
January 1997

Director Compensation and the Management-Captured Board - The History of a Symptom and a Cure

Charles M. Elson

Recommended Citation

Charles M. Elson, *Director Compensation and the Management-Captured Board - The History of a Symptom and a Cure*, 50 SMU L. REV. 127 (1997)
<https://scholar.smu.edu/smulr/vol50/iss1/9>

This Article is brought to you for free and open access by the Law Journals at SMU Scholar. It has been accepted for inclusion in SMU Law Review by an authorized administrator of SMU Scholar. For more information, please visit <http://digitalrepository.smu.edu>.

DIRECTOR COMPENSATION AND THE MANAGEMENT-CAPTURED BOARD— THE HISTORY OF A SYMPTOM AND A CURE*

Charles M. Elson**

TABLE OF CONTENTS

I. THE HISTORY OF DIRECTOR COMPENSATION	135
II. THE CONSEQUENCES OF THE PRESENT COMPENSATION SYSTEM	156
III. COMPENSATION AS THE CURE TO BOARD PASSIVITY	164
IV. CONCLUSION	173

The most significant problem facing corporate America today is the management-dominated, passive board of directors. A common occurrence in many of our largest corporations is that passive boards are responsible for excessive executive compensation and, more importantly, poor corporate performance.¹ The board, created to moni-

* Copyright 1996 by Charles M. Elson. All rights reserved.

** Professor, Stetson University College of Law; Visiting Professor, Cornell Law School, Spring 1996; B.A., 1981, Harvard University; J.D., 1985, University of Virginia; Salvatori Fellow, The Heritage Foundation, Washington, D.C.; Member, National Association of Corporate Directors' Commission on Director Compensation. The author wishes to thank Chris Dalrymple, Scott Davies, and Ellsworth Summers for their excellent research assistance.

1. The following Article draws from and expands upon two earlier works that both examined the negative impact on corporate performance resulting from passive boards of directors and offered an equity-based solution to create more active board oversight and greater corporate performance. See Charles M. Elson, *The Duty of Care, Compensation, and Stock Ownership*, 63 U. CIN. L. REV. 649 (1995) [hereinafter Elson, *Duty of Care*]. This article examined the relation between a passive board of directors and the director's legal duty of care. It suggested that the duty in its present form enhances board passivity and why substantial director stock ownership will counter that passivity. *Id.* at 691. To achieve high levels of director equity ownership, it suggested compensating directors with stock and presented an empirical study to support its conclusions. *Id.* at 700-06. See Charles M. Elson, *Executive Overcompensation—A Board-Based Solution*, 34 B.C. L. REV. 937 (1993) [hereinafter Elson, *Board-Based Solution*]. This article examined the history of the executive overcompensation problem and critiqued as either ineffective or harmful to corporate well-being, the solutions offered by other commentators, including heightened disclosure, tax-based remedies, judicial involvement, institutional shareholder activism, strengthened board compensation committees, and a market-based approach. Based on an empirical study of the executive compensation voting behavior of boards composed of outside directors with substantial stockholdings, *Board-Based Solution* suggested that a link exists between heightened equity ownership and more effective compensation over-

tor management in order to ensure effective decision-making, has evolved into a body that, in its most extreme form, simply "rubber stamps" executive prerogative. Management, no longer checked, freely engages in conduct that is slothful, ill-directed, or self-dealing—all to the corporation's detriment. Shareholders, mindful of recent disasters at General Motors, IBM, American Express, Archer-Daniels-Midland, W.R. Grace, and Morrison Knudsen, are keenly aware of this problem.²

sight. *Id.* at 990-95. See Dennis C. Carey et al., *How Should Directors Be Compensated?*, DIRECTORS & BOARDS, Special Report No. 1, 1996, at 1; Charles M. Elson, *Shareholding Directors Create Better Corporate Performance*, ISSUE ALERT, May 1996, at 3; Charles M. Elson, *Shareholding Directors Create Better Corporate Performance*, in DIRECTORSHIP—SIGNIFICANT ISSUES FACING DIRECTORS 7-1 (1996) [hereinafter Elson, *Shareholding Directors Create Better Corporate Performance*]; Charles M. Elson, *Major Shifts Seen in Director Pay*, CORP. GOVERNANCE ADVISOR, May-June 1996, at 1 [hereinafter Elson, *Major Shifts Seen in Director Pay*]; Charles M. Elson, *The Director as Employee of Management*, DIRECTORS & BOARDS, Spring 1996, at 34 [hereinafter Elson, *The Director as Employee of Management*]; Charles M. Elson, *Shareholding Non-Executives Should Limit Excessive Directors' Pay*, FIN. TIMES, July 28, 1995, at A2 [hereinafter Elson, *Shareholding Non-Executives Should Limit Excessive Directors' Pay*]; Charles M. Elson, *Manager's Journal: Board Pay Affects Executive Pay*, CORP. BOARD, Mar.-Apr. 1994, at 7 [hereinafter Elson, *Board Pay Affects Executive Pay*]; Charles M. Elson, *Manager's Journal: A Board-Based Solution to Overpaid CEOs*, WALL ST. J., Sept. 27, 1993, at A22 [hereinafter Elson, *A Board-Based Solution to Overpaid CEOs*]; Charles M. Elson, *Director-Owners Can Lower High Pay*, N.Y. TIMES, July 18, 1993, at F15 [hereinafter Elson, *Director-Owners Can Lower High Pay*].

2. The effects of a derelict board are evidenced by the recent fortunes at a number of well-known American companies. The recent turmoil at General Motors, IBM, American Express, Archer-Daniels-Midland, W.R. Grace, and Morrison Knudsen demonstrates the consequences of an inattentive board. Throughout its history, the GM Board was typically beholden to GM management with board meetings being little more than social gatherings in which the CEO's agenda was approved. After a long, steady decline during which GM's share of the American car market dropped from 52% to 35%, the GM Board finally took affirmative steps to improve the company's performance, including firing GM's CEO Robert Stempel. See John Greenwald, *What Went Wrong?*, TIME, Nov. 9, 1992, at 42, 44; see also Dana W. Linden et al., *The Cosseted Director*, FORBES, May 22, 1995, at 168 [hereinafter Linden et al., *The Cosseted Director*]; Kathleen Day, *GM's Move Symbolizes Wider Fight*, WASH. POST, Oct. 27, 1992, at A1 (noting that "boards typically have been captive to the wishes of the company chairman," but that pressure has been mounting on the boards to assume a more proactive stance in the fulfillment of their duties).

In January 1993, IBM CEO John Akers was forced to resign amid sagging profits and lost market share. Preceding this resignation, IBM saw its worldwide market share drop from 30% in 1985 to 19% in 1991, its stock price lose half its value over a six-month period, was forced to make a 55% cut in its quarterly dividend, and recorded a \$4.97 billion loss in 1992. Carol J. Loomis, *King John Wears an Uneasy Crown*, FORTUNE, Jan. 11, 1993, at 44; Michael W. Miller & Laurence Hooper, *Signing Off: Akers Quits at IBM Under Heavy Pressure; Dividend Is Slashed; Outsiders Will Lead Search for New Chief Executive to Be a "Change-master,"* WALL ST. J., Jan. 27, 1993, at A1.

Similarly, American Express board members dissatisfied with the company's recent financial performance and public relation gaffes deposed CEO James D. Robinson, III. Bill Saporito, *The Toppling of King James, III*, FORTUNE, Jan. 11, 1993, at 42-43. Robinson, who served as CEO for 16 years, developed American Express into a "financial services supermarket." *Id.* at 42. However, the number of American Express cardholders was down worldwide, earnings were lackluster as a result of a \$112 million charge at Optima, and its stock price remained depressed. *Id.* at 43.

Following a shareholder revolt resulting from damaging disclosures relating to a federal antitrust investigation of the company, the Archer-Daniels-Midland board of directors in October 1995 announced that it would form a corporate governance committee consisting of several present board members to recommend possible changes in board structure. An-

But is there a solution?

