlement is] not going to change anything."

These cases suggest the important question whether it is possible to devise a selection process which reliably recruits board members who would fit the requirements of the new board. A number of alternatives to traditional modes of selecting directors have been recently proposed, but as yet courts have not seriously contemplated

78. Id. at 58.
79. Proxy Statement, supra note 76, at 11.
them. Some of these proposals focus on the pool of potential directors and suggest more extensive use of professional directors or full-time insider directors.\textsuperscript{82} Others look to the duties of the directors and advocate redefining the director's constituency by requiring him to represent the "public" or a specific group.\textsuperscript{83}

Behind these proposals lies the worthy hope that they will diminish management's domination of boards. Unfortunately, the success of these reforms is problematic and unlikely.

To be sure, the appointment of "non-establishment" directors or of directors responsible for articulating the concerns of the public would broaden a corporation's perspective. Yet, directors unfamiliar with corporate finance or the company's business operations are ill-equipped to give constructive advice or to supervise management effectively. And a director who was distrusted or perceived as an obstructionist would only reduce the board's influence. Management might withhold information from the board lest an independent director feed the information to a public agency or to hostile shareholders.\textsuperscript{84} The presence of directors dedicated to goals incompatible with, if not antithetical to, the traditional aim of profit maximization might fragment and polarize the board. If the board became highly political and resolved conflicts through shifting alliances among representatives of divergent interests and values, timely and consistent decisions could become impossible. Management might then ignore the plenary board and, by dealing informally with the "reliable" directors, reduce board meetings to formality.\textsuperscript{85} If directors were chosen as representatives of constituencies, it would be necessary to decide which constituencies merit representation, to de-

\textsuperscript{82} See generally \textit{W. DOUGLAS, DEMOCRACY AND FINANCE} 52-55 (1940); \textit{P. DRUCKER, supra note 27, at 635-36; Barr, The Role of the Professional Director, HARV. BUS. REV., May-June 1976, at 18 (extra-time directors); Douglas, \textit{Directors Who Do Not Direct}, 47 HARV. L. REV. 1305 (1934); Drucker, \textit{supra note 3, at 24; Leech & Mundheim, supra note 29, at 1810-11; Mace, The Changing Role of Directors in the 1970s, 31 BUS. LAW. 1207, 1211 (1976).}


\textsuperscript{84} See \textit{Schwartz, Governmentally Appointed Directors in a Private Corporation—the Communications Satellite Act of 1962, 79 HARV. L. REV. 350, 359 (1965) (government-appointed public directors serving the board of Union Pacific in the nineteenth century claimed, "they were treated as spies and antagonists and kept in the dark about many things"). Cf. C. STONE, supra note 83, at 173 (suggests that if general public-directors are used, guidelines be established for secrecy and release of information).}

\textsuperscript{85} For example, Peruvian law mandated participation of workers in the ownership and management of industrial corporations. A general manager of a corporation reported that workers' representatives on a board disrupted meetings and that nonworker directors therefore met informally at the corporate president's house. \textit{See Kendell, Workers Share in Peru Industry, N.Y. Times, April 22, 1973, at 16, col. 1; Martin, Working Partner: Peruvian Regime Seeks Labor Harmony by Giving Employees Say in Management, Wall St. J., Feb. 4, 1975, at 42, col. 1.}
fine the constituency, and to develop adequate selection processes. Some authors have suggested that representatives of the public be chosen by a governmental organ. But this might permit political patronage to dictate the selection and produce unqualified public directors. Moreover, to minimize the tension between these public directors on one hand and management and the remaining directors on the other, it might be necessary to allow the corporation to participate in the selection of the public directors. Yet that could vitiate the independence of these directors. In light of these considerations, and of the difficulties of assuring that public interest directors remain faithful to their constituents, it is not surprising that the limited experience with public directors in the United States is discouraging.

87. C. Stone, supra note 83, at 159; Moscow, The Independent Director, 28 Bus. Law. 9, 12 (1972).
88. See, e.g., Investor Responsibility Research Center, Inc., supra note 16, at 32-34 (1974) (government appointments to the board of directors of General Aniline & Film Corp., when the federal government controlled the corporation, were used as instruments of political patronage). See also Conard, supra note 86, at 956-67 (government-appointed directors might look more to their superiors in Washington than to their constituents).

