CORPORATE LAW SYMPOSIUM

THE DUTY OF CARE, COMPENSATION, AND STOCK OWNERSHIP*

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In the United States today, many corporate executives are paid much more than their performance seems to justify.[1] The public fury generated by the popular perception of this fact has increasingly dominated the nation's legislative, political, and financial agendas.[2] In light

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1. The following Article draws from and expands upon an earlier work that examines the executive compensation controversy in substantial detail. *See* Charles M. Elson, *Executive Overcompensation — A Board-Based Solution*, 34 B.C. L. REV. 937 (1993). The prior article explored the history of the compensation problem and critiqued as either ineffective or harmful to corporate well-being the solutions offered by other commentators, including heightened disclosure, tax-based remedies, judicial involvement, institutional shareholder activism, strengthened board compensation committees, and a market-based approach. It suggested that the solution to the controversy rested in substantial stock ownership on the part of corporate outside directors and presented an empirical study to support its conclusion.

2. The recent legislative and political attention that has been directed toward the executive compensation issue is best evidenced by the 1993 tax bill proposed by President Clinton and approved by Congress. Omnibus Revenue Reconciliation Bill of 1993, H.R. 2264, 103d Cong., 1st Sess. (1993). The legislation imposed a 10% surtax on any annual salary in excess of $250,000 and prohibited publicly held corporations from deducting executive compensation in excess of $1 million per annum unrelated to performance. *Id.*; *see also The FOB Loophole*, WALL ST. J., Oct. 14, 1993, at A16 (questioning the disparate impact of the tax bill on Hollywood celebrities and chief executives). Promoting passage of the legislation, President Clinton stated that "the tax code should no longer subsidize excessive pay of chief executives and other high executives." David E. Rosenbaum, *Business Leaders Urged by Clinton to Back Tax Plan*, N.Y. TIMES, Feb. 12, 1993, at A1; *see also* Charles M. Elson, *A Board-Based Solution to Overpaid CEOs*, WALL ST. J., Sept. 27, 1993, at A22 (suggesting that stock ownership by directors is a key in the overcompensation controversy) [hereinafter Elson, *A Board-Based Solution*]. However, attacks on excessive executive compensation have not come exclusively from the President and members of his political party. As a political cause, the excessiveness of executive salaries has cut across party lines. During the 1992 campaign season, Republican Vice-President Dan Quayle joined then-presidential candidate Bill Clinton in criticizing the high salaries received by some of the nation's corporate executives. Jeffrey H. Birnbaum, *From Quayle to Clinton, Politicians Are Pouncing on the Hot Issue of Top Executives' Hefty Salaries*, WALL ST. J., Jan. 15, 1992, at A14.

The Securities and Exchange Commission (SEC) has also directed its attention toward the public outcry over excessive executive compensation by implementing regulations requiring heightened disclosure of corporate executive compensation practices. Executive Disclosure, Ex-

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of this problem, we must consider whether some sort of legal response is necessary and, if so, what form it should take. Unfortunately, the problem of executive overcompensation is not an isolated and particularized corporate malady, but is merely one manifestation of a much larger, more generalized problem affecting our entire system of corporate governance. The solution requires a fundamental reexamination of the way in which our law regulates corporate conduct—more specifically, the present legal structure of the corporate director's fiduciary duty of care.

In many of America's leading corporations, management is supervised by a board of directors largely appointed by management.[3] This

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change Act Release No. 33-6962, 57 Fed. Reg. 48,126 (1992) (codified at 17 C.F.R. §§ 228, 229, 240, 249); Executive Compensation Disclosure, Exchange Act Release Nos. 33-6940 & 34-30851, 57 Fed. Reg. 29,582 (1992) (codified at 17 C.F.R. §§ 229, 240). Under these regulations, among other information to be disclosed, corporations must compare overall financial performance with the amount of compensation paid to top executives. Executive Disclosure, Exchange Act Release No. 33-6962, 57 Fed. Reg. 48,126; Executive Compensation Disclosure, Exchange Act Release Nos. 33-6940 & 34-30851, 57 Fed. Reg. 29,582.

Additionally, over the course of the past few years, executive compensation has increasingly become a regular topic in the popular and financial media. The large salaries collected by the nation's top executives have provided the basis for numerous articles, editorials, and compensation surveys. *See, e.g.*, Amanda Bennett, *A Little Pain and a Lot to Gain*, WALL ST. J., Apr. 22, 1992, at R1; Derek Bok, *It's Time to Trim Hefty Paychecks*, N.Y. TIMES, Dec. 5, 1993, at F13; John A. Byrne, *What, Me Overpaid? CEOs Fight Back*, BUS. WK., May 4, 1992, at 142; *CEO Pay: How Much Is Enough?*, HARV. BUS. REV., July—Aug. 1992, at 130 (a collection of editorial columns by various authors); Geoffrey Colvin, *How to Pay the CEO Right*, FORTUNE, Apr. 6, 1992, at 60; Tommy Denton, *Where Is the Justice in Bloated Executive Bonuses?*, L.A. DAILY J., May 14, 1991, at 6; *Executive Compensation Scoreboard*, BUS. WK., May 4, 1992, at 148 (surveying executive compensation at the 500 largest companies); Elson, *A Board-Based Solution*, *supra*; Charles M. Elson, *Director-Owners Can Lower High Pay*, N.Y. TIMES, July 18, 1993, at F15 [hereinafter Elson, *Director-Owners*]; John E. Robson, *With Executive Pay, Keep Exploring Options*, WALL ST. J., Oct. 5, 1992, at A12; *The Boss's Pay*, WALL ST. J., Apr. 21, 1993, at R13 (examining executive compensation at 350 of the nation's largest companies).

Executive compensation has also provided the basis for numerous texts and law review articles. *See, e.g.*, DEREK BOK, THE COST OF TALENT 95—118, 223—48 (1993); GRAEF S. CRYSTAL, IN SEARCH OF EXCESS (1991); IRA KAY, VALUE AT THE TOP: SOLUTIONS TO THE EXECUTIVE COMPENSATION CRISIS (1992); Linda J. Barris, *The Overcompensation Problem: A Collective Approach to Controlling Executive Pay*, 68 IND. L.J. 59 (1992); Carl T. Bogus, *Excessive Executive Compensation and the Europe of Corporate Democracy*, 41 BUFF. L. REV. 1 (1993); Douglas C. Michael, *The Corporate Officer's Independent Duty as a Tonic for the Anemic Law of Executive Compensation*, 17 J. CORP. L. 785 (1992); Detlev Vagts, *Challenges to Executive Compensation: For the Markets or the Courts?*, 8 J. CORP. L. 231 (1983); Geoffrey S. Rehnert, Comment, *The Executive Compensation Contract: Creating Incentives to Reduce Agency Costs*, 37 STAN. L. REV. 1147 (1985); Richard L. Shorten, Jr., Note, *An Overview of the Revolt Against Executive Compensation*, 45 RUTGERS L.J. 121 (1992).

3. *See* ROBERT A.G. MONKS & NELL MINOW, CORPORATE GOVERNANCE 184, 193 (1994). Although director candidates are recommended to the board by the nominating committee, "the CEO plays an important, even dominant role in the selection of director candidates." *Id.* at 193. Furthermore, Monks and Minow noted that a 1991 study found that 82% of board

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situation, in which board members owe their positions to executive largesse, creates an environment in which corporate directors have little incentive to monitor management, but great reason to acquiesce to any management initiative. This problem, more commonly referred to as "management capture,"[4] is the real cause of the overcompensation problem. Excessive compensation results when passive boards beholden to management agree to salary packages on demand in the absence of spirited negotiation. Thus, any solution to the executive overcompensation controversy must first address the problem of the passive board.

How can we motivate a board, compositionally suited to passivity, to become an active monitor of management? Traditionally, we have attempted to compel effective board behavior through the imposition of a legal duty of care, violation of which led to personal liability on the part of an offending director. The Delaware Supreme Court attempted to bolster compliance with this duty in its landmark *Smith v. Van Gorkom*[5] decision, which resulted in the creation of certain guidelines to decisionmaking that a board must follow to avail itself of the protection of the business judgment rule to avoid liability for a duty-of-care violation. As will be discussed, this decision has not lessened, but has in some respects created a costlier form of, board passivity. It was a triumph of form over function. The solution to the problem of the passive board lies not in using the threat of legal liability to force compliance with some theoretical standard of care, but in creating an environment where a board finds it in its own self-interest to engage in active oversight.

Some reform in board structure is warranted to create better board-level review of executive compensation and to promote more effective management monitoring. The outside directors must be made to consider management initiatives, not from the perspective of one engaged by and beholden to management, but from the viewpoint of the stock-

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vacancies were filled as a result of recommendations by the CEO. *Id.*

4. *See* MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION 139–48 (1976). "[I]n life as in the law the power to hire implies the power to fire. A director who has been brought on board by a chief executive—as outside directors typically are—is therefore likely to regard himself as the latter's sufferance." *Id.* at 147; *see also* MYLES L. MACE, DIRECTORS: MYTH AND REALITY 72–73 (1986) (discussing the powers of control in a corporation); ROBERT A.G. MONKS & NELL MINOW, POWER AND ACCOUNTABILITY 73–79 (1991) (opining that directors are often captive because "they are selected by management, paid by management, and . . . informed by management").

5. 488 A.2d 858 (Del. 1985). In *Van Gorkom*, the Delaware Supreme Court held that the directors of Trans Union Corporation breached their fiduciary duty of care when they approved a merger without making an "informed" decision on the fairness of the offered price. *Id.* at 874. For a detailed examination of *Van Gorkom* and a discussion of the director's duty of care, see *infra* notes 48–84 and accompanying text.

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holders to whom they are legally responsible. The best way to create this perspective is to appeal directly to these directors' pecuniary interests. To ensure that they will examine a management proposal in the best interests of the stockholders, we must make them stockholders as well. Corporations should pay their directors' annual fees in company stock that is restricted as to resale during the directors' terms in office. In a few years, each director will have accumulated a reasonably substantial portfolio and will, therefore, possess a powerful financial incentive to act more independently of management.[6] Additionally, directors' term lengths must be significantly expanded. This would ensure that their equity positions will reach the level necessary to influence their decisionmaking; by stretching out the time between elections, the chilling effect of a management threat not to renominate the director to the board is mitigated.[7]

For an equity-based approach to the problem of board passivity to be effective, it must first be demonstrated that equity ownership has a salutary effect on outside director behavior—that board members who own substantial amounts of company stock are, in fact, more effective monitors of corporate performance. Recently, two independent business

6. The salutary effects of directors' ownership of a substantial amount of stock have been well documented. *See, e.g.*, MACE, *supra* note 4, at 61–65 (noting that outside directors who own substantial amounts of stock in their companies are more likely to ask discerning questions than their nonstockholding counterparts); Charles M. Elson, *Board Pay Affects Executive Pay*, CORP. BOARD, Mar.-Apr. 1994, at 7–11 (stating that directors with substantial equity in companies are more inclined to keep pay tied to performance); James J. Fitzsimmons, *A Better Approach to Director Pay*, DIRECTORS & BOARDS, Spring 1992, at 48, 49–50 (concluding that directors paid in stock are more closely aligned with shareholders and in a better position to ensure that management is paid based upon performance); Edmund W. Littlefield, *A Stake with Restricted Stock*, DIRECTORS & BOARDS, Spring 1985, at 51, 52 (stating that "[p]aying directors in meaningful amounts of restricted stock gives them a common stake with the shareholders"); Joann S. Lublin, *Director's Cut*, WALL ST. J., Apr. 13, 1994, at R5 (stating that companies are increasingly turning to stock options as compensation for outside directors); David J. McLaughlin, *The Director's Stake in the Enterprise*, DIRECTORS & BOARDS, Winter 1994, at 53–59 (studying the relationship between outside director stock ownership and corporate performance); Pearl Meyer, *The Rise of the Outside Director as an Equity Owner*, DIRECTORS & BOARDS, Spring 1986, at 41 (observing that, historically, directors owned a large amount of stock and that they may be returning to this compensation scheme); Robert Stobaugh, *Director Compensation: A Lever to Improve Corporate Governance*, DIRECTOR'S MONTHLY, Aug. 1993, at 1–4 (comparing the performance of companies with a high degree of stock ownership by its directors with companies whose directors' stockholdings are relatively small). *See generally* Elson, *supra* note 1, at 981–96 (stating that the key to independent and dutiful outside directors is not simply stock ownership, but substantial stock ownership).

7. For instance, some commentators have called for fixed five-year terms that would help to establish a corporate "long-term view" and benefit corporate "vitality." Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187, 216 (1991); *see also* Elson, *supra* note 1, at 983–87 (discussing the benefits of combining quinquennial elections and an increase in directors' stockholdings).

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researchers conducted empirical studies of the relationship between outside director stock ownership and corporate performance. They found that companies with substantial outside director equity ownership tended to outperform companies whose directors had insubstantial holdings.[8] Expanding on this research, I conducted a broader study that yielded similar results. I found that companies with boards composed of outside directors with significant shareholdings tend to be considered better managed and to outperform those companies without such equity-holding boards. Those companies that are viewed as being poorly managed had fewer outside directors with significant holdings in the business. On the other hand, those businesses viewed as being well-managed tended to have a greater number of outside directors with significant equity holdings. An alignment of the directors' interests with those of the shareholders, rather than with those of management, through the development of substantial equity holdings that result in more effective management oversight would explain this phenomenon. Despite vigorous judicial enforcement of the duty of care exemplified by the *Van Gorkom* ruling, the passive, management-captured board has flourished, bringing in its wake executive overcompensation and poor overall corporate performance. Because of this apparent link between effective oversight and equity ownership, an equity-based approach to the problem of the passive board appears to be highly desirable and, as this Article argues, is the most effective

8. The first of these studies was conducted by Professor Robert Stobaugh of the Harvard Business School. *See* Stobaugh, *supra* note 6, at 1−4. Stobaugh found that compensating directors in stock resulted in improved corporate performance. *Id.* at 4. The study examined and compared investors' returns from two groups of corporations. The first group was comprised of nine companies that "were corporate governance 'targets' of at least three shareholder groups," and the second group consisted of the nine highest ranked companies on the *Fortune* list of "most admired companies." *Id.* at 2. Professor Stobaugh discovered that the average stockholding of directors at the "most admired" companies was much greater than that of the directors at the poorly performing companies. *Id.* As a result of his study, Stobaugh concluded that there was an apparent correlation between corporate performance and stockholding by members of the board of directors. *Id.* at 2−3. Consequently, he recommended paying half of a director's annual compensation in company stock until "stock ownership by corporate directors . . . increased to a level at which the value of the director's stock ownership is perhaps ten times the director's annual compensation." *Id.* at 4.

David J. McLaughlin, the president of a Connecticut management consulting firm, conducted the second of these studies. *See* McLaughlin, *supra* note 6, at 53−59. McLaughlin's study examined the stock holdings of outside directors at 70 companies, comparing the performance of companies with a high degree of director stock ownership to those with a low degree of director stock ownership. *Id.* at 54. The study found that the companies with the highest degree of director stock ownership "delivered a return of 174% to their shareholders over five years from 1988 to 1992, while those with the lowest delivered only a 73% return." *Id.* For further discussion of the Stobaugh and McLaughlin studies, see *infra* notes 105−14 and accompanying text.

solution.

Part I of this Article considers the problem of executive overcompensation and its root cause—inadequate bargaining resulting from passive boards. Part II examines the corporate director's fiduciary duty of care, which has been the traditional route the law has taken to counteract board inactivity and its consequent dilatorious effect on corporate well-being. Subsequent judicial application of this duty—most notably the Delaware court's decision in *Smith v. Van Gorkom*[9]—although seeking to compel active board monitoring, instead has had the opposite effect and has compounded the passivity problem. The duty-of-care standard need not be abandoned, but judicial attempts to compel adherence through compliance with rigidly prescribed board procedure are ineffective and should be reconsidered. Part III focuses on stock ownership and lengthened board terms as an alternative and preferred approach to preventing board passivity and encouraging active oversight. This Section examines the link between substantial equity holdings by directors and more effective corporate performance and argues that companies should create such holdings in their outside directors. In this light, the facts of *Van Gorkom*, most notably the stockholdings of the outside members of the defendant Trans Union Board, are reexamined to lend support to this equity-based proposal. A director equity-ownership program should create more reasonable executive compensation practices and, of greater importance, a more effective and competitive corporation.

I. The Overcompensation Crisis and Its Cause

Excessive compensation results when individuals are paid more for their labor than is warranted in return for services rendered. To determine what part of one's pay is deserved and what part is not, we must first determine the precise value of one's services. Unfortunately, this is not an easy task; for what is the true value of the deployment of human capital? Although human effort is in one sense easily quantifiable, limited to the physical capacity of the worker and the time limitation of the twenty-four-hour day, human capital is highly differentiated. The tasks required to maintain a complex economy are incredibly varied and require vastly different skills. Some skills are valued more highly by society and are compensated at higher levels. What those levels may be is determined through the routine function of the market.

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9. 488 A.2d 858 (Del. 1985). It is interesting to note that the defendant Trans Union directors held little equity in the company. For a detailed examination of this point and its implications for the duty of care, see *infra* notes 128—30 and accompanying text.

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How much individuals are compensated for their labor is the result of an implicit or explicit bargaining process. One party has labor to offer, and another has a need for the skill. The resulting compensation is the product of the matching of expectations—what one expects to receive and what the other is willing to give. These expectations, created through ordinary market function, determine compensation levels. What others are giving or receiving for similar tasks produces the expectations that determine particular compensation levels for particular skills. The value of a particular skill is not implicit in the skill itself, but is simply the result of this bargaining process. In this regard, there is really no such thing as an implicitly "fair" salary, only one that is acceptable to both parties.

Reasonableness is the product of the bargain. If one is voluntarily willing to part with a large amount of capital, say one million dollars, to obtain a particular service, then one million dollars is the value of that service. The compensation is thus reasonable. Compensation becomes unreasonable when it is not the product of balanced bargaining. Excessive compensation results when one party to a bargain, due to external pressures, is unable or unwilling to bargain effectively to maximize self-interest. This is the crux of the overcompensation controversy.

In the corporate setting, executive overcompensation results when there is a failure in bargaining between the executive and the corporation. The executive possesses managerial skills that the corporation desires. The corporation possesses capital that the executive desires in exchange for services rendered. How much capital will be given for these services is the result of bargaining. The resulting salary may be problematic where effective bargaining does not take place because one party does not attempt to maximize its own self-interest. An executive salary arrangement is the product of negotiation between the executive and the company's board of directors, which represents the interests of the company and its owners, the shareholders. If the board is reluctant to bargain effectively with management because, despite its fiduciary obligations, it finds itself more closely aligned with management than with the shareholders, then the product of such a "bargain" may be no bargain at all to the corporation and its owners. Alliances between bargaining parties may result in acquiescence rather than a bargained-for agreement. A salary arrangement resulting from such one-sided, passive bargaining is potentially excessive.

Although today many focus simply on large executive salaries as proof in and of themselves of an overcompensation problem, the real problem involves the process by which those salaries were determined,

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not the dollar amount.[10] A high salary does not, on its own, necessarily suggest that the recipient has been overcompensated. As long as the salary was the result of an active, good-faith bargaining process between the board and the executive in question, the compensation cannot be labeled unreasonable. Spirited negotiation by both parties assures proper compensation. That is the very nature of a market-based economy at work.

Compensation amounts do become problematic, however, when a board beholden to a particular executive agrees to a salary package upon demand, in the absence of self-interested bargaining. But under what circumstances would this phenomenon occur? Why would an independent board elected by the shareholders find itself blindly and passively responsive to management in compensation negotiations? The failure to negotiate an executive's compensation request is most likely to occur in those corporations where the outside directors find themselves obligated to no particular shareholder or shareholder block, but gain and maintain their board positions because of executive favor. This situation most commonly exists in large, publicly traded companies that, due to their large size and consequent atomistic shareholding patterns, are controlled by incumbent management and not by one shareholder or group of shareholders.[11]

In such businesses, no one shareholder or shareholding group possesses enough shares to exercise control of the corporation through the election of a majority of the board. Instead, incumbent management, through control of the proxy process, fills the power vacuum and nominates its own candidates for board membership.[12] The board of directors, theoretically composed of representatives of various shareholding groups, is instead peopled by individuals selected by management. The board is thus not representative of any one shareholder or shareholder

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10. Elson, *supra* note 1, at 947. "Excessive CEO pay is symptomatic of inattentive boards and uninformed shareholders." *CEO Pay: How Much Is Enough?*, *supra* note 2, at 130, 138 (comments of Nell Minow).

11. As of December 31, 1974, management controlled 165 of the 200 largest publicly owned nonfinancial corporations in the United States. EDWARD S. HERMAN, CORPORATE CONTROL, CORPORATE POWER 58 (1981). "[W]ide diffusion [of stock] does not increase the power of holders of small blocks of stock; it enhances the power of whoever controls the proxy machinery." *Id.* at 53. "[E]xecutive leadership is becoming more indispensable than ever. Only the executive can mediate among the multitude of constituencies vying to influence every corporation." Thomas A. Stewart, *The King Is Dead*, FORTUNE, Jan. 11, 1993, at 35, *quoted in* MONKS & MINOW, *supra* note 3, at 193; *see also* MACE, *supra* note 4, at 83–84.

