University of Miami Law Review

Volume 37
Number 2 *Eighth Annual Baron de Hirsch Meyer Lecture Series: ALI Corporate Governance Project*

Article 4

1-1-1983

Corporate Governance Eludes the Legal Mind

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Corporate Governance Eludes the Legal Mind*

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Professor Andrews argues that the American Law Institute's Principles of Corporate Governance and Structure: Restatement and Recommendations *fails to consider the recent evolution of the large publicly held corporation and the relationship among shareholders, the board, and management. He suggests that the legal and management communities work together to solve the problems in corporate governance.*

The effrontery of my title, especially in a company so highly educated in the law, may seem less outrageous if I say at once that I am not declaring war. In fact, I propose an overdue rapprochement between the legal profession and business management. Furthermore, within the legal profession, I propose an accord between lawyers in independent partnerships and government agencies on the one hand, and law schools and the law department of corporations on the other. Although this reconciliation is subversive of the adversarial process of seeking truth and destructive of status distinctions within the profession, it is essential to economic and social progress.

En route to armistice, I do not intend to belabor in detail the recommendations of the American Law Institute's Draft Principles of Corporate Governance ("ALI Draft").[1] Instead, I hope to stimulate inquiry into why the recommendations have failed (for those who, like me, think they have)[2] and into why a storm has arisen over the ALI Draft's proposals (for those who still support this approach to reform).

It is now well known that the recommendations have received overwhelming disapproval by the management community and the

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* Professor Andrews delivered the following remarks at the Eighth Annual Baron de Hirsch Meyer Lecture Series, University of Miami School of Law, March 4, 1983. Members of the *University of Miami Law Review* edited his remarks and footnotes for publication.

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1. PRINCIPLES OF CORP. GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS (Tent. Draft No. 1, 1982) [hereinafter cited as RESTATEMENT].

2. I have already attempted criticism in Andrews, *Rigid Rules Will Not Make Good Boards*, HARV. BUS. REV., Nov.-Dec. 1982, at 34.

corporate bar. The chorus of objections has culminated in an elaborate refutation by a law firm retained by the Business Roundtable.[3] The intensity of the rejection, as I will attempt to show, does not come simply from the wish to perpetuate the autonomy of the publicly held corporation. Opposition to the Draft centers in the conviction that the recommendations, when considered against the subtlety and complexity of corporate governance, are unrealistic and irrelevant. This is partly because the roots of the new proposals come from the adversarial logic of regulatory law instead of from the observation and direct experience of the management of large corporations. I do not support all of the Roundtable's refutation of the ALI Reporters' reasoning, but I do know from research and my own experience that the recommendations do not take into account the recent evolution of the large corporation as the dominant institution of our society, with relationships ranging far beyond the corporation's original obligations to shareholders. Moreover, the recommendations do not recognize the way in which management and directors do and must relate to each other if the corporation is to achieve its purpose.

Without attempting to characterize the biases that surface in the controversies created by the Draft, I find disturbing the implication that legal scholars, of which the ALI Reporters[4] are distinguished representatives, have alienated themselves from understanding a complex human and social process. The alienation results from the thought processes inculcated by the legal scholars' discipline and culture. Economists, political scientists, and other highly trained specialists also lack comprehension of the untidy conceptual world of the generalists.

Professor Eisenberg is correct in observing that corporation law is obsolete.[5] He and his colleagues, however, may not understand the reasons why black letter law lags behind common law

3. THE BUSINESS ROUNDTABLE, STATEMENT OF THE BUSINESS ROUNDTABLE ON THE AMERICAN LAW INSTITUTE'S PROPOSED "PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS" (1983). Although my article criticizing the ALI Draft, Andrews, *supra* note 2, is reprinted as Exhibit A in the Roundtable's statement, the Roundtable did not retain me in connection with its statement or position. Ira M. Millstein and Daniel J. Block of Weil, Gotshal & Manges are the senior authors of this statement.

