Hastings Law Journal

Volume 30 | Issue 5 Article 8

1-1979

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Donald E. Schwartz

Response: Some Thoughts on The Directors' Evolving Role

By DONALD E. SCHWARTZ*

Marshall Small's article quite correctly focuses the corporate social responsibility issue on the process by which corporations act. This helps extricate us from the semantical goo that often surrounds discussion of corporate social responsibility; for example whether it means corporate philanthropy or internalizing social costs, or something else. Essentially, I believe it means conducting one's business with an eye to the manner in which external constituencies are affected, but I confess that that mix of words does not paint a truly representational portrait. That is why I think it is more fruitful to talk about process.

On aspect of the corporate process, the governance structure, has received considerable attention in recent times. The Securities and Exchange Commission, the Federal Trade Commission, various committees of the United States Senate, the American Law Institute, the American Bar Association, the Business Roundtable, and the American Assembly, have all probed the issue of how the corporation should be organized in order to meet its responsibilities. By and large, those who have taken part in this examination have thought in terms of protection of corporate investors. They were not seeking methods for altering the governance scheme so as to better enable the corporation to face its other publics. Marshall Small, however, recognizes that these two broad categories of claimants, investors and those affected by corporate conduct, will have conflicting demands, and most of these must be resolved by corporate managers acting in their discretion. Thus, although there are other factors bearing on the resolution of the conflict, such as numerous regulatory laws, there is a need to provide a corporate framework to work through the problems internally.

One requirement is to come up with a handle on the problem; there is a need for a conceptual framework. Mr. Small states that deci-

* A.B., 1952, Union College; LL.B., 1955, Harvard University; LL.M., 1966, New York University. Professor of Law, Georgetown University Law Center.

sion makers must be guided by the "longterm interests of the owners of the enterprise in its economic survival and success." This outlook provides the means of achieving a synthesis of competing interests. I have no better formula to offer, but certain observations are in order.

First, the synthesizing is to be performed only by persons who are on one side of the conflict. Only the investors are represented in the internal decision making process, not employees, customers or the general public. I do not suggest that it should be otherwise, but this fact must be recognized as a limitation on the ability of corporate decision-makers to decide conflicts against the investors' interest, even when such a decision is the sounder long-term solution. Certain mechanisms for providing a public input into the process might be explored, such as requiring fuller public disclosure of corporate activities, or utilizing public advisory committees. These devices are not explored.

Second, Mr. Small refers to the long-term interest of investors. I do not believe investors have long-term interests; their investments are liquid and terminable. On the other hand, the corporation, the *personna ficta*, has a long-term interest. But it must be recognized that when managers favor that "long-term" interest, they are not simply deferring benefits to stockholders, they are denying them and shifting benefits to another group. Ultimately another generation of stockholders will reap some reward because they will find the corporation a viable investment vehicle, whereas othersise it might have proven too brittle to survive. This more precise way of expressing Mr. Small's formula is necessary in order to appreciate the magnitude of the conduct Mr. Small is quite properly sanctioning. He is, in reality, saying that today's investors must be made, or at least may be made, to pay a price for a benefit they will not receive. This assertion gives wide latitude to managers, wider perhaps than some who espouse this notion may appreciate. It gives to the salaried employees of the corporation the discretion to impose costs on investors balanced by immediate benefits to other community interests. It makes the notion of long-term profitability a concept with some bite to it. A recent illustration is provided by Mr. Small in his discussion of the Control Data charter amendment. There may be nothing remarkably new in all this, however. Several years ago, a court sustained a stock purchase and issuance plan that was used to thwart a possible takeover of a locally owned newspaper by a large national chain on grounds that community interest in local ownership could be weighed by the board along with the interests of the stockholders.[1]

1. Herald Co. v. Seawell, 472 F.2d 1081 (10th Cir. 1972). The contested tender offer

Mr. Small's focus is on the directors. He looks less at how the board is to be structured than at how the directors should conduct themselves, or in other words, more on process than on structure. There are, in truth, only a few restructuring alternatives available if one is to maintain the large corporation essentially as we know it. More unaffiliated directors and more committees[2] are possible; perhaps some changes in the nominating and electing process can be achieved, but these are all modest in scope. They almost trivialize the problem. Indeed, the modesty of these approaches led one commentator at the recent ALI symposium on corporate structure and governance, Victor Palmieri, to observe that this entire area which he once thought vital now appeared to him to be without much significiance at all. Mr. Palmieri added that the really important issue was the role in fact played by the participants, and he chose to comment upon the role of lawyers. Mr. Small analyzes in depth the role of directors. Both would seem to be crucial.

