The Proposed Restatement of Corporate Governance: Is Reform Really Necessary?

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The Proposed Restatement of Corporate Governance: Is Reform Really Necessary?

The role of the director in a modern corporation has recently come under new scrutiny. The American Law Institute has proposed a "Restatement of Corporate Governance" which offers explicit guidelines for the conduct of corporate directors. The Institute proposes to increase the board of directors' responsibility for corporate affairs by raising the board's standard of care. The Proposed Restatement has, however, been criticized by the business community for failing to take into account the realities of corporate governance and for imposing a suffocatingly narrow set of guidelines. Corporate management is not in need of reform. But even if it were, the Proposed Restatement is not the solution.

I. INTRODUCTION

There have been a number of recent attempts at corporate reform, some governmental, and some private. Such attempts arise because of the role that the corporation plays in the world economy. At the root of this reform movement is a belief that directors are inefficient, and that tighter restrictions are needed to control their actions.

The American Law Institute (ALI) has entered the fray by drafting a restatement of corporate law. The proposal is insufficient, however, because its drafters failed to take a realistic look at the role that executive officers play in the corporation, and because they failed to consider the economics of the business world. For this reason, the Business Roundtable has vigorously criticized the Proposed Restatement.

This comment focuses on the Proposed Restatement and how its implementation would detrimentally affect the operation of the modern corporation.


2. BUREAU OF THE CENSUS, U.S. DEPT OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES 544 (1981). In 1980, the largest 500 corporations had assets in excess of 1,175 billion dollars.

3. See infra notes 18, 25-50 and accompanying text.
II. THEORIES OF CORPORATE GOVERNANCE

The question of who should control a corporation is indeed perplexing. However, it has been just as difficult to determine where corporate control actually lies. Originally, control was thought to lie in those persons who actually had the power to select the board of directors, i.e., the shareholders. In the 1920's and 30's, however, this control theory was deemed impractical; corporate control was proven to lie with the corporation's directors and officers. This type of control resulted from the wide dispersal of corporate ownership. In 1932, sixty-five of the two hundred largest non-financial corporations did not have one shareholder with more than 5% of the corporate stock, presumptive evidence that ownership and control were not synonymous. Indeed, this "realistic" view was enacted in a majority of state corporate laws.

The board of directors, however, wields very little actual power. Most boards meet no more than once a month to discuss problems. This leaves the directors little time to become familiar with the problems facing the corporation, and much less time to come up with appropriate remedies. Actual control is thus wielded by the corporation's executive officers. This characteri-

4. A. Berle & G. Means, The Modern Corporation and Private Property 69-70 (1933). Berle and Means characterized five types of control: (1) control where one person owns nearly all of the corporation's stock; (2) majority control where one person holds the most stock; (3) control through a legal device such as a trust or pooling agreement; (4) minority control; and (5) management control. The first three types are based on the right of the majority to vote its stock, while the last two are based on a factual, rather than a legal, basis of control. Id. at 70.

5. Id. at 69-70.

6. Id. at 94-118. Additionally, only 12% of the corporations were controlled by a majority, while 23% were controlled by minority blocks of shares, and 65% were controlled by management. Id.

7. See, e.g., DEL. CODE ANN. tit. 8, § 141(a) (Supp. 1980) ("[T]he business . . . of every corporation . . . shall be managed by or under the direction of a board of directors"); N.Y. BUS. CORP. LAW § 701 (McKinney Supp. 1981-82) ("[T]he business of a corporation shall be managed under . . . its board of directors"); MODEL BUSINESS CORP. ACT § 35 (2d ed. 1977) ("All corporate powers . . . shall be managed under the direction of, a board of directors").


zation of corporate control has been called the *working model* of corporate governance.\(^\text{10}\) In the working model, the board of directors has been relegated to the role of a rubber stamp for the officers' decisions.\(^\text{11}\) Indeed, one noted economist has said: "While the board's approval function was more important than its initiating activities, . . . 'even with respect to approval, many boards in these large companies are almost completely passive,' and . . . the final approval function was usually exercised by the chief executive. . . ."\(^\text{12}\)

The failure of the board to manage the corporation does not stem from the fact that the board has a lack of interest in the management of the corporation. Rather, it is a reflection of the fact that the board is on the outside of every managerial decision.\(^\text{13}\) Many boards have been, and still are, primarily composed of inside directors,\(^\text{14}\) making the chief executive officer the dominant member.\(^\text{15}\) The board's information is usually prepared by the chief executive or another executive officer, who typically presents only management's viewpoint.\(^\text{16}\) Additionally, corporate directors usually receive a minimal salary, indicating their insignificant role in providing proper management.\(^\text{17}\)

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10. CARY, *supra* note 9, at 215. The working model "embodies actual corporate practice." *Id.* It is to be distinguished from the monitoring model. See infra notes 19-24 and accompanying text.


