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Corporate Governance: A Director's View

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Corporate Governance: A Director's View*

BRYAN F. SMITH**

The Draft Restatement prescribes the composition and activities of boards of directors. Based on his experience as a member of several corporate boards, the author is convinced that these requirements would have a harmful impact on corporate governance.

The Draft Restatement impedes directors' responses to the corporation's needs by stipulating the number and role of independent directors and mandating monitoring activities, by requiring a "rational basis" for business judgments, and by relaxing procedural barriers to derivative suits. These formal requirements emphasize restraint at the expense of effective governance. The board of directors should remain free to meet the changing demands of the modern corporation.

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I. INTRODUCTION

So much has been written on corporate governance that one fears undue repetition. Yet, additional insight may be gained from a look at the problems involved in creating an effective board

* The author gratefully acknowledges the invaluable contributions of Richard L. Joosten and James H. Johnson.

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structure from the point of view of one who has served on the boards of several very different corporations and participated in intense debate among the academic community, the corporate world, and the general public concerning the internal structure and governance of the corporation.

From the boardroom, the problems of choosing the next chief executive officer, setting up and participating in an effective committee structure, monitoring top-level management, and participating in strategic planning decisions are not abstract concepts. A board is composed of individuals, and the process by which these problems are resolved is a very dynamic and organic one.

Last year alone my duties as a director required attendance at regular meetings of the board, many meetings of various committees, and innumerable small conferences on board-related matters. Decisions were made regarding buildups and layoffs, the replacement of chief executive officers (both planned and unplanned), reorganizations, innovative financing and strategic directions. In one instance, a compensation committee on which I served authorized annual compensation of a million dollars per year to a corporate officer. These matters involved the exercise of the business judgment, intuition, and experience of each of the directors called upon to consider them. During the last five years the Texas Instruments ("TI") board has authorized over \$1.8 billion in capital expenditures, issued debentures valued at \$200 million, authorized over \$750 million for research and development, and monitored the investments of a pension fund valued at \$400 million.

Today's board members must face such troublesome issues as terrorism, crime, and the adequacy of the corporation's reserves in an unstable international economic environment. Compliance with both the letter and the spirit of complex laws, such as the disclosure requirements of the Securities and Exchange Commission ("SEC"), is another area of constant concern. In short, when we discuss corporate governance, we must never lose sight of the fact that this "institution" of the corporate board is a dynamic organization, and one that imposes tremendous responsibilities and obligations upon the individuals who are elected to serve.

The modern corporation can be an incredibly complex institution. Thousands of business decisions are made every day at various levels within the management structure, which is organized through mechanisms of delegation and review to promote efficient use of the corporation's resources. The interface among shareholders, management, and the board of directors, and the role of each

in the overall structure of the corporation, cannot always be readily described or even identified.

Generalization tends toward oversimplification. In fact, the very diversity of what has been described as the corporate "cultures" makes it highly improbable that any one set of structural mandates could be imposed on even a discrete segment of the corporate world without a significant disruption of those cultures.¹ These corporate cultures are only partly the product of the formal structuring of the relationships among management, directors, shareholders, employees, and others. They are often equally keyed to the individual personalities of the chief executive officers ("CEO's"), or to the personal interaction among the CEO, management in general, and the board. Often it is the board itself that is in a position to protect and preserve the continuity of a successful corporate culture during changes of upper-level management. The balance between board and management can be quite delicate at times, and any wholesale attempt at imposing a set of duties on the workings of the boardroom will likely result in the disruption and perhaps even in the destruction of that balance.

Nevertheless, the concept of formulating an ideal set of guiding principles for what has become known as corporate governance appears to be one that appeals to many and that refuses to go away.

II. HISTORY OF THE DEBATE AND THE EMERGING CONSENSUS

During the past decade corporate governance has become a topic for heated debate. The American Law Institute's *Principles of Corporate Governance and Structure: Restatement and Recommendations* ("Draft Restatement")² represents the latest addition to the extensive body of commentary and analysis of corporate structure. Departing from the traditional task of synthesizing and codifying existing legal principles, however, the Reporters have fashioned a document that is more statement than restatement.³ The document uses such normative phrases as "corporate law should provide" and "as a matter of good corporate practice."⁴

1. For an interesting treatment of the importance of corporate culture, see T. DEAL & A. KENNEDY, *CORPORATE CULTURES* (1982).

2. *PRINCIPLES OF CORP. GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS* (Tent. Draft No. 1, 1982) [hereinafter cited as *RESTATEMENT*] (available from American Law Institute's Executive Office, Philadelphia, Pa.).

3. *Id.* introductory note at xxi.

4. The following is just one example:

In his foreward to the Draft Restatement, American Law Institute (ALI) Director Herbert Wechsler characterizes the Restatement as the fulfillment of the early expectations of Louis Loss, who had stated: "The new art form that I would hope would evolve would be a combination of classic restatement, forward looking guidelines, and perhaps also model provisions — without having a model code."⁶ To understand this "new art form" and to evaluate its potential significance, it is helpful to explore, at least briefly, the context of the debate of which it is a product.

