CORPORATE GOVERNANCE: THE UNITED STATES DEBATE

LEONARD M. LEIMAN *

The last several years have seen considerable attention given to what has become known as "corporate governance", an ambiguous phrase that is meant to describe the system under which the American business corporation is internally managed, and the system of governmental rules and regulations that limit the freedom of corporations to set procedures for governing themselves. There are several reasons for this attention. One is, of course, the enormous importance of the large corporations and their influence over our lives. How they are managed will affect not only the products we are able to buy in the stores, and how much we will pay for them, but other things as well. For example, corporations like Exxon, Mobil and Xerox are substantial contributors to the Public Broadcasting System, the United States non-commercial television stations; although we do not see their advertisements on those stations, support by these corporations will affect what programs the stations can afford and therefore what we can see on them. Business corporations are also principal lobbyists in Washington; they are an effective political force even though they are prohibited by law from contributing to federal political campaigns. Oil and gas industry lobbies are estimated to have an annual budget of about $60 million; U.S. Steel pays over an estimated $2.5 million each year to one trade association. It is in our own self-interest, therefore, to look closely at the way these corporations are run and to ask whether reforms are needed.

American corporations are subject to both federal and state laws that affect their internal management and the relations between their stockholders, directors, and officers. Most corporations are organized under the laws of one of the states, which need not be the state in which the corporation will conduct its business. In order to conduct business in a state, unless it is incorporated under the laws of that particular state, the corporation must "qualify" to do business there, a process that involves little more than filing a record of its existence and paying local taxes. Thus, regardless of where it will do business, the corporation generally has complete freedom to choose the state in which it will incorporate.

* Member of the New York bar. This article is a development of the Thomas A. O'Boyle Memorial Lecture delivered by the author at the Center for Study of Financial Institutions of the University of Pennsylvania Law School on April 13, 1978.
In some respects all these state laws are similar. For example, they all require that the equity interest in the business be owned by stockholders, who elect directors. The directors are responsible for supervising management, and they elect the officers, who are charged with everyday operating responsibility. But the choice of the state of incorporation can be significant, because the state laws vary in important detail. Matters such as the calling of special stockholders' meetings, the removal of directors, whether a vote of stockholders is required for extra-ordinary corporate transactions, and liabilities of directors and officers for failure to fulfill their duties are some of the subjects that each state may treat differently in its corporation law.

Federal law, on the other hand, applies uniformly to all corporations. The Securities Exchange Act of 1934, for example, applies to any corporation that has shares held by 500 or more stockholders and assets of at least $1 million, wherever the corporation happens to have been organized. But federal law covers only specific subjects. The Securities Act of 1933 requires a prospectus when securities are offered to the public. The 1934 Act imposes periodic filing requirements, prescribes the form of financial statements that must be published, requires proxy statements and prescribes their contents when a stockholder vote is solicited, and imposes liability on insiders who engage in short-term trading in their corporation's shares and who trade on confidential information. Matters covered by the federal statutes are aimed primarily at protecting investors. The federal law does not purport to be a pervasive scheme to regulate managerial conduct or to control the structure of corporate organization. These matters are left to state law. And because those who organize corporations are usually the managers, who want the fewest restrictions on their actions and the least likelihood of liability for their future conduct, there is a tendency to choose a state of incorporation which offers, or is perceived to offer, these advantages. Several states, of which Delaware is the most notorious, have taken advantage of this tendency, by offering a general corporate law attractive to organizers, with the fewest limits on their freedom. As a result, the number of corporations created under Delaware law is greatly disproportionate to that state's size or economic importance.

