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The board as a path toward corporate social responsibility

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Academic prescriptions to ensure corporate social responsibility (CSR) as such have little hope of achieving significant change. CSR has become a widespread topic of conversation and scholarship over the past decade. But while codes of conduct, principles of investment, corporate codes of ethics and the like fill corporate boardrooms and spill off the presses, often with great fanfare, more often than not they reduce to so much sound and fury. CSR remains ill-defined, if defined at all, and proliferating precatory pronouncements are no better than the paper on which they are written. To the extent that corporations behave in a manner that would achieve consensus description as responsible, they do so for their own reasons and in the course of conducting their quotidian businesses.

At the same time, recent years have witnessed heightened interest in corporate governance from removing anti-takeover protections, featured prominently in the 1990s, to the financial performance of corporations following the collapse of Enron. More recent attacks have been focused on executive compensation and the right of shareholders to veto directors. In contrast to the activists and scholars promoting corporate social responsibility, the actors involved in this aspect of corporate agitation (including institutional investors, corporate governance activists, politicians, policymakers and pundits) are interested in the financial well-being of shareholders. Unlike the CSR debate per se, the corporate governance debate does repay scholarly attention as a focus of social responsibility, defined as it is by the traditional parameters of corporate law and articulated within a well-developed framework of corporate fiduciary duties. Whereas CSR operates free-form and can seem either superfluous or threatening, corporate governance issues operate within well-defined and accepted structures.

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By asserting that the debate over principles of CSR is likely to be fruitless, I do not mean to suggest that it is an unimportant concern. Quite the contrary. It is precisely because it is so important that it needs to be treated as something central to the corporation's business, not as something the corporation does in addition to its business. Peter Drucker famously distinguished between two kinds of social responsibility. The first deals with issues of social policy external to the corporation, that are decidedly not the business of the corporation (and that we who live in political democracies would not want the corporation to solve). The second are social problems created by the corporation itself in the course of its production of goods and services. These latter problems are undoubtedly the corporation's responsibility, if for no other reason than that the most basic principles of human behaviour require that we should clean up our own messes.

This latter understanding of CSR, in which management is to take responsibility for the consequences of corporate behaviour, is too important to be lost in broader arguments over corporate morality. The easier rejection of the latter could make it all too simple for corporate managers to reject the former as well. I have elsewhere argued that corporate directors and managers have the same moral obligations and should exercise the same moral personhood in their corporate roles as in their ordinary lives, and I am not in any way shrinking from this position. My argument here is a more practical one, and is based upon the premise that managers will have a hard time accepting personal moral accountability for their corporate behaviour if they fail to accept the most fundamental notions of corporate responsibility. Facilitating good corporate citizenship is simply too important to insist on perfection.

It is for these reasons that I argue that the most likely way for proponents of CSR to achieve their goals is to recast their issues as issues of corporate governance. This is a position I have taken for years, but as corporate governance reform increasingly, at least in the United States, takes centre stage, issues of corporate responsibility *simpliciter* are easily pushed aside.[1] It is therefore important to talk in terms that will lead corporate decision-makers to listen. And that means talking about corporate responsibility in terms of corporate performance.

[1] Lawrence E. Mitchell, 'Cooperation and Constraint in the Modern Corporation: An Inquiry into the Causes of Corporate Immorality', *Texas Law Review* 73 (1994–1995), 477, 490–1; Lawrence E. Mitchell, 'A Critical Look at Corporate Governance', *Vanderbilt Law Review* 45 (1992), 1263, 1269–73; and Lawrence E. Mitchell, *Corporate Irresponsibility: America's Newest Export* (New Haven, CT: Yale University Press, 2001).

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My argument, as developed in this chapter, is intuitive. Corporate management that looks to the best interests of the business over the long term will largely, if not completely, fulfill many of the goals of CSR. Indeed, as one scholar has written, American corporate governance at the height of American industrial dominance, the 1940s and 1950s, was a governance that privileged the interests of workers and customers, two of the principal targets of CSR concern.[2] It may be that expressing CSR concerns in the language of business itself has the potential to marginalise some issues. But these are, more often than not, likely to be the broader societal problems arising from modern corporate capitalism that fall into Drucker's first category. Management that keeps its own house in order, management that understands that running a successful and sustainable business requires it to behave in a manner that does not risk undermining its own legitimacy, is management that will run a corporation that, as a matter of course, will address most of the problems with which CSR is concerned.

How, then, can we guarantee that management keeps its own house in order and in so doing fulfils CSR goals? It is hardly enough to note that a corporation and its managers ought to look to the long term in order to fulfil its social obligations and leave it at that. If nothing else, we also need to understand the incentives and disincentives that affect whether managers are likely to look to the long term in their strategic, tactical and day-to-day operating decisions.[3] The legal structure of the large modern public corporation is particularly sensitive to the stock market and, increasingly over the last twenty-six years, the stock market has become a place to look only for short-term behaviour.[4]

Short-term market pressures can produce two contradictory responses in the boardroom; either the board can bend to the pressure, operating the corporation in the short term to satisfy the market by increasing current earnings and thus stock prices, or it can resist that pressure, weeding out the short-term traders, attracting long-term investors and educating shareholders to understand the benefits of long-term management. The particular approach a board will take will be a function not only of its own philosophy, but of the incentives it creates for its management and itself. Once a board has made its choice clear, we have every right to hold

[2] Jeffrey N. Gordon, 'Independent Directors and Stock Market Prices: The New Corporate Governance Paradigm' 59, 6 *Stanford Law Review* (2007, forthcoming).

[3] The constant search for profit guides corporations and their managers to short-term outlook and discourages responsible long-term accountability. Further discussion may be found in Mitchell, *Corporate Irresponsibility*.

[4] Mitchell, *Corporate Irresponsibility*, pp. 4–5, 52.

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it accountable for its decisions, the consequences of those decisions and its responses to those consequences.

My argument thus far presumes that the board has a choice. And, of course, in a Kantian sense, if I may misuse Kant by personifying the board, it does. But the practical realities may be different. There is, for example, a huge gulf between Berkshire Hathaway, whose chairman controls the corporation's equity and its shareholders' votes, and Exxon Mobil Corporation – even though a majority of the shares of Exxon Mobil are owned by institutions. And even though institutions are sufficiently concentrated that they might vote in a way that resembles control, those institutions do, and should be expected to, behave very differently from Warren Buffett. Buffett is an individual, a human being, with a human sense of responsibility and clear identification with his corporation such that he is in a very real sense accountable for its actions. Moreover, he makes it publicly known that he stands accountable for his actions.[5] The money managers at Fidelity or the Californian Public Employees Retirement Scheme (CalPERS) are largely unknown to the public and face their own business obligations and imperatives that will affect the way they vote their shares in Exxon Mobil. Buffett therefore has a choice in the free, Kantian sense. The choices facing the managers of Exxon Mobil are far more constrained.

Not only are the choices faced by the boards of large public corporations constrained in non-human ways, but the legal structure of the modern public corporation makes the board a particularly limited and ineffective institution.

The lynchpin concerns the ways in which both the structures of corporate law and the behaviour of the capital markets push corporate boards and officers (to whom I will refer to collectively as 'management') to run the corporation in the short-term interests of the shareholders. In the heyday of efficient capital markets theories, one who identified shareholder short-termism as a problem was a pariah, a voice in the wilderness – or perhaps both.[6] Five years after Enron, the Conference Board, among other business organisations, has finally acknowledged the problem of short-termism as a serious business issue, most recently in its April 2006

[5] Warren Buffett, 'Symposium: The Essays of Warren Buffett: Lessons for Corporate America', *Cardozo Law Review* 19 (1997), 5.

[6] Mitchell, 'A Critical Look at Corporate Governance', 1263. I remember a conversation in 1993 with an eminent corporate scholar to whom I voiced my concerns and received, in exchange, an offhand, 'I'm not worried about short-termism' – last I read his work, he is now!