It is a curious turn that directors have come in for so much attention as of late. The customary legal formulation, that directors are charged with the responsibility for managing the business and affairs of the corporation, is regarded as a quaint relic of simpler times, but is not a suitable description of today's world. Recently a number of states have departed from that rule. The corporate critics have berated the board as an unrepresentative institution composed largely of manage-

provides a dramatic illustration of this analysis. The focus of the federal law regulation of tender offers is said to be protection of shareholders. Piper v. Chris Craft Indus., Inc. 430 U.S. 1 (1977). Presumably, a well-informed shareholder will base a decision to accept or reject a tender offer, in part, on the disclosures made about the target company and the bidder seeking control. Thus, protection will be afforded to the company. In truth, the stockholder is influenced almost exclusively by the price. Borden & Weiner, *An Investment Decision Analysis of Cash Tender Offer Disclosure*, 23 N.Y.L. SCH. L. REV. 553 (1978). Surely this is rational behavior. A bidder who intends to wreck the target, and is willing to pay a sufficiently high price to the stockholders in order to gain the chance, is likely to succeed. The stockholders, it is often observed, have no loyalty to the corporation.

On the other hand, think how different the result would be if it were left to a vote of the employees. I do not suggest that such a course be followed; I wish only to examine the notion that the interests of the enterprise and its investors are always co-extensive, and that worker participation would be destructive. Of course, some employees—the management—are already making significant decisions about the future of the company and they are considering a large number of factors that are not necessarily favored by stockholders. The rejection by the McGraw-Hill Corporation board of directors of the American Express tender offer, at a substantial price above the market, was based on many factors. *See* Opinion of Wachtell, Lipton, Rosen & Katz to McGraw-Hill Board (Jan. 30, 1979).

2. Mr. Small discusses audit, nominating, and compensation committees, but he does not mention public policy committees. Others, such as the 54th American Assembly, have discussed the usefulness of the latter.

ment's rubber stamps. Even those responding to the critics have rarely defended the board with much vigor. They acknowledge that management runs the business and that directors do not have the time or opportunity to do anything more than act as an occasional sounding board. Why, then, does everyone concentrate on the board, this creaking anachronism, as the means to achieve reform, large and small? It could be that the board is chosen because it is the easiest or only, access point to outsiders. Whatever its deficiencies, it is there. Mr. Small has the wisdom to recognize that only modest reforms are within attainment, and he has set his sights low enough to be within reach, yet high enough to mean something.

Thus, the subject of corporate responsibility goes beyond adherence to the law and includes areas of managerial discretion. Surely, that is consistent with the descriptions managers provide of their functions. Yet Mr. Small develops with care the role of directors in assuring compliance with law and he does not explore the possibility of directors in monitoring social performance in a broader spectrum. Given the great difficulty in formulating any wider role within the existing framework of corporate law, this may be an appropriate limitation. Nevertheless, it is important to recognize that this is only part of the story.

The director's role is largely a reactive one. Therefore, Mr. Small concentrates on how directors should react when faced with a proposition for corporate action that may be illegal. Since illegality rarely proclaims itself, directors may, indeed, wind up authorizing programs that are subsequently judged to be illegal, or not terminating conduct that is also held to be illegal. No one suggests that accountability should be based solely on results. What is important is to develop a sensitivity to the possibility that the law may be violated and to work out a program that reduces the likelihood. By and large, Marshall Small's suggestions for doing that make practical sense.

What intensifies the director's interest in the subject is his exposure to civil liability when the corporation is held to violate the law. Will the director be liable to the corporation in a derivative suit under those circumstances? Results alone rarely dictate the conclusion, because most violations do not so clearly appear, and the usual judgment call will be close, or the facts bearing on the question may be elusive. It can be argued that directors would be foolhardy to ignore precautionary steps (like having an audit committee and institutionalizing a flow of information), or the taking of certain procedures when considering a proposed transaction, or in failing to react to suspicions of wrong doing. They would be foolhardy because these measures describe the new norms for directors' behavior, and their omission may spell liability even if that has not always been the case. Earlier standards of lassitude which have defined the directors' duty of due care may not suffice when conduct is judged by contemporaneous standards and devices for assuring diligence. Learned Hand's refusal to accept the laggard standards of an industry as the definition of prudence stands as fair warning.[3]

Although some sort of business judgment rule is necessary, of course, I believe Mr. Small is inclined to allow it too much scope. It is not at all clear what he would do with the like of *Graham* v. *Allis-Chambers Manufacturing Co.*[4], which many commentators regard as a most disturbing application of the business-judgment rule. In that case, the directors of a company convicted as a co-conspirator to fix prices were found not responsible for the conduct of subordinates, of whose actual conduct they were ignorant although the company was subject to a consent decree concerning similar conduct. Critics believe the case encourages studied indifference to activities not brought directly to the board's attention; no active monitoring is demanded. Mr. Small stresses that outside directors are held to a different standard from that applied to inside directors (although, curiously, he cites only cases decided under federal securities law for this point), and this distinction may further encourage ostrich-like behavior.