Corporate governance scholars have debated potential solutions for years. Numerous legal reforms have been proposed, often involving such acts as the creation of the professional "independent" director,³ the de-

gry institutional shareholders had withheld their votes for reelecting the board—resulting in board members being reelected with only 80% of the total vote. Kurt Eichenwald, *Cheers, and Boos, at Archer-Daniels Meeting*, N.Y. TIMES, Oct. 20, 1995, at D2; Joann S. Lublin, *Is ADM's Board Too Big, Cozy and Well Paid?*, WALL ST. J., Oct. 17, 1995, at B1. See Kurt Eichenwald, *A Shareholder Rebellion: Investors Demand Answers from Archer-Daniels*, N.Y. TIMES, Oct. 19, 1995, at D1; *Archer-Daniels Faces Informal SEC Inquiry into Executive Pay*, WALL ST. J., Oct. 10, 1995, at C18; Thomas M. Burton & Richard Gibson, *ADM Director Ross Johnson Spouts Off on FBI Inquiry, Whitacre and Forgery*, WALL ST. J., Oct. 12, 1995, at A4.

The governance committee recommended that the size of the board be reduced from its current size of 17 members to between 9-15 members and that a majority of the board members be outside directors. The committee defined an outside director as someone "who is not a current or former Archer-Daniels executive, has no material business or professional relationship with the company, has no close family relationship with the company's management and is not receiving compensation from the company other than as a director." Kurt Eichenwald, *Shift by Company Will Bring in More Outsiders*, N.Y. TIMES, Jan. 16, 1996, at D1. The committee also proposed a mandatory age 70 board retirement policy. *Id.* Additionally, the committee recommended that the directors' pension plan be eliminated and the board members be compensated 50% in company stock. *Id.*

On March 2, 1995, it was reported that J.P. Bolduc, W.R. Grace's president and CEO, had abruptly resigned following a long dispute with the former company chairman, Peter Grace. It had been alleged that Grace and his son had received substantial stipends from the company in addition to their regular salaries. Grace himself, in addition to his monthly consulting fee of \$50,000, received \$165,000 annually for nursing care, \$200,000 for security guards, \$30,000 for a full-time cook, and \$74,500 to maintain a New York apartment largely for his family's personal use. Later, pressure from institutional shareholders forced the company to announce substantial changes in the structure of its board, including a reduction of the board's size, an age limit of 70 for directors, and the inclusion of six new outside directors. PR NEWswire, Feb. 2, 1995; PR NEWswire, Mar. 2, 1995; James P. Miller et al., *Bad Chemistry: W.R. Grace Is Roiled by Flap Over Spending and What to Disclose, Departed CEO Makes Issue of the Chairman's Perks, Son's Use of Grace Funds*, WALL ST. J., Mar. 10, 1995, at A1; Joann S. Lublin, *Attempts to Banish Harassment Reach into Executive Suite, Action on Grace CEO Reflects Firms' Greater Willingness to Oust High Officials*, WALL ST. J., Mar. 31, 1995, at B4.

In 1992, Morrison Knudsen's chairman William Agee announced that he wanted to turn the construction company into a rail-car maker. The effort initially seemed successful; however, one year later, in July 1994, the company announced an unexpected second-quarter loss of \$40.5 million and disclosed delays with various construction projects as well as with testing and delivery of new rail-cars. In early 1995, the company announced that it expected a substantial loss for 1994, was in default on its loan agreements, and would eliminate its dividend. Agee was then relieved of his duties, and it was disclosed that he had attempted to run the Boise, Idaho-based company from his Pebble Beach, California estate, flying in corporate vice presidents for weekly briefings. His 1993 compensation of \$2.4 million amounted to 6.8% of MK's net income; the \$4 million spent on Mr. Agee's jet equaled 13% of the general and administrative budget. Board resignations followed and eventually the entire board was replaced. *Morrison Knudsen Pact*, WALL ST. J., Oct. 27, 1993, at B14; *Morrison Knudsen Gets Contract*, WALL ST. J., Dec. 21, 1993, at C24; Carrie Dolan, *Morrison Knudsen Rail Plans Hurt by Unexpected Loss*, WALL ST. J., July 20, 1994, at A14; Joan E. Rigdon, *William Agee Will Leave Morrison Knudsen*, WALL ST. J., Feb. 2, 1995, at B1; Joann S. Lublin, *Five More Big Companies to Stop Giving Pensions to Outside Members of Boards*, WALL ST. J., Feb. 12, 1996, at A2.

3. See Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 883-92 (1991) (calling for institutional investors to organize a core of professional directors who would sit on corporate boards to ensure effective management); Jayne W. Barnard, *Institutional Investors and the*

velopment of strengthened board fiduciary duties,⁴ or the stimulation of effective institutional shareholder activism.⁵ All, it seems, have yielded little success because the passive board still flourishes. Yet the solution may be simple and obvious. Just as compensation is used to motivate employees to do their best, directors' compensation must induce directors to think more like shareholders. A shareholding mind-set will stimulate the outside directors to engage in the kind of active management oversight that so many boards now fail to exercise.

To create this perspective, companies should compensate their outside directors primarily in company stock that is restricted as to resale during

New Corporate Governance, 69 N.C. L. REV. 1135, 1168-73 (1991) (recommending that institutional investors sit on the corporate boards to oversee daily activity); George W. Dent, Jr., *Toward Unifying Ownership and Control in the Public Corporation*, 1989 Wis. L. REV. 881, 896 (1989) (encouraging the use of professional directors to supervise day-to-day operations).

4. Professor Cox has argued for the application of a stronger, more rigorous duty of care. James D. Cox, *Compensation, Deterrence, and the Market as Boundaries for Derivative Suit Procedures*, 52 GEO. WASH. L. REV. 745, 762-63 (1984). Other commentators suggested similar approaches. See, e.g., Stuart R. Cohn, *Demise of the Director's Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule*, 62 TEX. L. REV. 591, 595 (1983) (proposing a standard of reasonable care so that "the business judgment rule would resume its historical basis as a protection against hindsight evaluation of erroneous decisions, but would shed its protective role as a shield for all director action in the absence of fraud or other illegal behavior").

5. Indeed, much scholarly attention has been devoted to the "promise" of "institutional investor voice." Bernard Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 816 (1992). See generally ROBERT A.G. MONKS & NELL MINOW, *POWER AND ACCOUNTABILITY* 73-79 (1991) (noting that institutional investors closely monitor boards because of their desire to increase portfolio values and avoid "liability for breach of fiduciary duty"); Barnard, *supra* note 3, at 1135 (examining the concept of shareholder advisory committees and the appropriate role of institutional investors in corporate governance); Bernard S. Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 UCLA L. REV. 895 (1992) (discussing the benefits institutional oversight could have on corporate performance); Richard M. Buxbaum, *Institutional Owners and Corporate Managers: A Comparative Perspective*, 57 BROOK L. REV. 1 (1991) (analyzing the transnational effects of institutional investments); John C. Coffee, Jr., *Liquidity Versus Control, The Institutional Investor As Corporate Monitor*, 91 COLUM. L. REV. 1277 (1991) (discussing the efficiency and development of institutional investors in the United States); Alfred F. Conard, *Beyond Managerialism: Investor Capitalism?*, 22 U. MICH. J. L. REF. 117 (1988) (discussing the motivations of institutional investors and the prospective consequences of investor activism); Dent, *supra* note 3, at 881 (analyzing the separation of ownership control and offering a solution to corporate governance); Gilson & Kraakman, *supra* note 3, at 863 (proposing a strategy for improving corporate governance through increased activity on the part of the institutional investors); Louis Lowenstein, *Why Managements Should (And Should Not) Have Respect for Their Shareholders*, 17 J. CORP. L. 1 (1991) (advising corporations on the proper relationships with shareholders); Thomas C. Paefgen, *Institutional Investors Ante Portas: A Comparative Analysis of an Emergent Force in Corporate America and Germany*, 26 INT'L LAW. 327 (1992) (suggesting that long-term financial strategies of institutional investors will increase effective board monitoring in American and German corporations); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445 (1991) (analyzing the significance of increased shareholder activism); Robert D. Rosenbaum, *Foundations of Sand: The Weak Premises Underlying the Current Push for Proxy Rule Changes*, 17 J. CORP. L. 163 (1991) (addressing the underlying premise on calls for proxy reformation). For a contrary view on the effectiveness of institutional shareholder activism, see D. Gordon Smith, *Corporate Governance and Marginal Incompetence: Lessons from Kmart*, 74 N.C. L. REV. 1037 (1996).

their term in office. Each director will thus possess a powerful personal financial incentive to examine questionable management initiatives with the vigorous, independent, and challenging eye of an owner. All other forms of director compensation, which I believe promote board passivity and a pro-management bias, should be discontinued in favor of this equity-based approach.