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report, *Revisiting Stock Market Short-Termism*.[7] While the multivariate pressures of the stock market, from price punishment for missed earnings estimates to institutional corporate governance proposals, push management to focus on stock price, the structure of corporate law permits the corporation to externalise the costs of short-term performance on the rest of society.[8] When this occurs, corporate irresponsibility follows.

I do not mean to suggest that particular types of irresponsible corporate behaviour – pollution, worker maltreatment, under-investment in research and development, poor quality production, accounting irregularities and the like – are exclusively caused by short-term management. But there can no longer be any question that it is a major factor. The job for those interested in stanching this externalisation, and perhaps reversing it, is to identify the pressure points in the corporate legal and financial structure most likely to be reached effectively and to be responsive to concerns generally articulated by those who advocate CSR.

The most obvious and, I think, perhaps the most effective pressure point is the board of directors. The board has been the corporate institution most roundly criticised by corporate governance activists in the wake of Enron, and is also the target of much of the CSR movement. To the extent that the board is the corporate organ that has most directly been subjected to stock market and institutional short-term pressures, it seems more than reasonable to believe that focusing CSR efforts on the board is the best method of achieving good results.

But the board is a particularly problematic institution. An examination of the history of the modern American board reveals that, far from ensuring corporate responsibility, the contemporary structure of the board and legal doctrines create disincentives for the board even to protect the shareholders, let alone anybody else. This is because the modern American board was designed to protect directors and managers from liability, not to function effectively. Protection was achieved by combining a minimalist model of board function with a singular focus on shareholders. When this reality is combined with short-term market pressures on the board, it is little wonder that the board fails to perform either for shareholders or other stakeholders. The answer is to insulate the board to some reasonable extent from market and institutional pressures. If we accomplish this result, we will have given the board the choice of how to manage its

[7] Matteo Tonello, *Revisiting Stock Market Short-Termism* (New York: The Conference Board, 2006).

[8] Mitchell, *Corporate Irresponsibility*, p. 6.

corporation and, in so doing, made it accountable for its decisions rather than shielding it from that accountability.

I will first discuss the development of the modern board model, the monitoring board, highlighting its implications for CSR. Following that discussion, I will briefly tell the parallel story of how broad economic and social developments grew from 1980 to reinforce the short-term, stockholder-centric nature of board governance. Then I will suggest several different types of reforms that would help break the resulting tight connection between the board and the stock market. Such devices as a revised capital gains tax structure, changes in board terms and the introduction of new accounting principles could go some way toward freeing the board from excessive market pressures, empowering it to function in the best interests of the corporation itself. In short, these reforms would restore meaningful board responsibility.[9]

I. Board reform and the beginning of modern corporate social responsibility

American legal and management scholarship paid very little attention to the role and function of the board of directors before the 1970s. In that earlier period, managerial control with boards comprised largely of insiders of some type was correctly presumed, and there was little apparent reason for concern as long as American corporations were profitable and growing.

The 1970s began a new era. That was a time when legal and social developments threatened the security of managers and directors.[10] Corporate governance, and particularly the role of the board, was on everybody's agenda.[11]

The combination of events that contributed to the atmosphere of crisis was both economic and political. Without the economic problems of that era, political issues would have received little attention. Without the political issues, board reform might not have been as readily embraced by corporate America.

[9] A more in-depth analysis of these reforms is discussed in Mitchell, *Corporate Irresponsibility*, pp. 157–61, 162–3, and 203–4.

[10] Roberta S. Karmel, 'The Independent Corporate Board: A Means to What End?', *George Washington Law Review* 52 (1984), 534, 539; Bryan F. Smith, 'Corporate Governance: A Director's View', *University of Miami Law Review* 37 (1983), 273, 276.

[11] Marshall L. Small, 'The Evolving Role of the Director in Corporate Governance', *Hastings Law Journal* 30 (1979), 1353; Melvin A. Eisenberg, 'The Modernization of Corporate Law: An Essay for Bill Cary', *University of Miami Law Review* 37 (1983), 187, 209–10.

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The economic problems were dramatic. By the early 1970s, many corporations created during the conglomeration movement of the 1960s were beginning to falter, and the stock market reacted accordingly.[12] The multiplication of businesses in the new conglomerates created significant conflicts of interest for directors, and the overwhelming complexity of disparate and worldwide businesses made meaningful board governance all but impossible.[13] The impregnable Pennsylvania Railroad, once the nation's largest corporation, and itself a giant conglomerate, had gone bankrupt after merging with the New York Central without ever missing a dividend, and with this came a Securities and Exchange Commission (SEC) investigation into its causes, numerous suits against directors and the development of the securities class action.[14] A number of other bankruptcies and severe financial losses, brought on in part by recession, occurred, and with them the resignations or firings of some prominent Chief executive officers (CEOs). Chrysler was in need of its eventual federal bailout, and even New York City faced bankruptcy.[15] An activist SEC, aided by the Second Circuit, had a string of successes in its attempt to make the securities laws into a body of federal corporate law with far more teeth than state law had presented.[16]

The economic mess provided an environment in which real and perceived abuses of corporate power received wide attention. The Watergate investigation's revelation of illegal corporate campaign contributions, followed by the SEC's discovery of corporate domestic and foreign bribery,

[12] Nader, Green and Seligman describe 1975 as 'a year of reckoning for a dozen major conglomerates'; Ralph Nader, Mark Green and Joel Seligman, *Taming the Giant Corporation* (New York: Norton & Company, 1976), p. 78.

[13] Richard J. Farrell and Robert W. Murphy, 'Comments on the Theme: Why Should Anyone Want to Be A Director?', *Business Law* 27 (1972), 7.

[14] *SEC Staff Study of the Financial Collapse of the Penn Central Co. – Summary* (1972–1973 Transfer Binder), Fed. Sec. L. Rep. (CCH) Par. 78,931 (1972). Numerous lawsuits resulted from the collapse of Penn Central, e.g. *In re Penn Central Transport* Co., 484 F 2d 1300 (3d Cir. 1973); *In re Penn Central Transport* Co., 452 F 2d 1107 (3d Cir. 1971); *SEC* v. *Penn Central Co.*, Fed. Sec. L. Rep. P 94, 527 (E. D. Pa. 2 May 1974). The securities class action first became a practical remedy for shareholders after 1966. J. Vernon Patrick, Jr, 'The Securities Class Action for Damages Comes of Age (1966–1974)', *Business Law* 29 (1974), 159.

[15] Senator William Proxmire, 'Quote, In Quotes', *New York Times*, 25 September 1988.

[16] *Escott* v. *BarChris Construction Corp.*, 283 F Supp. 643 (*SDNY* 1968). See also *Gould* v. *American–Hawaiian SS Co.*, 535 F 2d 761 (3rd Cir. 1976). *Securities and Exchange Commission* v. *Texas Gulf Sulphur*, 446 F 2d 1301 (2d Cir. 1971), *cert. den.* 404 *US* 1005 (1972).

A history of the SEC's attempts to federalise corporate law is told in Roberta S. Karmel, 'Realizing the Dream of William O. Douglas: The Securities and Exchange Commission Takes Charge of Corporate Governance', *Delaware Journal of Corporate Law* 30 (2005), 79.