Professor William Carey, a former chairman of the Securities and Exchange Commission and a respected scholar, commented on this phenomenon in an article published in 1974 [1]; the article attracted wide notice and indeed may be an additional reason for the recent focusing of attention on the corporate governance question. Carey pointed out that no state can impose meaningful standards on corporations through its corporate laws so long as a state like Delaware is willing to draw corporations in by regulating them to the least degree. Carey noted that so long as Delaware imposes only minimal standards on corporations, it will be a favored state of incorporation. He found a need, in his words, "to escape from the present predicament in which a pygmy among the 50 states prescribes, interprets, and indeed denigrates national corporate policy as an incentive to encourage incorporation within its borders . . .".
Carey’s call for federal action was reinforced by the great revelations of Watergate and the exposure by the Securities and Exchange Commission of the “foreign payments” problem. A considerable number of corporations were found to have deliberately violated federal law by contributing to the presidential election campaign. Corporations were also found to be bribing foreign officials to obtain business or to protect their established business abroad. Of course these payments were not correctly recorded on the books of the corporations; the money was obtained through false accounts, which resulted in inaccurate financial statements and an inability to audit the use of corporate assets. To a lesser extent, the SEC also discovered abuses in the extension of perquisites to corporate officers, who took personal benefits without either disclosure to stockholders or accountability to directors. Largely because other agencies lacked the authority, or chose not to exercise the authority they had, it fell to the SEC to investigate and report on many of these matters; although even that agency’s enforcement powers are limited, the SEC has been the most persistent and articulate critic in calling our attention to these corporate failings. The SEC’s disclosures have suggested that the system under which corporations are governed does not work very well. Where were the directors when all this was going on? Where were the auditors? What had become of the controls that were supposed to protect investors against this sort of thing? If these abuses can be prevented in the future by structural reforms now, should we not put those reforms in place as soon as we can?

In considering these questions, it is necessary to distinguish “corporate governance”, which deals with the management of corporations, from general rules of corporate conduct, which deal with the way corporations are supposed to behave in relation to the outside world. For example, it is illegal for corporations to contribute to federal political campaigns. At least since the enactment of the Foreign Corrupt Practices Act of 1977, it is illegal for United States persons to bribe foreign officials. We also have laws forbidding pollution of the environment, and prohibitions against false advertising, and anti-monopoly laws. The corporate governance question is not whether these laws are good or bad. Instead, the question is whether, in light of the demonstrated violation of these laws by our public, investor-owned corporations, we can devise a system of corporate management that is likely to ensure, or at least encourage, more responsible corporate behavior.

Another reason for looking at the corporate governance question is to adjust relationships between the corporation and its stockholder-owners. There is a continuing, painful stress between management and investors. Managements often view themselves as running their own business with capital hired from the stockholders; many investors, on the other hand, view the business as their own, run by hired management. The truth is somewhere in between. Fine-tuning the relationship leads to questions of structure. How should directors be selected? How should responsibility be shared among stockholders, directors and officers? What kind of vote should be needed for significant corporate action?

There are currently a number of suggestions for change that parade under the
banner of improving corporate governance but are really designed to change the economic and social role of corporations in American life. For example, some discussions of corporate governance, in focusing on the role of directors, suggest that the board be reconstituted into a body that represents not only stockholders generally, but also special interest groups. There is the German model, which puts labor representatives on the board. Ralph Nader, in advocating reform along this line, would have a nine-man board, each member with "a separate oversight responsibility, a separate expertise, and a separate constituency, so that each important public concern would be guaranteed at least one informed representative on the board" [2]. His directors would include representatives for employee welfare, consumer protection, and environmental protection and community relations, as well as for more customary areas of responsibility, such as shareholder rights, finances, and purchasing and marketing. All this would be subject to the general obligation that the corporation be "profitably administered" [3]. But there is an inherent practical inconsistency in the Nader program: a director whose constituency is, for example, employee welfare is going to have a different view of profitability than the director in charge of stockholder rights.

Obviously it is possible to make considerable change in our society by changing corporate objectives. Reforming the board along the lines of the Nader suggestion would really begin a process of change in the economic function of corporations. Just as the Ford Foundation would be run differently if it had to produce profits, so would the Ford Motor Company be run differently if it did not operate as a profit-making business. The implications of that line of analysis are beyond my reach, and certainly outside the scope of this article. We can argue about limiting the size or power of corporations, or changing what I believe to be the basic premise of our present law, that corporate managements are obliged to maximize profits in all lawful ways. These would be social reforms. But so long as we continue the currently accepted view of corporations as aggregations of capital designed to produce profits for their owners, then suggestions that directors should represent other interests are irrelevant.

Starting, then, with the assumption that corporations continue to have traditional economic objectives, and accepting the premise that past abuses provide a basis for demanding reform, we ask whether there are structural changes that might improve corporate behavior. Can we, by adjusting the present mechanism, make corporations more responsive to the legitimate demands of their public investors?

