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Panel Discussion*

Professor Mofsky: The first topic that I would like to raise for your consideration is the question of independent directors. Who are independent directors? How do we identify their independence? Why do we want to put them in control of a board, and what evidence do we have with regard to independent directors?

I am going to make a couple of assertions to which you may wish to respond. First, there is no organized empirical study that has demonstrated that so-called "independent directors" are in fact independent. Second, there is no body of empirical studies conclusively establishing that independent boards produce greater profits. I suggest that we are dealing with a phenomenon that is based upon guess work and questionable psychological theories. Now, having made those assertions, let us begin first with Professor Eisenberg.

Professor Eisenberg: I disagree with your conclusion, but not with your preliminary statements. Your preliminary statements are accurate; the only problem is that we would have to erase every statute from the books if we waited until we had conclusive empirical verification of the predicates of the statute. The fact is that the social scientists are not in a position to make conclusive empirical judgments or empirical conclusions on any major area of human activity that meets their own canons of reliability. Human activity simply involves too many variables. What we are talking about here is a sort of lifeguard function. There are a lot of very profitable corporations that do not have independent directors. We are not asserting that this is the critical aspect of corporate life. If you gave me a choice between two worlds, and in one of the worlds, boards were completely controlled by managers, but managers were really good (that is, efficient), and in the other, boards were completely objective—independent of managers—but managers were really bad, of course I would pick the first. But we do not have this either/or dichotomy. We can have a world in which we trust that managers will be good, but we can also have somebody sitting there watching their performance. There are

* The panelists were Professor Kenneth R. Andrews, Professor Victor Brudney, Professor Melvin A. Eisenberg, Mr. Nicholas deB. Katzenbach, Dean David S. Ruder, Mr. Bryan F. Smith, and Professor Marc I. Steinberg. The moderator was Professor James S. Mofsky.

good managers and there are bad managers, and what we are saying is that we want somebody around to protect against the one case in forty or one case in fifty where the managers are bad managers and ought to be removed. So your conclusion is a little like saying that we have two beaches next to each other, one has a lifeguard and the other has no lifeguard, but no one has drowned at either beach, so we should no longer have any lifeguards, because there is no empirical evidence that lifeguards save lives. I think we can use our judgment and our experience here—as we have to do in so many areas of law—and say that in the marginal case, in the incremental case, a board that is free of significant relationships with managers is more likely to weed out the really bad manager than is a board that is dominated by managers.

Professor Mofsky: I would like to ask Ken Andrews to address the question of independent directors.

Professor Andrews: Certainly it is true that there is no empirical evidence one way or the other, and so this becomes a provocative question. We have to relate the independence to the purpose of this definition. You have a formal definition of independence with which we are all familiar—not working for the company, not being related. I think we could carry that all the way forward to not knowing anything about the company or the industry or even being interested in the firm. That would be carrying independence to its absurd extreme. The formal definition is not of any particular interest, except for preserving the formal purity of the separation between inside and outside. It happens, of course, that independence becomes important, and it can occur in outside directors or inside directors, particularly if you have a venerable financial vice-president or executive vice-president or a relatively young CEO [chief executive officer] and a board of outside directors that knows them both. Such an inside director is independent because he does not feel insecure or suppressed and because he recognizes the difference between his or her role as board member and that of manager. Independence becomes important only in the context of a very basic problem in corporate governance and board management.

Our concern is the phenomenon of CEO dominance of the board. The chairman can dominate a board composed of so-called “formally independent directors” just as easily as he can dominate a board composed of insiders who report to him or are dependent upon him for their livelihood. So the real issue becomes the extent to which either inside directors or especially outside direc-

tors—because it is easier for them to disagree—can actually feel free to disagree.

Academicians are the second most frequent source of board members; chief executive officers of other companies are the preferred source. The one thing you can say about academic directors is that they do not tell you how they do things in their companies. There are outside directors who specialize in bringing their own experience into a board and disrupting its operation by not recognizing changes in circumstances. We do not mean that kind of independence. The ability to permit directors to be usefully independent is a function of the skill of the chairman, and we are very short of that skill.

Professor Brudney: I suppose the answer to your questions really is another question—In what context do you seek answers? You have used the concept of independence as though it means something. You have said that we have no statistics; maybe we ought to look at history to see how the concept of independent director originated.

The independent director originated not as a policeman of managerial efficiency or an assurer that management will perform well for the company. Instead, he originated in the context of conflict of interest. That is where independence first showed up, and the definition means something different in that context than it means in the next context in which it showed up historically. In the sixties and seventies, the independent director was urged as the representative of unrepresented “externalities”—environmentalists, ethnic groups, and the like. The meaning of that “independence” is quite different from the definition of independence for purposes of conflict of interest. Then along comes the Draft Restatement¹—and I think it is really an accident as to the part of the body of corporate law it happened to describe first—and it uses the term independent director not to cover representing outside constituencies in order to bring different social or economic points of view into the boardroom or resolving conflicts of interest among managers or among other directors inside the board, but to refer to the monitoring of the board for “efficiency” on behalf of the stockholders. Of all the roles, that role is the most difficult. I doubt that we have operating criteria by which to measure when management is performing minimally. I do not know

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

what "independence" means in the context of "efficiency." For instance, with regard to the CEO's of other organizations, will their empathy with the CEO on whose board they serve prevent them from being critical? With regard to academics, I do not know to what extent their institutional interests impede their service as diligent policemen.

In any event, the thrust of much of the talk here has been that what is needed are directors who will help firms to do better, not directors who will prevent them from doing worse. And if that is the objective, then we do not need much law. The reason for the law impinging on this area of corporate behavior or structure is to reduce the downside risks. We all recognize that the law cannot make companies perform better. The question is how should the law protect stockholders from managements that are doing poorly in matters of efficiency. And to that question the history of duty-of-care case law teaches that we have precious few answers. It is hard, if not impossible, to find cases in which directors have been held liable for lack of care in a nonfinancial company, except when management has been engaged in a conflict of interest that the directors have failed to police. I do not know whether there is a solution, nor do I know whether your statistics are going to prove anything.

Professor Mofsky: Just as a technical matter, Professor Eisenberg, you may want to point out that there may be a different definition of the term "independence" in connection with terminating derivative actions.

Professor Eisenberg: I do want to make that point. There was a statement made that directors who are not free of significant relationships with the senior executives, for purposes of board composition, also would not be considered disinterested for purposes of terminating derivative actions. That is not the case. For purposes of sitting on a committee that would investigate whether a derivative action should be terminated, the test is disinterestedness. And a director who has a significant relationship for purposes of part III of the ALI [American Law Institute] Draft might nevertheless be disinterested for purposes of parts IV, V, and VII.

Professor Mofsky: Mr. Katzenbach, would you care to address the independence of directors?