12. GORDON, *supra* note 9, at 128-29.


14. See HEIDRICK & STRUGGES, THE CHANGING BOARD UPDATE 3 (1978) [hereinafter cited as HEIDRICK]; H. KOONZ, THE BOARD OF DIRECTORS AND EFFECTIVE MANAGEMENT 123 (1967) [hereinafter cited as KOONZ]. An inside director is also an officer of the corporation or of other corporations affiliated with it. See HENN, *supra* note 9, at 553.

15. Dent, *supra* note 11, at 621. See HEIDRICK, *supra* note 14, at 6; see also Small, *The Evolving Role of the Director in Corporate Governance*, 30 HASTINGS L.J. 1353, 1356 (1979). The chief executive becomes the dominant member of the board because the other insiders, as officers, are his subordinates in the daily activity of the corporation and are, therefore, reluctant to disagree when the chief executive makes a board proposal.

16. M. MACE, DIRECTORS: MYTH AND REALITY 73, 107 (1971). Even if the board was composed of outside directors, the outside directors would usually be executives of other companies and would have neither the desire nor the understanding of another corporation's problems to analyze management proposals with vigor.

17. KOONZ, *supra* note 14, at 147. In the managerial hierarchy, directors are the lowest paid. In addition, former Securities and Exchange Commission Chair-
Many authorities believe that there must be a revamping of the corporate structure. The model most heavily touted is the monitoring model. This model gives the board the duty of monitoring the functions of the company and its officers. These duties include: (1) the selection, evaluation, and removal of the corporation's executives; (2) the fixing of salaries of top management; (3) review of transactions between the corporation and its insiders; and (4) oversight of management's compliance with the law.

III. THE MONITORING MODEL V. THE BUSINESS ROUNDTABLE

A. The Proposed Restatement

The American Law Institute (ALI) sought to make corporate operation easier in both the short and long run. The ALI hoped its proposal would enable the corporation to maximize profits without worrying about control of the corporation. The ALI's man Hills said that the directors' compensation is set at such a low figure that no work can really be expected of them. Corporate Rights and Responsibilities: Hearings Before the Senate Comm. on Commerce, 94th Cong., 2d Sess. 327-28 (1976).


19. Under the monitoring model, the board of directors is no longer charged with the management of the corporation but with the oversight of corporate activities. The board's role will be to hold the executive accountable for adequate results, while the executive's role will be to achieve such results. Cary, supra note 9, at 219.


21. Id. at 63-66.
22. Id. at 106-14.
23. Id. at 66-67.
24. Id. at 65-66.
25. The ALI is composed of over 1,800 leading lawyers, judges, and law professors. It was designed to clarify and simplify the law, and to adapt it to social needs. It clarifies common law rules and summarizes that which has been decided by state courts. Andrews, Rigid Rules Will Not Make Good Boards, 60 Harv. Bus. Rev. 34, 35 (Nov.-Dec. 1982) (as reproduced in Statement of the Business Roundtable, infra note 46) [hereinafter cited as Andrews].

answer was the Restatement of Corporate Governance. In the Proposed Restatement, the ALI offered bright line rules under which the corporate entity would function. Section 2.01 of the Proposed Restatement states that the "objective . . . of the Business Corporation" is shareholder profit, unless it would be realized from illegal or unethical conduct. The ALI also sought to "delineate and clarify the proper role of a director and to describe the director's duties, obligations, and responsibilities."

The ALI set out to obtain these goals by suggesting five changes in the director's duties. The ALI first proposed to place a series of oversight responsibilities on the board of directors to monitor every other director and, more importantly, the executive officers. This is the basic monitoring model. Second, the ALI proposed that a majority of the board be composed of outside directors free from any economic or personal relationships with the corporation's senior executives.

Third, the ALI proposed three types of committees: an audit, a nomination, and a compensation committee. The proposal makes the audit committee mandatory. Its primary function would be to nominate the corporation's independent auditor, to supervise the relationship between the firm and the independent

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27. Id. The draft of the ALI proposal was to have been voted on in May, 1982 at the ALI's annual meeting. However, due to opposition, the ALI postponed the vote until May, 1984.
28. A bright line rule is a clearly defined law. In other words, it is a specific law meant to guide activity.
29. PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE, supra note 18, at XXV.
30. Id. at 57-70.
31. Id. Under this model, the board would monitor the conduct of the corporation's business, implement major plans, and oversee the corporation's use of resources.
32. The ALI defines an inside director as one with a significant relationship with the corporation's senior executives. Id. at 71. The ALI seems to define an outside director as one free of any significant relationship with the corporation's senior executives. Id.
33. Id. This standard, according to the ALI, is for all large publicly-held corporations unless a majority of the company's voting securities are owned by one person or family. Id. The ALI defines a "large, publicly-held corporation" as one which has 2,000 or more stockholders and $100 million or more in total assets. Id. at 6.
34. Id. at 82-95.
35. Id. at 97-106.
36. Id. at 106-14.
The nomination and compensation committees are not required, but are strongly recommended. The function of the nomination committee would be to evaluate potential candidates for membership on the board and to monitor the performance of the board's present directors. The compensation committee's job would be to determine the compensation of senior management.