The first place to look for possible change is at the level of the stockholders. They own the corporation; why shouldn't they have more say in how it is run? If only we could make directors and officers more responsive to the needs of stockholders, the whole thing would work better! This is the rationale of the "corporate democracy" advocates, whose solution would be to run a corporation like a New England town meeting. Even using the term "corporate democracy" does a lot of harm to any reasoned discussion of this subject, because we are all trained to respond favorably when we hear the word "democracy". To come out against some-
thing claimed to be more democratic somehow sounds unpatriotic. But the political analogy does not hold true; corporations are not governments, and democracy is not a virtue when it comes to managing a complex business enterprise, any more than it would be in running the White House. We should examine specific proposals not to see whether they improve the stockholder's franchise, which is only a means to an end, but to see whether the proposed reforms are likely to produce more responsible, better corporate behavior. My own view is that we are much more likely to achieve that result with less democracy, rather than more, because it will allow a concentration of responsibility and enhance the ability to identify those who should be held accountable for success or failure.

The idea that stockholders should have more to say in corporate affairs crops up continually. "The power in corporations now rests far too much with management and too little with shareholders," according to Senator Metzenbaum, who has been looking into the subject with an eye to federal legislation [4]. The popularity of the notion that there should be more stockholder participation in corporate governance is attributable in good part to special interest groups, who are trying to use the proxy machinery to generate expressions of stockholder sentiment in order to change corporate attitudes toward social and political issues. These special interest groups come in a number of sizes and shapes. Their pet projects range from fighting the Arab boycott, or limiting business with South Africa, to prohibiting charitable contributions by corporations. It is good to remember that while many of the special interests being pushed as stockholder proposals seem wholesome, not all of them are, and no one should have any reason to believe that his own blend of political and social ideas is shared by the bulk of the investors in American corporations.

In any event, stockholder participation seems no answer to the corporate governance problem. Stockholder proposals, when they do appear on ballots, get very little support from stockholders generally; many proposals do not receive even the minimum three percent of the vote that, under SEC rules, allows resubmission in the following year by a non-management stockholder. When they do make the minimum vote, the same proposals are submitted over and over again by the same people, or the same proposals are tried with other corporations, so that the cumulative effect of the noise these special interest groups make obscures the fact that they are not representative. The bulk of stockholders are interested only in the economics of their investment; although they have no great loyalty to management as such, they will not support action that inhibits management from maximizing profits. The SEC's view apparently is that stockholder indifference is the result of years of disuse and that an affirmative action program can change this. I doubt that this is so. In fact, innovation at the stockholder level is more likely to lead to manipulation of the system by a few stockholder activists. I suggest, therefore, that we look instead to a more fruitful area of change: strengthening the role of the board of directors.

Is it possible to strengthen the board itself, through a change in its composition?
Certainly, as a first step, we can look to outside, non-management directors as a help in protecting stockholders and the public against management's illegal proclivities. The New York Stock Exchange used to require, in theory at least, two outside directors, but that was not strictly enforced. I would favor a requirement that there be a majority of non-management directors, although it seems unnecessary to go as far as the chairman of the SEC, Harold Williams, who has suggested that there be only one management director, the chief executive. Boards are supposed to be deliberative bodies, and the presence at meetings of knowledgeable employee-directors, acting as directors, not as visitors, ought to be helpful. But we do want to encourage a measure of independence, and having a majority of outside directors ought to give each of them a sense of confidence through strength of numbers that he might not otherwise have.

Who ought these outside directors be? Business Week, a conservative business magazine, advocated what it called "federal guidelines" for electing some "genuine" shareholder representatives as board members. "In theory", said Business Week, "today's directors are elected by the shareholders as the guardians of their rights. In reality, the chief executive too often picks his friends. Shareholders are then almost always given the Hobson's choice of voting for the management slate of directors or not voting" [5]. Business Week is a serious publication. It cannot really be proposing that the board be composed of enemies of the chief executive. Nor would it make much sense to choose strangers, leaving it to random chance whether they get along with the chief executive, in which case they would be fired, or fight with him, in which case they could stay.

The point, I suppose, is that the theoretical role of the board of directors is subverted if the board members do not exercise independent judgment, if they are sycophants responding only to the demands of the chief executive. Directors are more likely to be independent in judgment if they are not employed by the corporation. That is obvious, although I do not think it terribly important if the corporation's outside lawyers and investment bankers are counted as outside directors. In fact, because of the skills they bring to the board room, I think they are a great help on boards, and treating them as outside directors is more likely to keep them as directors. As Justice Jackson once said, "Men are more often bribed by their loyalties and ambitions than by money". It is not their income as suppliers of services to the corporation that is likely to affect the independent judgment of the bankers and lawyers nearly as much as it is likely to be their loyalty to the chief executive. That is a problem common to all directors, not just bankers and lawyers. My own experience is that even loyalty to the chief executive is subordinated to the sense of professional integrity and responsibility of the bankers and lawyers who sit on boards of directors.