Mr. Katzenbach: Very briefly, just to discuss it from another slightly different viewpoint. People have talked about independent directors as meaning essentially nothing more than those who are not employed by the company and who are not related to the man-

agement of the company. Yet, those who are not independent in this sense can make a lot of contributions to how that company is run, particularly if they are chief executive officers of other companies and have had experience of this kind. Many times companies, even in obviously very different areas of business, have had the same experience. On the other hand, with respect to independent directors, if you attempt to select strong people because you think it is advantageous to the company, then you at least avoid some of the tunnel vision that you can get from people who are so engaged in the management of the company that they do not see some of the larger issues. I think there is a contribution that independent directors can make. That is not necessarily saying that they can improve, by some insight that they have, the bottom line on the profitability of that company. But they do have an enormously important function.

The reason I think that it is really advantageous to have a majority of independent directors is that, if a company is not doing well financially, the directors ought to be able to remove that management and try again with new people. And I think that the primary function of the board's independence is an ability simply to fire the manager. The board may pay him off very generously, but they do get rid of him. And directors exercise that power if they have been well-selected. Remember, when a company is not doing well financially, the internal management of the company loses some of the loyalty of the board, except in very rare situations. Therefore, they are likely to be informed about gross mismanagement. And I think that is the most useful function that independent directors perform; that probably could be said about university trustees, too.

Professor Eisenberg: I am in full accord; that is the major underlying theory of part III of the ALI Draft.

Professor Mofsky: I know Dave Ruder has thoughts on this subject.

Dean Ruder: I have some notes to add to the last topic. There is a difference between an independent board that provides a monitoring function in conflict of interest transactions and an independent board that functions with regard to management responsibility. It seems to me that if you draft standards for independence, you should ask whether there are some distinctions that should be drawn between these two functions. The purpose of having so-called "outside directors" should be to give them the responsibility of monitoring conflict of interest transactions. Also, as

Mr. Katzenbach suggested, outside directors should throw management out if management consistently is doing a bad job. Whether the standards for independence should be the same may require some additional thought.

In any event, there is not much to be gained by defining the outside director with the degree of strictness that the present Draft Restatement uses.² As I view that draft, its specificity results in almost as restrictive a definition as the Metzenbaum³ and Rosenthal⁴ bills contained. I prefer the New York Stock Exchange definition.⁵ You might take the position that you should not count someone as being an independent director if that person is employed by the corporation or has a current material investment, banking, or legal relationship with the corporation. The present draft goes further than that, and it seems to me to be too strict.

Professor Eisenberg: The definition in the ALI Draft is very close to what you just suggested. If you look at it carefully, the only people we pick up that you have not picked up are those who are in effect doing five percent of their business or \$200,000 worth, whichever is more, in the case of managers of vendors or suppliers, or \$200,000 worth of business, in the case of an owner of a vendor or supplier. Five percent of your business is a very high test. As to managers, the \$200,000 is not going to be the operational test, because in most cases that will not be five percent. So really, there are very few vendors or suppliers that those tests would reach, and the other categories are the tests you just mentioned.

Dean Ruder: No, you use "affiliated with" language: "affiliated in a professional capacity with corporate counsel . . . , or with an investment-banking firm that has been retained by the corporation, or acted as a managing underwriter in an issue of the corporation's securities, within the *two* preceding years"⁶

Professor Eisenberg: I thought you said that you would agree that—

Dean Ruder: I said, I do not know where I am on it. I could

2. See RESTATEMENT, *supra* note 1, § 1.24.

3. Protection of Shareholders' Rights Act of 1980, S. 2567, 96th Cong., 2d Sess., 126 CONG. REC. S3754 (daily ed. Apr. 16, 1980).

4. Corporate Democracy Act of 1980, 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).

5. See NEW YORK STOCK EXCHANGE, LISTED COMPANY MANUAL § 303.00 (1983) (audit committee membership).

6. RESTATEMENT, *supra* note 1, § 1.24(5) (citation omitted).

argue about it, but you may want to say that you do not want a lawyer to be the chief lawyer for the corporation and also to be on the board. There is a lot of room for argument there. But when you say, "I do not want anybody who is in this firm or was ever in this firm or was in this firm in the last two years," you go a lot farther. It seems to me that one has to be very careful in the definition of outside director.

More interesting to me is the question whether you can trust people. Perhaps I am more trusting than others, but when you get into the trust question, you are evaluating notions of goodness. I believe it is possible to trust independent directors. I know that the Investment Company Act works upon the belief that it is possible to use independent directors in dealing with potential conflict situations.⁷

Professor Mofsky: There have been some suggestions about eliminating directors entirely. Mr. Smith, would you like to address that question?

Mr. Smith: I would like to add a few quick comments. First, I do not know whether this would fit within the definition of empirical evidence, but some years ago a study was made by Professor Vance.⁸ His study concluded that those companies whose boards were composed of inside directors were more successful than those whose boards were composed of a majority of outside directors. The study is out of date, but I offer it to address the question regarding studies of that kind.

More importantly, I feel that independence is simply a state of mind. Some people have the ability to be independent, others do not. Definitions and standards of independence do not help much when independent directors are confronted with the dynamics of a very difficult boardroom situation.

The other point I would like to emphasize is how important it is for work to be done to enhance the qualities of leadership at the board level, not merely in technique but in the effective functioning of the board.

Professor Steinberg: I think the real reason for requiring independent directors is to obtain directors who have the ability to exercise impartial judgment on behalf of the corporation. One potential problem with this approach is that you want not only im-

7. 15 U.S.C. § 80a-15(c) (1982) (requiring, for approval of investment adviser's contract, vote or majority of directors who are not parties to the contract or interested persons of such party).

8. S. VANCE, *THE CORPORATE DIRECTOR: A CRITICAL EVALUATION* (1968).

partial judgment, but competent judgment. If directors without skill or experience are put on the board, then, as Professor Andrews implied, those directors are going to be very much dependent upon the insiders.

Traditionally, the definition of an independent director has excluded corporate insiders, such as officers, relatives of officers, and controlling persons of the corporation. I agree with Dean Ruder that the Draft Restatement goes significantly further by excluding such persons as major suppliers, investment bankers, and counsel to the corporation. The whole effort here, however, is to draw an appropriate line regarding which persons can exercise impartial judgment. I am not sure that the Draft Restatement draws the correct line, either. An argument can be set forth—and I am by no means endorsing it—that chief executive officers of other corporations, even if those corporations are engaged in totally different industries, are not independent. For example, such officers may well have been involved during their managerial careers in derivative suits, perhaps as defendants themselves. They are thus more likely to side with management of the corporation on whose board they serve for purposes of assessing the merits of the present litigation. As another example, what about golfing cronies? Although these individuals do not come within the significant-relationship standard of section 1.24, it would seem that close friends would agree on many issues. A further example is the case of college professors. The salaries of many college professors are in dire need of increase, and many corporations will pay substantial remuneration to a professor who serves as a director. These illustrations therefore go back to the basic question of where to draw the line.

An interesting statement was made by Judge Cudahy dissenting in *Panter v. Marshall Field & Co.*⁹ There, Carter-Hawley made a tender offer for Marshall Field, which Carter-Hawley subsequently withdrew prior to the offer becoming effective. At the time, Marshall Field stock was selling for approximately twenty dollars per share, while Carter-Hawley's offer was for approximately forty dollars per share. The directors of Marshall Field took the position that the tender offer was against the best interests of the corporation and its shareholders. The board thereupon engaged in a number of defensive tactics, which included the undertaking of defensive acquisitions, the filing of an antitrust suit against Carter-Hawley, and the issuing of a number of statements

9. 646 F.2d 271 (7th Cir.), cert. denied, 454 U.S. 1092 (1981).

to Marshall Field shareholders. The United States Court of Appeals for the Seventh Circuit affirmed the district court's holding that the directors' actions were protected by the business judgment rule. Apparently a major reason for the appellate court's holding was the fact that a majority of Marshall Field's board consisted of "independent outside directors."

