

# THE 1970S: THE COMMITTEE ON CORPORATE LAWS JOINS THE CORPORATE GOVERNANCE DEBATE

MARSHALL L. SMALL\*

## I

### INTRODUCTION

The 1970s decade—like the decade now ending—was marked by a number of corporate scandals. The decade was ushered in by the revelation of the Watergate break-in and its aftermath. Watergate was followed by disclosures of numerous cases of bribery of foreign officials, leading eventually to the enactment of the Foreign Corrupt Practices Act in 1977.<sup>1</sup> The decade was also marked by other types of questionable payments by publicly held corporations, both in the United States and overseas, leading to a series of enforcement actions by the Securities and Exchange Commission (SEC) that resulted in consent decrees.<sup>2</sup> These revelations stimulated a vigorous debate in Congress, the federal regulatory agencies, the academic community, the organized bar, public interest groups, and the business community, as to how publicly owned corporations should be governed to prevent corporate misconduct, and to enhance oversight of the corporation, with some suggesting that corporation law should be federalized.<sup>3</sup>

## II

### PRE-EXISTING LAW ON DIRECTOR RESPONSIBILITIES

The role of the corporate director—particularly the non-management director—became a focus of attention in this ongoing debate. Although there had been a marked increase in the number of manufacturing corporations whose boards of directors contained a majority of non-management directors—

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\* Senior Counsel, Morrison & Foerster, LLP; Member of the California and New York Bars. Mr. Small was a member of the American Bar Association Corporate, Banking, and Business Law Section's Committee on Corporate Laws from 1974 through 1982.

1. See Pub. L. No. 95-213, 91 Stat. 1494 (1977).

2. See A. A. Sommer, Jr., *The Impact of the SEC on Corporate Governance*, 41 LAW & CONTEMP. PROBS. 115 (Summer 1977).

3. See Marshall L. Small, *The Evolving Role of The Director in Corporate Governance*, 30 HASTINGS L.J. 1353, 1353–55 (1979).

from 63% in 1967 to 83% in 1977<sup>4</sup>—at the start of the decade, the non-management director was often not regarded as playing an active governance role. A survey of board of directors' practices and procedures of twenty-five large, public corporations, published by the General Counsel of General Electric Company in December 1969, disclosed that only about fifty percent of those corporations ever sent out advance notice to their directors of the agendas for board meetings.<sup>5</sup> This view of the passive nature of non-management directors was also reflected in an influential book published in 1971 by Myles Mace, a well-known professor at the Harvard Business School.<sup>6</sup>

Existing legal standards similarly reflected the view that directors (particularly non-management directors) were not expected to be proactive. In the leading Delaware Supreme Court case of *Graham v. Allis-Chalmers Mfg. Co.*, the court held that directors of a large, public company were not expected to be aware of, or take action to guard against, anti-trust violations by subordinates.<sup>7</sup> It would be another thirty years before the Delaware Chancery Court reexamined the *Allis-Chalmers* decision in *In re Caremark Int'l, Inc. Derivative Litigation* and recognized a duty of directors to monitor the affairs of corporations.<sup>8</sup> It would be still another ten years before the Delaware Supreme Court endorsed the Chancery Court's decision in *Caremark*, holding that the necessary conditions predicate for director oversight liability were either (1) an utter failure to implement any reporting or information system or controls; or (2) having implemented such a system or controls, conscious failure to monitor or oversee its operation, thus disabling themselves from being informed of risks or problems requiring their attention.<sup>9</sup> However, during the 1970s, such a duty of directors to monitor was not generally recognized by courts.<sup>10</sup>

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4. Nat'l Indus. Conf. Bd., *Studies in Business Policy No. 125*, CORPORATE DIRECTORSHIP PRACTICES, at 6 (1967) (1966 figure); Subcomm. on Functions and Responsibilities of Dirs., ABA, *Corporate Director's Guidebook*, 33 BUS. LAW. 1591, 1644 (1978) (citing Nat'l Indus. Conf. Bd. report containing 1977 figure).

5. Office of the Gen. Counsel and Sec'y, Gen. Electric Co., *Survey of Board of Directors Practices and Procedures* 6 (1969) (on file with author).