12. In testimony before a United States House subcommittee, Dale Hanson, CEO of California's Public Employee Retirement System, stated that "[n]ominating committees all too often are sham, pure and simple." MONKS & MINOW, *supra* note 3, at 193. Monks and Minow note that a 1991 study showed that 82% of board vacancies were filled pursuant to recommendations from the chairman, who in the vast majority of instances also serves as the CEO. *Id.*

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group, but is instead responsive to the leading officers of the corporation. This phenomenon may be described as the "captured board" syndrome.[13] The directors on a captured board, responsible for oversight, are generally the officers themselves, individuals performing various professional services for the corporation such as lawyers and investment bankers, and, finally, those with no real professional attachment to the enterprise other than board membership.[14] The first two groups, because of their employment or financial relationship to management, may find it difficult to exercise independent oversight. The third group will rarely challenge management prerogative either, although there have been recent exceptions.[15] Such board members are usually se-

13. *See* EISENBERG, *supra* note 4, at 139–48; *see also* Stephen M. Bainbridge, *Independent Directors and the ALI Corporate Governance Project*, 61 GEO. WASH. L. REV. 1034, 1058, 1058 n.127 (1993) (examining the shirking of the duty to monitor management by "independent" directors who, because of composition and constraints on time and information, simply "rubberstamp" management decisions); Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 873–76 (1991) ("All too often . . . outside directors . . . turn out to be more independent of shareholders than they are of management.").

14. The first two groups of directors—the corporate officers and those who perform services for the corporation—are respectively known as "inside" directors and inside "outside" directors. Alternatively, those directors with no connection to the corporation other than board membership are known as "outside" directors. *See* Avery S. Cohen, *The Outside Director—Selection, Responsibilities, and Contribution to the Public Corporation*, 34 WASH. & LEE L. REV. 837, 837 (1977) (classifying directors as "inside directors," "non-independent outside directors," and "independent outside directors"); *see also* WILLIAM L. CARY & MELVIN A. EISENBERG, CASES AND MATERIALS ON CORPORATIONS 156–57 (concise 6th ed. 1988) (noting that inside directors and outside directors who perform services for the corporation are unable to exercise independent oversight because they have strong professional and economic ties to the corporation and are therefore likely to acquiesce to the decisions of the chief executive); Bainbridge, *supra* note 13, at 1059 (questioning the independence of outside directors); *CEO Pay: How Much Is Enough?*, *supra* note 2, at 130, 131 (comments of Ralph V. Whitworth, proposing that if one wants truly independent directors then the question should be how they obtained their position on the board and not whether they worked for the corporation). *But see* AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 1.34 (1994) [hereinafter ALI] (abandoning the use of labels, but stating that a director has a "significant relationship" with a corporation's senior executives when, among other things, he is employed by the corporation, a member of the immediate family of an officer, or affiliated in a professional capacity with a law firm that is the primary legal advisor to the corporation).

15. Recently, outside directors have become emboldened and have challenged management in several notable cases. For example, in October 1992, the outside directors of General Motors ousted their CEO, Robert Stempel, in response to the company's lackluster performance. *See* Paul Ingrassia, *Board Reform Replaces the LBO*, WALL ST. J., Oct. 30, 1992, at A14. Similarly, James D. Robinson, III, was removed from his position as chief executive of American Express in a move orchestrated by outside directors in January 1993. Chief executives at Westinghouse and IBM met similar fates as a result of director revolts led by outside directors, many of whom were former CEOs. *See* Julie Amparano Lopez, *CEOs Find That Closest Chums on Board Are the Ones Most Likely to Plot a Revolt*, WALL ST. J., Mar. 26, 1993, at B1; *see also* Eben Shapiro, *Philip Morris CEO Resigns Under Pressure*, WALL ST. J., June 20, 1994, at A3

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lected either by the chairman or other senior management, and they possess extensive professional and personal ties to the officers that compromise their effectiveness as monitors.[16] These directors are often officers of other public corporations[17] and frequently ask their counter-

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(examining the resignation of Philip Morris CEO Michael A. Miles in the wake of the company's loss of more than $30 billion in stock market value in two years and mounting criticism of his leadership from the board and institutional investors); Stewart, *supra* note 11, at 34 (discussing the recent firings and forced resignations of CEOs at several of the nation's largest corporations).

While these cases demonstrate a board's ability to dispose of an ineffective chief executive, some commentators argue that such board action occurs too infrequently and often only after serious damage to the corporation.

> Cases like RJR-Nabisco, General Motors, and American Express, among others, show us that if the situation gets bad enough, directors will do the right thing. However, they also show us that current board structures impose substantial obstacles to doing it sooner and more consistently. For example, the financial press heralded the board of IBM for pushing out CEO John Akers in January 1993. Yet this action took place after the company had lost over $80 billion in market value in just a couple of years. Where was the board during that period?

Nell Minow & Kit Bingham, *The Ideal Board*, CORP. BOARD, July-Aug. 1993, at 11; *see also* Martin Lipton & Jay W. Lorsch, *A Modest Proposal for Improved Corporate Governance*, 48 BUS. LAW. 59, 59 (1992) ("Directors eventually may act . . . but their actions often are late, after the shareholders have lost value, employees jobs, and the corporation its competitive market position.").

16. *See supra* note 4; *see also* BOK, *supra* note 2, at 98 (arguing that the selection of new directors is frequently dominated by senior executives); CARY & EISENBERG, *supra* note 14, at 157; CRYSTAL, *supra* note 2, at 224−30 (discussing factors that lead to ineffective compensation committees); HERMAN, *supra* note 11, at 31 (discussing the "transitory" and "guestlike" nature of an outside directorship); MONKS & MINOW, *supra* note 4, at 77−79 (stating that many directors are picked, not for their business acumen, but for their "business or personal relationship[s]" with management); Gilson & Kraakman, *supra* note 13, at 884 (noting that the way in which outside directors are selected leads to lack of incentive for corporate governance); Minow & Bingham, *supra* note 15, at 12 (comparing shareholder elections of directors to elections held by the communist party of North Korea in that management selects the candidates and counts the votes).

17. The most common selection for an outside director is the chief executive of another corporation. JAY W. LORSCH & ELIZABETH MACIVER, PAWNS OR POTENTATES: THE REALITIES OF AMERICA'S CORPORATE BOARDS 18 (1989) (noting that "63% of all board members are CEOs of other corporations"); J. Spencer Letts, *Corporate Governance: A Different Slant*, 35 BUS. LAW. 1505, 1515 (1980). "For a CEO, the most highly coveted boardmembers are CEOs of other companies. A startling two-thirds of all corporate directors are CEOs." *CEO Pay: How Much Is Enough?*, *supra* note 2, at 132 (comments of Ralph V. Whitworth). "One wonders, however, if the person among all who is most likely to be generally supportive of the chief executive isn't another chief executive." Letts, *supra*, at 1515; *see also* Barris, *supra* note 2, at 76 (discussing the lack of impartiality of outside directors). Such directors are deemed to be "outside" directors despite their close personal and professional ties to the executives of the company on whose board they sit. For a definition of "outside directors," see *supra* note 14. However, Martin Lipton and Jay Lorsch would "not view as independent an executive of another company on the board of which an executive of the company serves." Lipton & Lorsch, *supra* note 15, at 67-68. Lipton and Lorsch propose that the exclusion of these otherwise "outside" directors would lead to a more independent and active board. *See id.* at 68 n.32 (citing Kenneth A. Macke, *The Board and Management: A New Partnership*, DIRECTORSHIP, July-

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parts, whom they oversee, to serve as members of their own boards. Cross-directorships are not uncommon.[18] While such board composition may lead to affable board gatherings, the oversight function may be severely compromised. Board passivity in regard to management monitoring is the result of this compositional structure.[19] Consequently, the outside directors have little incentive other than fiduciary duty (which, for reasons to be discussed, has proven ineffective in creating incentive) to bargain effectively with management over compensation. Passive boards, created by management capture, are ineffective compensation negotiators.

Aug. 1992, at 8 ("The composition of the board is critical to how well it functions. We like to make sure that everything is geared toward making the board as independent and active as possible.")).

18. Barris, *supra* note 2, at 76, 78 n.113. A recent study of 788 of the nation's largest public companies conducted by Directorship, a consulting firm located in Westport, Connecticut, found that in 39 of the companies surveyed, the leaders of those businesses served on one another's boards in a "cross-directorship" phenomenon. The study further detailed that in five of those companies, the cross-directorships involved the board's compensation committees. Alison L. Cowan, *Board Room Back-Scratching?*, N.Y. TIMES, June 2, 1992, at C1. The five compensation committee cross-directorships were B.F. Goodrich Co. and Kroger Co.; Conagra, Inc. and Valmont Industries, Inc.; Kellogg Co. and Upjohn Co.; Sonoco Products Co. and NationsBank Corp.; and Allergan, Inc. and Beckman Instruments, Inc. *Id.* In order to be truly independent, The Blue Ribbon Commission on Executive Compensation recommends that compensation committees exclude "any interlocking directorates, particularly among CEOs." Joann S. Lublin, *Panel Adopts a Tough Line on CEO Pay*, WALL ST. J., Feb. 10, 1993, at B1; *see also* HERMAN, *supra* note 11, at 43 (suggesting that the cross-directorships are the result of the directors' trusting each other to be truly "outside" directors).

19. *See* James R. Repetti, *Corporate Governance and Stockholder Abdication: Missing Factors in Tax Policy Analysis*, 67 NOTRE DAME L. REV. 971, 977 (1992). Discussing executive compensation in light of board composition, Professor Repetti stated:

> Since 63% of all outside directors on the boards of America's 1000 largest companies are chief executives of other firms, the abdication of the board of directors should be expected. Chief executives who serve as directors for companies other than their own are generous in establishing the salaries of management of those companies because the high salaries can then be used to justify large salaries from their own companies.

Id.

Similarly, Graef Crystal observed that most compensation committees are comprised of directors who serve as chief executives of other companies. CRYSTAL, *supra* note 2, at 227. Consequently, these executives bring an attendant bias with them to their services on the board that prohibits true arms-length bargaining over compensation. *Id.* Interestingly, Crystal has noted that a correlation exists between the compensation of chief executives and the compensation of director-CEOs serving on compensation committees. "[T]he higher the pay of the CEOs who sit on the compensation committee, the higher will be the pay of the CEO whose pay the committee regulates." *Id.*

Ralph V. Whitworth, President of the United Shareholders Association, characterizes the relationship between the CEO and his hand-picked directors as one where "[y]ou dance with who brought you." *CEO Pay: How Much Is Enough?*, *supra* note 2, at 131 (comments of Ralph V. Whitworth). Therefore, it is not surprising that "this crowd rarely argues when it comes to approving a CEO's pay." *Id.* at 132.

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Many of the largest American public corporations have shareholding patterns that dispose them to such potential management capture and attendant compensation problems.[20] It is these companies that have traditionally paid their executives the largest salaries and that are currently the target of popular attention.[21] As noted earlier, a large salary is not in and of itself malignant. However, a significant executive compensation package paid by a large public corporation subject to management capture may be indicative, because of its size, of a failure by the directors to bargain effectively. Such compensation may thus be overcompensation. Because of the rapid escalation in executive compensation scales in the United States and in the large number of companies whose boards do not report to a controlling shareholder group, it is clear that a strong potential for overcompensation may exist.[22] It is

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20. *See supra* note 11. As public corporations developed and grew during the 20th century, ownership was spread "among tens of thousands of individual shareholders, none of whom could cast a meaningful vote in governance of their companies." Stewart, *supra* note 11, at 35 (citing ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1933)). According to Berle and Means, the result of this wide diffusion of ownership was the birth of a class of professional managers who controlled the corporation while owning a de minimis amount of the company's stock. *Id.*; *see also* BERLE & MEANS, *supra*, at 6 (discussing the results of separating ownership from management); Elmer W. Johnson, *An Insider's Call for Outside Direction*, HARV. BUS. REV., Mar.—Apr. 1990, at 46, 46 (stating that capitalism evolved from a "market society dominated by corporations . . . with absentee owners and professional managers"). "The separation of ownership from control produces a condition where the interests of owner and of ultimate manager may, and often do, diverge and where many of the checks which formerly operated to limit the use of power disappear." *Id.*

21. *See generally* MONKS & MINOW, *supra* note 4, at 166 (explaining that in 1989, the average CEO at the nation's top 200 companies received $2.8 million in salary and bonuses); Arch Patton, *Those Million Dollar-A-Year Executives*, *in* EXECUTIVE COMPENSATION: A STRATEGIC GUIDE FOR THE 1990S, at 43, 44 (Fred K. Foulkes ed., 1991) [hereinafter A STRATEGIC GUIDE] (noting that executive pay in the 100 largest publicly owned corporations increased by an average of 13.7% in 1983); Byrne, *supra* note 2, at 142 (discussing the outcry over executive compensation); *Executive Compensation Scoreboard*, BUS. WK., May 4, 1992, at 148—62 (rating executive compensation among the 500 largest American companies); Carol J. Loomis, *King John Wears an Uneasy Crown*, FORTUNE, Jan. 11, 1993, at 44 (discussing IBM's difficulties and the potential removal of CEO John Akers); Joann S. Lublin, *Higher Profits Fatten CEO Bonuses*, WALL ST. J., Apr. 21, 1993, at R1 (discussing executive compensation at America's larger corporations); Joann S. Lublin, *Looking Good*, WALL ST. J., Apr. 13, 1994, at R1 (examining executive compensation at America's largest corporations); Kevin Maney & Michelle Osborn, *Megabucks Amid Layoffs Stoke Outrage*, USA TODAY, Mar. 27, 1992, at 1B (examining executive compensation packages in light of continued corporate failures); Stuart Mieher, *Westinghouse's Paul E. Lego Resigns as Chief*, WALL ST. J., Jan. 28, 1993, at A3 (discussing Lego's resignation in "the midst of financial troubles and pressure from directors and shareholders"); Stewart, *supra* note 11, at 34 (examining the removal or resignation of 13 Fortune 500 CEOs in 18 months, including chief executives at General Motors, American Express, and Time Warner).

22. In 1991, the average chief executive of a large corporation was paid approximately 104 times the average factory employee's wage. Byrne, *supra* note 4, at 142. In 1980, the average

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therefore not surprising that the popular media have sounded an alarm. Although it is very difficult to look at a specific salary and immediately reach an informed conclusion as to its excessiveness (for how do we know with any precision what one's services are worth?),[23] given the great potential for ineffective, passive bargaining that the captured board presents, we cannot downplay the significance of the overcompensation controversy. Some sort of reasoned response must be developed.

But what sort of response should be forthcoming? How can we prevent corporations from overpaying their executives? The problem is not high salaries, but excessive salaries. Such is the result of ineffective negotiation between boards and executives. This lack of effective bargaining comes about through board passivity, which is the result of management capture. Passive boards do not negotiate effectively. Eliminate the board passivity created by management capture, and you will solve the compensation crisis. The solution lies not in addressing the malady's results, overpaid executives, but in facing its root cause, board passivity. The captured, passive boards—not excessive salaries—are the real evil that must be addressed. Executive overcompensation is but a symptom, not the illness.[24]

The core malady afflicting all too many large United States corporations today, board-based passivity, in addition to being problematic in

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chief executive earned only 42 times the average factory worker's wage. *Id.* at 143; *see also* MONKS & MINOW, *supra* note 4, at 166—67 (observing that United States executive pay significantly outpaced inflation, wage, and profit rates from 1977 to 1987 and that American CEOs in billion-dollar companies receive two to three times the pay of comparable executives in Europe and Japan). A 1991 study of 282 large and medium sized corporations by the Hay Group found that CEOs earned an average of $1.7 million a year in total compensation and that CEOs at the 30 largest corporations earned an average of $3.2 million. Colvin, *supra* note 2, at 60.

23. It is impossible to determine the excessiveness of an executive's compensation in a vacuum; such a determination requires the use of some type of quantitative measure. For instance, an executive who produces an increase in corporate profitability that results in larger returns for shareholders may be worth paying more to retain in a competitive labor market. *See* CRYSTAL, *supra* note 2, at 159—73 (arguing that the high-paid CEOs of Reebok, Walt Disney, and H.J. Heinz are properly compensated given the risks that they take and the profits that they generate for their shareholders). Consequently, most executive compensation plans attempt to align executive compensation with the company's performance in various areas, most notably, stock prices and profits. *See* Seymour Burchman, *Choosing Appropriate Performance Measures, in* A STRATEGIC GUIDE, *supra* note 21, at 189; Stephen F. O'Byrne, *Linking Management Performance Incentives to Shareholder Wealth*, J. CORP. ACCT. & FIN., Autumn 1991, at 91; S. Prakash Sethi & Nobvaki Namiki, *Factoring Innovation into Top Management's Compensation*, DIRECTORS & BOARDS, Winter 1986, at 21.

24. As *Forbes* editor James W. Michaels put it, "[T]he sin against society is not in the size of the paycheck, it's in the dereliction by boards that don't police the reward system." James W. Michaels, *Should Anyone Earn $25,000 a Day?*, FORBES, May 25, 1992, at 10.

the compensation area, is extraordinarily detrimental to the well-being of the entire corporate enterprise. It robs the corporation and its owners, the shareholders, of the necessary independent oversight, guidance, and reasoned control vital to the health of the entity. Theoretically, under the traditional legal model, the board is responsible for the overall direction of the enterprise. It should manage the corporation's business and set general business policy.[25] Management is engaged to carry out that policy and operate the company on a day-to-day basis. The board is expected continually to monitor corporate performance and management effectiveness in maintaining optimal business operation and carrying out board policy.[26] If management performs sub-

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25. *See* CARY & EISENBERG, *supra* note 14, at 154–57. The American Law Institute has established general duties for boards of directors:

> (1) Select, regularly evaluate, fix the compensation of, and, where appropriate, replace the principal senior executives;
> (2) Oversee the conduct of the corporation's business to evaluate whether the business is being properly managed;
> (3) Review and, where appropriate, approve the corporation's financial objectives and major corporate plans and actions;
> (4) Review and, where appropriate, approve major changes in, the determinations of other major questions of choice respecting, the appropriate auditing and accounting principles and practices to be used in the preparation of the corporation's financial statements; [and]
> (5) Perform such other functions as are prescribed by law, or assigned to the board under a standard of the corporation.

ALI, *supra* note 14, at § 3.02(a); *see also* LORSCH & MACIVER, *supra* note 17, at 8–12 (examining the historical concept of the burden of proof); MONKS & MINOW, *supra* note 3, at 182-84 (examining the board of directors' duties).

However, in reality, the traditional legal model of the corporation serves only as a starting point for the study of corporate structure and governance. "It has become increasingly clear that in practice the board rarely performs either the management or policymaking functions." CARY & EISENBERG, *supra* note 14, at 155. Consequently, most of the power supposedly vested in the board is actually held and exercised by management. *Id.* at 156.

Discussing this current view of the board's role, Chancellor William Allen of the Delaware Court of Chancery stated:

> The conventional perception is that boards should select senior management, create incentive compensation schemes and then step back and watch the organization prosper. In addition, board members should be available to act as advisors to the CEO when called upon and they should be prepared to act during a crisis.

Chancellor William T. Allen, Address at the Ray Garret, Jr., Corporate & Securities Law Institute, Northwestern University, Chicago (Apr. 1992), *in* Lipton & Lorsch, *supra* note 15, at 62.

26. *See* CAREY & EISENBERG, *supra* note 14, at 154–57. "[T]he board of directors is the linchpin of our system of corporate governance, and the foundation for the legitimacy of actions taken by management in the name of the shareholders." SEC Chairman Richard Breeden, Address at the Town Hall of California (June 1992), *in* Lipton & Lorsch, *supra* note 15, at 62. Actively monitoring corporate performance and management in an informed manner is foremost among the responsibilities of the board of directors.

> Outside directors should function as active monitors of corporate management, not just in crisis, but continually; they should have an active role in the formulation of

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standardly, the board as an effective monitor must either provide executives with new direction or replace them.

The active monitoring role of the board of directors is not only central to the traditional legal model of the corporation, but critical to ensuring the success of the enterprise. Management operates, boards monitor. When the monitoring function of the board becomes compromised for any reason, the corporation may be destined for disaster.[27]

> the long-term strategic, financial, and organizational goals of the corporation and should approve plans to achieve these goals; they should as well engage in the periodic review of short and long-term performance according to plan and be prepared to press for correction when in their judgment there is need.

Allen, *supra* note 25.

27. The effects of a derelict board of directors are evidenced by the recent fortunes of corporations such as American Express, General Motors, and IBM. For instance, the recent turmoil at General Motors demonstrates the consequences of an inattentive board and the resulting benefits of more activist directors. Throughout its history, the GM Board was typically beholden to GM management, with board meetings being little more than social gatherings in which the CEO's agenda was approved. After a long, steady decline during which GM's share of the American car market dropped from 52% to 35%, the GM Board finally took affirmative steps to improve the company's performance, steps that included firing GM CEO Robert Stempel. *See* John Greenwald, *What Went Wrong?*, TIME, Nov. 9, 1992, at 42, 44; *see also* Kathleen Day, *GM's Move Symbolizes Wider Fight*, WASH. POST, Oct. 27, 1992, at A1 (noting that "boards typically have been captive to the wishes of the company chairmen," but that pressure has been mounting on boards to assume a more proactive stance in the fulfillment of their duties).