Fourth, the duty of care for directors would be greatly expanded under the ALI's proposal. The proposal requires the directors not only to carry out their responsibilities in good faith and in a manner thought to be in the best interests of the corporation, but also to perform their duties with the degree of care that an ordinarily prudent person would reasonably be expected to exercise in a similar position, under similar circumstances. This standard of care would curtail the "business judgment rule" which currently requires a director to use only good faith, and which would hold him liable only for gross negligence.

Finally, the proposal facilitates shareholder derivative suits, and makes them more difficult to terminate. The Proposed Restatement would remove present procedural barriers to bringing the derivative suit.

The ALI proposal has already faced strong opposition. The

38. Id. at 1626.
39. Id.
40. PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE, supra note 18, at 141-216. Section 4.01 is an integration of the business judgment rule with ordinary negligence standards.
41. Under the business judgment rule, a director is not liable for decisions which are made in good faith, absent a showing of gross negligence. The ALI sought to reduce the gross negligence standard to ordinary negligence, thus curtailing the liberal approach the courts have taken in holding directors liable under the traditional business judgment rule.
42. See Financial Indus. Fund, Inc. v. McDonnell Douglas Corp., 474 F.2d 514 (10th Cir. 1973) (discussing the rationale of the business judgment rule); Slensky v. Wrigley, 95 Ill. App. 2d 173, 237 N.E.2d 776 (1968) (declining to interfere with the business judgment of directors absent a clear showing of dereliction of duty).
43. A shareholders' derivative suit is a suit brought by stockholders on behalf of the corporation. Henn, supra note 9, at 1035.
44. The business judgment rule is used to bar derivative actions. The board sets up an independent committee of directors to determine if the accused director's actions were in the best interests of the company. If they were, then the board of directors dismisses the suit. Sections 7.01 through 7.05 of the PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE, supra note 18, seek to eliminate the use of the independent board in determining shareholder derivative suits.
45. "As a general rule the plaintiff [shareholder] must first make a demand on the board of directors that the corporation take the steps necessary to enforce its cause of action." Henn, supra note 9, at 1069.
46. E.g., THE BUSINESS ROUNDTABLE'S CORPORATE RESPONSIBILITY TASK FORCE, STATEMENT OF THE BUSINESS ROUNDTABLE ON THE AMERICAN LAW INSTITUTE'S PRO-
business community claimed that it was not ready for four lawyers to tell them how a corporation should be run. Business also objected to the Proposed Restatement on two grounds: procedural and substantive. The procedural objection resulted from the business community's belief that the ALI had departed from its traditional role of clarifying existing principles of law to recommending what new corporate law should provide. The substantive objection was that the drafters of the Proposed Restatement did not know enough about the operations of the boards of directors to be an authority on the subject.

B. The Business Roundtable Report

The group primarily responsible for criticizing the ALI's Proposed Restatement is the Business Roundtable. The Business Roundtable agreed with the ALI that efficiency should be the main goal of corporate governance, but objected to the "bright line rules that were proposed [because they] would not provide efficiency but would in fact provide an over-emphasis on litigation." The Roundtable declared that the ALI proposal would lead to serious consequences.

The consequences characterized by the Roundtable as being imminent were: (1) an inability to be flexible and adaptive to...
changing markets and competition; (2) an increase in costs to the corporation accompanied by decreased corporate productivity; (3) an unwillingness and inability to take corporate risks that would be necessary to maintain competitiveness; (4) a focus by the director on short-term rather than long-term performance; and (5) an unwillingness among qualified people to serve on a corporation's board. 55

IV. THE EFFECT OF THE PROPOSED RESTATEMENT ON THE DIRECTOR'S DUTIES

A. PROFIT MAXIMIZATION

Shareholders invest in a large, publicly-held corporation to make a profit through dividends and the subsequent sale of their shares. 56 The investors are willing to supply capital to enable the corporation to operate efficiently because they trust the abilities of the corporate executives. 57

Imposition of the Proposed Restatement's monitoring function may, however, decrease earnings available for dividends by increasing both direct and indirect costs of governance. 58 The additional direct costs would include extra staff members, salaries, and an increased level of bureaucracy. 59 The direct cost increases would occur because of the increased role of the director in monitoring the corporation's business. 60 The director will demand an increase in his salary proportionate to the extra duties and liabilities he would assume under this function. 61 To become involved in the day-to-day operation of the corporation, the director would need a large staff to advise him of issues that must be addressed. 62 This increase in director's knowledge would, therefore,

55. Id.
56. The goal of most investors is to buy shares at a low market rate and sell when the market is high. Therefore, as long as the corporation is making money, shareholders will generally not question who is controlling the corporation.
57. A conference board study by the Business Roundtable showed that approximately 93% of surveyed companies have audit committees, 90% have compensation committees, and 23% have nomination committees. The Business Roundtable, The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation, 33 BUS. LAW. 2083, 2105-06 (1978) [hereinafter cited as The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation].
58. Fischel, supra note 46, at 1282.
59. Id.
60. The director must now become knowledgeable in all phases of the company's operation in order to make an informed and intelligent decision.
61. For the new liability standard proposed by the ALI, see Principles of Corporate Governance and Structure, supra note 18, at 241-378.
62. The director alone cannot possibly become familiar with all aspects of a corporation, especially in a technical field (e.g., the drug industry). The corpora
unnecessarily add to the numerous levels of corporate bureaucracy already in existence.

