REWEAVING THE CORPORATE VEIL: 
MANAGEMENT STRUCTURE AND THE 
CONTROL OF CORPORATE INFORMATION 

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INTRODUCTION

There is a striking similarity of imagery in much recent writing about the 
derelictions of large corporations. Corporations, it is asserted, often behave 
badly as a result of their internal organization and structure; the remedy for 
this disturbing proclivity is said to involve going behind the corporate veil, 
forcibly intruding on the corporation’s private spheres, to reshape the process 
through which it makes decisions. Equally striking about this genre of corpo-
rate literature is its failure to describe actual experience behind the veil and to 
examine specific instances of the kinds of corporate decisions to be reached 
by its proposed reforms. Similarly, much of this writing tends to downgrade 
more traditional remedies for corporate wrongdoing—the shareholder’s der-
ivative suit, civil and criminal fines and penalties—in favor of changes in 
management structure.

The restructured corporation envisaged by these critics would feature an 
independent and knowledgeable board of directors vigilantly monitoring the 
performance of operating management, assessing that performance in terms 
of goals set by the board while detecting any crucial missteps in management’s 
operation of the business. After describing these proposals for restructuring, 
this article examines some recent instances of corporate behavior which, in 
the author’s view, bear heavily on the proposals’ likelihood of success.

I

REWEAVING THE VEIL— 
PROPOSED CHANGES IN INTERNAL CORPORATE STRUCTURE

The recent style in critical writing about corporations has been to attribute 
a fair number of their misdeeds to the nature of their internal organization. 
Examples of socially disfavored behavior as various as polluting the environ-
ment,1 marketing unsafe products2 and paying out corporate funds for sensi-
tive purposes3 have all been pointed to as the results of internal corporate

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2. See id. at 135.
structure. Not surprisingly, the proposed remedies accompanying such critiques of corporate behavior have changes in the corporation's internal structure as their focus, while often discounting substantially or disregarding entirely other kinds of remedies.

The most extensive exposition in this style, that of Christopher Stone, argues that corporations are less responsive than other entities to traditional legal sanctions. The structure of large corporations diffuses the impact of those sanctions, as well as making it difficult to allocate responsibility for illegal acts to individuals and providing a climate in which individual managers may perceive the risks associated with illegal conduct as worth taking. As a result, Stone asserts, the civil and criminal penalties with which the corporation and its employees are threatened oftentimes do not effectively deter illegal conduct. Lacking as well, according to this analysis, is any effective internal check on corporate wrongdoing. The board of directors, mandated by statute to manage the corporation, is seen as having abdicated that task to the corporation's executives long ago, remaining as only an honorific vestige of a legal model that never matched business realities. Further, the corporate structure itself provides incentives to employees to keep information about activities which may prove embarrassing or harmful to the corporation away from the board.

To be sure, there are precedents for these critiques of boards of directors in earlier descriptions of directors' performance. The persistent charge is that many corporate boards fail to monitor effectively the performance of the corporation's executives, with the result that the board, as well as observers outside the corporation, may be surprised and dismayed by the consequences of some of the executives' activities. Consequently, these analyses of corpo-

4. See C. Stone, supra note 1.
5. See id. at 35-73.
6. See id.
7. See id. at 125-30.
8. See id. at 61-62. The fact that directors' lack of actual knowledge of illegal acts by corporate employees may be an effective defense in shareholders' derivative litigation may itself create a desire to protect board members through the insulation of ignorance. Cf. Graham v. Allis-Chalmers Mfg. Co., 41 Del. Ch. 78, 84-85, 188 A.2d 125, 130 (Sup. Ct. 1963) (directors under no duty to suspect wrongdoing by corporate employees in the absence of specific grounds for suspicion). This defense has proved unsuccessful in prosecutions under the Federal Food and Drug Act, because that statute imposes liability on corporate managers who may not know of specific violations but nonetheless are authorized within the corporation to prevent or correct them. See United States v. Park, 421 U.S. 658, 670-71 (1975).
rate behavior all include proposals which, while varying in their specifics, uniformly look toward increasing and improving the level of board performance. For example, Ralph Nader’s proposal for federal incorporation,\(^\text{11}\) which attributes the low quality of board performance to the heavy influence of the corporation’s chief executive officer on the board,\(^\text{12}\) would increase director independence by prohibiting a corporation’s officers, employees and providers of services from serving on its board.\(^\text{13}\) To upgrade board performance, the board would be furnished with its own separate staff, and individual directors would be limited to serving on only one board at a time.\(^\text{14}\) Another critic of contemporary boards, Melvin Eisenberg, although favoring the suggestion that boards ought to be composed solely of outsiders, argues that much the same advantages can be obtained by requiring only that a majority of the directors be outsiders.\(^\text{15}\) On the other hand, Eisenberg rejects the proposal that boards be separately staffed as a change which would create an inefficient adversary relationship between the board’s staff and the corporation’s operating management.\(^\text{16}\) Finally, Christopher Stone’s analysis recommends, along with some changes in board composition discussed later, enactment of a legislative mandate to directors to review management’s performance.\(^\text{17}\)

What is most striking about these critiques is that they all recognize, at least implicitly, that boards of directors appear to have difficulty in obtaining information about their corporations and making meaningful use of it, and are thereby severely restricted in their capacity to monitor management. Whether this difficulty is entirely the consequence of corporate structure, or whether it may be attributable even in part to other factors, is not investigated by these critiques. They do, however, present a variety of proposed methods for strengthening the board’s posture in the flow of corporate information.

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\(^\text{12}\) See R. NADER, supra note 11, at 97.

\(^\text{13}\) See id. at 126-27.

\(^\text{14}\) See id. at 121, 126-27.

\(^\text{15}\) See M. EISENBERG, supra note 10, at 174-75.

\(^\text{16}\) See id. at 155-56.

\(^\text{17}\) See C. STONE, supra note 1, at 143-44. It is not clear how this requirement could be made enforceable to exclude pro forma or rudimentary reviews. The existence of the mandate might, nonetheless, have a hortatory effect.
Eisenberg analyzes the board's effective isolation from corporate information solely in terms of the present deficiencies of independent auditors; he would have the auditors, rather than management, select the accounting principles appropriate to the corporation's financial statements, while placing the power to select and dismiss the auditors with the board rather than with operating management or with the shareholders. Obviously, these changes, however desirable in themselves, would not improve the board's access to information which management keeps from or misrepresents to the auditors.

Although Eisenberg suggests that the board might want to direct the auditors to undertake nonfinancial audits of management's performance to assist it in evaluating the quality of that performance, the board may still be effectively precluded from learning of some of management's activities until the corporation has been harmed. In short, it may be desirable to increase the independence of outside auditors and limit management's choice of accounting principles; doing so will not necessarily give the board prompt information about all of management's actions which may prove harmful to the corporation.

In contrast to Eisenberg's emphasis on improving the performance of outside auditors, both the Nader and Stone proposals envisage more direct director access to information about the corporation through the appointment of directors with designated responsibilities. To assure that critical problems do not slip by the board's purview, Nader proposes assigning to each director a specific area of concern with its own identifiable constituency—employee welfare, consumer protection, compliance with law, environmental protection, finances—corresponding to each director's expertise. Presumably, to be ef-

18. See M. Eisenberg, supra note 10, at 186-87.
19. See id. at 198-209.
20. See id. at 205-09. Eisenberg would require the board of each publicly held corporation to have an audit committee composed solely of independent directors to nominate and recommend dismissal of the outside auditor and to direct and set the terms of the auditor's engagement, on behalf of the entire board. Id. at 205. Eisenberg disagrees with Douglas Hawes' proposal that the power to appoint and dismiss outside auditors be placed solely in the corporation's shareholders, see Hawes, Stockholder Appointment of Independent Auditors, A Proposal, 74 Colum. L. Rev. 1 (1974). Although Eisenberg argues that the shareholders' involvement resulting from Hawes' proposal would be too limited and would be unduly responsive to management's suggestions, his argument leaves open the possibility of shareholder ratification of the audit committee's recommendations. See id., at 205-06. See also Lovdal, Making the Audit Committee Work, 55 Harv. Bus. Rev. 108 (1977).
21. The auditors themselves may not be able to detect "false entries made by people in responsible positions," see Forbes, May 15, 1976, at 92, reprinted in Staff of Subcomm. on Reports, Accounting and Management, Senate Comm. on Gov't Operations, 95th Cong., 1st Sess., Study on the Accounting Establishment 663 (1977) [hereinafter cited as Accounting Establishment Study] (quoting William Gladstone, managing partner of the New York office of Arthur Young & Co.) Gladstone was of the view that management was more likely to heed the admonitions of an outside auditor who generally had a positive, can-do attitude than one who maintained a persistently adversary stance. Id.
22. See M. Eisenberg, supra note 10, at 210-11. Eisenberg does not, however, explore the magnitude of the cost of such audits.
23. See R. Nader, supra note 11, at 125. Short of the board level, Nader has also proposed that the board be required by statute to designate an internal SEC compliance officer to be
fective in scrutinizing the corporation's performance in each of these areas, the designated directors, with the board's separate staff, would need to obtain access to internal corporate information, wholly apart from any they might receive from operating management or the corporation's outside auditors. This proposal is awkward in at least two respects. First, it presents some of the same problems as the proposed separate staff for the board: operating management may strongly resent the directors' efforts, leading to an unhealthy degree of adversariness, while some duplication of activities appears to be inevitable. Second, identifying each director with a separate constituency might vitiate the board's collegiality, thereby weakening its ability to deal vigorously with management.

Stone's method for assuring greater director access to corporate information turns on government appointment of designated "public" directors to the boards of large corporations whose duties would include, along with acting as the corporation's "superego" in reminding it of legal and ethical concerns, reviewing the adequacy of the corporation's internal systems for handling critical information and serving as a receptive audience for employees who seek to bring pieces of information to the board's attention. Since these directors would, under Stone's proposal, be nominated by a government agency, their presence on the board would represent a marked increase in governmental intrusion into the private corporate sphere. In the absence of a convincing

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24. See text accompanying note 14 supra.
26. See id. at 165-70.
27. Stone proposes that such directors be appointed by a Federal Corporations Commission, if one comes into existence, or by the Securities and Exchange Commission. Appointment to a corporate board as a "general public director" would require a majority vote of the other board members. Ten per cent of each board would be composed of such public directors, who would be removable only by unanimous board vote without a showing of cause, or by a two-thirds board vote with a showing of cause. Shareholders would not vote on the appointment or retention of such public directors. See id. at 158, 159.

Stone's reasons for thereby disenfranchising shareholders as to part of the board are not apparent from his discussion. To be sure, shareholders under his proposal would still elect the remaining members of the board, whose majority vote would be required to seat a public director, leaving shareholders with an indirect franchise as to the public directors. This in itself does not explain why shareholders ought to be denied the right to vote on the retention in office of public directors once they have served a term on the board. Equally unclear is whether Stone intends to divest shareholders of their judicially recognized inherent power to remove directors for cause, see Campbell v. Loew's, Inc., 36 Del. Ch. 565, 572-73, 134 A.2d 852, 858 (1957), a right presently recognized by statute in Delaware, see Del. Code Ann. tit. 8 § 141(k) (Michie Supp. 1976), which his proposal on its face surely appears to do. If shareholders cannot remove public directors for cause, Stone's proposal denies shareholders one remedy if the non-public members of the board are unwilling to act to remove errant public directors. Again, there appears to be no reason to so penalize shareholders.
demonstration that the public directors would succeed, it is difficult to regard this proposal seriously. One can only hypothesize that the response of the "id" directors and of operating management to their superego public directors might be one of hostility and evasion. Stone also proposes enactment of a legislative requirement that information falling into designated categories be brought to the board's attention. However, the legislative designation of critical categories may lag somewhat behind current problems, and if corporate directors are as remote from crucial information about their corporations as these critiques suggest, they may have difficulty in determining whether they should request additional kinds of information, as well as whether management is obeying the legislative mandate.

Interestingly enough, some of the critiques also propose that the shareholders' derivative action be revived by prohibiting devices such as corporate indemnification of managers' expenses, which reduce the costs of such litigation to individual managers, and by providing a variety of novel sanctions to be available against individual defendants who are found liable in such litigation. None of the proposals, however, considers whether the posited need for extensive structural reform might thereby be reduced.

28. The only historical experience proffered at any length by Stone to support his proposal is a discussion of the public directorships created by Congress in the nineteenth century on the board of the Union Pacific Railroad. By Stone's account, Union Pacific's public directors performed dismally, failing to protect the government's substantial financial interests in the efficient development of the railroad. C. STONE, supra note 1, at 153-56. Stone concludes that the functions of the Union Pacific directors were insufficiently defined and that the directors themselves were not of the professional stature their jobs required. Id. at 155-56.