A. *The Corporate Accountability Debate*

Although in some ways the debate surrounding the Restatement echoes the corporate reform literature of the first half of this century,⁶ the current corporate governance debate can best be understood by reviewing the events of the last decade. The growing importance of such public issues as pollution and the environment, consumerism, and civil rights in the late 1960's and early 1970's led to the enactment of hundreds of new regulatory restraints on business enterprises. The revelations of Watergate and instances of corporate bribery and corruption represented to many a breakdown of effective control in certain elements of American business. The general spirit of distrust of powerful institutions that had been developing throughout this period was now increasingly appearing as an antibusiness sentiment. Equity Funding and other corporate disasters, such as the collapse of Penn Central, contributed to a climate of distrust and suspicion of the operation and integrity of American business. Public perception of business, as reflected in public opinion polls, was at an all-time low.⁷

Scores of books and academic articles were published, all of

§ 3.03. Composition of the Board of Directors

(a) *Corporate law should provide that at least a majority of the directors . . .*

(b) *As a matter of good corporate practice, a publicly held corporation . . .*

Id. § 3.03(a)-(b) (emphasis added).

5. *Id.* foreward at ix (quoting Loss, *Concluding Remarks*, in COMMENTARIES ON CORPORATE STRUCTURE AND GOVERNANCE: THE ALI-ABA SYMPOSIUMS 1977-1978, at 555 (D. Schwartz ed. 1979) [hereinafter cited as COMMENTARIES]).

6. See, e.g., A. BERLE & G. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932); Berle, *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931); Dodd, *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932).

7. "For example, in mid-1975 'Big Business' had a 61% negative confidence rating. Business in general had a 48% negative rating. These negative ratings were strongest among young educated persons." Greenough & Clapman, *The Role of Independent Directors in Corporate Governance*, 56 NOTRE DAME LAW. 916, 917 n.7 (1981), (citing G. GALLUP, *THE GALLUP POLL: PUBLIC OPINION 1972-1977*, at 529 (1978)).

which had as their principal theme the failure of the board of directors, both as a legal entity and as an element of corporate governance, to fulfill its function.⁸ The SEC, particularly through the activities of its then-Chairman Harold Williams, produced a steady stream of speeches, reports and proceedings that publicized the Commission's views regarding the diligence expected of directors of a publicly held corporation.⁹

Legislation, including the Corporate Democracy Act of 1980¹⁰ and the Protection of Shareholders' Rights Act of 1980,¹¹ was introduced in Congress. Private sector groups, like the Business Roundtable and the American Bar Association Committee on Corporate Laws, responded with contributions such as the *Corporate Director's Guidebook*¹² and the *Statement on Corporate Responsibility*.¹³ With the onset of the economic troubles of the early 1980's, the clamor for reform decreased in intensity, but beneath the surface calm there remained an active, sometimes heated, debate among those who proposed one or another reform, or no reform at all.

B. The Consensus

One result of this debate was the gradual emergence of a rough consensus concerning the proper function of the board and its role in correcting and preventing the kinds of abuses that had been occurring. Within the traditional corporate structure concept of assuring profit maximization, the board became "identified as the entity within the corporation which could and should perform

8. See, e.g., COMMENTARIES, *supra* note 5, *passim*; CORPORATIONS AT THE CROSSROADS: GOVERNANCE AND REFORM (D. DeMott ed. 1980); M. EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS (1976); Ruder, *Corporate Governance: An Analysis of Duties, Attacks, and Responses*, 4 DEL. J. CORP. L. 741 (1979) (sources cited therein).

9. For a concise enunciation of Harold Williams's views on the directorship, see H. WILLIAMS & I. SHAPIRO, POWER AND ACCOUNTABILITY: THE CHANGING ROLE OF THE CORPORATE BOARD OF DIRECTORS (1979) (The 1979 Benjamin F. Fairless Memorial Lectures).

10. H.R. 7010, 96th Cong., 2d Sess., reprinted in *Protection of Shareholders' Rights Act of 1980: Hearings on S. 2567 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs*, 96th Cong., 2d Sess. 360 (1980) (introduced by Congressman Rosenthal of New York).

11. S. 2567, 96th Cong., 2d Sess., 126 CONG. REC. S3754 (daily ed. Apr. 16, 1980) (introduced by Senator Metzenbaum of Ohio).

12. Committee on Corporate Laws, ABA Section of Corporation, Banking and Business Law, *Corporate Director's Guidebook*, 33 BUS. LAW. 1591 (1978) [hereinafter cited as *Corporate Director's Guidebook*].

13. THE BUSINESS ROUNDTABLE, STATEMENT ON CORPORATE RESPONSIBILITY (1981); see also Committee on Corporate Laws, ABA Section of Corporation, Banking and Business Law, *The Overview Committees of the Board of Directors*, 34 BUS. LAW. 1837 (1979).

a monitoring role to prevent such conduct [activities violating law] from reoccurring and to replace management not performing up to established goals."¹⁴ Central to this idea is the concept of an "independent" board acting in part as the legitimizer of corporate power in society. This role is anchored in the duty of the board to monitor management decisions and to act as the conscience of the corporation by considering the larger questions of the corporation's role in society and the need for ethical and socially responsible conduct by the corporation both in its "external" business activities and in its internal culture.

Increasingly, commentators have assigned the board a role in the strategic planning process, tying this role to the board's obligation to consider the long-term effects and the full consequences of corporate actions.¹⁵ This role is also seen as rooted in the board's independence and unique semi-autonomy within the overall corporate structure—an autonomy that gives it a fresh perspective on the long-term strategic impact of corporate decisions.

The duty of the board to select top management is another universally recognized function. This power, and the power to replace management, enables the board to oversee managerial performance of the wealth-maximizing tasks, as well as to monitor for compliance with the law.