The indirect costs are not as obvious. The ALI’s proposed requirement of a majority of outside directors may cause a loss of experience on the board. The directors, therefore, may not know when to go through with a merger, develop or produce a new product, or fire the existing officers. Conservative decisions would result from the outside director’s desire to minimize his liability and his refusal to take the risks necessary for the company to prosper. Accordingly, the stockholder may lose prospectively high dividends because of these conservative business decisions.

While the proposed monitoring committees would benefit senior management by relieving them of some of their present duties, investors will have a tough time justifying their added expense. For example, the improved accounting principles formulated by the audit committee would increase the company’s accounting expense, leaving less money for the investor. A compensation committee might not be the best solution in determining salaries of senior management. A better method might be to examine market constraints and to develop the incentive needed to get managers to monitor each other. Additionally, the job of nominating the directors and officers could be more efficiently undertaken by the directors and officers who have a stake in the corporation’s outcome.

The costs produced by the ALI’s increased board monitoring function are, however, ones which can easily be avoided by less

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63. Fischel, supra note 46, at 1282.
64. Id. The firm’s decision-making processes will become less effective. The experience of the board will decrease because many corporations will have to go into the market and seek new people to serve on their boards.
66. Development of a new system of accounting takes time and money. It requires the hiring of accountants and time spent by the directors on the audit committee.
67. Fischel, supra note 46, at 1283. “Accounting changes in which real earnings were not affected do not fool investors—they do not cause investors to re-evaluate the prospects of the firm.” Id. See also Sunder, Relationships Between Accounting Changes and Stock Prices: Problems of Measurement and Some Empirical Evidence, 11 J. ACCT. RESEARCH 138 (1978).
68. Fischel, supra note 46, at 1283.
69. Id.
intrusive means. Forces that are presently in existence will serve to protect the shareholder's financial interests. These forces include laws promulgated to regulate corporations, as well as antitrust, securities, and tax laws. These laws ensure that the corporation will follow certain minimum standards. Even so, market forces may be the best way to make a corporation profitable. According to Professor Alfred E. Kahn, competition will ensure that corporate production remains efficient by the "objective test of market survival;" it will enable producers to offer their customers services for which they are willing to pay, and it will insure labor allocation into production lines creating the maximum contribution to total output. These constraints will provide the basis for maximizing profits without legal interference. "The ability freely to sell one's shares, . . . the so-called 'Wall Street Rule,'" is without question the single most important safeguard to all shareholders that [the executives of the corporation] will act in their best interests."

B. Acting Within Legal Boundaries

It is important that every corporation act within the boundaries

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70. The costs can be avoided by placing a sufficient number of inside directors on the board to allow the directors to run the company. See infra notes 115-16 and accompanying text.


76. Id. at 15-16.

77. Id.

78. The Wall Street Rule involves the buying and selling of securities on one of the exchanges or over the counter.

79. Fischel, supra note 46, at 1278. If a shareholder is not satisfied with management he can sell his shares on the open market. This will cause stock prices to be reduced and force management to make the necessary changes. Most shareholders find it easier to sell their shares than to bring a costly shareholders' derivative suit.
of applicable state and federal laws. Through the Proposed Restatement, the directors would be required to know all applicable laws and ensure management’s compliance with them.

However, directors cannot guarantee that every manager in a large corporation will engage in lawful activity. This difficulty arises because the legal and regulatory requirements currently imposed on corporations are so numerous and complex that it would be impossible for the board of directors to realize when certain laws were being violated. Each director would have to be an experienced lawyer with a background in securities and antitrust law in order to ensure management’s compliance.

The board can most effectively ensure the corporation’s compliance with relevant laws by hiring the best management available. Through the informal and subjective process of hiring, the board will best be able to assess the manager’s individual integrity and sense of professionalism. This informal process will engender a relationship of mutual trust between the board and top management. Maintaining high employment standards will ensure managers with the requisite technical knowledge. The Restatement’s black letter rules cannot replace this very human and flexible process; indeed, it is ludicrous to allow directors, who know little about an area such as federal securities laws, to attempt to monitor top management’s decisions in that area.

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81. *The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation*, supra note 57, at 2101.

82. *Id.* Strong policies and procedures are needed which are designed to promote and maintain legal compliance throughout the corporate structure.


84. *Baker, Directors and Their Functions* 136, Division of Research, Harvard Business School (1945) [hereinafter cited as *Baker*].

85. *The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation*, supra note 57, at 2102. An arbitrary exclusion of inside directors frustrates the objective of a board having a broad range of backgrounds and perspectives. *Id.* at 2102.

86. *Id.* at 2102.