What prompts Stone's belief that his public directors would perform more satisfactorily? First, presumably, the lessons of history, the assumption that by analyzing the reasons for past failures one avoids their future repetition. As it happens, public directors have failed in contexts other than that of the Union Pacific, see, e.g., id. at 154-57 (discussion of government-appointed directors on the board of the Communications Satellite Corporation); S. VANCE, supra note 9, at 144-51 (conclusion that government-appointed boards at the General Analine and Film Corp. were "the epitome of ineffectiveness"). The inference that the difficulty lies with the institution of government-appointed directors, rather than with any particular strategy for appointing them, appears irresistible. Second, Stone argues that business attitudes have evolved to such an extent that his public directors would be able to perform their superego function effectively. This may be true—such a statement is impossible to disprove—but it may also be the case that such changes consist primarily of a stronger understanding of the benefits of good public relations. Finally, Stone maintains that if the other changes he recommends in boards of directors are made, the public directors are more likely to be effective. C. STONE, supra note 1, at 161. It is nonetheless possible that other directors, however independent and well motivated, might resent the presence of a government appointee in their midst. Cf. Schwartz, Governmentally Appointed Directors in a Private Corporation—The Communications Satellite Act of 1962, 79 HARV. L. REV. 350, 357, 359, (1965) (public directors of Union Pacific Railroad complained they were treated "as spies and antagonists" by remainder of board).

29. See C. STONE, supra note 1, at 151.
30. See R. NADER, supra note 11, at 251.
31. See C. STONE, supra note 1, at 148-149 (suspension of culpable directors from eligibility to serve on boards).
32. Although two of the critiques also refer reproachfully to the extensive substantive protec-
As it happens, some aspects of these structure-oriented critiques of corporate behavior are reflected in several recent settlements of shareholders' derivative actions and of injunctive actions brought by the Securities and Exchange Commission (SEC). The settlements, as relief ancillary to the defendants' consent to an injunction barring the repetition of illegal conduct, typically change the composition of the corporation's board so that outsiders constitute a majority of the members; in some cases the composition of the board's executive committee has been similarly altered. Some of the mechanisms to restructure the board are more intrusive than others: in some cases the corporation simply consented to the appointment of directors to be approved by the court, or selected through negotiations between incumbent management and the SEC, while in other cases incumbent management agreed to nominate and propose new unaffiliated directors to the shareholders for their election to the board. Since the corporation is ordered to maintain a majority of such directors on its board for a specified period of time, it is clear that if the corporation simply consents to the appointment of the new directors, without any shareholder involvement through an electoral process, the "business judgment" defense—the defense that, although negligent, management's conduct fell somewhere within the very broad perimeters of the permissible exercise of business judgment—neither appears to recommend any changes in the defense. See R. NADER, supra note 11, at 102-05; C. STONE, supra note 1, at 62-63.

See Springer v. Jones, Civil No. 74-1455 (C.D. Cal. 1975). Plaintiffs in Springer alleged that directors and officers of the Northrop Corp. violated the federal proxy rules by failing to disclose the corporation's involvement in illegal contributions to the 1972 campaign of President Nixon.

For a list of the SEC injunctive actions involved, see Mathews, Recent Trends in SEC Requested Ancillary Relief in SEC Level Injunctive Actions, 31 BUS. LAW 1325, 1334-35 (1976). See generally Levine & Herlihy, SEC Enforcement Actions, 10 REV. SEC. REG. 951, 953-54 (1977); Treadway, SEC Enforcement Techniques, 32 WASH. & LEE L. REV. 637 (1975); Comment, Court-Appointed Directors, 64 GEO. L.J. 737 (1976). See also Mathews, SEC Civil Injunctive Actions—II, 5 REV. SEC. REG. 949 (1972); Pitt & Markham, SEC Injunctive Actions, 6 REV. SEC. REG. 955 (1973).


See Undertaking at 3-4, Springer v. Jones, Civil No. 74-1455 (C.D. Cal. 1975) (incorporated by reference into Final Judgment). The corporation also agreed to solicit proxies for shareholder election of its new outside directors. Id. The Undertaking does not contain provisions which would be applicable if shareholders fail to abide by the board's recommendation that they vote in favor of the election of the court-approved outside directors. It is not clear from the Undertaking whether the shareholder vote was believed to be necessary to the election of the new directors; the Undertaking appears to contemplate that the new directors would assume office on the board prior to the next shareholders' meeting.

See Second Amended Judgment at 4, SEC v. Mattel, Inc., Civil No. 74-2958 (C.D. Cal. 1974). In Mattel the corporation agreed to "appoint to, and maintain on, its Board of Directors" the new outside directors. No shareholder participation in this process is mentioned.

See Judgment at 5-6, SEC v. Canadian Javelin, Ltd., 73 Civil 5074 (S.D.N.Y. 1974).
the shareholders are being at least partially disenfranchised for a corresponding period of time.  

The legality of this kind of disenfranchisement has never been directly confronted by any court, and indeed, incumbent management may have a strong incentive to consent to the structural changes rather than litigate the SEC's ability to obtain them otherwise. At the least, however, shareholders in some of the settlements are being temporarily deprived of one of the incidents of stock ownership, the right to elect the members of the corporation's


41. The case closest to the point, Int'l Controls Corp. v. Vesco, 490 F.2d 1334, 1352 (2d Cir.), cert. denied, 417 U.S. 932 (1974), involved an attempt in state court by defendants to enjoin International Controls' new federal-court-appointed board from exercising its powers, on the argument that the old board had improperly abdicated its responsibility to shareholders when it consented to the federal court's appointment of new directors. The Second Circuit upheld the lower court's injunction restraining the defendants from prosecuting their state-court challenge to the new board, on the rationale that the federal court was thereby protecting its judgment from frustration by a state-court proceeding. The question of the legality of the remedy, especially in the absence of the defendants' consent, has proved a troublesome one to commentators, however. See, e.g., Stevenson, supra note 3, at 86.


One motive for settling with the SEC is the possibility that, through litigation, the Commission may be able to persuade the court to appoint a receiver for the corporation, a prospect presumably more bothersome to operating management than court-appointed directors. Indeed, many of the analyses of the remedial propriety of court-appointed directors analogize the remedy to that of receivership. See, e.g., id. at 1790; Malley, supra note 40, at 50-52; Comment, Equitable Remedies in SEC Enforcement Actions, 123 U. PA. L. REV. 1188, 1206-07 (1975); cf. SEC v. Beisinger Industries Corp., 552 F.2d 15 (1st Cir. 1977) (analogizes appointment of special agent to bring corporation into compliance with SEC reporting requirements to receivership).

Thus, it is ironic that in one of the injunctive actions discussed herein, that brought against Canadian Javelin, Ltd., the SEC initially sought the appointment of a special receiver to assure compliance with SEC regulations, for a Canadian corporation with apparently no assets in the United States. See Complaint at 2, 20, SEC v. Canadian Javelin, Ltd., 73 Civil 5074 (S.D.N.Y. 1974).

That Canadian Javelin's shares were listed on the American Stock Exchange sufficed, under the reasoning of Schoenbaum v. Firstbrook, 405 F.2d 200, 206-09 (2d Cir.), rev'd en banc on other grounds, 405 F.2d 215, (2d Cir. 1968), cert. denied, 395 U.S. 906 (1969), to give the court subject matter jurisdiction. Similarly, listing the shares on an American exchange, along with issuing press releases directed to American investors, as Canadian Javelin did, is enough of a purposive involvement with American commerce to support personal jurisdiction over the corporation. See Bersch v. Drexel Firestone, Inc., 389 F. Supp. 446, 459 (S.D.N.Y. 1974), modified, 519 F.2d 974 (2d Cir. 1975).
board of directors, without any showing that the stockholders’ exercise of their voting rights had any connection with management’s illegal conduct. Although an argument can be made that shareholders are thereby being afforded protection of their interests which is more effective than the shareholder franchise, all shareholders may not be persuaded. They may strongly prefer the shareholder franchise to other mechanisms for choosing the board of directors; they may even prefer incumbent management over a restructured board with a different management style. Further, identifying the

Although subject matter and personal jurisdiction are prerequisites to the appointment of a receiver, their presence alone is insufficient. The court must further be satisfied that only through receivership can the corporation's interests be protected. See 1 R. Clark, Law of Receivers §§ 59, 59(a) (3d ed. 1959). Moreover, although the appointment of a receiver is an equitable remedy premised on a suit in personam, a receivership is regarded as being in the nature of a proceeding in rem. Consequently, even when courts possess the jurisdictional requisites of appointment, they will generally not appoint a receiver when there are no corporate assets within their territorial jurisdiction. See id. at § 77(a). Although the court takes constructive possession of res in appointing a receiver, that constructive possession does not extend beyond the court's territorial jurisdiction. Thus, the receiver cannot go outside the territorial jurisdiction of the appointing court to exercise his official power. See id. at § 71(a). The court could, however, give binding instructions to the parties before it concerning the extrajurisdictional property, on penalty of contempt. See id.

Consequently, the court could have required Canadian Javelin to consent to the appointment of a receiver to handle its SEC compliance problems, on penalty of contempt or perhaps delisting or suspending trading of its stock. This is, nonetheless, not the simple receivership remedy sought by the SEC.

43. See Comment, supra note 42, at 1206.

44. Cf. M. Eisenberg, supra note 10, at 65 n.1 (that many shareholders regularly execute and return proxies is some indication that they regard voting as meaningful). Divesting stock of some of its voting rights presumably lessens the possibility that an outsider might purchase shares with the objective of eventually achieving voting control. This possibility has been hypothesized to act as a check on management inefficiency, see Manne, Some Theoretical Aspects of Share Voting, 64 Colum. L. Rev. 1427, 1431-32 (1964), by stimulating management efforts to prevent the price of the corporation's stock from becoming undervalued, see M. Eisenberg, supra note 10, at 66. Restructuring the corporation's board by disenfranchising shareholders denies existing shareholders any choice between the checks on management misconduct implicit in the market for corporate control and the checks provided by court-appointed directors. Prospective shareholders may choose simply not to purchase stock with truncated voting rights.

45. Of course, the quality of a corporation's management is one of the factors traditionally deemed material to investors in their decisions to purchase or retain stock, see In re Franchard Corp., 42 S.E.C. 163, 169-71 (1964), and shareholders may prefer to make their own assessments of the proper response to indicia of management quality.

One of the corporations involved in the injunctive actions discussed herein, Mattel, Inc., apparently underwent a substantial change in management style as a consequence of the proceeding. Prior to the SEC's injunctive action, Mattel was operated as a small company in which formal organizational lines were ignored and various functions were attributed to specific persons rather than to management positions. See Report of Special Counsel at 34, SEC v. Mattel, Inc., Civil No. 74-2958 (C.D. Cal. 1974). The company's management was in the habit of disseminating press releases which falsely overstated its business prospects, see Complaint at 2-5, SEC v. Mattel, Inc., Civil No. 74-2958 (C.D. Cal. 1974), and tended to increase the price of its stock. To settle the SEC action, the corporation agreed, among other things, to regularize its handling of the media by creating a board-level committee, with a majority of court-appointed directors, to review and approve or disapprove all information released to the media. See Second Amended Judgment at 4-6, SEC v. Mattel, Inc., Civil No. 74-2958 (C.D. Cal. 1974).

Another company against which the SEC obtained similar relief, Canadian Javelin, Ltd., see
precise constituency to be served by these directors may be difficult. They, like government-appointed directors and directors with designated areas of concern, may be representing constituencies other than the corporation's shareholders.

The settlements address the problem of improving the board's access to information about the corporation in a variety of ways. One, in a provision reminiscent of a very general New Year's resolution, simply commits the corporation to an undertaking to strengthen its management structure. Some settlements mandate that certain kinds of transactions or activities—consultants' contracts, press releases, internal financial control systems—be brought to the board's attention or submitted for its approval. Although one of the settlements required the appointment of an internal SEC compliance officer and the creation of a compliance committee of the board, none appears to assign separate oversight responsibilities to individual directors, as the Nader proposal advocates, or to specify the duties to be performed by the new directors.

Quite apart from the conceptual problems created by restructuring corporations as a remedy in litigation or through government intrusion into internal corporate structure, these proposals raise a number of questions, two of which will be addressed in the remainder of this article. First, are outside directors on all restructured boards likely to be significantly more successful in deterring or correcting questionable corporate conduct than directors have been in the past? More specifically, how will their mandate be defined and how will the directors themselves interpret it? Second, is it likely that outside directors will attain effective control over corporate information? If such control is achieved, is the accomplishment necessarily related to changes in management structure?

note 48 infra, also appears to have undergone changes in its management style, at least as to the dissemination of press releases. In sharp contrast to its prior practices of quickly issuing optimistic press releases about developments in its business, see Complaint at 8-12, SEC v. Canadian Javelin, Ltd., 73 Civil 5074 (S.D.N.Y. 1974), after institution of a board-level committee to review all such releases, the company went through 17 drafts of one release prior to its issue. See Letter from Meyer Eisenberg, Esq. to Michael Drake, Esq. (Jan. 9, 1975) (contains handwritten note that “There really were 17 drafts . . . [s]ometime I'll show you the first . . . ”) (copy obtained pursuant to 5 U.S.C. § 552 (1970) on file with author).