4. The Reporters are Stanley A. Kaplan, Chicago, Chief Reporter; Harvey J. Goldschmid, Columbia University School of Law, Deputy Chief Reporter and Reporter for Part IV; Melvin A. Eisenberg, University of California School of Law, Berkeley, Reporter for Parts I, II, and III; and John C. Coffee, Jr., Columbia University School of Law, Reporter for Part VII.

5. *See* Eisenberg, *The Modernization of Corporate Law: An Essay for Bill Cary*, 37 U. MIAMI L. REV. 187 (1983).

and case law. Needs, motives, and initiatives not acknowledged in statutes energize the corporation. As a response to the forces that shape it, the corporation has accumulated responsibilities unrecognized in traditional corporation law and the attempted modernization embodied in the Model Business Corporation Act. With the implied consent of its customers, members, and interested public, the corporation sprang loose long ago from traditional economic and legal models. Any attempt to rebottle this corporate genie in its original vessel is a futile exercise, exposing the inadequacy of outmoded economic models.

We should not feel hardpressed to devise controls to restrain a spirit ominously unbottled. Market forces and detailed regulatory apparatus check the power of the corporation. There may still be unsolved problems of logical legitimacy, but there are no claims of a great crisis of misbehavior or irresponsibility. Gross abuses are presently subject to prosecution.

Unlike the Roundtable, I believe that serious problems remain in management performance, in executive compensation, in the leadership and functioning of boards of directors, and in the structure of the relationships (different in each company), in which management and boards are enmeshed. But these problems lie beyond the reach of the law. They involve issues, not of legality or illegality, but of professional competence and responsibility. The exercise of ethical leadership in organizations requires values and skills in intricate combinations that cannot be prescribed by black letter law.

I will emphasize the apparent intellectual origins of the ALI Draft's recommendations, not their substance. The definition of the "objective and conduct of the business corporation" as corporate profit and shareholder gain (limited by reasonable deductions for compliance with the law, acknowledgement of ethical principles, and philanthropy)[6] originates in an obsolete and simplistic economic theory. Even though management and economic circles subscribe to the definition, sometimes without the exceptions, the definition does not synchronize with reality or capture the complexity of real life in the corporation. Adherence by responsible business people to this rationale is possible under the ingenuous proposition that contributions in the name of corporate responsibility and other modifications of single-minded pursuit of profit made today, will somehow redound to the shareholders' wealth to-

6. RESTATEMENT, *supra* note 1, § 2.01.

morrow. For the less responsible corporations, the single-purpose profit-maximization hypothesis justifies hostile takeovers, such as the Bendix-Martin Marietta extravaganza.[7] The hypothesis once led to the justification of questionable payments as ethical because the payments benefited shareholders. The Roundtable sidesteps controversy by taking no exception to the ALI definition, despite the difference in its own interpretation of the relationship of economic and noneconomic objectives.[8]

The maximization of shareholder wealth is no longer the simple single purpose of the universe we name the large publicly held corporation. The old model of ownership, which is still vital in the small firm, breaks down under the behavior of shareholders of large corporations who come and go on the spur of the moment, assume no responsibility of ownership, and invest and sell without knowledge of their corporation's capability and intentions. Although shareholders own shares, they expect to exercise no influence on management decisions. In addition, institutional and other less speculative investors expect that their freedom to sell under the so-called "Wall Street rule" is more important than enhancement of their power over board and management decisions.