87. *See supra* note 73 and accompanying text.

88. *The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation*, supra note 57, at 2102.
C. Devotion of Resources Toward Social Goals

Section 2.01 of the Proposed Restatement allows corporate resources to be devoted, within reasonable limits, to public welfare, humanitarian, educational, and philanthropic purposes. However, this devotion of resources may be inconsistent with the goal of maximizing shareholders' profits. The ALI has "[fallen] into the trap of defining profit, not as the necessary result of or reward for the pursuit of product-market and organization-sustaining objectives, but as the only goal, one so all encompassing and vague that it sets no direction."91

Whether a corporation should have a social conscience is a debate that has gone on for over sixty years. Ralph Nader and E.M. Dodd argue the managerialist view which espouses that a corporation can and should devote itself to the public interest, while Milton Friedman and A. Berle support the view that the

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89. PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE, supra note 18, at 17.

Corporate law should provide that the objective of the business corporation is to conduct business activities with a view to corporate profit and shareholder gain are not thereby enhanced, the corporation, in the conduct of its business
(a) is obliged to the same extent as a natural person, to act within the boundaries set by law,
(b) may properly take into account ethical principles that are generally recognized as relevant to the conduct of business, and
(c) may devote resources, within reasonable limits, to public welfare, humanitarian, educational, and philanthropic purposes.

Id.

90. Andrews, supra note 25, at 38.
91. Id.


93. Dodd, Is Effective Enforcement of the Fiduciary Duties of Corporate Managers Practicable?, 2 U. CHI. L. REV. 194 (1933); Dodd, For Whom are Corporate Managers Trustees?, 45 HARV. L. REV. 1145 (1932). These two articles were E.M. Dodd's half of the famous Berle-Dodd debates of the 1930's concerning corporate governance.

94. Managerialism, as an involuntary duty, has never been enforced by the courts. The courts will not impose a duty on the corporation to donate money to social causes without the consent of the directors. See generally Bangor Punta Operations, Inc. v. Bangor & Aroostook R.R. Co., 417 U.S. 703 (1973). The argument in support of the managerialistic view is the concern that the public will have confidence in a business that does not try to balance its interests with the public's interest. Williams, The Role of the SEC in Overseeing the Accounting Profession, Address at Oxford, England 38 (March 13, 1980). See also Kripke, The SEC, Corporate Governance, and the Real Issues, 36 BUS. LAW. 173, 183 (1980).

95. M. FRIEDMAN, CAPITALISM AND FREEDOM 133 (1962). In a Playboy interview, Milton Friedman said: "A corporate executive's responsibility is to make as much money for the stockholders as possible; . . . [when] an executive decides to take action for reasons of social responsibility, he is taking money from someone else—from the stockholders. . . ." Friedman further stated that: "I wouldn't buy stock in

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primary aim of the corporation is profit maximization for the shareholders. Berle believes that it is impossible to measure public policy claims against stockholder claims.97

One of the first cases to recognize the issue of social interest versus profit maximization was Dodge v. Ford Motor Co.,98 which stated the Berle view. In Dodge, the court stated that a business corporation is organized primarily for stockholder profit, and the director's discretion is to be exercised in light of that end, and such discretion "does not extend . . . to the reduction of profits, or to the nondistribution of profits among stockholders in order to benefit the public, making profits of the stockholders incidental thereto."99

However, in Ashwander v. Tennessee Valley Authority,100 Justice Brandeis stated in a concurring opinion that while stockholders may invoke judicial remedies to enjoin management acts which threaten their property interests, they cannot secure the aid of a court to arrest mistakes of judgment.101 Thus, if management in good faith elects to donate money to charitable interests, the decision cannot be questioned as long as it was made in good faith and was reasonable. It appears, therefore, that under existing law, management may donate a reasonable amount for charitable purposes.102

This objective would not be furthered by the Proposed Restatement. The directors would still be subject to shareholder's deriv-

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96. Berle, Corporate Powers as Powers in Trust, 44 HARv. L. REV. 1049 (1931); Berle, For Whom Corporate Managers Are Trustees: A Note, 45 HARv. L. REV. 1365 (1932) [hereinafter cited as For Whom Corporate Managers are Trustees: A Note]. These articles were Berle’s side in the Berle-Dodd debates.

97. Berle said in For Whom Corporate Managers Are Trustees: A Note, supra note 96, “you cannot abandon emphasis on the view that business corporations exist for the sole purpose of making profits for their shareholders until such time as you are prepared to offer a clear and reasonably enforceable scheme of responsibilities to someone else.” Id. at 1367.

98. 204 Mich. 459, 170 N.W. 668 (1919) (profits are the main goal of the corporate director).

99. Id. at 475, 170 N.W. at 684.

100. 297 U.S. 288 (1936) (management may elect to donate money, and if it is done in good faith, it is protected by the business judgment rule).