46. See Undertaking at 5, Springer v. Jones, Civil No. 74-1455 (C.D. Cal. 1975) (incorporated by reference into Final Judgment). The corporation also undertook to appoint a president within 18 months, separating that office from that of the chairman of the board and chief executive officer.

47. See id. at 5-7.

48. See Judgment at 6-7, SEC v. Canadian Javelin, Ltd., 73 Civil 5074 (S.D.N.Y. 1974); see note 45 supra (Mattel, Inc.).


51. See text accompanying note 23 supra.
II

PEERING OVER THE VEIL—THE EMERGENCY LOAN GUARANTEE BOARD AND THE LOCKHEED CORPORATION

A. Introduction

Central to all proposals to restructure corporations is the institution of an independent entity to scrutinize the performance of operating management, although proposals vary in how they define the tasks to be performed by these outside monitors. The proposals, as described above, appear to recognize, at least implicitly, that the outsiders' mandate to monitor management is difficult to pursue effectively without access to internal information about the corporation and the ability to make meaningful use of that information. Nonetheless, strategies to restructure corporations do not resolve the problem of control of corporate information in any promising or even coherent fashion.

The escapades of the Lockheed Aircraft Corporation over the past few years illustrate the tenuous nature of the connection between management structure and the control of corporate information. Lockheed revealed in 1975 that it, like a number of large American corporations, had made sizeable commission payments to foreign agents to facilitate sales of its aircraft and that the ultimate recipients of some of these payments may have been officials of foreign governments. Indeed, it soon became apparent that Lockheed itself had made direct payments to foreign government officials. Apart from the general pother raised by all such revelations of "sensitive" payments, Lockheed's behavior created special consternation in some quarters, for the federal government's credit had been pledged to guarantee bank loans to the company in 1971. As part of the loan guarantee legislation, a government board—the Emergency Loan Guarantee Board (ELGB)—composed of the Secretary of the Treasury and the Chairmen of the Board of Governors of

52. See text accompanying notes 7-10 supra.
53. See text accompanying notes 23, 25-26 supra.
54. See text accompanying notes 18-29 supra.
55. See id.
57. See id.; cf. Korchian, Lockheed's 70-Day Mission to Tokyo, SATURDAY REV., July 9, 1977, at 6 (personal account of making payments to foreign government officials).
the Federal Reserve System and the Securities and Exchange Commission, was created to administer the guarantees and, significantly for our purposes, to attend to the quality of Lockheed's management. That Lockheed's sensitive payments came as a complete surprise to the ELGB was itself an unpleasant revelation to many observers. The history of the creation and operation of the ELGB is an instructive one in the context of proposals to restructure corporations.

B. The “Financial Tonkin Gulf Resolution” — The Tortured History of the Board's Mandate

In 1971, Lockheed was afflicted by a serious cash flow problem caused by a variety of factors. The corporation had recently settled, at substantial losses to itself, four contract performance disputes with the Department of Defense. Further, Lockheed had begun to diversify its production, reentering the commercial airplane market with the goal of becoming less dependent on sales to the Department of Defense. After it failed to obtain the government contract for development of the supersonic transport, Lockheed concentrated its commercial aviation efforts on a wide-bodied subsonic jet, the L-1011. Lockheed reached a crisis point in its relationships with its bankers when Rolls Royce, the British manufacturer of the engine chosen for the L-1011, went into receivership. The British government, which acquired the aeronautical engine operations of Rolls Royce, initially supplied substantial funding for the engine's continued development and eventually refused to proceed further with the L-1011 engine unless it received assurances of Lockheed's continued existence.

Lockheed's own financial condition worsened throughout 1971; by April 1974 the corporation was on the verge of bankruptcy, with $400 million in bank credit outstanding, and $350 million (including $100 million in prepayments from airline customers for the L-1011) in new credit needed to meet its cash requirements.
The Nixon administration responded to its perception of the widespread economic dislocations that would follow a Lockheed bankruptcy by introducing legislation to authorize federal loan guarantees of up to $250 million for Lockheed. Although the administration’s bill did not contain any provision going specifically to the quality of Lockheed’s management, the bill authorized the Secretary of the Treasury to make guarantees “on such terms and conditions as he may determine,” suggesting the possibility of conditioning the grant of the guarantee on reviewing and upgrading the quality of Lockheed’s management.

The loan guarantee legislation passed by Congress in August 1971, in contrast to the administration bill, included a specific mandate to the ELGB to assess the quality of the corporation’s management and the relationship between that management quality and the corporation’s inability to obtain credit. Under section 6(b) of the Act, if the ELGB determines that the inability of an enterprise to obtain credit without a guarantee under this chapter is the result of a failure on the part of management to exercise reasonable business prudence in the conduct of the affairs of the enterprise, the Board shall require before guaranteeing any loan to the enterprise that the enterprise make such management changes as the Board deems necessary to give the enterprise a sound managerial basis.

There appears to have been considerable confusion at the time the legislation was proposed about the scope and nature of the mandate thereby imposed on the ELGB—about its proper function prior to making the guarantee as well as its role once the guarantee was made—a confusion which persisted throughout congressional consideration of the measure.

That the provision appeared in the loan guarantee legislation is attributable to the attention given during the congressional deliberations to the quality of Lockheed’s management. Some supporters of the legislation were unequivocally complimentary to management’s performance. Other supporters of the legislation emphatically attributed part of the responsibility for Lockheed’s plight to the procurement practices and dispute settlement techniques of the Department of Defense, leaving one to infer that the remain-

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72. See Emergency Loan Guarantee Legislation: Hearings Before the Senate Comm. on Banking, Housing and Urban Affairs, 92d Cong., 1st Sess. 5-9 (1971) (testimony of John B. Connally, Secretary of the Treasury) [hereinafter cited as 1971 Senate ELGA Hearings].
74. Id. § 3(a).
76. Present section 6(b) became part of S. 2308 as a result of an amendment proposed by Senator Cranston. See 117 Cong. Rec. 26423 (1971) (remarks of Senator Cranston).
77. See, e.g., 1971 Senate ELGA Hearings, supra note 72, at 283 (testimony of Daniel J. Haughton, Chairman of the Board, Lockheed Aircraft Corp.)
78. See, e.g., id. at 162 (testimony of David Packard, Deputy Secretary of Defense). In Secretary Packard’s later appearance before the House Banking and Currency Committee, his prepared statement expressly attributed fault for Lockheed’s plight to the corporation’s management and to
ing portion of responsibility might be allocated to Lockheed's internal management. Those of Lockheed's bankers,79 suppliers80 and customers81 who testified before congressional committees appraised its management favorably, as did representatives of the Nixon administration, although some administration witnesses reserved judgment on management's quality.82

The rhetoric of opponents of the loan guarantee legislation typically asserted that Lockheed had been poorly managed,83 oftentimes with the same degree of generality and hyperbole surrounding the claims that Lockheed's management had behaved admirably.84 Most of the specific criticism of management performance centered on Lockheed's experience with four contracts

the Department of Defense, claiming that the Department's procurement process encouraged contractors to take on projects they could not effectively control under the assumption that means of covering large cost overruns would be found. Secretary Packard refused to read this portion of his prepared statement—other aspects of it conflicted with the position taken by other administration witnesses—but Representative Patman read it into the record. See To Authorize Emergency Loan Guarantees to Major Business Enterprises: Hearings on H. R. 8432 Before the House Comm. on Banking and Currency, 92d Cong., 1st Sess. 292 (1971) (testimony of David Packard, Deputy Secretary of Defense) [hereinafter cited as 1971 House ELGA Hearings].

The banks' position in opposing changes in management appears to have been internally inconsistent. See 1971 Senate ELGA Hearings at 713 (testimony of Vern Countryman, Professor, Harvard Law School):

[While everybody professes to prefer going along with the present Lockheed management rather than taking their chances on something else, somebody, and I am still mystified as to who, wants a $250 million Government guarantee before they will go along with the present management.

80. See 1971 Senate ELGA Hearings, supra note 72, at 679 (testimony of Gerald J. Lynch, President and Chairman of the Board, Menasco Corp.) (manufacturer of L-1011 landing gear).
81. See, e.g., id. at 338 (testimony of Charles C. Tillinghast, Jr., Chairman of the Board, Trans World Airlines).
82. See 1971 House ELGA Hearings, supra note 78, at 379 (testimony of John B. Connally, Secretary of the Treasury).
83. See, e.g., 1971 Senate ELGA Hearings, supra note 72, at 853-54 (testimony of John K. Galbraith, Professor of Economics, Harvard University) ("[t]he corporation has established a reputation of spectacular mismanagement as a defense contractor."); 117 CONG. REC. 26983 (1971) (remarks of Senator Weicker) ("the most incredible record of corporate mismanagement that we have witnessed within our free enterprise system within our lifetimes.").
84. See, e.g., 1971 Senate ELGA Hearings, supra note 72, at 452 (testimony of Fred J. Borch, Chairman of the Board, General Electric Co.) (statement that Lockheed's management did not perform incompetently but merely took high risks).
awarded it by the Department of Defense, especially with its development and production of the C-5A troop and supply transport. That Lockheed's costs in developing the C-5A exceeded its own internal cost forecasts and reports as well as cost estimates and reports submitted to the Department of Defense was singled out by critics of the loan guarantee program as an indication that management lacked sufficient control over operations. Indeed, the Department of Defense recognized problems in the plant working on the C-5A and expressed its concern with the management of some of Lockheed's subsidiaries.

Some of the specific doubts cast on the quality of Lockheed's management concerned the corporation's apparent inability to forecast its costs with sufficient accuracy when bidding on fixed-price government contracts. Similarly, doubts about the validity of Lockheed's financial projections for its L-1011 project were viewed as reflecting on the adequacy of the corporation's internal planning and forecasting abilities. Concern was also expressed over the disparity between Lockheed's internal projections of future sales of the L-1011 and the much lower projections available from other sources. Finally, some critics of the loan guarantee pointed to Lockheed's choice for the L-1011 of an untested foreign-produced engine using novel technology over an American-made engine which became certified by the Civil Aeronautics Board for actual use much more rapidly than did the engine chosen by Lockheed.

Disenchantment with Lockheed's management was also reflected in some Senators' suggestions of the appropriate remedial response for Congress to make to Lockheed's plight. One argument advanced in favor of doing nothing was that Lockheed would thereby plummet into a chapter X bankruptcy proceeding in which its present management would be investigated by independent trustees and then, if warranted, replaced by suitable

85. See, e.g., 1971 Senate ELGA Hearings, supra note 72, at 171 (testimony of David Packard, Deputy Secretary of Defense).
86. See 1971 Senate ELGA Hearings, supra note 72, at 466-70 (statement of A.E. Fitzgerald).
87. See 1971 House ELGA Hearings, supra note 78, at 309 (testimony of David Packard, Deputy Secretary of Defense).
88. See 1971 Senate ELGA Hearings, supra note 72, at 167 (testimony of David Packard, Deputy Secretary of Defense).
89. See note 85 supra.
91. See id.
92. See 117 Cong. Rec. 26426 (1971) (remarks of Senator Weicker) (characterization of the Rolls Royce engine chosen by Lockheed as a paper engine and of Lockheed's selection of it as "the substitute of a calculated gamble for sound business judgment").
93. See 1971 Senate ELGA Hearings, supra note 72, at 447 (testimony of Fred J. Borch, Chairman of the Board, General Electric Co.).
95. See 117 Cong. Rec. 26815 (1971) (remarks of Senator Hart). The remarks of some of the supporters of loan guarantee legislation indicate that they regarded the prospect of bankruptcy as one having a punitive significance for Lockheed's management. See, e.g., 117 Cong. Rec. 26423
new management personnel. It was also suggested that, short of precipitating Lockheed's bankruptcy, Congress obtain for the corporation the therapeutic equivalent of chapter X by conditioning its grant of loan guarantee authorization on the ouster and replacement of Lockheed's incumbent management.

None of these arguments prevailed; Congress passed the Emergency Loan Guarantee Act with the view that it was thereby keeping Lockheed from certain bankruptcy, in an atmosphere characterized by high-pressure politics and intense lobbying efforts. The legislation passed contained the present section 6(b) of the Act; to the extent that Congress' deliberations considered the meaning of the section, they demonstrate only confusion about its significance, along with unnoticed conflicts in its interpretation.

On its face, the section is susceptible of several equally plausible interpretations of the mandate thereby conferred on the ELGB. Before guaranteeing any loans, it could be, on the one hand, that the ELGB is mandated to conduct an independent fact-finding review of management's performance in which it may not indulge any presumptions about the quality of that performance. On the other hand, the ELGB's role prior to guaranteeing a

(remarks of Senator Cranston) (supports S. 2308 out of desire to help "innocent" Lockheed employees and subcontractors; but in general the free enterprise system "penalizes" inefficiency with financial failure).