Together with this view of the function of the board, the corporate governance debate has produced a rough agreement on certain principles of corporate governance that should ensure the proper execution of the board's functions. An essential element of this understanding is the concept of independence. The American Bar Association Committee on Corporate Laws, the Business Roundtable, the Metzenbaum and Rosenthal legislation proposed several years ago, former SEC Chairman Harold Williams, and now the ALI Reporters have all endorsed the idea of an independent board.¹⁶ This concept is based on the belief that board members whose judgment is unaffected by business ties or personal employment concerns can best carry out the monitoring function.

In addition to independence, all agree on the need for an in-

14. *The World of the '80's—1980 Annual Meeting Program of the Section*, 37 BUS. LAW. 203, 229 (1981) (comments by Edward F. Greene concerning corporate governance).

15. See, e.g., Lear, *Getting the Board into the Strategic Planning Program*, DIRECTOR'S MONTHLY, Nov. 1982, at 1.

16. Ruder, *Current Issues Between Corporations and Shareholders: Private Sector Responses to Proposals for Federal Intervention into Corporate Governance*, 36 BUS. LAW. 771, 775-77 & nn.19-29 (1981) (discussion of independent board concept).

crease in time spent by directors on corporate affairs. Sufficient remuneration to reflect the increased demands of a more active role for the board, as well as to ensure that the board can attract and retain qualified individuals, is another necessity. This increased involvement can be effectively implemented through the use of committees, which can focus attention on limited key areas such as corporate audits and board nominations. The committee experience should thereby help to ensure adequate exposure and knowledge on the part of directors.

C. *Business's Response to the Challenge*

The most notable aspect of the debate that has occurred during the past decade is not that the debate has resulted in a fairly coherent theory of the role of the board, but instead, that most corporations have voluntarily implemented so many elements of this theory. The empirical data assembled in the past few years by Heidrick and Struggles, Korn/Ferry, Hay Associates, and others are compelling.¹⁷ There has been a marked increase in the number of corporations preferring that a majority of directors be "independent" of management.¹⁸ There are also more boards with audit, compensation, nominating, and public policy committees composed of a majority of such "independent" directors.¹⁹ One study of the rapidly evolving corporate governance structure of American corporations calls this rise in the importance of committees "the most significant change in board structure."²⁰ The time spent by

17. While definitional differences make exact comparisons between data generated by different sources difficult, the trends shown by the various studies are identical. A 1981 Korn/Ferry report indicated that an average of nine out of thirteen board members, or about 70%, were "outside" directors. KORN/FERRY INTERNATIONAL, BOARD OF DIRECTORS: EIGHTH ANNUAL STUDY 3 (1981). An August 1980 survey of large industrial companies indicated that outside directors constituted a majority of boards of directors at 88% of the responding firms. Wall St. J., Nov. 3, 1980, at 33, col. 3. The 1983 Heidrick and Struggles study of the Fortune 1350 companies, which used a narrow definition of "independence," showed that 59% of all directors were "independent" in 1982, as compared with 54% in 1980. The study revealed also an increased use of committees of the board. Audit committees were found in nearly 100% of all companies, compensation committees in 98%, nominating committees in 79%, finance committees in 65%, and corporate responsibility committees in 36%. The comparable percentages for 1976 were 93%, 85%, 9%, 33%, and 5%, respectively. HEIDRICK & STRUGGLES, INC., THE CHANGING BOARD (1983), cited in Deloitte, Haskins & Sells, The Week in Review, Feb. 4, 1983, at 1-2.

18. KORN/FERRY INTERNATIONAL, *supra* note 17, at 3, 10.

19. *Id.* at 12.

20. Cox, *Facing Major Issues in Corporate Governance*, DIRECTOR'S MONTHLY, Oct. 1982, at 1, 3 (citing ARTHUR YOUNG EXECUTIVE RESOURCE CONSULTANTS, THE NEW DIRECTOR: CHANGING VIEWS OF THE BOARD'S ROLE (1981)).

outside directors both at committee and board meetings and in preparation for them has been increasing, reaching an annual average of more than fifteen days, according to a 1981 report.²¹

D. *The Independent Director Movement*

Of course, an honest assessment of board independence and effectiveness in its new roles must look behind these statistics and address the harder question of how an individual board works. Thus, it may be helpful to touch on some of the possible causes of the private sector's apparent swing away from the "rubber stamp" and toward an independent, active board of directors.

The threat of federal intervention may have influenced some corporations to adopt structural changes simply to keep the government out of corporate affairs. Harold Williams, anticipating a movement toward federal legislative action, urged business to take measures calculated to defuse federal intervention.²² These warnings, no doubt, opened a few eyes to the need for an analysis of the existing corporate governance structure. Yet, it would be misleading to characterize the recent broad-based evolution as a mere reaction to a perceived threat of federal intervention.

Active and effective boards of directors certainly existed prior to the recent corporate governance debate. Many corporations, including Texas Instruments, have long realized that the increasing complexity and competitiveness of the modern business world demand full use of all corporate resources, including the board of directors. Critics of the corporate world studied the most effective boards very little because their attention was naturally drawn to newsmaking corporate abuses. The directors' constituents—the shareholders—demonstrated a notable lack of interest in the debate and on the whole appeared to be satisfied with the existing structure. Within the corporate circle itself, some of the more significant experiments in the use of the board came in the area of

21. KORN/FERRY INTERNATIONAL, *supra* note 17, at 8.

22. Williams wrote:

I oppose federal legislation or regulatory action to charter corporations, to dictate board structure, or even to impose my own suggestions. My goal is to highlight my sense of urgency that corporations, their managements and boards assume that initiative in assessing the responsibilities of corporate boards and how they might better be carried out so as to strengthen the case against legislation, and make it unlikely — not to hasten its passage. While some apparently believe that legislation is the key to reform, I am concerned that federal encroachment into the board room would likely cripple rather than strengthen its functioning.