101. Id. at 343.

102. Id. Within recognized limits, shareholders may invoke judicial remedies to enjoin acts of management which threaten their property interests.
tive suits because of their failure to comply with section 2.01.103. The outside directors, not knowing the proper method to allocate resources, would subject all directors to the possibility of losing their jobs because of shareholder pressure to maximize profits. Thus, if the monitoring model is accepted, the board will tend to be committed toward financial, rather than social, goals.104

D. The Outside Director

The ALI has called for the board to consist of a majority of outside directors.105 Under the monitoring model, the outside directors are asked to monitor management, rather than manage the corporation.106 However, the outside director requirement may severely limit the board. Insiders bring to the board intimate knowledge of the business operation which can be very valuable in arriving at a sound business judgment.107

[A] "good" board is something more than a combination of "good" directors, and that among other things not all directors—even skilled and qualified directors—"fit" all boards equally well; that there had to be some "mix" in a board—a mix of skills, backgrounds or personalities that create a chemistry in the board; that there had to be an attitude toward the board—and especially an "environment" in board meetings—that encouraged board participation; and finally that there had to be board management or "leadership" that directed and coordinated the board and its work.108

A good board, therefore, does not need a majority of outside directors.109 The insider may have a vast array of skills and background able to assist the board in difficult decision-making

103. See generally Principles of Corporate Governance and Structure, supra note 18, at 241-378.
104. Directors would then become committed to making conservative decisions. The director might be hesitant to make a decision which would enhance the reputation of the company, and would only strive for profit maximization through traditional means.
105. See supra notes 32-33 and accompanying text.
108. Id. at 23 (quoting J. Lynch, Activating the Board of Directors: A Study of the Process of Increasing Board Effectiveness 333-34 (1979) (available in Harvard Business School Library)).
109. Presently, 83% of manufacturing companies and 86% of non-manufacturing companies have a majority of outside directors. The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation, supra note 57, at 2109. This shows that companies are deciding the proper mixture for a good board; the rules of the Proposed Restatement are, thus, not necessary to control the board.
processes. The limitation of the number of insiders would hamper the objective of including those on the board with the best skills, backgrounds, and personalities.

The goal of the corporate enterprise should not be an exclusion of insiders serving on the board of directors, but one of ensuring a proper mixture between the inside and outside directors. What a corporation should look for in determining the composition of its board members is not the close personal tie the individual has with the corporation, but the integrity, ability, alertness, experience, and interest of the particular individual.

The major concern should be to select as many outside directors as are needed so that they will have a substantial impact on the board's decision-making process. This is referred to as the critical mass theory. If every board needed a majority of outside directors, there would be a limited pool of capable persons available for the position. The number of directors capable of making complex corporate analysis is limited, and the "disqualification of insiders would reduce the selection pool to a still smaller number, [with] the net result . . . [being] corporate boards whose members were less competent and effective than those now sitting."

There is nothing inherently wrong with having outside directors on the board, but the main goal should be to strive to maximize shareholder wealth. This can be achieved by increasing specialization on the board and by allowing individuals with specific backgrounds and expertise to join.

110. For example, placing a securities expert on the board would enable it to analyze and recommend specific procedures to the entire board regarding mergers, while an accountant on the board would be able to recommend and devise the most appropriate accounting system.
111. The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation, supra note 57, at 2107.
112. Id. at 2108.
113. BAKER, supra note 84, at 136.
114. The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation, supra note 57, at 2108.
115. Id. "Critical mass" means that although there may be a majority of inside directors, there should be enough outside directors to influence the decision-making process.
117. Id.
118. This is a goal that has been strived for by Friedman and Berle. See supra notes 96-97 and accompanying text.
E. Uniform Duty of Care

Through a series of judicial decisions, courts have held a director liable in three main types of cases: (1) when a director is guilty of "an obvious and prolonged failure to exercise oversight or supervision;"119 (2) when a director commits an illegal act;120 or (3) when a director ignores facts sufficient to put him on notice that further inquiry and/or action is required.121 Only a small number of courts have found directors liable for simple negligence.122

The courts have recognized that litigation occurring after the fact is an imperfect way to evaluate the decisions of the director.123 Business decisions are generally immediate determinations usually based on less than perfect information. These circumstances are not easily reproduced in a courtroom years later. "[I]t is very much in the interest of shareholders that the law not create incentives for overly cautious corporate decisions."124

The Restatement, however, proposes to eliminate the business judgment rule and subject the directors to a higher standard of care. The commentary to sections 4.01(a) through (c) of the Proposed Restatement asserts that the duty of care standards "are intended to establish at least as rigorous a duty of care test as would the 'personal business affairs' standard."125 In addition, section 4.01 would hold the directors to a duty of inquiry, and thus presumably ensure compliance with the law.126 The director can raise the business judgment rule only after he makes a reason-