Of course, legislation relieving public interest directors of liability for breach of certain traditional directorial responsibility to shareholders, see id. at 947-49, and defining their duties to the public would be needed.

The statute creating the Communications Satellite Corp. and permitting the President to appoint, subject to Senate confirmation, 3 out of 15 board members does not indicate whether the public directors have any special duties, functions, or responsibilities. 47 U.S.C. § 7331 (1970). The Prudential Insurance Co. of America has six public directors who are appointed by the Chief Justice of the Supreme Court of New Jersey. N.J. Rev. Stat. § 17B:18-20 (1977). The powers and duties of the public and nonpublic (elected) directors are the same, except that the public directors may petition the Commissioner of Insurance demanding that an opposition slate of director candidates be nominated if they are not satisfied with the recommendations of the board. N.J. Rev. Stat. § 17B:18-24 (1977). Stone recommends a nine-point definition of public directors' functions and powers. C. Stone, supra note 83, at 160-73, 180-83.

89. Christopher Stone, for example, advocates that public directors selected by a proposed Federal Corporations Commission or, in its absence, the SEC, would be seated only upon approval by a majority of the board and could be removed by the corporation without cause (by a unanimous vote) or for cause (by two-thirds vote). C. Stone, supra note 83, at 159.
In sum, if these drawbacks to the external selection of directors could be eliminated, selection by this mode might be preferable, especially if it is deemed desirable for the board to become a political organ and to represent society's broader interests. But, if we settle for the board which only attempts to monitor management, selection of directors by the corporation may be more appropriate.

Beyond the formal requisite of independence, a director should possess three paramount attributes. First, a director must be familiar with the management of complex organizations, knowledgeable about corporate business and finances and sensitive to the concerns of social policy. Second, a director must be able to raise unpleasant questions without losing the respect of other board members and management. Third, a director must be willing to spend the time needed to do the job properly.

But are there enough qualified and willing candidates? Academics are generally not experienced in corporate affairs and, as outsiders to the corporation, might be thought untrustworthy or lacking in judgment. Executives and professionals, who are most likely to be experienced, are unlikely to be independent of the corporate ethos. Active academics, executives, and professionals are all likely to be too busy to pass the third test. Retired or semi-retired executives or professionals may be just as, if not more, imbued with the corporate outlook as their active counterparts.

The difficulties of securing competent yet independent directors might be overcome by using professional directors or full-time inside directors. A professional director would be experienced in business, would serve full-time as a director of one or more corporations and would be well paid and reasonably protected from dismissal during a term of office. To prevent a dependency on or co-optation by management, or too great an identification with a corporation, it might be desirable to bar professional directors from serving consecutive terms in the same corporation. However, proponents of the idea have not specified how such directors should be selected or which corporations should be required to use them. It is not clear that there would be enough qualified applicants for positions as professional directors. Finally, professional directors might take their commissions too zealously and meddle in the daily operations of the

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92. See, e.g., Lewis, Choosing and Using Outside Directors, HARV. BUS. REV., July-Aug. 1974, at 70, 73 (directors should have analytical intelligence, an awareness of social and political and economic environment, and a capacity to evaluate a corporation's strategy). See also J. LOUDEN, supra note 10, at 37.

93. See text infra at note 94.
company or incessantly call upon management to account for itself. Corporate executives apparently fear these possibilities and have evinced little relish for professional directors.

Nor do corporate executives advocate the use of full-time inside directors. Such a director might be a retired officer or an active senior officer of the corporation temporarily relieved of most of his managerial responsibilities. Texas Instruments allows officers who have taken early retirement and senior executives to serve as "general directors." Such directorial duties take at least thirty days a year. General directors also assume a major responsibility outside the corporation, such as service as a director of another corporation, consultation, participation in civic organizations, or part-time government service, with the hope that such experience will broaden the directors' perspective on the corporation's affairs. But an individual performing directorial duties thirty days a year is hardly a full-time director. Few corporations, further, can afford highly paid executives who perform no managerial functions. More fundamentally, the outlook of the inside director is cabined, cribbed, and confined by his long experience in and allegiance to the corporation. One doubts the full-time insider director would be any more "independent" than the traditional part-time insider director.