In order to understand why stock-based compensation will solve the problem of board passivity, we must first examine its origins and the history of board compensation. This passivity problem is not a new one, but dates back over seventy years with the rise of the large-scale public corporation. Adolph Berle and Gardiner Means, in their 1932 landmark work, *The Modern Corporation and Private Property*, were the first to identify the force that was to lead to passive boards—the rise of management domination of the large corporation through the separation of ownership from control.⁶ Traditionally, corporate directors were major shareholders and received no compensation for their services. Early corporate legal doctrine clearly stated that directors were not entitled to remuneration for their activities as board members.⁷ However, with the tremendous expansion of the American economy occurring throughout the early part of the twentieth century, corporations became vast financial entities. With this growth in the size of the modern corporation, shareholdings in these enterprises became proportionally smaller and smaller, with no one shareholder or shareholding group possessing enough stock to exercise effective control over the entity. Consequently, professional management filled this control vacuum. Directors, rather than being selected from among shareholder ranks, instead were nominated by management. Their connection with the enterprise generally resulted from a prior relationship with management (in fact, many directors were themselves members of management), not the shareholding owners, and they often had little or no shareholding stake in the company.⁸ However, as the shareholders' legal fiduciaries, directors were expected to expend independent time and effort in their roles, and, consequently, it was recognized that they must now be compensated for their activities. By the mid-1950s, the legal prohibition against director

6. ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932). According to Berle and Means, the result of the wide diffusion of ownership in the modern corporation was the birth of a class of professional managers who controlled the corporation while owning a de minimis amount of the company's stock. *Id.* at 47-68; see Elmer W. Johnson, *An Insider's Call for Outside Direction*, HARV. BUS. REV., Mar.-Apr. 1990, at 46 (stating that capitalism evolved a "market society dominated by corporations . . . with absentee owners and professional managers").

7. See *infra* notes 18-36 and accompanying text. *Cahall v. Lofland*, 114 A. 224, 229-30 (Del. Cl. 1921); *National Loan & Inv. Co. v. Rockland Co.*, 94 F. 335, 337 (8th Cir. 1899); JOSEPH W. BISHOP, JR., *THE LAW OF CORPORATE OFFICERS AND DIRECTORS* §§ 1.01-.02 (1981); DOUGLAS M. BRANSON, *CORPORATE GOVERNANCE* § 8.18 (1993).

8. See *infra* note 45 and accompanying text. See Elson, *Duty of Care*, *supra* note 1, at 658-61; Elson, *Board-Based Solution*, *supra* note 1, at 942; Elizabeth MacIver Neiva, *Are Directors Overpaid? What History Tells Us About Compensation*, in *DIRECTORSHIP—SIGNIFICANT ISSUES FACING DIRECTORS* 2-4, 2-6 (1996).

compensation was crumbling, and directors increasingly were receiving cash compensation for their services.⁹

Because directors primarily were appointees of management and subject to management approval in relation to retention, the interests of the directors naturally became more aligned with the group that selected and retained them than with the stockholders. This was the real origin of the board passivity vis-à-vis management oversight with which we grapple today. If a director owed his or her position (and continuance in that seat) to management largesse and that position entailed considerable compensation and prestige, the director had little personal incentive to actively challenge the appointing party.¹⁰ This trend became increasingly more pronounced throughout the 1980s with changes in board compensation practices. In addition to simple cash retainers (which were becoming increasingly more generous—amounting to \$40,000 or more at many companies), directors began to receive numerous and substantial other benefits for board service. The typical director of a large, publicly traded corporation was now provided, among other things, with a substantial pension for board service following retirement, company-sponsored health and life insurance, and significant charitable donations to organizations of the director's choosing. Perhaps the most generous benefit of all, provided to selected directors, was a rich consulting contract, at rates far exceeding those for regular board service.¹¹

9. See *infra* notes 31, 46-51 and accompanying text. Elson, *Shareholding Directors Create Better Corporate Performance*, *supra* note 1, at 7-3; Carey et al., *supra* note 1, at 3. MODEL BUSINESS CORP. ACT § 33 (1953); EDWARD S. HERMAN, CORPORATE CONTROL, CORPORATE POWER 58 (1981).

10. Elson, *Duty of Care*, *supra* note 1, at 658-61; Elson, *Board-Based Solution*, *supra* note 1, at 942. Ralph V. Whitworth, President of the United Shareholders Association, characterizes the relationship between the CEO and his hand-picked directors as one where "[y]ou dance with who brought you." *CEO Pay: How Much Is Enough?*, HARV. BUS. REV., Jul-Aug. 1992, at 131 (comments of Ralph V. Whitworth). Therefore, it is not surprising that "this crowd rarely argues when it comes to approving a CEO's pay." *Id.* at 132. See MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION § 11.2 (1976). See generally MYLES L. MACE, DIRECTORS: MYTH AND REALITY (1986).

11. See NATIONAL ASSOCIATION OF CORPORATE DIRECTORS, REPORT OF NACD BLUE RIBBON COMMISSION ON DIRECTOR COMPENSATION app. (1995) [hereinafter NACD REPORT]; Elson, *Duty of Care*, *supra* note 1, at 692-94; Elson, *Board-Based Solution*, *supra* note 1, at 947-49; Linden et al., *The Cosseted Director*, *supra* note 2, at 168; SPENCER STUART, EXECUTIVE SEARCH CONSULTANTS, 1995 BOARD INDEX: BOARD TRENDS AND PRACTICES AT MAJOR AMERICAN CORPORATIONS 38-43 (1995) [hereinafter 1995 BOARD INDEX]. Remuneration for nonemployee directors often exceeds \$40,000, including their annual retainer, the fee received for attending meetings, and any additional compensation they may receive for chairing committees. For example, nonemployee directors receive annual compensation in the amount of \$50,000 at General Electric, \$40,000 at Exxon, \$55,000 at IBM, and \$64,000 at American Express. Moreover, these nonemployee directors usually receive a fee of between \$1000 and \$2000 for each meeting attended. In addition, committee chairmen usually receive a supplemental retainer of between \$3000 and \$5000 per year. AMERICAN EXPRESS CO., MAR. 15, 1995 PROXY STATEMENT 7 (1995); INTERNATIONAL BUSINESS MACHINES CORP., MAR. 16, 1995 PROXY STATEMENT 10 (1995); GENERAL ELECTRIC CO., MAR. 7, 1995 PROXY STATEMENT 7-8 (1995). Often remuneration goes beyond annual compensation and payments for meetings attended. Each nonemployee director at Eastman-Kodak is covered by group term-life insurance in the amount of \$100,000. EASTMAN-KODAK, MAR. 10, 1995 PROXY STATEMENT 5 (1995). Until this

All of these special forms of compensation, it has been argued, were necessary to retain the services of top-flight director talent.¹² Unfortunately they also compromised outside director independence from management, thus further fueling the board passivity that resulted in minimal management oversight and poor corporate performance. Today, board compensation treats the outside director as an employee of management, rather than a fiduciary of the shareholders. The nonmanagement board member's stake in the enterprise does not reflect the performance-based concerns of ownership, but instead reflects the interests of a highly salaried company employee. Outside directors, whose compensation is unrelated to corporate performance, have little personal incentive to challenge their management benefactors. Eager not to "bite the hand that feeds them," it is little wonder that boards became so passive and subject to management domination.