121. STATEMENT OF THE BUSINESS ROUNDTABLE, supra note 46, at 41-42. See, e.g., Roth v. Robertson, 118 N.Y. 351 (1909).
122. See Bishop, Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers, 77 YALE L.J. 1078-99 (1968) (a search for cases in which directors have been liable for ordinary negligence).
123. Joy, 692 F.2d at 886. The courts must allow the directors to take risks for the company to be able to prosper.
124. Id.
125. PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE, supra note 18, at 151. The "personal business affairs" standard is that a director or officer would normally work harder when fulfilling his corporate obligations than if his personal standards were involved. See generally Selheimer v. Manganese Corp., 423 Pa. 563, 573-74, 334 A.2d 634, 640-41 (1966); Mace, The President and the Board of Directors, 50 HARV. BUS. REV. 37, 48-49 (Mar.-Apr. 1972).
126. Principles of Corporate Governance and Structure, supra note 18, at 141.
able inquiry to determine that his decision was correct.\textsuperscript{127}

The ALI's duty of care proposal would make it almost impossible for a corporation to dismiss a shareholder's derivative suit challenging the director's conduct.\textsuperscript{128} Dismissal of the derivative suit could only be done by an independent committee, working with special counsel free from corporate ties. Its findings of fact would need to be documented in a written report.\textsuperscript{129}

In general, the courts have not agreed with the ALI's duty of care proposal.\textsuperscript{130} Courts are thought to lack the expertise and information necessary for them to make complicated business decisions. Thus, in \textit{Graham v. Allis-Chalmers Manufacturing Co.},\textsuperscript{131} the court said that liability will only be imposed on a director "if he has recklessly reposed confidence in an obviously untrustworthy employee, has refused or neglected cavalierly to perform his duty as a director, or has ignored either willfully or through inattention obvious danger signs of employee wrongdoing. . . ."\textsuperscript{132}

Legal compliance can be secured by existing constraints. Some states have codified the business judgment rule with a reasonable inquiry standard.\textsuperscript{133} The reasonable inquiry standard was intended to be a duty of inquiry only when the circumstances indicate a need for it.\textsuperscript{134} Thus, under current law, there is no duty of inquiry when there is an adequate presentation made by management through an attorney, accountant, or other professional.\textsuperscript{135}

In order for the director to continue his goal toward profit maximization, the business judgment rule is needed to protect him. The director will be constrained by the market conditions to make thoughtful decisions. The director should be left to balance the cost of securing additional information against the anticipated

\textsuperscript{127} \textit{Id.}
\textsuperscript{128} See supra notes 44-45.
\textsuperscript{129} Fischel, \textit{supra} note 46, at 1291. This involves a large expenditure without a guarantee that it is cost-justified. See also Fischel, \textit{"The Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware Corporation Law}, 76 Nw. U.L. Rev. 913, 941 (1982).
\textsuperscript{130} E.g., Graham v. Allis-Chalmers Mfg. Co., 182 A.2d 328 (Del. Ch. 1962), aff'd, 188 A.2d 125 (1963) (at least gross negligence must be found to hold a director liable for bad business judgment). See also Harman v. Willbern, 520 F.2d 1333 (10th Cir. 1975) (upheld the business judgment rule).
\textsuperscript{131} 188 A.2d 125 (1963).
\textsuperscript{132} \textit{Id.} at 130.
\textsuperscript{133} CAL. CORP. CODE § 309 (West 1977).
\textsuperscript{134} \textit{Id.}
\textsuperscript{135} This means that a director may reasonably rely on the information supplied by a professional.
benefits he would receive. If the ALI's duty of care proposal is adopted, directors will have no qualms about spending extra money, even if a decision is trivial because they will be deterred by the possibility of prosecution for not making a deliberate decision. These direct costs will come out of the shareholders' pockets, indicating that present market constraints are more beneficial than future court imposed liability in making the necessary business decisions.\textsuperscript{136}

If the Restatement were adopted, three major factors would have to be reevaluated: (1) the courts’ ability to evaluate the merits of business judgments;\textsuperscript{137} (2) the deterrence the directors will face when taking risks or focusing their attention on matters that seem crucial at the time;\textsuperscript{138} and (3) that highly qualified individuals will be discouraged from becoming directors.\textsuperscript{139} Judge Learned Hand said that if detailed supervision of the business were required, it would take most of the director's time, and if he had time to do that, there would be no need for directors.\textsuperscript{140}

The courts, presently, are required only to delve into the reasons behind the director's decisions when it appears the director used bad faith in arriving at his conclusion.\textsuperscript{141} This approach is necessary for the corporation to make money. The director cannot fear that his every decision will be subjected to litigation; he must be free to make decisions in order to reduce corporate costs and make better decisions.\textsuperscript{142}

In order to retain the important role the director plays, he must continue to be an educated, experienced, and intelligent individual. "The Business Judgment Rule grew principally from the judicial concern that persons of reason, intellect, and integrity would not serve as directors if the law exacted from them a degree of prescience not possessed by people of ordinary knowledge."\textsuperscript{143} In order to preserve this integrity, the business judgment rule must not be diluted to the point where experienced

\textsuperscript{136} See generally Fischel, supra note 46, at 1291. Allowing a derivative suit because it enhances state or federal public policy forces investors to subsidize the litigation, making the derivative suit less valuable.

