The ALI, Institutionalization, and Disclosure: The Quest for the Outside Director's Spine

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Introduction

The outside director is an important institution in corporate law. Nowhere does the outside director assume more importance than in the American Law Institute's (ALI) recently completed Principles of Corporate Governance (Principles), in which the outside director is the linchpin of the ALI's regulatory and procedural provisions. Those who wish to capture the natural forces that accompany the increasing influence of financial institutions on the American financial and political scenes also are dusting off and reshaping the outside director. This Article offers a highly critical assessment of the contributions that the ALI and the rise of institutionalization make in ensuring improved corporate governance through their respective efforts to strengthen the resolve of outside directors to serve the stockholders' interests.

To consider fully the potential role of outside directors in improving the corporation's governance, it is necessary to understand the meaning of corporate governance concerns. Governance in its broadest sense focuses on the outside directors' impact on the firm's financial performance, implicating their effect on such staid considerations as market share, technological leadership, and the bottom line. The recent events at General Motors (GM) illustrate this dimension of corporate governance. The outside directors received

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plaudits in the press for bringing about the resignation of the Chairman, Robert Stempel, and two other senior officers, and for carrying out a minor purge of the insiders on the board of directors.\footnote{1} After the once-proud industrial giant lost $4.45 billion in 1991, the outside directors instituted these changes because of their concern that management was not acting aggressively to downsize GM and position it as a price-competitive manufacturer, as the two other U.S. auto makers had done.\footnote{2}

Another dimension of governance focuses on curbing managerial self-interest and overreaching. The headlines have highlighted this governance question by focusing on and criticizing excessive executive salaries and perquisites as well as management's often brazen maneuvers to thwart changes in control, such as greenmail payments and the issuance of poison pills. On a wider scale, management buyouts, particularly when undertaken in response to an outside bid, pose a serious threat of managerial overreaching.\footnote{3}

The third dimension of corporate governance is the role outside directors can play in curbing illegal activities by the corporation or, more specifically, its personnel. Interest in the outside director's role in improving the corporation's record in this respect was at its height in the aftermath of the Watergate hearings, during which it was revealed that hundreds of American companies had engaged in illegal or questionable payments.\footnote{4} Episodically, we are treated to renewed instances of corporate criminal conduct that raise the question: Where were the directors when corporate personnel were breaking the law? This Article describes the way in which doctrinal obstacles prevent the law from adding further incentives for outside directors to detect and deter crime by subordinate personnel.\footnote{5}

Part I contrasts the role that the ALI prescribes for the outside directors with the outside directors' critique of their own performance. Part II reviews a collection of empirical studies of the impact of outside directors on the three aforementioned governance areas. The studies offer some support for the belief that, in limited areas, outside directors can make a difference. As will be seen in Part III, the Principles deal with each of these three governance questions. Part III criticizes the ALI for eroding, in its procedural provisions,


\footnotesize{2. Ingrassia & White, supra note 1, at A4.}

\footnotesize{3. See generally Victor Brudney & Marvin A. Chirelstein, A Restatement of Corporate Freezeouts, 87 YALE L.J. 1554, 1565-70 (1978) (discussing the danger that management will use its positional and informational advantages to the detriment of shareholders); Deborah A. DeMott, Puzzles and Parables: Defining Good Faith in the MBO Context, 25 WAKE FOREST L. REV. 15 (1990) (reviewing the treatment of MBOs under Delaware law).}


\footnotesize{5. See infra Part III.C.}
the strong monitoring model that it embraces in its substantive sections. Part IV reviews the many reasons that institutionalization probably will not contribute much to the outside directors' ability to improve the financial performance of corporations. Part V examines the manner in which recent developments under the disclosure laws should underscore the strong fiduciary obligations of outside directors when they are confronted with managerial self-dealing or overreaching.

1. The Outside Director: Faint Hope and Harsh Reality

The tradition of placing outsiders on boards of directors has accelerated since the early 1970s: In 1989, approximately eighty-six percent of public corporations had nonemployee directors composing a majority of their boards, an increase from sixty-three percent in 1966. The personal profile of board members has changed little over the years, with scant representation of minorities or women. Most outside directors are themselves captains of industry or their close advisers. While as a body not pluralistic, the outside directors bring rich experiences to the board that complement the important oversight role the ALI assigns to them. Temporal and informational limitations do not permit the outside directors to manage the corporation or to supervise closely those who do manage it. Their role is more akin to a dispatcher of the flock's shepherd, rather than the shepherd herself. The ALI embraces the contemporary view that the principal functions of outside directors are to evaluate senior management's stewardship of the firm and to review management's strategic plans.

It is interesting to consider the reasons for the ALI's assignment of these responsibilities to the board of directors and, more importantly, the reasons for our belief that outside directors can carry out these responsibilities. My concern is not whether the duties we ask directors to discharge are worthy or necessary tasks, but why we commit those tasks, particularly the task of monitoring management, to a board of directors that, under the ALI's formulation, is

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6. JEREMY BACON, MEMBERSHIP AND ORGANIZATION OF CORPORATE BOARDS 8, tbl. 6 (1990).
7. See id. at 6 tbl. 3, 7 tbl. 4, 8 tbl. 5, 10-11 tbl. 10, 11 tbl. 12. One area of change in the boardroom's composition is the increasing number of foreign directors. See Joann S. Lublin, More U.S. Companies Venture Overseas for Directors Offering Fresh Perspectives, WALL ST. J., Jan. 22, 1992, at B1 (reporting that the number of foreigners on boards of the 1000 largest American companies increased from 152 in 1990 to 186 in 1991).
8. See BACON, supra note 6, at 6 tbl. 3, 7 tbl. 4, 8 tbl. 5.
substantially represented by outside directors. 10

The Corporate Governance Project's (Project) Chief Reporter, Professor Melvin Eisenberg, examined this question and concluded that the tasks of reviewing management's performance and participating in the development of business strategies fall to the board of directors because the other bodies or mechanisms in position to discharge these tasks are profoundly inefficient. 11 For example, dependence upon shareholders to discharge these tasks is impracticable because the shareholders must overcome significant collective-action problems. 12 Even in an era of significant concentration of ownership in the hands of a few financial institutions, the shareholders' records on such matters as cancelling poison pills, initiating antitene-mail proposals, and reining in executive compensation are reason to question their ability regularly to discharge a monitoring task except in situations in which management's ineptitude brings the firm to the brink of disaster. 13

The market for control is a second mechanism for disciplining poor managerial performance, because poor performance can lead to a hostile takeover or proxy contest that displaces management. 14 Both of these displacement mechanisms, however, are expensive, so much so that they are invoked only when managerial shirking or misbehavior causes the firm to trade at a substantial discount.

A third possible mechanism is some form of governmental monitoring. 15 In an era in which private-market incentives and deregulation dominate, however, reliance on a government agency to oversee managerial performance clearly is not politically viable. Moreover, little reason exists to believe that even the most optimal structure of such a governmental response would be different from

10. Among the Principles' hortatory recommendations that certain conduct be a "matter of corporate practice" is the recommendation that large public corporations have a majority of their board free of any significant financial ties with the firm or its senior management. Id. § 3A.01. For smaller publicly traded firms, there should be a minimum of three such directors. Id.


12. Id. at 159-60, 167.

13. See generally Bernard S. Black, The Value of Institutional Investor Monitoring: The Empirical Evidence, 39 UCLA L. REV. 895 (1992) [hereinafter Black, Institutional Investor Monitoring]. To be sure, legal rules exist that erode the effectiveness of a meaningful exercise of shareholder voice. Reform of these rules may well improve the institutions' record on these matters. See id. at 896; see also Bernard S. Black, Shareholder Passivity Reexamined, 89 Mich. L. Rev. 520, 523, 525 (1990) [hereinafter Black, Shareholder Passivity] ("[I]nstitutional shareholders are hobbled by a complex web of legal rules that make it difficult, expensive, and legally risky to . . . undertake joint efforts. . . . The way to see if shareholder voting can matter is to change the legal rules that obstruct individual and collective shareholder action. . . . "). As discussed in Part IV infra with respect to the incentives of financial institutions, however, Professor Black and others appear to overstate the case for financial institutions' willingness to so involve themselves in the corporation's affairs. See infra notes 142-95 and accompanying text. Moreover, most of Black's focus is on straightforward questions of overreaching and self-dealing behavior—which can be expected to arouse shareholder interest in voting against management—rather than on the more mundane consideration that the firm is not performing as well as it could. Black, Institutional Investor Monitoring, supra, at 898-917.


15. Id. at 167-68.
the contemporary use of outside directors.16 As a result, the outside director wins the position of monitor by default. The task assigned to the outside director is justified not by what outside directors actually do, but rather by an abstract belief in what outside directors can do relative to other potential monitoring mechanisms.17

Outside directors generally do not object to the tasks they are called upon to perform. A recent comprehensive study of outside directors documents their frustration with the fact that limited time, available information, and manner of operation do not allow them to evaluate senior management adequately.18 Outside directors spend most of their time reacting to management's strategic planning and reviewing other corporate policies and practices,19 to an extent that allows only infrequent explicit and formal review of management's performance.20 For example, a recent poll of nearly 4100 directors found that forty-two percent had never participated in a formal review of the CEO's performance.21 This high percentage reflects in part that it is generally the firm's CEO who controls the agenda for board meetings, especially if the CEO also serves as the chairman of the board.22

A further limitation on the effectiveness of outside directors is that they almost never meet as a body separate from the entire board of directors. To be sure, the board is a highly cohesive

16. Id. at 168.
19. See id. at 66-69.
20. Id. at 63-65. Outside directors also complain that the demands on their time are too great and that their tasks frequently are stressful. For these reasons, it is increasingly more difficult to recruit outsiders to the board. See Carol Hymowitz, Board Stress Deters Prospective Directors, WALL ST. J., Dec. 22, 1992, at B1.

The stress of being immersed from time to time in strategic plans may be mitigated by the increasing use of advisory boards of nondirectors who have particular expertise; this practice may well free up directors' time for monitoring management's performance. See Donna Brown, Life in the Boardroom, 1990s Style, MGMT. Rev., Oct. 1990, at 14, 16. The proliferation of board committees also is a response to the increasing demands for directors to involve themselves more in the firm's affairs. See Amanda Bennett, Corporate Boards Do More by Committee, WALL ST. J., Nov. 11, 1992, at B1.

21. See Joann S. Lublin, Recent Wave of Activism in Boardroom Will Gain Momentum, Survey Suggests, WALL ST. J., Dec. 9, 1992, at A5. A positive step toward changing this pattern is the manifesto agreed to by an influential group of attorneys who represent institutions and management groups. This document calls for, among other reforms, yearly reviews of top management. See The Working Group on Corporate Governance, A New Compact for Owners and Directors, HARV. BUS. REV., July-Aug. 1992, at 141, 142.

22. Lorsch & MacIver, supra note 18, at 13. Evidence suggests that a trend may have begun to separate the two positions. See Joann S. Lublin, Other Concerns Are Likely to Follow GM in Splitting Posts of Chairman and CEO, WALL ST. J., Nov. 4, 1992, at B1.
group,23 but the outside directors as a distinct group lack any similar cohesiveness. This weakness in outside directors exists because there is little opportunity, short of a crisis, for the outside directors to assume a group identity and the strength that goes with it.24 It is generally perceived as de rigeur for the outside directors not to discuss the corporation's business with each other outside an officially convened meeting.25 Thus, outside directors are very reluctant to confront management when performance declines only gradually over time, and challenges to the CEO are limited to crisis situations.26

Finally, outside directors suffer an identity crisis that impacts their ability to reach a consensus on their mission.27 They are both distrustful of shareholders as a beacon of the corporate interest and confused by the “constituency” statutes enacted by many states.28 For example, outside directors continue to be disgruntled about the short-term horizons of stockholders.29 Outside directors commonly believe their stockholders suffer from acute bottom-line myopia, and the directors are thus suspicious of the goals of stockholders.30 Consequently, the stockholders' goal of short-term financial gain does not have normative appeal in the outside director's assessment of the wisdom of proposed policies or the direction of the corporation's performance. Similarly, the well-recognized weakness in constituency statutes is that they afford boards of directors a choice among sometimes conflicting interests,31 and the nonshareholder interests sometimes are opposed to the stockholders' quest for short-term profit maximization. Therefore, they can leave the board without direction as to what interest group, standard, or goal should guide its policy choices.