The place of profit and the timing of its realization in the hierarchy of corporate purposes can be debated at length. Profit is the undeniably essential result of a corporation's mission to apply its financial and human resources to the production of goods and services to a public that thinks it needs those goods and services. In the formulation and execution of the long-term strategy of the large firm, profit at a planned level of return is the outcome of a complicated orchestration of risk and opportunity, of short- and long-term combinations of investment and return, and of intricate, if sometimes improvisatory, interactions of management, shareholder, employee, and customer interest. Richard W. Duesenberg, a member of the ALI, recently wrote, "[E]arning a profit is no more the purpose of a business than eating is the purpose of living."[9] Let us skip the rest of this argument. I ask, however, that

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7. Representative Henry S. Reuss, Chairman of the Congressional Joint Economic Committee, characterized the Bendix Corporation takeover as an "embarrassing scene of four corporations all trying to gobble each other up" and as a "spectacular misuse" of funds. N.Y. Times, Oct. 3, 1982, § 1, at 37, col. 1. The four corporations battling for control were Bendix, Martin Marietta, the Allied Corporation, and the United Technologies Corporation. The battle resulted in the merger of Allied and Bendix. *Id.*

8. *See* The Business Roundtable, *The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation*, 33 BUS. LAW. 2083, 2096-103 (1978).

9. Duesenberg, *Governance, Who Knows What's Best?*, CORP. DIRECTOR, Nov.-Dec.

you acknowledge that law should not be worded as if it were not taking place.

Behind the Draft Restatement's rigid recommendations to impose a single model of the monitoring-overseeing board and a mandated corporate structure,[10] there appears a complex series of assumptions. The model of the board policing the management, lest the managers make off with the corporation's assets, promotes an adversarial relationship between an errant management and a vigilant board of overseers. This model is reminiscent of the old mutual hostility between business people and their cynical observers in the Federal Trade Commission and in the Department of Justice. The Reporters have applied the economic calculus governing the corporation to the individual, expecting him to pursue personal profit at the expense of the corporation, just as they expect the corporation to do at the expense of its customers.[11] The corporation is so prone to lawlessness, apparently the inevitable result of profit maximization, that the ALI Draft specifically directs the board to see to it that the corporation obeys the law.[12]

It is interesting to note why Professor Fischel of Northwestern University Law School contests this recommendation of the Reporters.[13] In his total loyalty to the concept that the board's sole responsibility is the enhancement of shareholder wealth, Fischel contends that if it costs more to observe than to violate the law, the costs should not be incurred: "[I]f the expected costs of fines are less than the costs of installing compliance programs, the proper course to maximize shareholders' wealth is to do nothing and pay the fines."[14] Here is a potentially classic *reductio ad absurdum* of the profit maximization model of the corporation. Its

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1982, at 1, 2. Mr. Duesenberg is Senior Vice-President of Monsanto Corporation.

10. *See* RESTATEMENT, *supra* note 1, §§ 3.01-.03, .05-.06; *see also id.* § 3.07. "At least five kinds of boards have been categorized in a recent study: the *legitimating* (most perfunctory), the *advisory* (somewhat less distant but casual), the *judicial* (closest to the monitoring model), the *dominating* (highly managerial), and the *participating* board." Andrews, *supra* note 2, at 39 (citing J. Lynch, Activating the Board of Directors (1979) (unpublished doctoral thesis, Harvard Business School)).

11. *Cf.* Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597 (1982). Objecting to "some conception of 'fairness,' " *id.* at 628, instead of categorical legal prohibition, in appraising potential conflict of interest in transactions between management and the firms, Professor Brudney writes, "Conflicts of interest are inevitable in management's relationship to the firm, at least on the assumption that managers may be viewed as rational economic agents who wish to divert as much of their principal's assets to themselves as they can." *Id.* at 629 n.83.

12. *See* RESTATEMENT, *supra* note 1, § 2.01(a); *see also id.* § 2.01 comment f, at 24.

13. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259 (1982).

14. *Id.* at 1290 (footnote omitted).

amorality and inherent impracticality are *not* to be ascribed to the ALI Reporters. Fischel's hypothesis, however, illustrates the danger of overreliance on a single model of the corporation and the care with which complications must be introduced into the model.