H. WILLIAMS & I. SHAPIRO, *supra* note 9, at 21.

strategic planning, not in the area of monitoring and oversight. This is not to suggest, however, that the public corporate accountability debate itself did not contribute to the growth of the genuine independence and vitality of corporate boards. The impact of the dynamic, free exchange of ideas on corporate governance is undeniable. It is now widely accepted that the board ought to function as a key element of corporate governance and as a protector against the kind of corporate mismanagement that was roundly denounced in the 1970's.²³

The evolution of the corporate board revealed by the various surveys and studies should demonstrate to those critics of the existing corporate governance structure that the business world is open to change. Indeed, all corporations actively seek to improve the effectiveness of their boards of directors. Nevertheless, it would be a mistake to assume that if eighty percent of today's boardrooms hold a majority of "independent" directors (however that term is defined), an effort should be made to bring the remaining twenty percent into that same position. Although independence is valuable, committees are useful, and monitoring is a proper function of the board, the requirement that every board conform to a particular model or set of standards presumes that there is a single model that will produce the most effective board for all corporations. I do not believe that such a model exists.

As today's boardrooms experiment with new techniques of governance, all of which are aimed at achieving the goal of promoting a more effective role for the board, we are learning more about the utility of the structural proposals brought forth in the debates of the last ten years. This process of experimentation and evolution holds the real promise for progress in the area of corporate governance.

E. *The ALI Proposal and the Need for Flexibility*

The theories that have emerged from the recent corporate governance debate, although extremely useful in providing guidelines to corporate boards, are limited by the fact that no two boards, and no two corporations, are the same. Each board must identify its goals, help define its function, and then set out to implement

23. "[T]hose interested in the future of our corporations must soon take or support affirmative and constructive steps that will provide greater accountability — more effective monitoring of decisional processes — or run the risk that possibly excessive measures may eventually be taken by legislative bodies reacting to the societal expectations." Kroll, *Introduction by the Chairman*, in COMMENTARIES, *supra* note 5, at 30, 31.

whatever formal structures it believes necessary to meet those goals and fulfill that function. Unless the board is motivated by an internal commitment to achieve excellence, no amount of formal structuring will bring about that excellence.

It is equally important to realize that the problems of corporate governance require flexibility of response on the part of the board even when the commitment to excellence already exists. I currently serve on the boards of two corporations engaged in two very diverse businesses. One board has a majority of "independent" directors, and the other is composed primarily of "insiders." The latter functions every bit as effectively as the board having a majority of "independent" directors.

A recent article by Kenneth Andrews²⁴ examined the ALI proposals and concluded:

The case against formalizing into law the proposed definition of board function, formal committee structure and composition, the substantial modifications of duty of care, the business judgment rule, and the termination conditions for derivative actions is shaped by the answers to these questions:

1 How much do the ALI authors know about how boards actually work, what is reasonable to expect of outside directors, how business judgments are arrived at, and how progress is made in making management of complex corporations more effective and responsible? How responsive have they been to their advisers from business, management, and boards of directors?

2 What is the probable effect of the proposals for new law on the actual functioning of boards of directors, on the decision-making process, and on the evolution in board practice now under way?²⁵

These are excellent questions, and crucial ones. Although the individual elements of the ALI proposal can be attacked and debated, it is perhaps more important to step back from that debate and explore the implications of the Restatement's proposed blueprint for the law of corporate governance. The Reporters must consider the questions Mr. Andrews has posed, and they must respond to the answers they receive.

24. Andrews, *Rigid Rules Will Not Make Good Boards*, HARV. BUS. REV., Nov.-Dec. 1982, at 34.

25. *Id.* at 36.

III. THE TEXAS INSTRUMENTS EXPERIENCE

Perhaps the best way to illustrate the evolutionary process by which many corporations have instituted changes in their governance structure is to present a case history. One example of an internally generated reform of board structure is that of Texas Instruments. Back in 1966, Pat Haggerty, then TI's chairman, observed that it was time "to do some real pioneering in the structuring of a board of directors."²⁶ Haggerty recognized the need, especially in volatile technology-intensive businesses, of a mechanism at a very high level for objective deliberations on questions of basic corporate policy and direction.

At his urging, TI began to look to the board for an objective assessment of the changing opportunities presented by TI's rapid growth and complexity. The evolution of its board structure has continued slowly and deliberately since 1966. Various statements of policy and guidance memoranda formally adopted by the board express the principles developed with regard to the composition of the board and the responsibilities and time requirements of its members.

One stated objective of the company is that a majority of the board, excluding the chairman and the president, be individuals whose primary experience has been other than at TI. Ordinarily, only those board members who serve as chairman, vice chairman, president, or officer of the board are employees of the company. At present, two of our thirteen directors, the President and the Chairman, are TI employees, and four others have been employed with the company in the past.