In sum, these factors leave the outside directors adrift. They complain not only of insufficient time to review management's stewardship or overall financial performance, but also of a lack of clear standards for measuring the corporate interest.

23. See, e.g., James D. Cox and Harry L. Munsinger, Jr., Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion, LAW & CONTEMP. PROBS., Summer 1985, at 83, 91-108 (examining the social and psychological mechanisms that foster cohesion among members of the board and that rob the directors of the ability to evaluate independently members of their own group).

24. For example, GM's outside directors never met privately until after the company recorded a historic loss of $4.45 billion for 1991. White, supra note 1, at B10. After that meeting, the outside directors initiated major managerial changes at GM, a step the board had not previously considered. Id.

25. LORSCH & MACIVER, supra note 18, at 93.

26. See id. at 95, 141, 167; see also Michael W. Miller & Laurence Hooper, At Hard-Hit IBM, Akers Faces Criticism But Is Likely to Stay, WALL ST. J., Dec. 1, 1992, at A1 (reporting that, despite a series of fundamental business miscalculations over seven years, the CEO retained support of the outside directors, who only recently have expressed unease with his leadership). Akers subsequently was removed as CEO.

27. See LORSCH & MACIVER, supra note 18, at 37-54. On the other hand, management is "likely to be very clear about its goals." Id. at 49.

28. See id. at 50-53.

29. See id. at 43-49.

30. See id.

II. The Utility of Outside Directors

Before rallying around the cause of incremental improvements in the life of the outside director, we should push beyond outside directors’ complaints and determine the precise task that we believe the outside director can discharge and evaluate the relative efficiency of the outside director in performing that task. With American businesses facing a worldwide recession and increasing competition from abroad, there has been a good deal of study on the connection between corporate governance and firm performance. The rationale for assignment to the board of directors of the aforementioned functions is that management will be under greater incentive to excel than if they were not subject to accountability through board oversight. In addition, under the "two-heads-are-better-than-one" postulate, strategic planning that invokes the experience of a wide range of individuals, such as those found on the boards of large public corporations, should result on average in a more cohesive and constructive plan than could be formulated by management alone. All these mechanisms should work better if the board of directors has a critical mass of outside directors, whose independence and broad experience will ensure more independent and careful consideration of important decisions and plans. This theory, however, does not comport with experience.

Overall, studies have found no correlation between board composition and firm performance. The most encouraging findings are those by Professors Baysinger and Butler, who found above-average financial performance by firms that began the ten-year study period with the highest percentage of outside directors on their boards. For other categories of firms, including firms that expanded their numbers of outside directors, Professors Baysinger and Butler found no correlation between board composition and company performance. Professors Baysinger and Butler did not examine the characteristics of firms that began the ten-year study period with more independent boards than others. It is not possible, therefore, to extrapolate from their findings the conclusion that the group of firms with the highest percentage of outside directors performed

32. This view is not universally held. Several authors argue that outside directors can not be expected to enhance corporate performance because such improvement generally requires technical expertise and management experience not found in outside directors from a different industry than that of the corporation that they direct. See, e.g., Stanley Vance, Boards of Directors: Structure and Performance 5-6 (1964); Jeffrey Pfeffer, Size and Composition of Corporate Boards of Directors: The Organization and Its Environment, 17 Admin. Sci. Q. 218 (1972).


34. Id. at 119.
better *because* they had a more independent board of directors at the commencement of the study period. The inconclusiveness of the authors’ findings is emphasized by the fact that the trends of particular boards toward more or less independence—that is, changes in the proportion of outside directors—did not cause any observable changes in the firms’ financial performance.35 Other studies also have failed to document the contribution that board independence makes to firm performance.36

The explanation for the absence of clearer connections between the proportion of outside directors and firm performance lies in understanding the factors that contribute to changes in any firm’s performance. All such studies have the great difficulty of normalizing among corporations the many endogenous and exogenous variables that influence a company’s performance. These factors range from the varying capital requirements of individual firms to the competitive structure of the industry. Moreover, the studies need to disaggregate within their “outside”-board category those firms in which the outside directors are neither proactive nor participatory. That is, there is a wide range of interaction possible between the CEO and the board of directors, so that even firms with a majority of their board comprising outside directors still may be stifled by the CEO’s operating style. Simply put, the CEO may discourage the active participation of the directors.37 Performance may well depend, therefore, not simply on the proportion of outside directors, but also, and more significantly, on the degree of interaction between the

35. *Id.* Equally interesting is the finding that boards of firms with the greatest improvement in performance were not made up of a majority of outside directors. This finding suggests diminishing returns associated with increasing independence on the board. *Id.*


37. See John A. Pearce II & Shaker A. Zahra, *The Relative Power of CEOs and Boards of Directors: Associations with Corporate Performance*, 12 STRATEGIC MGMT. J. 135 (1991) (concluding that participatory boards, whether or not a majority are outside directors, are most often associated with above-average performance levels); see also Lorsch & MacIver, *supra* note 18, at 77-80 (discussing the relationship, and the power imbalance, between boards and CEOs).
board and management—a matter likely to turn on the managerial styles and personalities of the CEO and the board members.

One area in which empirical support exists for the outside director’s ability to contribute to improving corporate performance is the firing of poorly performing management. Executive changes, though increasing in frequency, remain traumatic events within the corporation. Such a change a priori is more likely to occur if the board is not financially dependent on the CEO. Thus, executive changes should bear some rough relationship to the degree of the board’s independence. On this point, empirical data does not disappoint expectations. The likelihood that a board will terminate an underperforming executive increases as the board’s overall size increases.\(^{38}\) That likelihood increases even more as the proportion of outside directors increases.\(^{39}\) Moreover, the highest level of executive terminations occurs when the board has underscored the importance of performance by establishing performance goals, and managers have failed to meet those internally established goals.\(^{40}\)

Examining specific types of director decisions to isolate results that are clearly traceable to a particular decision may provide a glimpse of the outside directors’ potential to contribute to the overall welfare of the firm. For example, the payment of greenmail is a transaction that not only reduces stockholder wealth—at least by the amount of the payment itself—but is also rife with managerial self-interest.\(^{41}\) Professor Kosnik found that firms that resisted payment of greenmail had more outside directors than those that did pay greenmail.\(^{42}\) Professor Kosnik’s study suggests that outside directors can perform a useful check on management’s entrenchment motive for requesting that its board deflect an unwanted suitor.

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38. See Donald L. Helmich, Organizational Growth and Succession Patterns, 17 ACAD. MGMT. J. 771, 774 (1974).


42. Rita D. Kosnik, Greenmail: A Study of Board Performance in Corporate Governance, 32 ADMIN. SCI. Q. 163, 178 (1987). Of even greater statistical significance was the amount
As seen above, empirical evidence supports the view that outside directors can help to shield the corporation from managers' self-dealing or overreaching conduct. No such assurance is provided, however, for the conviction that outside directors can reduce the incidence of illegal conduct by subordinate managers. A study of the composition of boards of directors of corporations that violated the antitrust laws reveals that adding outside directors does not lessen the likelihood of antitrust violations. As developed more fully later, the low impact of outside directors on the criminal activities of firm personnel is symptomatic of the substantial causation problems that insulate outside directors from their responsibility for effective surveillance and deterrence mechanisms within the firm. Most criminal violations, and especially antitrust violations, are not committed by the board of directors; instead, they occur outside the board's view, in the lower reaches of the corporate organization. Even a well-designed compliance system can be circumvented by the stealth of subordinates whose private agenda may cause them to ignore exhortations from above. In such an environment, a change in the number of outside directors is not likely to affect a subordinate's desire, or lack thereof, to comply with the law.

### III. What the Principles Add to Corporate Governance

The outside director is the linchpin of the ALI provisions. The ALI places the outside director at the vortex of each of the above-described corporate governance areas—improving financial performance, curbing overreaching conduct, and discouraging illegal behavior. This Part assesses the value of the ALI's effort to improve outside directors' contribution in each governance area.

#### A. The ALI and Improving Financial Performance

The ALI recommends that a majority of the board of directors of a large public corporation be outside directors and that the boards of other public corporations include at least three outside directors. The ALI prescribes substantial monitoring of management for all public boards and arms the outside directors with authority to retain their own experts if necessary to discharge this responsibility. Within this framework, however, many structural problems remain that are likely to hobble outside directors in improving firm performance.

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of ownership in the hands of institutional investors: The greater the concentration of institutional ownership, the less prevalent the payment of greenmail. Id. Professor Kosnik's data thus demonstrate that a cohesive voice from the stockholders stiffens the outside directors' resolve to withstand management entrenchment. See infra Part IV.

44. See infra Part III.C.
45. Proposed Final Draft, supra note 9, § 3A.01.
46. See id. § 5.02(a)(1)-(3).
47. Id. § 3.04.
As seen earlier, several conditions contribute to the limited effectiveness of outside directors.\footnote{See supra notes 22-26 and accompanying text.} The ALI does not deal with these disabling conditions. For example, the ALI does not separate the positions of CEO and chairman of the board; nor does the ALI call for regular meetings of the outside directors alone.\footnote{See supra notes 22-26 and accompanying text.} The ALI does seek to weaken the impact of the CEO on the director-nomination process in its "Recommendations of Corporate Practice,"\footnote{Proposed Final Draft, supra note 9, Part III-A.} by recommending that nominating committees for large publicly held firms exclude corporate officers.\footnote{Id. § 3A.04(a).} Given the prevalent ethos of nominating committees, however, to submit names believed acceptable to the CEO,\footnote{Cox & Munsinger, supra note 23, at 98; see also John Perham, The Men Who Pick the Board, DUN'S REV., Dec. 1978, at 57-58 (stating that the CEO is often invited to sit in on nominating committee meetings, thus preventing the committee from electing a director of whom the CEO disapproves).} the overall contribution of this structural change to board independence is uncertain.

Furthermore, several provisions of the Principles obscure the vision of directors who wish to be provided a crisper image of their constituency. For example, although it embraces the goal of profit maximization,\footnote{Proposed Final Draft, supra note 9, § 2.01(a).} section 2.01(b) permits departures from that goal for "ethical considerations" and the "public welfare."\footnote{Id. § 2.01(b).} Further cleavage between the residual owners and the board of directors appears in section 6.02(b), wherein the board of directors is permitted to consider the "best interests of the corporation and shareholders" when responding to a bid for control.\footnote{Id. § 6.02(b) (emphasis added).} As the debate on the floor of the ALI's annual meeting reflects, the identification of the interests of both the corporation and the shareholders was purposeful: It intended to sweep within the field of consideration interests beyond those of the shareholders and not to require necessarily that board action advancing an interest of the corporation also advance the shareholders' interests. The notion that there may be recognizable interests beyond and in conflict with those of the shareholders is remarkably similar to the purpose of state constituency statutes.\footnote{See 68 A.L.I. Proc. 223, 228-29 (1991); 67 A.L.I. Proc. 65, 98-160 (1990).}

Thus, the Principles can be faulted in this respect in two major ways. First, the ALI does not address several structural features of the contemporary boardroom that have the effect of accreting the board's power in the company's CEO. Second, the ALI obscures the directors' vision by diffusing their obligations over a broad
group of potential constituents, instead of anchoring the directors’ mission more directly to the interests of stockholders.

The ALI wisely avoids enshrining the derivative suit as a tool to discipline managers for poor financial performance, demonstrating that the ALI understands the forces that surround liability standards. Liability standards will not stimulate the outside directors to improve the firm’s financial performance, because the doctrine of causation strips these standards of their effectiveness.57 The principle is well-established in corporate law that the director is only liable for damages proximately flowing from a breach. Thus, in *Barnes v. Andrews*,58 the court held that Andrews, an outside director whose tenure on the board was less than nine months, was not liable for losses associated with the firm’s rapid failure.59 The court reached this conclusion despite its finding that Andrews had breached his duty to inform himself adequately about the newly created corporation’s operations and on-going problems.60 Andrews was shielded from liability, Judge Hand concluded, because the plaintiff failed to establish that the firm’s failure could have been averted if Andrews had been fully aware of its operational difficulties.61 More broadly, *Barnes* teaches that the doctrine of causation precludes any real possibility of successfully establishing through a derivative suit that a firm’s earnings per share would have been fifty, twenty, or even five percent greater if its outside directors had taken an even more active role in monitoring the corporation. As a result, it is nearly impossible to establish directors’ liability for poor financial performance.