As board compensation practices may have acted to compound the problem of board passivity, these practices may also form the basis for its solution. To break management's grip on the board and stimulate real oversight, an appeal must be made to the director's same sense of personal self-interest that initially created the problem. There is nothing inherently wrong with a management-appointed board. The problem arises when a management-sponsored director fails to exercise appropriate oversight because of loyalty to the appointing party. The outside directors must be motivated to view management not from the perspective of a loyal employee, fearful of discharge, but from the viewpoint of an owner, concerned with overall profitability. To ensure that directors will examine executive initiatives in the best interest of the business, the outside directors must become substantial shareholders. To facilitate this, directors' fees must be paid primarily in company stock that is restricted

year, nonemployee directors at American Express who have served at least five years were eligible to receive \$30,000 per annum upon their retirement from the board; these payments continue for a number of years equal to the time served on the board or until death. AMERICAN EXPRESS CO., MAR. 14, 1991 PROXY STATEMENT 5 (1991). Similarly, General Electric's nonemployee directors who have served at least five years, are over the age of 65, and retire directly from the board are eligible to receive either an annual payment for life equal to the amount of the last retainer received or a \$450,000 life insurance policy. GENERAL ELECTRIC CO., MAR. 3, 1992 PROXY STATEMENT 13 (1992). Heinz Co. pays, upon a company director's death, \$1 million to the charity of choice. The amount the company will donate to qualifying charitable organizations on each present director's behalf ranges from \$750,000 to \$2 million based upon the director's length of service to the company. HEINZ CO., MAY 24, 1996 PROXY STATEMENT (1996). Ogden Corp. pays one board member \$1000 per month to consult with management on health issues. The company pays to another director \$5000 monthly for consultation on "international" issues. OGDEN CO., APR. 12, 1996 PROXY STATEMENT (1996).

12. See Joann S. Lublin, *Management: Investors Push to Ax Pensions for Outsiders*, WALL ST. J., Apr. 10, 1995, at B1. "We want to attract the best directors that we can," says Rae Paltiel, corporate secretary of the Morris Plains, N.J., drug maker. The trick "is to make sure directors have a comparable package, and being on our board is as good as being on any other board." *Id.* "Such pensions also 'encourage directors to think about the company long-term, which is one of the things you want directors to do.'" *Id.* (quoting William G. Bowen, president of the Andrew W. Mellon Foundation in New York and an outside member of Merck, American Express Co., and Reader's Digest Association Inc.).

as to resale during their term in office. No other form of compensation which acts to compromise their independence from management should be permitted. The goal is to create within each director a personal motivation to actively monitor management in the best interest of corporate productivity and to counteract the oversight-inhibiting environment that management appointment and cash-based fees create.

In June 1995, in what business commentators termed a major development in American corporate governance, the National Association of Corporate Directors' Commission on Director Compensation released a report calling for a radical overhaul of the compensation system for U.S. public company directors.¹³ Focusing on greater board equity ownership, the Commission made a series of recommendations designed to improve corporate governance by changing board pay practices to more closely align director and shareholder interests. Of greatest importance, the panel called upon companies to pay their directors primarily in stock, set substantial stock ownership targets for directors, and abolish all benefit programs, including pension plans, for board members.¹⁴

Since the report's release, a substantial number of companies have adopted the Commission's recommendations on director stock ownership and elimination of directors' pensions, including some of the nation's largest and most respected corporate institutions.¹⁵ That trend accelerated considerably with the approach of the 1996 proxy season, as the Investor Rights Association of America (IRAA), a small-shareholder advocacy group, announced that it was proposing over 120 shareholder resolutions calling for the discontinuation of director pension plans and the adoption of outside director stock-based compensation.¹⁶ With the

13. NACD REPORT, *supra* note 11, at 9-18.

14. *Id.* See Joann S. Lublin, *Give the Board Fewer Perks, A Panel Urges*, WALL ST. J., June 19, 1995, at B1; Allen R. Meyerson, *Panel Backs Shift in Board Members' Pay*, N.Y. TIMES, June 19, 1995, at D4; Philip Bassett, *US 'Greenbury' to Call for Radical Shake-up on Pay*, TIMES (London), June 16, 1995, at A4; Tony Jackson & William Lewis, *Call to Pay US Directors in Stock*, FIN. TIMES, June 19, 1995, at 3; Martha M. Hamilton, *Panel Recommends that Corporate Directors be Paid with Stock*, WASH. POST, June 20, 1995, at D5.

15. Some of the companies making these changes include the following: American Express, Archer-Daniels-Midland, Bell Atlantic, Campbell Soup, Chrysler, Digital Equipment, IBM, ITT, Kaufman & Broad, McGraw Hill, NationsBank, NYNEX, Texas Instruments, Westinghouse Electric, and Woolworth. Elson, *Major Shifts Seen in Director Pay*, *supra* note 1, at 3; Jonathan Auerbach, *Director's Cut: The Trend Toward Stock-Based Pay Has Spread to Board Members*, WALL ST. J., Apr. 11, 1996, at R6; Jill E. Lyons, *Restructuring Director Pay Leads to Increased Payouts*, ISSUE ALERT, June 1996, at 1; Dana W. Linden, *Off With Their Perks*, FORBES, Dec. 4, 1995, at 54, 60. In fact, prior to the report's release and apparently mindful of the relationship between director stock ownership and better oversight and performance, a number of large corporations accordingly adjusted their compensation practices. Scott Paper, Travelers Group, and Alexander & Alexander adopted solely equity-based director compensation plans. In fact, Scott Paper's stock jumped three percent in value on the date its equity plan was made public; IBM announced that it was scaling back its board pension program and was switching from a primarily cash-based to a 50% equity, 50% cash director compensation package. Elson, *Shareholding Directors Create Better Performance*, *supra* note 1, at 7-4.

16. Letter from Thomas E. Flanagan, President, Investors' Rights Association of America, to the members of Investors' Rights Association of America (1995) (on file with author). See Linden, *Off With Their Perks*, *supra* note 15, at 60; Auerbach, *supra* note 15,

widespread coverage of the IRRA's efforts by the national financial press along with the group's success in previous years in attracting substantial shareholder support for their efforts, a number of companies voluntarily adopted the director compensation changes requested by the organization in exchange for the withdrawal of its shareholder proposals.¹⁷ If current trends continue, within a short time equity-based director compensation will have become the norm for most of America's largest corporations.

This development has significance far beyond the change it represents in director compensation structure. It promises to fundamentally alter a decades-old norm of corporate governance—the separation of ownership and control and resulting management-created board passivity. Oddly enough, while director compensation was an outgrowth of the split between ownership and control, it may also result in their reunification. By changing the form of compensation to include primarily equity, we will make the directors substantial owners of the corporation once again and perhaps will have finally found the solution to the conundrum Berle and Means identified over sixty years ago. With board control in the hands of *owner*-directors once again, boards should become more active management monitors and the oversight-driven problems resulting from board passivity will become much less prevalent. This Article will explore the legal history of director compensation and explain why the current movement towards equity-based compensation will reunite ownership and control to create more active board oversight of management and a healthier, more competitive corporation.

I. THE HISTORY OF DIRECTOR COMPENSATION

To understand why equity-based director compensation will reinvigorate previously passive boards, it is first necessary to examine the historic origins of board compensation and how the rise of the large-scale public corporation effected dramatic change in its prevalence and structure. Traditionally, corporate directors received no direct compensation for their services. Early corporate legal doctrine clearly stated that directors were not entitled to remuneration for their activities as board members. In the early days of the American industrial age, virtually all companies were closely held by a relatively small group of investors. Directors were simply major shareholders and their board service was considered to have

at R6; Jonathan P. Decker, *Firms Cut Director Pay, but CEO Salaries Soar*, CHRISTIAN SCI. MONITOR, Apr. 10, 1996, at 6; Joann S. Lublin, *More Companies Are Dumping Pensions for Outside Directors as Activists Prevail*, WALL ST. J., Dec. 14, 1995, at A4; Michael Selz, *Big Companies Heed Investors' Call for Cutting Outside Directors' Benefits*, WALL ST. J., Jan. 10, 1996, at B2; David Henry, *Investor Rights Gadfly Group Has a Big Sting*, USA TODAY, Nov. 27, 1995, at B3.