If there were some way to develop a nomination process that would be reasonably independent of management and yet would produce an experienced, compatible, constructive group of directors, that would be welcome. I have yet to see a workable proposal for nomination by stockholders directly, using the proxy
machinery. A few years ago, the Association of the Bar of the City of New York, after a vote in favor of some form of stockholder nomination process, tried to develop one. But no appropriate method was proposed, and the project seems to have been dropped. My view is that nomination should be left to the outside directors, although consultation with the chief executive is inevitable and desirable, and in this, as in almost every other area of board action, his strength of personality will be a decisive factor in the selection.

Once the board is in place, the next problem is to get directors to do their jobs properly. My first suggestion is that there be a more formalized definition of board responsibilities, an allocation of some particular responsibilities to the board that go beyond the present law's simple mandate to "manage" the business. The process of defining responsibility is already under way with the pressure on corporations to create audit committees, although too much attention has been paid merely to creating audit committees and not enough to defining what they should, or can, do. The principal function of an audit committee is simply to be there in case the independent auditors want to talk to the board without screening by management, and to be sure that management does not interfere with the scope or implementation of the audit or does not force unsatisfactory accounting principles on the auditors. But there is no reason why the audit committee cannot be charged also with specific oversight responsibility for the record-keeping activities of the corporation, including compliance with the bookkeeping and internal controls requirements of the Foreign Corrupt Practices Act of 1977.

There should also be responsibility at the board level for overseeing general legal compliance and reviewing litigation for and against the corporation, something like a legal audit committee. And there are other specific supervisory functions that can be carried out by the board, such as responsibility for:

- employee compensation and labor relations, including responsibility over executive compensation, how it is paid, and the perquisites executives receive;
- planning and research, to work with management in developing long-range objectives;
- budgeting, to review cash requirements, capital expenditures and operating budgets.

This list could be changed or expanded and would somehow have to take into account the differing circumstances of particular corporations. What is important, though, is that exercise of reasonably specific responsibilities be legally mandated for action at the board level. Chief executives will not like this, but in the long run they well not only get used to it but will find the enforced discipline a positive advantage.

Second, in order to carry out these responsibilities, the board members will have to have help in the form of staff, availability of management personnel, some legal and accounting support, and above all a steady flow of the information necessary to
make decisions. Making the board legally responsible for doing this work, and management legally responsible for providing accurate information to the board, should go a long way toward forcing boards into productive activity. The risk that a separate staff for the board will create an adversary relationship between the board and management is one that will have to be avoided.

My third suggestion reflects a conviction that it is unrealistic to expect directors to be ultimately responsible for technical or professional decisions, even with outside help. There can be only a marginal improvement in director oversight unless some of the work can be done effectively by others. For example, it should not be a reasonable expectation that members of the audit committee actually review the books and records of the corporation; that is a job for accountants, who at least know where to look and what to look for. And so, I would expand substantially the role of outside professionals, not necessarily as staff aids to the directors, but with direct responsibilities to the stockholders. The Commission on Auditors' Responsibilities, under the chairmanship of Manuel F. Cohen, made a start in this direction in 1977 in its Report of Tentative Conclusions [6]. The Commission recognized that, in the public mind, auditors already have a greater responsibility to detect illegality than classical auditing theory would have it and suggested some small expansion of auditing responsibilities to help meet the public's expectations.

I would propose that the scope of the audit be expanded substantially, under the supervision of the board of directors, to the end that the auditor's opinion each year would not assert merely that the statements "present fairly" the financial position of the company, subject to all the implicit limitations of materiality and the vicissitudes of auditing on a sampling basis. I would want auditors' opinions that come closer to telling the stockholders that the books mean what they purport to say and that management is in fact conducting itself in the way the records say it is.

Similarly, the lawyers are going to have to do much more. Lawyers have inserted themselves as essential intermediaries in the corporate disclosure system but have made relatively little contribution to the ongoing governance process, particularly as their participation tends to be limited to specific assignments initiated by management, such as providing a formal opinion on a particular question or preparing a specific document. Quite understandably, the rendering of a formal written opinion has been surrounded with a number of practical and professional safeguards [7]. But what the directors of the corporation who are not part of management will need, if they are to be more effective, is some kind of regular audit of the corporation's legal affairs, ranging from a review of pending litigation to a survey of the corporation's methods of complying with substantive laws affecting its operations and the nature of any legal risks being taken by management.