Dissenting, Judge Cudahy said the following:

Directors of a New York Stock Exchange-listed company are, at the very least, "interested" in their own positions of power, prestige and prominence (and in their not inconsequential perquisites). They are "interested" in defending against outside attack the management which they have, in fact, installed or maintained in power—"their" management (to which, in many cases, they owe their directorships). And they are "interested" in maintaining the public reputation of their own leadership and stewardship against the claims of "raiders" who say that they can do better.¹⁰

In other words, I am suggesting that there is no easy answer. We are trying to balance the corporation's basic objective of profit maximization on the one hand with corporate accountability and governance on the other. The key criterion, therefore, is whether the director can exercise impartial and competent judgment. There is no clear answer to that question.

Professor Mofsky: It was asserted this morning that the concept of the board of directors was an evolving one. Someone also stated that it would be a mistake to restate the requirements with respect to the board of directors because to do so would decrease the flexibility needed to generate a board of directors that maximized the efficient operations of the firm. In that regard, Professor Eisenberg, I am sure you have a criticism.

Professor Eisenberg: Allow me to give some background here. One of the problems in discussing the ALI Draft at all is that it is in a process of evolution. The Draft has not been put to a vote by the general membership of the American Law Institute; it is being changed in response to comments we are receiving from the membership, advisors, consultants, and American Bar Association committees. So it is a little difficult either to criticize it or to defend it. I say that, because some of the criticisms we heard this morning regarding, for example, flexibility, were more relevant to

10. *Id.* at 300-01 (Cudahy, J., concurring in part and dissenting in part) (footnote omitted).

earlier drafts than to the present draft. Now if you study evolution, you find that there is a genetic code shared by every organism at every stage of evolution. That is to say, there are some base elements upon which the process of evolution builds. Similarly, the ALI Draft addresses only some base elements.

The ALI Draft says that the board should oversee the business of the corporation. This is not new. It would shock a lot of people if you told them that the board would not be derelict in its duties if it did not oversee the management of the corporation. To say that the board may sit back and have no responsibility to oversee management—that would be new, that would be radical. The Draft's approach is therefore very simple. We are saying to the board: "You must oversee the management, you must select or elect at least the principal senior executives, and you must make decisions on major corporate transactions—period. Whatever else you do is up to you." So the reports of our inflexibility and of the extent to which we interfere with evolution are greatly exaggerated.

Let me say a couple of other things about evolution. I very much agree with a statement that Ken Andrews made, that no major decision can await perfect information. The people who are saying—and I am talking about the community at large—"Let evolution go forward," are not suggesting rules that are going to govern the functioning of a board of directors now. The corporation is a major social institution. It may be the dominant social institution in this country. Accordingly, there must be some minimum rules of accountability. We hear complaints—with which I happen to agree—that it should not be said that the fear of a derivative action keeps corporations honest and is the driving engine of corporate avoidance of conflict of interest. But if you do not want the litigation model—which I do not want—then you have to have a substitute for litigation. What the Reporters are suggesting is to let the corporation regulate itself. But if it is going to regulate itself, there must be some mechanisms within the corporation that will perform that function. It was also said that the Reporters are talking about a structure in which the board is antagonistic toward the officers. This is not correct. After all, we are talking about a common modality. That is, at least sixty percent of large publicly held corporations already have this structure. One can have a collaborative structure in which there is nevertheless some room for criticism. For example, in the decentralized corporation the headquarters office works cooperatively with, and at the same time judges

the performance of, divisional management. We have in mind a model very much like the model of the decentralized corporation. I do not think a corporation can function well with ongoing antagonism or an adversarial relationship between the board and its officers. Compare this situation to the relationship between a dean and a faculty member. A dean has to support his faculty members. Nevertheless, he has to be able to make judgments about faculty members. So the idea of supportiveness on the one hand, and evaluative judgments on the other, is not an idea that is internally inconsistent in the context of the board and officers of the corporation.

So, I really do not agree with this inflexibility argument. Also, I just do not see how we are cutting off the evolution of the board by requiring the board to perform an oversight function.

By the way, the present statutes say the board shall manage the business of the corporation. It is not as if the ALI Draft suddenly is introducing a mandated structure when none existed before. We are giving content to what the legislatures always assumed when they adopted the idea of the mandated board.

Dean Ruder: Did you deliberately eliminate the language "the corporation shall be managed by or under the direction of the board of directors"? One could read that change as reducing the power of the board.

Professor Eisenberg: The answer to the first question is yes. The answer to what that change means is that at one point we did intend to reduce the power of the board of the large publicly held corporation in that respect, but we ultimately discarded that idea. The traditional statute says that the board shall manage the business of the corporation. Actually, the board does not manage in the ordinary sense of the word. We thought it was not a good idea for the law to be out of step with reality. Therefore, at one point we did say that in the large publicly held corporation the board could not manage. But we have dropped that, and now we propose to give the board power to manage.

Dean Ruder: In another draft?

Professor Eisenberg: Yes.

Professor Mofsky: In light of those changes, Professor Andrews, do you want to address the question of evolution?

Professor Andrews: Yes, because I am reassured by what I have heard. I have stopped stressing the lack of flexibility argument, because the Reporters have wisely retreated from what many interpret to be a degree of arbitrariness. The problem

is—and this may be a problem of communication between the Reporters and the management community—that if evolution is improving boards, it is because directors and chairmen of boards are realizing increasingly that in individual situations the board can make a more effective contribution to the function of the corporation. It is very difficult to prescribe that involvement by the board from a position outside of the corporation. So I think fear rather than reality causes a lot of the talk about the lack of flexibility in prescribing standards for directors.

When we know what the theory ought to be of the board of a large publicly held corporation, then we can record it. In the meantime, people in the management community are having a problem with the Restatement's use of a single, monitoring model—and nothing that I said this morning should be interpreted as meaning the board should not monitor management. But the idea that monitoring should be the single, dominant public mission of the board poses a problem. The monitoring board will arrive at a meeting in the posture of—if we use Victor Brudney's phrase—"diligent policemen." A chief executive officer, particularly if he is somewhat insecure about his position, is not likely to enjoy a board meeting where the outside directors come dressed as Gilbert and Sullivan characters from the *Pirates of Penzance*. So there is a sensitivity to monitoring and to criticism, which a skillful board will suppress. A skillful board will not keep a chief executive officer constantly under fire; it will monitor a CEO with—as Mel Eisenberg described—a combination of support and evaluation. That combination of support and evaluation can result in a board's confidence that management is not only not derelict, but it also has a positive program for enhancing the company's future.