More significantly, if the ALI had unleashed the derivative suit to police poorly performing managers and their directors, it would jeopardize the derivative suit’s vitality in more useful areas. Compare the relative fault of those directors who, on the one hand, knowingly acquiesce or participate in their managers’ overreaching conduct with, on the other hand, directors who unwittingly approve a plan or transaction that results in a substantial loss to the corporation. One difference between these two types of cases is that the amount in controversy for managerial overreaching tends to be less than that involved with suits challenging bad decisionmaking by the

57. Director breaches of the duty of care—the obligation most directly implicated by questions of the directors’ role in the firm’s financial performance—are found infrequently, almost always in the limited case of directors’ approval of significant structural decisions. See, e.g., Smith v. Van Gorkom, 488 A.2d 858 (1985).

To be sure, courts have found directors liable for failing to be sufficiently vigilant when the managers have engaged in massive misappropriation of company assets. See, e.g., Francis v. United Jersey Bank, 432 A.2d 814 (N.J. 1981) (holding director negligent for failure to notice and prevent management’s misappropriation of entrusted funds). Such cases do not address the role of outside directors in improving performance, but rather in the second category of governance—discouraging managerial overreaching.

58. 298 F. 614 (S.D.N.Y. 1924).
59. Id. at 618.
60. See id. at 615. The facts revealed that Andrews attended only a single board meeting during his tenure and, although he frequently commuted into Manhattan with the company’s president, he never inquired deeply into the company’s operations.
61. See id. at 618. Although the firm had raised a substantial amount of capital through a public offering and possessed a well-equipped plant, materials, and personnel, the firm encountered dramatic delays in production and ultimately failed.
board of directors. A second distinction between the two types of suits is the gravity of the breach on the part of the outside directors. In the case in which the directors approve of injurious overreaching, the directors are as blameworthy as the manager who reaps the tangible rewards of the violation. In contrast, the derivative-suit court may believe that holding outside directors liable for a poor business judgment visits disproportionate damages upon the breaching directors.

Consider further that the court's involvement occurs early in the proceedings, in deciding whether a demand on the board of directors is necessary or, if demand is made, whether the rejection of the demand by the board should lead to the suit's dismissal. Viewing matters solely on the pleadings, the derivative-suit court, in a case arising simply from the directors' poor judgment, can be expected to reach procedural and substantive conclusions that have the overall effect of temporizing the substantive demands on outside directors and to erect procedural barriers to the trier of fact. The effects of these rulings, especially procedural ones, are like the rain that falls on the good and the bad alike. Rulings on procedural matters such as the necessity of a demand, a committee's independence, and the like, become precedents that later impact, with the same temporizing effects, suits against directors who knowingly acquiesce in management overreaching. The negative effects of using the derivative suit to police poor financial performance and bad decisionmaking by managers and directors, therefore, are not worth the occasional recovery for such violations—especially when one considers that other mechanisms likely will encourage managers and boards to improve their performance.

More fruitful alternatives for stimulating managers and directors

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62. The visibility of the decision or transaction is a key factor in any derivative suit arising therefrom. Board decisions that elicit such scrutiny are those that tend to have produced a material decline in stockholder wealth. In a large corporation, such a decline requires a rather sizable mistake to have been made. Self-dealing and overreaching, however, gain visibility because of their occurrence, not because of their overall impact on stockholder wealth. Therefore, the derivative suit is not so much compensatory as it is a deterrence mechanism. See generally James D. Cox, Compensation, Deterrence, and the Market as Boundaries for Derivative Suit 'Procedures,' 52 GEO. WASH. L. REV. 745, 775 (1984).

63. For this reason, placing a ceiling on damages for negligence and lesser forms of misconduct emphasizes deterrence over compensation and may thus avoid the temporization of substantive and procedural norms. See John C. Coffee, Jr., Litigation and Corporate Governance: An Essay on Steering Between Scylla and Charybdis, 55 GEO. WASH. L. REV. 789, 809-12 (1984) (comparing the objectives of deterrence and compensation in derivative litigation and recommending a damages ceiling); see also VA. CODE ANN. § 13.1-692.1 (Michie 1993) (imposing a statutory liability ceiling for director care violations).

64. See Kenneth E. Scott, Corporation Law and the American Law Institute Corporate Governance Project, 35 STAN. L. REV. 927, 947 (1983) (stating that numerous procedural and substantive issues could be simplified or eliminated if derivative suits were confined to breaches of loyalty).
to improve financial performance focus on the market mechanisms by which control is exercised and displaced. The recent loosening of the restraints on intershareholder communication and coordination, as well as the call for incumbent directors periodically to subject themselves more directly to review and displacement, are more promising methods of effectively stimulating action than the derivative suit.

The Project does not send the derivative suit on such a misguided mission, but instead relies on market forces and potential shifts in control as the dominant incentives for improvements in financial performance. By adopting a damages limitation provision for mere care violations, the ALI alleviates the directors' fears that they may be liable for their poor performance. The overall effect of this provision is to shift the focus of the derivative suit to cases involving overreaching—conduct beyond the protection of the permitted charter limitations on liability. The ALI thus allows courts to interpret the Principles' procedural and substantive demands in cases involving overreaching without fear that the precedents the courts create will have unintended consequences in unrelated suits based on alleged breaches of the duty of care. On the other hand, the Principles do not provide their own mechanisms for stimulating improved financial performance or for enhancing the monitoring by outside directors of their managers' stewardship.

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66. See, e.g., George W. Dent, Jr., Toward Unifying Ownership and Control in the Public Corporation, 1989 Wis. L. Rev. 881, 907-08 (proposing a small committee of the firm’s largest shareholders to nominate directors through proxy); Martin Lipton & Steven A. Rosenblum, A New System of Corporate Governance: The Quinquennial Election of Directors, 58 U. Chi. L. Rev. 187, 225 (1991) (proposing that shareholders elect directors for five-year terms).

67. Proposed Final Draft, supra note 9, § 7.19. In this respect, events have bypassed the ALI, because limitations enacted by most states authorize charter provisions that shield the outside directors from any damages for breaches of their duty of care, see, e.g., Del. Code Ann. tit. 8, § 102(b)(7) (repl. vol. 1991); N.Y. Bus. Corp. Law § 402(b) (McKinney 1988), whereas the approach the ALI embraces authorizes reducing the damages to an amount not less than the director’s annual compensation, Proposed Final Draft, supra note 9, § 7.19. In any case, the overall effect of these provisions is to remove the threat of personal liability for care violations, a threat that is not a great consideration in improving the firm’s overall performance.

There is one dramatic scenario where the prospect of liability is likely to be an important factor in outside directors’ motivation to improve corporate performance: Concern for liability is likely to be great if the corporation’s charter does not contain such an immunity provision and, because of steady and expanding losses, a near-crisis situation exists within the boardroom. Recent events at General Motors reflect such a crisis situation, where losses mounted and outside directors ousted management that reacted too slowly. See supra notes 1-2 and accompanying text. It is suggested here, however, that such cases are rare and that motivations even more significant than the prospect of liability contribute to the outside directors’ response.

68. See supra notes 62-66 and accompanying text.
B. The ALI and Overreaching Conduct

Liability rules play a more significant role in policing managerial overreaching than they do in either of the two other subsets of corporate governance concerns, improving financial performance and deterring illegal activity. Despite the historical and practical import of liability rules in policing overreaching behavior, the Principles offer conflicting and self-defeating responses to managerial overreaching.

By far the most substantial contribution of the ALI is its treatment of situations involving the potential for overreaching behavior. In matters involving senior-management conflict of interest, use of corporate property or information, diversion of business opportunities, and competition with the firm, the Principles make the outside directors a key element of the regulatory mechanism: Absent disinterested-director approval, a suspect transaction in each of the above categories is made vulnerable to judicial review, and the interested manager bears the burden of proving the transaction's overall fairness.

Of all the ALI provisions, section 5.05, dealing with the taking of corporate opportunities, is likely to have the most impact on the development of fiduciary obligations. The ALI's clear and reasonable treatment of corporate opportunities stands in stark contrast to the near chaos that exists in the case law, which is preoccupied with a factor analysis that robs the law of its predictability. An important aspect of section 5.05 is its channeling of the director or senior executive officer considering a business opportunity first to obtain the approval of the disinterested directors. More significantly, the disinterested directors are allowed to approve the director's or senior executive's acquisition of a business opportunity in advance, thereby invoking the presumptions of the business judgment rule. If the disinterested directors ratify the transaction after the acquisition has

69. Proposed Final Draft, supra note 9, § 5.02(a)(2)(B)-(C).
70. Id. § 5.03(a)(2)-(3).
71. Id. § 5.04(a).
72. Id. § 5.05(a)(3)(B).
73. Id. § 5.06(a)(2).
74. There is an alternative mechanism to disinterested-director approval in each of these provisions—securing stockholder approval. See, e.g., id. §§ 5.02(a)(2)(D), 5.03(a)(4), 5.04(a)(4), 5.05(a)(3)(C), 5.06(a)(3). This route customarily is untravelled because of the expense, time, and uncertainty of result.
75. Id. §§ 5.02(b), 5.03(b), 5.04(b), 5.05(c), 5.06(b).
76. See, e.g., Miller v. Miller, 222 N.W.2d 71, 81-82 (Minn. 1974) (applying a two-step analysis involving a number of facts). But see Victor Brudney & Robert C. Clark, A New Look at Corporate Opportunities, 94 Harv. L. Rev. 997, 999 n.2 (1981) ("The [Miller] methodology in fact adds only a new layer of confusion to an already murky area of law, without forwarding the analysis in any significant fashion.").
77. See Proposed Final Draft, supra note 9, § 5.05(a)(3)(B).
78. Id.
been completed, however, the transacting officer or director receives no such protective presumption. Absent disinterested-director approval, the only options are the more cumbersome and expensive process of obtaining shareholder approval and the less predictable burden of proving fairness to the corporation.

This approach is markedly different from the ALI's treatment of conflict-of-interest transactions, in which presumptions of the business judgment rule are invoked even if the directors or a committee ratify a consummated transaction. The ALI's commentary does not reveal why disinterested-director ratification is not available for a director's or senior officer's purchase of Blackacre from a third party, but is available if Blackacre is purchased from the corporation. An explanation for this treatment, however, is not difficult to divine. Section 5.05 encourages early consideration of the corporate interest in seizing or rejecting the opportunity. The emphasis in the commentary is to defer to the natural forces within the corporation to sort out ex ante whether an opportunity is one within the corporation's interest. This purpose is further underscored by the ALI's broad definition of "opportunities" in the case of senior executive officers, so that the opportunity need only be one that is "closely related to a business in which the corporation is engaged or expects to engage." Because of the wide variety of opportunities that might fall within such an expansive standard, certainty and fairness are best served by allowing an independent board to consider whether the corporation should acquire a specific opportunity. These provisions thus reflect the wisdom of extending the presumptions of the business judgment rule only when the senior executive officer has secured the decision of an independent board prior to acquiring an opportunity.

There are, however, several troubling aspects of the ALI's perception of the outside directors' capacity to protect the corporation and its stockholders from overreaching. First, by providing more elaborate and demanding requirements for ratifying a consummated transaction than for approving a proposed transaction, the ALI reflects its unease with the notion that outside directors will be as independent and assertive when faced with a "done deal" as they will be regarding a transaction yet to be completed. The ALI's preference is a good one, because it expressly takes note of the type of environmental conditions likely to compromise the independence of

79. See id. In contrast, disinterested directors may ratify the use of corporate property or information, id. § 5.04(a)(4), and they may ratify a director's or officer's competition with the corporation, id. § 5.06(a)(2). Directors retain the power to ratify compensation arrangements, but it is circumscribed. Id. § 5.09(a)(3). Ratification by disinterested directors under each of these provisions has the effect that when the directors urge dismissal of a derivative suit, the standard of review of the motion to dismiss is the deferential standard accorded by the ALI to business judgments. See id. § 7.10(a)(1).

