

COMPOSITION OF THE BOARD OF DIRECTORS

BY HOWARD M. HANDELMAN*

MR. HANDELMAN: At the end of the morning session Dean Ruder got into my topic. I would like to respond to some of the questions he raised.

If you remember, he discussed the criticism being made of the abuse of power by management and the need for the appearance of objectivity on the board, and that this objectivity was coming about increasingly by the use of independent directors. He raised questions as to what proportion of a board should be independent directors, how do you define them, and how do you determine the composition of various committees, especially the key ones—the audit, compensation and nominating committees?

With regard to those questions, I would like to approach them from the points of view of two very influential groups: one, the corporate attorneys as they have spoken through the ABA publication of the *Corporate Director's Guidebook*,¹ which has been mentioned by several speakers and which was cited in my outline; and also by the statement of the Business Roundtable,² also cited in my outline, which, as you know, is a regional group of the chief executive officers of 180 very prestigious corporations.

Let me note at the outset that there is definitely a trend, at least on the part of large, publicly-owned corporations, to increase the number and the role of the outside directors. According to one study involving 238 corporations, almost all of which had assets of \$200 million or more, 83% of the manufacturing companies had a majority of outside directors, and 86% of the non-manufacturing companies had a majority of outside directors.³ That's a very substantial proportion.

Now there is always the question, as pointed out by Dean Ruder, as to whether to classify directors who were former employees, but

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1. Subcommittee on Functions and Responsibilities of Directors, Committee on Corporate Laws, ABA Section of Corporation, Banking and Business Law, *Corporate Director's Guidebook*, 33 BUS. LAW. 1591 (1978) [hereinafter cited as *Guidebook II*].

2. Business Roundtable, *The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation*, 33 BUS. LAW. 2083 (1978) [hereinafter cited as *Roundtable*].

3. *Guidebook II* at 1644 app.

no longer have any assigned duties with the company, as outside directors or inside directors. If you eliminate those former employees, those figures change, but they are still impressive. Instead of 83% of the manufacturing companies having boards consisting in the majority of outside directors, it goes to 60%.⁴ For the non-manufacturing companies having boards in which the majority are outside directors, the figure changes from 86% to 80% and, again, remains substantial.⁵

That study, incidentally, appears in Appendix C of the *Guidebook*. That Appendix also points out the comparison between a study in 1973 and one in 1977 showing the increase in the number of corporations that have nominating committees. The growth was 7% in 1973 to 23% in 1977.⁶

I think the first point to make with regard to the outside directors is the role that is expected by virtue of the change by the addition of the words "under the direction of" when referring to the management by the board, as such language appears not only in the Model Business Corporation Act⁷ but also in the Delaware Corporation Act.⁸ That change emphasizes the role of the director as a monitor, i.e., the selector of management and then the monitor of the performance of management and the performance of the enterprise; a role which lays the foundation for the use, much more so than in the past, of the outside director.

But who is the outside director? The members of the Business Roundtable do not attempt to define who is the outside director. They do say that the non-management director is one whose main effort is in pursuits other than those of the corporation, and he is one who has no stake or any prior involvement in the matter under review.⁹ Very loose, as Dean Ruder said, and perhaps that's the way to leave it.

They do raise the question as to how a former corporate employee fits into that classification and also how attorneys, as counsel for that corporation, may fit into that classification. But they don't attempt any specific definition.

On the other hand, the *Guidebook* does attempt to be more specific. It defines a management director as a person who substantially devotes his full time and attention to the corporation, or to a subsidiary of the corporation, or to a corporation which is in turn controlled by or controls the corporation.¹⁰

4. *Id.*

5. *Id.*

6. *Id.* at 1643-44 app.

7. ABA-ALI MODEL BUS. CORP. ACT § 35 (1977).

8. DEL. CODE ANN. tit. 8, § 141(a) (Supp. 1977).

9. *Roundtable, supra* note 2, at 2107-08.

10. *Guidebook II, supra* note 1, at 1619.

How does the *Guidebook* treat former officers or employees? Well, it says, presumably they are going to have to be considered as management because of the likelihood that their prior experience or their prior ties would somehow come under consideration and prevent them from exercising independent judgment.¹¹ However, it does recognize that it is possible to have former employees and officers who will be able to be in a position to exercise their independent judgment, and if that circumstance is found to be so by a finding made by a committee comprised of completely non-management directors, then that person may be considered to be a non-management director.¹² If you recall, that's the criteria used in the Metzenbaum Committee report as mentioned by Dean Ruder.

The *Guidebook* goes further. It attempts to distinguish between those non-management directors who are affiliated or are unaffiliated. By affiliated it means those individuals who, although they may not have any relationship to the matter under consideration, have a relationship with the corporation that precludes them from being considered 100% independent under all circumstances.¹³ The illustrations it used were the commercial bankers, investment bankers and attorneys (outside counsel for the corporation) or other suppliers of goods to the corporation.¹⁴

The unaffiliated non-management directors are generally defined as those individuals who have no close familial tie to the key management and also who have no interest in any transactions with the corporation, transactions that generally have to be disclosed by proxy statements, or the like.¹⁵

Dean Ruder asked about the composition of the various key committees. I don't think there's that much of a difference between the Business Roundtable and the *Guidebook*; and I think that it's rather important to recognize that both of those groups give strong support to the concept of the outside directors being on these committees.

The ABA says that the audit committee and the compensation committees should consist of 100% of non-management members.¹⁶ And in addition, the majority of those non-management directors should be unaffiliated.¹⁷ That is a rather high standard.