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diminished confidence in the integrity of corporate America and brought forth calls for reform.[17] Corporations' roles in providing material for the Vietnam War, like Dow's manufacture of napalm, opened another avenue of political attack. American corporations were praised for their efforts in ensuring victory in the century's major wars.[18] But those were popular wars and Vietnam was different. Industrial contributions to the military effort in a wildly unpopular war were not publicly separated from the political aspects of the war itself.[19] And the civil rights movement of the preceding decade unleashed criticisms of the large corporations' contributions to economic inequality and workplace injustice.[20] Shareholder proposals by activist groups advocating a variety of social causes were being thrust on corporations and litigated in court.[21]

These events not only created the atmosphere for reform, but they also suggested a particular type of reform. Outside directors had, by the early 1970s, come to constitute the majority of directors on most corporate boards. While outside directors first became a popular way of helping boards to insulate themselves from liability for conflict of interest transactions, they were now beginning to be envisioned as a way of ensuring responsibility to different corporate stakeholders.[22] Moreover, Congress itself was investigating the structure of corporate law with particular attention to the social purpose of the corporation and the role of the shareholder. This necessarily implicated questions of the role and function of the board and its responsibility for economic and social problems.[23] In

[17] The story is well-told in Joel Seligman, 'A Sheep in Wolf's Clothing: The American Law Institute Principles of Corporate Governance Project', *George Washington Law Review* 55, 2 (1987), 325, 333–6; Securities and Exchange Commission, *Report on Questionable and Illegal Corporate Payments and Practices* (1976). Karmel gives a less sympathetic account of the era; see Karmel, 'Realizing the Dream of William O. Douglas', 86–90.

[18] See George Wald, 'Corporate Responsibility for War Crimes', *New York Review of Books*, 2 July 1970, 4.

[19] *ibid.*

[20] Suits were brought against corporation under the Civil Rights Act of 1964 alleging racial discrimination in hiring and promotion practices, such as *Claiborne* v. *Ill. C. R.R.*, 583 F 2d 143 and *Marks* v. *Prattco, Inc.*, 607 F 2d 1153 (disapproved of in 1982 by *Knight* v. *Bogalusa*, 673 F 2d 759). These legal challenges to unjust corporate practices spurred feminist activists to launch similar suits opposing corporations' sex discrimination. See *Zambuto* v. *American Telephone and Telegraph Co.*, 544 F 2d 1333.

[21] E.g., *Medical Committee for Human Rights* v. Securities and Exchange Commission 432 F 2d 659 (1970).

[22] Victor Brudney, 'Panel Discussion', *University of Miami Law Review* 37 (1983), 319, 321.

[23] Hearings on Corporate Rights and Responsibilities Before the Senate Committee on Commerce, 94th Congress, 2nd Sess. (1976); The Role of the Shareholder in the Corporate World: Hearings Before the Subcommittee On Citizens and Shareholder Rights and Remedies of the Senate Committee On the Judiciary, 95th Congress, 1st Sess. (1977).

1971, Myles Mace published his famous study demonstrating the almost complete passivity of corporate boards.[24] All of these developments put increasing pressure on boards to figure out how to avoid liability. Despite the broad acknowledgement that outside directors could be of some benefit, questions arose as to what the specific function of the outsiders was to be.[25] The first question that had to be asked was, what was the board as a whole expected to do?

Thus, board reform became an important subject of discussion for the first time in American history.[26] But, as Mel Eisenberg pointed out, most reform proposals began with 'the received legal model of the board', that is, the board as manager.[27] And the variety of proposals demonstrates that this idea of board as manager retained a strong hold on the legal imagination, as Eisenberg classifies them into 'those calling for professional directors; those calling for full-time directors; and those calling for fully-staffed boards'.[28]

II. Board reform and the start of modern corporate social responsibility

While originating in an atmosphere of economic crisis, the move to board reform was also an attempt to break managerial control of American corporations in order to ensure their greater political and social accountability. Perhaps the high point of the drive for social reform through board reform is Nader, Green, and Seligman's 1976 book, *Taming the Giant*

[24] Myles Mace, Directors, *Myth and Reality* (Boston: Division of Research, Graduate School of Business Administration, Haward University, 1971).

[25] Cyril Moscow, 'The Independent Director', *Business Law* 28 (1972), 9; Noyes E. Leech and Robert H. Mundheim, 'The Outside Director of the Publicly Held Corporation', *Business Law* 31 (1976), 1799. It was this increase (or recognition of the increase) in the number of outside directors that led the Committee on Corporate Laws to amend section 35 of the Model Business Corporation Act in 1974 to move to a monitoring model of the board. Committee on Corporate Laws of the Section of Corporation, Banking, and Business Law of the American Bar Association, Model Business Corporation Act (with revisions through 1974) 143 (1974). By 1973, according to data published by the Conference Board and the American Society of Corporate Secretaries, 77 per cent of 855 corporations surveyed had a majority of outside directors considering former or retired employees as such, and 62 per cent considering them as management directors. By 1977, the data were 84 per cent and 66 per cent (*Guidebook*, Appendix C).

[26] Indeed Brudney, who observed in 1982 that 'Lawyers, both academic and practicing, have long been concerned with the function of the board' cites literature almost exclusively from the 1970s to support his claim. Brudney, 'Panel Discussion', 603.

[27] Eisenberg, 'The Modernization of Corporate Law', 187, 209–10. [28] *ibid.*, 149.

Corporation.[29] *Taming the Giant Corporation* captured the deep fear of insulated corporate power that characterised the social moment.[30] The authors shaped their reform suggestions to reflect the extent of corporate power by describing a board composed of representatives from all corporate constituencies and working in the overall public interest.[31] Breaking corporate power over the powerless, or at least redirecting that power to help the powerless, was their goal. Management uncontrolled was management running the country. And management operating in its own interest and that of capital, protected by plutocratic boards, created a particularly worrisome vision of American society.[32]

In the end, the board was reformed. But the shape of reform was not political. It did not result in stakeholder directors or labour representatives or the imposition of environmental and other responsibilities on the board. It did not result in a new vision of the role and purpose of the corporation in modern society. Reform was, instead, highly conservative. While it appeared to respond to concerns about concentrated and unassailable managerial power, reform was structural and internal in a way that could only indirectly be responsive to political concerns.[33] And it was reform embraced by corporate America precisely because it was reform that restructured the board in a way that would protect the board and management from liability.[34] Among the ways it did this was to sharpen the board's focus on the shareholders.[35]

III. The development of the monitoring board

At the height of the 1970s social and economic agitation, Mel Eisenberg published *The Structure of the Corporation*, based on a series of scholarly

[29] Christopher Stone, *Where the Law Ends*: *The Social Control of Corporate Behavior* (New York: Harper & Row, 1975), while not as focused on governance, is another important contribution to the reform literature of the era.

[30] Nader, et al., *Taming the Giant Corporation*, pp. 76–7, quoting Anthony Sampson.

[31] *ibid*., pp. 120–2. For a more moderate exploration of the social responsibilities of business and a description of a board model to accompany it, see William R. Dill (ed.), *Corporate Governance in America:* Fifty-fourth American Assembly, 13–16 April 1978, Arden House, Harriman, New York.

[32] *ibid*., p. 76.

[33] John C. Coffee, Jr, 'Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response', *Virginia Law Review* 63 (1977), 1099, 1111–12.

[34] Marcel Kahan, 'The Limited Significance of Norms for Corporate Governance', *University of Pennsylvania Law Review* 149 (2001), 1869, 1880.

[35] Margaret M. Blair, 'Reforming Corporate Governance: What History Can Teach Us', *Berkeley Business Law Journal* 1 (2004), 1, 28–31.

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articles he had been writing since the late 1960s. Eisenberg presented the first coherent description and defence of the monitoring board as the appropriate description of the board's function,[36] and *The Structure of the Corporation* became the blueprint for board reform.

Eisenberg studied each of the various possible roles of the board and the structural models that accompanied them – professional directors, full-time directors and fully staffed boards. By a process of elimination, he concluded that the board was, for reasons of time, resources and other practicalities, incapable of performing any of the functions attributed to it by these different models.[37] All that the board could do practically was to hire and fire the chief executive and monitor his performance.[38] These are the functions he targeted for reform by describing a new model of oversight boards with adequate information to perform their tasks. In other words, having eliminated all other possible functions of the board, Eisenberg was left with the monitoring model.[39]

Eisenberg does note that the board is the only corporate organ that can perform the monitoring function (with a similar observation made roughly contemporaneously in financial economics by Jensen and Meckling).[40] Thus, there is a strong normative component to the monitoring model.[41] Monitoring might be all the board could do, but if it was a necessary corporate function and the board was uniquely equipped to perform it, then the board ought to do it.