Eleven of our board members are currently designated as general directors and as such are required to assume board duties with a minimum time commitment of approximately thirty days per year. These board duties include membership in or chairmanship of committees as well as optional additional activities in TI's direct interest. Actual annual time commitments for general directors range from thirty to seventy-five days, and corresponding fees, exclusive of expenses, range from \$46,500 to \$90,375.

Directors, as contrasted with general directors, are expected to spend fifteen days per year on TI business, including scheduled board meetings. The director's fee corresponding to the minimum fifteen-day commitment is \$23,250. Ordinarily, there will be no

26. P.E. Haggerty, Memorandum to Members of Board of Directors of Texas Instruments 4 (Dec. 15, 1966) (available at the *University of Miami Law Review* Office).

more than two or three persons serving in this capacity, and at present there are none.

The activities of the TI board members include attendance at monthly and special board meetings, attendance at corporate planning meetings, and occasional visits to TI plant and office locations. For example, during 1982 TI's directors were invited to conduct two separate two-week-long tours of all TI operations in Europe, Japan, and the Pacific Basin. To ensure the desired relationship between the board and operating organizations, TI expects most board members to attend some of the scheduled operating organization meetings, internally known as Quarterly Management Reviews, at which the activities and performance of the various product groups are summarized by management.

In the spring of each year, TI board members attend a strategic planning conference to discuss business opportunities for the next ten years. Managers present their assessments of long-range opportunities and goals and reassess their strategies for the realization of such goals. In an environment that allows for considerable give and take, board members evaluate management's allocation of the company's resources and the potential for profitable growth. After the conference, the board assesses these projections, in light of corporate objectives, so that necessary actions can be defined.

In addition, TI directors are encouraged to contact management outside normal board or committee meetings to discuss informally specific items of interest to them, such as product development, marketing, or financial matters. Obviously, carried to extremes, this might have a disrupting effect on the management. But we have found that it is possible to strike an appropriate balance on both sides, resulting in a very useful and constructive interchange.

In order to familiarize themselves with TI's operations, general directors often serve as directors of one or more of TI's subsidiary corporations. Such service not only reflects the TI board's interest in the affairs of its subsidiaries; it also demonstrates the board's concern for how the subsidiary corporations' activities may be viewed by various groups and institutions, including foreign governments, to which those subsidiaries are exposed. Serving on one or more board committees can be one of the most vital parts of a director's activities, because certain subjects can be pursued in greater depth. In particular, committee members can explore those areas that would be too time-consuming if pursued by the board of directors as a whole.

At TI, the committees of the board are expected to hold three to seven meetings of varying duration each year. Each general director is currently expected to devote approximately ten to eighteen days each year to committee work. Currently, we have five committees of the board: Audit, Board Organization and Nominating, Finance, Compensation, and Stockholder Relations. The review of long-range policy and planning at TI was formerly the province of the Corporate Objectives Committee, but it was recently decided that these matters should be considered by the full board.

According to TI written board policies, a primary criterion in the selection of candidates for general director, director, or officer of the board at TI is the ability to bring to the board a dispassionate point of view. In an effort to ensure that those board members with prior TI experience are able to develop and maintain the desired degree of independence, TI board policy provides that the selection of a former TI employee as a board member anticipates that he will enter into activities outside TI that will supplement his TI experience in a meaningful way.

These policies, and others designed to enhance the knowledge of TI's outside directors and the independence of its inside directors, are the product of TI's independent resolve. TI has resolved to establish a corporate board with a composition designed to guarantee that its primary function, ensuring that the affairs of the corporation are conducted in the best interest of the stockholders, is fulfilled within the context of the corporation's societal responsibilities.

I do not suggest that this is the ideal solution. TI's board practices may be inappropriate in other companies. But these practices have added precision to the distinction between the board and operating management and have fostered a deeper appreciation of the objective and independent viewpoints of board members. At the same time, these practices have effected a more fruitful interchange between board and management. TI's board spends a considerable amount of time on the job, and the fee schedule reflects this fact. But the key factor in its evolution has been TI's commitment to the proposition that the board ought to play an important role in the company.

The evolutionary process at TI has occurred without legislative or peer pressure. And the fact that a fundamental restructuring of the board began years before this debate became fashionable illustrates the responsiveness of the private sector to the perceived

benefits of a vital, independent board of directors.

IV. THE DRAFT RESTATEMENT: STRAITJACKETING THE BOARD

Although in many respects the recommendations of the Restatement Reporters for the structuring of an effective board have been anticipated by the evolution of the Texas Instruments board, it is important to recognize that the Draft Restatement differs from the TI model. The differences that exist reflect the impact of TI's internal culture and unique organizational needs upon its decision to implement one or another of the currently available organizational options.

A. *Section 1.24 and the Independent Director*

The divergent definitions of "independence" provide a useful example of the differences between the Restatement and the TI model. As I have mentioned, it has long been a policy of TI's board that each and every director be able to approach the task of governing the corporation with a dispassionate and independent point of view. The Restatement's definition of "significant relationship" is of critical importance to the project. Section 1.24 provides that a director has a "significant relationship" with the senior executive, and thus is not independent, if he is employed by the corporation or was so employed within the preceeding two years, if he is a close relative of such a person, or if he has potentially significant contact with the corporation through his ownership interests or employment by companies that have done any substantial business with the corporation.²⁷ Those board members who have such a relationship to the corporation are relegated to a less significant role on the board. They must constitute the minority of the board of large companies.²⁸ They cannot serve on the audit committee,²⁹ and they cannot dismiss derivative actions against corporate fiduciaries.³⁰

Unlike the ALI proposals, TI board policy does not automati-

27. RESTATEMENT, *supra* note 2, § 1.24.

28. *See id.* § 3.03(a):

Corporate law should provide that at least a majority of the directors of a large publicly held corporation . . . shall be free of any significant relationship . . . with the corporation's senior executives, . . . unless a majority of the corporation's voting securities . . . are owned by a single person . . . or a family group

. . . .
Id. (citations omitted); *see also id.* § 3.03(b) (inside director limitations for smaller publicly held corporations).