In January 1993, IBM CEO John Akers was forced to resign amid sagging profits and lost market share. IBM saw its worldwide market share drop from 30% in 1985 to 19% in 1991, witnessed its stock price lose half its value over a six-month period, was forced to make a 55% cut in its quarterly dividend, and recorded a $4.97 billion loss in 1992. Loomis, *supra* note 21, at 45, 48; Michael W. Miller & Laurence Hooper, *Signing Off: Akers Quits at IBM Under Heavy Pressure; Dividend Is Slashed*, WALL ST. J., Jan. 27, 1993, at A1.

Similarly, American Express Board members, dissatisfied with the company's recent financial performance and public relations gaffes, deposed CEO James D. Robinson, III. Bill Saporito, *The Toppling of King James III*, FORTUNE, Jan. 11, 1993, at 42–43. Robinson, who served as CEO for 16 years, developed American Express into a "financial services supermarket." *Id.* However, the number of American Express cardholders was down worldwide, earnings were lackluster as the result of a $112 million charge at Optima, and the stock price remained depressed. *Id.* at 43.

The recent allegations of nefarious activity by Orange & Rockland Utilities CEO James F. Smith, however, present perhaps the most egregious example of executive largesse at the hands of an indulgent and derelict board. Joann S. Lublin, *Less-Than-Watchful Eyes Didn't Oversee Expenses of Utility Chairman*, WALL ST. J., June 15, 1994, at B1. Smith allegedly appropriated nearly $326,000 of company money for his personal use during his 14 years as chief executive. *Id.* The Orange & Rockland Board was "handpicked" by Smith and contained some personal friends and several directors who owned little stock. *Id.*; *see also* ORANGE & ROCKLAND UTILITIES INC., APR. 6, 1994 PROXY STATEMENT 3–5, 9 (1994) (The proxy statement listed board members' stockholdings, including those of directors with relatively few shares: Linda C. Taliferro, Audit Committee, 53 shares; Frank A. McDermott, Jr., Compensation Committee Chairman and Executive Committee, 697 shares; James F. O'Grady, Jr., Compensation and Executive Committees, 600 shares; Michael J. Del Giudice, Audit Committee, 0 shares.). In the words of Kenneth Gribetz, the district attorney prosecuting Smith, the Orange & Rockland

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The benefits to be achieved by effective board supervision of management are obvious. Thoughtful, judicious management is encouraged; unnecessarily risky or imprudent behavior is discouraged. The potentially dilatorious impact of the unproductive, foolish, or felonious is lessened by a vigilant board.[28] On the other hand, the pernicious impact of the absence of active board oversight is equally obvious. Without effective board monitoring, the corporation becomes, in effect, a runaway stagecoach likely to do great damage to those within and to its owners who watch in horror from the sidelines.

The primary consequence of board passivity created by management capture is decreased management monitoring. But why does management control over board appointments necessarily create board passivity? Why would nonmanagement, outside directors on such captured

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Board "was one big, happy family." Lublin, *supra*, at B1.

28. The board's preeminent duty is to monitor management and "*prevent* crisis." Minow & Bingham, *supra* note 15, at 15. "The board's most important function is to ask tough questions, listen to responses from management, and work together to find the right answers." *Id.* at 11. If directors perform their monitoring function, "they may prevent a significant portion of the long-term erosion of corporate performance that has plagued many once successful U.S. corporations." Lipton & Lorsch, *supra* note 15, at 62.

In order to fulfill this monitoring obligation, boards must be comprised of individuals with "the financial and strategic expertise and time to do the job." Robert A.G. Monks, *To Change the Company, Change the Board*, WALL ST. J., Apr. 27, 1993, at A20. In short, the keystone of a vital public corporation must be a "reformed and revitalized [board] of directors willing to monitor management and capable of mustering the courage and will to conduct themselves with a fiduciary conscience." Johnson, *supra* note 20, at 55. In order to effectuate the establishment of independent boards of directors, Elmer Johnson, a former General Motors Board member, has suggested removing retired CEOs from the boards of their former companies, limiting the size of boards to as few as seven directors, requiring directors to own a "significant" number of the company's shares, and compensating management with shares of the corporation's stock. *Id.* at 54-55. As Johnson puts it, "Patient capital is the foundation on which long-lived, wealth-creating institutions rest. But since patient capital is helpless capital unless it has a voice, its prerequisite is a properly functioning board of directors." *Id.* at 46; *see also* Lipton & Lorsch, *supra* note 15, at 62 (quoting Chancellor Allen, who stated that the board's "most basic responsibility [is] the duty to monitor the performance of senior management in an informed way"); The Working Group on Corporate Governance, *A New Compact for Owners and Directors*, HARV. BUS. REV., July—Aug. 1991, at 141, 142 (suggesting that "outside" directors should evaluate the performance of the chief executive annually).

Professor Cox notes that empirical evidence demonstrates that outside directors may "help to shield the corporation from managers' self-dealing or overreaching conduct." James D. Cox, *The ALI, Institutionalization, and Disclosure: The Quest for the Outside Director's Spine*, 61 GEO. WASH. L. REV. 1233, 1234, 1242 (1993). Examining the relationship between board composition and the termination of poorly performing management, Cox points to data that show that the "likelihood that a board will terminate an underperforming executive increases as the board's overall size increases" and continues to increase with the proportion of outside directors. *Id.* at 1241 (citing Donald L. Helmich, *Organizational Growth and Success Patterns*, 17 ACAD. MGMT. J. 771, 774 (1974)); Michael S. Weisbach, *Outside Directors and CEO Turnover*, 20 J. FIN. ECON. 431 (1988); Joann S. Lublin, *More Chief Executives are Being Forced Out by Tougher Boards*, WALL ST. J., June 6, 1991, at A1.

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boards be unwilling to challenge management prerogative and engage in active oversight? There are three problems with a management-appointed board that lead to ineffective oversight. First, personal and psychic ties to the individuals who are responsible for one's appointment to a board make it difficult to engage in necessary confrontation. It is always tough to challenge a friend, particularly when the challenging party may one day, as an officer of another enterprise, end up in the same position. Second, conflict with a manager who is also a member of one's own board may lead to future retribution on one's own turf, thus reducing the incentive to act. Third, when one owes one's board position to the largesse of management, any action taken that is inimical to management may result in a failure to be renominated to the board, which—given the large fees paid to directors[29] and the great reputational advantage to board membership—may function as an effective club to stifle dissension. Such realities hinder effective oversight by a corporation's outside directors.

It appears, therefore, that board passivity may be a problem structurally inherent in the management-appointed board. This passivity chills effective oversight of management activity, including the presently controversial area of executive compensation. If management domination of the board appointment process leads to board passivity, why not simply forbid management involvement in that process? Would such a prohibition eliminate the passive board?[30] Although this sort of rule might create a group of directors more independent of management, in the realities of the large, modern corporation, it is both ill-advised and completely unworkable.

First, simply because management proposes an individual for board membership does not automatically make that individual unworthy of service. Management, with its knowledge of the company and its in-

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29. For example, nonemployee directors receive annual compensation in the amount of $35,000 at General Electric, $35,000 at Exxon, $55,000 at IBM, and $48,000 at American Express. Moreover, these nonemployee directors usually receive a fee of between $1000 and $2000 for each meeting attended. In addition, committee chairmen usually receive a supplemental retainer of between $3000 and $5000 per year. AMERICAN EXPRESS CO., MAR. 14, 1991 PROXY STATEMENT 5 (1991) [hereinafter AMEX PROXY]; INTERNATIONAL BUSINESS MACHINES CORP., MAR. 16, 1992 PROXY STATEMENT 10 (1992) [hereinafter IBM PROXY]; GENERAL ELECTRIC CO., MAR. 3, 1992 PROXY STATEMENT 13 (1992) [hereinafter GE PROXY]; *see* Barris, *supra* note 2, at 78-79, 78 n.114.

30. In fact, many corporations, presumably in an effort to create a more independent board, have begun to limit management participation in the selection of new directors. Stuart Mieher, *Firms Restrict CEOs in Picking Board Members*, WALL ST. J., Mar. 15, 1993, at B1. Proposals to limit the role of CEOs in director selection have been made by a number of commentators, including Jay Lorsch and Elizabeth MacIver. *See* LORSCH & MACIVER, *supra* note 17, at 173–76.

dustry and its contacts in the general business community, may be well-suited for finding those whose experience and skill would make them productive board members. To rule out management involvement in the recruitment process might eliminate a whole pool of individuals whose board service could be highly valuable to the business. And, while friendship with management should not be the reason for one's appointment to a board, neither should it act as an automatic disqualifier.

Second, such a prohibition would be unworkable in a very practical sense. Management domination of the board appointment process occurs when a company, due to atomistic shareholding patterns and ineffective communication among shareholders, has no dominant shareholder or shareholding group. Management simply fills the void. If management is forbidden from dominating the process, who will? Prohibiting management involvement will not necessarily create a shareholder's utopia. It was small shareholdings that created the vacuum; there was no economic incentive for a small holder to become actively involved in the process.[31] Removing management from the process will not change this reality and will only lead to chaotic board

31. Because of their relatively small stockholdings, shareholders will become actively involved in running the corporation "only if the expected benefits of doing so outweigh its costs." Bainbridge, *supra* note 13, at 1055 (citing ROBERT C. CLARK, CORPORATE LAW 390–92 (1986)). Professor Bainbridge notes that the average shareholder is presented with opportunity costs that far outweigh the concomitant benefits of becoming involved. *Id.* Furthermore, because of atomistic shareholding patterns and divergent interests, it is extremely difficult for shareholders to organize and act as a cohesive unit to produce significant change. EISENBERG, *supra* note 4, at 159–60, 167; Bainbridge, *supra* note 13, at 1054–55; Cox, *supra* note 28, at 1236. "Shareholders are thus rationally apathetic." Bainbridge, *supra* note 13, at 1055; *see* Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 402 (1983); Martin Lipton, *Corporate Governance in the Age of Finance Corporatism*, 136 U. PA. L. REV. 1, 66–67 (1987). Management, with its access to information, is able to fill the vacuum left by shareholder apathy to provide uniform and coherent leadership. *See* CARY & EISENBERG, *supra* note 14, at 141 (noting that shareholders who own a relatively insignificant amount of the corporation's stock "will normally not want to spend a significant amount of time on the corporation's affairs, and management fills the vacuum"); MACE, *supra* note 4, at 191 (observing that management controls large public corporations in the absence "of control or influence by the [unorganized] owners of the enterprise"); MONKS & MINOW, *supra* note 3, at 98-103 (examining the separation between ownership and control of the corporation). *But see* Bainbridge, *supra* note 13, at 1054 n.108 (discussing those commentators who believe that institutional investors can provide an active voice in corporate governance); Cox, *supra* note 28, at 1258–59 (discussing the role that institutional investors may play in monitoring); *infra*, note 86 (discussing the role that institutional investors may play in corporate governance). *See generally* John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277 (1991) (arguing that institutional passivity is a result of insufficient incentives to monitor the corporation rather than a result of overregulation); Gilson & Kraakman, *supra* note 13, at 863 (proposing a strategy for increased corporate governance by institutional investors).

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elections.[32] This approach would promote corporate uncertainty and instability, certainly no blessing.

If prohibiting management involvement in the board appointment process is not a workable or desirable solution to the passivity problem, what is? How can we stimulate a board, compositionally suited to passivity, to become an active monitor of management? The answer to this question will not only solve the executive overcompensation dilemma, which is but one result of the passivity problem, but will also create much more effective corporate performance. The real problem confronting United States corporate law today is not excessive executive compensation, but the passivity of the management-captured board.

II. Board Passivity and the Duty of Care

If board passivity is the real problem hindering the effective operation of the large public corporation, what then is the appropriate legal response? What can be done to motivate a board, which is compositionally passive, to become an active management monitor? The problem of board supervisory laxity is not at all new. In fact, it probably dates back to the development of the modern board-managed corporation with its severance of ownership and control. Corporate law traditionally has been highly responsive to this issue. In part to counteract the potentially dilatorious effect of director inattentiveness and inactivity, the law created the corporate director's fiduciary duty of care, which was formulated to compel effective oversight. A standard of conduct was developed, violation of which led to personal liability on the part of the offending board member.[33] The duty of care was an effort

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32. Bainbridge, *supra* note 13, at 1054.

33. Most commentators have suggested that the duty of care developed from the law of fiduciaries and originated in equity. *See* Duties and Responsibilities of Outside Directors 20 (Avery S. Cohen & Ronald M. Loeb eds., 1978) ("The classic definition of the duty of care of directors arose from the law of fiduciaries, and it was only through an evolutionary process that there began to be differentiation in form and substance between the duties of corporate directors and the duties of other fiduciaries, such as trustees."); Howard H. Spellman, A Treatise on the Principles of Law Governing Corporate Directors 14-15 (1931) ("Numerous decisions iterate the proposition that the directors bear a fiduciary relationship toward the corporation, its stockholders and creditors."); 2 Seymour D. Thompson & Joseph W. Thompson, Commentaries on the Law of Corporations § 1320 (3d ed. 1927) ("The rule is thoroughly embedded in the general jurisprudence of both America and England that the status of directors is such that they occupy a fiduciary relation toward the corporation and its stockholders, and are treated by courts of equity as trustees."); *see also* Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 Duke L.J. 879, 880 ("As a legal principle, the [fiduciary] obligation originated in Equity. . . . The term 'fiduciary' itself was adopted to apply to situations falling short of 'trusts,' but in which one person was nonetheless obligated to act *like* a trustee."). *But see* E. Norman Veasey & William E. Man-

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to force desired behavior through a threat of legal liability for noncompliance. It proved to be ineffective, however, as passive boards flourished. In response, the Delaware Supreme Court created a new legal stricture designed to strengthen board adherence to the duty in its landmark *Van Gorkom* ruling.[34] Unfortunately, as will be discussed, like most economic regulations designed to create desired behavior through a mandate rather than an incentive, this approach has not proven to be particularly effective. In fact, it has bolstered rather than discouraged board passivity.

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ning, *Codified Standard-Safe Harbor or Uncharted Reef? An Analysis of the Model Act Standard of Care Compared with Delaware Law*, 35 BUS. LAW. 919, 925 (1980) (citing MODEL BUSINESS CORP. ACT ANN. § 35 cmt. at 256 (2d ed. Supp. 1977), for the proposition that the American Bar Association Committee, which is responsible for the Model Business Corporation Act, omitted any reference to the term fiduciary in its formulation of the duty of care).

The fiduciary duty of care developed as a means to compel oversight by an independent board, which, according to the traditional view, possessed broad power over corporate affairs. Howard Spellman, in a 1931 treatise on corporate directors, described the development of this duty in the following manner:

> [T]he legal situation in which a director finds himself is the product of judicial precaution, motivated by the necessity of safeguarding the interests of the corporation, of its stockholders, and of those who deal with it from overreaching by the members of its managing body for their own advantage. The reason for holding corporate directors to a high degree of accountability is a result of their dominant position, growing out of the complete control accorded to the board in the management of corporate affairs. . . . The courts have consistently upheld the board's independence. But it is a proper corollary of the grant of extensive powers that their misuse be prevented and their abuse punished. Accordingly, equity subjects the directors of a corporation to the same liability for negligence or misconduct as it does trustees.

SPELLMAN, *supra*, at 15–16; *see also* HENRY W. BALLANTINE, BALLANTINE'S MANUAL OF CORPORATION LAW AND PRACTICE § 114, at 359 (1930) (stating that the duty of care requires directors "to exercise an active and vigilant supervision over the officers of the company . . . to be familiar with the requirement of the by-laws of the corporation and enforce them . . . [and] to take the usual methods to inform themselves of the true condition of the affairs of the company"); 4 WILLIAM M. FLETCHER, OF THE LAW OF PRIVATE CORPORATIONS § 2261, at 3510 (1918) (stating that directors occupy a fiduciary relationship with stockholders because they are "agents intrusted with the management of the corporation"); 2 HOWARD L. OLECK, MODERN CORPORATION LAW § 959, at 730 (1959) (arguing that directors act as fiduciaries to shareholders because they are "the central power of management").

Recent commentators have similarly suggested that the duty of care was developed to compel active oversight of the modern board-managed corporation. *See* Kenneth E. Scott, *Corporation Law and the American Law Institute Corporate Governance Project*, 35 STAN. L. REV. 927, 927 (1983) (arguing that the duty of care developed in response to "the freeing of management . . . from effective discipline by stockholders" and the consequent "separation of ownership and control in the modern publicly-held corporation"); *see also* Alan R. Palmiter, *Reshaping the Corporate Fiduciary Model: A Director's Duty of Independence*, 67 TEX. L. REV. 1351, 1353 (1989) (noting that "over the last century," the duty of care imposed "a set of standards—a regime—for judicial review of corporate decisionmaking").

34. Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985). For a complete discussion of the standards that the court in *Van Gorkom* created to bolster director adherence to the duty of care, see *infra* notes 52–58 and accompanying text.

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Under the traditional duty of care, a director was expected to carry out his or her responsibilities "with the care that an ordinary prudent person in a like position would exercise under similar circumstances."[35] Failure to meet this standard would result in the imposition of liability upon the slothful director. This would theoretically compel circumspect and diligent conduct in carrying out the various responsibilities of board membership, including executive salary negotiations. Under the business judgment rule, however, a director would be found to have met this duty of care if in making a specific business decision he or she acted without self-interest, in an informed manner, and with a rational belief that the decision was in the best interests of the corporation.[36] A director who so acted in reaching a business decision was

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35. MODEL BUSINESS CORP. ACT § 8.30 (rev. ed. 1991). The Model Business Corporation Act states the director's duty of care as follows:

> A director shall discharge his duties as a director, including his duties as a member of a committee:
> (1) in good faith;
> (2) with the care an ordinary prudent person in a like position would exercise under similar circumstances; and
> (3) in a manner he reasonably believes to be in the best interests of the corporation.

Id.

The American Law Institute has defined the duty of care in a similar fashion:

> (a) A director or officer has a duty to the corporation to perform the director's or officer's functions in good faith, in a manner that he or she reasonably believes to be in the best interests of the corporation, and with the care that an ordinary prudent person would reasonably be expected to exercise in a like position and under similar circumstances.

ALI, *supra* note 14, § 4.01(a).

Approximately 37 states have adopted statutory duty-of-care provisions; the rest have a common-law duty of care. *Id.* at 200. Most states have adopted a reasonable care standard. *Id.*; *see* CAL. CORP. CODE § 309(a) (West 1990 & Supp. 1994); N.Y. BUS. CORP. LAW § 717 (McKinney 1994); Graham v. Allis-Chalmers Mfg., 188 A.2d 125, 130 (Del. 1963); 2 MODEL BUSINESS CORP. ACT ANN. § 8.30, at 934 (3d ed. 1990). *See generally* Stuart R. Cohn, *Demise of the Director's Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule*, 62 TEX. L. REV. 591, 593 n.7 (1983) (discussing the evolution of a common-law duty of care and the later statutory duties of care); Veasey & Manning, *supra* note 33, at 919 (comparing the standard of care in the Model Business Corporation Act section 35 with that of Delaware case law). *But see* KY. REV. STAT. ANN. § 271B.8-300(1) (Baldwin 1994) ("A director shall discharge his duties. . . [i]n a manner he honestly believes to be in the best interests of the corporation.").

36. In Aronson v. Lewis, 473 A.2d 805 (Del. 1984), the Delaware Supreme Court described the business judgment rule as follows:

> [A] presumption that in making a business decision the directors of a corporation acted on a informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company . . . . Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption.

Id. at 812 (citations omitted).

The American Law Institute has defined the rule in the following manner:

then protected from any legal liability to his or her shareholders. Over the years, this standard of care proved not to be very difficult to satisfy, and it was quite unusual for a board to be found to have violated this duty.[37] Questions then began to arise as to its effectiveness in assuring

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> (c) A director or officer who makes a business judgment in good faith fulfills the duty under this section if the director or officer:
>
> (1) is not interested in the subject of the business judgment;
>
> (2) is informed with respect to the subject of the business judgment to the extent the director or officer reasonably believes to be appropriate under the circumstances; and
>
> (3) rationally believes that the business judgment is in the best interest of the corporation.

ALI, *supra* note 14, § 4.01(c); *see* Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985); *see also* Teren v. Howard, 322 F.2d 949, 952-53 (9th Cir. 1963); Richardson v. Blue Grass Mining Co., 29 F. Supp. 658, 665 (E.D. Ky. 1939), *aff'd*, 127 F.2d 291 (6th Cir. 1942); Wall & Beaver Street Corp. v. Munson Line, Inc., 58 F. Supp. 109, 115-16 (D. Md. 1944); Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360 (Del. 1993); Citron v. Fairchild Camera & Instrument Corp. 569 A.2d 53, 64 (Del. 1989); Haber v. Bell, 465 A.2d 353, 357 (Del. Ch. 1983).

Where a director has not made a business decision, such as in the case of an omission, the business judgment rule does not apply, and the director should not be judged under the reasonable care standard. *Aronson*, 473 A.2d at 812−13.

For a complete discussion of the differences between the ALI's formulation of the business judgment rule and that of the Delaware Supreme Court in *Aronson v. Lewis*, see Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461 (1992).