I have not seen the revised drafts, nor did I see the sternness of monitoring as moderated by the role of outside directors supporting a chief executive until the time when the board's support is no longer possible. If the Reporters are now stressing that they do not mean to freeze a model of a monitoring board, then the criticism of interference with the board's evolution will disappear. The boards are getting better for reasons that are related to the progress of the management process generally. This progress may be statistically difficult to prove, but it is a belief that sustains the interest in management of many of the people who take part in the management of the corporation.

Professor Brudney: I hate to see conflict evaporate like this.
[Laughter]

Professor Mofsky: I did not intend to create harmony here.

Professor Brudney: First of all, as to the diligent policeman's role, it is a matter of context. The monitoring board members arrive, and, properly, they should constitute a warning to management with respect to conflicts of interest situations. There ought to be policemen there. When we move to problems of managerial efficiency, however, we are indeed in the quagmire that the seven of us find ourselves in—agreeing and not agreeing. The fundamental assertion that Mr. Smith and Professor Andrews make is that the affirmative, productive value of the board—even if it is inconsistent with a monitoring role—ought to be the dominant value. But Professor Andrews just conceded that he does not mean the board should refrain from any monitoring. I would like to ask each of you—particularly since each of you gave illustrations of how the American Law Institute's proposals *could* interfere with efficient management, *could* create obstacles to an imaginative board—is it the case that a majority of outsiders *would* be likely to prevent experimentation? Or would an audit committee composed of a majority of outsiders be likely to prevent experimentation and a productive relationship?

Where is the rigidity in the Draft Restatement model of the board? Rigidity is a word that could be used to describe the prescription of fire escapes after the "Triangle" fire. Any flat prohibition that is part of a minimal safety net can be characterized as "rigid." The issue here is what is rigid about the proposed requirements? Why cannot corporations live easily with these requirements? Unless you can answer that, I do not think we have an issue.

Mr. Smith: In the spirit of what Professor Eisenberg has described this afternoon, we have seen and heard a tone that—I am sorry to say—is not reflected in the written form of the project or in some of the dialogue. For example, as to statements like "we did intend to reduce the power of the board," I question whether it is within the power of the Reporters to undertake such a massive task and to succeed in institutionalizing it. Many feel that well-established legal principles of corporate governance have evolved into workable patterns, and if those patterns are reduced to a more rigid form, substantial time and effort will be spent conforming to the new pattern. But the recent evolution of corporate boards and the establishment of audit committees or compensation committees demonstrates that the existing structure is working. The corporate view is that we do not need to have this system of audit

committees or compensation committees institutionalized, particularly if it is in the form of statutory prescriptions.

I also have heard this afternoon what Ken Andrews has described, that is, a tone somewhat different from the impression that the public drafts associated with the project have made. To draw an analogy, rejection of the new patterns of the board's function resembles the attitudes held toward the Financial Accounting Standards Board [FASB]. It is similar to the very single-minded attitude of the FASB, which has tended to disregard input from its constituencies.

The biggest concerns are (a) that we do not think that we need a restatement, and (b) that, if it is put into the rigid forms that have been suggested, it will at least slow down the evolutionary process.

Mr. Katzenbach: I thought that your shifting of the burden of proof, Professor Brudney, was a little unfair. Are you suggesting that it is not possible to monitor a corporation with a board that has less than a majority of outside directors?

Professor Brudney: I would guess that the probability is that you are less likely to be monitoring rather than more likely. It is not a binary choice.

Mr. Katzenbach: Thirteen-to-twelve would not be able to do it?

Professor Brudney: Well, if you want to play that law professor's game—

Mr. Katzenbach: You were playing it to some extent—I said that I agree that a majority should be outside directors, but I do not agree that you cannot have an ethos in your board, as you do in your management style, that will give you in a board just as much monitoring without the necessity for a majority of outside directors, however you define outside directors.

Professor Brudney: In the real world, we must act not on isolated possibilities but on probability judgments. It is true that I cannot assert that in any given case twelve directors will monitor less independently than thirteen. It is just more probable that you are going to get independence with a majority of independent directors than with a minority. You do not deny that either.

Mr. Katzenbach: It seems to me that the power of those outside directors could be a lot greater if they were in a minority than if they were in a majority.

But the question had to do with rigidity. I merely suggest to you that this particular problem of monitoring is sometimes per-

ceived as rigid because people say it must be done in a certain way—even though I approve of the notion of monitoring. I cannot imagine today an audit committee that is not composed of outside directors. One of you can tell me whether twenty-five years ago that would have been the case. I do not know. But if not, that is the evolution that was being talked about, and I just wanted to restore a little debate in this group.

Professor Brudney: Requiring a majority by law at a time when a majority is by far the prevailing arrangement does not interfere with evolution of the board.

Professor Andrews: Let me illustrate with the nature of the SEC [Securities and Exchange Commission] regulation of industry. Many people believe that it is more acceptable for the SEC to proposition the New York Stock Exchange to install a rule for Exchange members—a practice far exceeding the SEC's original charter—than it is for the SEC to specify a wider-ranging, rigid series of rules.

The Watergate business made the outside audit committee an absolute necessity, because in that kind of situation the appearances of conflict of interest become as bad as the reality of conflict of interest. So the board, in terms of evolution, responded to the Stock Exchange's requirement by saying, "Okay, why not." Some companies went through hell; Johnson and Johnson did not have any outside directors on its board. It went around trying to recruit enough directors for an audit committee, in order not to be delisted.

Audit committees not only had to appear independent, but they actually became independent when they dug into the affairs of corporations. Directors had access for the first time to a variety of information—where do you think these voluntary admissions of improper payments came from? It was not just a sudden fear of the SEC finding out; it would have taken the SEC a hundred years to find out those things. But when the outside directors found out about improper payments, the directors wanted them reported. And they were reported. And the accountants were emboldened for the first time to report what they knew and, even more, to find out what they should have known. Also, internal audit committees, which can find out more in a week than outside independent audits can find out in a year, began to become effective. These committees began to produce information that was then reported by boards, notwithstanding the CEO's objections. Pretty soon, the CEO was not going to those meetings, at the suggestion of the

outside directors. Shortly after that, all the management representatives—secretary of the board, the financial vice-president, whoever else was there—were also invited to leave the meeting during the last fifteen minutes, so that the auditors and audit committee could talk and so that there could be at least a formal “speak now or forever hold your peace,” or “is there anything that you know that we ought to know that the ordinary processes of interference with communication in large organizations are preventing us from finding out?” Now, that is an evolution.

The second stage of board evolution is represented by the compensation committee, which is, for the first time in a long while, showing conscientious and effective concern about the problem of executive compensation. This is something different. Outside directors serving on compensation committees are one of the many forces that have propelled executive compensation upward. That is a severe problem now being faced and discussed by the executive compensation committees. It is a thorny one; I have no idea what the solution is.

The nominating committee represents another stage. Although the chief executive officer must be on that committee, and the committee cannot come up with nominees that would be repugnant to him or her, for the first time the committee is not composed of the cronies or the old friends—the “safe people.” Neither the chief executive officer nor most members of the board know the people who are being elected to boards. This is being done as a recruiting process. Given the internal dynamics of boards, these are major advances. That is what we mean by evolution; it can be supported by external regulation; it is not necessarily interfered with by external regulation.