29. *Id.* § 3.05(a)(1).

30. *Id.* § 7.03a(ii), b(i), c(i), e.

cally relegate persons such as recently retired officers or employees to a subordinate role on the board. Instead, TI seeks to assess each individual's capacity for independent judgment. This policy is akin to that adopted by the New York Stock Exchange, which leaves it to the board to determine the independence of a proposed new director and the significance of his contacts with the corporation he must direct.³¹ Not only does this approach have the inherent benefit of increased flexibility; more importantly, it allows those candidates who may be able to bring valuable experience to the board an opportunity to share that experience without reference to some preset formula for membership. Although independent judgment is indeed an important quality, the mechanistic application of a rigidly defined concept of independence may actually impair the functioning of the board by excluding, at least from positions of responsibility, board members with valuable first-hand management knowledge of the corporation. As one commentator has noted:

When one eliminates from consideration all interested people, one must then consider who is left. Disinterested directors, by definition have little or no personal contact with or knowledge of the company, have little reason to be knowledgeable about the industry in which the company operates, and do not have a substantial economic interest in the success of the company.

It is very difficult to know very much about a company with which one has no business relationship. If the hypothesis of disinterest excludes all past or present employees of the company, its competitors, customers and suppliers, almost everyone who knows much about the corporation's business must be excluded.³²

This may overstate the case, and the point here is not that independence is a concept without merit, but that there is danger in a too narrow application of that concept. This objection applies equally well to other elements of the ALI proposal, perhaps most particularly to the rigidly cast monitoring role of the board.³³

31. Ruder, *supra* note 16, at 776 & n.24.

32. Letts, *Corporate Governance: A Different Slant*, 35 BUS. LAW. 1505, 1514 (1980).

33. See RESTATEMENT, *supra* note 2, § 3.02(a) (board of directors to monitor the corporation for compliance with corporate plans, policies, standards, and objectives); see also *id.* § 3.02(a) comment a, at 59-60 (comparison of present law with section's monitoring provisions).

B. Section 3.02(a) and the Monitoring Model

Although the monitoring function of the board is universally recognized, mandating a monitoring structure for all corporations may have undesirable consequences. The ABA Subcommittee of the Committee on Corporate Law Departments, charged with reviewing the Draft Restatement, noted that once the flexibility of the board to define its oversight function is removed, the "courts are free to conclude, after the fact, that the directors do not have such flexibility and must conform to rigid requirements—nowhere precisely spelled out—in all cases."³⁴ The emphasis placed on the duty of the board to monitor management controls much of what is in the remainder of the Restatement. For example, the compositional requirements of Restatement section 3.03³⁵ are said to "flow from" the monitoring model embodied in section 3.02.³⁶ The compositional requirements and the "independent" nominating committee, as defined in section 3.06, are intended to provide "a board that can objectively evaluate the performance of the senior executives,"³⁷ while the audit committee, defined in section 3.05, is intended to furnish "an accurate and reliable flow of information to the board concerning that performance."³⁸

Although theoretically appealing, this formulation is not only overly simplistic, but it also fails to recognize the need for flexibility in board function to meet the demands of an everchanging business environment. The Business Roundtable has noted:

Some successful companies have been headed by a strong chief executive officer aided by a competent board filling an advisory and consultative role. Other boards have been required by circumstances to take an active role in management of the company's affairs over time in order to meet the problems of a particular period in corporate history, going far beyond a monitoring role.³⁹

The structure of many of today's boards would fall between the extremes of the monitoring and the managerial models. The very fact that these boards are free to adjust their operations as

34. American Bar Association, *Report of the Subcommittee on the American Law Institute's Proposals on Corporate Governance of the Committee on Corporate Law Departments*, DIRECTOR'S MONTHLY, Dec. 1982, at 1, 4 n.7.

35. See *supra* note 28.

36. RESTATEMENT, *supra* note 2, § 3.03 comment c, at 73.

37. *Id.*

38. *Id.*

39. Sigler, *The Business Roundtable*, DIRECTOR'S MONTHLY, Dec. 1982, at 5, 5.

circumstances warrant contributes to their effectiveness. It may be true that the oversight function should be of paramount importance to most corporate boards most of the time. But by mandating that function as the central role for all boards at all times and by building a network of obligations and liabilities around that role, the Draft Restatement may foreclose the use of more effective board structures and discourage experimentation with board activity in areas that are not purely monitoring.⁴⁰ Directors have a role to play in the resolution of substantive business questions. Isolating them from the business operations of the corporation and from the management responsible for the daily conduct of these operations through a too strict adherence to a monitoring model would be a mistake. Former SEC Commissioner A. A. Sommer, Jr. has noted that "[u]nless we emphasize the economic functions of directors, there is the danger that we will overload the system with policing functions to the detriment of the economic functions of the officers, directors, and others who are involved in the corporate governance process."⁴¹

In addition to inhibiting the board's involvement in strategic decisionmaking, the narrow monitoring role mandated by the Draft Restatement would tend to create a barrier between management and the board that could lead to antagonism and the increased isolation of the board. This could ultimately lead to ineffective performance of the monitoring function itself.