80. Id. § 5.05(a)(3)(A), (C).

81. Id. § 5.02(a)(2)(B)-(C).

82. Id. § 5.05(b)(2).

83. Compare, e.g., id. § 5.02(a)(2)(B) with id. § 5.02(a)(2)(C).
the outside directors. 84

The ALI further recognizes the possibility that outside directors may be compromised by providing that the outside directors may not validate overreaching conduct by the firm's controlling stockholder. 85 This approach reflects a sounder view than does contemporary case law regarding the degree of independence the outside directors are likely to exhibit in such cases. 86 The same potential for compromising the outside directors' independence, however, occurs in overreaching transactions involving senior management. That is, there is little reason to believe that outside directors are functionally less able to police the misbehavior of a controlling stockholder than they are that of senior management. Each case presents an opportunity for outside-director deference, even obeisance, to a manager or controlling person. To maintain consistency on this point, the Principles either should have removed the outside directors as a cleansing mechanism altogether or, preferably, should have conditioned the outside directors' power to approve all overreaching transactions, whether shareholder or management, on a high degree of independence.

Any improvements in the substantive treatment of overreaching conduct are eviscerated by the ALI's conservative treatment of the derivative suit. To be sure, the ALI makes an important contribution in rationalizing many aspects of derivative litigation. Foremost among its achievements is the treatment of the demand requirement. 87 The ALI embraces a universal demand requirement: A demand on the board of directors must be made in all but the limited

84. See supra notes 18-31 and accompanying text.
85. That is, for controlling stockholder conflict-of-interest transactions, Proposed Final Draft, supra note 9, § 5.10, use of corporate property or information, id. § 5.11, or acquisition of business opportunities, id. § 5.12, the outside directors cannot act to insulate the controlling stockholder from liability, but merely may shift the burden of proof onto the party challenging the transaction.
86. See, e.g., Puma v. Marriott, 283 A.2d 693 passim (Del. Ch. 1971) (deferring to the business judgment of the disinterested directors, rather than analyzing fairness, in an interested-director acquisition).
Concerns for the outside directors' independence in dealing with controlling stockholders may not be justified in all instances. A classic illustration involves the unfriendly position the outside directors of Shell Oil took in negotiating the terms of a cash-out merger with the 76% owner, Royal Dutch Shell. See Joseph v. Shell Oil Co., 482 A.2d 355, 359 (Del. Ch. 1984). The outside directors were constituted as a separate bargaining group for the interests of the minority stockholders and thus assumed legal responsibility for submissive or collusive actions. Moreover, the directors had a history of independence that further contributed to their alignment with the minority stockholders rather than the dominant stockholder.

The ALI's removal of the outside directors from the controlling-stockholder regulatory scheme appears to recognize the improbability that the outside directors will challenge the proposals of a controlling stockholder or align themselves with the minority stockholders, notwithstanding the rare Shell scenario.

87. Proposed Final Draft, supra note 9, § 7.03. Other important contributions include the allowance of noncontemporaneous stockholders, in limited circumstances, to
instances in which the corporation will suffer specific irreparable harm as a result of any delay caused by the demand.\textsuperscript{88} Demand under the ALI thus assumes an informational purpose and is robbed of the dispositive effects it has under the laws of most states.\textsuperscript{89}

By trivializing demand, the ALI shifts the pretrial battle to the board's or committee's power to deflect the unwanted suit. The ALI thus makes the profound choice to regularize the process by requiring a formal presentation of the board's or committee's belief that continuation of the derivative suit is not in the corporation's interest. Such formal reports, customary when a special litigation committee makes a motion to dismiss a suit, historically have not been required by courts to explain the board's denial of a plaintiff's demand. In these demand-required cases, the primacy of the board's decision was reflected in the great deference courts accorded the board's unsupported recommendation that the suit be dismissed.\textsuperscript{90} By requiring the board to support its decision that the derivative suit harms the corporation, the ALI assures greater accountability for those who speak for the corporate interest that is asserted to be served by the suit's dismissal.

The ALI sets the entire treatment of overreaching adrift by inserting into this well-integrated scheme a provision that prescribes the level of review a court is to exercise in response to a board's or committee's motion to dismiss a derivative suit.\textsuperscript{91} This provision makes the level of review of the board's motion to dismiss turn on the nature of the wrong allegedly committed by the defendant.\textsuperscript{92} Whereas the court is invited to evaluate substantively the appropriateness of the board's or committee's recommendation in suits alleging illegal behavior, unfair dealing, or self-dealing,\textsuperscript{93} the court's role is more muffled if the complaint focuses on a breach the duty of care, unfair use or acquisition of property, or excessive compensation.\textsuperscript{94} In this latter group of cases, the court merely assesses whether the board's recommendation is consistent with the business judgment rule; in contrast, the former group of cases require the court to make an affirmative finding that "the board or committee initiate derivative suits, see id. § 7.02(a)(1); the articulation of definitive limits on the corporation's defenses in such suits, id. § 7.05; express authority for the assignment of costs and attorneys fees for bad faith or the want of reasonable cause, id. § 7.04(d); a clear statement of the procedures to be followed by the board of directors, or a committee thereof, to dismiss a derivative suit, id. §§ 7.09, 7.13; and rules of indemnification designed to avoid circular recovery, id. § 7.20.

\textsuperscript{88} Id. § 7.03(b).


\textsuperscript{90} See Cramer v. General Tel. & Elec. Corp., 582 F.2d 259, 275 (3d Cir. 1978) ("[C]ourts have some limited power to review the reasonableness of the directors' judgment that a derivative suit is not in the best interests of the corporation."). cert. denied, 439 U.S. 1129 (1979). See generally Comment, The Demand and Standing Requirements in Stockholder Derivative Actions, 44 U. Chi. L. Rev. 168 (1976) (explaining the use of demand and standing requirements to prevent abuses of derivative suits by minority shareholders).

\textsuperscript{91} Proposed Final Draft, supra note 9, § 7.10.

\textsuperscript{92} See id. § 7.10(a)(1)-(2).

\textsuperscript{93} Id. § 7.10(a)(2).

\textsuperscript{94} Id. § 7.10(a)(1).
was adequately informed under the circum[s]stances and reasonably
determined that dismissal was in the best interests of the corpora-
tion, based on grounds that the court deems to warrant reliance."95
The distinction fulfills the overall objective of the ALI to harness
the derivative suit to its historical task of policing self-dealing behavior
and virtually to eliminate the derivative suit as a policing mechanism
for care violations.96 As demonstrated earlier, this choice will not
sacrifice many viable care-based suits on the ALI's altar, because sig-
nificant doctrinal considerations remove the threat of liability as an
important deterrent to care violations;97 in this light, the standard
of judicial review of dismissal recommendations for care-violation
cases is all but meaningless. The ALI, however, sweeps more than
just care-based cases from the potential disciplining force of the der-
ivative suit and condemns the entire Project to a disappointing
journey, for reasons examined below.

1. Boarding the Wrong Ship

The ALI purports to be guided in its choice of review standards
by the talisman of whether the challenged transaction is of the sort
to which the business judgment rule applies.98 Thus, if the question
is whether the directors have acted negligently in concluding, for
example, that only day baseball should be played,99 the decision is
one intrinsically within the protection of the business judgment rule
and thus the review standard used by the courts in considering an
attack on that decision will embody the same level of deference as
that which applies to the underlying decision. In contrast, the ALI
holds self-dealing transactions to a more penetrating review.100
This distinction is pure sophistry.

First, this formulation mischaracterizes the setting in which the
review standard is to be applied. The issue is not whether the direc-
tors' decision to play day baseball was correct, but whether the court
should abide by the board's or committee's recommendation that
there should not be a proceeding to determine whether the underly-
ing decision is protected by the business judgment rule. The degree

95. Id. § 7.10(a)(2).
96. See id. § 7.10 cmt. c(3), at 780, 782 ("[T]he most important role of the derivative
action has been to police unfair self-dealing, not unwise business decisions."); id. § 7.10
cmt. d, at 792-93 ("[V]iolations of the duty of fair dealing represent a more serious
threat to the integrity of the corporate system than violations of the duty of care.").
97. See supra text accompanying notes 57-61.
98. See Proposed Final Draft, supra note 9, § 7.10(a)(1) ("[I]f the underlying transac-
tion . . . would be reviewed under the business judgment rule,” the court should analyze
the motion to dismiss under the business-judgment doctrine.").
99. Whether baseball should be played only during the day was held to be within the
broad discretion of the board of directors in Shlensky v. Wrigley, 237 N.E.2d 776 (Ill.
App. 1968).
100. See Proposed Final Draft, supra note 9, § 7.10(a)(2).

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of deference to be accorded such a recommendation should depend not on the character of the underlying decision, a matter likely to be poorly explored in such preliminary litigation skirmishes, but on the overall trustworthiness of the board or committee proffering the recommendation that the derivative suit be dismissed.

Second, the ALI misunderstands its own treatment of self-dealing transactions. Its conclusion that the court's review should be more penetrating in suits challenging self-dealing transactions because such transactions are outside the business judgment rule context is correct only in the rare case in which there has not been disinterested stockholder or disinterested-director approval of the self-dealing transaction. If such approval has been obtained, section 5.02 clearly states that the transaction is surrounded with a high presumption of validity; that is, that the presumption of the business judgment rule attaches. Only if such approval has not been obtained is the burden placed on the interested party to establish the overall fairness of the transaction.

This formulation applies throughout Part V of the Project, suggesting that wherever there has been impartial approval, under the Principles a dismissal recommendation would be subject to a lower level of review. That is, the Principles' substantive provisions purport to accord several varieties of overreaching behavior the protection of the business judgment rule if certain steps are followed in the approval or ratification of that behavior. Procedurally, however, the ALI ignores its substantive commands by offering a false and indefensible dichotomy for the courts' review of a board's or committee's response to a derivative suit. The message of this dichotomy to outside directors is that the ALI considers some decisions more important than others. The ALI thereby emphasizes the importance of some self-dealing transactions and accords lesser importance to others, such as the executive's use of property or information, competition with the corporation, and the taking of corporate opportunities. This dichotomy is not supported by the substantive provisions of the Principles.

2. A Journey Worth Taking

There is one situation in which the outside directors' failure to exercise reasonable care deserved special treatment in the ALI's procedural provisions for the purpose of reducing the incidence of overreaching behavior. There is a need for closer scrutiny of the outside directors' care violations when their lapse is a failure to curb another's overreaching.

As seen above, the ALI authorizes charter provisions that limit director liability for care violations and also limits the reviewing court's role in assessing whether there has been such a violation.  

101. See id. § 5.02.
102. Id. § 5.02(b).
103. See supra note 67 and accompanying text.
The destructive effects of joining these substantive and procedural provisions on curbing overreaching conduct are illustrated by *Francis v. United Jersey Bank*, 104 where the New Jersey Supreme Court refused to allow a director to invoke her ignorance of the corporation's performance as a shield against liability for her failure to discover that her two fellow directors were engaged in massive misappropriation of funds. 105 In a statement that mirrors the ALI's monitoring model for outside directors, the court embraced significant director obligations:

Directors are under a continuing obligation to keep informed about the activities of the corporation. . . . Directors may not shut their eyes to corporate misconduct and then claim that because they did not see the misconduct, they did not have a duty to look. The sentinel asleep at his post contributes nothing to the enterprise he is charged to protect.

Directorial management does not require a detailed inspection of day-to-day activities, but rather a general monitoring of corporate affairs and policies. 106

By limiting, but not abolishing, directors' damages, the ALI substantively reaches the right result in encouraging directors to monitor. 107 This limitation avoids the draconian result, evident in *Francis*, of holding outside directors liable for all the losses proximately caused by a failure to monitor, 108 an amount truly disproportionate to the breach and sure to cause courts, over time, to temporize the directors' obligations. At the same time, the ALI provides some sanction for a breach, not less than the director's annual compensation, so that a breach is not without its costs to the director. 109 In this respect, the ALI strikes a balance between deterrence and draconian results that is lacking in those states that have authorized charter provisions granting complete immunity to directors for breaches of their duty of care.