Dean Ruder: The point, if I can just follow that up, is this: If you say to an organization that is in evolution, “Every time you bring yourself forward a little bit more, we are then going to enact that movement into law,” then you are going to constrain any forward movement. The organization may not want to take a step if it thinks that every time it does so, another group will come along and say, “Hey, we like that one; that is the evolution we like; now that is law; now let us see you do something more.”

Professor Steinberg: I would like to make a comment. In my understanding, although former SEC Chairman Williams did put pressure on the New York Stock Exchange to require independent audit committees for listed domestic companies, the fact of the matter is that the Exchange voluntarily adopted this rule.

Some commentators have argued that the SEC virtually thrust this audit committee rule upon the New York Stock Exchange. Even presuming that is true—and I am not presuming that it is—there is authority for the SEC's exercise of such authority. Indeed, at about the time that Chairman Williams "encouraged" the adoption of such a rule, the SEC General Counsel came out with a legal opinion—which I believe was issued entirely in good faith—that the SEC did have the authority to require publicly held companies to maintain independent audit committees.¹¹

Also, I want to point out that during Harold Williams' chairmanship, he made several innovative proposals with which a number of corporate managers disagreed. For example, Chairman Williams suggested that all directors of a corporation should be outside directors, except for the chief executive officer who would not serve as chairman of the board. He also stated that audit committees should be comprised solely of disinterested directors and that neither the inside nor the outside general counsel to the corporation should serve as a director. Irrespective of whether one agrees with these proposals, it should be noted that Chairman Williams believed in the voluntary adoption of these changes. Indeed, during hearings on the Metzenbaum bill,¹² which would have imposed federal minimum standards relating to corporate accountability and governance mechanisms, Chairman Williams testified against such governmental intervention. He stated that legislation that sought to regulate the corporate boardroom would basically retard the purposes that it intended to achieve.¹³

With respect to the monitoring model, it is my belief that to ensure accountability within the corporate structure, directors should monitor or oversee managerial conduct. I must say, however, based largely on Professor Andrews' insightful article in the *Harvard Business Review*,¹⁴ that the board should be allowed to engage in managerial activities, if it so desires. Indeed, in his article, Professor Andrews points out four kinds of corporate boards, in addition to the board that adopts exclusively a monitoring model.

11. Securities and Exchange Commission Report to Congress on the Accounting Profession and the Commission's Oversight Rule, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,120 (June 28, 1979).

12. The Protection of Shareholders' Rights Act of 1980, *supra* note 3.

13. Professor Steinberg deals with these issues at length in his recent book, *CORPORATE INTERNAL AFFAIRS: A CORPORATE AND SECURITIES LAW PERSPECTIVE* (1983).

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

Another interesting article, written by Professor Dent in the *Boston University Law Review*,¹⁵ debatably argues that the monitoring model is really a minority model. Basically, Professor Dent contends that "expositions of the monitoring model to date have been rudimentary. Its proponents have not suggested what forces will prompt corporations to adopt the model and thereby move it from theory to widely accepted reality."¹⁶ At a later point, Professor Dent asserts: "Acceptance of monitoring by commentators and corporations has led the *Corporate Director's Guidebook* and some other authorities to speak of a duty of monitoring as if it were established fact rather than a remote ideal."¹⁷

Professor Eisenberg: I am glad that you pointed out that the *Corporate Director's Guidebook*,¹⁸ which was prepared and issued under the auspices of the ABA, talks about monitoring. So does the Business Roundtable's *Statement on Corporate Governance*, in effect (although it does not use that term as such).¹⁹ I find it ironic for Professor Dent to say that this is a new concept, or not established, when it is in the *Corporate Director's Guidebook*. That is a little bit like what someone once said about Plato: that he was out of the mainstream of Greek thought. [Laughter] When the *Corporate Director's Guidebook* says that there is a monitoring function, even if there was not one before it said so, there is one then. But believe me, despite what Professor Dent says, there was a monitoring function before the *Corporate Director's Guidebook* came out with it.

Dean Ruder: I was on the committee that drafted the *Corporate Director's Guidebook*, and I agree with you that the monitoring model was part of the *Corporate Director's Guidebook*. The only offense I take is that, after substantial consideration of whether to make the monitoring model voluntary, we chose the voluntary model. You have taken the opposite view.

Professor Eisenberg: Yes, but nevertheless we built on your experience.

Professor Mofsky: Until we moved on to this subject, several of you were focusing on the questions of whether new statu-

15. Dent, *The Revolution in Corporate Governance, the Monitoring Board, and the Director's Duty of Care*, 61 B.U.L. REV. 623 (1981).

16. *Id.* at 624.

17. *Id.* at 633 (footnote omitted).

18. Committee on Corporate Laws, ABA Section of Corporation, Banking and Business Law, *Corporate Director's Guidebook*, 33 BUS. LAW. 1591 (1978).

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

tory law is at all desirable in this area and how the Model Business Corporation Act fits into this proposed restatement. In that regard, there were some significant assertions this morning that new law is neither desirable nor needed. I will ask Mel Eisenberg to respond to that and then see if anybody else wishes to address it.

Professor Eisenberg: To some extent this is a false issue. The problem is that corporation law is a unique jurisprudential animal. Although most bodies of law are either largely case or common law, or else are largely of statutory origin, corporation law is a hybrid. Many of the most important rules of corporation law, such as duty of care and duty of loyalty, are largely common law rules, although there is some statutory overlay. But many other areas, such as distributions, mergers, and so forth, involve basically statutory areas. You simply cannot get away from statutory rules if you are going to deal with the high points of corporation law.

This morning, Dave Ruder mentioned the Model Act. I think that as of ten years ago it was not a very good act. But the Act has been substantially improved in a number of areas, although it still has some significant defects. The states, however, have not yet adopted most of its newer provisions. Furthermore, Delaware probably will not adopt many of them. Although it has in some respects come together with the Model Act, Delaware is very fierce about preserving its independence from the Model Act.

Some of the major issues that the ALI Draft covers have to be governed by statute. The Model Act touches on them, and we touch on them. Certainly, the Model Act cannot, and ought not, preclude the ALI from thinking about the same issues. The ALI Draft comes from a somewhat different frame of reference; it is a somewhat different process.

There is, however, a real issue here. In part III, we are treading new ground in proposing some statutory rules. It is not new ground to say that composition and structure should be determined by statute, because the basic rule now is that the board of directors shall manage the business of the corporation. That is a structural rule that all states require. Furthermore, there is some law regarding composition of the board, although it is restricted mostly to investment companies. But certainly, to require composition and to require an audit committee, and so forth, would be new. The issue is not so much statute versus nonstatute, but mandatory versus nonmandatory. If you want to make a procedure mandatory, the only way to do so is by statute.

As to other issues, such as the provisions governing security

for expenses, what shareholders get to vote on, and so forth, you can only mandate those procedures by statute.

Dean Ruder: I agree that some of the things you have suggested can be accomplished only by statute. Your derivative suit section is suitable for a statutory provision, and it requires treatment as though it were a statutory provision.