In order for the monitoring board to work as the reform that Eisenberg planned, the board needed the kind of true independence from management that would provide for serious monitoring. Thus he concludes with a normative recommendation. Legal rules must, 'to the extent possible: (1) make the board independent of the executives whose performance is being monitored; and (2) assure a flow of, or at least a capability for acquiring, adequate and objective information on the executives'

[36] M. Eisenberg, *The Structure of the Corporation: A Legal Analysis* (Boston: Little, Brown, 1976). Eisenberg based the book on an earlier set of law review articles including 'Legal Models of Management Structure in the Modern Corporation: Officers, Directors, and Accountants', *California Law Review* 63 (1975), 375. Harvey Goldschmid had also described the monitoring board in a speech given in 1973. Harvey J. Goldschmid, 'The Greening of the Board Room: Reflections on Corporate Responsibility', *Columbia Journal of Law and Social Problems* 10 (1973), 17, 24–5.

[37] Eisenberg, The Structure of the Corporation, pp. 156–70.

[38] *ibid.*, pp. 147–8. [39] *ibid.*, p. 170.

[40] Michael C. Jensen and William H. Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure', *Journal of Financial Economics* 3 (1976), 305; see also Eugene Fama, 'Agency Problems and the Theory of the Firm', *Journal of Political Economics* 88 (1980), 288.

[41] Eisenberg, *The Structure of the Corporation*, pp. 316–20.

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performance'.[42] Had Eisenberg's suggestions been fully adopted, with a substantially independent and adequately informed board, the monitoring board might well have developed with a meaningful function, broad perspective and substantial discretion.[43] Instead, businesses and their lawyers hijacked the model, embracing its structure without its substance. They turned it into a shell of what Eisenberg had imagined – and a very protective shell at that.[44] Eisenberg's reform effort was sandbagged by America's corporate bar during the 1980s when the model received its only real chance for implementation, in the American Law Institute (ALI) *Principles of Corporate Governance*.

IV. The monitoring board as liability shield

Three highly influential groups embraced the monitoring model in different ways and with different emphases in the late 1970s. But despite their differences, the American Bar Association (ABA), the Conference Board and the Business Roundtable all understood how the structure of the monitoring model could be used to protect directors from serious threats of legal liability. And part of that protection was to emphasise the board's focus on shareholders.

V. The American Bar Association's contribution – the Corporate Director's Guidebook: 1978 to 2004

Board reform didn't take the political direction reformers like Nader hoped for. But their agitation, along with the congressional investigation and other events I have described above, did create real concern in corporate boardrooms. The atmosphere created the possibility of new regulation. The fear this engendered in corporate boardrooms led business to organise pre-emptive strikes, launched in particular by three major organisations; the ABA, the Conference Board and the Business Roundtable. Each of these organisations embraced some form of the monitoring board and aimed its focus on the shareholders.

The ABA's publication of the first *Corporate Director's Guidebook* in 1976,[45] with the revised edition published in 1978,[46] was a major salvo

[42] *ibid.*
[43] American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations* (American Law Institute Publishers, 1994).
[44] Kahan, 'The Limited Significance of Norms', 1879–80.
[45] ABA, 'Corporate Director's Guidebook', *Business Law* 32 (1976), 5.
[46] 'Corporate Director's Guidebook', *Business Law* 33 (1978), 1595.

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and placed the ABA's imprimatur on the monitoring board aimed at shareholders as the best board model.

It is clear in the 1978 edition that the *Guidebook* was in large part a response to directorial fears of liability. The Introduction notes that: 'As a general observation, it is believed that directors who act within the framework of conduct outlined in this *Guidebook* will not only be performing their directorial functions competently, but will also be reducing the risk of being charged with deficient individual performance as a director.'[47] The *Guidebook* was a guide to avoiding liability. The ABA was attempting to use its powerful influence to create a safe harbour for directorial behaviour.[48] And that safe harbour was the monitoring board and its relatively light directorial responsibilities.

Among its many functions, the *Guidebook* took upon itself the task of presenting a 'proposed model' for corporate governance, taking account of 'current concerns in areas of public policy and emerging trends of corporate governance'.[49] Even a casual reading of the *Guidebook* makes it clear beyond question that the monitoring model is the model it endorses.[50] Directors are to 'review and confirm basic corporate objectives', as well as select and monitor the CEO and senior management.

As I noted earlier, the monitoring model by itself might well have been harmless and perhaps even an improvement in corporate governance. But the monitoring model described by the *Guidebook* had significant implications for the subsequent development of American corporate capitalism and corporate behaviour, implications contained and reflected in its single focus. That focus also made it abundantly clear that the ABA was rejecting the political and social reform that was a large part of public concern:

[47] *ibid*., 1597. [48] *ibid*.

[49] There never was, nor is there, any model of the board prescribed by statute. To the extent the law prescribes a model of the board it can be inferred from the duty of care. Brudney, in 1982, noted that 'courts have not yet formally addressed the distinction between a duty to manage and a duty to monitor in assessing whether the common law duty of care has been met' (Brudney, 'Panel Discussion', 632). One could argue that the Delaware Supreme Court's opinion in *Graham* v. *Allis-Chalmers*, 188 A 2d 125 (1963), while it long antedated the concept of the monitoring board, did just that. Certainly it has been argued that Chancellor Allen's opinion *In re Caremark International Inc. Derivative Litigation*, 698 A 2d 959 (1996), has the potential to establish a duty to monitor, at least in terms of requiring effective information systems in a corporation operating within a regulated industry. This requirement appears in almost all of the descriptions of the monitoring board.

[50] David Ruder, 'Panel Discussion', *University of Miami Law Review* 37 (1983), 336 ('I was on the committee that drafted the Corporate Director's Guidebook, and I agree with you that the monitoring model was part of the Corporate Director's Guidebook').

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> It is important to emphasize that the role of the director is to monitor, in an environment of loyal but independent oversight, the conduct of the business and affairs of the corporation on behalf of those who invest in the corporation. The director should not be perceived as, or perceive himself as, a representative of any other constituency, either private or public. Were the role of any director – whether management or non-management – to be otherwise, profound changes would be required in defining the director's rights and obligations in a variety of contexts.[51]

And there it all is. The monitoring model was the ideal. And the social role of the corporation was clear. Shareholders, and shareholders alone, were to be the objects of directors' concern.[52]

The 1994 edition of the *Guidebook* acknowledges that 'a lot has happened and continues to happen, in the corporate governance world since 1978', justifying a revision of the *Guidebook*.[53] But while the takeover decade had passed, the ALI had adopted its *Principles of Corporate Governance*, institutional investors were beginning to arise from their slumber, and the savings and loan crisis and insider trading scandals of the 1980s were history, the ABA found itself in a position to declare victory in the revised edition. No longer was it modest about its adoption of the monitoring board.

> We deleted the 'proposed model' of the board of a publicly held corporation for two reasons: first, much of this material is now found in the discussion of the structure of the board and its committees; and second, developments in applicable law have removed much of the need for the tentativeness reflected in the concept of a model.[54]

The monitoring board was an accomplished fact. Its shareholder focus was assumed, and the Delaware courts had done their best to reinforce that focus in cases like *Revlon* v. *MacAndrews & Forbes*.[55]

[51] Guidebook, 1621.
[52] While the phrase 'those who invest in the corporation' as the sole constituent is ambiguous, it clearly contemplates shareholders. While it is possible that the language could include creditors, that interpretation is improbable given the modern position of creditors in corporate law.
[53] 'Corporate Director's Guidebook, 1994 Edition', *Business Law* 49 (1994), 1247.
[54] *ibid.*, 1248.
[55] *Revlon, Inc.* v. *MacAndrews & Forbes Holdings, Inc.*, 506 A 2d 173 (Delaware Supreme Court, 1986).