2. Board Committees

Reformers, we have seen, hope that a board committee charged with a specific responsibility such as nominating new directors or reviewing the company's finances can develop greater expertise and authority than the board acting as a whole. Since settlements of

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94. Administrative Committee of the Board, Texas Instruments Inc., Organization of the Board of Directors and Retirement Practices of Directors and Top Officers, Texas Instruments Inc. at 3, 6 (1974). See generally Remarks by Bryan F. Smith, then General Director, Texas Instruments Inc., to a conference, The Responsible Corporate Board and the Effective Director (sponsored by Graduate School of Business, Columbia University) (April 25, 1977); Remarks by Bryan F. Smith, General Director, Texas Instruments Inc., to a conference, Chief Executives Update (sponsored by School of Business Administration, Southern Methodist University) (Oct. 2, 1975); Board of Directors, Texas Instruments Inc., Statement of Policy—Subject: Composition of the Board and Responsibilities and Estimated Time Requirements of Board Members, reprinted in Administrative Committee of the Board, supra at 16 app. See also J. BACON & J. BROWN, supra note 2, at 37-39; Mace, Designing a Plan for the Ideal Board, HARV. BUS. REV., Nov.-Dec. 1976, at 20, 36 (1976). Active executives appointed to a general directorship are relieved of most or all managerial responsibilities. To encourage general directors to be conscientious, the corporation pays them $30,000 annually plus a per diem fee. Addendum, Organization of the Board of Directors and Retirement Practices of Directors and Top Officers, Texas Instruments Inc., Exhibit 40 (Guidance Memorandum for Determining the Fees of Directors) (Sept. 1975).

95. See text at notes 22-27.
litigation arising out of managerial misbehavior often establish board committees, we can tentatively appraise their value.

a. **Nominating Committees.** A principal cause of directorial diffidence is that the chief executive officer, who traditionally selects the candidates for board membership, can intimidate would-be dissenters who wish to remain on the board and who know he can deny them reappointment. Reformers have promoted the formation of nominating committees composed primarily or entirely of outside directors, to screen candidates and recommend nominees to the full board.

Nominating committees were established as part of the remedial changes made at Northrop and Mattel. Northrop's settlement followed the general practice of giving a majority of seats on nominating committees to outside directors, and the Northrop committee consisted of three new outside directors and one old one; the Mattel committee consisted of four new independent directors and one inside director. One cannot say whether the directors these committees nominated were any more independent than traditionally selected directors. Certainly the choices appear to represent no new departure. The Northrop committee nominated a former senior vice-president of the company, and the Mattel committee picked three outside corporate executives and an executive vice-president of Mattel. Given the troubles of Northrop and Mattel, the pool of potential nominees was probably small.

Possibly a nominating committee cannot significantly insulate the board from management. Because management is responsible for daily operations of a business, the nominating committee invaria-

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96. Eisenberg, supra 16, at 175-76; Nine Countries, supra note 33, at 88; Leech & Mundheim, supra note 29, at 1830.

97. A nominating committee may also propose committee memberships and successors to the chief executive officer.


100. Mattel, Inc., Annual Report to Shareholders for the Year Ending Jan. 29, 1977, at 5. See also 1 Report of the Special Committee to the Board of Directors of Ashland Oil, Inc. 201 (June 26, 1975) (recommending that the nominating committee consist of the corporation's chief executive officer and two outside directors appointed by the board as a whole); Report of the Special Review Committee of the Board of Directors, Lockheed Aircraft Corp. 24 (May 16, 1977) (proposing that the nominating committee consist solely of outside directors).