There are two sections that may not restate prior law. I would be interested in your reaction to them. We have not talked about one of them, section 2.01. That section states: "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"—with which I agree—"except that, even if corporate profit and shareholder gain are not thereby enhanced, the corporation, in the conduct of its business . . . (c) may devote resources, within reasonable limits, to public welfare, humanitarian, educational, and philanthropic purposes."²⁰ I read that provision as creating new law. The notes to that section state: "There is very little direct authority on the permissibility of taking ethical principles into account in framing corporate action where doing so might not enhance profits."²¹ I think even you, as the drafters, should agree that this section changes the law by saying that, even if the corporation is not going to make a profit, it may take its resources away from the shareholders and use those resources for public welfare. I regard that as quite a new wrinkle. It is very interesting that the business community does not seem to be bothered by this. The business community seems to take the position that this is good because now nobody can sue corporate officers and directors for making charitable contributions. I guess I come out as being both left and right in this situation.

Professor Eisenberg: Certainly there is room for differences as to how to interpret the cases. In a lot of situations, devoting resources to public-welfare purposes is consistent with an economic motive; the corporation may believe that its long-run profitability will be enhanced by that kind of action. But what about devoting resources to public-welfare purposes when there is no assurance of long-run profitability? I read the cases as supporting the view that devoting resources to public-welfare purposes can be done within reasonable limits even in this type of case. Section 2.01 does put an objective limit on that. Because there is large potential for draining

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

21. *Id.* § 2.01 reporter's note 5, at 42.

the corporation's assets, and, by hypothesis, you do not have a necessary nexus between the activity and the profit objective, there must be a reasonable limit. The principal test for whether such a use is reasonable is "the customary level at which resources are devoted to such purposes among comparable corporations, in proportion to earnings and assets, and the strength of the nexus between the use of corporate resources and the corporation's business."²² In addition, I would say that apart from the cases, this section reflects widespread corporate practice. The practice does not make it right, but we would be making extreme changes if public-welfare-motivated activities were not permitted. There really is a lot of money being given to public-welfare activities by corporations that could plausibly be considered as furthering corporate profits, but that is truly motivated by public-welfare considerations.

Finally, there is the Model Act, which in section 4(m) states, "Each corporation [that is incorporated under this act] shall have power . . . [t]o make donations for the public welfare or for charitable, scientific or educational purposes."²³ This section, which is widely adopted, does not say anything else, and that is essentially what section 2.01(c) of the ALI Draft says. So I think that widespread statutory precedent, existing case authority, and corporate practice supports the position.

Dean Ruder: I think it is wrong.

Professor Eisenberg: That is another question, and you can make a strong argument that way.

Dean Ruder: I share the comment that is in your text that says, "There is very little direct authority on the permissibility of taking ethical principles into account"²⁴

Mr. Katzenbach: The Reporters have an extraordinarily difficult job, in part, because of the restatement format itself. In trying to cover all of the subject matter that they think should be covered, the Reporters run the gamut between restating what they think the better rule is under the law of fifty states and engaging in judicial legislation. That is a very difficult task to undertake. Some of the controversy that the Draft Restatement has encountered is the result of the project's format as an American Law Institute restatement, which makes it about ten times tougher than

22. *Id.* § 2.01 comment h, at 33.

23. MODEL BUSINESS CORP. ACT § 4(m) (1979).

24. RESTATEMENT, *supra* note 1, § 2.01 reporter's note 5, at 42.

drafting a piece of legislation, irrespective of the existing law.

Professor Brudney: To elaborate on what Mr. Katzenbach was saying, I would like to ask whether there is a case that falls within the ALI rule, but that would not be successfully defended by eminent counsel as conduct that in the long run benefits the corporation. Are we not just talking about a null case, and maybe the ALI Reporters are trying to be more explicit than they have to be.

Dean Ruder: The answer, in my view, is that almost anything that a corporation wants to do can be done, justifiably, within the long-range profit-maximization theory. But if that is the case, there is no reason for saying that a corporation may do whatever it wishes without regard to profit maximization as long as it stays "within reasonable limits." I do not go from *A* to *B* in your logic; I go in a different direction, maybe left and right at the same time.

Professor Mofsky: It is time to take some questions from the floor.

Audience Member: Professor Eisenberg started the discussion today by giving us a rather interesting political overview of the development of corporate law. I was wondering whether that same political overview, as brought to bear on the ALI project, might not lead to an unfortunate outcome. We have seen the discussion divide the project into two areas: conflict of interest and structural change. In the conflict of interest area, we are apt to get a political compromise at the ALI level that codifies or restates the law and freezes it in an unsatisfactory status and chooses from a range of precedents that are nonneutral and that unduly favor the managers of the corporation. In the structural area, all the ALI project attempts to do, and can attempt to do, is to ensure the form, but not the substance, of corporate governance. Yet the discussion today makes it evident that it is the substance that is critical in many respects—what people do on audit committees, what people do on compensation committees. Professor Andrews made reference to the way we have compensation committees composed of outside directors who carefully scrutinize executive compensation. But we also read about compensation committees composed of outside directors that grant multimillion dollar golden parachutes and are insulated by the structure of law that is being created. It seems to me that there is a fairly powerful case for concluding that the ALI project is going to lead to an unsatisfactory formulation of the law and, for that reason, is not a constructive

effort.

Professor Eisenberg: That is an excellent point/question. I think there is that danger, although I am hopeful it will not come to pass.

This afternoon, Bryan Smith and Ken Andrews said that they perceived a difference in the tone of the ALI Draft from what they had seen before. Unquestionably, there have been some changes that I think they both would want—for example, dropping the provision that the board cannot manage the business of a large publicly held corporation. To that extent, their perception is accurate. But, basically, I do think there has been a change in perception more than a change in tone. We have adopted, by and large, positions that are fair and that reflect good corporate policy, good social policy. I think there has been a lot of misconception. I hope that when people see where we are going and when they understand the details of this document, there will be more acceptance than there is now. Therefore, I hope that eventually we will be able to get the approval of the vast group of lawyers and of the ALI. I think they will go along with what I perceive to be fair rules based on good policy.

The danger that you mention does exist. We have to be watchful. Obviously, the Reporters would not want to be associated with a product that is retrogressive.

Audience Member: Professor Eisenberg, this morning you mentioned that the law in the area of statutory mergers is rather anachronistic. Does the American Law Institute plan to address that area in the Restatement?

Professor Eisenberg: Yes, part III is divided into two chapters. One has to do with administrative structure. That is what I have been talking about today—boards, committees, and so forth. The second chapter will deal with shareholder rights and shareholder votes. There are projected sections in that chapter that will relate to the topic of statutory mergers.

Audience Member: Professor Andrews, you seem to take the view that the Restatement is creating a litigation model between board and management and also among shareholders, lawyers, and the various institutions that impact corporations. Do you believe that the legal process is the appropriate vehicle to supervise or influence the rights of the shareholder and the corporate supervisors in modern society?

Professor Andrews: One point I made this morning was that, in my article, I was interested in the internal dynamics of the

board and the possibility of the diversion of its attention from its main business.²⁵ I was concerned about the possibility that a decision treated as routine today might, in the future, be considered as not having received a proper amount of deliberation. This observation is not necessarily objectively correct. It is just my prediction as to the possibility of distraction.