37. Joseph W. Bishop, Jr., *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1099 (1968). After extensive research, Professor Bishop discovered only four cases in which a court found that a director violated the duty of care, absent an allegation of self-dealing. *Id.* at 1099−1100; *see* New York Credit Men's Adjustment Bureau v. Weiss, 110 N.E.2d 397 (N.Y. 1953); Syracuse Television, Inc. v. Channel 9, Syracuse, 273 N.Y.S.2d 16 (Sup. Ct. 1966); Clayton v. Farish, 73 N.Y.S.2d 727 (Sup. Ct. 1947); Selheimer v. Manganese Corp. of Am., 224 A.2d 634 (Pa. 1966). Even though all of these decisions resulted in director liability, Bishop stated that "none of these cases carries real conviction." Bishop, *supra*, at 1100.

Several more recent commentators have also taken the view that the duty of care was an easily satisfied standard for directors. They argued that in the few cases where the courts found a breach of the duty of care, elements of director self-interest were present. *See* William J. Carney, *The ALI's Corporate Governance Project: The Death of Property Rights?*, 61 GEO. WASH. L. REV. 898, 992 n.126 (1993) ("I am aware of only five cases in the history of American corporate law that have held directors liable for breaches of the duty of care, four of which seem tainted by conflicts of interest."); Cohn, *supra* note 35, at 591 n.1 ("Research reveals only seven successful shareholder cases not dominated by elements of fraud or self-dealing."); Palmiter, *supra* note 33, at 1360 ("During their century-long tenure, [care] standards have produced remarkably few cases holding directors liable for unreasonable or careless decisions."); Scott, *supra* note 33, at 933 ("[V]ery few cases have imposed liability solely on the basis of a violation of the duty of care."). Professor Scott also noted that "[m]any of the 'negligence' cases are tainted by the presence of some elements of conflict of interest or personal gain." *Id.* at 933 n.23 (citing Francis v. United Jersey Bank, 432 A.2d 814 (N.J. 1981)); *see also* Dooley, *supra* note 36, at 482 (indicating that the lack of decisions holding directors liable for violating the duty of care signifies that "American judges have followed an authority model [designed to preclude judicial review] and have therefore intended that their articulation of the duty of care be mostly hortatory").

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diligent board behavior.[38]

The American Law Institute (ALI), in connection with its landmark Corporate Governance Project in the early 1980s, consequently decided to reexamine the entire duty-of-care concept and its continuing viability.[39] This reexamination sparked a great deal of controversy among

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38. Professor Bishop was one of the first to question the effectiveness of the duty of care in assuring diligent board behavior. Bishop, *supra* note 37, at 1078-81. A number of other commentators were similarly critical of the duty's efficacy. *See, e.g.*, Carney, *supra* note 37, at 923 ("Although courts frequently stated that directors owed their corporations and shareholders a duty of care, courts' failure to enforce that duty in cases of erroneous decisions meant that for practical purposes, the law played no role in enforcing diligence of directors."); George W. Dent, Jr., *The Revolution in Corporate Governance, the Monitoring Board, and the Director's Duty of Care*, 61 B.U. L. REV. 623, 654 (1981) ("[T]he duty of care has hitherto been an ineffective tool for requiring directors to perform a meaningful function within the corporation."); Scott, *supra* note 33, at 932−33 (using a two-fold approach to explain why the duty of care is ineffective).

According to Professor Dent, the duty was ineffective because of judicial reluctance ever to find that a board was in violation of the duty. Dent, *supra*, at 646−54. Among other reasons for this judicial reticence, Dent explores what are considered the three traditional explanations. First, courts do not feel "that they are competent to review business decisions," as they "possess no special expertise in business affairs." *Id.* at 648. Second, rigorous enforcement "would pose such a substantial threat of personal liability that the best qualified persons would decline to serve as directors." *Id.* at 649. Finally, a stringent review "would force directors to become unduly cautious in order to avoid risky ventures that might result in losses to the corporation." *Id.* at 650.

39. The American Law Institute initiated its Corporate Governance Project in 1978. Roswell B. Perkins, President of the ALI, in discussing the project's origins, may have had the controversy concerning the duty of care in mind when he stated that "[a] commitment to the health and vigor of the free enterprise system requires that the law as to governance of business associations be fully as efficient and effective as, for example, the law of contracts and the law relating to commercial transactions." Melvin A. Eisenberg, *An Introduction to the American Law Institute's Corporate Governance Project*, 52 GEO. WASH. L. REV. 495, 495 (1984) (quoting Roswell B. Perkins, *The President's Letter*, 4 A.L.I. REP. 1 (1982)). Perkins further commented that "there has been a degree of uncertainty and inconsistency in the law which cries out for rational, dispassionate analysis and the development of guiding principles." *Id.* at 496.

For further commentary concerning the origins and methodology of the Corporate Governance Project, see Eisenberg, *supra*, at 498-500; Melvin A. Eisenberg, *An Overview of the Principles of Corporate Governance*, 48 BUS. LAW. 1271 (1993); Elliot Goldstein, *The Relationship Between the Model Business Corporation Act and the Principles of Corporate Governance: Analysis and Recommendations*, 52 GEO. WASH. L. REV. 501 (1984); Joel Seligman, *A Sheep in Wolf's Clothing: The American Law Institute Principles of Corporate Governance Project*, 55 GEO. WASH. L. REV. 325 (1987). Professor Seligman suggested, among other things, that the following governance problems led to the ALI's reconsideration of American corporate governance:

> Directors did not establish the basic objectives, corporate strategies, and broad policies in most large and medium-sized companies. . . . Nor did the board select the corporation's chief executive officer. . . . Outside directors were not expected to play an adversarial role . . . . Moreover, few boards met frequently enough to perform a useful role.

Id. at 330−32.

For an alternative perspective on the origins of the Corporate Governance Project, see Jonathan R. Macey, *The Transformation of the American Law Institute*, 61 GEO. WASH. L.

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corporate law commentators. A fierce debate ensued,[40] with Professor Scott arguing for the complete abolition of the duty because he believed it to be of minor importance. He suggested:

> [V]ery little if any value would be lost by outright abolition of the legal duty of care and its accompanying threat of a lawsuit. Other incentives for an appropriate degree of care in corporate decision-making would remain, and mechanisms would exist outside the courtroom to correct shortcomings.
>
> What would be gained by such an abolition? . . . There would be savings in litigation expense, insurance premiums, unnecessary record building, and risk-averse decisionmaking by the board. More important, abolishing duty of care liability could enormously clarify and

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REV. 1212, 1214 (1993) ("[T]he ALI was motivated to embark on its reform effort by internal bureaucratic incentives rather than by external public policy concerns. . . . [Moreover], [t]he ALI's initial interest in the Project is best characterized as little more than a bureaucratic exercise in turf-grabbing.").

40. Three different viewpoints emerged in the debate over the duty of care. The first, most notably propounded by Professor Scott, called for the abolition of the duty. Scott, *supra* note 33, at 936–37. A number of other commentators subscribed to this view. *See, e.g.*, Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1, 7, 28–32 (1990) (stating that corporations are contractual in nature and that fiduciary duties should be governed by contract); Jonathan R. Macey, *Externalities, Firm-Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes*, 1989 DUKE L.J. 173, 174 (advocating the contract theory of corporate governance and suggesting that parties affected by corporate changes are better served by private contracting than by regulatory intervention); Palmiter, *supra* note 33, at 1436–64 (suggesting the creation of a director's duty of independence); David M. Phillips, *Principles of Corporate Governance: A Critique of Part IV*, 52 GEO. WASH. L. REV. 653, 704 (1984) (stating that the ALI's current approach to the duty of care will "undermine the utility of corporate doctrine to tackle managerial self-enrichment"); Larry E. Ribstein, *The Mandatory Nature of the ALI Code*, 61 GEO. WASH. L. REV. 984, 987–98 (1993) (suggesting that corporate governance should arise from contract rather than mandatory rules).

The second approach, typified by arguments by Professor Cox, called for application of a stronger, more rigorous duty of care. James D. Cox, *Compensation, Deterrence, and the Market as Boundaries for Derivative Suit Procedures*, 52 GEO. WASH. L. REV. 745 (1984). Other commentators suggested a similar approach. *See, e.g.*, Cohn, *supra* note 35, at 595, 607–27 (proposing a standard of reasonable care so that "the business judgment rule would resume its historical basis as a protection against hindsight evaluation of erroneous decisions, but would shed its protective role as a shield for all director action in the absence of fraud or other illicit behavior").

The third viewpoint on the controversy called for maintenance of the duty of care as it was then currently structured. *See* John C. Coffee, Jr., *Litigation and Corporate Governance: An Essay on Steering Between Scylla and Charybdis*, 52 GEO. WASH. L. REV. 789, 828 (1984); *see also* Victor Brudney, *The Role of the Board of Directors: The ALI and Its Critics*, 37 U. MIAMI L. REV. 223 (1983) (defending the ALI's formulation of the duty of care); Robert C. Clark, *Contracts, Elites, and Traditions in the Making of Corporate Law*, 89 COLUM. L. REV. 1703, 1747 (1989) (exploring arguments for and against the duty of care and offering a model provision "in the style of the ALI's Corporate Governance Project"); Melvin A. Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1525 (1989) (defending the use of mandatory rules in corporate governance and fiduciary duties).

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simplify the legal system in this field.[41]

Responding to this attack on the duty of care, a number of commentators rushed to its defense, some even calling for a stronger, invigorated, more easily enforceable duty.[42] Professor Cox argued:

> [T]he law should find violations of the duty of care and impose remedies to compensate shareholders for their losses because of egregious decisionmaking by managers . . . . Derivative suit procedures should be drafted so that violations of the duty of care can be vindicated as efficiently as violations of the duty of loyalty.[43]

In response, taking what he termed a middle course between the Scott and Cox position—"Steering Between Scylla and Charybdis"[44]—Professor Coffee also called for the duty's retention, although he was critical of an "invigorated" duty as one having the potential to "chill the movement towards independent directors or produce excessive risk aversion."[45] Coffee suggested that the duty still had value because of "its socializing and exhortative impact" and that it should be left intact because of its "aspirational" potential.[46]

In the end, despite the attacks on its viability, the traditional duty of care was more or less retained by the ALI and continued to function as corporate law's response to the problem of the inattentive board.[47]

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41. Scott, *supra* note 33, at 937. Professor Scott believed that pressures and incentives in the free market would compel active board oversight. *Id.* at 935-36. For instance, "proxy contents, negotiated takeovers, and hostile tender offers" existed to provide protection of shareholder interests without the necessity of due care litigation. *Id.* at 935. Further, performance-based compensation packages, competition in the market place, and "managerial labor market[s]" also provided incentive for effective board management. *Id.* Lastly, Professor Scott suggested that board members' personal reputations and stock portfolios would facilitate active board monitoring. *Id.* at 936.

42. For those commentators calling for a stronger, more invigorated duty of care, see *supra* note 40.

43. Cox, *supra* note 40, at 788.

44. Coffee, *supra* note 40, at 789.

45. *Id.* at 799.

46. *Id.* at 798.

47. For the ALI's statement of the duty of care, see ALI, *supra* note 14, § 4.01(a).

Beginning in 1982 and throughout the drafting of § 4.01(a) as part of its Corporate Governance Project—including the final draft adopted in 1992—the ALI continually represented that its formulation of the duty of care did not represent a radical departure from traditional doctrine. *See* ALI, *supra* note 14, § 4.01(a) cmt. a; AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01(a) cmt. a (Tentative Draft No. 11, 1991); AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01(a) cmt. a (Tentative Draft No. 4, 1985); AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01(a) cmt. a (Tentative Draft No. 3, 1984); AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS § 4.01(a) cmt. a (Tentative Draft No. 1, 1982); *see also* Brudney, *supra* note 40, at 225 (noting that the duty of care under the ALI is largely "a description of existing legal

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Then in mid-1985, the Delaware Supreme Court shocked the corporate and legal communities by dramatically changing the nature of the duty-of-care action through its ruling in *Smith v. Van Gorkom.*[48]

As discussed earlier, traditionally it was very rare for a court to rule that a board had violated its duty of care. The courts were very liberal in their application of the protective business judgment rule to challenged board actions. Provided that the directors had no financial interest in the decision they had made, and the decision was not "so removed from the realm of reason" as to appear absolutely irrational (few decisions could ever be so characterized), two of the business judgment rule's three elements had been met.[49] The final element, that an informed decision be made, was never really an issue, because the courts seemed to give boards great latitude in their decisionmaking process.[50] It was highly unusual for a court to characterize a board

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doctrine"). *But see* William J. Carney, *Section 4.01 of the American Law Institute's Corporate Governance Project: Restatement or Misstatement?*, 66 WASH. U. L.Q. 239, 240 (1988) (stating that "section 4.01 represents a change in the 'real law' governing directors").

Despite the ALI's actions, the issue was far from settled among some commentators. Professor Ribstein attacked the ALI's "regulatory" approach and suggested that the duty of care be imposed contractually rather than by operation of law. Ribstein, *supra* note 40, at 987–88. Professor Ribstein further noted that "[t]he contract theory of the corporation holds that legal rules should effectuate the parties' contracts through interpretation, enforcement, and standard form rules, rather than by supplanting existing contracts or restricting the contracts the parties can make." *Id.* at 989. For more discussion on the contract theory of corporate governance, see FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 1–39 (1991); Butler & Ribstein, *supra* note 40, at 7, 28-32. *See also* Armen A. Alchian & Harold Demsetz, *Production, Information Cost, and Economic Organization*, 62 AM. ECON. REV. 777 (1972); Barry D. Baysinger & Henry N. Butler, *The Role of Corporate Law in the Theory of the Firm*, 28 J.L. & ECON. 179 (1985); Steven N.S. Cheung, *The Contract Nature of the Firm*, 4 ECONOMICA 386 (1937), *reprinted in* R.H. COASE, THE FIRM[,] THE MARKET AND THE LAW 33 (1988); Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301 (1983); Oliver E. Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J.L. & ECON. 233 (1979).

48. 488 A.2d 858 (Del. 1985). For a complete discussion on the *Van Gorkom* decision, see *infra* notes 52–84 and accompanying text. The ALI's approach to the duty of care was initially formulated in 1982, prior to *Van Gorkom.* However, in the final version of its *Principles of Corporate Governance*, adopted by its membership in 1992, the ALI cited *Van Gorkom* with seeming approval in its discussion of § 4.01(a). ALI, *supra* note 14, § 4.01(a) reporter's note 15; *see also* Macey, *supra* note 39, at 1220 (noting the ALI's seeming approval of *Van Gorkom*).

49. ALI, *supra* note 14, § 4.01(c) cmt. f.

50. To receive business-judgment-rule protection from liability, directors must inform themselves of all reasonably available material prior to making a business decision. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); *see* Lutz v. Boas, 171 A.2d 381, 395–96 (Del. Ch. 1961) (holding outside directors liable based on their uninvolved and uninformed posture during their tenure as directors); Mitchell v. Highland-Western Glass Co., 167 A. 831, 833 (Del. Ch. 1933) ("[There was] no justification in the evidence for concluding that the defendant's directors acted so far without information that they can be said to have passed an unintelligent and unadvised judgment."); *see also* Cohn, *supra* note 35, at 615 (stating that to meet a reasonable

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judgment as uninformed and, therefore, undeserving of the business judgment rule shield. This is why the duty of care was never considered to be a particularly difficult standard to meet and why it was

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care standard, the following question must be answered affirmatively: "Have the directors sought adequate information?"); Joseph Hinsey, IV, *Business Judgment and the American Law Institute's Corporate Governance Project: the Rule, the Doctrine, and the Reality*, 52 GEO. WASH. L. REV. 609, 610 (1984) (describing the elements of the business judgment rule and stating its common-law presence in corporate governance law); E. Norman Veasey and Julie M. S. Seitz, *The Business Judgment Rule in the Revised Model Act, the Trans Union Case, and the ALI Project—A Strange Porridge*, 63 TEX. L. REV. 1483, 1485 (1985) (discussing the origins of the common-law definition of the business judgment rule); *cf.* Palmiter, *supra* note 33, at 1382–83. Professor Palmiter has described "uninformed" director conduct in the following manner: " 'uninformed' has been understood to mean that directors were grossly negligent or that they engaged in a 'sustained pattern of inattention.' " *Id.* (citations omitted).

Courts, however, have generally given broad discretion to a director's decisionmaking process and thus rarely question whether an informed decision was made. *See* Warsaw v. Calhoun, 221 A.2d 487, 492–93 (Del. 1966) ("In the absence of a showing of bad faith on the part of the directors or of a gross abuse of discretion the business judgment of the directors will not be interfered with by the courts."); Auerbach v. Bennet, 393 N.E.2d 994, 1000 (N.Y. 1979) ("It appears to us that the business judgment doctrine . . . is grounded in the prudent recognition that courts are ill equipped . . . to evaluate what are and must be essentially business judgments."); Kamin v. American Express Co., 383 N.Y.S.2d 807, 812 (N.Y. App. Div. 1976). The court in *Kamin* stated:

> The directors are entitled to exercise their honest business judgment on the information before them, and to act within their corporate powers. That they may be mistaken, that other courses of action might have differing consequences, or that their action might benefit some shareholders more than others presents no basis for the superimposition of judicial judgment.

Id.; *see also* Cohn, *supra* note 35, at 594 (stating that the business judgment rule "has come to preclude inquiry into the merits of directors' decisions in the absence of evidence of bad faith, fraud, conflict of interest, or illegality"); Dent, *supra* note 38, at 648 (suggesting that courts give broad latitude to director's judgment because "[c]ourts sometimes deny that they are competent to review business decisions"); Hinsey, *supra*, at 612 ("As long ago as 1917, Justice Louis Brandeis recognized the principle that courts leave matters of internal management to the directors' discretion and courts will seldom interfere with this discretion absent misconduct or a breach of the duty of loyalty." (citing United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261, 263 (1917))); Scott, *supra* note 33, at 933 ("In recognition of the fact that risk taking and uncertainties about future developments characterize most business decisions, courts will not second-guess corporate decisionmakers unless the mistakes in judgment are extreme."); *see also* Palmiter, *supra* note 33, at 1361–62. Professor Palmiter has stated that "the business judgment rule shield[s] board decisions from judicial second-guessing and directors from liability unless a challenger shows that the corporate decision either was tainted by interest . . . was uninformed . . . or lacked a rational business purpose." *Id.* at 1361. Referring to the latitude that courts give directors under the business judgment rule, Palmiter further argued that "courts accord near-complete deference to corporate decisions untainted by interest." *Id.* at 1361–62. *See generally* S. Samuel Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93 (1979) (discussing the different versions of the business judgment rule and concluding that the business judgment rule is essentially embodied in § 35 of the Model Business Corporation Act); Franklin A. Gevurtz, *The Business Judgment Rule: Meaningless Verbiage or Misguided Notion?*, 67 S. CAL. L. REV. 287 (1994) (advocating the abolition of the business judgment rule).

For a discussion of judicial reluctance to overturn a board decision concerning executive compensation, see Elson, *supra* note 1, at 959–63.

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considered to be somewhat ineffective in combating the problem of board laxity.[51]

However, the Delaware court in *Smith v. Van Gorkom*, in a startling change of approach, stiffened substantially the standards that a board must meet to demonstrate that its decisionmaking process was "informed" and therefore merited the protection of the business judgment rule. In that case, after describing in great detail the decisionmaking process by which the defendant Trans Union Corporation Board (Board) had approved the sale of its company, the court ruled that the Board's decision was uninformed. Although many in the financial community firmly believed that the Board's actions in reaching its decision were perfectly reasonable in the context of events and in no way demonstrated an uninformed judgment (an opinion apparently shared by the court's two dissenting justices),[52] the majority's detailed

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51. *See supra* notes 37—38.

52. It has been vigorously argued that the facts in *Van Gorkom* did not warrant the court's finding of director liability. Critics of *Van Gorkom* have pointed out, among other facts, the following:

> 1) There was no indication that the Trans Union directors acted out of self-interest or impropriety, and the directors all possessed substantial business expertise, experience and in-depth knowledge of the affairs of the company;
>
> 2) The offered price was substantially above the market value of the company's stock;
>
> 3) The directors were aware that previous attempts to sell the firm were unsuccessful; and
>
> 4) Trans Union possessed extensive tax credits which could be utilized only through a merger.

Carney, *supra* note 47, at 283-85; Daniel R. Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 BUS. LAW. 1437, 1438 (1985) ("[T]he Delaware Supreme Court erred in holding that the actions of Trans Union's directors were not protected by the business judgment rule."); Macey, *supra* note 39, at 1221 ("From a business perspective, the directors [of Trans Union] probably thought they had all the information they needed."); Paul H. Zalecki, *The Corporate Governance Roles of the Inside and the Outside Directors*, 24 U. TOL. L. REV. 831, 838 (1993) ("The opinion [in *Van Gorkom*] surprised many, particularly because Van Gorkom was a large stockholder and was satisfied with the price.").

Consequently, observers in the financial and legal communities felt that the Board's decision was reasonable and informed. In commenting on the *Van Gorkom* decision, Professor Carney made the following observation:

> The result [of *Van Gorkom*] was that the court upset a decision made by a disinterested board, charged with no fraud or illegality, on the recommendation of a CEO with a substantial ownership interest, because the court did not believe these directors had sufficient information to protect their decision under the business judgment rule. As one dissenting justice pointed out, the five inside directors had 68 years of combined experience, while the five outside directors had 53 years cumulative experience as directors of this company. One outside director was an economist, formerly a Professor of Economics at Yale, Dean of the Graduate School of Business of the University of Chicago, and presently Chancellor of the University of Rochester. The other four were chief executives of major business corporations.