102. Mattel, Inc., Proxy Statement, Notice of the Annual Meeting of Stockholders To Be Held June 9, 1977, at 4-5. One of the outside directors was a woman.
bly consults it regarding nominees, and because the board must have rapport with management, a nominating committee, even one composed entirely of outsiders, generally accedes to management's wishes. Only a rare committee would recommend a person management thought unacceptable. Nominating committees thus face what appears to be unresolvable tension between choosing inexperienced outsiders, who are distrusted by management, or selecting insiders overly sympathetic to management, who are distrusted by the "public."

b. Audit Committees. The board committee that has received the greatest attention as an instrument for improving board oversight of management is the audit committee. Audit committees, which monitor and investigate a company's financial transactions, are designed to prevent financial improprieties. Audit committees are increasingly popular among large corporations and have stimulated extensive writing.

The audit committee has been a flexible institution. It is generally composed of four or five members, most of whom are outside directors. It is a direct line between the independent accounting firm and the directors, and it can perform a wide range of tasks under the rubric of its general responsibility for coordinating and evaluating internal and external audits. Audit committees recommend an auditing firm to the full board; confer with the auditors

103. Thus, the Report of the Special Review Committee of the Board of Directors, Lockheed Aircraft Corp. 24 (May 16, 1977), proposed that the nominating committee, which consisted solely of outside directors, make recommendations to the full board "[a]fter a full review of each possible nominee's qualifications and in consultation with the Company's chief executive."


106. In 60% of the corporations responding to the Coopers & Lybrand survey, the audit committee appointed or nominated the outside auditors. Coopers & Lybrand, supra note 105, at 13 (figure 3).
before, during, and after the audit about its scope, procedures, problems, and results ¹⁰⁸ and discuss with the corporation's internal auditors the nature and effectiveness of their work. In addition, auditing committees have frequently investigated suspect payments and other financial irregularities.¹⁰⁹

Ideally, the audit committee helps outside directors, management, and the auditors. Through its independent access to financial information and its contact with the independent auditors, the audit committee can better inform the board of the company's financial activities and improve the board's supervision of management. The committee offers management an opportunity to review the company's financial reporting and controls. The audit committee gives internal auditors direct access to the board of directors. It shields the external auditors from undue management influence¹¹⁰ by providing a forum in which they can confer directly with board mem-

¹⁰⁸. According to the Coopers & Lybrand survey, supra note 106, only 43% of the committees met with the independent auditor to discuss the scope of the engagement before the audit, and 40% met with the independent auditor to review the financial statements before publication. In contrast, a New York Stock Exchange survey of listed corporations with audit committees found that in 97% of the corporations the audit committee periodically met with the independent auditor before and after the audit, and that in 75% of the corporations the audit committee periodically met with the independent auditors to review the company's control procedures. The New York Stock Exchange, Response to the White Paper Questionnaire Concerning Recommendations and Comments on Financial Reporting to Shareholders and Related Matters 3 (n.d.).


¹¹⁰. Over 68% percent of the independent CPAs surveyed by Mautz and Neumann believed that audit committees enhanced their independence; a number also indicated that with an audit committee, independent CPAs could more easily fulfill their role. R. MAUTZ & F. NEUMANN, supra note 38, at 48, 115.
bers about their accounting practices, about the quality of internal accountability, or about suspicious financial transactions. Of course, the committee can best protect the auditors if the outside accountants cannot be replaced except upon the recommendation of the committee.

Audit committees could disrupt corporate leadership. Management might resent a committee which appears to intrude upon management's activities or its relations with its internal auditors. Yet, according to one survey of executives, directors, and accountants, conflicts are infrequent and are not thought to imperil the company's welfare. In practice management and committees have respected each other's jurisdiction, and reasonably precise guidelines can probably be devised to forestall conflict.

We do not yet know how well audit committees work in practice. According to one survey, chief executive officers and internal auditors generally approve of audit committees. Significantly, outside auditors are less pleased; more than one third of the independent accountants who responded said that the audit committees ineffectively review financial information provided to government agencies, the shareholders, and the public.