Another point I made this morning was that, with respect to evolution of society's dominant institution, the model of the caring shareholder has become ridiculous. And speaking of anachronisms—and this whole panel subscribes to it—we keep building on the model of owners whose rights should be protected. Yet the number of shares that are traded on the stock exchange everyday indicates that, when you speak of the shareholders of a company today, you are speaking about an entirely different group tomorrow. For example, the shareholders of Bendix profited greatly from the hostile takeover action, and Agee [William M. Agee, then-CEO of Bendix] can be defended for his takeover attempt because the shareholders received about twenty-five dollars per share more from his maneuver than they did from his management. Therefore, should we forget about the fact that the shareholders of Martin Marietta have been displaced entirely and that Allied owns a third of a company with which it cannot do a thing and that Martin Marietta's balance sheet is in a shambles with nine billion dollars worth of debt? I do not know what this has to do with either defending or advocating hostile takeovers, but the old model of the shareholder, although appropriate to the small firm, does not seem to be appropriate to the large corporation. And one of my cautions is that, until we find out more about the correct model of the shareholder, let us not elaborate indefinitely on that shareholder model, which I think is obsolete.

Dean Ruder: Professor Andrews, from my point of view as a legal scholar, the basis of the whole web of legal, fiduciary principles that we have been talking about stems historically from the proposition that there is an obligation owed to the corporate shareholders. I really could be enthusiastic about a project in which we said, "Let us try to see what kind of legal principles we might come up with if that were not the case." That would require us to develop some rules you might not like because we would have to worry about legal rules that would provide protections for groups other than those with which we are expressing concern—those we

25. See Andrews, *supra* note 14.

now believe have the primary interest in the corporation. I do not know where we would go with that, but we would have a real project if we had to start from scratch in forming an analysis of the operation of the large publicly held corporations.

Professor Andrews: Thank you for returning to a third point that I raised this morning. A generation ago, when the judgments being made in the courts about antitrust laws were deemed to be unrealistic, the legal fraternity told itself that it should learn more about economics and find out how competition really works and how oligopoly functions, in order to extend the interpretation of the Sherman Act in useful and realistic directions. That led to the legal profession's turning to the industrial-organization field, which is a highly theoretical branch of economics and which derives its concept of the corporation from theory rather than observation. I suggest that instead of joining forces with economics or political science, legal scholarship should be directed to management and the law. The study of management has achieved a considerable degree of sophistication. Most of it is based on how the corporation works as viewed from inside the corporation. That view from inside the corporation should be useful to people viewing the corporation from the perspective of outside regulation. I have no idea what the outcome would be. I would be surprised if a research study of this sort, after this experience, developed new law very quickly or made recommendations for new law. Nevertheless, this kind of study might develop new insights and new ways of interpretation. I am not terribly concerned about whether corporation law is current; we have been getting along very nicely with this totally obsolete idea that the board of directors manages the corporation. No one has been paying any attention to it. It has been in a state of benign desuetude; no one has worried about that until the last five years.

Professor Eisenberg: I would like to address that. I must say I heard one revolutionary statement today—and it did not come from me. Ken Andrews said, in effect, that the board, rather than the shareholders, owns the corporation. I never knew that you had less of a private property interest if you bought and sold quickly than if you bought and sold slowly. I thought that, if I bought and sold wheat a couple of times a day, I owned it while I had it just as much as if I had bought and stored it.

There is a speech that was given by Bevis Longstreth,²⁶ who is

26. B. Longstreth, *Defining the Corporate Objective and Implications for Philanthropy*

an SEC commissioner and a corporate lawyer. He analyzes the position of the Business Roundtable on this matter, which is virtually identical with the position of Ken Andrews. Longstreth talks about the idea of the constituency representation: employees, customers, communities, and so forth. He notes that the position of the Business Roundtable is curiously close to that of Ralph Nader—and you know the old bridge adage that if both sides lead the same suit, one side is crazy. [Laughter] Then Longstreth points out: “This ideology seems to abandon any notion of a shareholder as owner of the corporation Once the responsibilities of management are defined to include many different constituents with often competing claims, the notion of a fiduciary becomes difficult to apply”²⁷—and this is really David Ruder’s point. Longstreth continues—and I think rightly—

One emerges from a reading of the Business Roundtable Statement, in particular, with the idea that *management* owns the corporation, with diverse and often conflicting responsibilities to many different constituencies. This, in my judgment, is a formula for achieving accountability to none.

. . . The corporation would assume quasi-governmental powers and responsibilities, but without the Madisonian checks and balances which have been the keystone to our democratic systems of government This country does not easily accept aggregations of property and power unchecked by any form of accountability. If corporations are successful in describing their objectives as quasi-governmental, in the manner suggested by the Business Roundtable and the Nader group, they will invite governmental interference in the management of their affairs.²⁸

Longstreth concludes: “I view this trend, whether espoused by so preeminent a business organization as the Business Roundtable or by so well known a ‘public citizen’ as Ralph Nader as dangerous to our free enterprise system.”²⁹ I must say I share that view.

Professor Andrews: First of all, I had nothing to do with that view of the Roundtable, nor was I retained or in any way involved in the Roundtable’s development of its own statement about the ALI project, despite the fact that an article of mine is

(remarks to the Financial Executives Institute North Central Area Conference, Hilton Head Island, S.C., May 22, 1982) (available from Securities and Exchange Commission).

27. *Id.* at 6.

28. *Id.* at 6-7.

29. *Id.* at 7.

appended to the Roundtable refutation of the ALI report.³⁰ The Roundtable arranged for me to speak at the ALI 1982 annual meeting because they suspected, in fact knew, that my views were similar to their views, and they thought that it might serve their cause to have a "foreigner" say something about this whole business.

The concept of ownership is not just a matter of buying wheat this morning and selling it this afternoon. And a corporation is not just a piece of business property; it is a human institution. It is a social and political institution. Therefore, the life of its most important members has to be a concern of management. The notion of the corporation as a political institution is developing in practice and in the consensus that surrounds the corporation in our society. The responsibilities of ownership are being argued; we should be as loyal to the interests of uncaring and irresponsible shareholders as we were originally when the corporation was created. The notion that responsibilities can be discharged to investors rather than to the owners is not one I find difficult to address. But it should be looked at, and one of the things that a joint project of management and legal scholarship might discuss is the concept of ownership. The law is very well-developed in this area; I am not qualified to say anything more about the legal development of this concept. But I can tell you that, in legal terms of the responsibilities of ownership, there have been changes in the way our society looks at the ownership of corporations. Therefore, "ownership" as a concept should be examined. Who owns Northwestern University? To whom is it accountable? Is that a real problem? Who owns Harvard? Nobody. The property is owned by the corporation, by the trustees. Is there a problem about its accountability? Probably, yes. Is it an urgent problem? No. The reason it is not an urgent problem is that those trustees would be out of their minds if they were not sensitive to the needs of the people who might like to think that *they* are the owners of the university. The faculty, of course, thinks it owns the university. It probably does run it often enough. But that is not ownership—management is not ownership. I did not ever say that it should be. But there is something to think about here. The question to whom would management be accountable does not automatically end a discussion, because ac-

30. Andrews, *supra* note 14, reprinted in THE BUSINESS ROUNDTABLE, STATEMENT OF THE BUSINESS ROUNDTABLE ON THE AMERICAN LAW INSTITUTE'S PROPOSED "PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS" exhibit A (1983).

countability does not necessarily have to be exercised in a legal or formal manner. Perhaps there are accountability problems with regard to the trustees of a private university. There are certainly problems in the way that universities are run; there are ethical problems ranging from professional football to lots of other things. I do not know whether that is a governance problem that anyone intends to address. I am simply saying that the concept of ownership as applied to the large publicly held corporation, which has developed as the dominant institution of our society, needs reexamination.