The deficiency of the overall ALI approach is that it fails to include challenges to the directors' failure to detect or deter overreaching conduct within the same procedural context as that in which the overreaching conduct itself is evaluated. It would have been a far stronger message to the outside directors, as well as to reviewing courts, for the derivative suit procedures to accentuate the seriousness with which the ALI views the outside directors' obligation to respond to overreaching. This objective could easily have been accomplished by defining the courts' review function to be the

105. Id. at 820-26.
106. Id. at 822 (citations omitted).
108. Francis, 432 A.2d at 827-29.
same for the directors’ alleged poor response to overreaching as it is for overreaching conduct itself.

3. Missing the Boat

A final criticism of the ALI formulation—that the review standard turns upon the type of misbehavior alleged on the part of the directors—is that it misunderstands the very purpose of judicial review. As seen earlier, there is ample reason to isolate care violations. This isolation will allow courts to consider derivative suit procedures more clearly, and perhaps more favorably, by authorizing courts to scrutinize intentional self-enriching behavior rather than to impose draconian sanctions on the failing good samaritan. Even this distinction, however, places too much emphasis on the substance of the complaint and blinds the court from consideration of what should prompt it to undertake a penetrating review of a board’s or committee’s dismissal recommendation. Moreover, in the light of the broad authorization of charter provisions that effectively eliminate the liability of outside directors for breaching their duty of care, it is unnecessary to reemphasize in the procedural context the de minimis role of care-based suits in corporate governance. The ALI would have been better advised to focus on just what should prompt a court to involve itself in a board or committee recommendation that a derivative suit is not in the corporation’s interests. Here, the principal concerns should be the board’s or committee’s independence and the reasonableness of the recommendation.

In analyzing complaints alleging overreaching conduct—that is, not involving care violations—the courts exercise a degree of review dictated by the relative trustworthiness of the directors or committee proffering the dismissal recommendation. This problem, of course, raises questions of “structural bias,” but it also raises questions of how thoroughly the recommending body of directors has considered the matter. There is no reason to believe that directors are less trustworthy in conducting, or less likely to conduct, a thorough review of the charges in a case involving the purchase of Blackacre from a senior executive officer, for which the more-demanding review standards apply, than where the complaint alleges that the executive wrongfully acquired Greenacre for her personal use. The Principles would better reflect reality if they required the court in each instance to make an independent finding that “the board or committee was adequately informed . . . and reasonably determined that dismissal was in the best interests of the corporation, based on grounds that the court deems to warrant reliance.”

Requiring this determination would serve the important symbolic

110. See supra Part III.A.
111. See Cox & Munsinger, supra note 23, at 91-108 (analyzing “ingroup” and “intergroup” biases and concluding that boards of directors will tend to be homogeneous, conformist, cohesive, self-validating, and “systematically biased” against outsiders).
112. See Proposed Final Draft, supra note 9, § 7.10(a)(2).
C. The ALI and Criminal Violations

The third category of corporate governance, the outside directors’ role in reducing the incidence of illegal behavior, receives reasonable treatment under the Project; as will be seen, however, the ALI’s treatment of this category is doctrinally hobbled when the focus shifts to the obligation of the outside directors in deterring the illegal conduct of others.

The ALI admirably addresses the problem of outside directors who knowingly participate in illegal conduct. Such violations are outside the protection of the business judgment rule; they are not within the permissible bounds of charter provisions immunizing the directors from liability for damages; and the recommendation of a board or committee that a derivative suit for intentional illegality be dismissed is subject to a higher level of review by the court than are care violations and most overreaching behavior. Overall, the ALI provisions remind outside directors that they have substantial obligations not to participate in the illegal schemes of subordinates or the corporation.

113. The commentary states that the plaintiff must prove not only a knowing violation of law, but also that the director or officer failed to comply with the standards of § 4.01 with respect to engaging in or approving such violation. Id. § 4.01(a) cmt. d, at 197. The commentary then approvingly cites Miller v. Am. Tel. & Tel., 507 F.2d 759 (3d Cir. 1974), which held that proof of a violation removes the decision from the business judgment rule, id. at 762, but that there nevertheless continues to be a separate question of overall loss to the corporation, id. at 763 & n.5. On the latter point, the ALI invites courts to disallow any gains flowing to the corporation as a consequence of the violation when to offset those gains against liability would be "contrary to public policy." Proposed Final Draft, supra note 9, § 7.18(c).

The overall effect, therefore, appears to be that the outcome of such a case will depend upon whether the crime reaped profit in a particular instance, because it would appear that a decision to engage in a criminal violation that does not yield a net benefit would be difficult to justify after the fact as rational or in good faith, twin requirements for treatment under § 4.01. See id. § 7.10 cmt. f(i), at 740-41 ("If it would be inappropriate to consider the violation non-culpable, even though the course of conduct was entered into with the intent of benefiting the corporation."). On the other hand, an illegal activity that nets a benefit to the corporation will survive the damages requirement of Miller, as seemingly adopted by the Principles.

114. See Proposed Final Draft, supra note 9, § 7.19(1).

115. See id. § 7.10(a)(2).

116. Professor Dooley questions why shareholders would have a "greater interest in corporate lawfulness than any other member of society." Michael P. Dooley, Two Models
The legal demands on outside directors to detect and deter the violations of others pale in comparison to the directors’ obligation not knowingly to violate the law. In view of the overall framework of the ALI’s prescriptions for the corporation and its officers and directors, one naturally might have expected greater demands on the outside directors with respect to their responsibilities to reduce the frequency of legal violations by subordinate personnel.

Among the obligations subsumed under the general duty-of-care requirement of section 4.01 is compliance with the mandate, under section 2.01(b)(1), that the corporation “act within the boundaries of the law.”\footnote{See Proposed Final Draft, supra note 9, §§ 2.01(b)(1), 4.01(a); id. § 4.01(a) cmt. d, at 196-97. In particular, see the commentary, id. § 4.01(a) cmt. d, at 196 (“Directors . . . have oversight obligations with respect to the corporation’s obligation to obey the law . . . in accordance with the provisions of § 4.01.”) (citation omitted).} To understand how this requirement may be interpreted, consider the classic case of Graham v. Allis-Chalmers Manufacturing Co.,\footnote{Id. at 127-28.} in which the plaintiff brought a derivative suit to recover damages that the company suffered because its employees engaged in massive bid-rigging with competitors.\footnote{Id. at 130.} One of the theories the plaintiff advanced was that the directors acted unreasonably in failing to establish any system to detect or prevent such antitrust violations.\footnote{See supra notes 104-06 and accompanying text.} The Delaware Supreme Court rejected this argument, holding that absent knowledge or notice of possible wrongdoing, the directors were entitled to rely upon reports and summaries from subordinates who they had no reason to believe were untrustworthy.\footnote{This distinction was expressed in the ALI’s comments, in an effort to limit Graham’s impact. See Proposed Final Draft, supra note 9, § 4.01(a)(1)-(2) cmt. c, at 217.}

Absent from Graham is the rhetoric of monitoring found in Francis.\footnote{See id. §§ 3.01-.02.} The gulf that separates these two views of director obligations is explained by the historical settings of the two cases.\footnote{See supra notes 104-06 and accompanying text.} Graham’s reasoning is understandable in the context of an era when directors were perceived as “super-managers” rather than monitors of those who manage. In contrast to the atmosphere in which the court decided Graham, a solid perception now prevails\footnote{See id. §§ 3.01-.02.} that the role of directors is to monitor management’s stewardship.\footnote{See supra notes 104-06 and accompanying text.} A corollary of this perception is the well-received practice among public corporations of designing, installing, and enforcing legal-compliance systems such as those for which the plaintiff in Graham argued.
Because the content of the law is informed and legitimized by prevailing practices, there is ample reason to believe that Allis-Chalmers' board today would be pressed to justify the absence of any compliance procedures.126

This analysis does not compel the conclusion, however, that the directors in Graham would be liable for their subordinate's behavior under current law. Even reasonably designed and superintended compliance programs will not detect or discourage all misbehavior—law-compliance programs are not foolproof, and many violations by subordinates are likely to go undetected even under the most aggressive compliance systems. In this regard, consider the point emphasized earlier that the plaintiff has a heavy burden of linking the directors' nonfeasance with the harm for which recovery is sought.127 The plaintiff likely would have great difficulty establishing a causal relationship between the absence of any compliance system, or the particular defects in an existing compliance system, and the harm to the corporation. The directors' failure to impose any law-compliance system constitutes no more than a technical breach, similar to the court's view of Andrews' failure to inform himself in Barnes v. Andrews.128 It appears, therefore, that the requirement of a causal relationship alleviates the threat of personal liability for directors who fail aggressively to pursue legal-compliance systems. Because the ALI did not adopt a position on causality, the provisions dealing with outside directors' obligations to assure legal compliance are severely weakened.129

IV. Institutionalization and Outside Directors

In both black-letter provisions and commentary, the ALI generally charts a course between managerial prerogatives and zealous protection of stockholders. The protection the ALI embraces for

126. Two leading Delaware practitioners have persuasively reasoned that Graham would be decided differently today for the reasons stated supra text accompanying notes 124-25. See E. Norman Veasey & William E. Manning, Codified Standard—Safe Harbor or Uncharted Reef? An Analysis of the Model Act Standard of Care Compared with Delaware Law, 35 BUS. LAW. 919, 930 (1980) (arguing that, although the duty of care has not changed since Graham was decided in 1963, there has been a "natural development in the role of an 'ordinarily prudent director' which might, today, result in closer scrutiny of, and possible liability for, Graham-like failure to monitor). This is also the position taken in the Principles' comments. See Proposed Final Draft, supra note 9, § 4.01(a)(1)-(2) cmt. c, at 217-18.
127. See supra notes 57-61 and accompanying text.
128. See supra notes 58-61 and accompanying text.
129. One possible solution is that state statutes might mandate some minimum damages for which directors would be liable upon proof of gross disregard for the risks of the individual firm's legal environment in authorizing and reviewing a compliance system. Damages could well follow the approach of the ALI's immunity provision, so that the recovery would equal the director's compensation for a twelve-month period coterminous with the violation. See Proposed Final Draft, supra note 9, § 7.19.
stockholders and the corporation is focused on the vigilance and independent resolve of the outside directors. As seen above, however, the ALI provides no incentive for outside directors to pursue this course beyond the natural incentives that outside directors bring to their task. In a sense, the ALI provisions offer nothing more than business as usual in the American boardroom. The Principles provide no remedy for the weaknesses in directorial monitoring that have existed to date, or the glaring instances of outside directors' failure to protect the corporation or its stockholders from managerial overreaching. The most the ALI provisions can be expected to accomplish is the establishment of a fundamental framework within which such protection may occur. It remains for another force to steel the outside directors' resolve to provide such protection more vigorously than directors have thus far been expected to do.

Some believe that the recent rise of financial institutions may provide that force.130 Financial institutions now own a majority of all publicly traded U.S. stock,131 and the trend toward institutional ownership has accelerated.132 One effect of this move toward institutionalization is the increasing concentration of share ownership in the hands of a few institutions. For example, a 1989 Business Week survey found that 29.6% of the 1,000 largest U.S. companies had more than 60% of their stock owned by financial institutions.133 The extreme example of an institutionally held firm is Capital Cities/ABC, where 88% of all outstanding stock is held by financial institutions.134 This dramatically surpasses the 66% institutional ownership of 3-M,135 and the 56.1% average institutional ownership of all manufacturing firms.136 Such a concentration of ownership has the potential for uniting the institutions into a cohesive voice in

130. Commentators who envision improved corporate governance riding the wave of institutionalization argue that institutional investors have much to gain and little to lose from the improvement of corporate performance; to this end, these institutions will involve themselves selectively in the oversight of their portfolio companies. See, e.g., John C. Coffee, Jr., Liquidity Versus Control: The Institutional Investor as Corporate Monitor, 91 Colum. L. Rev. 1277, 1356-66 (1991); Ronald J. Gilson & Reinier Kraakman, Reinventing the Outside Director: An Agenda for Institutional Investors, 43 Stan. L. Rev. 863, 879-92 (1991).