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description of that decisionmaking process and the problems that they felt were implicit in the defendant Board's actions served to create a number of new and important guideposts to "informed" decisionmaking.[53]

By detailing where the Trans Union Board's decision was in contravention with what it felt was acceptable behavior, the court created new standards for defining what was and what was seemingly not appropriate conduct for availing oneself of the protection of the business judgment rule. While it never actually mandated any specific requirements in the opinion, the court created its new guidelines for effective decisionmaking by negative implication through its critique of the Trans Union Board's actions. The defendant Board's actions became, in effect, a model for improper conduct, against which other boards' actions would be measured. By criticizing the short amount of time the Board spent deliberating its decision, among other things, the court seemed now to require that a board demonstrate that it had spent some substantial amount of time making a particular judgment in order to demonstrate informed decisionmaking.[54] However, the most significant new requirement to emerge from *Van Gorkom* involved the use of third-party advisors. Although the court's attack on the Trans Union Board's decisionmaking process explicitly stated that investment-bank-rendered fairness opinions were not "required as a matter of law,"[55] the fact that the court imposed liability on a board that failed to obtain such an opinion, and indicated that the procurement of such an opinion would have insulated the directors from liability, suggested the imposition of an informal requirement.[56] It seemed apparent that, as a

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Carney, *supra* note 47, at 285. For further discussion of the *Van Gorkom* decision and its implications, see Michael Bradley & Cindy A. Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance*, 75 IOWA L. REV. 1, 36–74 (1989); Leo Herzel & Leo Katz, Smith v. Van Gorkom*: The Business of Judging Business Judgment*, 41 BUS. LAW. 1187 (1986); Carey Kirk, *The Duty of Care and Duty of Loyalty in the Aftermath of Trans Union*, 5 COOLEY L. REV. 1 (1988); Jonathan R. Macey & Geoffrey P. Miller, *Trans Union Reconsidered*, 98 YALE L.J. 127 (1988); William T. Quillen, *Trans Union, Business Judgment, and Neutral Principles*, 10 DEL. J. CORP. L. 465 (1985).

The two dissenting justices in *Van Gorkom* apparently felt similarly. Justices McNeilly and Christie both argued that the Trans Union directors exercised sound business judgment with full knowledge of the pertinent facts when they approved the merger. *Van Gorkom*, 488 A.2d at 893–99.

53. *See* Douglas M. Branson, *Intracorporate Process and the Avoidance of Director Liability*, 24 WAKE FOREST L. REV. 97, 103–9 (1989); Bayless Manning, *Reflections and Practical Tips on Life in the Boardroom After* Van Gorkom, 41 BUS. LAW. 1, 8–14 (1985); *see also* Carney, *supra* note 47, at 283–88.

54. *Van Gorkom*, 488 A.2d at 874 (stating that the Board was grossly negligent when it approved the sale of the company after only two hours of deliberation).

55. *Id.* at 876.

56. *Id.* at 876–78; *see* Lucian A. Bebchuk & Marcel Kahan, *Fairness Opinions: How*

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general proposition, the retention of some independent third-party advisor might assist a board in meeting the "informed" requirement. This was to have tremendous impact on the way boards made decisions in all kinds of circumstances. Prudent corporate counsel now mandate the use of independent third-party counsel in various situations to enable a board to demonstrate that it has made an informed judgment.[57] In corporate control transactions, the acquisition of an investment-bank-rendered fairness opinion has become a virtual necessity.[58]

If few felt that what the Trans Union directors had done was improper, and the court's actions signaled a break with precedent, what then was the reasoning behind this result? Why liability?[59] Perhaps the court felt that, despite common practice and acceptance, the Board's actions were lax and inimical to the interests of the shareholders. By seemingly acquiescing to a management-initiated plan to sell

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Fair Are They and What Can Be Done About It?, 1989 DUKE L.J. 27, 28 (1989); Charles M. Elson, *Fairness Opinions: Are They Fair or Should We Care?*, 53 OHIO ST. L.J. 951, 958 (1992); Robert J. Giuffra, Jr., *Investment Bankers' Fairness Opinions in Corporate Control Transactions*, 96 YALE L.J. 119, 119–20 (1986); Dennis J. Block & Jonathan M. Hoff, *Investment Banker Opinions and Directors' Right to Rely*, N.Y. L.J., Nov. 17, 1988, at 5; *see also* Polk v. Good, 507 A.2d 531, 537 (Del. 1986) (finding that the board's reliance on the advice of an investment banker fulfilled its duty of good faith and reasonable investigation); Citron v. E.I. Du Pont de Nemours & Co., 584 A.2d 490, 512 (Del. Ch. 1990) (holding that the board's reliance on the advice of an investment banker satisfied its fiduciary duty).

57. *See* Branson, *supra* note 53, at 103 (stating that to avoid due care violations after *Van Gorkom*, directors should "make use of independent, outside experts, at least when the transaction is large enough to justify their use"); Fischel, *supra* note 52, at 1453 ("The most immediate effect of Trans Union will be that no firm considering a fundamental corporate change will do so without obtaining . . . documentation from outside consultants.").

58. *See* Branson, *supra* note 53, at 104; Elson, *supra* note 56, at 958–59; Giuffra, *supra* note 56, at 119–20; Macey, *supra* note 39, at 1221; Macey & Miller, *supra* note 52, at 139. Professor Fischel, commenting on the *Van Gorkom* ruling shortly after its announcement, wryly noted that the "outside consultants are the biggest winners after [*Van Gorkom*]. The decision requires their participation as a type of insurance no matter how worthless their opinion is or how much it will cost." Fischel, *supra* note 52, at 1453.

59. Commentators have offered varying explanations as to why the Delaware court found the Trans Union directors liable. Professor Carney cited *Van Gorkom* for the proposition that "Delaware courts have shifted from an assumption of adequate process to an examination of the actual processes." *See* Carney, *supra* note 37, at 924. He added that "these cases begin with a presumption of director ignorance and place the burden on directors of demonstrating that sufficient 'evidence' was introduced at the meeting at which the final decision was made, rather than respecting the accumulated experience and knowledge of the directors." *Id.*; *see also* Fischel, *supra* note 52, at 1445, 1447 ("The court in Trans Union was extremely critical of the procedures followed by Van Gorkom and the other directors. . . . Another aspect of the transaction that troubled the court was the failure of Trans Union's directors to conduct an auction."); Macey, *supra* note 39, at 1220 ("The *Van Gorkom* court based its opinion on its conclusion that the board of directors making the underlying decision was grossly negligent for recommending the merger to the company's shareholders without having constructed an 'appropriate procedural framework for the decisional process.' " (citing Jonathan R. Macey, *Civic Education and Interest Group Formation in the American Law School*, 45 STAN. L. REV. 1937 (1993))).

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the business without great argument or inquiry,[60] the Board had abdicated its traditional supervisory role and had consequently diminished shareholder value by getting less for the company than might have been received had it taken a more active role in the sale process. By imposing liability on the Trans Union directors, the court was making an example of the group to the rest of the corporate community. This harsh result thus would act both to create guideposts for effective decisionmaking and to compel better behavior through the threat of individual director liability. If boards simply followed the guidelines for good decisionmaking created by implication in the Trans Union Board's transgressions, the result would be better oversight and enhanced shareholder wealth.

Whatever the motivation of the *Van Gorkom* court, the result was clear. Through its decision, the Delaware court had signaled that the duty of care, rather than being simply "aspirational,"[61] had now been fitted with a new, sharp set of teeth that would compel effective board behavior. The court's attempt to force compliance with the duty resulted in the creation of certain procedures that a board must follow to avail itself of the protection of the business judgment rule to avoid liability for a duty-of-care violation. Avoid the pratfalls of the Trans Union Board, and liability will thus be averted. The Delaware court's response to board passivity was to enhance the duty of care by making it more difficult for a board to avoid its violation by claiming business-judgment-rule protection. Unless it followed certain implied rules of procedure, a board's actions would be subject to judicial review and potential liability.

Van Gorkom had a profound impact on corporate behavior. In an attempt to avoid liability for loss-producing decisions, corporate boards developed various procedures, based on the missteps of the Trans Union Board, to ensure that their decisions would be labeled informed

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60. The court noted that the Trans Union Board approved the merger recommended by Van Gorkom without extensive questioning. *Van Gorkom*, 488 A.2d at 875, 877. The court stated:

> [T]he directors were duty bound to make reasonable inquiry of Van Gorkom and [Chief Financial Officer] Romans, and if they had done so, the inadequacy of that upon with they now claim to have relied would have been apparent. . . . No director sought any further information from Romans. No director asked him why he put $55 at the bottom of his range. No director asked Romans for any details as to his study, the reason why it had been undertaken or its depth. . . . [T]he Board accepted without scrutiny Van Gorkom's representation as to the fairness of the $55 price per share for sale of the company—a subject that the Board had never previously considered.

Id. at 875, 877.

61. Coffee, *supra* note 40, at 799.

and therefore subject to the protection of the business judgment rule. Detailed, lengthy discussions regarding the decisions at issue were held, records were made of these debates, numerous documents were presented to each director, and most importantly, third-party "independent" advisors were retained to advise the board on the issues to be resolved.[62] All of these steps were designed to meet the criticism that the Delaware court leveled at the Trans Union directors. Each new step was responsive to some problem with the Trans Union Board's decisionmaking process as identified by the court. By following the guidelines implicitly laid out in *Van Gorkom*, it was thought, a board could avoid the disastrous consequence of personal liability.[63]

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62. For a listing of steps that directors should take to ensure a judicial finding of "informed" decisionmaking, see Branson, *supra* note 53, at 103-09; Manning, *supra* note 53, at 8—14. *See also* Carney, *supra* note 47, at 283—88 (discussing the judicial determination of a properly informed business decision); Macey, *supra* note 39, at 1219—21 (discussing the steps that directors should take, pursuant to the ALI).

63. Branson, *supra* note 53, at 103—09 (listing 15 specific guidelines that, if followed, insulate directors from duty-of-care violations); Manning, *supra* note 53, at 8—14 (listing factors implicit in the *Van Gorkom* decision that enable directors to avoid liability).

In response to the *Van Gorkom* decision, a number of state legislatures took action to reduce a director's risk of personal liability for actions taken while a board member. Delaware was the first state to enact a statute that allowed the placement into a corporation's certificate of incorporation by shareholder vote of a clause limiting or eliminating director liability for a breach of the duty of care. Dennis J. Block & Jonathan M. Hoff, *Protecting Outside Directors: D & O Insurance*, N.Y. L.J., Oct. 12, 1989, at 5, 7. The Delaware statute provides that a certificate of incorporation may contain the following:

> A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such a provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or knowing violation of law; (iii) under § 174 of the title; or (iv) for any transaction from which the director derived an improper personal benefit.

DEL. CODE ANN. tit. 8, § 102(b)(7) (1991). "Within two years" following enactment of the Delaware statute, some 41 states similarly amended their corporations statutes to limit director liability. Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 EMORY L.J. 1155, 1160 (1990) [hereinafter Romano, *Aftermath of the Insurance Crisis*]. Most of these statutes tracked the Delaware approach, but there were some variations. Some states increased the level of culpability necessary to find personal liability. *See, e.g.*, IND. CODE ANN. § 23-1-35-1(e) (Burns Supp. 1994) (requiring "willful misconduct or recklessness"); OHIO REV. CODE ANN. § 1701.59(D) (Anderson 1992) (requiring "deliberate intent" or "reckless disregard"); WIS. STAT. ANN. § 180.0828 (West 1993) (requiring "willful failure to deal fairly," "violation of criminal law," "improper personal profit," or "wilful misconduct"). At least one state simply limited the amount of damages for which a director may be liable. *See* VA. CODE ANN. § 13.1-692.1 (Michie 1994) (capping the liability at $100,000 or the amount of compensation received from the corporation within the last 12 months). For further discussion on the different approaches state legislatures used to limit director liability, see JOSEPH W. BISHOP, LAW OF CORPORATE OFFICERS AND DIRECTORS INDEMNIFICATION AND INSURANCE §§ 6.36-.86 (1994); Block & Hoff, *supra*, at 5, 7; Deborah A. DeMott, *Limiting Directors'*

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Almost ten years have passed since the ruling in *Van Gorkom* was handed down. Despite numerous attacks on its viability and logic,[64] the decision still stands. In fact, recently the Delaware court explicitly reaffirmed *Van Gorkom* in *Cede & Co. v. Technicolor.*[65] In that case, which among other things involved an alleged board duty-of-care violation, the court approvingly cited and applied *Van Gorkom* to determine whether the defendant Technicolor Board had made an "informed" decision in approving the sale of the company.[66] It found that they had not. And in the most recent Delaware takeover decision, *Par-*

Liability, 66 WASH. U. L.Q. 295 (1988); James J. Hanks, Jr., *Evaluating Recent State Legislation on Director and Officer Liability Limitation and Indemnification*, 43 BUS. LAW. 1207 (1988); Romano, *Aftermath of the Insurance Crisis, supra*, at 1160–68.

These statutes, however, have not necessarily eliminated the potential for, or director's fear of, personal liability. *See* Leo Herzel et al., *Next-to-Last Word on Endangered Directors*, HARV. BUS. REV. Jan.-Feb. 1987, at 38, 43 (stating that courts can circumvent the new Delaware statute because "[w]ith only a little effort, courts could find directors liable for disloyalty where before they would have found them liable for negligence"); Romano, *Aftermath of the Insurance Crisis, supra*, at 1161 (questioning the effectiveness of the legislative response to director liability because "the statutes in most states do not exempt from liability claims for breach of the duty of loyalty, violation of federal securities laws, and breach of the duty of care by directors who are also officers"); Roberta Romano, *What Went Wrong with Directors' and Officers' Liability Insurance?*, 14 DEL. J. CORP. L. 1, 32 (1989) (stating that limited liability statutes are ineffective because "plaintiffs will, in all likelihood, be able to redraft their complaints to continue to bring lawsuits; for example, instead of alleging negligence they will allege reckless behavior").

In addition to reducing directors' exposure by limiting personal liability, some states increased director indemnification rights. *See, e.g.*, LA. REV. STAT. ANN. § 12:83E (West Supp. 1994); MO. ANN. STAT. § 351.355(7) (Vernon Supp. 1991); N.Y. BUS. CORP. LAW § 721 (McKinney Supp. 1994); Block & Hoff, *supra*, at 5, 7; DeMott, *supra*, at 317–22; Hanks, *supra*, at 1221–24; Romano, *Aftermath of the Insurance Crisis, supra*, at 1162–63. This approach, however, has also proved problematic. *See* Dennis J. Block, *Advising Directors on the D & O Insurance Crisis*, 14 SEC. REG. L.J. 130, 146–47 (1986); Theodore D. Moskowitz & Walter A. Effross, *Turning Back the Tide of Director and Officer Liability*, 23 SETON HALL L. REV. 897, 912 (1993); John F. Olson, *The D & O Insurance Gap: Strategies for Coping*, LEGAL TIMES, Mar. 3, 1986, at 25, 33 (stating that "[indemnification is] only as good as the assets of the corporation"); *see also* MICHAEL A. SCHAEFTLER, THE LIABILITIES OF OFFICE: INDEMNIFICATION AND INSURANCE OF CORPORATE OFFICERS AND DIRECTORS 143–44 (1976) (listing several instances where indemnification does not protect directors).

Despite these statutory attempts to limit director personal liability, either through liability limitations or indemnification, director concern with potential liability for improper decisionmaking still remains. DeMott, *supra*, at 298 (arguing that directors must continue to be concerned with litigation risks because "[a]s a result of these unfortunate deficiencies [in legislative responses to director liability], the risk exposure of directors and officers to liability is unpredictable"). Therefore, either because of continued fear of personal liability or simply the desire to avoid the embarrassment and inconvenience of a shareholder lawsuit on a particular decision, boards continue to follow the *Van Gorkom* guidelines for "informed" decisionmaking.

64. For criticisms of the *Van Gorkom* reasoning, see Carney, *supra* note 37, at 894; Fischel, *supra* note 52, at 1438; Macey, *supra* note 39, at 1219-22.

65. 634 A.2d 345 (Del. 1993).

66. *Id.* at 366, 367.

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amount Communications v. QVC Network,[67] the court cited to its decision in *Van Gorkom* when attacking the defendant Paramount Board's decisionmaking process as "uninformed."[68] So *Van Gorkom* survives. But should it? Has the alteration in board behavior occasioned by the decision really resulted in more "informed" decisionmaking? Have we seen better, more active board oversight and enhanced shareholder wealth? Despite the best intentions of the Delaware court, no such good has resulted. Although, theoretically, the new board procedures that resulted from the heightened attention to the duty of care occasioned by *Van Gorkom* should have acted to compel more informed and circumspect decisionmaking, they have not. And, in fact, some have had the opposite effect and have acted to protect and therefore encourage the dangerous board passivity created by management capture that so perplexed the *Van Gorkom* court.

One major change in board behavior created by *Van Gorkom* involves the time that a board spends on a particular decision. The criticism that the court leveled on the Trans Union Board because it devoted only two hours to deliberating the sale of the company[69] has resulted in boards' devoting much more time to decisionmaking. Accordingly, the decisionmaking process now generally runs for a period of some hours and involves detailed questioning of management by board members on the proposal before the group. Numerous documents involving the decision are made available to the directors, and detailed records are made of the discussions held. While this may create the appearance of an "informed" active process, the reality may be something quite different. It is not unlikely that the proceedings have been informally, or even formally, scripted in advance by corporate counsel keenly aware of the *Van Gorkom* parameters and eager to create a protective paper record.[70] Staged like a good play, such proceedings may evoke a recitation of the required emotions on the part of the

67. 637 A.2d 34 (Del. 1994).

68. *Id.* at 50.

69. Smith v. Van Gorkom, 488 A.2d 858, 874 (Del. 1985).

70. *See* Branson, *supra* note 53, at 110 ("This nearly total emphasis on process may be criticized as resulting in an excessive amount of play-acting, out-of-pocket costs, inefficiency, and reliance upon process by both courts and corporations."); Carney, *supra* note 37, at 924 (stating that the duty-of-care cases after *Van Gorkom* "begin with a presumption of director ignorance and place the burden on directors of demonstrating that sufficient 'evidence' was introduced at the meeting at which the final decision was made"); Macey, *supra* note 39, at 1221 ("[T]he [*Van Gorkom*] case will increase the use of investment bankers and lawyers in corporate decision-making. . . . [This] increased 'papering' of board decisions will not substantially raise the level of deliberations." (quoting Jonathan R. Macey & Geoffrey P. Miller, *Trans Union Reconsidered*, 98 YALE L.J. 127, 139 (1988))). For a list of actions that directors should take to create a protective paper trail, see also Manning, *supra* note 53, at 8–14.

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actors that, in the final analysis, when the stage lights dim, have only been an illusion. Nothing is gained by such a charade. Entertaining, maybe; shareholder value-enhancing, absolutely not.

A requirement that one spend a certain amount of time at a task does little to ensure the proper administration of the job. A requirement to provide one with documents pertaining to a decision does little to assure that they will be read. The key is not dictating the time involved or information provided, but giving the participant some incentive to be both well-versed in the subject and actively engaged when it is discussed. The *Van Gorkom* requirements do little to accomplish this goal.

The other major change in board behavior occasioned by *Van Gorkom* has been the active retention of the "independent" third-party advisor to aid boards in their decisionmaking process. As noted earlier, the *Van Gorkom* court suggested that the use of an independent investment bank by the Trans Union Board to assist it in evaluating the fairness of the price being offered for the company would have aided the Board in precluding liability by helping it to meet the "informed" requirement of the business judgment rule.[71] Since then, the use of the third-party advisor as an aid to informed decisionmaking has grown tremendously. In the corporate control transaction area, the procurement of an investment-bank-rendered fairness opinion has become a virtual necessity because it is considered to be a vital prophylactic measure for ensuing business-judgment-rule protection for buy or sell decisions.[72]

Theoretically, the retention of an independent third-party advisor acts to ensure the probity of a particular decision. If an independent expert suggests that all is well with a particular decision, then it would apparently be hard to quibble with the process by which that decision was made. The key to the effectiveness of this theory is that the advice of the third party be objective and independently rendered. Any ties to the decisionmaker that would act to compromise the independence and objectivity of the advice proffered must be avoided. Otherwise, the advice rendered may not really aid the decisionmaking process, but may simply act to "rubber stamp" the decision that the advisee has already made. This kind of compromised advice does nothing to ensure the probity of the decision reached, but, in fact, is terribly harmful to the entire process. It acts to give legitimacy to a potentially illegitimate decisionmaking process and therefore encourages bad decisions through

71. *See supra* notes 55—57 and accompanying text.

72. For a discussion of the necessity of fairness opinions, see *supra* note 55—58 and accompanying text.

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protecting the decisionmaker from liability for the decision. This is why the *Van Gorkom*-inspired third-party-advisor concept is so problematic. If there is anything in the relationship between the third-party advisor and the board that acts to compromise the objectivity of the advice given, then the presence of that advisor does nothing to ensure the thoughtfulness of the decision to be made. Thus, giving business-judgment-rule protection to such decisions on the basis of the presence of the third party is not only unwise, but potentially harmful to stockholder interests. If, by engaging a "captured" third party, a passive board may completely shield itself from liability for failing carefully and actively to consider a management proposal, there is absolutely no incentive to challenge management on any issue, but a good reason to remain passive. The legal response to board passivity represented by *Van Gorkom* may thus not only fail to discourage board passivity created by management capture, but may even act to encourage such harmful behavior.