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Although there was a 2001 revision of the *Guidebook*, the final interesting ABA document is the *Guidebook* revision of 2004.[56] The reason for revision was obvious:

> Since the publication of the third edition, the stunning failures of several prominent US corporations, and the disclosure of abuses of office by some of their senior executives, have led to widespread public concerns about the role and responsibilities of corporate directors . . . The public belief that good corporate governance could have prevented these corporate failures has resulted in a new reality in which corporations perceived not to have good corporate governance will be penalized in the marketplace.[57]

Left unsaid, of course, was that in this new era, penalisation in the marketplace also meant penalisation in the boardroom and the executive suite. The director-protective monitoring board needed some reconsideration.

What was that reconsideration? Not much, except for a strikingly clearer definition of the director's role: 'As a general matter, a business corporation's core objective in conducting its business activities is to create and increase shareholder value.'[58] And monitoring was still the mode of behaviour.[59]

Thus, the monitoring model proposed and refined by the ABA, begun in a climate of political agitation and directorial fear, and most recently revised in a similar climate, specifies relatively minimal duties for directors which, if minimally performed, will allow them to avoid liability.[60] Reform agitation which would recast the board in a way that would make its social responsibilities commensurate with its social power led instead to an increasingly narrow focus on shareholders, at least in part in order to restrict the scope of directorial accountability and liability.[61] In the years between the adoption of the 1978 model up to and including the present, this monitoring board has performed its protective function admirably well and its shareholder-centric nature has continued to dominate.

The history and development of the *Guidebook* is revealing. But there were other significant discussions surrounding the new monitoring model and its focus. The Conference Board and The Business Roundtable endorsed it in the late 1970s, and for the same reason – fear.[62] Again,

[56] 'Corporate Director's Guidebook, Fourth Edition', *Business Law* 59 (2004), 1057, 1058.
[57] *ibid.*, 1060. [58] *ibid.*, 1063. [59] *ibid.*, 1064. [60] Guidebook, 27–9.
[61] *ibid.*, 27. [62] *ibid.*, 27–9.

their reasons for favouring the monitoring board seem clearly aimed at liability protection.[63]

The Conference Board had long paid attention to boards, but its modern contribution began in 1967 with its publication of *Corporate Directorship Practices*.[64] The Conference Board reported that by 1953 a majority of manufacturing companies had a majority of outside directors, growing to 63 per cent by the time of the Report. Nonetheless, the function of these directors – as, indeed, the function of all directors – remained a question. It was clear on one level that the function of outside directors was to sanitise conflict of interest transactions.[65] But, beyond that, they had no particular purpose other than to ratify management's decisions. What else they might do, if anything, was uncertain.[66]

The Report directly confronts the issue, noting that 'it is difficult, if not impossible, to delineate with precision the boundaries between the functions of the board of directors and those of corporate management'.[67] As a general matter, the Report describes the board's appropriate role as a cross between an advisory board and a monitoring board.[68]

By 1975, in a very different atmosphere, the Conference Board had revisited and modified its views. Interestingly, the Report begins not with the question of what the board should do, but to whom it is accountable, and that, unsurprisingly, is the shareholders.[69] This question, it states, is a necessary precondition to determining the board's role, and it is one we

[63] Sandra K. Miller, 'What Remedies Should Be Made Available to the Dissatisfied Participant in a Limited Liability Company', *American University Law Review* 44 (1994–95), 465, 495.

[64] National Industrial Conference Board and American Society of Corporate Secretaries, *Corporate Directorship Practices: Studies in Business Policy* No. 125 (1967).

[65] Lucian Ayre Bebchuk and Jesse M. Fried, 'Executive Compensation as an Agency Problem', *The Journal of Economic Perspectives* Summer (2003), 77.

[66] The reality of outsider dominated boards by the 1970s suggests that the outpouring of conversation about outside directors was more about their purpose than their need, although it is fair to say that there was considerable debate about their appropriate identity and the definition of outside directors.

[67] National Industrial Conference Board, *Corporate Directorship Practices*, p. 96.

[68] *ibid.*, p. 93.

[69] *ibid.* The report describes the legal duties of the board as 'to manage the company in the interests of the stockholders' (p. 109), at the same time that it acknowledges that directors 'have a responsibility to the company's employees, its customers, and to the general public, upon whose good will the well-being of the corporation depends. Failure to take cognizance of the responsibility to each of these four groups [including stockholders] can adversely affect the solvency of the corporation' (p. 93). There is little question of the stockholder-centric nature of this position, but it expresses that attitude in a way that, taken seriously, is not far from the position I advocate in this paper. The subsequent history of the development of stockholder valuism seriously has distorted this possibility.

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have seen the ABA answer in the *Guidebook*, although rather more indirectly. The Report describes some sort of a monitoring board, although not quite as pure a one as Eisenberg's model, as its description leaves some significant managerial powers in the board itself.[70] For example, strategic planning remains a significant function of the board, a function that still rings of the board's managerial role that was in the process of being phased out.[71] Nonetheless, the Report can be seen as a serious attempt at giving greater specificity to the role of the board at a time when directors felt as if they were coming under increasing legal attack.

The Business Roundtable also provided its own significant endorsement of the monitoring board. Like the Conference Board and the ABA, the Business Roundtable began its own statement in fear.[72] 'Some unfortunate developments of the last few years have caused the U.S. business community to reexamine intensively board operations and procedures as well as board composition.'[73] The same liability environment that had prompted the ABA and the Conference Board to act also motivated the Business Roundtable.

It was motivated by fear, but adopted a tone of defiance. The *Statement* begins with a defence of the role of American business in our democracy. In a note on 'Corporate Legitimacy and Corporate Power', it states: 'We think it incontestable that the U.S. system has led to greater political freedom, to better economic performance, and to more personal autonomy, than any other actual – as distinct from idealized – system with which it might be compared.'[74] Defending its members further, it briefly summarises the regulatory and competitive environments in which American corporations operated, noting the restraints they imposed on excessive or antisocial behaviour. While the Business Roundtable understood the legitimating effect these restraints created, it was not with unqualified enthusiasm: 'We enumerate all these legal, regulatory and political constraints on U.S. business organizations with some mixed emotions because a number of them impose excessive and unnecessary costs – costs borne ultimately by the consuming public.'[75] Having asserted its own primacy and exculpation, having tied its own victimisation to that of the American public, it was ready for a substantive discussion of board reform.

That discussion was both more philosophical and considerably more defensive than the statements of the ABA and the Conference Board. Its

70 *ibid.*, pp. 108–9. 71 *ibid.*, pp. 94–5.
72 The Business Roundtable, 'Statement on the Role and Composition of the Board of Directors of the Large Publicly Owned Corporation', *Business Law* 33 (1978), 2083.
73 *ibid.*, 2087. 74 *ibid.*, 2089. 75 *ibid.*, 2091.

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general thrust was less one of board reform than of corporate legitimacy, defending the corporate enterprise in the atmosphere of legal and social onslaught that characterised the decade. Instead of defining the board's role in terms of what the directors were to do – although it did that as well – it defined the board's role in terms of who it was to serve. And to that question the answer was the same as the ABA's and the Conference Board's – the shareholders. It was this role that legitimated corporate management. The Business Roundtable's approach to protecting directors from increasing liability was to accept the inevitability of the monitoring board but to make sure that the focus of that board was crystal clear, thus also accomplishing the purpose of limiting the scope of director behaviour and thus liability.

Most important for my purposes, the Report also described the board's role in maintaining the corporation's 'social responsibility'. This was the board function perhaps most in keeping with the Business Roundtable's view of the board as legitimating corporate management. But that responsibility was narrow. Long-term profit maximisation that might indirectly benefit other constituents was legitimate, but the interests of the stockholders (and, interestingly, the employees) were first and foremost.[76] While this long-term approach could well be good for business, the Report cautioned, 'other groups affected by corporate activities cannot be placed on a plane with owners', shareholder proposals under Rule 14a-8 should be limited to business, and 'many of the social causes pursued by activist groups represent minority views rather than a prevailing consensus'.[77] More than the two other organisations, the Business Roundtable articulated a vision of corporate social responsibility in keeping with the view I present here, but its emphasis on the stockholders rather than the corporation itself helped to privilege the development of shareholder primacy.