6. See MYLES L. MACE, DIRECTORS: MYTH AND REALITY (1971).

7. *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130–31 (Del. 1963).

8. *In re Caremark Int'l, Inc. Derivative Litig.*, 698 A.2d 959, 968–70 (Del. Ch. 1996).

9. *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006). Some courts have been reluctant to conclude that non-management directors fail to fulfill their duty to monitor due to so-called "red flags," while other courts have concluded that non-management directors should have been on notice sufficient to trigger action. Compare *In re Citigroup, Inc.*, S'holder Derivative Litig., 964 A.2d 106 (Del. Ch. 2009), with *In re Abbott Labs. Derivative S'holder Litig.*, 325 F.3d 795 (7th Cir. 2003), and *McCall v. Scott*, 239 F.3d 808, amended on denial of reh'g, 250 F.3d 997 (6th Cir. 2001). In *Lanza v. Drexel*, 479 F.2d 1277 (2d Cir. 1973) (en banc), the Second Circuit declined to find that an outside director had a duty to investigate, over a dissent that concluded the director had seen "seagulls on the water." The phrase "seagulls on the water" is a maritime reference to the fact that, well in advance of a storm, seagulls assume a V-formation on the surface of the water and head into the wind. When "old salts" see this, they take heed and prepare for a storm. For those not qualifying as "old salts," the term "red flags" has become a more common description for the type of information that should put a director on notice.

10. See, e.g., *Lanza*, 479 F.2d at 1281.

In the face of widespread disclosure of corporate misconduct, the SEC, under the chairmanship of G. Bradford Cook, undertook to prepare a position paper on the responsibility of directors. However, this effort was later abandoned by his successor as chairman, Ray Garrett, Jr., as being unworkable.<sup>11</sup>

### III

#### ACTIVITY OF THE COMMITTEE ON CORPORATE LAWS

##### A. Model Act Revisions

In 1973, the Committee on Corporate Laws (Committee) entered the intense debate about the role of corporate directors by establishing a panel on the functions and responsibilities of directors.<sup>12</sup> The initial task of the panel was to consider sections 35 and 48 of the Model Business Corporation Act (MBCA), dealing with the board of directors and liabilities of directors.<sup>13</sup> The work of the panel (which later became a subcommittee of the Committee) resulted in the adoption in 1974 of amendments to sections 35 and 48 of the MBCA.<sup>14</sup>

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11. See *New SEC Rulings: Cook Speech on Directors' Responsibilities*, [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) P82,916, 82,916 (1973); Ray Garrett, Jr., Chairman, Sec. and Exch. Comm'n, Address to the Conference Board (May 7, 1974) (transcript on file with author).

12. The panel consisted of Joseph Hinsey (chair), George W. Coombe, George Gibson, Junius Hoffman, David Ruder, William Bew White, Jr., and me.

13. Section 35 corresponds with sections 8.01, 8.11, and 8.30 of post-1984 MBCA editions; section 48 corresponds with section 8.33.

14. The comment to these amendments noted, *inter alia*, that:

In addressing these matters, the Committee not unnaturally considered the role of the corporate director and, in particular, the language of the Act—and the vast majority of counterpart state statutes—stating that the business and affairs of the corporation shall be *managed* by the board of directors (unless otherwise provided in the articles of incorporation). Many commentators have recently voiced concern that this language may be interpreted to mean that directors must become involved in the detailed administration of the corporation's affairs. Before the advent of the so-called "outside" director, it was not unreasonable to expect the board to be actively involved in the corporation's business; however, with the development of board participation by individuals not otherwise actively involved with the corporation, any such expectation can no longer be viewed to be reasonable. Indeed, such involvement is clearly neither practical nor feasible insofar as today's complex corporation, other than perhaps the closely-held corporation, is concerned.

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The purpose of the modification of the first sentence of Section 35 is to eliminate any ambiguity as to the director's role in formulating major management policy as opposed to direct involvement in day-to-day management. . . . The first sentence of Section 35, as modified, clearly implies that the board has the power to probe to any depth but has a responsibility to do so only to the extent that the standard of care would require.