Another troubling aspect of directors' liability that inhibits the development of corporate responsibility through action of the board is the so-called "net benefit rule." As Mr. Small states it, "furthermore, while there is no proof of harm to the corporation as a result of taking action subsequently found to be illegal, there has been a tendency to deny recovery against those responsible for authorizing the transaction, even where the business judgment rule may not be available as a defense." By this standard, if a corporation paid a bribe from which it received commercial advantage, or violated environmental control standards to avoid an expensive retooling, or engaged in similar profitable trade offs, there could be no recovery in a derivative suit against the officials for the *gross* loss. The benefits from the illegal action could set off those expenditures. Moreover, it would seem that the burden of proof might even be on the objecting stockholders to establish the net loss.

Well, why is this not sound? After all, the corporation has suffered

3. The T.J. Hooper, 60 F.2d 737 (2d Cir. 1932). *See generally* Coffee, *Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response*, 63 VA. L. REV. 1099, 1185 ff. (1977).

4. 41 Del. Ch 78, 188 A.2d 125 (1963).

no harm, and those that have, can bring their own suit. Additionally, there is always the possibility of criminal action. First, the law might appropriately react that it is against public policy to allow a set-off from the gains of illegal activity. Such a view is surely not unknown; witness the tax law's denial of certain deductions. As to the availability of other remedies, these may be more theoretical than real. The victims may have a hard time recognizing themselves in the situation I have described, or there may be standing problems. For the same reasons, the New York Court of Appeals (the same jurisdiction that created the net benefit rule) allowed corporate recovery when insider trading occurred, in *Diamond v. Oreamuno*,[5] largely because this was an effective deterrent to conduct properly discouraged. Thus, corporate recovery might be allowed when violations of the law occur. While Judge Fuld went to some pains in *Diamond* to argue that there was corporate injury, the argument is not really believable. Indeed, the two jurisdictions subsequently confronted with the same or similar problem have refused to follow *Diamond* on precisely the grounds that no corporate injury was shown.[6] However, most observers of the corporate scene lavish praise on *Diamond* as evidence that state courts are fully capable of protecting the interests of minority stockholders.

I recognize that there is an important distinction because *Diamond* was a self-dealing situation where it is especially offensive to allow fiduciaries to retain the benefits of their offending conduct. Moreover, the nexus to the corporation of the impropriety is much stronger. Nonetheless, the case points to the great practical disciplining effect of stockholder derivative litigation to enforce standards of public policy. It is not squarely on point, but it is a commendable extension of the doctrine. A further distinction, and a more troubling one perhaps, is that in *Diamond* the recovery equals the wrongdoer's personal gain, even if it is not the measure of the corporation's loss. In the violation of the antitrust laws, and the like, typically the gross loss is not the measure of the director's gain; in fact there may be no such gain at all. In such a case courts will be reluctant to impose damages. Courts, therefore, need new remedies at their disposal, such as banishment or suspension from the board, in order that they have an alternative to imposing money damages.

Finally, Mr. Small raises the issue of the role of stockholders in imposing on directors their views on how the corporation should be

5. 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969).

6. *See* Freeman v. Decio, 584 F.2d 186 (7th Cir. 1978) (applying Indiana law); Schein v. Chasen, 313 So. 2d 739 (Fla. 1975).

governed. This issue is given a new urgency because of the Supreme Court's decision in *First National Bank of Boston v. Bellotti*,[7] which permits corporations to take positions in the political arena. In his response to Justice White's concern, in dissent, about the potential for management to waste the stockholders money on political causes that do not enhance the common goal of the stockholders, Justice Powell, writing for the majority, noted, among other things, that the corporate political process was available to protect dissidents. All of us, including Justice Powell, realize the limited viability of that process, but perhaps his observation, when coupled with the broad recognition of corporation rights recognized in the opinion, underscore the need to provide full opportunity for stockholder input into the decision making process. Mr. Small recognizes it, and he observes that there is value in allowing some vehicle for shareholder contribution to the nomination process and in welcoming stockholder proposals for inclusion in the proxy statement.

I think shareholder participation enriches the process and is deserving of enthusiastic support. It is the process, and only the process, that matters because shareholder proposals or nominations will prevail under only the most unusual circumstances. The increased institutionalization of the stockholder body provides more expertise and more clout to that group, which should not be overlooked. The shareholder role reminds management of its limited right to exercise their massive power. And the process ventilates numerous issues management, and even most of the stockholders, do not customarily relate to the conduct of corporate business. The ensuing articulation of positions, in the open forum of proxy solicitations and annual meetings, will, and does, achieve beneficial results.

There is an immense amount of wisdom, practical advice, and first rate scholarship in Marshall Small's article. I have only scratched some of what I consider to be the rougher edges of the surface. On the whole I think he proposes appropriate steps in the development of a body of corporate law that will help promote not only the stockholders' interests, but the interests of sound public policy as well.

7. 435 U.S. 765 (1978).