96. See 1971 Senate ELGA Hearings, supra note 72, at 240 (remarks of Senator Cranston). The professed support of Lockheed's bankers for its incumbent management, see note 79 supra, caused one Senator to query whether management would be ousted even in a Chapter X reorganization proceeding, because "the people who would be concerned" would elect the incumbents. See 117 Cong. Rec. 28014 (1971) (remarks of Senator Gambrell).

97. See 1971 Senate ELGA Hearings, supra note 72, at 67-68 (remarks of Senator Cranston). Senator Taft introduced a bill, S. 1892, which would have made federally guaranteed loans available only to corporations which had actually gone into involuntary bankruptcy and were in a bankruptcy reorganization. See 117 Cong. Rec. 15495-96 (text of S. 1892).

98. By its terms, the Act does not limit the availability of federal loan guarantee assistance only to Lockheed, although the maximum amount available for guarantees under the Act, $250 million, see 15 U.S.C. § 1847 (Supp. V 1975), was viewed as the amount necessary to meet the needs of Lockheed, see S. Rep. No. 92-270, 92d Cong., 1st Sess. 7 (1971). The bill reported out by the Senate Banking, Housing and Urban Affairs Committee, S. 2308, would have authorized a total of $2 billion in guarantees, with a limit of $250 million on loans to any one enterprise, to establish general federal standby authority to assist major business enterprises in dire financial condition. See id. at 5, 7. Some Senators objected that the implications of providing a general guarantee authority had not been sufficiently considered, since the hearings had been concerned specifically with Lockheed, see 117 Cong. Rec. 26408-11 (1971) (remarks of Senators Proxmire and Aiken), while others favored a general program of federal guarantees to distressed large businesses, see 117 Cong. Rec. 26971 (1971) (remarks of Senator Javits). The final version of the legislation, however, does not contain the additional amount authorized in the Senate committee bill for a wider guarantee program. See 15 U.S.C. § 1841-52 (Supp. V 1975).


100. Some of the language in the Senate Committee Report explaining the bill reported out supports this interpretation: "The Committee contemplates that in assessing the need for assistance under this guarantee program, the Board will discover from the relevant records and persons both within and without the enterprise what management personnel or policy changes, if any, need to be made." S. Rep. No. 92-270, 92d Cong., 1st Sess. 11 (1971).
loan may be limited to assessing the facts about management's performance developed by other sources, perhaps looking only for indications that management did not behave reasonably. The legislative history is not dispositive on this point. One Senator expressed justifiable confusion about the nature of the review the Board would undertake.\textsuperscript{101} The Secretary of the Treasury assured Congress that the Board's review would be a "careful" one of "the whole question of management's performance,"\textsuperscript{102} but the starting point and initial assumptions of that review were never clarified. Likewise, views differed on the aggressiveness with which the ELGB was expected to carry out its review tasks: one Senator who supported the legislation argued that the Board clearly had the capacity to make substantial changes in Lockheed's management, even to the extent of insisting that the corporation go into bankruptcy reorganization proceedings,\textsuperscript{103} while another, an opponent of the legislation, emphasized that any such changes, because they were discretionary with the Board, were not likely to be made.\textsuperscript{104} Statements made to Congress by two of the prospective members of the ELGB referred only to the Board's mandate to "look at"\textsuperscript{105} and "review"\textsuperscript{106} management's performance; they did not indicate what kind of review was contemplated, how it would be conducted, or what results might follow a negative assessment of management.

The Act is equally unclear as to any mandate the ELGB would have to continue reviewing management's performance once it guaranteed a loan. The language of section 6(b) may be construed such that the mandate expires once a loan is guaranteed, since section 6(b) refers to the review process as occurring only "before" a loan is guaranteed. This interpretation is supported by the testimony of one putative member of the ELGB that the legislation would not involve the Board in any "surveillance" of management.\textsuperscript{107} Similarly, there is nothing in the Act to prevent the Board from making long-term blanket guarantees rather than serial guarantees of relatively short durations, which even under a narrow interpretation of the section 6(b) mandate would

\textsuperscript{101}. See 117 Cong. Rec. 26995 (1971) (remarks of Senator Mondale) ("[h]ow does the board determine whether the problem is management, changing demand for the product, or whatever?").


\textsuperscript{103}. See 117 Cong. Rec. 27150 (1971) (remarks of Senator Javits).

\textsuperscript{104}. See 117 Cong. Rec. 27141-42 (1971) (remarks of Senator Proxmire).

\textsuperscript{105}. See 1971 House ELGB Hearings, supra note 78, at 432. (testimony of Arthur F. Burns, Chairman, Board of Governors, Federal Reserve System).

\textsuperscript{106}. See text accompanying note 102 supra.

\textsuperscript{107}. See 1971 House ELGB Hearings, supra note 78, at 432 (testimony of Arthur F. Burns, Chairman, Board of Governors, Federal Reserve System). One Representative stated that the Board ought "to take into account" Lockheed's important contributions to the nation's defense establishment. \textit{Id.} at 417 (remarks of Representative Blackburn). It was also his view that any corporation, such as Lockheed, which could produce an airplane, like the L-1011, which was competitive in price and in some of its operating characteristics was "obviously . . . not practicing bad management." \textit{Id.}
require the Board to review management's performance more than once; namely, prior to making each guarantee commitment. 108

Nonetheless, it is equally plausible that the statute contemplates a continuing review of management performance by the ELGB. Such an interpretation is clearly not expressly excluded by the Act, and the federal government's interest in the borrower's ability to make timely repayments of its loan—the basic rationale for the creation of any review capacity in the ELGB—is surely no less once a guarantee has been made than it is before. Finally, one Senator, arguing in support of the legislation, asserted that, if the Board members were "worthy of their salt," they would "oversee the requirement that... there is not inefficient management." 109

The scanty and inconsistent nature of the legislative history of section 6(b) leads to the conclusion that Congress' consideration of the management review function of the ELGB was neither extensive nor detailed enough to result in a clear definition of the Board's mandate. Thus, it is far from surprising that the Board apparently chose to define its responsibilities narrowly and that it failed to perceive Lockheed's practices of paying dubious foreign sales commissions.

C. The ELGB in Operation

Once the Emergency Loan Guarantee Act became effective, the ELGB met to consider the loan guarantee application of the Lockheed Corporation. 110 The Board reviewed documentation of the gravity of Lockheed's financial problems; it also considered, citing its statutory mandate, "whether [these problems] were the result of imprudent management," determined that they were not and that Lockheed would not be required to make any management changes as a condition of its loan guarantee. 111 Before the ELGB made its

108. An amendment, No. 234, to S. 1891 to prohibit blanket guarantees and require the Board to proceed on a 90-day serial guarantee system was introduced by Senator Stevenson. See 117 CONG. REC. 22292-93 (1971) (remarks of Senator Stevenson). The amendment, never adopted, would also have required that the ELGB be furnished financial statements and all other pertinent documents which the borrower had provided to its banks before a guarantee could be made by the Board.


110. See 1972 ELGB ANNUAL REPORT, supra note 66, at 4.

111. See id. at 31. In addition, the statute provided that the Board could guarantee loans only if it found that

(A) the loan is needed to enable the borrower to continue to furnish goods or services and the failure to meet this need would seriously affect the economy of or employment in the Nation or any region thereof,

(B) credit is not otherwise available to the borrower under reasonable terms or conditions, and

(C) the prospective earnings power of the borrower, together with the character and value of the security pledged, furnish reasonable assurance that it will be able to repay the loan within the time fixed, and afford reasonable protection to the United States. . . .

decision, the chairman of Lockheed's board of directors announced that changes in Lockheed's management were planned. The corporation's board was also realigned so that a majority of its membership was not otherwise affiliated with Lockheed.

However, the Board's review of management, as described in its annual report, was something much less than a searching inquiry into management's performance. Far from requiring Lockheed's management to justify the results or techniques of its stewardship over the company's fate, the Board may have presumed management's competence and looked only cursorily for evidence to rebut that presumption. The Board apparently gave heavy weight to the congressional committee testimony of Lockheed's bankers, suppliers and customers, which in the Board's view "indicated that the persons who had long-standing business relationships with the company would have been troubled by sudden changes in key management." There is no indication that the Board pursued these statements further with the witnesses, or made any other attempt to determine the causes, extent or consequences of their opposition to management changes.

Thereafter, the Board apparently made no systematic effort to scrutinize the overall performance of Lockheed's management. It received financial data about Lockheed's operations and met from time to time with Lockheed's bankers, outside auditors and management to discuss the corporation's cur-

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not make the loan but for the guarantee was also required. 15 U.S.C. § 1843(a)(2) (Supp. V 1975).

Furthermore, the Board was prohibited from guaranteeing a loan unless it received an audited financial statement for the borrower and unless the borrower permitted the Board access to any of its records bearing on its ability to make timely repayment of the guaranteed loan, the interest of the United States in its property, and assurances of reasonable protection for the United States. 15 U.S.C. §§ 1845(c), 1846(a) (Supp. V 1975).

112. See 1972 ELGB ANNUAL REPORT, supra note 66, at 31-32.

113. See id.

114. The Board describes its conclusion as one that "on the basis of the record before it . . . it could not find the need for a guarantee was a result of the failure on the part of management to exercise reasonable business prudence . . . ." Id., at 31. This, of course, suggests that such a failure may have occurred, but that the Board was unable to isolate it as the sole cause of the company's financial predicament, perhaps as a result of the kind of record on which it made its decision.

115. See id.

116. Although the testimony of all four witnesses mentioned in the Board's report, see id. at 31 n.21, is surely complimentary to Lockheed's management, it differs sharply in the witnesses' reaction to the suggestion of changes in Lockheed's management. Three of the witnesses addressed this specific point. One witness, William H. Moore, Chairman of the Board, Bankers Trust Co., stated that "the continuity of this management at this time is vital to the future success of the company." 1971 Senate ELGA Hearings, supra note 72, at 377. Another witness, Floyd D. Hall, Chairman of the Board and Chief Executive Officer, Eastern Airlines, responded that the question was a hypothetical one, unanswerable unless one knows "what moves are made, and who is being replaced by whom." Id. at 363. The third witness, Charles C. Tillinghast, Jr., Chairman, Trans World Airlines, stated that he "hope[d] there are no management changes," because any shifts would result in delay on the L-1011 program. Id.

117. See note 128 infra.
rent financial results. In particular, the ELGB became concerned about disparities between actual and projected costs on the L-1011 program, prompting it to meet many times with Lockheed's management to review the situation. Although the ELGB consented to a request by the fiscal agent for the preparation of a report by Arthur Young & Company, Lockheed's outside auditors, describing its procedures for auditing Lockheed and describing and evaluating Lockheed's internal accounting and forecasting procedures, it does not appear that the Board required any changes in Lockheed's internal systems based on the report, even as to management problems directly affecting the L-1011 program. Indeed, one critic of the Board's operations characterized it as having demonstrated "little interest in expediting such internal reforms."

Consequently, it is not surprising that the ELGB was apparently unaware prior to June 1975 of Lockheed's payments to foreign officials and political organizations. On August 1, 1975, the company publicly announced that an estimated fifteen per cent of its $147 million in payments to foreign sales consultants and others was known or strongly suspected to have gone ultimately to government officials and political organizations in several foreign countries. That the ELGB was remote from the decisionmaking structure at Lockheed on the foreign payments question is best demonstrated by the fact that the Board and its review and monitoring functions are nowhere mentioned in the Lockheed directors' report intensively scrutinizing the payments problem, although the report discusses other potential controls on management's actions. Thus, whether one takes at face value the ELGB's

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121. See 1976 House Hearing on Termination, supra note 59, at 10 (testimony of Representative Harrington).

122. See Lockheed Bribery: Hearings Before the Senate Comm. on Banking, Housing and Urban Affairs, 94th Cong., 1st Sess. 22 (1975) (testimony of William E. Simon, ELGB Chairman) [hereinafter cited as 1975 Senate Hearings on Lockheed Bribery]. The ELGB became aware of Lockheed's sensitive payments after Arthur Young & Co., Lockheed's outside auditor, refused to certify the company's financial statements unless the company acknowledged that it had paid bribes to foreign officials and defined the extent of those payments. See id., at 6.


claim that it was "intensive[ly] monitoring" Lockheed's activities,\textsuperscript{125} or chooses instead to conclude that the Board interpreted its statutory mandates very narrowly,\textsuperscript{126} the ELGB's review of Lockheed's management does not appear to have been an effective and fully informed one.\textsuperscript{127}

In retrospect, some of the Board's ineffectiveness seems attributable to its apparent passivity with respect to internal Lockheed information. The Board rarely if ever initiated inquiries to which Lockheed would respond and never initially scrutinized internal Lockheed data itself.\textsuperscript{128} Even in its "intensive monitoring" stages the Board was confined to a role of reviewing information presented by Lockheed. Perhaps the Board's passivity is understandable in light of its meagre staff.\textsuperscript{129} On the other hand, Lockheed had been persistently reticent about releasing internal information, both during congressional consideration of the loan guarantee legislation\textsuperscript{130} and after the Board began its monitoring functions,\textsuperscript{131} and its disclosure practices had earlier been

\textsuperscript{125} See 1975 ELGB Annual Report, supra note 118, at 9.