Nowhere is this problem more evident than in the investment-bank-rendered fairness opinion area that was one of the subjects of the *Van Gorkom* ruling. As discussed, following *Van Gorkom*, fairness opinions were sought by decisionmaking boards in virtually all corporate control transactions. However, if the fairness opinion is to provide the necessary "back-up" to a board's decision, the process by which that opinion was formed must necessarily be well-reasoned and honestly and properly performed. Unfortunately, the processes for determining fair value are varied and easily manipulatable,[73] and there exist structural factors implicit in the environment in which investment banks operate that militate against the objective and independent valuation advice necessary for effective board decisionmaking. These structural factors include, among other things, a desire by the opining bank to

73. Elson, *supra* note 56, at 960−65. The procedures available for determining fair value include discounted cash flow analysis, evaluation of comparable companies, evaluation of comparable acquisitions, and liquidation value. *Id.* at 961; *see, e.g.*, ROBERT L. KUHN, INVESTMENT BANKING 97−123 (1990) (surveying valuation methods utilized by investment bankers); Giuffra, *supra* note 56, at 137−39 (summarizing the four traditional valuation methods); Michael W. Martin, Note, *Fairness Opinions and Negligent Misrepresentation: Defining Investment Bankers' Duty to Third-Party Shareholders*, 60 FORDHAM L. REV. 133, 139−41 (1990) (listing break-up analysis as a fifth method); Arthur H. Rosenbloom & Arthur H. Aufses III, *On Understanding Investment Banker Liability*, INSIGHTS, Apr. 1990, at 3, 4 (discussing the valuation methods used by investment bankers and their underlying assumptions); Brian H. Saffer, *Touching All Bases in Setting Merger Prices*, MERGERS & ACQUISITIONS, Fall 1984, at 42 (analyzing concisely the strengths and weaknesses of the four traditional valuation techniques).

Although there are arguably merits to each method, it has been suggested that any proper valuation analysis should utilize a combination of some or all of these approaches. Elson, *supra* note 56, at 960−65.

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complete a desired transaction so that it can share in the fees to be generated and the need of that bank to build and maintain an active client base created in part by satisfying management, which is responsible for future employment.[74] As a consequence, we have witnessed the development of a "fairness for hire" regime, where the advice rendered by the retained third-party bank is not the result of a truly independent valuation process, but simply reflects what the board (or actually management in many cases) so desires.[75] The investment banker's fairness opinion merely "rubber stamps" a previously reached conclusion. Although the retention of such advisors may act to preclude board liability under *Van Gorkom*, little is accomplished to assure the probity of the board's decisionmaking process.

In fact, because the procurement of a fairness opinion helps to preclude liability, board passivity may even be encouraged in the management-captured entity. If there is no punishment for passivity, those structural factors promoting board passivity[76] will continue to dominate the directors' decisionmaking process. Additionally, because the expense of retaining an investment bank to render a fairness opinion is likely to be quite substantial, often running into the millions of dollars, the passivity protected by the fairness opinion is likely to be costly to the shareholder in more ways than one.[77] The fairness opinion requirement, rather than working to protect shareholder wealth, may thus be having the opposite result, something that could not have been the intention of the *Van Gorkom* court.

A similar phenomenon can be observed in the compensation area. Excessive compensation is the result of a passive bargaining process between boards and executives.[78] Legal protection for a board's inactivity in this process is available through application of the business judgment rule. Provided that a board has no actual interest in the salary recommendations that it is considering, has spent a significant amount of time discussing the compensation proposals, and has relied on the advice of a third-party advisor as to the appropriateness of a salary package, its compensation decisions will be labeled "informed" and, thus, will be protected under the *Van Gorkom* rule.[79] The reten-

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74. *See* Elson, *supra* note 56, at 964–70.

75. *Id.* at 964–65; Giuffra, *supra* note 56, at 123; Dale A. Oesterle & Jon R. Norberg, *Management Buyouts: Creating or Appropriating Shareholder Wealth?*, 41 VAND. L. REV. 207, 250 (1988); Robert McGough, *Fairness for Hire*, FORBES, July 29, 1985, at 52.

76. *See supra* notes 29–32 and accompanying text.

77. Elson, *supra* note 56, at 966-68.

78. *See supra* Part I.

79. For a discussion of how directors could protect themselves under the *Van Gorkom* rule, see *supra* notes 53–63 and accompanying text.

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tion of an independent compensation consultant acts to insulate the board from liability.

Theoretically, the use of a third-party advisor helps to ensure director probity in compensation decisionmaking. This, of course, assumes that the consultant acts in an objective and independent manner when advising the directors. Unfortunately, this is rarely the case. There are two fundamental problems in the structure of the consultant-corporation relationship that undercut objectivity. First, these advisors are generally hired by management and frequently perform multiple tasks for the corporation.[80] Thus, there is a powerful disincentive for recommending a salary structure that management would consider to be inadequate. It is difficult to cross the party who has engaged you, particularly if the promise of future dealings with that party or friends of that party lies in the offering.[81] Second, compensation structuring is not a precise art or science. It is based on comparisons with what other businesses are paying. There is tremendous subjectivity involved in deciding with what businesses the client's compensation structure will be compared. The consultant may look to companies in the same industry, differing types of businesses of similar size, or even companies with a similar profitability picture; the universe is practically infinite, limited only by the number of businesses in existence. Moreover, the relative weight given to each element is completely up to the advisor.[82] The high level of subjectivity inherent in compensation analysis and the reengagement concerns discussed above have left consultants prone to management capture in the same way that investment bankers who render corporate fairness opinions lack independence from the corporations that retain them.[83] As a result, the advice given by a compensation consultant potentially lacks the objectivity and independence necessary to assure that a compensation package is reasonably related to

80. For example, Towers Perrin, one of the nation's largest compensation consulting firms, also designs employee pension and health plans for companies. CRYSTAL, *supra* note 2, at 219–20.

81. *See id.* at 218–19.

82. *Id.* at 42–50; *see* Elson, *supra* note 1, at 974 n.105.

83. *See* Suein L. Hwang, *Ties That Bind, Fired Tambrands CEO Was Unusually Close to a Consulting Firm*, WALL ST. J., Aug. 23, 1993, at A1. Immediately following the ouster of Tambrands Chairman and Chief Executive Martin C. Emmett, the corporation terminated all contracts with Personnel Corporation of America (PCA). *Id.* PCA, a corporation with which Emmett had close personal ties, is a human resources firm that had been retained to advise the board of directors concerning, among other matters, executive compensation. *Id.* As a result of PCA's efforts, Emmett received a lucrative benefit package and options to purchase close to 600,000 Tambrands shares. *Id.* Judith Fischer, publisher of Executive Compensation Reports, says that "it is, or can be, an incestuous relationship" when a chief hires a compensation consultant to advise the board concerning executive compensation. *Id.*

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an executive's professional contributions. This compensation consultant "for hire" phenomenon, particularly when combined with boards partly comprised of outside directors who may be unwilling to challenge management, results in compensation arrangements that are acquiesced to and not bargained for and, thus, that are potentially unreasonable.[84] Unfortunately, these arrangements enjoy legal protection through the operation of the business judgment rule, as modified by the *Van Gorkom* decision. The idea that a board's retention of a third-party advisor leads to more effective and responsible decisionmaking has proven to be a great disappointment. It has only led to continued—and it may be argued, heightened—board passivity.

The Delaware court's liability-imposing ruling in *Van Gorkom* was intended to bolster compliance with the duty of care as a means of creating more effective board behavior. As a result of the decision, boards began to follow certain procedures—based on the Trans Union Board's transgressions—that were designed to ensure that each decision made would receive business-judgment-rule protection and thus be in compliance with the duty of care. Theoretically, those procedures should have created more effective decisionmaking. They did not and, in fact, have only resulted in continued board passivity, potentially injurious to shareholder interests. It was a classic triumph of form over function. The duty of care, strengthened by *Van Gorkom*, has proven to be ineffective in resolving the passivity problem. Thus, another approach must be developed.

III. THE EQUITY-BASED APPROACH

How can we motivate a board, compositionally passive, to become an active management monitor? The traditional approach to this problem, reflected in the duty of care, sought to compel effective board behavior through the threat of personal liability for those boards who abrogated their responsibilities. Despite this duty, harm-producing board passivity created by management capture flourished, and it was rare that courts ever found boards to be in violation.[85] *Van Gorkom* attempted to bolster compliance with this duty, but as discussed, has proven unsuccessful in reducing board passivity.[86] This malady illus-

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84. *See* CRYSTAL, *supra* note 2, at 214—40. *But see* Frederic W. Cook, *Executive Pay and the Board*, DIRECTORS & BOARDS, Spring 1992, at 43, 45 (observing that the best compensation consultants are not advocates for the CEO, but merely provide independent, objective advice).

85. *See supra* note 37 and accompanying text.

86. Perhaps recognizing the difficulties inherent in the duty of care, combating the problem of the passive board, and resulting ineffective management, a number of commentators have

trates the difficulty in attempting to induce desired behavior through

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recently focused on the potential of institutional shareholder activism in forcing boards to become more active "monitors" of corporate management. The size and financial sophistication of institutional investors, who increasingly constitute the largest shareholders in many of the largest corporations, make them particularly well-suited to an active role in creating more effective shareholder oversight of both boards and managers. As a corporation's largest shareholders, institutions may have the clout to force a board effectively to monitor corporate management. For example, the Teachers Insurance and Annuity Association—College Retirement Equities Fund (TIAA-CREF) recently promulgated a policy statement on corporate governance. In an effort to improve corporate governance policies and procedures, TIAA-CREF advocates a board comprised primarily of independent directors, implementation of a pay-for-performance executive compensation system, annual board review of CEO performance, and board exercise of fiduciary oversight. TEACHERS INSURANCE AND ANNUITY ASSOCIATION—COLLEGE RETIREMENT EQUITIES FUND, POLICY STATEMENT ON CORPORATE GOVERNANCE (1994). Failure to so act could result in a board's ultimate replacement by a coalition of shareholders spearheaded by the agitated institutional investors. The prospect, or even the actual or perceived threat, of such action would be strong enough to convince otherwise passive directors to act more effectively.

Indeed, much scholarly attention has been devoted to the "promise" of "institutional investor voice." Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 816 (1992). *See generally* MONKS & MINOW, *supra* note 4 (noting that institutional investors closely monitor boards because of their desire to increase portfolio values and to avoid "liability for breach of fiduciary duty"); Jayne W. Barnard, *Institutional Investors and the New Corporate Governance*, 69 N.C. L. REV. 1135 (1991) (examining the concept of shareholder advisory committees and the appropriate role of institutional investors in corporate governance); Bernard S. Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 UCLA L. REV. 895 (1992) (discussing the benefits institutional oversight could have on corporate performance); Richard M. Buxbaum, *Institutional Owners and Corporate Managers: A Comparative Perspective*, 57 BROOK. L. REV. 1 (1991) (analyzing the transnational effects of institutional investments); John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM L. REV. 1277 (1991) (discussing the efficiency and development of institutional investors in the United States); Alfred F. Conard, *Beyond Managerialism: Investor Capitalism?*, 22 U. MICH. J.L. REF. 117 (1988) (discussing the motivations of institutional investors and the prospective consequences of investor activism); George W. Dent, Jr., *Toward Unifying Ownership and Control in the Public Corporation*, 1989 WIS. L. REV. 881 (1989) (analyzing the separation of ownership and control and offering a solution to corporate governance); Gilson & Kraakman, *supra* note 13 (proposing a strategy for improving corporate governance through increased activity on the part of institutional investors); Louis Lowenstein, *Why Managements Should (And Should Not) Have Respect for Their Shareholders*, 17 J. CORP. L. 1 (1991) (advising corporations on the proper relationship with shareholders); Thomas C. Paefgen, *Institutional Investors Ante Portas: A Comparative Analysis of an Emergent Force in Corporate America and Germany*, 26 INT'L LAW. 327 (1992) (suggesting that long-term financial strategies of institutional investors will increase effective board monitoring in American and German corporations); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445 (1991) (analyzing the significance of increased shareholder activism); Robert D. Rosenbaum, *Foundations of Sand: The Weak Premises Underlying the Current Push for Proxy Rule Changes*, 17 J. CORP. L. 163 (1991) (addressing the underlying premise on calls for proxy reformation).

It is unquestionable that institutional investors have begun to exercise more power over corporate affairs than they did even a few years ago. In a number of large corporations, they have been active advocates for change in corporate policy and personnel. Most recently, a number of large institutions have played a major role in forcing boards to make changes in manage-

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the threat of punishment for noncompliance with accepted practice. Although external force is sometimes useful in creating desired conduct, it may have little impact or even produce an unanticipated harmful result if not effectively applied.

As a well-known parable suggests, it is not the stick that compels acceptable behavior, but the carrot as incentive. The *Van Gorkom*-enhanced duty of care functions as an ineffective "stick"; we must replace it with a carrot. But how can we incentivize outside directors in the large public corporation to eschew their traditional passivity? We must make it clear that it is in their own self-interest to do so. They must not become active participants in the oversight process because someone is ordering them to so engage, but must act because they feel that it is in their own self-interest.

The board's failure to monitor management effectively and the consequent overcompensation controversy are the result of unchecked initiative and self-interest on the part of management and passive indifference on the part of the corporation's directors. Externally based pressure on a board to monitor actively—and to bargain forcefully on compensation matters—has proven to be ineffective. The real solution lies with stimulating effective board oversight from within the boardroom itself. We must create a corporate regime based on board self-motivation. Only then will the board function as the effective monitoring force of general corporate affairs for which it was originally created. But how can we create the kind of self-motivation that will

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ment and policy at such prominent corporations as IBM, Westinghouse, American Express, Phillip Morris, and even General Motors. *See supra* notes 15, 21, 27.

Despite this activity, it is unclear whether these groups will be able, over the long run, to place the kind of constant and continual pressure on boards that will result in effective oversight. There are several reasons why sole reliance on institutions to resolve the passivity controversy would be a mistake. First, as Professor Coffee has pointed out, a preference for liquidity in their investment portfolios "chills the willingness of institutional investors to participate in the control of major corporations." Coffee, *supra*, at 1281. Second, because each institution's holdings in the various corporations in which it invests is likely to be quite small proportionally, effective control over the affairs of the target corporation would only be effected through a coalition of institutional investors. Differences over investment goals and strategy may make such coalitions difficult to form and maintain, hindering effective action. Additionally, to act as a group, the varying shareholding institutions must be able to communicate with one another freely. Under present SEC regulations (including the proxy rules), however, such communication may be restricted. There is no doubt that institutions are becoming more restless shareholders and have begun to demand a more active role in corporate governance. But, for the above reasons among others, they may never prove as effective as their proponents suggest in a general corporate monitoring role. This does not mean that efforts to encourage institutional voice should cease, but this voice may not bring as much positive change as earlier envisioned. *See* *Elson*, *supra* note 1, at 970−72; *see also* Bainbridge, *supra* note 13, at 1054 n.108 (discussing commentaries that state institutional investors can provide an active voice in corporate governance).

counter the kind of pro-management pressures placed on outside directors due to management capture?

A. Stock Ownership

The outside director must be made to consider management activity from the viewpoint of a company stockholder, to whom the director is legally obligated, instead of from the perspective of one beholden to management. It is the stockholders who stand to lose the most from the lackluster corporate performance created by ineffective board monitoring. Thus, it is crucial that the company's outside directors realign their interests and thinking with those of the shareholders.[87] The most

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87. "Under traditional state and corporate law doctrine, officers and directors of both public and closely held firms owe fiduciary duties to shareholders and to shareholders alone." Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L. REV. 23, 23 (1991). The Michigan Supreme Court stated in *Dodge v. Ford Motor Co.*:

> A business is organized and carried on primarily for the profit of stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the nondistribution of profits among stockholders in order to devote them to other purposes.

Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919), *cited in* Stephen M. Bainbridge, *In Defense of Shareholder Wealth Maximization Norm: A Reply to Professor Green*, 50 WASH. & LEE L. REV. 1423, 1423 (1993).

Professor Berle ascribed to the principle that directors owe a fiduciary duty only to the company's stockholders, stating that "you can not abandon emphasis on 'the view that business corporations exist for the sole purpose of making profits for their stockholders' until such time as you are prepared to offer a clear and reasonably enforceable scheme of responsibilities to someone else." A.A. Berle, Jr., *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365, 1367 (1932).

However, Professor Merrick Dodd challenged this theory, thereby providing the basis for the contemporary debate concerning to whom the benefits of the director's fiduciary duty should flow. E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustee?*, 45 HARV. L. REV. 1145 (1932) (arguing that directors should represent constituencies other than shareholders). This argument has been coopted and advocated by numerous contemporary scholars. *See generally* John C. Coffee, Jr., *The Uncertain Case for Takeover Reform: An Essay on Stockholders, Shareholders and Bust-Ups*, 1988 WIS. L. REV. 435 (1988) (advocating protection of middle managers whose jobs are threatened by bust-up takeovers); Ronald M. Green, *Shareholders as Stakeholders: Changing Metaphors of Corporate Governance*, 50 WASH. & LEE L. REV. 1409 (1993) (arguing for a shift in the law and a new definition of corporate directors' fiduciary duties); Morey W. McDaniel, *Bondholders and Stockholders*, 13 J. CORP L. 205, 265–73 (1988) (arguing for protection of bondholders harmed by takeovers); Morey W. McDaniel, *Stockholders and Stakeholders*, 21 STETSON L. REV. 121 (1991) (arguing why constituency statutes are beneficial and necessary); Marleen A. O'Connor, *Restructuring the Corporation's Nexus of Contracts: Recognizing a Fiduciary Duty to Protect Displaced Workers*, 69 N.C. L. REV. 1189 (1991) (arguing that directors should owe employees a fiduciary duty to alleviate employee displacement caused by corporate restructuring); Katherine Van Wezel Stone, *Employees as Stakeholders Under State Nonshareholder Constituency Statutes*, 21 STETSON L. REV. 45 (1991) (advocating the creation of fiduciary duties on behalf of employees); Steven

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effective way to create such perspective is to appeal directly to these directors' personal pecuniary interests. The outside directors must not remain mere observers of the corporate enterprise, but must become active equity participants. If a director's personal capital is potentially affected by inept or corrupt management, that director is much less likely to acquiesce passively to such a group. From a personal standpoint, there is much less incentive to stand watch over what one considers to be someone else's property than over what one considers to be one's own. Interestingly enough, this was the whole point behind the creation of the externally imposed director's duty of care.

By becoming equity holders, the outside directors would assume a personal stake in the success or failure of the enterprise.[88] Decisions that had a negative impact upon the business would be collaterally harmful to their own personal financial interests. Thus, director demand for effective management would no longer be the result of compliance with a distant legal requirement (or vaguely understood pressures from outside institutions), but would emanate from within. Directors would have a substantial personal interest in creating an efficient and competitive management structure. To demand any less would be disadvantageous to their own financial well-being.

Equity ownership would act to counter the pressures placed on the outside directors as a result of management capture. It is very hard to resist the demands of individuals to whom you owe your position when your involvement in the venture is limited to the fee you receive for your services and the continuance of that fee is subject to the will of management. Possessing an actual stake in the venture itself alters the nature of this relationship considerably.[89] In addition to considering that the active monitoring of management may lead to replacement, an outside director must also consider that the failure to exercise effective oversight may result in the diminution of his or her personal wealth. Under such an arrangement, it would not be quite so easy simply to acquiesce to the demands of management. This dynamic creates a more

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M.H. Wallman, *The Proper Interpretation of Corporate Constituency Statutes and Formulation of Director Duties*, 21 STETSON L. REV. 163 (1991) (examining corporate constituency statutes and the benefits of permitting directors to consider the interests of nonshareholder constituencies).

88. *See supra* note 6. Brown Brothers Harriman's Lawrence Tucker, who served as a director on one particular corporate board that had an average director investment of nearly $1 million, described that group as a "board that pays attention . . . . I've never seen the pocket calculators come out so quickly in my life." Ted Bunker, *Editor's Page*, INVESTORS' DAILY, July 7, 1993, at 4.

89. As Professor Stobaugh has observed, "A director with little stock ownership but substantial annual compensation would have little financial incentive to 'rock the boat' if that presents any danger of his or her being replaced as a director." Stobaugh, *supra* note 6, at 3.

balanced relationship between management and equity-holding outside directors and, in turn, encourages the kind of oversight presently lacking in the traditional management-dominated board.[90]

B. Lengthened Director Terms

Very often, though, outside directors do in fact hold stock in the companies they serve. If equity ownership has any motivational impact or potential, why then are these directors still so susceptible to management capture? It is not that the possession of an equity position in a venture has no impact on director motivation, but the fact that these directors' stockholdings in their companies are insubstantial compared with the monetary and reputational compensation they receive for board service. In the typical large public corporation, many of the outside directors own relatively small amounts of company stock.[91] Their major stake in the venture is the fee they receive each year for board service. Such fees, particularly in the larger corporations, may well exceed $40,000 per annum—no small reward for a position in-

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90. David McLaughlin, a noted management consultant, has stated:

> Stock ownership obviously helps to align shareholder and director interests . . . . Some boards have been slow to respond to deteriorating company fortunes (witness the sagas of IBM, General Motors, Westinghouse, and Eastman Kodak). Perhaps if the directors of those companies had significant personal stakes in their enterprises, they would have been quicker to reveal and resolve fundamental issues of strategy and leadership. While compensation has been overrated as a motivator, when six-figure sums are involved, even wealthy individuals pay attention to trends in the stock price.