The better question for the ALI Reporters is how can a board effectively enforce law compliance programs when the management depends in large part upon the morality and good faith of the managers of its decentralized profit centers. Compliance with the law, and ethical and responsible behavior, compose an integral part of the corporation's total strategy; they are part of its definition of itself and its mission. Morality and good faith decline and flourish in the corporation, as in all institutions, guided by the professional quality and competence of its leadership and the norms of its society. Enacting a law to force somebody to obey existing law is a "catch-22" pass at human fallibility.

The drawing of a logical straight line from any concept to its consequences, to the exclusion of other concepts and their inherent consequences, exposes the shortcomings of a one-dimensional view of a complicated human organization. The political scientists' model of a democratic society leads, in the absence of all other factors, to legislation encouraging shareholder democracy and to proposals for the election of constituency representatives. The bases for this model are two erroneous assumptions: shareholder democracy is of interest to shareholders, and the hierarchical structure of authority in corporations is not an inevitable consequence of the life and death necessity for efficiency in competition.

The desire for precision and the distaste for ambiguity inherent in legal analysis may lead to fruitless deductions from oversimplified premises. Something else besides unfamiliarity with the corporation has to explain the ALI Draft's arbitrary imposition, on every kind of large corporation, of not only a single corporate purpose, but also a single kind of board. I sense in the ALI Draft something that is explicit in the writing of other legal scholars—a deep distrust of business, perhaps derived from the proposition that when profit is paramount, greed is its inevitable servant.

The universal legal distrust of the corporation may be a result of the fact that lawyers see more violations of law than observance of law. Their loyalty to the doctrine of self-interest may include a hidden abhorrence leading them to a dim view of professional integrity in business. In any case, Professor Coffee's affirmation in the ALI Draft of an old opinion of the Supreme Court—that the shareholders' derivative suit is the principal assurance of corporate integrity—is the apotheosis of distrust and a singularly provocative expression of hostility offered by one profession to another.[15]

It is not surprising that the business community returns this lapse of polite antagonism; it huffs and puffs at the cost, waste, and distortion of litigation that loses problems addressed and optimum solutions sought in the technicalities and special pleading of adversarial proceedings. Does the inevitable familiarity of lawyers with corporate wrongdoing lead to a jaundiced view of executive integrity? Are lawyers unfamiliar with the fact that business management spans a fuller range of human accomplishment and fallibility than do the more ritualized professions? Direct inquiry into the normal course of corporate decisionmaking might reduce the suspicion of business that breeds a sense of crisis. This imagined crisis has led to a set of prescriptions that, because of their inherent unworkability, could not possibly alter the performance of management for the better.

Moreover, the threat of punishment contained in the Draft provides no realistic solution for resolving the real problems of corporate governance. Despite the protections of the business judgment rule, the liabilities imposed by the ALI Draft would paralyze the processes of the board, which already barely gets the job done. The possibility that an innocuous decision made today might be discovered by a court to be wrapped in asbestos some years later, could inhibit the board's decisionmaking under the pressures of time. The safe harbor provisions of the business judgment rule apply only to "deliberative" decisions.[16] These provisions ignore the role of hindsight in assessing the importance of certain decisions. Uncertainty, risk, untested innovation, and above all, the pressures of shortage of time surround managers and directors in their decisionmaking. No major decision can await perfect information.

I hope the ALI Reporters will not dismiss the detailed responses by critics to recommendations considered impracticable[17] as prejudiced. The legal community's suspicion of business should not be the basis for refuting the charge of unworkability and irrelevance. Inquiry into the present-day role and function of the corporate board of directors reveals the need for more sophisticated leadership of boards of directors and better ways to improve the

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15. RESTATEMENT, *supra* note 1, pt. VII, ch. 1 introductory note A, at 225 (citing Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 548 (1949)). Professor Coffee is the Reporter for Part VII of the ALI Draft.

16. *See* RESTATEMENT, *supra* note 1, § 4.01(d) comment a, at 144.

17. *See, e.g.*, THE BUSINESS ROUNDTABLE, *supra* note 3.

combined capacity of their membership. But if the Reporters want to address the problems of corporate governance, they must first understand them; the difficulties do *not* derive from self-interest.