The Business Roundtable bowed to the inevitability of outside directors, noting both the importance of experienced business people on boards and the significant diversification of board membership it had perceived to have already taken place. At the same time, it resoundingly rejected the idea of constituency directors or co-determination, perhaps with the recent publication of *Taming the Giant Corporation* in mind.[78]

Thus, the 1970s ended with substantial convergence by academics, lawyers and business people on a stockholder-centric version of the

[76] Mark J. Roe, 'Political Preconditions to Separating Ownership from Corporate Control', *Stanford Law Review* 53 (2000), 539, 542.
[77] *ibid.*, 2100. [78] *ibid.*, 2105–6.

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monitoring model as the dominant vision of board function. That happy state of agreement was about to be blown apart in the 1980s. The political and social atmosphere had rapidly changed and the chance for meaningful corporate reform evaporated. The Supreme Court decision in *Santa Fe* v. *Green*[79] and the election of Ronald Reagan in 1980 significantly diminished the immediate range of political possibilities.[80] It was in this new environment that the American Law Institute was to introduce its version of the monitoring board.

The *American Law Institute Principles of Corporate Governance* (the *Principles* or 'the project') did as much as anything to cement the monitoring board as the dominant model of board governance. But it did not do so until the controversy surrounding the *Principles* almost destroyed the monitoring board and, in the process, did destroy any notion that the monitoring board's visions should extend beyond shareholders. The ABA, the Conference Board and the Business Roundtable collectively did a *volte face* from their position in the 1970s to attack the very model they had unanimously promoted.

There were a number of reasons for the retreat, the most significant of which revolved around the *Principles*' attempt to define and specify the directors' duty of a care in a way that neither courts nor legislatures had previously done. Moreover, while corporate groups had been willing to accept reform proposals during the agitation of the 1970s, the atmosphere following Reagan's election in 1980 was different: 'The ALI project was the only significant corporate governance initiative with any reform component remaining.'[81] With real pressure for reform out of the way, all criticism was focused on the one viable reform proposal, no matter how pallid.[82]

Also significant was the fact that the neo-classical, free-market model of the corporation had been developing and was now reaching maturity.[83] A

[79] *Sante Fe Industries, Inc.* v. *Green*, 430 US 462 (1977).

[80] By the time of publication of Elliott Weiss's 'Social Regulation of Business Activity: Reforming the Corporate Governance System to Resolve an Institutional Impasse', (*UCLA Law Review* 28 (1981), 343), the chances for political reform had more or less passed. Ronald Reagan had been elected president and the next decade for corporate law was to be centered on the work of lawyers employing the tools of neo-classical economics to make the case for a corporation more strongly grounded in the sanctity of private property. Jensen and Meckling's work had begun to have its influence; the new scripture for this movement was Frank Easterbrook and Daniel Fischel, *The Economic Structure of Corporate Law* (Cambridge, MA: Harvard University Press, 1991), p. 9.

[81] Seligman, 'A Sheep in Wolf's Clothing', 325, 359. [82] *ibid.*

[83] Easterbrook and Fischel, *The Economic Structure of Corporate Law*, p. 9; Fama, 'Agency Problems', 288; Jensen and Meckling, 'Theory of the Firm'.

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vision of the corporation, restrained in its behaviour principally by market mechanisms and able to operate with a freedom that would not be possible when constrained by law, had to be very attractive to business people. Moreover, the model itself led, almost inexorably, to the shareholders as the appropriate focus of the board's attention.[84] The evidence suggests that business groups had a keen awareness of this relatively new scholarship.[85] *Any* specification of director's functions or duties would have restricted this freedom. And now economics seemed to prove that any concern with stakeholders was misplaced.

The *Principles* also famously opened the way to a broader set of board concerns, as set forth in its famous section, 2.01. Although viewed in some quarters as radical, 2.01, with its direction to the board to focus on both the shareholder and the corporation itself, was rather conservative, harking back to the case that is mistakenly taken as the urtext on shareholder primacy, *Dodge* v. *Ford Motor Co.*[86] In light of the shareholder primacy doctrine articulated by the ABA, the Conference Board and the Business Roundtable in the 1970s, not to mention the new, neo-classical arguments for shareholder-centrism, section 2.01 nonetheless sounded like significant reform of the type called for by Nader. But the trouncing administered to the *Principles* by business and the bar led its authors to secure its passage at the expense of meaningful reform. The surrender is reflected in a comment to section 3.02 that first appears in *Tentative Draft 11*, published in 1991 and embodying the first significant changes to section 3.02 (which changes survive in the adopted *Principles*):

> Section 3.02 is intended as a statement of the rules that a court would adopt, giving full weight to all of the considerations (including the judicial precedents) that the courts deem it appropriate to weigh. Section 3.02 is not intended . . . to enlarge the scope of a director's legal obligations and liability, the performance expected from directors to comply with the duty of care, or the role and accountability of directors concerning the corporation's compliance with law.[87]

[84] Dalia Tsuk Mitchell, 'Shareholders As Proxies: The Contours of Shareholder Democracy', *Washington and Lee Law Review*, 63, 4, (2006) 1503; Dalia Tsuk Mitchell, 'From Pluralism to Individualism: Berle and Means and 20th Century American Legal Thought', *Law and Social Inquiry* 30 (2005), 179.

[85] Seligman, 'A Sheep in Wolf's Clothing', 346–9; The Business Roundtable, 'Statement on the Role and Composition of the Board of Directors', 24, 29.

[86] 170 NW 668 (Mich. 1919).

[87] American Law Institute, Principles of Corporate Governance and Structure: Analysis and Recommendations, Tentative Draft No. 11, 110–11 (Philadelphia: American Law Institute Publishers, 1991).

Section 3.02 was intended to clarify, not expand. It wasn't about reform at all. There was no need for anybody to be upset.

The new economic model of the firm, embraced by legal scholars and remodelled on a set of assumptions that gave rise to a strong statement of shareholder primacy, also made a significant contribution to cementing that model as dominant in American corporate capitalism.[88] The Delaware courts have firmly embraced the monitoring model in this minimalist form.[89]

VI. The broader context

While I have so far broadly described the historical context in which the monitoring model arose and the way in which it developed, the period of its refinement and growth was also an era in which social, economic and financial forces developed together to cement shareholder valuism – and a particularly short-term concept of shareholder valuism at that – as the dominant corporate norm. The 1980 election of Ronald Reagan as President of the United States marked a sharp break with the era of political and social turmoil that began with the Civil Rights movement in the early 1960s, worked its way through the Vietnam War, and ended in America's humiliation in the Iranian revolution.[90] It began an era of looking inward, of looking to new prosperity, of looking to ourselves as the constituency to serve.[91] Reviving a long-dead version of *laissez-faire* social thought, a version that had not been embraced by serious thinkers since the 1880s,[92] the American leadership preached a vision that by looking to maximise your own well-being, your own wealth, you not only would be serving yourself but would be creating more wealth for society as well.[93] The rebirth of an also long-dormant, crabbed form of neo-classical economics in financial and legal scholarship, educated

[88] Easterbrook and Fischel, *The Economic Structure of Corporate Law*, pp. 80–1.

[89] Lawrence E. Mitchell, *The Trouble with Boards*, The George Washington University Law School Public Law and Legal Theory Working Paper No. 159 (2005), available at ssrn.com/abstract = 801308.

[90] Philip G. Altbach and Robert Cohen, 'American Student Activism: The Post-Sixties Transformation', *The Journal of Higher Education* January (1990), 33–4.