132. Consider that the percentage of equities owned by individuals has declined from 84.1% in 1965, id., to 55% in 1990, id.; see also Carolyn Kay Brancato, The Pivotal Role of Institutional Investors in Capital Markets: A Summary of Economic Research at the Columbia Institutional Investor Project (unpublished manuscript, on file with The George Washington Law Review) 19 tbl. 5 (1990), to 49.7% today, Siconolfi, supra note 131.

133. See Brancato, supra note 132, at 22-23 tbl. 9 (citing Business Week survey as source of data).

134. Id. at tbl. 8.

135. Id.

136. Id. at tbl. 10; see also George H. Cain, Oligarchy in Corporate America: Voting by Public Institutions, N.Y. L.J., Oct. 25, 1990, at 2 (stating that the "top 20 funds and 10 money managers . . . could well control between 22 and 29 percent of the equity in the top 10 corporations by the year 2000") (quoting Brancato, supra note 132, at 26).
the governance of individual corporations.\textsuperscript{137} Whereas the gulf between management and ownership when Berle and Means wrote their classic work\textsuperscript{138} was great because of the prohibitory coordination costs inherent in trying to mobilize large numbers of individual stockholders, that gulf has narrowed considerably because there may now be perhaps as few as ten or twelve such holders contributing a decisive voice to a particular issue. These institutions' holdings will often be significant enough that any improvement in the corporation's performance will yield rewards for the institutions that exceed the relatively modest costs of coordination efforts.\textsuperscript{139}

One consequence of institutional concentration is a corresponding lack of institutional liquidity. Because investors frequently have varying expectations with respect to particular stocks, anxious institutional sellers may be able to find a willing institutional buyer and thus may enjoy modest liquidity even for large blocks of shares. There is, however, a substantial risk of illiquidity, or liquidity only with a substantial discount, for a large block sold into a market at a time when investors' expectations about the corporation are uniformly negative.\textsuperscript{140} There may, however, be a silver lining for improving corporate governance under the threat of such illiquidity, because illiquidity may influence fund managers to adopt a long-term view of their ownership objectives and attendant responsibilities, so that institutions may be more willing to orchestrate improvements in their portfolio companies.

A similar motivation can be found in those firms adopting a strategy to index a substantial portion of their portfolios. Indexing, a

\textsuperscript{137} See, e.g., Blasius Indus. v. Atlas Corp., 564 A.2d 651, 659 (Del. Ch. 1988) (Allen, Ch.) ("It may be that we are now witnessing the emergence of new institutional voices... that will make the stockholder vote a less predictable affair than it has been.").


\textsuperscript{139} Despite this recent move toward institutional reduction of coordination costs, however, the legal environment provides additional obstacles to the problem of shareholder inactivity by restraining the amount financial institutions may own of a particular company, by imposing burdensome requirements on controlling persons, and by proscribing securities trading while in possession of material nonpublic information. See, e.g., Black, Shareholder Passivity, supra note 13, at 533 (examining the many legal "obstacles faced by shareholders who would be active"); Mark J. Roe, A Political Theory of American Corporate Finance, 91 Colum. L. Rev. 10 (1991) (analyzing political and legal constraints that help to create the separation of ownership and control in the modern corporation). The author does not disagree with the commentators' views that many regulations are inconsistent with the financial institutions' ability to become active in corporate governance matters; however, we should be hesitant to relax these regulations without stronger evidence than has yet been presented that the financial institutions will perform the tasks that some believe they can perform.

\textsuperscript{140} See Coffee, supra note 130, at 1288-89 & n.33.
practice most prevalent among public pension funds,\textsuperscript{141} is an investment strategy that does not try to beat the market; rather, it attempts to track the market. Indexing entails investing much of a fund's assets in securities in proportions roughly equal to the composition of a well-recognized market index, such as the Standard and Poor's Industrial 500 Index. A potential favorable effect of indexing is that index-fund managers are aware that improved performance in their portfolio companies translates into a higher index value, and thus a higher fund value. Moreover, because indexers balance their portfolios among a fixed list of companies—the index companies, which remain essentially constant over time—these investors are by definition long-term owners, with consequent long-term horizons for their portfolio companies' prospects and plans.

With the advent of institutionalization, proposals to reform the corporation have begun increasingly to involve harnessing the outside directors to the financial power and sophistication of institutional owners. For example, Professors Gilson and Kraakman propose a cadre of professional directors who would become specialists at monitoring managers.\textsuperscript{142} According to the authors, these directors would be elected solely by institutions and thus likely would be responsive to the needs and requests of their institutional electors.\textsuperscript{143} By linking the directors' continued service directly to an identifiable and cohesive group of stockholders, the Gilson-Kraakman proposal weakens the directors' bond to management and thus assures greater director independence.\textsuperscript{144} Moreover, because the institutional directors will have no vocational demands aside from their service on a limited number of corporate boards, they will devote more attention to the corporation's affairs and its management than do current outside directors.\textsuperscript{145} A further virtue of the creation of a class of full-time directors is that this breaks the social and ideological linkage that outside directors have with those they are to monitor, because current outside directors customarily are themselves captains of industry.\textsuperscript{146}

Professor Coffee, on the other hand, argues that more is needed than strengthening the bonds between outside directors and institutional holders.\textsuperscript{147} He counsels that unless professional fund managers are provided with new incentives, they will have little desire to influence the boards of their portfolio companies to improve the portfolio companies' performance.\textsuperscript{148} Among the regulatory

\textsuperscript{141} Professors O'Barr and Conley question whether the prevalence of indexing is the cause or symptom of the management style of public pension fund managers, which is more passive than the style of their private counterparts. See William M. O'Barr & John M. Conley, Fortune and Folly: The Wealth and Power of Institutional Investing 139 (1992).
\textsuperscript{142} See Gilson & Kraakman, supra note 130, at 905.
\textsuperscript{143} See id. at 886.
\textsuperscript{144} See id.
\textsuperscript{145} See id. at 885.
\textsuperscript{146} See id. at 884.
\textsuperscript{147} See Coffee, supra note 130, at 1361.
\textsuperscript{148} Id. For this reason, Professor Rock observes that the Gilson-Kraakman proposal
changes Professor Coffee proposes to motivate fund managers are mandating proxy advisers, proscribing "excess diversification," and, most importantly, relaxing the rules that currently restrict performance-based compensation for fund managers. Foremost among Professor Coffee's proposed reforms is his concern for rewarding fund managers. He argues that, absent performance-based awards, fund managers will remain not only over-diversified but also rationally apathetic to improving the governance and performance of their portfolio companies.

A threshold question regarding the impact of institutionalization is what contributions fund managers will be inclined to make to improved corporate governance. Professor Bernard Black has offered the most extensive examination of this question to date. The empirical data he examines, however, focus almost exclusively not on improving overall profitability but on matters involving managerial self-promotion and self-dealing—such as the quest for managerial job security through greenmail, poison pills, and golden parachutes—and the quest for self-importance through conglomerate acquisition strategies. Professor Black provides no evidence that funds either participate in improving the financial performance


149. Coffee, supra note 130, at 1353-54.
150. See id. at 1355-57.
151. See id. at 1362-66.
152. See id. at 1362-63, 1365.
153. Professor Coffee may well have misidentified the cause of fund managers' rational apathy. The source of the restriction on performance-based compensation invoked by Professor Coffee, see id. at 1365, is § 205(a)(1) of the Investment Adviser's Act of 1940, 15 U.S.C. § 80b-5(a)(1) (1988). The Act, however, exempts from its provisions the advisers to the second-largest category of financial institutions, insurance companies. See id. §§ 80b-5(b)(2), 80b-5(a). Moreover, although § 205 does reach mutual-fund advisers, it operates only to restrict the compensation arrangement between the management-advisory company and the fund. See id. § 80b-5. It thus remains possible for the management-advisory company—or, for that matter, the sponsor of the private pension fund—to provide performance rewards to its managers. Thus, Fidelity Investors could and did lavish substantial rewards on its most successful fund manager, Peter Lynch, during his tenure as head of the Fidelity Magellan Fund. Professor Coffee's thesis, that current regulations block private contracting that the parties otherwise would undertake to reward productive behavior, appears to be ill-founded.

154. Financial institutions can, of course, seek to protect their interests through means other than internal-governance procedures. For example, financial institutions have sought to prevent Marriott Corporation's controversial corporate restructuring, which would have substantially devalued bonds held by the financial institutions, by pressuring Marriott's financial advisers. See Constance Mitchell, Internal Rift Led Merrill Lynch to Quit as Marriott Adviser, WALL ST. J., Nov. 24, 1992, at C1.
of their portfolio companies or immerse themselves in the challenge of turning failing companies around. Despite the paucity of empirical data upon which he draws and his own cautious observation that fund managers lack the time and prior experience to micro-manage their portfolio companies, Professor Black nevertheless concludes, somewhat wistfully, with the conviction that monitoring is not intrinsically more difficult than trading. He reasons that good stock trading requires an ability to assess management; thus, institutions “may be able to add value through monitoring.” Nevertheless, Professor Black’s conclusion remains a mere prayer that financial institutions may make nontrivial contributions to improved governance, much like the prayer, decades earlier, that outside directors might make similar contributions.

As the extensive empirical studies reviewed by Professor Black reveal, the impact of institutionalization on corporate governance is likely to be significant in curbing managerial overreaching, but not in improving financial performance. That is, through a combination of increased concentration of share ownership and the recent changes in the proxy rules, large holders have indeed become a force to be dealt with. To date, however, this force has been limited to isolated issues: most frequently antitakeover provisions favored by management; less frequently management’s overall stewardship of the firm; and never the specific operations of the firm’s business.

In the area of improving financial performance, the proposals of

156. Id. at 854.
157. Id.
158. Black, Institutional Investor Monitoring, supra note 13, at 925; see also Susan Pulliam, Calpers Looks to Increase Stock Portfolio, WALL ST. J., Feb. 26, 1993, at C1 (reporting that CalPERS plans to allocate $1 billion to $1.5 billion to invest in underperforming companies, in the belief that this will stimulate management to improve performance to CalPERS’ benefit).
159. See, e.g., Black, supra note 154, at 831-34; Black, Institutional Investor Monitoring, supra note 13, at 901.
160. The amendments to the proxy rules that the SEC recently adopted will accommodate any activist sentiments of the financial institutions. For example, Rule 14a-2(b) now allows written or oral communications among shareholders without requiring compliance with the full array of formal proxy requirements, provided that the communicators are not seeking proxies, does not have a substantial interest in the matter to be voted upon, and does not have a "special relationship" with the company. 17 C.F.R. § 240.14a-2(b)(1) (1992). Rule 14a-1 now permits shareholders to announce how they intend to vote and to offer reasons for their decisions. Id. § 240.14a-1(2). Rule 14a-4 requires the proxy to unbundle resolutions so that each can be voted upon separately, thus reducing the possibility of distorting shareholder votes. Id. § 240.14a-4(a)(5), (b)(1). Rule 14a-4(d) permits dissident shareholders to round out their dissident slate with consenting management nominees. Id. § 240.14a-4(d).
161. For an overview of this history, see Rock, supra note 148, at 482-84. Professor Black's survey considers the impact of six governance concerns on the overall value of the firm: outside directors, corporate diversification, acquisition, pro-incumbent rules, cash retention, and management compensation. See Black, Institutional Investor Monitoring, supra note 13, at 899-916. Later he builds the case that institutional investors may add value to the firm through their positive impact in each of these six areas. See id. at 918-27. The actual evidence he adduces on the willingness of financial institutions to so act, however, is slight, limited exclusively to institutional opposition to antitakeover provisions. See id. at 926-27.

In this regard, Professor Black's findings are consistent with the sobering assessment
Professors Gilson and Kraakman, even coupled with the enhanced incentives recommended by Professor Coffee, are unlikely to overcome the natural forces that determine boardroom culture. To be sure, Professors Gilson and Kraakman propose a mechanism for institutional representation on the boards of public corporations. In the abstract, their proposals appear to ensure that these professional directors will be responsive to the institutions' desire for improved financial performance in the institutions' portfolio companies. There is no reason, however, to expect that institutions will either appoint or guide nominees who can perform better than do current outside directors. Gilson and Kraakman separate their directors from management and professionalize the institutional directors so that they will have more time to devote to their tasks. There is ample reason to believe, however, that even these improvements will fall short of their objective: changing the focus of the entire board on which the professional directors sit.