The American Institute of Certified Public Accountants has not endorsed wholeheartedly the tentative first step advocated by the Cohen commission, and I would suppose the bar associations will also resist any extension of lawyers' responsibilities, just as they did with respect to lawyers' responses to auditors a few years ago [8]. There are undoubtedly ways of forcing movement in this area, through legis-
lation creating requirements that the professions as a practical matter will have to meet for their clients.

Finally, there remains the question of how all this is to be imposed. Do we, for at least the larger corporations, follow Nader's suggestion that we adopt a federal corporate law, pre-empting the states, or do we set minimum federal standards for corporations that would otherwise operate under state law?

The minimum standards approach has the virtue of already having a head start. Federal law now goes far beyond the disclosure requirements we think of as the keynote of federal regulation. We have the proxy rules, of course. Tender offers, as a method of changing control of a corporation, are heavily regulated. If control of the board is to be changed after a tender, federal law requires a waiting period and disclosure to the stockholders. Abuse of inside information since 1934 has been covered twice, once under the insider trading provisions of Section 16 and again under the well-known Rule 10b-5. The SEC's general counsel believes that the agency already has the authority to require corporations to have audit committees [9]. And in what may be the most significant intrusion of all, the Foreign Corrupt Practices Act of 1977 requires that there be adequate internal controls and accurate bookkeeping practices, giving the SEC vast power over the internal workings of corporations that I do not believe it had before.

There are also indirect federal corporate governance provisions, through the operation of the tax law. Stock options may be taxed differently, depending on whether or not there has been stockholder approval, which is a way of forcing stockholder participation in executive compensation matters. And if we think of the large limited partnerships as corporations, which they really are for many purposes today, the tax law can go deeply into determining their capital structure. Indeed, although in a direction counter to the one I am proposing, by threatening adverse tax treatment the federal tax law at one time actually stopped a state law attempt to create more investor rights by giving limited partners a greater say in partnership management. So it would not be a great innovation for federal tax law to enforce minimum standards in selected areas, such as the composition of the board of directors and the board's duties to stockholders.

A law on federal chartering of corporations, on the other hand, would have the advantage of enforcing completely uniform rules for all corporations subject to its requirements. Nader suggests that those with $250 million in sales or employing more than 10,000 persons ought to be covered; he says that this would cover about 700 corporations [10]. There is great appeal to his argument, but it seems unwise to concentrate more power in the federal government, if substantially the same thing can be accomplished through minimum standards legislation. The problem of corporations drifting to the least-regulation state is similar to that faced when industrial states were losing businesses to poorer states with lower wages: the answer then was the federal minimum wage law, not some form of nationalization of industry. Federalism ought to be preserved when it can be, if only to leave the states free to innovate in the corporate area when they care to. Indeed, there is evi-
dence already of positive state movement in the going-private area, even in Delaware [11]. So I favor the continuance of federal setting of minimum standards, presumably through SEC rules and legislation where needed, and leaving federal chartering as a last resort if it should prove necessary.

To sum up briefly, first, there is a demonstrated need for improvements in the mechanism by which corporations are governed. Second, reform should not be through extensions of the stockholder franchise, because stockholders are not interested and because it would not solve the problems that need attention. Third, I would try to accomplish change through the board of directors. There should be a majority of non-management directors, and the board should have defined responsibilities, not merely the present law's general command to supervise the business. The board should have staff support, and I would increase the scope of auditors' and lawyers' responsibilities in helping the board do its job. Finally, I would accomplish these changes through federal minimum standards legislation, not by a system of federal chartering of corporations.

Notes

[5] Id.
[6] The Commission was established by the American Institute of Certified Public Accountants.
[10] Nader et al., op. cit. supra n. 2 at 240–41.

Leonard M. Leiman (b. 1931) is a partner in the New York City law firm of Reavis & McGrath. He received his LL.B. from Harvard Law School in 1954 and served as law clerk to Judge Learned Hand of the U.S. Court of Appeals for the Seventh Circuit and Justice John M. Harlan of the United States Supreme Court. In 1964–66 he was executive assistant to the chairman of the SEC. He is a frequent lecturer at the Practising Law Institute and a contributor of articles to its annual institute on securities regulation. Mr. Leiman is the chairman of the Securities Regulation Committee of the Association of the Bar of the City of New York.