[91] Leo P. Ribuffo, 'The Burdens of Contemporary History', *American Quarterly* Spring (1983), 11.

[92] Lawrence E. Mitchell, *The Speculation Economy: How Finance Triumphed Over Industry* (San Francisco: Berrett-Koehler, 2007 (forthcoming)).

[93] Graef S. Crystal, *In Search of Excess: The Overcompensation of American Executives* (New York: W. W. Norton, 1991), p. 42.

policy-makers and investors in the new creed.[94] Business leaders were among the last to embrace this notion, which for them meant looking only to the narrow interests of their shareholders – but economic events conspired to pressure them to accede.

The hostile takeover boom of the 1980s is too well known to sustain repetition. The important point to take from that era is that shareholders suddenly found themselves able to maximise the value of their investments in the short term, rather than having to invest and wait for the long term, through the medium of substantial premiums paid by bidders for their stock.[95] While there undoubtedly was some rationalisation of business after the failed conglomerate movement of the 1960s in the form of bust-up takeovers, it is more or less generally recognised that the imperative for the takeover movement was financial, not efficiency-oriented, at least if efficiency is considered to be managing the business for the long term.[96]

The potential of hostile takeovers did exert significant pressure on corporate management.[97] Corporations with share prices that lagged behind market expectations were prime takeover candidates.[98] The logical solution was clear; make sure stock prices rose. Thus the push toward short-term shareholder valuism began.

But that wasn't all. The 1980s were the growth spurt of institutional investors.[99] By the early 1990s, scholars, policy-makers and reformers were all calling for institutional investors to band together and play the active role in corporate governance that the widely dispersed shareholdings of small investors characterised by the Berle-Means corporation denied. Surely, it was argued, institutions largely had the same interests as other

[94] Ribuffo, 'The Burdens of Contemporary History', 11.

[95] Martin Lipton and Steven A. Rosenblum, 'A New System of Corporate Governance: The Quinquennial Election of Directors', *University of Chicago Law Review* 58 (1991), 187, 189.

[96] Sanjai Bhagat, Andrei Shleifer, Robert W. Vishny, Gregg Jarrel and Lawrence Summers, 'Hostile Takeovers in the 1980s: The Return to Corporate Specialization, Brookings paper on Economic Activity', *Microeconomics* (1990), 3–4.

[97] Stephen M. Bainbridge, *Corporation Law and Economics* (New York: Foundation Press, 2002), p. 228.

[98] Bengt Holmström and Steven N. Kaplan, 'Corporate Governance and Merger Activity in the United States: Making Sense of the 1980s and 1990s', *The Journal of Economic Perspectives* Spring (2001), 121.

[99] Michael Bradley, Cindy Schipani, Anant Sundaram and James Walsh, 'The Purposes and Accountability of the Corporation in Contemporary Society: Corporate Governance at a Crossroads', *Law and Contemporary Problems* 62, 3 (1999), 18.

shareholders, and any pressure that they could bring to bear on corporate management could only be for the good?[100]

The problem is that institutions had their own short-term pressures. In particular, their compensation systems were structured in a manner that rewarded fund managers for their quarterly performance. If the institutions – or those who managed them – were to use their power for anything, the natural financial incentive would be for them to use their power to increase their own compensation. And so they did.[101] While some reformers saw institutional activism as potentially producing better boards of directors and more responsible corporate governance, and others looked to institutions to pursue social responsibility concerns, the reality, from then until now, has been that institutions use their influence almost always in the service of short-term shareholder profit.[102] Proposals to eliminate classified boards, lift poison pills and otherwise make corporations more takeover-friendly were aimed at precisely this end.[103] And this was as true if the pressure came from the pension funds of the AFL–CIO[104] or TIAA–CREF[105] as if it came from mutual funds. Institutions harnessed their power in the pursuit of short-term profit, and it is in that pursuit they largely continue today.[106]

Compensation further became an issue in executive suites. In 1993, Congress prohibited corporations from deducting more than $1 million in cash compensation for any single employee.[107] The desired response was swift. Boards now began to compensate executives, and often themselves, in stock options, more often than not unrestricted as to exercise.[108] If compensation incentives were powerful for institutional fund managers, they were even more so for the corporate managers who had their hands on the corporate machinery.[109] Management began to bend toward the

[100] See Bengt Holmström and Steven N. Kaplan, *The State of US Corporate Governance: What's Right and What's Wrong?*, ECGI – Finance Working Paper No. 23/2003 (September 2003), available at ssrn.com/abstract = 441100.
[101] Bebchuk and Fried, 'Executive Compensation as an Agency Problem', 72.
[102] Kahan, 'The Limited Significance of Norms', 1878.
[103] Mitchell, *Corporate Irresponsibility*, p. 180.
[104] i.e. the American Federation of Labor and Congress of Industrial Organizations.
[105] i.e. the Teachers Insurance and Annuity Association – College Retirement Equities Fund.
[106] *ibid.*, pp. 176–8.
[107] In August 1993, Congress enacted the Omnibus Budget Reconciliation Act (OBRA). Section 162(m) provided that publicly held companies may be limited as to income tax deductions for certain covered executive officers to the extent that their total remuneration exceeds $1 million in any one year. Available at www.businessweek.com/1999/99_16/b3625017.htm.
[108] Bebchuk and Fried, 'Executive Compensation as an Agency Problem', 73.
[109] *ibid.*

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short-term imperative, aided by a market that had come to expect short-term gains and now punished those corporations who failed to meet quarterly projections by a swift drop in stock price. Short-termism continued on the rise.[110]

The final straw, perhaps, was the internet bubble of the late 1990s. Initial public offerings (IPOs) that saw stock prices rise multiple times in a day, and investment money rushing to the latest new thing, created expectations in the market that it was a short-term game.[111] The phenomenon of day trading developed to take advantage of this, to the point where by the late 1990s, a full 15 per cent of market volume was represented by day traders (and another 15 per cent was represented by executive stock compensation).[112] Short-termism had become the order of the day, and the market, comprised of the shareholders to whom the monitoring board was responsible, fulfilled the neo-classical dream of controlling the corporation. Until, that is, the market crash in early 2000 and Enron's bankruptcy the next year.[113]

It is not over. Institutional activism continues to create short-term pressures. CEO termination has increased, as boards try to satisfy the market.[114] At the same time, CEO compensation has spiralled to the point of becoming a national issue.[115] Everybody seems to be in it for the short term. And boards have little power, or incentive, to resist.[116]

VII. Some remedies

It is probably unreasonable to expect any major restructuring of the board any time soon. Reform proposals usually centre around the question of inside versus outside director, lead directors, speciality directors (such as the Sarbanes-Oxley mandated audit committee) and the like.[117] The story I have told so far suggests that the board needs space to manage the corporation, space away from the market. While the monitoring board remains a flawed device, certainly as a legal matter, as a practical matter

[110] Mitchell, *Corporate Irresponsibility*, pp. 4–5, 52.
[111] Jay R. Ritter and Ivo Welch, 'A Review of IPO Activity, Pricing, and Allocation', *The Journal of Finance* August (2002), 1795.
[112] Brad M. Barber and Terrance Odean, 'The Internet and the Investor', *The Journal of Economic Perspectives* Winter (2001), 49–51.
[113] Mitchell, *Corporate Irresponsibility*, pp. 4–5, 52; Paul M. Healy and Krishna G. Palepu, 'The Fall of Enron', *The Journal of Economic Perspectives* Spring (2003), 3.
[114] Bebchuk and Fried, 'Executive Compensation as an Agency Problem', 75–6.
[115] Mitchell, *Corporate Irresponsibility*, p. 109. [116] *ibid.*
[117] The remedies discussed here are examined in more detail in Mitchell, *Corporate Irresponsibility*.

I assume, as I always have, that most corporate directors want to do their jobs well. I also assume that most corporate directors, like most of us, have trouble resisting the kinds of pressures that market incentives combined with poorly aligned compensation structures create.[118] The latter is being repaired, albeit slowly. Grants of restricted stock options are down. But market pressure continues. So it seems best to address corporate social responsibility from the governance perspective by freeing boards to govern their corporations in their best judgements.