Audit committees have on several notable occasions exposed an executive's malefactions. For example, the audit committee created by the SEC's consent decree with Firestone Tire & Rubber Co. reported that a former vice-chairman and chief financial officer of the corporation controlled but could not account for an approximately one million dollar company fund for illegal domestic political contributions. At Gulf Oil a special "ad hoc" audit committee of two outside directors and a nondirector attorney chronicled fourteen years of clandestine and illegal expenditures in the United States and abroad. Partly as a result of this report, the board of directors ousted the chairman and three senior executives. Similar committees at General Tire and Rubber Co. and American Ship Building Co. investigated and reported on corporate subsidies of campaign

111. Id. at 41; Coopers & Lybrand, supra note 106, at 27 (1976).
112. R. MAUTZ & F. NEUMANN, supra note 38, at 39-42.
113. Id. at 114.
114. Id. at 59.
115. Id. at 61.
contributions by top executives. Yet, audit committees have not always done well. Audit committees at Gulf Oil and Lockheed failed to discover illegal uses of corporate funds. At Lockheed, members of the audit committee inquired about commissions paid to foreign agents but evidently were satisfied with management's assurance that the payments were legal.

The failures at Gulf and Lockheed may be attributable to the fact that the outside directors were personal friends of top management. Nevertheless, management can probably hide fraud from an audit committee if it wants to. Not only has the sophistication of misfeasance reached new heights, but it is difficult for audit committee members to remain alert to the rare but flagrant situations in which they are needed. At best, an active, independent audit committee composed of seasoned, knowledgeable business executives may lessen opportunities for improprieties. The mere presence of an audit committee may deter questionable activities by management. But if so, the efficacy of the deterrence may be difficult, if not impossible, to measure.


121. As to Gulf's outside directors, see Robertson, supra note 11, at 122. Daniel J. Haughton, Lockheed's chairman of the board and A. Carl Kotchiam, vice-chairman of the board and chief operating officer, apparently "leaned on" at least two outside members, Dwight M. Cochran and Jack K. Horton, of the Lockheed audit committee. Telephone conversation with John R. Phillips, Nov. 11, 1977.

122. The Conference Board reached this conclusion, J. Bacon & J. Brown, supra note 2, at 118, as did J. Wilson Newman, who chaired Lockheed's special review committee: "If management really wants to sway foreign customers through bribes, it can probably keep the board in the dark." Bus. Week, Oct. 10, 1977, at 74, 77. Dr. John Retaliate, president, Illinois Institute of Technology and a member of corporate boards, noted, "You really don't know what's going on. If management really wants to put something over on a director, it can." Vanderwicken, supra note 19, at 158.
IV. CONCLUSION

The traditional corporate board of directors is part of management's team. The chief executive establishes corporate goals and strategy and the board accepts his proposals, adding, perhaps, some friendly advice. Reformers envisage a board prepared to oppose management. Board members are independently to evaluate management and corporate performance and to propose corporate goals and strategy or, at least, to criticize those of management.

This Article has examined two means of increasing the independence of corporate boards—allocating more board seats to outside directors and creating more board committees. Certainly, institutional reform in these directions can improve corporate governance. But as long as directors are drawn largely from the ranks of past and present corporate executives and professionals, we are unlikely to witness major shifts in the character of the board. Committees are an uncertain check on management, and they may proliferate only to undertake trivial functions which occupy the time of outside directors and create only the illusion of board independence.

Ultimately, the obstacle to effective control of management lies in the size and structure of the modern large corporation. Major corporate enterprises are sprawling institutions in which power is dispersed among a small army of technocrats. Countering this decentralization is the hierarchy led by the chief executive officer. Even a reformed board of directors is ill-suited to exert a major influence. It is too remote from "local" decision makers, and it cannot match the chief executive's institutional authority and control over the machinery of corporate government. Corporate reformers are well-advised either to look to other means of regulating corporate conduct or to adopt a more radical approach to the problem of corporate governance.

123. The author of one empirical study of the impact of outside directors disparages the idea that the presence of outsiders has any significance. Schmidt, Does Board Composition Really Make a Difference?, 12 CONF. Bd. REC. 38 (Oct. 1975). Schmidt states, "[T]he whole idea of relating the behavior of corporations to the number of insiders or outsiders on the board is a sham. Perhaps other more important characteristics dominate, such as the merit of the individual director, the rapport between the board and operating executives, [and] the quality of information fed to board members."


125. See id.