11. *Id.*

12. *Id.* at 1619-20.

13. *Id.* at 1620.

14. *Id.*

15. *Id.*

16. *Id.* at 1626-27.

17. *Id.*

The Business Roundtable did not, if you remember, distinguish between the unaffiliated or affiliated; it used non-management or management. And the Business Roundtable said that it agrees that those two committees should be 100% non-management.¹⁸

I don't know how much of a distinction there might be between those positions, but regardless, it's a very strong supportive position to have the outside director controlling those committees.

Dean Ruder mentioned that the issue may come down to the nominating committee; and there is a difference between the ABA and the Business Roundtable as to that important committee. But I suggest that even though there is a distinction in their positions, both of them are very supportive of the role of the outside directors on the committee.

The ABA takes the position that not only should the nominating committee be comprised 100% of non-management members, but that it should consist exclusively of unaffiliated members, i.e., entirely of unaffiliated non-management members.¹⁹ That, again, is an extremely high standard.

The Business Roundtable says that there should be a majority of non-management directors on the nominating committee.²⁰ I think that is a very supportive role.

Dean Ruder had questioned whether the management would not want to control the key committees. But when you consider that the Business Roundtable has taken the position that the nominating committee should have a majority of non-management members and that the board itself should have a majority of non-management members, if those directors are truly non-management directors and are outside directors, then the CEO's do not have, in effect, control. I think that that's the real answer to the question of the abuse of the power by management. Both of these groups have taken positions that they are willing to turn the control of management over to the outside directors.

I mentioned that the CEO's have taken the position that the majority of the board should be non-management directors. The ABA has similarly taken that position. In the first version of the report of the *Guidebook*, the attorneys took an unqualified position that the majority of the board should consist of outside directors.²¹ Then they got some criticism that the concept should not apply in all

18. *Roundtable*, *supra* note 2, at 2108.

19. *Guidebook II*, *supra* note 1, at 1626.

20. *Roundtable*, *supra* note 2, at 2108.

21. Subcommittee on Functions and Responsibilities of Directors, Committee on Corporate Laws, ABA Section of Corporation, Banking and Business Law, *Corporate Director's Guidebook*, 32 BUS. LAW. 5, 33 (1976).

instances, even though both the ABA and the Business Roundtable limited their comments to the large, publicly-owned corporations.

In the subsequent and final version that was adopted by the Council, the *Guidebook* still highly recommends that a majority of the board consists of outside directors.²² However, there is the lawyers' language which gives comfort to those who cannot, or do not, want to do that.

A question was asked by Dean Ruder about the constituency representatives, i.e., directors selected from those people who represent a particular group of individuals, such as consumers. Well, both the ABA and the CEO's have taken the position that the idea is contrary to the duty owed by all directors to the shareholders. Now that is not to say that you should not select your directors from various segments of the society. You should have those who are academicians, those in the public life, and those who are scientists and attorneys and, of course, professors. But you should not select a person who is going to represent a particular point of view. I think that is consistent with the basic concept that we have always had about corporate governance.

That leads then to the role of the attorney on the board—the attorney who is outside counsel for the corporation. Dean Ruder said that he came out on balance as being against outside counsel being a director, especially on the boards of the large corporations.

As I mentioned in my outline, the Chairman, more than one, of the SEC, have taken a very strong position against outside counsel being on the board of directors.²³ Among the reasons given, not only by them but by others who have commented, is that there is a conflict of interest and even if under some circumstances there may not be a direct conflict of interest, there certainly is an appearance of a conflict of interest as far as the public is concerned.

Another reason given is that there is a reluctance on the part of other directors to terminate, or even monitor, the services of a director-lawyer. Also there is the interesting question whether he may jeopardize the position of his client with respect to the attorney-client privilege.

There are those who do favor the attorney being on the board. I really can't support those arguments too strongly myself. They contend that he has a special incentive to monitor because of his personal responsibility and liability as a director, that he would be advised early on about any problems occurring on the board, that he has

22. *Guidebook II*, *supra* note 1, at 1624-25.

23. See *Report of The Committee on Corporate Law Departments on Corporate Director's Guidebook*, 32 BUS. LAW. 1841, 1843 (1976).

special talents for inquiry and judgment which otherwise he would not want to provide as a director because he would not be getting the proper compensation, that he has special knowledge dealing with litigation he could share with other board members, that he should be on a basis equal with senior management, and that he should have a say in the selection of management.

For those who are interested in those contentions I refer you to an article in the *Business Lawyer*, Volume 33, pages 1507 to 1518.²⁴ It reports on a symposium at which they discussed the question whether the Code of Professional Responsibility should be revised to forbid lawyers from serving on boards of those corporations for which they act as outside counsel.

I think that some answers to most of these contentions are that the attorneys may attend board meetings or committee meetings upon request from directors and that whatever knowledge the lawyers have they should readily supply in their role as lawyers.

I don't think attorneys sitting on boards should be viewed as lawyers. They should be looked upon as directors. And they should be compensated adequately, as all directors should, to be sure that they are going to serve, and serve properly.

The bottom line, I think, is that there is much more support for independent boards on the part of corporate managers and corporate counsel than the public perceives. We should be aware of this support and let the public know about it.

24. Mundheim, *Should Code of Professional Responsibility Forbid Lawyers to Serve on Boards of Corporations for Which They Act as Counsel*, 33 BUS. LAW. 1507 (1978).