McLaughlin, *supra* note 6, at 59.

91. For example, the current and past holdings of a few noted directors at several larger public corporations are as follows:

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volving attendance at only a few meetings a year.[92] In addition, the social and reputational advantages for board service are obvious. The more prestigious the company on whose board an individual sits, the more influential one is considered to be in the business community,

COMPANY	DIRECTOR	SHARES
Bank of Boston	Wayne A. Budd	200
	Donald Monan	0
	Alfred M. Zeien	500
IBM	Harold Brown	321
	Nannerl Keohane	321
	Richard Munro	421
Mobil	J. Richard Munro	100
	William J. Kennedy, III	400
	Avlana L. Peters	100
Disney	Robert Stern	100
	Gary Wilson	0
Philip Morris	Rupert Murdoch	400
	Richard Parsons	500
Sears Roebuck	Mandell de Windt	450
	Norma Pace	400
	Nancy C. Reynolds	454
Ralston Purina	David Banks	200
	Francis Ferguson	556
Paramount	Benjamin L. Hooks	100
General Motors	Thomas E. Everhart	400
	Edmund T. Pratt, Jr.	200
	Louis W. Sullivan	100
Westinghouse	Paula Stern	411

BANK OF BOSTON CORP., MAR. 24, 1993 PROXY STATEMENT 6 (1993); GENERAL MOTORS CORP., APR. 13, 1993 PROXY STATEMENT 4—6 (1993); IBM PROXY, *supra* note 29, at 11; MOBIL CORP., MAR. 22, 1993 PROXY STATEMENT 8 (1993); PARAMOUNT COMMUNICATIONS INC., JAN. 29, 1993 PROXY STATEMENT 6 (1993); PHILIP MORRIS COMPANIES INC., MAR. 7, 1991 PROXY STATEMENT 10 (1991); RALSTON PURINA CO., DEC. 10, 1991 PROXY STATEMENT 9 (1991); SEARS ROEBUCK & CO., MAR. 21, 1991 PROXY STATEMENT 3 (1991); WALT DISNEY CORP., DEC. 27, 1993 PROXY STATEMENT 2 (1993); WESTINGHOUSE ELECTRIC CORP., MAR. 8, 1993 PROXY STATEMENT 14 (1993).

92. Remuneration for nonemployee directors often exceeds $40,000, including their annual retainer, the fee received for attending meetings, and any additional compensation they may receive for chairing committees. *See supra* note 29. Often remuneration goes beyond annual compensation and payments for meetings attended. For example, each nonemployee director at Eastman Kodak is covered by group term-life insurance in the amount of $100,000. Nonemployee directors at American Express who have served at least five years are eligible to receive $30,000 per annum upon their retirement from the board; these payments continue for a number of years equal to the time served on the board or until death. AMEX PROXY, *supra* note 29, at 7. Similarly, General Electric's nonemployee directors who have served at least five years, are over 65 years of age, and retire directly from the board are eligible to receive either an annual payment for life equal to the amount of the last retainer received or a $450,000 life insurance policy. GE PROXY, *supra* note 29, at 13; *see* Bruce Overton, *Remuneration of Outside Directors*, *in* A STRATEGIC GUIDE, *supra* note 21, at 383.

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which leads to other opportunities for financial benefit.[93] Outside directors may sometimes supplement their fees with lucrative consulting contracts provided by solicitous management. The most glaring example of this phenomenon occurred during the leadership of F. Ross Johnson, the legendary CEO of RJR/Nabisco, who had placed several outside directors on the company payroll prior to the leveraged buy-out that eventually cost Johnson his job.[94]

Generally, the cumulative annual fees paid to each outside director, particularly when considered over the multi-year terms of typical board membership, involve considerably more money than the usual value of that director's stockholdings in the business. Most business decisions involve a consideration of both the costs and the benefits of the contemplated strategy. When an outside director in a management-controlled enterprise makes a decision that challenges management prerogative, that director risks retribution from the dominant executives, which might involve the failure to be renominated to the board at the next election. Obviously, before making such a decision, the director will, consciously or not, weigh the various benefits that such a decision entails against any attendant costs. Where a director's stockholdings in a given corporation are substantially less than the income that the director receives in fees, the potential loss of such fees may weigh more heavily in that director's mind than any beneficial increase in stock value that might result from the corporate efficiencies created. This would explain management "capture" even in situations where the outside directors have equity positions in their companies. The key, then, is not merely stock ownership, but *substantial* ownership.

At what threshold do holdings become "substantial"? To have a salutary impact on director behavior, equity ownership by outside directors must be significant enough to affect a director's decisionmaking process. An outside director's shareholding position must be large enough that, in considering a particular course of action, concern about how a decision will positively affect equity value subsumes traditional desires to placate fee-paying management. A director's personal shareholdings must weigh more heavily in that individual's decisionmaking process than fee-maintenance concerns. The value of that individual's equity interest in the business must exceed the amount to be obtained through continued fee income. If a director's personal interest in the

93. *See* MACE, *supra* note 4, at 87–91; Overton, *supra* note 92, at 383.

94. *See* BRYAN BURROUGH & JOHN HELYAR, BARBARIANS AT THE GATE: THE FALL OF RJR NABISCO 97–98 (1991). At the time of the leveraged buyout, RJR Nabisco's outside directors were among the highest paid directors in American industry. Overton, *supra* note 92, at 388.

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company's stock were to exceed the annual compensation and prestige value of board membership, perhaps that individual would be less willing to side continually and complacently with management when such behavior could have a negative impact on the company's market value and, thus, on his or her personal holdings. We must make it in the director's own self-interest to challenge and monitor management. A large equity position in the business would go far toward accomplishing this goal. But how can we create a stake large enough to induce favored behavior?

To create the appropriate equity incentive, the corporation should simply pay the directors their annual fees in company common stock. It seems only natural that each director should be rewarded with an interest in the business itself as compensation for the exercise of oversight as a board member. In addition, the company should make a limited cash payment to each equity-compensated director to cover any income taxes that may be imposed as the result of such stock grants. To prevent the quick liquidation of these stock payments and consequent loss of equity-based incentive, the stock awarded must be restricted as to resale during the individual's directorship.[95] Although some might argue that a stock-option grant to directors may serve the same purpose, and at less cost to the corporation, such an approach would prove less effective than direct equity ownership simply because of the highly tentative nature of an option prior to exercise.[96] Stock ownership provides the director with a tangible stake in the enterprise, not merely some speculative expectancy of a discounted future position.

Although such a compensation system will create substantial stockholdings in the hands of the previously complacent outside directors, a few problems remain. To have any sort of favorable impact on director behavior, the amount of stock that each director holds must be reasonably substantial. The key is to provide each individual with a block large enough to induce active monitoring. Although a director's yearly fee may purchase a large amount of stock, it may not be enough to create the kind of stake that will counterbalance the fear of replacement that management challenge may bring. Therefore, a director's term of office must be expanded significantly. Instead of being elected to a term of one to three years, directors should instead serve five-year terms. In addition to minimizing the immediacy of any management replacement threat, such a term will create in each director both an

95. To alleviate any potential liquidity concerns that a director may have as the result of such restriction, the corporation may allow the individual to pledge the restricted stock as collateral for either a company-sponsored or third-party loan.

96. *See* Elson, *A Board-Based Solution*, *supra* note 2, at A22; Lublin, *supra* note 6, at R5.

immediate equity stake and, without yearly reelection concerns, the promise of a fixed number of future stock grants. Five years' worth of fees paid in company stock should result in the accumulation of a reasonably substantial equity position for each director.[97] Moreover, because of the fixed five-year term, the beneficial impact of equity ownership will manifest itself throughout the period of board service. A director will either possess the stock itself or the expectancy of a certain five-year accumulation that will provide similar incentive.

The quinquennial election of directors is not a new proposal. Martin Lipton and Steven Rosenblum, two prominent corporate practitioners, recently advocated such a change in board structure, along with a host of other major governance reforms.[98] They suggested that the creation of a five-year fixed term of office would create a corporate "long-term view" highly beneficial to corporate "vitality."[99] The main goal of their proposal, however, involves the creation of a corporate governance model "that will lead managers and stockholders to work cooperatively towards the corporation's long-term business success."[100] Their arguments advocating term expansion focus primarily on creating a management-shareholder "long-term" cooperation relationship, rather than corporate productivity through active director oversight.[101] Despite this goal, their call for a longer range perspective on company affairs, an obvious byproduct of five-year director terms, is a laudable and desirable result. Who can really argue when management and boards of directors make decisions with the long-term health of the enterprise in mind? Some of Lipton and Rosenblum's other proposals, especially those promoting the hindrance of changes of corporate control, are more problematic. However, they should not detract from the potential benefits of quinquennial director terms. If five-year terms can be combined with equity grants, an effective incentive for active director monitoring will be created, resulting in greater productivity and responsibility to the equity holders.

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97. For example, if a director is paid $35,000 per annum, at the conclusion of his term, he should own $175,000 in company stock. If he receives $50,000 per year, he would complete his term with $250,000 worth of stock.

98. Lipton & Rosenblum, *supra* note 7, at 187-253. The quinquennial election of directors is one part of Lipton and Rosenblum's proposal for comprehensive reform of the present corporate governance system. *Id.* Their proposal would also bar nonconsensual changes in control between elections, provide major shareholders with access to corporate proxy materials relating to elections of directors, require a detailed five-year report on the company's performance and a prospective five-year plan, and tie management compensation awards and penalties to the corporation's performance against the plan. *Id.* at 190.

99. *Id.* at 216.

100. *Id.* at 189.

101. *Id.* at 224–52.

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There are two potential drawbacks, however, to lengthened director terms. First, such terms may make corporate changes of control much more difficult to accomplish. Second, they could lead to the possible entrenchment of ineffective, or even disloyal, directors. These problems are not as dramatic as they would appear to be at initial glance. First, shareholders always have the right to remove a director for cause,[102] a power that should resolve the problem of the disloyal or inattentive director. Second, provisions could be made to allow shareholder removal of directors without cause, which should ease any potential chilling effect of the proposal on changes of corporate control. However, given the more active director behavior this proposal should entail, changes of control would not appear to be necessary to compel effective management. Moreover, the "long view" perspective that such a lengthened term may provide to the outside directors, no longer subject to the pressures of annual election, also weighs heavily in the proposal's favor. Directors, now possessing a five-year time horizon, will find it easier to make decisions that offer the promise of strong long-term returns even though they may have a negative impact on short-term profitability. The five-year term thus has great potential.

C. Potential Costs

Of course, as no approach to resolving a particular corporate problem comes without its costs, we must consider the negative impact that an equity-based approach may entail. One difficulty that increased equity ownership may create involves the possible chilling effect of positive risk-taking behavior by the outside directors. A business will only prosper by the amount of risk that management is willing to take. The greater the risk taken, the greater the potential return to the shareholders. It may be argued that outside directors who own large amounts of company stock, particularly those with limited outside assets, will have such a significant portion of their personal wealth tied to company stock that they will have an incentive to demand that management adopt a more conservative risk-taking posture. While such an approach may preserve the value of these individuals' personal holdings through the steady maintenance of corporate assets, it will concurrently deter the sort of aggressive behavior that brings the potential of

102. *See, e.g.*, Campbell v. Loew's, Inc., 134 A.2d 852, 859 (Del. Ch. 1957); Auer v. Dressel, 118 N.E.2d 590, 596 (N.Y. 1954). Some state statutes have modified the common-law rule and allow shareholders to remove directors without cause. *See e.g.*, CAL. CORP. CODE § 303(a) (West 1994); N.Y. BUS. CORP. LAW § 706 (McKinney 1986); REV. MODEL BUSINESS CORP. ACT § 8.08 (1984); *see also* CAREY & EISENBERG, *supra* note 14, at 153–54.

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significant profit and asset growth. Unfortunately, these individuals would have no opportunity to increase their personal tolerance to risk through the portfolio diversification techniques other investors utilize because they would be forced to hold unsalable restricted stock.

This problem, although not insignificant, is not as troubling as it would initially appear to be. It assumes that the commitment of a large portion of one's assets to a single enterprise inevitably leads to conservative behavior. This is not always the case. Many successful entrepreneurs have most of their personal wealth invested in their businesses. This does not discourage, but rather acts to encourage, risk, for the ultimate goal of wealth accumulation that motivates these individuals cannot be met without risk. They achieved success through risk, and their stockholdings encouraged still greater risk because of the potential to share in the larger returns that such risk brings. What about those in business who are not entrepreneurial in spirit but who possess a more restrained, managerial bent? For such individuals, unless they possess significant holdings in other ventures, the commitment of a large portion of their personal wealth to the company on whose board they sit may discourage risk-taking. On the other hand, can it be said that a fee-based compensation program will act conversely—to stimulate risk-taking behavior? Not necessarily. In fact, this is why there has been a shift in recent years to creating compensation programs for corporate management that result in executive equity accumulation rather than simple cash payments. One goal is to encourage risk-taking rather than position preservation.[103] Creating equity positions in outside directors may have the same impact.

Although some individuals are risk-averse by nature (and, indeed, the presence of such persons on a board may even be a welcome counterbalance to those with excessive dare), it is not at all clear that the payment of directors' fees in cash encourages risk-positive behavior. In

103. *See, e.g.*, Alisa J. Baker, *Stock Options — A Perk That Built Silicon Valley*, WALL ST. J., June 23, 1992, at A20 (questioning the crusade against stock-based compensation); Gilbert Fuchsberg, *Former Critic of Big Stock Plans for CEOs Now Supports Them*, WALL ST. J., Dec. 16, 1992, at B1 (noting that the United Shareholder Association, a former critic of stock-based compensation, now supports this compensation plan); Michael C. Jenson & Kevin J. Murphy, *CEO Incentives—It's Not How Much You Pay, But How*, HARV. BUS. REV., May—June 1990, at 138, 141 ("By controlling a meaningful percentage of total corporate equity, senior managers experience a direct and powerful 'feedback effect' from changes in market value."); Stephen F. O'Byrne, *Linking Management Incentives to Shareholder Wealth*, J. CORP. ACCT. & FIN., Autumn 1991, at 91, 97 (listing several strategies to increase management's performance incentive). *But see* Amanda Bennett, *Taking Stock: Big Firms Rely More on Options but Fail to End Pay Criticism*, WALL ST. J., Mar. 11, 1992, at A1 (commenting on the fact that while stock-based compensation is gaining popularity, it also allows for corporations to give more to their CEOs).

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the typical management-captured corporation, the expectation of continued fee income leads to passive conduct ultimately harmful to corporate productivity. Risk-averse individuals are particularly susceptible to such pressure. Creation of an equity-based incentive as an antidote to director passivity may produce the positive impact on behavior that will far outweigh any potential danger of elevated risk aversion among a few individuals. In fact, the impact may be risk-neutral (for some may be inherently risk-averse) or even risk-positive.

A second disadvantage of equity-based director compensation may be an exclusion from the pool of potential directors of those who would rather be compensated for their activities with cash. It could be argued that by refusing to compensate in cash, a corporation could deprive itself of the services of a large group of talented individuals. No such loss would occur by paying cash fees, for a company could attract the involvement of both those who desire cash and those who would prefer equity, as these individuals could easily convert their cash payments into company stock. This argument misses the point. It was the payment of fees in cash that, in the management-captured enterprise, created the passivity that led to oversight-driven productivity problems in the first place. A director who would demand only cash and refuse to take an equity position in the enterprise might be just the sort of individual who should not serve as a monitor of management behavior.[104] Of course, a director is not giving up the right to compensation by being paid in stock. The form of compensation is simply being varied. Indeed, to decline to serve simply because of a noncash form of payment suggests the sort of purely mercenary mentality that has led to the entire problem of management capture. A board made up of individuals willing to demonstrate a real commitment to the shareholders whom they were elected to serve by taking an equity position in the enterprise is a corporation's best hope. An equity-based director compensation system will lead to the type of board composition that will maximize management productivity.

104. One commentator states that he will not serve on private company boards unless he can make a substantial cash investment in the company. This large investment allows him to get involved in nearly every facet of the business, which in turn creates a chance to earn a substantial return and decreases the chance of lawsuits from other shareholders. William A. Sahlman, *Why Sane People Shouldn't Serve on Public Boards*, HARV. BUS. REV., May—June 1990, at 34. David McLaughlin has argued that stock ownership requirements on the part of corporate directors will not make it more difficult "to recruit first rate directors . . . . It is a myth that 'independent' non-corporate directors cannot afford to make an investment. Our analysis shows that directors who represent non-profit institutions own about as much stock as the average director." McLaughlin, *supra* note 6, at 59.

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D. The Empirical Evidence

Central, of course, to the effectiveness of an equity-based solution to the board passivity dilemma is the assumption that stock ownership has a positive impact on director behavior. For this approach to be successful, there must be a link between equity ownership and more motivated director behavior. An empirical examination of the behavior of boards composed of outside directors with substantial stockholdings, as compared with boards whose outside directors do not possess large equity stakes, may act to demonstrate the potentially positive impact of an equity-based approach.

Two businesses researchers, Professor Robert Stobaugh of the Harvard Business School and David McLaughlin, a noted management consultant, recently conducted separate studies examining the linkage between director stock ownership and more effective board oversight and corporate productivity. Both found that substantial outside director equity ownership led to heightened performance. In his study, McLaughlin randomly selected seventy of the largest publicly traded United States companies "with median sales of $9.4 billion, and examined the ownership pattern of the 631 non-management directors who sit on the boards of these companies."[105] He discovered that "the higher ownership commitment" on the part of the outside directors, the "greater the total shareholder return."[106] Those companies "whose outside directors have relatively high stock holdings outperform those whose non-management directors have minimal holdings."[107] Additionally, those businesses with the greatest outside director shareholdings "outperform the bottom half [of the companies surveyed] in both five-year compound earnings-per-share growth and average return on shareholders' equity."[108] McLaughlin concluded from his study that, as an aid to performance, boards must establish director-stock-ownership plans and create periodic audits of director shareholdings.[109]

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105. McLaughlin, *supra* note 6, at 55.

106. *Id.* at 56.

107. *Id.* at 53. McLaughlin reported that "our study of 70 companies . . . shows that those with the highest director ownership delivered a return of 174% to their shareholders over the five years from 1988 to 1990, while those with the lowest delivered only a 73% return." *Id.* at 54.

108. *Id.* at 56.

109. *Id.* at 59. McLaughlin argued:

> It seems reasonable, however, to require all directors, within three years of election, to hold an amount at least equal in value to the annual retainer. The ownership level should increase over time, to a value of two to three times the annual retainer after four to six years, and three to five times as the director approaches

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Professor Stobaugh conducted a similar study, but with a smaller sampling of companies surveyed. He contrasted the director stockholdings of nine companies on the *Fortune* magazine list of America's "most admired companies" with nine that were "corporate governance 'targets' of varying shareholder rights groups, including the California Public Employees Retirement System and United Shareholders Association."[110] The financial returns of those companies on the "most admired" list substantially exceeded those of the other companies examined.[111] Stobaugh discovered that the median amount of stock held by the directors of the former group of companies was eight times that of the latter group.[112] He concluded that these results were "consistent with the logic that tieing a director's financial well being to a company's performance might be important."[113] On the basis of this survey, he recommended the following:

> Stock ownership by corporations should be increased substantially so that directors will be further motivated to take prompt action in addressing corporate problems. In linking a director's personal financial interest to those of shareholders, shareholder interest will be better served . . . . [I]ncreasing substantially the ownership of stock by directors should improve corporate governance by providing additional incentives for directors to overcome the inertia that sometimes prevents them from making tough decisions.[114]

Expanding on the research conducted by McLaughlin and Stobaugh, I conducted a broader study that yielded similar results. Annually, *Fortune* magazine conducts a survey to determine America's most and least admired companies.[115] In 1992, the survey included 311 companies in 32[116] different industries.[117] The survey polled over 8000

> 10 years of service. The initial ownership goal can be facilitated for new directors if the company offers to supplement the individual's own "going in" commitment with an initial grant, or pays a portion of the annual retainer in stock.

Id.

110. Stobaugh, *supra* note 6, at 2.

111. *Id.*

112. *Id.*

113. *Id.*

114. *Id.* at 3, 4.

115. Jennifer Reese, *America's Most Admired Corporations*, FORTUNE, Feb. 8, 1993, at 44.

116. The 32 industries included were the following: mining, crude-oil production; petroleum refining; utilities; forest & paper products; pharmaceutical; chemicals; textiles; metals; building materials; rubber & plastics products; metal products; electronics, electrical equipment; computers, office equipment; scientific, photographic & control equipment; publishing, printing; apparel; soaps, cosmetics; retailing; furniture; diversified service; life insurance; diversified financial; commercial banking; savings institutions; food; beverages; tobacco; aerospace; motor vehicles & parts; industrial & farm equipment; transportation; and transportation equipment. *Id.*

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senior executives, outside directors, and financial analysts, asking them to rate the ten largest companies in their own industry on eight attributes of reputation, using a scale of zero (poor) to ten (excellent).[118] The eight reputational attributes polled involved both financial and nonfinancial measures, including such items as value as a long-term investment, use of corporate assets, quality of management, and quality of products or services.[119] These ratings were then combined to create a total reputational score, also on a zero (poor) to ten (excellent) scale, and each company was ranked by the total score received, from the most admired United States corporation (a score of 8.74) to the least admired (a score of 1.99).[120]

Assuming that there is some validity in suggesting that the companies most admired by the corporate and financial communities are more effectively managed and possess better board monitoring than those that are not, this survey provides an excellent starting point for an examination of the link, if any, between good corporate results and outside director stock ownership. Of the 311 companies examined in the *Fortune* study, I selected for review the 110 companies that were on either extreme of the survey—either receiving the highest or the lowest ratings for overall admiration. Fifty-eight of the companies I examined were "most admired," receiving a score of 7.0 or higher in the study.[121] The remaining fifty-two I studied were "least admired,"

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117. *Id.* at 53.