17. Lublin, *supra* note 16, at A4; Selz, *supra* note 16, at B2; Henry, *supra* note 16, at B3; *Checklist of 1995 Shareholder Proposals on Director Compensation*, INVESTOR RESPONSIBILITY RESEARCH CENTER CORPORATE GOVERNANCE BULLETIN, Apr.-June 1995, at 21, 21-22 [hereinafter *1995 Shareholder Proposals Checklist*].

resulted from their desire to protect and enhance the value of their investment. Hence no compensation was necessary or desirable.¹⁸ They assumed their posts not to earn a paycheck, but to monitor and grow the value of their stake. As an 1846 corporate law treatise noted, "Directors of corporations . . . are not usually compensated for their ordinary services as directors."¹⁹ This was because directors were not "servants of the company" (*i.e.*, employees) and therefore not entitled to remuneration for services in that capacity.²⁰

The courts' approach to the issue reflected this viewpoint. Throughout the nineteenth and early twentieth century, courts did not support the notion that a corporate director was entitled to remuneration for his ordinary services as director. In 1899, the Eighth Circuit Court of Appeals in *National Loan & Investment Co. v. Rockland Co.*²¹ clearly spelled out the traditional judicial approach to the issue when it stated:

The directors of a corporation are trustees for its stockholders. They represent and act for the owners of its stock. Ordinarily the employment of a servant by a corporation raises the implication of a contract to pay fair wages or a reasonable salary for the service rendered, because it is the custom to pay such compensation, and men rarely sacrifice their time and expend their labor or their money in the service of others without reward. Directors of corporations, however, usually serve without wages or salary. They are generally financially interested in the success of the corporation they represent, and their service as directors secures its reward in the benefit which it confers upon the stock which they own The presumption of law follows the custom From the service of a director, the implication is that he serves gratuitously.²²

Delaware law was similarly hostile to the concept of director remuneration because "[d]irectors [were] presumed to serve without compensation."²³ The leading case was *Lofland v. Cahall*.²⁴ In this 1922 decision, the Delaware Supreme Court, in affirming a Court of Chancery decision, ruled that the directors of a corporation had no right to compensation for services provided in the course of their duties as directors unless authorized by the company's stockholders, charter, or bylaws.²⁵ Neither the charter nor bylaws of the company involved in the litigation authorized payment to the directors of salaries or compensation for their services.²⁶

18. PERCIVAL E. JACKSON, CORPORATE MANAGEMENT 158-59 (1955). "The legal assumption that directors serve gratuitously was a natural concomitant of director-stockholder concurrence in the small local enterprise, in which directors had the incentives of stockholders to serve the common interest." *Id.* See MORTIMER FEUER, HANDBOOK FOR CORPORATE DIRECTORS 169-70 (1965); BRANSON, *supra* note 7.

19. JOSEPH K. ANGELL & SAMUEL AMES, LAW OF PRIVATE CORPORATIONS AGGREGATE 309-11 (1846).

20. *Id.* at 311.

21. 94 F. 335 (8th Cir. 1899).

22. *Id.* at 337.

23. *Cahall v. Lofland*, 114 A. 224, 229 (Del. Ch. 1921).

24. 118 A. 1 (Del. Ch. 1922).

25. *Id.* at 6-7.

26. *Id.* at 3.

All of the directors did, however, own a substantial amount of the company's capital stock.²⁷ The remuneration at issue involved cash payments voted by the directors to themselves in the years 1912 through 1917 and an issuance of stock to each director without consideration in 1911.²⁸ In finding these payments unlawful, the court endorsed what it called "general principles of law and equity" to be considered in this context:

1. Directors of a corporation are trustees for the stockholders, and their acts are governed by the rules applicable to such a relation, which exact from them the utmost good faith and fair dealing. . . .

2. [Directors] have no right to compensation for services rendered within the scope of their duties as directors, unless it is authorized by the charter, by-laws, or the stockholders of the company.

3. [Directors] have no right to compensation for services rendered outside their duties as directors unless there had been an express contract to pay for such services, or, . . . unless . . . performed under circumstances sufficient to show that it was understood by the proper officers, . . . that the services were to be paid for by the corporation.

4. A contract to pay compensation for such services must be made with directors, or other proper corporate officers who have no personal interest, directly or indirectly, in the contract²⁹

It is interesting to note that in setting forth these principles, the court explained that because each was "so well settled, it is not deemed necessary to cite cases to support them."³⁰ However, by stating that services provided by a director outside the scope of his regular duties might be

27. *Id.*

28. *Id.* The payments received were paid as salaries or compensation for extra services claimed to have been rendered for the company.

29. *Id.* at 3.

30. *Id.* A review of six of the more prominent corporate law treatises authored in the late 19th and 20th centuries revealed that all took a more or less common view on the director compensation issue. Each had the following elements in common:

1. Unless otherwise provided in the charter or by-laws, directors are not entitled to compensation for their services as directors. This is because they are presumed to work for the welfare of the corporation and not in expectation of receiving compensation.

2. Even though a director may also hold an executive position, there is still a presumption that he is serving gratuitously. This presumption may be overcome, however, by showing, from the surrounding facts and circumstances, that an understanding or implied agreement existed that he should receive compensation.

3. Where at the request of the board, a director performs some extra or special work (extraordinary) outside the line of his duties as director, he will generally be entitled to receive compensation, unless the circumstances justify an inference that he was giving his services to the corporation gratuitously.

4. Traditionally, the only compensation received by directors were nominal fees paid to them for attending board meetings.

WILLIAM L. CLARK, JR., *HANDBOOK OF THE LAW OF PRIVATE CORPORATIONS* 531-32 (1897); THOMAS CONYNGTON, *A MANUAL OF CORPORATE MANAGEMENT* 147-48 (3d ed. 1909); 5A WILLIAM M. FLETCHER, *FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* §§ 2109-10 (perm. ed. rev. vol. 1995); WILLIAM J. GRANGE, *CORPORATION LAW FOR OFFICERS AND DIRECTORS* 667 (3d ed. 1967); LOUIS PRASHKER, *CASES AND MATERIALS ON THE LAW OF PRIVATE CORPORATIONS* 1000-01 (1937).

compensable, the court left open the possibility of legal director compensation. In relation to this point, the Delaware Court of Chancery in a 1928 ruling stated:

[It was] aware that the Supreme Court in the *Lofland* case used language from which the inference might be drawn that if the services rendered by the directors in securing the sale of their company's stock or bonds were such as to amount to "exceptional or extraordinary efforts," it might be proper for them to receive compensation for such services. But this is only an inference.³¹

However, it would be a number of years before there would be full legal acceptance of broad-based director compensation in Delaware.

The legal hostility to ordinary director compensation had its origins in the nineteenth century and appeared to have remained very much intact even through the 1940s. In a 1946 case, an Ohio court, considering a compensation dispute, stated that "because of the fiduciary relationship of directors courts will closely scrutinize and strictly construe contracts for compensation between a corporation and a director."³² In this regard, the court noted the oft-cited presumption that directors serve without compensation and that "they are entitled to no salary or other compensation for the performance of the usual and ordinary duties pertaining to the office of director in the absence of some express provision or agreement to that effect."³³ But despite this court's concern with director compensation, by the time of this decision, the financial community as a practical matter had abandoned any concern with the propriety of such compensation and many directors were in fact being compensated.