\textsuperscript{127} The current chairman of Lockheed's board of directors, Robert W. Haack, has asserted that the company endeavors to keep the ELGB "as informed as we can." See Oversight on the Lockheed Loan Guarantee: Hearings Before the Senate Comm. on Banking, Housing and Urban Affairs, 94th Cong., 2d Sess. 118 (1976) [hereinafter cited as 1976 Senate Oversight Hearings].

\textsuperscript{128} Lockheed regularly furnished the ELGB with unaudited and audited annual, monthly and quarterly financial statements, copies of reports to stockholders and the SEC, and "other data pertinent to continuous surveillance of its operations." See 1972 ELGB Annual Report, supra note 66, at 60. Chairman Haack described the Board's operation as follows: "They have held our feet to the fire, there is no question about that. We met with them periodically, we review the finances, we show them our forecast, we endeavor to keep them as informed as we can." 1976 Senate Oversight Hearings, supra note 127, at 118. This suggests that most of the actual initiative and direction for such "informing" came from Lockheed rather than the ELGB.

\textsuperscript{129} Initially, the Board's staff consisted of an Executive Director who was also General Counsel to the Treasury Department and a Secretary who was a Special Assistant to the Treasury's General Counsel. The Board used personnel on a when-needed basis from the Treasury Department, the Board of Governors of the Federal Reserve System and the Securities and Exchange Commission. In March 1972 the Board hired a financial analyst to provide continuing staff assistance. See 1972 ELGB Annual Report, supra note 66, at 8-9. To advise it on the technical aspects of Lockheed's operations, the Board hired in April 1973 a technical analyst who went from full time to part time status in July 1974. See 1974 ELGB Annual Report, supra note 118, at 3 n.3.

\textsuperscript{130} See, e.g., 117 Cong. Rec. 15450 (1971) (speech of Senator Proxmire) (Lockheed refused to furnish Congress with a cash flow statement); 117 Cong. Rec. 28367 (1971) (remarks of Representative Mitchell) (staff of the Banking and Currency Committee had an "almost impossible" time obtaining breakdowns of cash flow and profits by divisions); 1971 Senate ELGA Hearings, supra note 72, at 656 (remarks of Senator Stevenson) (committee unable to get a copy of the recent Lockheed-Rolls Royce contract); id. at 768 (testimony of Ralph Nader) (General Accounting Office having difficulty in getting information about Lockheed).

\textsuperscript{131} Section 7(b) of the Act required the General Accounting Office (GAO), an investigative arm of Congress, to make a "detailed audit of all accounts, books, records and transactions of any borrower" applying under the Act, and to report the results to Congress and the ELGB, 15 U.S.C. § 1846(b) (Supp. V 1975). The GAO made a number of such reports. In August 1975, the GAO, complying with a request from Senator Proxmire, attempted to determine the amounts of payments made by Lockheed to foreign officials to consummate foreign sales. Lockheed refused to give the GAO access to any information other than records concerning the amount of pay-
ments that may have been charged to overhead allocable to U.S. Government contracts. See 1976 Senate Oversight Hearings, supra note 127, at 41 (statement of Elmer B. Staats, Comptroller General). Although section 13 of Lockheed's Loan Guarantee Agreement of 1971 authorized the GAO, along with the ELGB and its staff, to inspect the corporation's records, Mr. Staats concluded that, since the GAO lacked subpoena power, there was no "ready and direct method" for it to obtain records despite the statutory and contractual assurances of access. Id. at 45. Those granted access by the 1971 Loan Guarantee Agreement could use it in their sole discretion, in making determinations related to the borrower's ability to repay its guaranteed loans, the interest of the United States in the borrower's property, assurances that reasonable protection was afforded to the government, and compliance with the Act. The GAO's inquiry, concerning Lockheed's past sales practices and thus to some extent its future sales prospects, seems clearly encompassed by these purposes, which it could determine in its sole discretion. But cf. Abuses of Corporate Power: Hearings Before the Subcomm. on Priorities and Economy in Government of the Joint Economic Comm., 94th Cong., 1st & 2d Sess. 57 (1976) (testimony of Richard W. Gutmann, Director, Procurement and Systems Acquisition Division, GAO) (questions whether GAO needs the requested information to assess Lockheed's ability to repay its loans).

At any rate, the ELGB itself had an earlier skirmish with the GAO. In September 1971 representatives of the GAO met with representatives of the Board to arrange the GAO's audit of Lockheed. See Defense Production Act Amendments—1972: Hearings on S. 669 and S. 1901 Before the Subcomm. on Production and Stabilization of the Senate Comm. on Banking, Housing and Urban Affairs, 92d Cong., 2d Sess. 34 (1972) (letter from John B. Connally, ELGB Chairman) (Sept. 21, 1971) [hereinafter cited as 1972 Senate Hearings on Defense Production]. At the same meeting, when the question of GAO review of ELGB decisions was raised, the Board's representatives questioned the GAO's authority to review Board decisions. The Board subsequently met, formally took the position that the GAO lacked authority to review its decisions, and refused to grant the GAO's request for records and documents incident to such decisions. See id. at 34-35 (letter from John B. Connally to Elmer B. Staats) (Dec. 9, 1971). The Board eventually granted access to the GAO, asserting that it was complying only to accede to the wishes of congressional committees. See 1972 ELGB Annual Report, supra note 66, at 11.

As to the dispute over the GAO's authority, its position clearly appears to have been stronger than that of the ELGB. The GAO sought specifically to examine the data and analysis supporting the basic findings that the Board was required by statute to make prior to guaranteeing a loan, see note 111 supra, as well as whether the Board had received the required audited financial statement from the borrower. See 1972 Senate Hearings on Defense Production, supra at 52 (GAO memorandum). In addition, the GAO was interested in how the Board made its determination that Lockheed's inability to obtain other credit was not the result of management failures. See id.

The Board's initial argument, that Congress demonstrated its intent in the Emergency Loan Guarantee Act that the ELGB's decisions not be audited by the GAO, by failing to provide for such an audit, see id. at 34-35 (letter from John B. Connally to Elmer B. Staats) (Dec. 9, 1971), is unpersuasive if the GAO's basic statutory grants of authority are broad enough to extend access to the ELGB's records. See id. at 35 (letter from Elmer B. Staats to John B. Connally) (Feb. 10, 1972). The Board subsequently expanded its argument to one that the GAO lacked a statutory right of access to the internal records of executive agencies related to their decisionmaking processes. See Comptroller General of the United States, Report to the Congress on Implementation of Emergency Loan Guarantee Act 28 app. 11 (1972) [hereinafter cited as GAO Loan Guarantee Report]. This argument is undercut by the breadth of the GAO's statutory grants of audit authority. See, e.g., 31 U.S.C. § 53(a) (1970), authorizing the GAO to investigate "all matters relating to the receipt, disbursement, and application of public funds;" and 31 U.S.C. § 1154(a) (1970), authorizing the GAO to "review and analyze the results of Government programs and activities." Finally, although the Board initially stated a claim of executive privilege as to the records of its decisionmaking process, see GAO Loan Guarantee Report, supra at 24, it did not rely on that claim and probably invalidated it in a letter from its Chairman to the Comptroller General stating that "[i]f Congress intends for the General Accounting Office to review the decisions of the Emergency Loan Guarantee Board, we believe amendatory legislation should be enacted making it clear that the GAO has this authority," see 1972 Senate Hearings on Defense Production, supra at 34 (letter from John B. Connally to Elmer B. Staats) (Dec. 9, 1971). If Congress is able to pass appropriate amendatory legislation, that appears to rule out a constitutionally based claim of executive privilege.
criticized in a publicly available SEC staff report.132

Although Lockheed's prior history might have served to put the ELGB on notice of the corporation's secretiveness, Lockheed came extremely close to making affirmative misrepresentations to both Congress and the Board. About one month before the ELGB learned of Lockheed's sensitive payments overseas, the Board's staff asked Lockheed's management whether it had used overseas subsidiaries as a mechanism for making illegal domestic political contributions, as other corporations were then alleged to have done. Lockheed responded that no such activity had occurred; the Chairman of the ELGB later concluded that "[i]n retrospect it would have been advantageous to inquire as to whether Lockheed had made any payments to foreign officials."133 Further, in some instances, Lockheed appears to have structured foreign payments transactions while anticipating and planning around the reaction of its outside auditors.134 Since these evasions were partially successful as to the much more aggressive inquiries of Lockheed's outside auditors,135 one might doubt the ELGB's prospects for success even had it assumed a more assertive inquisitorial stance.

Once the Board learned of Lockheed's sensitive payments, it urged the corporation to take strong internal measures to assure that none would be made in the future, and it eventually procured an amendment to its 1971 Loan Guarantee Agreement with Lockheed making any additional such payment an event of default under the guarantee agreement.136 In addition, Lockheed

132. See 1 Securities and Exchange Commission, Staff Report of Investigation in Re Lockheed Aircraft Corporation 4, 43, 57 (1970). The focus of the investigation was the quality of Lockheed's disclosure of its cost overrun problems on the C-5A program. The investigators discovered that Lockheed's outside auditor, Arthur Young & Co., had developed a cynicism about Lockheed's internal cost estimates and had concluded that no one at Lockheed had an "overall grasp" of the C-5A program. See id. at 63.
133. See 1975 Senate Hearings on Lockheed Bribery, supra note 122, at 10 (testimony of William E. Simon, ELGB Chairman). Secretary Simon characterized Lockheed's behavior as not having been "forthright" with Congress and ELGB. Id. at 5.
134. See 1975 Senate Hearings on Multinational Corporations, supra note 56, at 1034-35.
135. Arthur Young & Co., Lockheed's outside auditors since 1933, questioned two series of foreign currency payments in the late 1950's and 1960's and were told that such payments were necessary marketing expenses. In the early 1970's, Arthur Young learned of questionable bank transfers in Japan and of commissions to a third party by a Lockheed consultant, and discussed these with Lockheed officers.

During its 1972 audit, Arthur Young discovered substantial cash payments in Japan and insisted, over the objection of Lockheed's then chairman and then president, on notifying the corporation's audit committee. That committee, composed of three outsider board members, was told that the payments might well be used for political campaigns in the foreign country. It decided that the payments were "proper" sales costs and did not need to be reported to the entire board. See Lockheed Director's Report, supra note 124, at 18-20.

This version of Arthur Young's knowledge of Lockheed's questionable foreign payments may conflict with its 1975 assertion, stated by Secretary Simon, that it was "unaware of the fact that Lockheed had paid bribes." See 1975 Senate Hearings on Lockheed Bribery, supra note 122, at 9. Apparently other questionable payments went undetected by Arthur Young. See A. Briloff, More Debits Than Credits 58 (1976).
was required periodically to certify to the ELGB that no questionable payments were being made.\textsuperscript{137} The Board also determined, soon after learning of the payments, that it “should obtain additional information about [them] so as itself to assess the potential impact of public disclosure of identifying details.”\textsuperscript{138} The Board’s staff, at its request, determined that Lockheed could “survive” the consequences of disclosing its past practices to repay its guaranteed debt.\textsuperscript{139}

Although the Board’s report does not reveal whether it was successful in obtaining the additional information it sought, it is apparent from other sources that Lockheed never provided the Board with two kinds of pertinent data: specifically, names of the recipients of the payments and of the countries in which they were paid.\textsuperscript{140} It is not clear from any source whether the ELGB ever requested that information. Moreover, in early 1976, the Board took the position that it did not need the kind of detail this information would supply “for it to perform its function of evaluating Lockheed’s ability to repay its guaranteed borrowings.”\textsuperscript{141} If, however, Lockheed’s financial strength and consequent ability to repay its guaranteed loans might be jeopardized by public disclosure of the payments’ recipients—as Lockheed argued it would be\textsuperscript{142}—then the Board needed the information to assess the magnitude and probability of the risk to which the government’s credit as guarantor had been exposed.\textsuperscript{143}

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{137} Id. at 11.
\item \textsuperscript{138} Id.
\item \textsuperscript{139} Id. at 11-12.
\item \textsuperscript{140} See 1976 Senate Oversight Hearings, supra note 127, at 4, 9 (testimony of William E. Simon, ELGB Chairman). To the extent the Board knew the countries in which the payments had been made, it gleaned the information from newspaper reports. See id. at 9.
\item \textsuperscript{141} See id. at 4.
\item \textsuperscript{142} See 1976 Senate Oversight Hearings, supra note 127, at 107 (testimony of Robert W. Haack, Chairman of the Board, Lockheed Aircraft Corp.); 1975 Senate Hearings on Multinational Corporations, supra note 56, at 348 (testimony of Daniel J. Haughton, Chairman of the Board, Lockheed Aircraft Corp.).
\item \textsuperscript{143} Secretary Simon may have rejected this argument in the following colloquy with Senator Proxmire, Chairman of the Senate Banking Committee:

THE CHAIRMAN: How can you adequately assess the prospect of repayment for the Lockheed loan unless you know the full facts about the bribe, the most devastating development that has hit Lockheed and Lockheed’s future prospects in recent history?