As an organ of governance, the board has only recently assumed great importance. In the large publicly held corporation, the board becomes the highest authority because the shareholders rarely want the real power to elect directors. Typically, the shareholders follow the board's recommendations in those matters still archaically put to shareholder vote. In effect, it is the board that exercises the power and responsibility of ownership. If any entity owns the corporation, it is the board. Neither alumni, students, faculty, nor the community own a university; in reality, the trustees are the "owners" who must be sensitive to the needs and desires of its constituents. Similarly, a corporate board has ultimate responsibility for the management, perpetuation, and development of its corporation. A theory of the board's function is developing along with the changes in the corporation. The board finds itself bound to take the interests of all the corporation's constituents, including investors, into account as it asks for and ratifies management's strategic decisions.

The corporation has indeed outgrown its archaic definition in corporation law; the new board, its functions defined by experience, has become the custodian of the legitimacy of the large corporation. When the large corporation maintains acceptance by its customers, suppliers, and employees, it has attained legitimacy. Additionally, legitimacy requires that the corporation comply with a multitude of specific regulations and rules of disclosure, contend successfully against local competition, and develop its own capability against increasingly demanding world competition. The corporation meets these requirements when governed by forces shaped and responded to by a board and management working in tandem.

It is unthinkable that, except in periods of crisis, an adversarial relationship should divide independent directors and managers. The relationship between chief executive officers ("CEO's") and their boards is a paradoxical one. Boards must support management's leadership of the corporation; at the same time, they must evaluate management. Latent tension, mutual respect, and the imminence of challenge condition this relationship in ways that must be experienced to be understood. The effectiveness of the board, the quality of its membership, and the participation of outside directors in objective examination of the proposals of the CEO are all in the hands of the chairman of the board. Although the formalities of board composition, structure, and function can be legislated, the important elements of professional skill, vision, and responsibility comprising board leadership and effectiveness defy legislative mandates.

The evolution of the board's recognition of its de facto importance in corporate governance has a long way to go. The remaining problems include the extent to which boards are asked and made able to contribute to the quality of strategic decision, the sensitivity of the relationships in which compensation and evaluation of performance take place, and the difficulty of setting a climate in which challenging discussion can occur without causing antagonism between management and the board. The major problem is the shortage of time available to outside directors for discussions about the types of questions that they should raise. The recommendations made by the Draft do not address these problems; the adoption of these recommendations would worsen the problems.

My own dismay over the widening gulf between corporate management and the corporate bar and segments of the academic and regulatory bar leads me now, as an educator, to wonder why the study of the formulation and execution of business policy is not a mandatory part of the required curriculum in our law schools. We have a bicameral Congress made up of law school graduates. Congress is served by committee staffs of young lawyers and surrounded by government agencies also composed largely of lawyers. We have at the head of an increasingly litigious society proportionately more lawyers than anywhere in the world. How has this army of high talent been indoctrinated with respect to the motives and responsibilities of corporate management? What are they taught about the limitations of the adversarial process (and its companion curse, the false dichotomy) as a way of solving multidimensional problems? What alternatives to the highly theoretical constraints of the branch of economics called industrial organization do they encounter?

The formulation and implementation of corporate strategy is a field of study that law students—initially surprised at the intellectual challenge of the business leadership and the technical, organizational, and human skills required—would find intensely interesting. But beyond this provincial suggestion, let me conclude with the hope that supporters of the Draft interpret the controversy over the ALI Draft, not as the outraged defense of inescapable privilege, but as a sign of a widening gulf that must be narrowed and bridged. The worlds of management and the law are too important to be at war. Social justice and freedom of initiative are two of the most important objectives of a democratic society. The problems of legitimacy, professional competence, and professional responsibility, in both worlds, have multiplied in complexity to exhaust the usefulness of old models from economics and political science. We should mount a serious inquiry from the combined points of view of law and management into the nature of these problems. We should not poke at them with white canes.