One way of diminishing market pressure on the board is to revisit our concept of capital gains taxation. The on-off switch between what is considered short-term capital gains (and thus tax disadvantaged) and long-term capital gains (tax advantaged) is one year. But one year is not a long term, at least in most businesses. If the point is to relieve the board of short-term pressures, then shareholder tax incentives must properly align with a period that one reasonably could consider to be long term. Thus, capital gains taxes should be tailored toward this goal, giving shareholders an incentive to hold their stock rather than to flip their shares for short-term gains.

In order to accomplish this goal, we might determine a 'long term' on an industry-by-industry basis. The long term for an automobile manufacturer might well be ten years, whereas one year might be legitimate for a new internet company. Short-term trading would be discouraged if we taxed the resulting gains at a punitively high rate, say 90 per cent in the first month (or week or year, depending on the term). We might then tailor the tax rate to diminish over a sliding scale reflecting the long term, ending in tax forgiveness at the end of the holding period. So, for example, we might impose a 90 per cent tax on trading profits for the first six months of our auto maker, diminishing to 50 per cent after five years, and 0 per cent after ten years. Of course I am making up rates and periods purely to illustrate, but the idea should be clear. By creating tax disincentives to sell quickly, and tax incentives to hold, we take pressure off management to perform for the short term while potentially harming the business in the long term. Obviously, we would have to build in reasonable conditions, exceptions perhaps for those who can demonstrate they had to sell out of financial necessity. And we could, I suppose, take the nature of the investor into account. Not only do pension funds typically turn over their portfolios in a year,[119] but they also have begun to invest heavily

[118] Crystal, *In Search of Excess*, p. 242.
[119] CalPERS Investments, available at www.calpers.ca.gov/index.jsp?bc=/investments/home.xml.

in hedge funds.[120] While pension funds, whether defined contribution or defined benefit, have to meet certain obligations every year, there is perhaps no investment vehicle so appropriately described as long-term. Pension funds, especially in light of their tax-advantaged status, perhaps should have punitive taxation imposed simply for exceeding a given rate of portfolio turnover in a single year. One can, I think, be reasonably confident that pension fund compensation structures would align accordingly, and long-term management would again become fashionable.

Marty Lipton has suggested another excellent method of removing pressure from boards: hold their elections every five years.[121] While this imposes a 'one size fits all' structure on board elections which might not comport with the long term in every industry, the fundamental idea of providing space for the board to manage is sound. Add to this the fact that average CEO terms run about five years as well,[122] and you provide a reasonably protected space for long-term management. At the end, of course, boards and their managers stand accountable before the shareholders. And if elections were to be held only every five years, this might also provide an opportunity to kick new life into the idea of shareholder democracy, limiting the time a shareholder would have to spend actually learning something about the performance of her company and vote.

The last suggestion I'll make here is one that shifts our ideas of expenses and assets in a way that might help foster long-term corporate well-being. One rather quick way to get stock prices up is to lay off workers. Sometimes too many workers are inefficient, and the only way to correct the inefficiency is to fire them. But that's typically not why stock prices rise; they rise because the diminished payroll promises higher earnings per share.[123] The same is true for workers' salaries, and investments in worker training.[124] These are expenses that hit the bottom line rather hard. Cutting them helps to improve earnings per share.

But workers obviously are the crucial engine that runs the business, at least in most cases. Well-trained, loyal workers, especially in an age of knowledge workers with portable skills, are a real business asset. The same

[120] CalPERS Press Release, 15 November 2004, available at www.calpers.ca.gov/index.jsp?bc = /about/press/pr-2004/nov/calpers–hedge-fund.xml.
[121] Lipton and Rosenblum, 'A New System of Corporate Governance', 190.
[122] Reinier Kraakman and John C. Coates IV, 'Why are Firms Sold? The Role of the Target CEO's Age, Tenure, and Share Ownership' (March 2006), available at repositories.cdlib.org/cgi/viewcontent.cgi?article = 1145 &context = berkeley_law_econ.
[123] Roe, 'Political Preconditions to Separating Ownership from Corporate Control', 543.
[124] *ibid.*

may be true for lower-level workers in an age of substantial outsourcing. In many, if not most, ways, workers are assets, not expenses.

If this is true, then the value of workers to the business has to be reflected on the financial statements. The problem is capitalising workers. But this should not be hard. Taking a note from my capital gains proposal, we might want to determine an industry average salary for workers at each level or job description. Perhaps we would continue to require corporations to deduct that average salary as an expense. But if we were to say to corporations that if they paid their workers above the tabled average they could capitalise that amount and depreciate it over some period, we would remove the current disincentive to pay workers well. We could, of course, do the same for training expenses, thus removing disincentives to substantial corporate investments in training.

This idea presents a few problems. What's to stop the corporation from laying off employees once they've capitalised these expenses? The desire to employ the worker and receive a return on its investment seems obvious enough. But we could also provide that the corporation would have to recapture the depreciation for workers who were terminated prior to the end of the depreciation period. This would provide a strong incentive to make management think twice before engaging in promiscuous layoffs. As with my tax proposal, we would have to allow for exceptions, where demonstrated efficiency or business necessity justify the firings. And corporations could game the system, terminating workers as soon as the depreciation period expired. But the corporation's interest in its own reputation, not to mention its investments (not expenses), should minimise this kind of behaviour.

These suggestions would go a long way towards helping boards govern their corporations the way they see fit, not the way the market sees fit. Price discovery, or valuation, and liquidity, the functions of the market, are not the same things as managing a corporation. But when management is tied to the market, as it has become, the two converge. My suggestions would recreate the space for managers to manage.

In exchange for making the board truly responsible in this way, the board must become more accountable. An institution can never demonstrate the kind of accountability we expect from humans. But institutions are run by humans, and we can expect humans within institutions to step up to the plate. Our current system of disclosure, under the securities laws, attempts to provide accountability by mandating disclosure of a slew of facts about the corporation. But these facts, except for a very limited group (like compensation), are facts in the aggregate. Human accountability is

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a matter of individual accountability. In order for us to hold corporate managers truly accountable, we need more.

One way of providing this, and perhaps of realising the original Brandeisian goal of disclosure, is to demand that each of the directors of a corporation be given the opportunity to include a thousand-word statement in the corporation's annual report, discussing his or her view of the important events of the year and the important challenges for the future. In this manner, each director would be required to stand exposed, before the corporation's stockholders and all other interested persons, as an individual human being with his or her own ideas, thoughts, positions and values. Those interested in the corporation, including the general public, would start to be in a position to evaluate each director as an individual human being, and to hold each accountable for the fit between his or her decisions, the well-being of the corporation, his or her own attitudes and accepted social norms of business conduct. Such a requirement would force directors to think deeply not only about the immediate effects of his or her decisions on the corporation, but on its broader effects on society and, perhaps most significantly, on his or her personal reputation. While it would be difficult to subject these statements to antifraud provisions, the credibility of their reasoning and the frankness of their statements would likely be enough to compel directors' honesty, and their interests in their own reputations should ensure that their decisions are defensible. As with all decisions, people will disagree. But, like all decisions, board decisions would finally be subjected to a meaningful public test of rationality and defensibility.

There are many more ways of tinkering with both shareholder and managerial incentives within the existing structure of corporate governance. And that, precisely, is the point. History shows us that governance structure is a very difficult thing to change, and change that seems beneficial can be manipulated to produce bad results. History also teaches us that changes in incentives, which are much more easily accomplished as a practical matter (even if they might run into some political haggling), typically have the effect intended, and powerfully so. The problem has not been with the use of incentives but the use of incentives to achieve the wrong ends. Long-term management is socially responsible management. Socially responsible management can occur only when managers are given the space to do the jobs they know how to do.