Secretary SIMON: I would say that it’s potentially devastating from the credit analysis and financial analysis point of view, yes, and no one can make a judgment as to what the future implication of these disclosures is going to have as far as future contracts and cancellations and indeed concern on the part of potential customers and existing customers as to whether Lockheed will still be in business. So knowing this uncertainty certainly helps, but knowing the specific names involved would not assist us as far as this financial analysis is concerned . . . .

1976 Senate Oversight Hearings, supra note 127, at 11. Nonetheless, had the Board reviewed the information it might have concluded, as its staff may well have concluded without reviewing the information, that Lockheed’s assessment of the devastation to be wrought by disclosure was exaggerated. See text accompanying note 139 supra. The Board might also have been able to make an
\end{enumerate}
\end{footnotesize}
D. The Significance of the ELGB's Failure

To be sure, the ELGB is not identical to the restructured boards of directors advocated by corporate reformers—Lockheed's board of directors, with a majority of outside members, coexisted with the ELGB. Thus, it may be argued that the ELGB's experience is irrelevant to proposals for corporate restructuring and that, in any event, the ELGB's failure is attributable to its position outside Lockheed's management structure, beyond the corporate veil. Neither of these arguments need long detain us. It is evident that the mandate given to the ELGB, unclear as it may appear in retrospect, was the same as that given by proposals for corporate reform to boards of directors—to monitor and assess the performance of operating management. Further, the resources available to the ELGB with which to pursue its mandate were similar to, if not greater than, those afforded boards of directors. As to the ELGB's position outside the formal structure of corporate management, the ELGB had substantial access to operating management personnel and may have met with them more frequently than would a board of directors.

Some of the ELGB's infirmities may also come to afflict restructured corporate boards. If the board's mandate is not defined clearly and specifically, the board may interpret it narrowly, as did the ELGB. Defining the board's mandate may be especially troublesome for some of the restructured boards, since it is apparent that the goals advanced by some of their proponents are inconsistent. Although vigilance on behalf of shareholders, especially minority shareholders, is imposed by the proposals on the board, some proposals also partially disenfranchise shareholders, as well as identifying individual directors with nonshareholder constituencies. The inherent confusion in the board's mandate thereby created is not likely to prompt aggressive board activity. Further, if the board's position with respect to internal corporate information is essentially a passive or receptive one, it, like the ELGB, may be unable to detect misrepresentations or deceptions by operating management as well as failures by the outside auditors. To enjoy a sustained and general success, restructured boards ought, at the least, to be premised on a realistic assessment of how corporations actually handle information. Without it, they may be compelled to monitor management from the same remote stance taken by the ELGB.

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144. See text accompanying note 113 supra.
145. See notes 111, 128, 129 supra.
146. See text accompanying notes 118 and 119 supra.
147. See M. Eisenberg, supra note 10, at 159-60; R. Nader, supra note 11, at 128-30; C. Stone, supra note 1, at 145.
148. See note 27 supra.
149. See text accompanying note 23 supra.
IV
LIFTING THE VEIL—SELF-SCRUTINY IN THE WAKE OF SENSITIVE PAYMENTS

A. Origin of the Self-Scrutiny Reports

Over a period of almost four years, many American corporations have revealed that they used corporate funds improperly, creating slush funds to make illegal domestic political contributions and to make payments to officials of foreign governments and to dubious overseas sales consultants. The efforts by the SEC to prompt disclosure of the payments have provoked a large volume of commentary analyzing their propriety; more relevant to our purposes, however, are the descriptions of corporate decisionmaking processes stemming from the Commission's disclosure and enforcement programs. By describing corporations' treatment of ticklish internal information, they suggest that corporate officers' behavior while making decisions perceived to be questionable or illegal is not likely to be reached by purely structural attempts at corporate reform.

The SEC first turned its attention to sensitive payments practices as a result of revelations during the Special Prosecutor's investigation of the Watergate scandals, which the SEC believed were pertinent to public investors and perhaps subject to the disclosure requirements of the federal securities laws. The Commission's staff, while examining matters initially investigated by the Special Prosecutor, discovered that secret corporate slush funds had been used for payments abroad, in some cases to officials of foreign govern-


151. See SECURITIES AND EXCHANGE COMMISSION, REPORT OF THE SECURITIES AND EXCHANGE COMMISSION ON QUESTIONABLE AND ILLEGAL FOREIGN PAYMENTS SUBMITTED TO THE SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, 94TH CONG., 2D SESS. 2 (P-H 1976) [hereinafter cited as SEC REPORT ON QUESTIONABLE PAYMENTS]; THE ACTIVITIES OF AMERICAN MULTINATIONAL CORPORATIONS ABROAD: HEARINGS BEFORE THE SUBCOM. ON INTERNATIONAL ECONOMIC POLICY OF THE HOUSE COMM. ON INTERNATIONAL RELATIONS, 94TH CONG., 1ST Sess. 68 (1975) (testimony of Philip A. Loomis, Jr., Commissioner, Securities and Exchange Commission) [hereinafter cited as 1975 HOUSE HEARINGS ON MULTINATIONAL CORPORATIONS]. Commissioner Loomis would not state whether he thought the SEC would otherwise have discovered the practices. Id.
ments, as well as for domestic political contributions.\textsuperscript{152} After bringing several enforcement actions in response to these revelations,\textsuperscript{153} the SEC concluded that a supplement to the enforcement actions was necessary due to the magnitude of the problem it perceived.\textsuperscript{154} Accordingly, it announced a voluntary disclosure program, in which companies suspecting the existence of sensitive payments practices would investigate their problem under the auspices of someone not involved in the practices, typically outside members of the board of directors, and then consult with counsel and perhaps with the SEC staff to determine the disclosures that might be necessary.\textsuperscript{155} Settlements of most of the enforcement actions, as well as the voluntary disclosure program, resulted in reports of internal corporate investigations of sensitive payments practices conducted under the direction of independent members of the board of directors.\textsuperscript{156}

Critics of the SEC's role in the sensitive payments incident argued that the Commission's staff was importuning the disclosure of information that was not material to investors\textsuperscript{157} and that the Commission lacked the requisite statutory authority to demand the extensive disclosures brought about by its voluntary program and settlements of enforcement actions.\textsuperscript{158} Further, the SEC was accused of considerable obtuseness in its refusal to set guidelines specifying the kinds and amounts of payments that needed to be disclosed.\textsuperscript{159} Without conceding that its present statutory base was lacking, the SEC proposed legislation which would have amended the Securities Exchange Act of 1934 to require that registered corporations keep records which accurately reflect their transactions and maintain an adequate system of internal accounting controls.\textsuperscript{160} Falsifying accounting records and making false statements to accountants would have been made unlawful.\textsuperscript{161} After Congress failed to pass its legislative package, the Commission restated the same provisions in rule-

\textsuperscript{152} See 1975 House Hearings on Multinational Corporations, supra note 151, at 36-37 (statement of Philip A. Loomis, Jr., Commissioner, Securities and Exchange Commission).

\textsuperscript{153} See SEC REPORT ON QUESTIONABLE PRACTICES, supra note 151, at 3-6.

\textsuperscript{154} See id. at 6-7.

\textsuperscript{155} See 1975 House Hearings on Multinational Corporations, supra note 148, at 63-64 (testimony of Philip A. Loomis, Jr.).

\textsuperscript{156} The Internal Revenue Service embarked on its own contemporaneous investigation of sensitive payments, posing a set of eleven broad questions to large corporations. For an analysis of the IRS investigation, see Special Subcommittee of the Committee on Practice and Procedure of New York State Bar Association, Report on the Internal Revenue Service “Slush Fund” Investigation, 32 TAX L. REV. 161 (1977).

\textsuperscript{157} See, e.g., Lowenfels, supra note 150, at 24.


\textsuperscript{159} See, e.g., Lowenfels, supra note 150, at 23-24.

\textsuperscript{160} The SEC's proposals were introduced as S. 3418, 94th Cong., 2d Sess. (1976). See generally Prohibiting Bribes to Foreign Officials: Hearing on S. 3133, 3379 and 3418 Before the Senate Comm. on Banking, Housing and Urban Affairs, 94th Cong., 2d Sess. (1976) [hereinafter cited as 1976 Senate Hearing on Prohibiting Bribes].

\textsuperscript{161} See S. 3418, 94th Cong., 2d Sess. (1976).
making proposals, asserting that the reporting requirements of the securities laws gave it authority to promulgate such a rule. This assertion has been criticized as aggrandizing the SEC's authority. Apart from the issues raised by the Commission's attempt to use its rulemaking authority, its self-scrutiny approach must assume that beneficial change will follow the discernment and disclosure of historical inadequacies, and presuppose the existence of some duty to maintain accurate accounting records and effective internal controls. If not, self-examination and disclosure are mere empty rituals. The Commission has also argued that investors' concern with the integrity of management makes material, information about management's falsification of accounting records or evasion of proper internal controls, without regard to the amount of corporate funds thereby affected. The risk thereby created that the funds might be used for noncorporate purposes, along with the doubt inevitably cast on management's judgment, supports this assertion.

B. How Corporations Make Decisions

The reports written by corporations describing their entanglements in sensitive foreign payments and illegal domestic political contributions provide some useful insights into how corporations make decisions which are inter-


163. See Fed. Sec. L. Rep. (CCH) No. 693, at 9-10 (1977), describing the position of the American Bar Association's Committee on the Federal Regulation of Securities. The Committee argued that the SEC's authority to promulgate the rules was weak, and was made especially dubious by the emphasis placed in the Supreme Court's opinion in Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977), on the desirability of not federalizing corporation law, in the absence of a strong showing of congressional intent to do so. Plaintiff's argument in Green, however—that defendants' plan to eliminate public shareholders in the corporation for no valid business purpose through a short-form merger legal under Delaware corporate law was a deceptive and manipulative device in violation of § 10(b) of the Securities Exchange Act of 1934 and rule 10b-5 promulgated thereunder—involved federalizing the regulation of conduct in which adequate disclosure was assumed to have been made to shareholders. Thus, at least initially, the SEC's stance in promulgating rules as to internal corporate accounting practices is stronger than the position of the plaintiff in Green, for the accounting rules are strongly related to disclosure concerns. Both the Securities Act of 1933 and the Securities and Exchange Act of 1934 give the Commission broad authority to establish accounting standards and compel compliance with them, by delaying or suspending the effectiveness of registration statements, and through investigations and injunctive actions. See Accounting Establishment Study, supra note 21, at 1451-56 (letter from Roderick M. Hills, Chairman, Securities and Exchange Commission, to Senator Metcalf). Since § 13(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78m(b) (1970), gives the Commission the authority to determine "the methods to be followed in the preparation of reports," it seems querulous to maintain that its authority over the methods of preparation extends only to financial statements filed with the Commission and not to the integrity of the internal systems behind those statements.

164. See SEC Report on Questionable Payments, supra note 151, at 13, 15.


nally perceived to be questionable. They suggest that such decisions may be made under a layer of secrecy so pervasive as to be impenetrable by the normal control and audit mechanisms available even to a restructured corporation.

It is apparent that corporations made illicit payments for a wide variety of reasons. Some large illegal domestic political contributions were made as the result of repeated solicitations by high campaign officials stressing that the size of the corporation made appropriate a contribution in a particular amount.\textsuperscript{167} Payments to officials of foreign governments were made to procure business in the country, to prevent government interference in the conduct of the business, to reduce foreign tax liability and to expedite low-level ministerial decisions, the so-called grease payments.\textsuperscript{168}

Apart from the variety of reasons and motives for making the payments there is a striking similarity in some aspects of corporations' decisions to make them. Generally, the decisions were made by a small number of the corporation's officers, and knowledge of the practices was similarly narrowly confined.\textsuperscript{169} Although in some cases top management did not know of the payments,\textsuperscript{170} it is significant that the most notorious instances were initiated by high-level officers and kept secret among them, thereby reducing the degree of review likely to follow the decisions.\textsuperscript{171} The decisions to make the payments were not submitted to the corporation's board of directors,\textsuperscript{172} and were only rarely reviewed by corporate counsel.\textsuperscript{173} In the few cases in which counsel became involved in the decisions and gave cautionary advice, it appears to have been ignored.\textsuperscript{174}

Ability to make the payments generally depended on the establishment of two separate mechanisms, one to generate a fund of off-the-books cash,

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\item [\textsuperscript{168}] These categorizations of purposes are set forth in Herlihy & Levine, Corporate Crisis: The Overseas Payment Problem, 8 Law & Pol. Int'l Bus. 547, 550 (1976).
\item [\textsuperscript{170}] See SEC Report on Questionable Payments, supra note 151, at 41.
\item [\textsuperscript{171}] In some cases officers initiating the payments created virtually a separate organization within the corporation, in which their subordinates learned not to question deviations from standard corporate procedures. See Lockheed Directors' Report, supra note 124, at 16.
\item [\textsuperscript{172}] See, e.g., Independent Outside Directors on the Board of Directors of Northrop Corporation, Report to the Board of Directors of Northrop Corporation on the Special Investigation of the Executive Committee 2 (1975) [hereinafter cited as Northrop Directors' Report].
\item [\textsuperscript{173}] See, e.g., Gulf Directors' Report, supra note 169, at 55.
\item [\textsuperscript{174}] See, e.g., Northrop Directors' Report, supra note 172, at 10.
\end{itemize}
another to disburse the cash to its designated recipients without leaving "tracks" apparent to the normal corporate control systems. Due, perhaps, to the corporate office and extent of discretion of the persons establishing them, a variety of such mechanisms were readily created. Funds with which to make illegal domestic political contributions were generated through several different methods: by paying "bonuses" to selected employees with the understanding that they would be used for contributions to candidates,175 by diverting and returning to headquarters funds transferred overseas for the apparent benefit of foreign operations176 and by withdrawing funds from the overseas accounts of foreign subsidiaries resulting from various overseas transactions.177 Similarly, the money used for sensitive foreign payments usually originated from transactions creating off-the-books funds,178 through some of the same methods used for illegal domestic political contributions as well as through rebates from brokers and suppliers179 and repayments on false invoices.180 Some corporations made extremely large commission payments to foreign sales agents, and failed to maintain much control over the agents' activities. As a result, some of the "commissions" were eventually paid to officials of foreign governments.181 In any event, some of the funds thereby generated were simply kept in cash under the custody of a corporate officer;182 some were maintained in foreign banks;183 and disbursements, often in cash, were under the control of a very small number of corporate officers.184

The most striking qualities of these schemes are the ease with which they

175. See, e.g., American Shipbuilding Co., Form 10-K Annual Report to SEC 12 (Sept. 29, 1974) [hereinafter cited as American Shipbuilding 10-K].