C. *Section 4.01(d) and the Business Judgment Rule*

Section 4.01 of the Draft Restatement, which establishes a duty of care and codifies the business judgment rule, possesses further problems. As stated by the Reporters in the commentary to the duty of care section, "there has been confusion in the cases and commentaries as to the proper standard for judicial review of a de-

40. In January 1981, Texas Instruments announced the formation of an international board advisory council to assist the TI board of directors on a wide range of political, economic, and social issues. This council spends 15 to 30 days a year advising the board as well as consulting with TI managers in particular areas of council members' expertise. Council members sometimes serve as directors of TI subsidiaries, particularly outside the United States, and are often able to bring a new perspective into both board and managerial discussions of important policy issues. This unique experiment, together with the recent efforts of many corporations to involve the board in the strategic planning process, provides a ready example of the kind of innovation that may suffer a "chilling effect" from the enactment of a rigid, monitoring model.

41. Sommer, *Should Corporation Laws Function to Restrain Antisocial and Illegal Conduct?*, in COMMENTARIES, *supra* note 5, at 255, 259.

liberative business decision."⁴² The Reporters apparently believe that by suggesting that "corporate law should provide"⁴³ for adoption of the Restatement's version of this standard, this confusion will disappear. Although the Reporters repeatedly assert that the formulation of the duty of care and business judgment rule contained in section 4.01 is consistent with present standards in "the overwhelming majority of states,"⁴⁴ the uproar emanating from the business community would suggest that a reasonable person could perceive a difference between the Restatement language and existing standards.

Under section 4.01(d), a director or officer is not subject to liability under the duty of care standard if he "(1) informed himself and made reasonable inquiry with respect to the business judgment; (2) acted in good faith and without a disabling conflict of interest; and (3) had a rational basis for the business judgment."⁴⁵ The scope of this "rational basis" test is the subject of some concern. If it is possible for a director to reasonably inform himself and act in good faith, but without a rational basis, then it would appear that the threat of unfair hindsight review of an unsuccessful business decision has been increased. This increased threat, or even the perception of such an increase, can only have the effect of stifling innovation and venturesome business activity.

The business judgment doctrine should not be viewed merely as a tool for shielding directors from potential liability; it is a positive statement on the part of the courts that in matters of business those who make the decisions must be assured of their freedom. An article appearing in *The Wall Street Journal* of June 21, 1982, examined the concept of "business intuition" and noted that "in business, decisions based on shrewd intuition are often superior to those based on careful analytical reasoning."⁴⁶ The authors observed also that "[i]ntuition, of course, can lead to just as many mistakes as rational logic can. By definition, creative intuition cannot be the product of a formula."⁴⁷ Although the great majority of business decisions are not of this "creative intuition" variety, the

42. RESTATEMENT, *supra* note 2, § 4.01(a) comment d, at 209.

43. *Id.* § 4.01.

44. *Id.* § 4.01 comment a, at 142; *id.* § 4.01 reporter's note 1, at 164-65. For a detailed chart setting forth duty of care formulations and their sources for each state, see *id.* § 4.01 reporter's note 1, at 166-70 (appended chart).

45. *Id.* § 4.01(d).

46. Feinberg & Levenstein, *How Do You Know When to Rely on Your Intuition?*, *Wall St. J.*, June 21, 1982, at 16, col. 3.

47. *Id.*

Restatement's emphasis on an "informed inquiry" and "rational basis" threatens the freedom of action required for creative decisionmaking.

The uncertainty generated by this "rational basis" requirement and by the Restatement's exclusion of vaguely defined "non-deliberative"⁴⁸ decisions from the rule's protection promises to have a negative impact on today's boards. The predictable response of many directors to a perception of increased exposure to liability would be to shun the risk-taking that is essential to effective corporate governance and to use valuable time to examine insignificant corporate actions. Moreover, the task of attracting and retaining persons who have the requisite talents and dedication to serve on corporate boards will become even more difficult.

D. Remedies and Derivative Actions

The reliance of the Draft Restatement on structural devices, restrictive definitions, and threatened liability reveals a dangerous misunderstanding of the true limitations on the effective functioning of the board. Most directors would agree that the biggest single obstacle to the successful involvement of the board in its many obligations is the limited time available. By providing for the relaxation of the procedural barriers to derivative actions, the Draft Restatement's sections on remedies would create further demands on the board's time.⁴⁹ Statutory prescriptions of directorial and committee functions and mechanical procedures for terminating derivative lawsuits tend to focus the board's attention on adherence to the letter of the law rather than on the business at hand. These requirements will lead to more levels of review, more hollow procedures, and more lawyers. The increased likelihood of director liability as a result of a stiffened business judgment rule, whether actual or apparent, can only add to the problem. The concern will be with "papering the trail" to show that the board addressed corporate plans and policies. The expense of such a course is loss of the time and freedom required to assess the workings, the direction, and even the risks the corporation is taking in the process of building its future.

48. See RESTATEMENT, *supra* note 2, § 4.01 comment a, at 144-47.

49. "[A]lthough the procedural complexity surrounding the derivative action is the product of legitimate concern about exposing corporate fiduciaries to excessive risks of liability, these procedural barriers frequently involve an unnecessary degree of overbreadth which chills meritorious and non-meritorious actions alike." *Id.* § 7.02 comment a, at 259; see also *id.* § 7.02, at 254 (general procedural requirements for derivative actions).