Professor Steinberg: It seems to me that the factors that have been discussed in the last few minutes—the rights and obligations of shareholder ownership, corporate accountability, and the apprehension that the Draft Restatement will become a political thicket—raise a sensitive subject that the Draft Restatement has not yet addressed. That subject is corporate-control transactions, or to be more precise, the thorny issues relating to tender offer contests. If the Draft Restatement is controversial now, the problems that it will encounter in the future in defining the propriety of management's conduct in defending against a hostile tender offer will be massive indeed. Given the Draft Restatement's present framework, it cannot consistently adopt the business judgment rule in regard to management's tactics in fending off a tender offer. At the minimum, to maintain consistency it would seem that the provisions that apply in the special litigation committee setting must apply in the tender offer context as well. Nonetheless, to a much greater extent than the special litigation committee setting, the tender offer context will really be a battleground. That is, such a Draft Restatement rule, were it promulgated, would have a tremendous impact upon potential target corporations, their investment bankers, and legal counsel.

There is, however, ample case law and literature saying that the business judgment rule applies in the tender offer setting, just like any other business decision made by management, provided there is no self-dealing or other disabling conflicts of interest implicated. On the other hand, there exists judicial and scholarly authority for the position that "[r]egardless of the tactic employed, management can easily manufacture a 'legitimate' corporate purpose for its action, even when it employed the [defensive] tactic solely to perpetuate its own status."³¹

31. Lynch & Steinberg, *The Legitimacy of Defensive Tactics in Tender Offers*, 64 COR-

A further question that may be asked in the tender offer context is what are the rights of stock ownership? After all, shareholders own these shares, and a tender offer is being made for these shares. It may be argued that shareholders should have the right to tender their shares, and they should not be prevented from disposing of these shares at a substantial premium by the obstructionist tactics of target management. This is a difficult issue; there is no question about that. I think, however, that the Draft Restatement is going to encounter its greatest opposition when it attempts to define the roles and duties of target management in the context of tender offers.

Audience Member: With regard to the caring stockholders, I am one of the babes who might get thrown out with the bath. I have held shares of stock in companies such as IBM for thirty or thirty-five years. I read proxy statements. I vote for and against option plans, and there are not many stockholders who do these things. If you listen to the radio in Miami at night, you will hear all kinds of widows and widowers and others who have held their stock for many years, and sometimes far too long. There has been no discussion today about officer and director insurance. I wonder whether you are going to address yourself to that.

Professor Eisenberg: The project will cover that issue. The work is divided, at least initially, among several Reporters. Jack Coffee is the Reporter for part VII, which covers remedies and which will include a provision on insurance. I cannot speak for Jack Coffee, but I do not envision any radical departure from existing statutes. He may, however, want to choose one statute over another in terms of the approach.

Professor Andrews: I believe there are responsible stockholders and irresponsible stockholders. I was talking about the stockholders who have no intention of assuming any of the obligations of ownership.

Audience Member: When I reflect on the criticisms of the American corporation, I see it in perhaps a broader light than has been suggested today. In many respects, the kind of debate that we had this morning could have been about the enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934 as well as the Draft Restatement. Times have changed. I wonder whether we should be drawing on that experience. For example, Professor Eisenberg mentioned that the California corporate law,

in its treatment of many of the difficult subjects that have been part of the race for the bottom, had been more reflective of his viewpoint. Is there any empirical evidence that California corporations behave differently with respect to any of the goals that we have talked about?

Professor Eisenberg: I ought to make clear that although I sat as a consultant on the committee that drafted the California law, it was drafted primarily by Harold Marsh.

I do not know of any empirical evidence that California corporations are run differently. Frankly, I think the California rules are sensible, fair rules, and that they are rules with which management can live. My guess is that they are rules that other states eventually will adopt. But as to whether California corporations are more or less efficient, and more or less responsive to shareholders, I do not think there is any empirical evidence.

Audience Member: Is that not inconsistent with the position you take in championing the views of the ALI Draft?

Professor Eisenberg: The California corporation statute does not address the issues of composition of the board, committees, and so forth. In that respect, it is like other statutes. I ought to add as a practical matter that our part III, which is structural, addresses large publicly held corporations. Very few of those corporations are likely to be incorporated in California. Therefore, our part III does not overlap with the California law.

Audience Member: There is an increasing use of financial intermediaries as a predominant vehicle for equity holding. I think I have recently seen statistics indicating that something approaching seventy percent of the transactions effected on the New York Stock Exchange are by institutional traders rather than by individuals. The trend is strongly upward. That has some interesting ramifications on some of these issues. For example, in many tender-offer battles, it turns out that the institutions end up, before and after, owning all of the players. In some battles, there is up to eighty-five percent commonality of ownership among the antagonists. It seems to me that there may be an opportunity for the development of a kind of law, extrinsic to the internal management-shareholder relationship, that might promote some of the ends about which we have talked—the contractual relationship, the stronger fiduciary duty of pension management to the behavior of their portfolio. Has this received some attention?

Professor Eisenberg: It cuts two ways. On the one hand, it cuts against the theory of shareholders being too small to have any

significant interest. In most corporations, you have a huge number of shareholders, and the average shareholding is very small. Nevertheless, a majority of stock is likely to be owned by sophisticated institutions with large shareholdings who are well able to understand what is going on. And they are not turning their stock over every day, even though they may not hold it for years. Therefore, we have a situation in which a majority of shareholders in most large corporations are very sophisticated, and they frequently will hold significant positions in the corporations that prevent them from turning over their stock too rapidly.

On the other hand, these institutional shareholders do follow the so-called "Wall Street rule." They will vote against certain kinds of proposals. But in terms of what might be called "active citizenship," I do not think that they are interested. Their feeling would be that, if a corporation needs a lot of intervention, they would rather avoid any involvement in the corporation. I am not faulting them for that. Nevertheless, while they are shareholders, they have a responsibility to their own beneficiaries to read the proxy statements and to vote. And I think they do read the statements and vote. But generally speaking they are not interested in reforming a bad situation in a corporation.

Mr. Smith: I just have one note about the recruiting of directors. The pool of potential directors is very, very small, contrary to what some people might believe. It is very difficult, particularly in a large corporation, given conflicts of interest, et cetera, to find directors who are willing to undertake the responsibility and who have the time to do it.

Professor Mofsky: We thank you very much for your presence and stand adjourned.