176. See, e.g., Ashland Directors' Report, supra note 169, at 5; Gulf Directors' Report, supra note 169, at 37-38. The United States Customs Service is reported to be investigating possible violations of the Bank Secrecy Act in movements of cash into and out of the country, see New York Times, June 27, 1977, at 41, col. 6.


178. See, e.g., Lockheed Directors' Report, supra note 124, at 13; Exxon Special Committee on Litigation, Determination and Report of the Special Committee on Litigation, Exxon Corp. 56 (1976) [hereinafter cited as Exxon Directors' Report].


180. See Exxon Directors' Report, supra note 178, at 21.

181. See, e.g., Northrop Directors' Report, supra note 172, at 6-9, 14-16, 20-25. Some corporations formed separate foreign corporations for the purpose of furthering their foreign sales interests. Very little, if any, actual control was retained over the foreign sales corporations' activities. See id. at 9-13.

182. See, e.g., Gulf Directors' Report, supra note 169, at 42-43.

183. See, e.g., Phillips 8-K, supra note 169, at 33. Several corporations favored Switzerland as the site for these bank accounts, probably sharing the view that "it does not excite anybody's curiosity if you walk in and ask for $100,000 out of a Swiss bank." Presidential Campaign Activities of 1972: Hearings Before the Senate Select Comm. on Presidential Campaign Activities, 95d Cong., 1st Sess., Bk. 13, at 5444 (1973) (testimony of Orin E. Atkins, Chairman of the Board, Ashland Oil Co.).

184. See, e.g., Gulf Directors' Report, supra note 169, at 64-66.
were established, the success with which they eluded corporate checks and the degree of disparity in their founders' attitudes toward various potential controls. For example, although some mechanisms set up to generate off-the-books cash resulted in federal tax consequences which may not have been recognized at the time,\textsuperscript{185} many corporations were scrupulous in the care with which they planned for the proper tax treatment of their payments practices.\textsuperscript{186} In sharp contrast to the deference with which they regarded the Internal Revenue Service, some officers initiating off-the-books funds and questionable payments expressed hostility and resentment toward corporate lawyers—and in one case outside members of the corporation's board—who might unearth and question their activities.\textsuperscript{187}

Similarly, internal corporate auditors, and to almost as great an extent, outside auditors, were not viewed as significant obstacles to the payments. Although most of the reports do not discuss in any detail the failure of internal audit systems to detect sensitive payments practices, it is apparent that the internal auditors' function could easily be circumvented or evaded.\textsuperscript{188} Within many corporations, the internal auditors apparently lacked independence and stature\textsuperscript{189} and in some cases failed to pursue indications that corporate funds were being used for unaccountable, sensitive ends.\textsuperscript{190}

On the other hand, most of the sensitive payments practices fell—through either coincidence or careful design—through the interstices of possible internal corporate checks. If the funds with which to make the payments were generated through a rebate scheme, they went off the books upon their receipt. Even as to funds produced through other mechanisms, ordinary cor-

\textsuperscript{185} See Phillips 8-K, supra note 169, at 34-35. Phillips obtained cash for domestic political contributions from the Swiss bank accounts of two Swiss corporations. Funds in the accounts represented rebates on contracts of an overseas subsidiary of Phillips along with interest income and miscellaneous receipts. Id. at 40-41.

\textsuperscript{186} See Herlihy & Levine, supra note 168, at 596-97. But see 1975 House Hearings on Multinational Corporations, supra note 148, at 57 (testimony of Donald C. Alexander, Commissioner, Internal Revenue Service) ("I am skeptical enough to be surprised if a majority of those making the illegal payments were so mindful of their tax obligations as to refrain from deducting them."")

\textsuperscript{187} When William F. Whiteford, Chairman of the Board and Chief Executive Officer of the Gulf Oil Corporation, established its off-the-books fund for political contributions, he emphasized to his associates his desire that knowledge of the arrangement be kept from the Mellon family, who at the time held the largest single block of Gulf stock and were represented on the board, as well as from other officers he characterized as "the Boy Scouts." See Gulf Directors' Report, supra note 169, at 33. Whiteford was also known by his close associates to dislike "bloodhound" lawyers who became involved in the corporation's business or policy questions. See id. at 231.

\textsuperscript{188} See Williams, Illegal Payments: The Legislative Outlook, 142 J. Accountancy 58, 60 (1977).

\textsuperscript{189} See, e.g., Gulf Directors' Report, supra note 169, at 209-12; Lockheed Directors' Report, supra note 124, at 18. Through coincidental budget cuts, the size of Lockheed's internal auditing force was drastically reduced during the period under review, changing the corporate perception of it "from a control concept to a trouble-shooting role." Id. One report states that the corporation's internal control procedures lagged behind the development of its overseas sales, although the cause of this lag is not explored. See Ashland Directors' Report, supra note 169, at 9.

\textsuperscript{190} See note 189 supra.
corporate checks and controls were easily circumvented. The departmental budgeting process, resulting typically in annual budgets reviewed by a central corporate officer and later compared to actual expenditures, did not provide much control over the actual use of corporate funds, at least as long as the amounts expended did not exceed those budgeted.\textsuperscript{191} Further, in the case of multinational corporations, control over current expenses may be left to the local foreign affiliate, with only capital expenditure items reviewed on the corporate level.\textsuperscript{192} Corporate controls over expenditures and over intracorporate transfers likewise were easily evaded, oftentimes as a result of the high level of the officials involved.\textsuperscript{193}

Although in a few instances outside auditors discovered some aspects of the sensitive payments practices,\textsuperscript{194} for the most part they did not unearth them.\textsuperscript{195} This failure has led to considerable discussion of the scope which an outside audit can reasonably be expected to attain, along with some reformulations of the approach with which an outside auditor conducts an inquiry.\textsuperscript{196} In addition, there has been some dispute about whether the outside auditors' failure to discover the practices was the result of a lack of diligence\textsuperscript{197} or merely the unavoidable consequence of successful management attempts to make the practices undetectable.\textsuperscript{198}

However, the secrecy with which some corporations surrounded their sensitive payments appears to have exceeded even that necessary to evade internal controls and outside auditors. It was common for domestic political contributions made from the funds to be disbursed in cash with no records kept of disbursements.\textsuperscript{199} Likewise, in some cases few records were kept of payments to foreign agents.\textsuperscript{200} This reluctance to record disbursements obviously

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\item \textsuperscript{191} See Gulf Directors' Report, supra note 169, at 199-201.
\item \textsuperscript{192} See Exxon Directors' Report, supra note 178, at 48-49.
\item \textsuperscript{193} See Gulf Directors' Report, supra note 169, at 202-04. Gulf's corporate controller was himself a knowing participant in the payments practices.
\item \textsuperscript{194} See note 135 supra.
\item \textsuperscript{195} See SEC Report on Questionable Payments, supra note 151, at 48-49; Accounting Establishment Study, supra note 21, at 7.
\item \textsuperscript{197} See Ashland Directors' Report, supra note 169, at 8 (conclusion that there was "some basis for suggesting that greater care might have been exercised" by the outside auditors).
\item \textsuperscript{198} See Gulf Directors' Report, supra note 169, at 207 ("In view of the elaborate measures taken by Gulf officials to conceal the facts it is doubtful that any outside auditors, performing normal audit procedures, would have detected the facts.").
\item \textsuperscript{199} See, e.g., Ashland Directors' Report, supra note 169, at 5.
\item \textsuperscript{200} See Northrop Directors' Report, supra note 172, at 19, 24. In contrast to its meagre records of these transactions, Northrop kept relatively full records of government and military personages entertained at its duck hunting facility in eastern Maryland, apparently for the purpose of determining the number of dressed birds to be delivered to each person, as required by state law. See 1975 Senate Hearings on Multinational Corporations, supra note 56, at 187-88; 199-237.
\end{itemize}
reduced effective corporate control over the ultimate end to which funds were applied, and increased the possibility that they might be used for unforeseen ends which would prove embarrassing to the corporation, or even that they might be expended for noncorporate purposes. Given these evident risks, it is surprising that some of the payments made from the off-the-books funds were for entirely legal purposes. Some corporations apparently made contributions to candidates for state office in states where such contributions were legal, using the same off-the-books funds used for making illegal federal campaign contributions, with a similar reluctance to keep records of the contributions. Similarly, some corporations made legal and unquestionably proper overseas payments—for legitimate attorneys' fees and other service fees—in the same furtive and unaccountable manner used to make payments to dubious agents and officials of foreign governments.

Remarkably enough, none of the corporations' reports on sensitive payments practices explores or explains this curious use of furtive means to accomplish legal ends. It is not apparent from the reports whether the off-the-books mechanisms were established with the express notion of using them for legal as well as illegal purposes, or whether they were initially intended for illegal or dubious ends and came only later to be used for legal and unquestionable ends as well. Thus, one is left with mere conjecture to explain this phenomenon. It may well be that once a secret unaccountable mechanism is established within a corporate hierarchy, the temptations to increase its uses are strong and even irresistible. For one thing, decisions made through this mechanism are unassailable, at least at the time, and can only add to the unchecked discretion of the officer in charge of the secret fund. Once a secret mechanism is available, it may prove tempting to eliminate all questions about some kinds of payments by using it rather than going through any systematic process of checks, reviews and audits. Use of a secret mechanism may also reflect the influence of some officers' expressed hostility toward outside monitors.

This analysis of the factors behind some corporations' compulsive internal secrecy is analogous to the explanation of corporations' attempts to keep information secret from outsiders developed by the sociologist Max Weber in his classic essay on bureaucracy. Weber postulates that the power of a bureaucratic organization resides in its mastery of quantities of detailed information, and that the bureaucracy increases its power to the extent it suc-

201. See Taylor, Preventing Improper Payments Through Internal Controls, 13 CONF. BOARD REP. 17, 19 (1976) ("I suspect that more than one board is wondering whether all funds presumed to have been used for unvouched and improperly accounted for corporate purposes were so used.").


203. See NORTHROP DIRECTORS' REPORT, supra note 172, at 27, 34-35, 37, 40-41.

204. See note 187 supra.

205. H. GERTH & C. MILLS, FROM MAX WEBER: ESSAYS IN SOCIOLOGY 196-244 (1946).
ceeds in keeping secret its knowledge and intentions. Thus, in Weber's analysis, wherever a bureaucracy feels threatened by outside forces, it responds with secrecy. However, the bureaucracy's obsessive penchant for secrecy may extend beyond its rational self-interest.

The pure interest of the bureaucracy in power, however, is efficacious far beyond those areas where purely functional interests make for secrecy. The concept of the "official secret" is the specific invention of the bureaucracy, and nothing is so fanatically defended by the bureaucracy as this attitude, which cannot be substantially justified beyond these specifically qualified areas.

Although Weber's essay is concerned with bureaucratic secrecy as to outside inquiry, the same analysis is applicable to secrecy within the corporate structure itself.

It is precisely this sort of disfunctional, obsessive secrecy within the corporation which proposals to restructure corporations through rejuvenated boards of directors fail to take into account. The only aspect of Christopher Stone's proposal that comes close is an argument in favor of protecting the job rights of employees who blow the whistle and disclose what the corporation prefers be kept secret. To be sure, the success of this remedy depends on the availability of a supply of whistle blowers; it is unlikely to be very effective in the absence of a more thoughtful examination of the reasons for corporations' obsessive internal secrecy.