A problem with the Gilson-Kraakman proposal is that the authors envision no more than two or three such professional directors on each portfolio corporation's board, so that the potential contribution will depend not solely on the institutional directors' actions, but also on their impact on other board members. Because of the relatively small number of institutional directors proposed, the results are likely, at best, to be inconsequential or problematic. To illustrate the problem overlooked by Professors Gilson and Kraakman, consider the GM boardroom. Years before the outside directors ousted senior management, H. Ross Perot, then a GM director, was calling for just this approach. Because he had acquired his fortune in an industry that specialized in the very problems GM was then having—systems management—one might have expected Perot to have an impact on GM policies and practices. Despite his sage

by Professor Rock, who concludes: "The success of takeover related proposals has uncertain significance for corporate governance and cannot be interpreted as an indication that shareholders will be similarly active in other, more internal forms of corporate governance." Rock, supra note 143, at 484. Recent activism has been more modest than that hypothesized by Professor Black, focusing on internal-governance procedures such as confidential voting and the separation of the positions of CEO and chairman of the board. See, e.g., Gilbert Fuchsberg, New York City Pension Funds Target Firms for Corporate Governance Reform, WALL ST. J., Nov. 6, 1992, at A4 (reporting the corporate governance activity of New York City's two largest pension funds in the underperforming "targeted" companies in their portfolios).

162. See supra note 143 and accompanying text.
163. See Bevis Longstreth, Reflections on the State of Corporate Governance, 57 BROOK. L. REV. 113, 118-20 (1991) (arguing that there is no evidence either that institutional directors are better able to govern corporations effectively or that current outside directors are unable to do so).
164. See Gilson & Kraakman, supra note 130, at 887.
observations, however, that GM lacked a coherent business strategy, that the acquisition of Hughes Technology was evidence of a lack of focus, that the company was bloated with middle-managers, and that the company rewarded managers regardless of their performance, Perot was uniformly unsuccessful in recruiting other directors to his cause.\footnote{166} Because he failed to persuade his fellow boardmembers of the wisdom of his course, Perot ultimately agreed to dispose of his GM shares and resign from the board.\footnote{167}

One may legitimately question whether two or even three institutional directors might be viewed, like Perot, as outsiders, especially if their opinions conflicted not simply with those of management, but with the corporation's culture. Studies repeatedly demonstrate that a recognized strength of the board of directors is its cohesiveness, so that a prime factor in identifying potential new directors is whether they are likely to "fit the mold."\footnote{168} The risk that Professors Gilson and Kraakman did not consider is that the remaining directors, who almost invariably trace their nominations to a source grounded in the corporation's management and culture, forever will treat the institutional directors as outsiders. This concern does not condemn the Gilson-Kraakman proposal, but it does identify an obstacle to the achievement of its intended effects.

The concern that noninstitutional directors will treat the institutional directors as outsiders raises the question of how long the institutional directors can persist in their resolve to provide an independent voice rather than one of consensus. This is Professor Coffee's focus in proposing to link the professional money manager's rewards with the performance of portfolio companies.\footnote{169} Through the fund manager's self-interest, Professor Coffee seeks to position the fund manager as the engine for steering outside directors' resolve.\footnote{170} Professor Coffee overlooks a critical factor, however: Fund managers, with few exceptions, very much prefer the quiet life of their professional culture.

Professors O'Barr and Conley have conducted an insightful study into the culture of pension fund managers. The authors raise substantial doubts that institutional investors will be the positive force for improved financial performance that Gilson and Kraakman and others have suggested.\footnote{171} Pension funds, private and public, are the largest group of institutional investors in America.\footnote{172} Their assets
exceed $2.5 trillion,\textsuperscript{173} with private pension funds accounting for roughly seventy percent of that amount.\textsuperscript{174} Both typically have relatively modest staffs\textsuperscript{175} and decisionmaking is commonly bureaucratic, involving multiple levels of analysis and review.\textsuperscript{176}

Rather than having either a microeconomic vision or a corporate vision, fund managers tend to view events and goals through their own experiences. Many fund managers informed Professors O'Barr and Conley that they lacked the interest and insight to involve themselves closely in any of their portfolio companies.\textsuperscript{177} The skill most prized in a public pension-fund manager is the ability to deal with the political infighting in the executive and legislative wings of state governments.\textsuperscript{176} Private pension-fund managers see corporate-governance matters as a burden, express grave reservations about involving themselves in the operations of their portfolio companies, and are extremely reluctant to take a position hostile to the portfolio companies' managements.\textsuperscript{179} In sum, private pension-fund managers tend to be strong proponents of the status quo in their portfolio companies.\textsuperscript{180} Professors O'Barr and Conley attribute this position to the potential for interaction between portfolio companies and the company sponsoring the pension fund.\textsuperscript{181} Overall, most funds have expressed their displeasure with poor performance by voting either to prohibit poison pills and greenmail or to support a more independent board of directors,\textsuperscript{182} but not by counselling management on improving sales, reducing costs, or pursuing new technologies.

Further cause to doubt that fund managers would be good monitors is their spotty record with respect to the selection and retention of external managers. Professors O'Barr and Conley report that external managers are fired infrequently,\textsuperscript{183} primarily because the fund managers themselves are not aggressive monitors of the

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amount (in trillions) of their assets are insurance companies ($1.9), investment (mutual fund) companies ($1.1), bank trusts ($0.79), and foundations and endowments ($0.19). \textit{Id. at} 173. \textit{Id. at} 174. \textit{Id. at }45 fig. 3-1. \textit{Id. at }139. \textit{Id. at }54. \textit{Id. at }189. \textit{Id. at }144. \textit{Id. at }194-98. \textit{Id. at }198. \textit{Id. at }200. Professors O'Barr and Conley call this the pension-fund "Golden Rule." They surmise that pension-fund sponsors are afraid of finding themselves eventually in the portfolios of funds sponsored by corporations that have been irritated by the sponsor's fund. \textit{Id. at} 185. \textit{Id. at }91.
external managers’ performance.\textsuperscript{184} External managers appear to be judged by vague characteristics rather than by a close examination of performance relative to that of their competitors.\textsuperscript{185} Interestingly, the attitude of such external money managers is much like that of their clients: They believe involving themselves in the affairs of the portfolio companies is unrelated to their own rewards.\textsuperscript{186}

The personal incentives for pension-fund managers to excel are not great. Although public pension-fund managers are fired more often than private fund managers,\textsuperscript{187} this difference is insignificant because private fund managers have virtually tenured positions and are subject to almost no sanctions for poor performance.\textsuperscript{188} The lure of both public and private fund management is job security; but the fund salary structure is often insufficient to attract outstanding managers.\textsuperscript{189} Underperformance by either a private or public pension-fund manager is “typically written off to the manager’s particular style being temporarily out of sync with the market.”\textsuperscript{190} Beating the market by a few basis points in three out of five years is seen as an indication of success.\textsuperscript{191} Fund managers believe that they receive no benefits for success; they fear only consistent failure.\textsuperscript{192} One wonders, therefore, whether the advantages of greater performance-based compensation, as recommended by Professor Coffee, would be realized.

Professors O’Barr and Conley, in their unflattering account of the culture of pension-fund managers, may not present a reliable description of those who manage the portfolios of insurance companies, mutual funds, bank trust departments, foundations and endowments. Nonetheless, it is at least likely that the culture of these entities is not vastly different from that of the private pension-fund manager. There is little chance that the rewards garnered by the fund manager for improving the performance of a particular portfolio company will be valued sufficiently to induce the fund manager to pursue that option over other, less burdensome, alternatives in order to increase the money manager’s wealth. The culture of money managers is a “custodial” one that puts “safety first”;\textsuperscript{193} even in the “gunslinger” culture of mutual funds, the emphasis is on sales and trading, not, for instance, on operating a steel

\textsuperscript{184} See id. at 85-93.
\textsuperscript{185} Id. at 89-99.
\textsuperscript{186} Id. at 197.
\textsuperscript{187} Id. at 130.
\textsuperscript{188} See id. at 128, 140.
\textsuperscript{189} Id. at 87. The position of a private pension-fund manager actually carries a negative reward in the sense that it ends further advancement within the sponsoring company’s managerial hierarchy.
\textsuperscript{190} Id. at 140.
\textsuperscript{191} See id. at 50.
\textsuperscript{192} See id. at 88, 141. For public pension funds, a major source of accountability is the press, which is more interested in failure than success. See id. at 141.
mill. Even if there were radical changes in the compensation schedule for money managers along the performance-based lines Professor Coffee recommends, this likely would not deflect much of the money manager's energies from sales, trading and other familiar, predictable avenues to increasing her private wealth. 194

A final weakness in the belief that fund managers will lead the way to improved performance of their portfolio companies is that the mutual-fund manager's expertise and comfort level lie in the area of finance, particularly in stock picking, and not in hands-on management or strategic planning. Money managers and their advisers will not have the type of information that allows the discrete operational interventions necessary to make a moderately profitable firm more successful. Those who believe that outside fund managers can from their distance offer concrete proposals on marketing, finance, and manufacturing to boost the performance of an already-successful firm must also believe that the pedestrian who stares through the knot hole in the fence surrounding the construction site can offer suggestions on how to reduce the building's cost by five percent. In both cases, the outsiders' perspective is too distant, their involvement too abbreviated, and their expertise too different. Moreover, those whose decisions the fund manager criticizes are likely to resist, or ignore, the money manager's advice. Private fund managers also can be expected to pursue the familiar route to increasing their personal wealth through sales and trading, instead of the marginally more costly and unfamiliar role of gearing up to become a captain of industry.

Most money managers do not perform as well as a broad market index195 but continue to survive and prosper. Whereas the football coach does not survive long on a six-and-five season, money managers are satisfied if they occasionally perform slightly better than Standard and Poor's Industrial 500. They retain their clientele through sales, service, and preaching the gospel of financial security, not through beating the market; these efforts are likely to continue. It is familiar terrain to money managers, and it is unlikely that their attention will be deflected by the possibility of enhanced rewards linked to the performance of unfamiliar tasks with uncertain outcomes.

V. Steeling the Directors' Resolve Through Disclosures

The federal securities laws, particularly the antifraud provisions, do not regulate the internal affairs of the corporation except through the mechanisms of disclosure. Thus the Supreme Court, in

194. See Rock, supra note 148, at 473-76.
195. See id. at 478.
Santa Fe Industries v. Green, 196 reversed the Second Circuit holding that deception is not a specific requirement in a Rule 10b-5 action for breach of fiduciary duty—in this case, an unfair price and lack of a proper business purpose for a freeze-out merger. 197 More recently, in Virginia Bankshares, Inc. v. Sandberg, 198 the Supreme Court held that directors' expression of an opinion can itself be a material misrepresentation subject to liability under Rule 10b-5. 199 The Court thereby charted a course for intertwining the federal securities laws and the monitoring obligations of outside directors to ensure that there is a meaningful and lasting steeling of outside directors' obedience to their monitoring obligations.