Although traditionally directors were not compensated for their services as "[c]orporate offices [were] usually filled by those chiefly interested in the welfare of such institutions by reasons of interest in stock or other advantages, and such interests [were] presumed to be the motive for executing duties of office without compensation,"³⁴ this did not necessarily mean that directors received absolutely no additional reward for their services. First of all, it was not uncommon for directors to receive some kind of "nominal" payment for their attendance at board meetings—usually a gold double eagle (worth twenty dollars) placed in front of their seats at each board meeting.³⁵ Secondly, there was probably some "unstated" compensation that directors received for board service. This form of compensation included such things as "lucrative tips—advance information—concerning proposed stock manipulations, consolidations, mergers, stock split-ups, opportunities to be included in preferred stock lists

31. *Finch v. Warrior Cement Corp.*, 141 A. 54, 63 (Del. Ch. 1928).

32. *Holms v. Republic Steel Corp.*, 69 N.E.2d 396, 402 (Ohio C.C.P. 1946).

33. *Id.*

34. *First Nat'l Bank of Allen v. Daugherty*, 250 P. 796, 797 (Okla. 1926).

35. *BISHOP*, *supra* note 7, § 1.02; *Linden, Off With Their Perks*, *supra* note 15, at 58; *Carey et al.*, *supra* note 1, at 2.

and to share in ground-floor stock subscription.”³⁶ Thus, the ability to engage in lucrative insider trading was a reward for faithful board service. Nevertheless, the ability to directly monitor one’s investment in a company still seemed the primary motivation for board service and explained why, for many years, directors were not directly compensated for their services.

The early twentieth century witnessed not only the phenomenal growth of the American economy, but also the growth of those corporate entities whose activities comprised that economy. Corporations were no longer local ventures owned, controlled, and managed by a handful of local entrepreneurs, but instead had become national in size and scope. Concomitant with the rise of the large-scale corporation came the development of the professional management class, whose skills were needed to run such far-flung enterprises.³⁷ And as the capitalization required to maintain such entities grew, so did the number of individuals required to contribute the funds to create such capital. Thus, we saw the rise of the large-scale *public* corporation—owned not by a few, but literally thousands and thousands of investors located throughout the nation. And with this growth in the size and ownership levels of the modern corporation, individual shareholdings in these ventures became proportionally smaller and smaller, with no shareholder or shareholding group now owning enough stock to dominate the entity. Consequently, the professional managers moved in to fill this control vacuum.³⁸ Through control of the proxy process, incumbent management nominated its own candidates for board

36. JACKSON, *supra* note 18, at 159.

37. Coincident with the rise of a new managerial class, was the development of an educational system to train this group. The creation of the modern business school and collegiate business curriculum was a response to the need for the professional manager. A history of the Columbia University Graduate School of Business written in 1954 details this phenomenon:

In the Wharton school, before the nineteenth century ended, business education began to shift in interest and emphasis from the general to the special, from the speculative to the practical, to the scientific, to the professional.

The remarkable spread of collegiate business education during the last forty years is not difficult to explain. It has been part and parcel of the growth and expansion of American economic activity. The increase in the number, in the size, and the complexity of business enterprises has given rise to progressive needs for better means and methods of supervision management, and control, as well as for highly specialized services designed to meet the requirements created by the division and the diversification of functions of the individual enterprise. Among all the needs of the business world, none has given greater concern than the need for a high grade of managerial personnel, competent to analyze problems as they arise and competent to cope with them promptly and successfully.

The main tasks of schools of business are (1) the training of technicians in fundamentals recognized as measurably common to a variety of businesses; and (2) the developing, in a carefully selected group of students, of an awareness of factors underlying policy and planning in business enterprise requiring the exercise of managerial responsibility and judgment.

THURMAN W. VAN METRE, A HISTORY OF THE GRADUATE SCHOOL OF BUSINESS COLUMBIA UNIVERSITY 6, 7, 9 (1954).

38. Neiva, *supra* note 8, at 2-6.

membership. The board of directors, theoretically composed of the representatives of various shareholding groups, instead was comprised of individuals selected by management. The directors' connection with the enterprise generally resulted from a prior relationship with management, not the stockholding owners, and they often had little or no shareholding stake in the company.

Berle and Means in their path-breaking book *The Modern Corporation and Private Property* described this phenomenon of the domination of the large public corporation by professional management as the separation of ownership and control. The firm's nominal owners, the shareholders, in such companies exercised virtually no control over either day-to-day operations or long-term policy.³⁹ Instead control was vested in the professional managers who typically owned only a very small portion of the firm's shares.⁴⁰ This separation occurred because stock ownership in the large-scale public company was diffused amongst many shareholders, with no shareholder or shareholding group owning enough shares to materially affect the corporation's management.⁴¹ Berle and Means spoke of the ownership/control split in terms of the surrender of control by the shareholders to management and the transformation of the owner from an active agent with discretion over property to a state of passivity in which the owner was "practically powerless through his own efforts to affect the underlying property."⁴²

[There] lies a more fundamental shift. Physical control over the instruments of production has been surrendered in ever growing degree to centralized groups who manage property in bulk, supposedly, but by no means necessarily, for the benefit of the security holders. Power over industrial property has been cut off from the beneficial ownership of the property We see, in fact, the surrender and regrouping of the incidence of ownership, which formerly bracketed full power of manual disposition with complete right to enjoy the use, the fruits, and the proceeds of physical assets. There has resulted the dissolution of the old atom of ownership into its component parts, control and beneficial ownership.⁴³

They summarized the state of the "modern corporation" as one "in which the individual interest of the shareholder is definitively made subservient to the will of a controlling group of managers even though the capital of the enterprise is made up out of the aggregated contributions of perhaps many thousands of individuals."⁴⁴

One consequence of this phenomenon identified by Berle and Means was the filling of board seats with individuals selected not from the shareholding ranks, but chosen instead because of some prior relationship with

39. BERLE & MEANS, *supra* note 6, at 3-6.

40. *Id.*

41. *Id.* at 47.

42. *Id.* at 66.

43. *Id.* at 7-8.

44. *Id.* at 277.

management. Boards were now comprised either of the managers themselves (the "inside directors") or associates of the managers, not otherwise employed by or affiliated with the enterprise (the "outside" or "nonmanagement directors"). As one prominent business historian has explained:

As they became increasingly influential, corporate managers had little incentive to invite assertive individuals who might challenge their authority to fill the board seats As one observer explained: "Many chief executives are not really convinced that they wanted a strong and independent group of directors. After all, the chief executive fought long and hard to reach his position of power. Is it not normal and natural for him to tend to avoid critical review of his stewardship?" Managers instead invited fellow insiders and prominent community members, as well as corporate attorneys and commercial bankers to serve on their boards

Although directors enjoyed next-to-no influence over senior managers and played a negligible role in the formulation of corporate strategy, executives had little difficulty finding individuals willing to serve on their boards. Some accepted invitations because they feared that if they refused, they might later find it difficult to locate executives to sit on their own boards. Others viewed directorships as a form of public service, "much as someone who must serve on the board of governors or greens committee of the golf club."⁴⁵

Because boards of the large public corporations were now comprised of a number of outside individuals with little connection to the enterprise other than their relation with management, changes would have to be made in the corporation's relationship with them. This new breed of outside director often had little or no shareholding interest in the enterprise and, as such, no longer represented their own personal financial stakes or those of the other shareholders in rendering board service. However, as the shareholders' legal fiduciaries, the outside directors were still expected to expend independent time and effort in their roles, and, consequently, it began to be recognized that they must now be compensated directly for their activities.