118. *Id.*

119. The eight attributes included were the following: quality of management; financial soundness; quality of products or services; ability to attract, develop, and keep talented people; use of corporate assets; value as long-term investment; innovativeness; and community and environmental responsibility. *Id.* at 46.

120. *Id.* at 54—55. Additionally, the opinion research firm of Clark Martire & Bartolomeo, who aided in the survey, explained the relationship between the poll data and actual financial performance of the companies surveyed. Twelve measures of performance, "including profits, assets, and return on shareholders' equity," were combined with the survey data into a spreadsheet. A multiple regression was then run to analyze the relationship between financial performance and reputation score. The resulting equation was used to predict a reputational score based solely on financial performance. *Id.* at 44, 53. Interestingly, financial performance did correlate with the reputational rankings, although there were obviously some exceptions. *See id.* at 44.

121. The following were the most admired companies: Merck; Rubbermaid; Wal-Mart Stores; 3M; Coca-Cola; Procter & Gamble; Liz Claiborne; J.P. Morgan; Boeing; Kimberly-Clark; Coring; Johnson & Johnson; PepsiCo; Pfizer; General Mills; Motorola; Golden West Financial; American Brands; Cooper Tire & Rubber; Du Pont; BellSouth; Hewlett-Packard; Sara Lee; Shaw Industries; General Electric; Harley-Davidson; Herman Miller; International Flavors & Fragrance; Dow Chemicals; Morgan Stanley Group; Anheuser-Busch; Gillette; Abbott Laboratories; Apple Computers; Reader's Digest; Illinois Tool Works; AT&T; Springs Industries; Colgate-Palmolive; Eli Lilly; Alcoa; American International Group; Great Western Financial; Bankers Trust N.Y.; Berkshire Hathaway; Southwestern Bell; Philip Morris; Xerox; Amoco; Bell Atlantic; Bristol-Myers Squibb; VF; Bandag; PPG Industries; Exxon; R.R. Don-

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receiving a score of 5.5 or lower.[122] I then reviewed the proxy statements of each of the 110 selected corporations to ascertain how much company stock was held by each of the companies' outside directors.[123] Next, I determined how many companies were run by boards in which outside directors with individual holdings valued in excess of $20,000[124] constituted a majority of the full board and, thus, theoretically controlled that institution. This procedure was then repeated for holdings valued in excess of $50,000, $100,000, $125,000, $150,000, $200,000, and $250,000. Finally, I compared the stockholdings of outside directors serving on the "most admired" companies' boards with the holdings of outside directors serving on the "least admired" companies' boards. This comparison was an attempt to test the hypothesis that outside directors on the boards of companies that were well-regarded and consequently better managed were more likely to have substantial equity holdings in those companies than outside directors on the boards of companies that were least admired and thus poorly run.

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nelley; Pacific Gas & Electric; and A. Schulman. *Id.* at 44.

122. The following were the least admired companies: Tektronix; W.R. Grace; Dr. Pepper/Seven-Up; Cigna; Whitman; Avondale Industries; Holnam; Collins & Aikman; Northrop; FirstFed Michigan; James River; First Chicago; Seagate Technology; Chase Manhattan; Burlington Industry Cap.; General Motors; USX; Grumman; Borden; Union Carbide; First Interstate Banc.; Inland Steel Industries; USG; Westinghouse Electric; Digital Equipment; Stone Container; Maxxam; Citicorp; Amoskeag; Champion International; West Point-Pepperell; Coast Savings Financial; McDonnell Douglas; Interco; Navistar International; Travelers; Travelers Corp.; USAir Group; Anchor Bancorp; Boise Cascade; Northwest Airlines; Brooke Group; Sears Roebuck; Hartmarx; Bethlehem Steel; Unisys; Crystal; Calfed; Dime; Glenfed; Continental Airlines Holdings; and Wang Laboratories. *Id.*

123. "Outside directors" was defined as those directors who were not and had not served as officers of the corporation. Furthermore, a family member, such as a widow or spouse, of an officer of the corporation was not considered to be an outside director.

124. The stock prices used to calculate the dollar value of the outside directors' stockholdings reflected the closing market values of the various stocks as of November 10, 1993. WALL ST. J., Nov. 10, 1993, at C3.

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TABLE 1

Total Number of Companies in Survey: 110
Number of Companies That Are Most Admired (score 7.0 +) : 58
Number of Companies That Are Least Admired (score 5.5 -) : 52

Number of Boards Controlled by Directors Who Own Substantial Amounts of Company Stock:

Size of Director Stockholdings	*Most Admired*	*Percentage of Total Companies in Most Admired Grouping*	*Least Admired*	*Percentage of Total Companies in Least Admired Grouping*	*Deviation Factor*
>20K	48	82.7%	32	61.5%	1.344
>50K	37	63.7%	26	50.0%	1.240
>100K	22	37.9%	14	26.9%	1.408
>125K	16	27.5%	10	19.2%	1.432
>150K	12	20.6%	7	13.4%	1.537
>200K	12	20.6%	6	11.5%	1.791
>250K	9	15.5%	4	7.69%	2.015

The results, presented in Table 1, confirm the initial hypothesis on the relationship between equity holdings and better corporate performance and oversight. The companies in the "most admired" category were much more likely to be run by boards with significant equity investments in the business than those that were considered the "least admired" and thus poor performers. Further, the greater the value of outside director holdings, the more likely it was that the corporation surveyed would fall into the "most admired" category.

In the group of companies that were "least admired," at the $20,000 director shareholding level, only 61.5% of the companies surveyed had boards numerically dominated by outside directors with at least $20,000 in company shareholdings. At the $100,000 level, the percentage dropped substantially to 26.9%; and at the $150,000 level, the percentage fell to 13.4%. Finally, in the $250,000 category, the highest level surveyed, only 7.69% of the companies in the "least admired" grouping had outside director equity holdings at that level.

The results for those companies in the "most admired" category differed substantially. To be sure, there was—as the dollar criteria grew—a decline in the numbers of companies meeting the holdings standards at each level. However, at each monetary level, the percentage of companies meeting the relevant criteria was always substantially greater than was seen in the "least admired" category, and the lowest percentage of compliance, seen at the highest survey level, $250,000, was significantly greater than the corresponding percentage in the alternative grouping of companies. At the $20,000 level, 82.7% of the

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companies surveyed had outside director shareholdings meeting the relevant criteria. At the $100,000 level, the percentage dropped to 37.9%; and at the $150,000 level, the percentage stood at 20.6%. Finally, in the $250,000 category, 15.5% of the companies in the "most admired" grouping had outside director equity holdings at that level.

Two points about these results are particularly worth noting. First, at every examined level of outside director stockholdings, there were proportionally significantly more companies in the "most admired" category than in the "least admired" category. Second, as the level of director holdings increased, the spread between the two groups of companies grew significantly. At the $20,000 level, only 61.5% of the companies in the "least admired" grouping met the equity-holding criteria; at $100,000, just 26.9%; at $150,000, only 13.4%; and finally at $250,000, just 7.69%. This differed substantially from those companies in the "most admired" grouping, where at the $20,000 level, 82.7% met the criteria; at $100,000, 37.9%; at $150,000, 20.6%; and at the $250,000 level, 15.5%. At the $100,000 level, there were almost one and one-half times as many companies in the "most admired" category as in the "least admired"; and at the $250,000 level, the spread between the two grew to exceed more than twice the number.

What, then, do these numbers demonstrate, and how do they relate to an equity-based solution to the passive board problem? The results of my survey, particularly if read in light of the Stobaugh and McLaughlin studies, suggest that the positive impact of outside director stock ownership on corporate performance and, obviously, effective board conduct is notable at all levels of director equity ownership. And, as the value of director holdings increases, the impact of stock ownership is even more notable, as the two groups of companies experience even greater divergence in results. Substantially fewer of the corporations that are considered poor performers, at least by the standards of the *Fortune* study, are run by boards numerically dominated by outside directors with substantial equity holdings in those businesses. Many more of the companies that are performing in a respected fashion have boards numerically controlled by outside directors with large equity positions. At the $250,000 level, there are more than twice as many companies that are considered good performers as those in the "least admired" category. Although this is not a survey of great scientific precision, it does suggest that there may be some connection between heightened equity ownership and better corporate performance, an important consequence of effective board oversight. The more substantial the holdings become, the greater the appearance of a link between stock ownership and the kind of effective monitoring that leads to desired company performance.

Missing, of course, from an interpretation of the results of the study is any indication of the effect of a five-year board term on director behavior. None of the 110 companies surveyed had such a term structure. What does appear from the results, however, is an indication of the positive impact, not simply of stock ownership, but of substantial stock ownership. The key to more effective board monitoring, then, is to create in each outside director a substantial equity position in the business itself. Payment of director fees in stock, combined with five-year terms of office, will create such holdings. As noted earlier,[125] implementation of this plan will result in outside director stakes in the larger corporations of at least $175,000, or even higher, which, as indicated in the survey, is well above the level at which positive benefit becomes pronounced.

The empirical evidence yielded by this study suggests that companies with boards composed of outside directors with significant shareholdings tend to outperform those without such boards. An alignment of the directors' interests with those of the shareholders, rather than with those of management, through the development of large shareholding positions resulting in more effective oversight, would explain this phenomenon. Thus, an equity-based attack on board passivity may be potentially helpful and warranted.[126]

E. The Duty of Care, Equity Ownership, and Van Gorkom

The equity-based approach to resolving the problem of the passive board has great potential and must be strongly encouraged. But what should become of corporate law's traditional response to the inattentive director—the duty of care? Should we abandon this institutionalized legal rule entirely? Not necessarily. The problem with the duty as it is now formulated, post-*Van Gorkom*, is that it has created a Byzantine pattern of behavior among corporate boards that, as discussed, leads nowhere helpful. We must therefore abandon the *Van Gorkom* ap-

125. *See supra* notes 88—97 and accompanying text.

126. Apparently as a result of the recognition of the beneficial aspects of director stock ownership, within the last year, the number of large United States corporations providing stock grants to outside directors has risen dramatically. According to an analysis of varied 1994 proxy statements by William M. Mercer, Inc., nearly three-fourths of a group of 350 large industrial and service companies reported using stock grants as part of their directors' compensation programs. *In Review—Recent Notes & Events: Compensation & Recruitment*, CORP. BOARD, July-Aug. 1994, at 28. Despite this trend toward creating stock grant programs for outside directors, it is rather disappointing to note that in its recently promulgated "Board Guidelines," designed to promote effective board behavior, General Motors failed to require or even suggest outside director equity ownership in the company. GENERAL MOTORS CORPORATION, GM BOARD GUIDELINES ON SIGNIFICANT CORPORATE GOVERNANCE ISSUES (1994).

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proach to the duty and transform it from a rule of law that attempts to coerce desired behavior through the threat of liability for noncompliance with mandated procedure to one that, as Professor Coffee has suggested, is more "aspirational"[127] in nature. A duty of care that serves more as a guide to desired behavior on the part of corporate directors through its "socializing and exhortative impact,"[128] though still available to punish extreme conduct, is, in combination with substantial board equity ownership, much more likely to have a positive impact on board behavior than the present *Van Gorkom*-styled approach. The real issue that we must confront is motivation. How do we create desired behavior—through coercion or individual-based self-motivation? Self-motivation is always more effective. When it is in an individual's own self-interest to act in an appropriate manner, that individual will so act. Equity ownership creates such motivation and synergistically, in combination with a return to a less rigid approach to the duty of care, will stimulate the effective board oversight that has been so lacking in both the pre- and post-*Van Gorkom* eras.

This point becomes much clearer through a reexamination of several aspects of *Van Gorkom* that until now have received scant attention. There are two most interesting facts relating to the compositional nature of the Trans Union Board that, in light of my empirical data, are highly relevant in explaining why the Board's actions might be seen as problematic. First, at the time of its fateful merger decision in late 1980, the Trans Union Board was comprised of ten members—five of whom were officers of the corporation and five of whom were "outside" directors.[129] None of the five outside directors, all of whom apparently supported the proposed merger, could be characterized as "substantial equity holders" in the company. Their rather paltry individual holdings ranged in size from 101 to 599 shares of stock. In fact, four out of the five owned less than 300 shares, which—at a then market price of $37.25 per share—represented total Trans Union holdings for these four directors (all present or former CEOs of very large publicly held corporations) ranging from $3763 to $11,175 in value.[130]

Second, cross-directorships abounded on this Board. Most of the

127. Coffee, *supra* note 40, at 798.

128. *Id.*

129. Trans Union's "inside" directors, those who served as directors and officers of the corporation, were Sidney H. Bonser, William B. Browder, Bruce S. Chelberg, Thomas P. O'Boyle, and Jerome W. Van Gorkom. Trans Union's "outside" directors were William B. Johnson, Joseph B. Lanterman, Graham J. Morgan, Robert N. Reneker, and W. Allen Wallis. TRANS UNION CORP., APR. 24, 1980 PROXY STATEMENT 3–6 (1980) [hereinafter TUC PROXY].

130. The stockholdings of Trans Union's "outside" directors were as follows:

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outside directors, in addition to Van Gorkom, who was the Trans Union Chairman and CEO, served either on one another's boards or as directors of common corporations.[131] It is no stretch logically to conclude that all of these individuals were probably either financial or social acquaintances of Van Gorkom, with fairly strong ties binding them together. It must also be noted that there appeared to be no one shareholder or group of shareholders holding enough Trans Union shares to exercise control of the company. From the small number of outside directors serving on the Board and the insubstantial stockholdings of each, it is fairly clear that management controlled the enterprise. Additionally, the average yearly fee paid each director, $10,000 plus $700 for each board and board committee meeting attended, adding up to about $18,000 in 1979,[132] well exceeded most of the outside directors' total equity holdings in the company. In sum, given the absence of a dominant shareholder control group at Trans Union, the

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DIRECTOR	SHARES OWNED
William B. Johnson	101
Joseph B. Lanterman	200
Graham J. Morgan	200
Robert W. Reneker	300
W. Allen Wallis	599

TUC PROXY, *supra* note 129, at 4-6.

131. An examination of Trans Union's Board of Directors reveals a network of interlocking directorships and provides one with an excellent case study of the cross-directorship phenomenon. The other directorships held by Trans Union's directors were as follows:

COMPANY	DIRECTOR
IC Industries	Johnson (Chairman/CEO, IC Industries) Van Gorkom Morgan
U.S. Gypsum	Morgan (Chairman/CEO, U.S. Gypsum) Reneker
Illinois Bell	Lanterman Morgan
Esmark	Reneker (Chairman, Esmark) Johnson
Continental Illinois	Johnson Reneker
International Harvester	Lanterman Morgan

TUC PROXY, *supra* note 129, at 4–6.

132. Trans Union's nonemployee directors received $10,000 annual compensation in 1979 and $700 for each board meeting attended in person. Additionally, directors received $700 for each committee meeting, unless the committee meeting was in communication with a board or other committee meeting, in which case they were paid $350 for attending such committee meeting. TUC PROXY, *supra* note 129, at 2.

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small shareholdings of the outside directors, the numerous cross-directorships, and the fact that the annual board fees exceeded most of the outside directors' total shareholdings, the Trans Union Board had all the markings of a group subject to management-capture or at least serious management domination. This may explain why the Board's rather quick decision to sell the company, following Van Gorkom's brief presentation, appeared to some, including the Delaware court, to be so problematic. There were structural factors inherent in the composition of the Trans Union Board that may have compromised the Board's independent decisionmaking, even with regard to so important a step as the sale of the company.

As discussed, the Delaware court's liability-imposing response to what it considered to be the Trans Union Board's "uninformed" decision in effect rejuvenated the duty of care. The heightened compliance with the duty required by *Van Gorkom* in its end result did nothing to resolve the problem of board passivity created by management domination, which was perhaps the source of the Trans Union Board's "uninformed" decision. In light of the empirical data collected on the potentially positive effect of equity ownership on board performance, one has to wonder what sort of review process the Trans Union Board might have conducted before making its decision to sell the company had each of the outside directors maintained a substantial equity stake in the company. Had the Board held the kind of equity position in Trans Union that might have counterbalanced the potentially compromising impact of management domination, they might have reached a decision on the merger in a very different manner and foreclosed the kind of shareholder and judicial concern that led to the *Van Gorkom* ruling. The facts of *Van Gorkom*, then, rather than providing the basis for the creation of a heightened duty of care, may actually lend support to an equity-based approach to the problem of board passivity.

IV. Conclusion

The most critical problem confronting United States corporation law today is not the overcompensation of corporate executives, but the flourishing of the passive board created by management capture. Board passivity has resulted in not only the overcompensation controversy, but the lackluster corporate performance that has made our basic industries falter in the international marketplace. Executive overcompensation is but a symptom of the much more serious malady affecting the modern corporation—the presence of management unresponsive to shareholder welfare because unchecked by active board monitoring and oversight. Such self-interested management, either generally unproduc-

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tive or motivated primarily by personal gain, creates the kind of ineffective corporate enterprise that results in both diminished shareholder profit and lessened overall societal wealth.

The problem of unproductive or self-serving management can be resolved by stimulating effective board oversight. However, the creation of active management monitoring in a board compositionally suited to passivity because of management capture is not an easy task. Traditionally, the corporate law has attempted to compel effective board behavior through the imposition of a legal duty of care, violation of which led to personal liability on the part of an offending director. This approach did little to halt the growth of the passive board. The Delaware court in *Van Gorkom* attempted to bolster compliance with the duty through the creation of certain guidelines that a board must follow to avoid liability for a duty-of-care violation. Unfortunately, this decision did not lessen, but compounded, the passivity problem. Its approach must therefore be abandoned. This does not mean that we should abrogate the duty of care, but judicial attempts to compel adherence through compliance with rigidly prescribed board procedure are ineffective and must be reconsidered.

The solution then lies, not in compelling, but in somehow encouraging effective board oversight. We must reinvigorate the board from within; each director must function as his or her own motivational force. The most promising solution to the corporate malaise created by poor management and the attendant executive overcompensation problem is to create effective management monitoring based on board self-motivation. Such internal motivation will result from substantial equity ownership on the part of the outside directors. To create the sizable shareholdings that will effect such positive monitoring, corporations should pay directors' annual fees in company stock. To ensure that directors' holdings grow large enough to induce the desired behavior, this equity-compensation proposal must be combined with a quinquennial term of office for each board member. Director stock ownership may not prove to be the comprehensive cure to the passive board, but the costs of this approach are minimal, and it is a good beginning. This proposal will result in more reasoned executive compensation schemes, more effective board oversight, and most importantly, a healthier and more competitive corporation.

ADDENDUM

On August 30, 1994, the Scott Paper Company, the nation's 108th largest public corporation, announced that henceforth all nine outside members of its Board of Directors would be compensated solely in

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company stock.[133] Specifically, each director would receive 1000 shares of Scott common stock.[134] The stock ownership plan replaced Scott Paper's existing compensation arrangements, which provided directors with retainers, meeting fees, stock option awards, and retirement benefits.[135] Immediately following the release of the announcement, Scott Paper stock—trading on the New York Stock Exchange—rose three percent, $2.125 a share, to close at a fifty-two week high of $65.875.[136] Scott Paper Chairman and CEO Albert J. Dunlap, in announcing the company's action, stated: "The directors unanimously decided to directly align themselves with our shareholders' interests [in an effort] to increase shareholder value."[137]

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133. *Scott Paper Board of Directors to Be Compensated Solely in Company Stock*, SCOTTNEWS, Aug. 30, 1994, at 1; *see* Glenn Collins, *Scott Paper to Pay Directors in Stock*, N.Y. TIMES, Aug. 31, 1994, at 3; *Scott Paper Co. to Pay Outside Directors in Stock*, WALL ST. J., Aug. 31, 1994, at B3.

134. *Scott Paper Board of Directors to Be Compensated in Company Stock*, *supra* note 1, at 1; *see* Tim Ferguson, *Tissues Turnaround Comes in Shades of Goldsmith*, WALL ST. J., Sept. 13, 1994, at A19; Jacqueline M. Graves, *While Directors Get Stock*, FORTUNE, Oct. 3, 1994, at 18; Keith H. Hammonds, *Austerity Starts at the Top*, BUS. WK., Sept. 12, 1994, at 46; Mike Seemuth, *Taking Stock*, FLA. TREND, Nov. 1994, at 67-70.

135. *Scott Paper Board of Directors to Be Compensated Solely in Company Stock*, *supra* note 1, at 1.

136. Collins, *supra* note 1, at 3; *see* Graves, *supra* note 2, at 18.

137. *Scott Paper Board of Directors to Be Compensated Solely in Company Stock*, *supra* note 1, at 1.

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