\textsuperscript{137} Statement of the Business Roundtable, supra note 46, at 50. See, e.g., Weiss v. Temporary Inv. Fund, Inc., 692 F.2d 928 (3d Cir. 1982) (a court should not play a management role for which it is not suited).

\textsuperscript{138} Statement of the Business Roundtable, supra note 46, at 50.

\textsuperscript{139} Id.

\textsuperscript{140} Barnes v. Andrews, 298 F.2d 614, 620 (S.D.N.Y. 1924).

\textsuperscript{141} Joy v. North, 692 F.2d at 891.

\textsuperscript{142} See generally Fischel, supra note 46, at 1291.

\textsuperscript{143} Arsht, The Business Judgment Rule Revisited, 8 Hofstra L. Rev. 93, 97 (1979).
people will not become directors for fear of being sued for even the most trivial decisions.¹⁴⁴

V. Conclusion

In every corporation, the goal of the directors is to maximize the profits of the corporation.¹⁴⁵ Social costs must be of secondary concern to the conscientious corporate director. He is elected not for his social policies, but his ability to make the corporation run profitably. Of course, the director must also concern himself with issues such as pollution,¹⁴⁶ foreign payments,¹⁴⁷ and civil rights.¹⁴⁸ But control of these social problems cannot be achieved by placing tighter constraints on the board of directors. The solution, therefore, is not to impose requirements for the directors to establish new social policies, but to have the legislature pass new laws. This lack of constraint would allow the directors greater managerial flexibility than the proposed monitoring theory.

The monitoring theory, however,¹⁴⁹ is not disastrous per se. Most large corporations have already adopted a form of the monitoring model. Additionally, most corporations have adopted audit, nomination, and compensation committees.¹⁵⁰ This, however, does not suggest there should be a black letter law requiring every corporation to follow the monitoring model and committee recommendations. Each corporation has its own unique strategy and personality, and is best able to know the structure suited to its business. If the directors are not functioning properly, the stockholders have existing adequate remedies: the stockholder

¹⁴⁴ See generally STATEMENT OF THE BUSINESS ROUNDTABLE, supra note 46, at 50.
¹⁴⁵ See supra notes 56-71 and accompanying text.
¹⁴⁶ E.g., Congressional Declaration of National Environmental Policy, 42 U.S.C. § 4331 (Supp. I 1977) (allowing federal, state, and local governments to use all practical means to create and maintain conditions essential to preserving the natural environment).
¹⁴⁹ See supra notes 20-24 and accompanying text.
¹⁵⁰ See supra note 57 and accompanying text.
may bring an action in most states for removal for cause,\textsuperscript{151} or he may sell his shares.\textsuperscript{152} If enough shareholders decide that the directors are doing an inadequate job, the shareholders can sell their shares, thereby dropping stock prices and forcing the company to reevaluate its position.\textsuperscript{153}

Many corporations also currently employ a majority of outside directors.\textsuperscript{154} The employment of outside directors, however, should not be a mandatory provision for the corporation. Rather, a proper balance should be struck with each individual corporation based on its individual needs for specialization. There is nothing inherently wrong with insiders on the board if there is an adequate number of outsiders to enable their presence to be known.\textsuperscript{155} Outside directors should have a particular skill so that they can conduct an efficient examination of that area. Each director could make a good faith decision based on another knowledgeable board member's finding of fact.

In addition, each director should have at his disposal the right to hire advisors.\textsuperscript{156} These advisors should be experts in their chosen field; they would form an advisory committee to the board. The advisory committee should not be mandatory, but it could help the board dispose of problems beyond the scope of the individual director's knowledge. This advisory committee could also enable the directors to decide matters which the directors think are of a trivial nature. Furthermore, the director could justifiably rely on the committee and avoid liability by reason of the business judgment rule.

To achieve the goal of a balanced board, good directors must be found and elected. In achieving this goal, directors must be assured discretion in their decision-making processes. Good faith should be the only restraint on a director in making corporate decisions. Since profit-making is based on risk-taking, it should be left to the experienced business judgment of the director to decide which course is best, and the courts should not inject them-

\textsuperscript{151} This means that a stockholder may bring an action against a director for bad faith. Bad faith is not protected by the business judgment rule. \textit{See generally} Henn, \textit{supra} note 9, at 1035.

\textsuperscript{152} This is also known as the "Wall Street Rule." \textit{See supra} note 78 and accompanying text.

\textsuperscript{153} \textit{See supra} note 79 and accompanying text.

\textsuperscript{154} \textit{See supra} note 109 and accompanying text.

\textsuperscript{155} An adequate number of outsiders is the number necessary to determine whether the inside directors are using good faith and are not overstepping the bounds of their authority. \textit{See supra} notes 114-16 and accompanying text.

\textsuperscript{156} This right to hire an advisor is allowed any time a director feels that the issue facing the company is important and the director does not have the requisite skills to understand or adequately deal with the problem. The advisor would be paid by the company.
selves into a management role for which they are neither trained nor competent. The business judgment rule157 should remain in force.

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157. See supra note 41 and accompanying text.