Without a substantial personal investment in the company, a token twenty-dollar gold piece did not constitute a sufficient reward for the time this new breed of director devoted to corporate activities. Thus, real compensation was necessary to encourage board membership and stimulate effective service. A 1940 article entitled *The Board of Directors* appearing in the *Harvard Business Review* argued:

The compensation of directors is peculiarly a problem to be worked out according to particular circumstances. To the extent that it is now possible to generalize, it can be said that if the optimum functions of a board are to be performed and one excuse for partial performance or invisible rewards removed, directors should be paid

45. Neiva, *supra* note 8, at 2-6 to 2-7.

substantial rather than nominal salaries or fees for their services.⁴⁶ In fact, Berle and Means themselves supported the establishment of a compensation scheme for corporate board members. They criticized the lack of an "adequate system of payment" for corporate directors because "[t]he director's fee does not remotely compensate for successful and faithful management."⁴⁷ Their solution was "an honest and fully disclosed profit sharing scheme of some kind"⁴⁸

Within fifteen years, the director compensation situation had changed dramatically. In a 1947 study entitled *Compensation and Duties of Corporate Directors*, the Conference Board reported the following:

There has been a significant trend in the last ten years toward remunerating directors on an annual salary basis. Approximately one out of every five of the surveyed companies now pays outside directors either a straight salary or a base salary plus a fee for each meeting attended. Paying directors a salary more nearly commensurate with the duties and liabilities attached to the position is coming to be recognized as serving the best interests of both the corporation and the shareholders.⁴⁹

This sea change in compensation practice can be traced to the changing composition of public corporate boards, now increasingly staffed with management appointees, rather than controlling shareholders—a by-product of the dramatic shift in corporate control identified by Berle and Means. As representatives of management, without a financial stake in the business, the outside, nonmanagement board members needed to be compensated for their time and effort devoted to corporate activities. Indeed, Berle and Means's work probably had something to do with this change in remuneration practice. In reporting on the move to director compensation, the Conference Board specifically referred to their study and its call for director remuneration, labeling the two professors "out-standing authority."⁵⁰

46. George E. Bates, *The Board of Directors*, 19 HARV. BUS. REV. 72, 85 (1940).

47. BERLE & MEANS, *supra* note 6, at 225 n.6.

48. *Id.*

49. Paul W. Dickson, CONFERENCE BOARD, INC., COMPENSATION AND DUTIES OF CORPORATE DIRECTORS 3 (1947) [hereinafter 1947 CONFERENCE BOARD REPORT]. A 1948 study sponsored by the Stanford Business School found the following:

Compensation of directors varies. All companies participating in this study reimburse directors for traveling expenses incurred in connection with attendance at board meetings. Most companies, in addition, pay fees for attendance, the amounts being about equally divided between \$20, \$50, and \$100 per meeting. Several companies compensate directors for attendance at committee meetings on the same basis as for attendance at directors' meetings. About one-half of the companies that pay fees for attendance at meetings exclude those directors who are full-time executives and who are on the salary roll of the company. Two companies pay annual stipends to outside directors regardless of the number of meetings attended. Five companies report that no fees are paid to any director.

PAUL E. HOLDEN ET AL., TOP-MANAGEMENT ORGANIZATION AND CONTROL 235 (1948).

50. 1947 CONFERENCE BOARD REPORT, *supra* note 49, at 6. As was noted in a 1955 treatise on corporate management:

In what was later to be a significant development, as the compensation of outside corporate directors in the large corporation became increasingly more typical, a movement began for substantially increasing the level of that remuneration. A 1950 article in the *Harvard Business Review* strongly encouraged this change:

An important step to be taken to improve the boards of most large companies is to increase the remuneration of board members. This is probably the most underpaid group of individuals in the American business system today, in view of its responsibilities and at least potential services. The average outside director received approximately \$850 during 1945, with other directors averaging \$625. By 1946, according to a study of 184 directors of large companies, about 3 out of 5 were receiving in the aggregate over \$1,000 per year—an improvement, but still by no means sufficient.

The importance of director's functions, together with the desirability of providing incentives for the best men, makes the remuneration problem a vitally important one. From a strictly psychological point of view, the director who is receiving only a nominal fee for attending board meetings may unconsciously devote to the affairs of the company only as much effort and time as the fee seems to warrant. In the case of professional directors, for whom salary is the prime incentive, the importance of compensation is obviously magnified. . . .

....

Other reasons for deeming increased remunerations desirable include the fact that legal liability may jeopardize the director's personal fortunes. There have been many cases where, even after his death, his estate has been involved in litigation for years. Another reason is the fact that executives are likely to feel greater freedom in using the abilities of directors who receive reasonable compensation. In turn, most directors will not be willing to accept substantial compensation unless they are able to give to the corporation commensurate performance. Obviously, the company which recognizes the importance of all these factors should be rated up.⁵¹

Despite the dramatic change in director compensation practice that began in the 1930s and 1940s and appeared to have its roots in the new type of director occasioned by the Berle and Means's separation of ownership and control, the legal recognition of this movement was a bit slow in coming, providing yet another demonstration of the difficulty in amending legal standards to meet changing cultural expectations. Even with the

The legal assumption that directors serve gratuitously was a natural concomitant of director-stockholder concurrence in the small local enterprise, in which directors had the incentives of stockholders to serve the common interest. But as the cycle has replaced the stockholder-director with separate ownership and management, so the legal concept of no compensation for directors has given way to the practical recognition of the need for director monetary incentive.

JACKSON, *supra* note 18, at 158-59.

51. Wilbur T. Blair, *Appraising the Board of Directors*, 28 HARV. BUS. REV. 101, 111-12 (1950).

growing recognition by the late 1940s that directors should and, in fact, were being regularly compensated for their services, the newly promulgated Model Business Corporation Act in its initial 1950 version⁵² provided no legal recognition of this phenomenon. Section 33, entitled *Board of Directors*, simply provided:

The business and affairs of a corporation shall be managed by a board of directors. Directors need not be residents of this State or shareholders of the corporation unless the articles of incorporation or by-laws so required. The articles of incorporation or by-laws may prescribe other qualifications for directors.⁵³

However, three years later, in 1953, the Committee on Business Corporations of the American Bar Association (ABA) revised the Model Act to authorize the board of directors to set their own compensation. To effect this change, a sentence was added to the end of section 33 that was to change dramatically the corporate law's approach to the director compensation issue. The new clause provided that "the board of directors shall have the authority to fix the compensation of directors unless otherwise provided in the articles of incorporation."⁵⁴ This statutory change effectively overruled the century-old common law hostility to director compensation and paved the way for even more sweeping change in the structure and functioning of corporate boards. In making this revision, the Committee noted that director compensation had "been a practice of long standing without statutory recognition in many jurisdictions."⁵⁵ The language of this provision, presumptively allowing for director compensation, has largely remained intact except for a change in 1984 which provided that by-laws, in addition to the articles of incorporation, could specifically prohibit director compensation.⁵⁶

52. The primary purpose of the Model Business Corporation Act was to provide states and bar association committees with a working model for revision and modernization of their own corporate laws. Using the Model Act as a guide, states could adopt in whole or in part provisions of the Model Act to modernize their corporate laws. The first draft of the Model Act was completed in 1946 by the Committee on Business Corporations of the American Bar Association under the title, "Model for State Business Corporation Acts." The Committee recognized that this initial draft was incomplete and required further intensive study. Following this further study and subsequent revisions, the Committee published the first complete Model Business Corporation Act in 1950. See MODEL BUSINESS CORP. ACT, iv (preface 1950). Since 1950, the Model Act has undergone a number of periodic revisions with the last full revision occurring in 1984 when the Committee published the Revised Model Business Corporation Act. See REVISED MODEL BUSINESS CORP. ACT (1984) (amended 1991).

53. MODEL BUSINESS CORP. ACT § 33 (1950).

54. MODEL BUSINESS CORP. ACT § 33 (1953). The current comparable provision is located at § 8.11 which provides: "Unless the articles of incorporation or bylaws provide otherwise, the board of directors may fix the compensation of directors." MODEL BUSINESS CORP. ACT § 8.11 (1991).

55. MODEL BUSINESS CORP. ACT ANN., COMMITTEE ON CORPORATE LAWS 756 (1971).

56. REVISED MODEL BUSINESS CORP. ACT § 8.11 (1984) ("Unless the articles of incorporation or bylaws provide otherwise, the board of directors may fix the compensation of directors.").