In Virginia Bankshares, First American Bankshares (FAB) undertook a freeze-out merger to eliminate the minority stockholders of its 85%-owned subsidiary, Virginia Bankshares. 200 The Virginia Bankshares directors expressed the opinion, in the proxy statement accompanying the merger, that the $42 cash price to be paid by FAB was "fair" and that the plan provided a mechanism for minority stockholders to obtain a "high" value for their holdings. 201 The directors expressed this opinion despite evidence that the directors possessed the information that, when the appreciated value of the Virginia Bankshares' real estate holdings were considered, the $42 price did not offer a premium over the firm's book value. 202 Moreover, the directors also possessed a report placing the firm's going-concern value in excess of $60. 203 The Court held that the trier of fact could find that the directors committed a material misrepresentation by publicizing the opinion that the transaction involved a "high" value and a "fair" price. 204 The Court's holding, however, was limited: Courts must find not only objective evidence inconsistent with the directors' belief, but also evidence that the misrepresentations were related to the subject matter of the securities transaction; 205 in Virginia Bankshares, the omissions and misrepresentations bore directly on the value of the securities to be sold to FAB. 206

The full effect of opinion statements being the basis of a disclosure violation was reflected in Mendell v. Greenberg, 207 where the

197. Compare id. at 471-80 with Green v. Santa Fe Indus., 553 F.2d 1283, 1287, 1291 (2d Cir. 1976). Justice White, for the Santa Fe Industries majority, stated: "We thus adhere to the position that 'Congress by § 10(b) did not seek to regulate transactions which constitute no more than internal corporate mismanagement.'" Santa Fe Indus., 430 U.S. at 479 (citation omitted).
199. Id. at 2757-61.
200. Id. at 2755.
201. Id. at 2756.
202. Id. at 2759.
203. Id.
204. Id. at 2761.
205. Id. at 2760.
206. See supra notes 201-03 and accompanying text.
207. 988 F.2d 1528 (2d Cir. 1991) (per curiam), modifying 927 F.2d 667 (2d Cir. 1990).
plaintiff challenged a proxy statement as materially misleading because it failed to disclose that the proposed cash sale of the corporation was guided not by the fairness of the price offered but by the dominant stockholder's need for cash to satisfy the tax liabilities of certain family members' estates. The record revealed that upon the deaths of Anita and Charles Loehmann, the Loehmann family lacked the necessary cash to extinguish the taxes due on the estates. Moreover, if the taxes were paid promptly, the estates would enjoy a substantial reduction in their tax liability. The plaintiff alleged that the Loehmann's heirs were accordingly anxious for a quick cash sale of the company, rather than a more deliberate course that may have yielded greater value for all of the corporation's stockholders. The Second Circuit reasoned that the proxy statement was materially misleading in failing to disclose these factors so that the corporation's stockholders themselves could judge whether the transaction was being proposed because of its financial merits or because of the pressures placed on the board of directors by its dominant stockholder, whose need for cash would be satisfied by the sale.

The implication of Virginia Bankshares and Mendell is that directors have an obligation to disclose those facts known to them that are inconsistent with the course of action they are recommending for approval to the stockholders. Such facts assume importance not solely because they call into question the fairness of the transaction, but because they are inconsistent with the professed opinion of the directors on the worthiness of the transaction. Because the focus is on the directors, rather than the terms of the transaction itself, Virginia Bankshares sends a strong message to directors regarding their obligations under the securities laws. It is a message not likely to be ignored by the directors' counsellors, who will now caution the directors to place in the proxy statement appraisals, estimates, and the financial position of the firm's controlling stockholder or managers whenever such factors implicate the overall price or structure of the transaction.

Directors thus will find themselves confronted with a Hobson's Choice: ignoring their counsellors' advice that conflicting data and

208. Mendell, 927 F.2d at 670.
209. Id.
210. Id. at 671.
211. Id. at 670.
212. Id. at 675. In a rehearing after Virginia Bankshares was decided, the Second Circuit held that its earlier decision was supported by Virginia Bankshares except that Virginia Bankshares required the plaintiff to evidence the misrepresentation in terms of Loehmann's sale. See Mendell v. Greenberg, 938 F.2d 1528, 1529 (2d Cir. 1991). Thus, the Second Circuit modified its holding to condition a finding of liability for material misrepresentation on a predicate showing that the fair value of the Loehmann stock was above the $31.50 offered in the cash sale. Id.
reports must be disclosed fully, thereby incurring the risk of violating the securities laws, or including information that materially conflicts with their opinion statement, in which case they most certainly will draw attention to their own divided loyalties. The respective perils of these choices hopefully will give way to a far wiser option: Directors will be even more forceful guardians of the corporation's and stockholders' interests. They will be induced to extract, from managers or controlling stockholders, improved terms for the transaction so that their opinions regarding fairness and value can be offered truthfully. The prophylactic benefits of *Virginia Bankshares*, therefore, may be substantial.

*Virginia Bankshares* can be seen as embracing the SEC's own approach to directors' disclosure obligations in the face of overreaching or unfair conduct. The classic illustration of a transaction posing such a threat is a going-private transaction, where SEC Rule 13e-3 mandates extensive disclosures on the part of the disappearing company's directors for the purpose of bringing any unfairness into the open; such disclosure has the indirect effect of compelling the directors to protect the minority stockholders' interests. For example, Item 8(a) of Schedule 13E-3 requires the directors to express their opinion of the transaction's fairness to the frozen out stockholders. Further, Item 8(b) of Schedule 13E-3 requires a reasonably detailed discussion of the "material factors upon which the belief stated in Item 8(a) is based." Mere itemization of factors relied upon is not sufficient; the SEC requires a full discussion. Thus, a general statement that the board of directors considered $29.50-per-share fair in the light of the company's book value of $3.77-per-share was held incomplete absent any discussion "of the reasons and extent to which book value is or is not an accurate reflection of the Company's value and therefore was accepted or rejected as a criterion for judging the fairness of the transaction."

Although *Virginia Bankshares* does not require full presentation of all the factors making up the directors' recommendation, unlike the SEC's more textured going-private rule, at least in the case of opinion statements, *Virginia Bankshares* requires a full presentation of any data, reports, and factors that are materially inconsistent with the directors' expressed opinion. Moreover, because a recommendation of the board can be seen as carrying the implied statement that the directors believe the recommended transaction is in the best interests of the corporation, it is quite likely that *Virginia Bankshares*

213. See infra note 228.
215. See id. § 240.13e-3(e).
216. See id. § 240.13e-100 (Item 8(a)).
217. Id. (Item 8(b)).
will not be limited to express statements of opinion. Indeed, this
appears to be the approach adopted by the Second Circuit in
Mendell,"220 because the Second Circuit applied the reasoning of Vir-
ginia Bankshares without first finding that the directors had proffered
an express opinion regarding the transaction’s fairness.221

More recently, the SEC has weighed in on the issue of executive
compensation, adopting new disclosure guidelines for the express
purpose of providing a clearer presentation of senior-executive
compensation.222 The objective of its new disclosure rules is
neither to bring greater efficiency to a very complex area nor to en-
hance comparability. Instead, the rules embrace Brandeis’ reason-
ing: “Sunlight is said to be the best of disinfectants; electric light
the most efficient policeman.”223

Among the provisions of the new rules is a requirement that ech-
oes the going-private rule: The compensation committee, or, in its
absence, the entire board of directors, must report on the board’s or
committee’s compensation policies, and the report must discuss the
relationship of corporate performance to executive compensation
with respect to compensation reported for the last completed fiscal
year.224 Even more specific discussion is required with respect to
relating the chief executive’s compensation to the firm’s perfor-
mane.225 The new SEC rules further emphasize these disclosures by
requiring a line-graph plotting, for five years, the relationship of ex-
cutive compensation to overall corporate performance as embo-
died in a measure of cumulative total shareholder return, which is to
be contrasted with an acceptable stock index, such as the Standard
and Poor’s Industrial 500 Stock Index.226 An interesting provision
mandates that these disclosures must be positioned over the names
of the directors or the body charged with making the disclosur—

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220. See Mendell v. Greenberg, 938 F.2d 1528 (2d Cir. 1991) (per curiam), modifying
927 F.2d 667 (2d Cir. 1990); supra notes 207-12 and accompanying text.
221. See Mendell, 938 F.2d at 1529.
223. Louis D. Brandeis, Other People’s Money 92 (1932). The twin focus of dis-
losure and the imposition of responsibility on outside directors is likely to be more
useful than, for example, legislative imposition of a ceiling on the amount of executive
compensation. A ceiling of sorts was at one time imposed for “golden parachutes”
above which the corporation lost certain tax deductions. See Amanda Bennett, Clinton
Victory Wouldn’t Slash Top Officer Pay, WALL ST. J., Nov. 3, 1992, at B1. An effect of the
ceiling was not to rid corporations of golden parachutes, but to cause companies “to
raise their planned payouts” to the ceiling level. Id
225. See, e.g., id. § 229.402(a)(4), 402(k)(2) (Items 402(a)(4), 402(k)(2)).
226. Other matters required to be disclosed relate to the potential compromise of the
directors’ independence, because the reporting CEO also sits on an outside director’s
board. See id. § 228.402(j)(3) (Item 402(j)(3)).
227. See id. § 228.402(k)(3).
a provision no doubt designed to remind the directors of their personal responsibilities with respect these disclosure obligations.

To be sure, in one respect the executive compensation disclosure requirements are not as stringent as the going-private rule’s disclosure demands. The going-private rule mandates that the directors express an opinion regarding the transaction’s fairness, whereas no such statement is mandated with respect to the senior executives’ compensation. However, in the process of discussing the relationship between performance and compensation relied upon by the compensation committee or the board in setting compensation, there is ample basis upon which Virginia Bankshares can operate to create liability for a presentation that does not disclose data, reports, or incidents that are materially inconsistent with the resulting presentation. The executive compensation disclosures are notable, even though they finessed the directors’ role in checking managerial excesses by not directly requiring the directors to opine on the fairness and appropriateness of the senior executives’ compensation package.

The going-private rule and executive compensation disclosure requirements hold the outside directors accountable in discrete but important areas of potential managerial overreaching. Virginia Bankshares reaches the same result universally. In combination, these three developments reflect the manner in which the disclosure requirements of the federal securities laws complement the monitoring duty that the ALI prescribes for directors, but which the ALI provides little incentive to discharge.228 Of even greater importance is that the new disclosure obligations reflected in Virginia Bankshares, the going-private rule, and now executive compensation disclosures, each provides a bully pulpit from which the counsellors of outside directors will remind the directors that they have a very

228. The vitality of these developments, however, depends on their respective enforcement efforts. On this point, there is cause for both hope and concern. For example, because the executive compensation disclosures are not treated as “soliciting material,” so that misrepresentation does not give rise to Rule 14a-9 liability, see 17 C.F.R. § 240.14a-9 (1992), and because the newly compelled disclosures are not deemed to be filed with the SEC, so that § 18 of the Securities Exchange Act is not available for private enforcement of any materially misleading representations, see 15 U.S.C. § 78r(a) (1988), breaches of the new executive compensation disclosure requirements are essentially beyond the reach of private enforcement actions. See 17 C.F.R. § 229.402(a)(9) (Item 402(a)(9)). Consequently, the effectiveness of the executive compensation disclosure requirements is dependent exclusively upon the SEC’s enforcement efforts. Given the high level of compliance with the SEC’s disclosure requirements, however, together with recent substantial increases in the agency’s enforcement staff, whose enforcement weapons were made more powerful and efficient in 1990, there is every reason to believe that the absence of private enforcement will not compromise the new rules on how outside directors discharge their responsibilities in setting management compensation. On the other hand, if a securities transaction lies at the heart of overreaching behavior, the antifraud provision most likely will be available to private litigants, to address any disclosure breach of the type proscribed by Virginia Bankshares. See supra notes 198-213 and accompanying text.
visible role in policing management. In combination, these obligations are an important contribution to improving corporate governance, because they present a powerful reminder to directors of their responsibilities to the stockholders.

Conclusion

The most fundamental criticism of Professors Gilson, Kraakman, Coffee, and Black is that each assumes that outside directors can make a difference, if energized, in bringing about improved financial performance. In essence, they embrace the false hope of the ALI—that outside directors can contribute to improved governance beyond the curbing of managerial overreaching. They reach their conclusions without first developing the foundation of just how the outside directors can make a difference in improving an individual firm’s financial performance. Indeed, there is an argument that improved financial performance may correlate with fewer, not more, outside directors: Inside directors, because of their intimate knowledge of the firm and its operating environment, can be expected to have more valuable observations, and a higher level of skill, than their outside counterparts.

It may be that the outside directors can, as Professors Gilson, Kraakman, Coffee, and Black assume, make a difference in financial performance. However, any legal prescription of this course should not be based on false hopes and faint evidence. We must await empirical evidence of the capacity of outside directors to make a difference. In the meantime, their presence serves the worthwhile purpose of discouraging managerial overreaching, a task that the outside directors can discharge more resolutely because of Virginia Bankshares, and because the new voice of the financial institutions has made the outside directors more aware of their task.