E. *Misplaced Reform*

Given the advances that have already been made in the redefinition of the board, and recognizing the process of experimentation and change that continues today, those who would impose the kind of potentially harmful reforms that are contained in the Draft Restatement must ask themselves: Are mandated reforms really desirable?

The value of healthy, productive business to our society requires no elaboration. At some point, the internal efficiency and flexibility that have made American corporations such successful institutions can be diluted or burdened to a point at which they can no longer function effectively. To those who would claim that the corporation is in need of the kind of rigid rules proposed by the Restatement Reporters, it must be pointed out that corporations are already subject to the constraints of the marketplace and to the demands of consumers and shareholders. As one corporate commentator has noted:

[W]hen it comes to constraints other than the economics of the market place, existing regulatory agencies influence corporate conduct far more than is commonly recognized. The EPA, DOE, SEC, IRS, FCC, NLRB, EEOC, OSHA, Justice, FTC, Treasury, Interior, and a host of other governmental agencies constantly confront the corporate executive. We also respond to consumers, employees, the media, and politicians, and to many other pressure groups.⁵⁰

Many of those who propose a mandated reform of corporate governance appear convinced that the abuses that have occurred in the past are not aberrations, but are somehow linked to the structural organization of the board. These reformers focus on perceived abuses of corporate power, some finding an absence of corporate social responsibility while others cite a lack of control over corporate actions resulting from the "race to the bottom"⁵¹ by state corporation statutes⁵² seeking to attract more corporate charters. All reformers appear to agree that legal restraints must be imposed upon the corporation, and the Draft Restatement is consistent

50. Farrell, *Corporations Are Already Overgoverned*, in COMMENTARIES, *supra* note 5, at 190-91.

51. Cary, *Federal Minimum Standards*, in COMMENTARIES, *supra* note 5, at 321.

52. For an excellent capsule summary of the opposing views of the "pragmatists" and the "reformers," see Werner, *Corporation Law in Search of its Future*, 81 COLUM. L. REV. 1611, 1650-53 (1981).

with this tradition.

What the advocates of reform fail to recognize is that it is to the advantage of everyone—shareholders, directors, managers, employees, and society at large—to maximize corporate profit. Shareholders, both individual and institutional, do recognize this fact and indeed have shown no interest in corporate reform movements, including those reforms that call for a return to some mythical “shareholder democracy.” The popularity of a Delaware charter has more to do with economic efficiency than with a desire for unfettered power. Existing laws work well. And although occasional abuses have occurred, the mandated reform of the structure of corporate governance, whether by federal chartering or by ALI recommended reform, threatens to halt the evolution of boards tailored to the real needs of corporations and society.⁵³ Progress toward that goal requires experimentation, flexibility, and freedom. Reginald Jones, the former chairman of General Electric, has said:

All the emphasis, in the discussion of corporate governance, is on the issue of constraints. This, I think, is characteristic of too much of the public debate today: We are more interested in restricting, constraining, watchdogging, than we are in enabling, encouraging, liberating, inspiring our people and our institutions to creative achievement.⁵⁴

V. CONCLUSION

The last decade has seen the corporate board's rapid development toward a greatly enhanced role: the increased use of committees, a new involvement in strategic planning, a renewed pursuit of effective monitoring, and generally more time spent by directors on the job of directing. The statistical surveys indicate all of these trends. This evidence, together with the movement toward increased remuneration to reflect the broader role of the board, is an important sign of progress in the area of corporate governance. The Draft Restatement now threatens this progress.

The progress that has already occurred in the redefinition of the board deserves a chance to continue to evolve through experi-

53. An interesting analysis of the flawed arguments used by many would-be reformers is found in Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259 (1982). Fischel contends that reformers perceive structural problems that do not in fact exist, concluding, “It is difficult to escape the conclusion that the corporate governance movement, despite its durability and widely held support, is much ado about nothing.” *Id.* at 1292.

54. Lorie, *An Economist's Perception I: A View on the Need to Revise Corporation Statutes*, in COMMENTARIES, *supra* note 5, at 60 (quoting Reginald Jones).

mentation in an atmosphere of freedom. A recent Business Roundtable commentary on the Draft Restatement concluded that the Restatement proposes significant changes in current law and objected to the presentation of such a proposal in restatement form.⁵⁵ The Roundtable concluded also that the structural changes proposed in the Draft Restatement would not achieve the objectives sought by the Reporters, but instead would "adversely impact upon the governance and performance of United States corporations."⁵⁶ The Roundtable Statement "urges that the ALI not proceed with its corporate governance and structure project in its present form."⁵⁷

On this there must be agreement. Those who call for reform have failed to demonstrate a corporate governance problem of a magnitude that would justify the mandated reforms proposed in the Draft Restatement. They have failed to consider the potential negative impact of such reforms on the performance of existing corporate governance structures. Finally, they have failed to recognize that experimentation, adaptation, flexibility, and freedom are critical to the continued evolution of effective techniques for governing the corporation.

55. 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). An encouraging indication that the concerns that have been expressed by many who have examined the Restatement are not being ignored is the news that the new part of the Restatement dealing with the duty of loyalty was not submitted to the membership of the ALI in May of 1983, as was originally planned, and nothing on the project is scheduled to go to the membership before the 1984 annual meeting.

56. *Id.* at 67.

57. *Id.*