MODEL BUS. CORP. ACT cmt. on amendments to sections 35 and 48 at 142–43 (1974).

## B. The Corporate Director's Guidebook

The Subcommittee on Functions and Responsibilities of Directors (Subcommittee), as it came to be known, continued in existence after completion of its work on sections 35 and 48.<sup>15</sup> During 1975, members of the Subcommittee prepared a series of position papers concerning the responsibilities and functions of directors. George Coombe (then general counsel of BankAmerica Corporation) and I prepared a draft of a proposed model for the boards of directors of publicly owned corporations that differentiated between management and non-management directors and identified the personal characteristics desirable for directors, their expected time commitment, and the size and composition of boards of directors. We recommended that non-management directors constitute a majority of the full board and have a primary role in selecting the chief executive officer and other key officers. Our proposed model also recommended that the non-management directors have the responsibility, through a compensation committee, of approving compensation of key management; that an audit committee of non-management directors be established to review the integrity, financial reporting, and internal financial controls of the corporation; and that a nominating committee composed of a majority of non-management directors be given the responsibility for recommending nominees to fill board vacancies.

In early 1976, the Subcommittee decided to prepare a handbook for the use by, and guidance of, directors. It was understood that the handbook was to be a practical guidebook for directors, intended to create a desirable corporate governance environment, rather than a statement of applicable legal principles which, as previously noted, were the subject of continuing debate.

In February 1976, Joseph Hinsey, as chair of the Subcommittee, asked David Ruder, a member of the Subcommittee, to prepare an outline for the handbook. In March 1976, Professor Ruder submitted an outline based on a consideration of position papers previously prepared by members of the Subcommittee; a report by Ralph Nader, Mark Green, and Joel Seligman on the case for federal chartering of corporations;<sup>16</sup> and a paper produced by Leech and Mundheim.<sup>17</sup> Part III of David Ruder's outline set out a comparison between a so-called Subcommittee Model (based on the model that George Coombe and I had prepared), a Nader Model, and a Leech–Mundheim Model. The Subcommittee voted to adopt the Subcommittee Model as part of the handbook.

When a draft of the proposed handbook became publicly available, it received intense criticism, particularly with respect to the proposed model for

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15. The Subcommittee maintained the same membership, with the addition of Leslie Duryea.

16. RALPH NADER, MARK GREEN & JOEL SELIGMAN, *TAMING THE GIANT CORPORATION* (1976).

17. The Leech–Mundheim paper was later published as: Noyes E. Leech & Robert H. Mundheim, *The Outside Director of the Publicly Held Corporation*, 31 *BUS. LAW.* 1799 (1976).

the board of directors. The handbook was criticized not only because it was not based on existing legal authority, but also because some feared that it might serve as a basis for judicial decisions, particularly if it bore the imprimatur of the American Bar Association.<sup>18</sup> The recommendation that non-management directors constitute a majority of the board drew especially harsh criticism even though, at that time, a substantial majority of large, publicly owned corporations had a majority of non-management directors on their boards. Some critics advocated abandoning the handbook project, or at least not having it carry the formal approval of the American Bar Association or its Section on Corporation, Banking, and Business Law. As a compromise, the initial Guidebook, as it was then re-styled,<sup>19</sup> was published in the November 1976 issue of the *Business Lawyer* for comment as the product of only the Subcommittee, without approval of either the Committee or the Section on Corporation, Banking, and Business Law.<sup>20</sup> Both the Committee on Corporate Law Departments and the American Society of Corporate Secretaries, Inc. (Society) submitted critical comments on the Guidebook, which were published in the July 1977 and the November 1977 issues of *Business Lawyer*.<sup>21</sup>

In May 1977, the Business Roundtable sponsored a Scholar's Symposium "to appraise the role of the boards of directors of large, publicly held enterprises."<sup>22</sup> The symposium "focus[ed] particularly on board selection procedures, the composition of the board, board operating procedures, and the structure and role of board committees."<sup>23</sup> The report of this symposium was prepared by David Ruder.<sup>24</sup> The Scholar's Symposium was followed by a conference of chief executive officers—principally the membership of the Business Roundtable Committee on Corporate Organization Policy—that took place in July 1977 to consider David Ruder's report. Thereafter, the Committee prepared a statement, which was approved by the Policy Committee of the Business Roundtable, endorsing the concept of board structure based on a majority of outside directors and the use of audit, compensation, and