C. The Literature of Corporate Self-Scrutiny

The corporations' reports on sensitive payments are interesting in themselves as a new genre of corporate literature: exercises in public self-examination and repentance. As such, they are useful background for assessing the prospects of some of the more optimistic proposals for reform. Perhaps the most striking characteristic of the reports is the wide variation in their quality. Although the former Chairman of the SEC expressed its satisfaction with the quality of the reports it had reviewed, some of the reports are unclear and confusing at points, a fact recognized by the SEC staff in its analysis of the reports. Contrasting with the evident care and thoroughness with which

206. Id. at 233.
207. Id.
209. See C. Stone, supra note 1, at 213-16.
211. See SEC Report on Questionable Payments, supra note 151, at 36, 40. The staff of the Subcommittee on Oversight and Investigations of the House Committee on Interstate and Foreign Commerce prepared a report criticizing the SEC for accepting disclosures about payments practices which omitted some identifying details. The Subcommittee report did not, however, comment on the occasional confusions in the corporate reports. See Staff of Subcomm. on
some reports have been prepared\textsuperscript{212} is the sketchy and confusing quality of others.\textsuperscript{213} Only a few reports contain discussions of the inadequacies of the internal corporate control and audit procedures which failed to check or detect sensitive payments.\textsuperscript{214} Moreover, few of the reports consider in any detail the frustration of the role of the corporation's independent auditors.\textsuperscript{215}

Not surprisingly, most of the reports conclude with a list of reforms to be implemented by the corporation, and a statement of optimism about the reforms' ability to prevent similar abuses in the future. More specifically, the assertion is made in many of the reports that the corporation's internal audit and control systems have been revised so that unaccountable applications of corporate funds cannot recur.\textsuperscript{216} However, the literature of the accounting profession recognizes explicitly, even though the reports do not, that no such internal procedure is tamper- or fool-proof and that all potentially can be subverted by management.\textsuperscript{217} The revelations of the reports also demonstrate


\textsuperscript{213} It is unclear from the report of American Shipbuilding, see note 175 supra, who designated the political candidates as recipients of the largesse of the company's bonus program. The report also fails to discuss any potential federal income tax consequences to the corporation resulting from the bonus program. In cases in which corporations used their slush funds to make legal domestic political contributions, see text accompanying note 203 supra, the reasons for such usage are not discussed. Further, it is impossible to determine from some reports whether some of the state contributions specifically disclosed were legal or illegal. See Phillips 8-K, supra note 169, at 24-27, 52.

\textsuperscript{214} See American Shipbuilding 10-K, supra note 175 (no discussion of internal audit and control systems); \textit{Ashland Directors' Report}, supra note 169, at 9 (no discussion of internal audit and control systems beyond a summary assertion that company's audit procedures failed to "keep pace" with its growing overseas involvement); \textit{Northrop Directors' Report}, supra note 169 (very little discussion of internal audit procedures); Phillips 8-K, supra note 169 (no discussion of internal audit systems).

\textsuperscript{215} See Cities Service 8-K, supra note 179 (no discussion of independent auditor's performance); Phillips 8-K, supra note 169 (no discussion of independent auditor's activities).

\textsuperscript{216} For example, Ashland Oil adopted a policy, recommended by its investigating board committee, prohibiting "the maintenance of, or any disbursement from, funds created or maintained for purposes which are not disclosed or are not appropriately reflected in its books and records." See \textit{Ashland Directors' Report, supra note 169, at 13. Lockheed's committee recommended upgrading the corporation's internal audit function, along with requiring periodic representations by management members that they are abiding by the corporation's code of business conduct. See \textit{Lockheed Directors' Report, supra note 124, at 25. A monitoring system introduced by Lockheed was elsewhere described as being "as tight as anything could be as far as the central approval mechanism that's been set up for all payments for the corporation"; at Lockheed, "[n]o outside funds. It's all back in the budget. No ability for slush funds where improper payments had existed before." 1976 Senate Oversight Hearings, supra note 127, at 24 (testimony of William E. Simon, ELGB Chairman).

\textsuperscript{217} See \textit{American Institute of Certified Public Accountants, Statement on Auditing Standards No. 1, § 320.32 (1972), which states that a system of internal control procedures should be regarded as "reasonable, but not absolute, assurance that the objectives expressed in it will be accomplished by the system." The assurance is less than absolute in part because

\textit{[P]rocedures whose effectiveness depends on segregation of duties obviously can be cir-
that no particular corporate officer—controller,\textsuperscript{218} corporate counsel\textsuperscript{219}—or independent board or its audit committee\textsuperscript{220} will always exercise sound judgment when questionable activities are proposed or discovered. Moreover, reforms directed to sensitive payments problems may not be effective deterrents against other kinds of corporate misconduct. Thus, it is not surprising that two of the reports expressly come to the conclusion that only the tone set by top management in its control of the company can assure that legal and ethical norms of conduct will be abided by.\textsuperscript{221} It is, nonetheless, ironic that this final assurance stems from factors other than the structure of the corporation's management.

D. Repent and Be Saved—Defenses to Shareholders' Derivative Suits

One consequence of the corporate self-scrutiny process, perhaps unforeseen by some of its proponents, is that it has the effect of furnishing the corporation's officers and directors with an additional defense in any derivative shareholder litigation challenging the conduct in question. Without the self-scrutiny ritual, defendants in a derivative suit would be in the position of arguing that their actions were good faith exercises of their business judgment.\textsuperscript{222} Specifically, operating management defendants would argue that they undertook the activities prompting the litigation in good faith,\textsuperscript{223} and outside members of the board would argue that their failure to detect or prevent operating management's activities was within the permissible scope of business judgment.\textsuperscript{224} Once the internal scrutiny process is undergone, however, the focus of the derivative litigation shifts, so that rather than litigating the business judgment attributes of the defendants' actual conduct, the plaintiff is forced to litigate the good faith and disinterestedness of those directing the self-scrutiny and deciding whether the corporation ought to assert claims against the defendants.\textsuperscript{225} This shift in focus narrows the permissible


\textsuperscript{222} See id.


\textsuperscript{224} See H. Ballantine, Corporations § 63a, at 160-61 (rev. ed. 1946); note 32 supra.

\textsuperscript{225} See H. Ballantine, Corporations § 147, at 349 (rev. ed. 1946); Lipton, Directors of
scope of the representative shareholder's discovery, reduces the showing the
defendants must make to support a motion for summary judgment, and in
general makes it very unlikely that the representative shareholder will ever
prevail on the merits in such litigation. The fact that the likelihood of success
in such shareholders' litigation is so slim virtually eliminates one potential way
of enforcing directors' and officers' duty of care to the corporation, by ensuring
that their actual behavior will not even be litigated.

One recent case, Gall v. Exxon Corp., illustrates the effect of the self-
scrutiny study in the context of a shareholder's derivative suit. Plaintiff in Gall
sued derivatively, alleging that the corporation's directors and officers, by fail-
ing to prevent its Italian subsidiary's payment of $59 million in bribes and
political contributions, had breached their fiduciary duties to Exxon, wasted
its assets and violated various provisions of the federal securities laws. Defendants,
apparently prior to any plaintiff's discovery, moved for summary judgment dismissing plaintiff's complaint on the grounds that a special com-
mittee of disinterested directors had investigated the payments problems and
had determined that it was not in the corporation's interest to maintain suit
against any of the defendants, thereby exercising their sound business judg-
ment. After affording plaintiff the opportunity to conduct discovery as to the
good faith and independence of members of the special committee, the
court granted defendants' motion and dismissed the complaint.

As a consequence of its procedural history, Gall does not raise directly the
question of whether Exxon's directors performed properly on its board; rather, the issue posed is one step removed—whether the special committee's
decision not to sue represented a good faith exercise of business judgment.
Nonetheless, some aspects of the special committee's report call into question
both the quality of the directors' service and the efficacy of the self-scrutiny

It is apparent from the report that Exxon delegated a great deal of au-
thority to the chief executives of its subsidiaries. The chief executive of its
Italian subsidiary, Esso Italiana, was believed to need extensive authority in
order to inspire sufficient confidence in the representatives of other com-

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227. See 418 F. Supp. at 509.
228. See id.
230. See Exxon Directors' Report, supra note 178, at 11-12.
panies and of the Italian government with whom he would be dealing.\textsuperscript{231} In particular, the chief of Esso Italiana had the authority to open bank accounts and borrow money.\textsuperscript{232} He used this authority to open secret bank accounts out of which he paid bribes and legal political contributions, generating the necessary funds through rebates and bank overdrafts.\textsuperscript{233} Ordinarily, the existence of the secret bank accounts would have been revealed in annual audits of Esso Italiana by its outside auditors, who would contact its banks as a part of normal audit procedures for confirmation of the balances in its accounts. The chief of Esso Italiana successfully defeated this audit check by asking the banks not to reveal the existence of the accounts or the overdrafts in them to anyone; the banks complied.\textsuperscript{234}

Although some members of Exxon's central management knew that Esso Italiana had been using rebates to make political contributions, they did not know of the secret bank accounts.\textsuperscript{235} Further, at the time central management control was almost exclusively concerned with subsidiaries' use of capital, while operating expense budgets were not examined in any detail.\textsuperscript{236} The board's interest was the bottom line; no individual expense items were examined.

While classical statements of directors' duty of care to the corporation clearly envisage a more active and detailed review of operating management's performance,\textsuperscript{237} Exxon's directors may not have behaved improperly. They may have had reason to believe that internal corporate check and audit systems and independent auditors' inquiries were sufficient to assure that corporate funds were being used for business purposes and were not being misapplied to other ends. Although it concludes with the assertion that internal audit and control procedures were inadequate in Italy until 1972,\textsuperscript{238} the special committee's report does not discuss the extent or quality of such procedures at Exxon, a striking omission in light of its significance to the propriety of the directors' conduct. Indeed, it appears that at least some directors knew that some financial records were false and thus perhaps had good reason to suspect other improprieties in expense records.\textsuperscript{238}

One interesting variation on the self-scrutiny defense, although not raised directly by the facts of Gall, is suggested by the practical implications of the

\textsuperscript{231} See id. at 12-13.
\textsuperscript{232} See id.
\textsuperscript{233} See id. at 8-9.
\textsuperscript{234} See id. at 57.
\textsuperscript{235} See id. at 41.
\textsuperscript{236} See id. at 16.
\textsuperscript{237} See M. Eisenberg, supra note 10, at 139. The classic statutory mandate is that the directors manage the corporation and set its business policy by exercising their good faith business judgment. See id.
\textsuperscript{238} See Exxon Directors' Report, supra note 178, at 80.
\textsuperscript{239} See id. at 38-41. Some directors knew that political contributions had been improperly recorded on the books of Esso Italiana.
case. Suppose the representative plaintiff in a similar litigation is able to demonstrate that information about the challenged activities was withheld from or misrepresented to the disinterested directors conducting the investigation and determining the corporation's position in the derivative litigation. Plaintiff's argument would then be that the defense otherwise afforded by the self-scrutiny exercise ought to be unavailable. If the sole permissible focus of the plaintiff's inquiry is the good faith and disinterestedness of those making the inquiry, then the defense is still available, for the plaintiff has shown only that the disinterested directors' decisions may have been mistaken, and has not shown that the decisions were not the result of a good faith exercise of business judgment. On the other hand, once the inquiry, albeit disinterested, has been tainted by withheld or misrepresented information, the integrity of the self-scrutiny process has been so seriously jeopardized that the defense ought not to be available. Especially if the information appears to be material to the decisions made by the disinterested directors, the self-scrutiny process has not fulfilled even its minimal role of enabling the corporation to have a fully informed stance in the derivative litigation.

Thus, unless the defense it affords is somehow made unavailable, the self-scrutiny mechanism may not get much further into an analysis of the quality of directors' performance than does the derivative suit with its procedural peculiarities. In light of the wide protective swath cut by the business-judgment rule, it is difficult to specify the incentive to directors to reform their conduct posed by such a self-study. Again, the success of reform appears to be tied to the overall tone of management rather than to the specific review process.

CONCLUSION

Increasing the proportion of independent directors on boards of large corporations while exhorting those directors to be knowledgeable and aggressive is a widely supported reform. So widely supported, in fact, that one suspects opposition to it could be grounded in only quixotic folly or "an invincible repose upon the status quo." Nonetheless, some of the predictions of universal success made for this reform by its proponents are exaggerated or unfounded.

Mere structural change is probably not sufficient to assure that large corporations will behave as law-abiding and ethical citizens. Effective reform requires an informed assessment of corporations' actual practices in handling and shaping information about the corporation; without such an assessment, even an independent board may be denied effective control and use of corpo-

rate information. Moreover, without coherence and clarity in the goals to be achieved by these structural reforms, the independent directors' mandate may be unclear. Finally, strong emphasis on structural reform probably has the effect of distracting attention from other possible remedies for corporate problems—shareholders' derivative suits, civil and criminal penalties—and diffusing efforts to make the other remedies more effective.