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18. A similar concern was later voiced when the reporters for the American Law Institute's Corporate Governance Project presented as part of their drafts, recommendations of corporate practice concerning composition of the board of publicly held companies, and audit committees, nominating committees, and compensation committees. As a result, these recommendations appear in the final ALI Principles of Corporate Governance in part III(A) in light face type, as contrasted with the other sections of the document, which appear in bold face type.

19. According to a report by a representative of the American Society of Corporate Secretaries who was present at a membership meeting, the change was made due to a copyright issue.

20. Subcomm. on Functions and Responsibilities of Dirs, ABA, *Corporate Director's Guidebook*, 32 BUS. LAW. 5 (1976–1977).

21. Comm. on Corporate Law Dep'ts, *Report of the Committee on Corporate Law Departments on Corporate Director's Guidebook*, 32 BUS. LAW. 1841 (1977); Am. Soc'y of Corporate Sec'ys., Inc., *Corporate Director's Guidebook: Comments Submitted by the American Society of Corporate Secretaries*, 33 BUS. LAW. 321 (1977).

22. Bus. Roundtable, *The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation*, 33 BUS. LAW 2083, 2085–86 (1978).

23. *Id.* at 2086.

24. *Id.*

nominating committees composed of outside directors, with the exception that the chief executive officer could also serve on nominating committees.<sup>25</sup>

The Guidebook, which had been revised to reflect various comments, but which essentially retained its proposed model for the board of directors of a publicly owned corporation, was approved by the Committee in December 1977 and by the Council of the Section of Corporation, Banking, and Business Law of the American Bar Association in January 1978.<sup>26</sup> In January 1978, after its initial strong criticism of the Guidebook, the board of directors of the Society adopted a resolution expressing its support for the Guidebook and recommending it to the membership of the Society for their consideration, recognizing that particular circumstances may suggest modifications to its provisions and policies.<sup>27</sup> The Guidebook was published in *Business Lawyer* in its April 1978 issue and thereafter widely distributed for use by U.S. corporations.<sup>28</sup> A supplement to the Guidebook on the overview committees of boards of directors, prepared by the Subcommittee, was approved by the Committee in December 1979 and thereafter used in conjunction with the Guidebook.<sup>29</sup>

In 1993, after fifteen years of use, the Guidebook was revised for the first time. Provisions from the Committee's 1979 supplement to the Guidebook, *The Overview Committees of the Board of Directors*,<sup>30</sup> were incorporated into the revised edition.<sup>31</sup> In addition, the proposed model for boards of directors was dropped. The introduction to the revised edition explained that the model was deleted for two reasons: (1) much of the material was now to be "found in the discussion of the structure of the board and its committees," and (2) "developments in applicable law ha[d] removed much of the need for the tentativeness reflected in the concept of a model."<sup>32</sup> The Committee is now preparing a sixth revised edition of the Guidebook. The Guidebook has, to date, been distributed to more than 120,000 users.<sup>33</sup>

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25. *Id.* at 2107-12.

26. Subcomm. on Functions and Responsibilities of Dirs., ABA, *Corporate Director's Guidebook*, 33 BUS. LAW. 1591, 1595 (1978).

27. *Id.*

28. *Id.*

29. Comm. on Corporate Laws, ABA, *The Overview Committees of the Board of Directors*, 34 BUS. LAW. 1837, 1837 (1979).

30. *Id.*

31. COMM. ON CORPORATE LAWS, ABA, CORPORATE DIRECTOR'S GUIDEBOOK 2 (2d ed. 1994).

32. *Id.* The second edition of the Guidebook retained the recommendation of the original Guidebook that at least a majority of members of the boards of publicly held corporations should be independent of management. *Id.* at 16. Section 8.01(c)(8) of the MBCA itself states only that the oversight responsibilities of the board of a public corporation include attention to, inter alia, "the composition of the board and its committees, taking into account the important role of independent directors." MODEL BUS. CORP. ACT § 8.01(c)(8). However, the official comment to section 8.01 notes that "in many cases," there is a requirement that independent directors constitute a majority of the board. MODEL BUS. CORP. ACT § 8.01 cmt. at 8-5 (2008).

33. See COMM. ON CORPORATE LAWS, *supra* note 31, at 1 (stating that over 20,000 reprints of the first edition had been sold); SECTION OF BUS. LAW PUBL'NS BD., ABA, REPORT TO COMMITTEE

## IV

## THE COMMITTEE'S LATER WORK

The work of the Committee and the Subcommittee in the corporate governance field did not end with the publication of the Guidebook. In 1980, the Subcommittee<sup>34</sup> drafted a successor to section 35 of the MBCA, dealing with standards of conduct for directors, in what would become section 8.30 of the revised MBCA, as adopted in 1984.<sup>35</sup>

In May 1978, the Council of the American Law Institute (ALI) voted to authorize a project on the structure and governance of corporations (Corporate Governance Project), which fifteen years later resulted in the ALI's *Principles of Corporate Governance: Analysis and Recommendations*.<sup>36</sup> Several members of the Committee served as consultants or advisors to the project.<sup>37</sup> Council Draft No. 1 of the ALI Corporate Governance Project was published in November 1981.<sup>38</sup> Elliott Goldstein, chair of the Committee, appointed a subcommittee, which he asked me to chair, to draft what proved to be a very critical letter commenting on Council Draft No. 1. This letter was transmitted to the chief reporter of the ALI Corporate Governance Project, Stanley Kaplan, in January 1982.<sup>39</sup>

Over the years that followed, the Committee was replaced in its role in dealing with the ALI's Corporate Governance Project by an ad hoc committee known as CORPRO,<sup>40</sup> which offered much constructive criticism to the project's reporters. Following completion of the ALI's Corporate Governance Project, the Committee created a task force to compare the MBCA with the final version of the ALI Principles of Corporate Governance to determine what changes might be appropriate in the MBCA.

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CHAIRS AND SECTION LEADERSHIP: FISCAL YEAR 2009–2010 (reporting that 100,249 copies of editions two through five had been sold).

34. In 1980, I succeeded Joseph Hinsey as Chair of the Subcommittee. Other members included Jim Cheek, Al Driver, Bob Hamilton, Morton Moskin, Donald Schwartz, John Subak, Herb Wander, and Frank Wheat.

35. I withdrew from the Committee late in 1982, while this project was still pending, in order to avoid any perception of a conflict posed by my appointment in spring 1982 as a reporter to the ALI Corporate Governance Project.

36. The President's Foreword to the ALI's Principles of Corporate Governance traces the history of corporation law in the American Law Institute, including corporate governance developments during the 1970s, and includes specific reference to the issuance of the Guidebook. ROSWELL B. PERKINS, *President's Foreword* to 1 PRINCIPLES OF CORPORATE GOVERNANCE xi, xvi–xix (2008).

37. These members included George Coombe, Joseph Hinsey, Bayless Manning, Donald Schwartz, Elliott Goldstein, John Subak, and Frank Wheat.

38. PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS (Council Draft No. 1, 1981) (on file at the American Law Institute Library).

39. Included among the members of the Committee and its consultants who participated in preparation of the letter were two of the consultants and five of the advisors to the project. Professor Donald Schwartz, as a member of the Committee, did not join in the letter as there were some aspects of the letter with which he disagreed.

40. The Committee was chaired successively by Elliott Goldstein, John Subak, and Loeber Landau.

## V

## CONCLUSION

The work of the Committee in the field of corporate governance has continued to this day, as changes continue to be considered and made in the MBCA to reflect desirable modifications dealing with current corporate governance challenges, including majority voting for directors and proxy access by stockholders. In my view, the willingness of the Committee to remain actively involved in dealing with corporate governance challenges is rooted in its initial willingness to engage in the corporate governance debates of the 1970s, which prompted the Committee to undertake preparation of the Guidebook.