The Model Act was designed to provide states with a working model for the revision and modernization of their corporate laws. Using the Act as a guide, states could adopt in whole or in part its various sections to modernize their corporate statutes.⁵⁷ In the years following the Model Act's addition of a director compensation provision, the states slowly began to enact their own versions,⁵⁸ sometimes changing the provision slightly.⁵⁹ Today, all but eight jurisdictions have enacted provisions expressly authorizing directors to fix board members' compensation.⁶⁰ Of

57. See MODEL BUSINESS CORP. ACT, iv (preface 1950).

58. During the six years following the enactment of the Model Act's director compensation provision (1954-60), twelve jurisdictions followed and enacted their own. See ALA. BUS. CORP. ACT § 24 (1959); ALASKA COMP. LAWS ANN. § 36-2A-41 (Supp. 1958); COLO. CORP. ACT § 34 (1958); CONN. GEN. STAT. ANN. §§ 33-313, 33-314 (effective Jan. 1, 1961); ILL. REV. STAT. ANN. ch. 32 § 157.33; IND. ANN. STAT. § 25-208; IOWA CODE ANN. § 496A.34; N.C. GEN. STAT. § 55-24, 55-30, 55-33; N.D. REV. CODE 10-1936 (Supp. 1957); VA. CODE ANN. § 13.1-35; WIS. STAT. ANN. § 180.30, 180.31.

Between 1960 and 1966, nine jurisdictions enacted director compensation provisions similar to the Model Act's. See ARK. BUS. CORP. ACT § 36 A 576 (effective Jan. 1, 1966); MISS. BUS. CORP. ACT § 34 (effective Jan. 1, 1963); NEB. BUS. CORP. ACT § 35 (effective Oct. 19, 1963); N.Y. BUS. CORP. LAW § 713(c) (effective Sept 1, 1963); S.D. BUS. CORP. ACT § 33 H. B. 893 (effective July 1, 1966); UTAH BUS. CORP. ACT § 33 (effective Jan. 1, 1962); WASH. BUS. CORP. ACT § 37 (effective July 1, 1967); WYO. BUS. CORP. ACT § 33 (effective July 1, 1961); D.C. BUS. CORP. ACT § 32 (effective Nov. 2, 1963).

Between 1966 and 1969, six jurisdictions enacted director compensation provisions similar to the Model Act's. See GA. CODE ANN. § 22-701; LA. REV. STAT. § 12:81A; MO. ANN. STAT. § 351.310 (Vernon); MONT. REV. CODE ANN. § 15-2233; OHIO REV. CODE ANN. §§ 1701.56(C), 1701.59(A), 1701.60; PA. STAT. ANN. tit. 15, §§ 1401, 1402.

Between 1969 and 1973, eight jurisdictions enacted director compensation provisions similar to the Model Act's. See DEL. CODE ANN. tit. 8, §§ 141(a), (b), (h) (effective July 15, 1969); KAN. STAT. ANN. 17-6301(a), (b), (h) (effective July 1, 1972); KY. REV. STAT. ANN. § 271A.175 (effective July 1, 1972); ME. REV. STAT. ANN. tit. 13-A, §§ 701, 702, 716, 717(5) (effective Jan. 1, 1972); MICH. COMP. LAWS ANN. §§ 450.1501, 450.1546(3) (effective Jan. 1, 1973); N.J. STAT. ANN. § 14A:6-1 (effective Jan. 1, 1973); R.I. GEN. LAWS ANN. § 7-1.1-33 (effective Jan. 2, 1970); VT. STAT. ANN. tit 11, § 1881 (effective July 1, 1971).

Between 1973 and 1977, six jurisdictions enacted director compensation provisions similar to the Model Act's. See ARIZ. REV. STAT. ANN. § 10-035 (effective July 1, 1976); CAL. CORP. CODE ANN. §§ 164.204(d), 212(b)(4), 300(a) (effective Jan. 1, 1977); FLA. STAT. ANN. § 607.111(1), (2), (3) (effective Jan. 1, 1976); MINN. STAT. ANN. § 301.28(1), (3), (4) (effective Mar. 30, 1973); N.M. STAT. ANN. § 51-24-34 (effective June 20, 1975); W. VA. CODE ANN. § 31-1-95 (effective July 1, 1975).

The last four states to enact director compensation provisions similar to the Model Act's did so between 1977 and 1993. See HAW. REV. STAT. § 415-35 (1993); IDAHO CODE § 30-1-35 (1980); N.H. REV. STAT. ANN. § 293-A:8.11 (Supp. 1995); TENN. CODE ANN. § 48-18-111 (1995).

59. When enacted in 1953, the Model Act provision allowed director compensation unless the articles of incorporation provided otherwise. Some states, however, provided in their provisions that the articles or by-laws could prohibit director compensation. See, e.g., CONN. GEN. STAT. ANN. §§ 33-313, 33-314 (effective Jan. 1, 1961); ILL. REV. STAT. ANN. ch. 32, § 157.33; WIS. STAT. ANN. §§ 180.30, 180.31. Today, this difference is no longer important as the current Model Act provision provides that both the articles and by-laws can prohibit director compensation. MODEL BUSINESS CORP. ACT § 8.11 (1991).

60. The current states statutes codifying the right of directors to fix their compensation are as follows: ALA. CODE § 10-2B-8.11 (1994); ALASKA STAT. § 10.06.450 (1989); ARIZ. REV. STAT. ANN. § 10-811 (Supp. 1996); ARK. CODE ANN. § 4-27-811 (Michie 1991); COLO. REV. STAT. § 7-5-101 (1986); CONN. GEN. STAT. ANN. § 33-313(c) (West 1987 & Supp. 1996); DEL. CODE ANN. tit. 8, § 141(h) (1995); D.C. CODE ANN. § 29-332 (1991); FLA. STAT. ANN. § 607.08101 (West 1993); GA. CODE ANN. § 14-2-811 (1994); HAW. REV. STAT. § 415-35 (1993); IDAHO CODE § 30-1-35 (1980); ILL. ANN. STAT. ch. 805, para. 5/8.05

those that have not, there does not appear to remain any judicial hostility to the notion of director compensation. With one exception, their corporate statutes are simply silent on the point.⁶¹

By the 1960s, director compensation had generally become an accepted part of the American corporate landscape. Remuneration essentially took one of three forms—a simple fee per board meeting attended, an annual fee, or a “hybrid”—an annual retainer “plus a stated fee per meeting.”⁶² But, despite the growing legal and financial acceptance of the notion, compensation amounts remained relatively small. A corporate director’s handbook written in 1965 detailed the evolution of director remuneration, yet was unenthusiastic with what it called the slow pace towards paying board members more substantial compensation amounts:

The tradition that directors serve with no or only token compensation stems from the early days of the corporation when the directors were the proprietors whose compensation for the time and effort devoted to corporate affairs was expected to come through their stockholdings But there has been considerable change since those days. Stock is scattered among many small owners, foundations, investment companies, mutual funds, Concomitantly, the trend has been away from “inside” control and towards an “outside” majority, which is likely to view corporate problem areas with a greater objectivity and, in theory at least, can represent the corporation (and the body of stockholders) as ‘independents’ in matters in which the officer-director group might have a personal interest and be tempted to let the opportunity for self-aggrandizement get the upper-hand. Despite this trend, and the fact that most corporations now have a majority of outside directors, the token compensation tradition is only slowly giving way to a realistic recognition that dedication-time and effort is not purchased with a peppercorn.⁶³

(Smith-Hurd 1996); IND. CODE ANN. § 23-1-33-10 (Burns 1995); IOWA CODE ANN. § 490.811 (West 1991); KAN. STAT. ANN. § 17-6301 (1988); KY. REV. STAT. ANN. § 271B.8-110 (Baldwin 1989); LA. REV. STAT. ANN. § 12:81(c) (West 1994); MICH. COMP. LAWS § 450.1505(3) (Supp. 1995); MINN. STAT. ANN. § 302A.211 (West 1985); MISS. CODE ANN. STAT. § 79-4-8.11 (1989); MO. ANN. STAT. § 351.310 (Vernon 1991); MONT. CODE ANN. § 35-1-427 (1995); NEB. REV. STAT. § 21-2035 (1995); N.H. REV. STAT. ANN. § 293-A:8.11 (Supp. 1995); N.J. STAT. ANN. § 14A:6-8(3) (West 1987 & Supp. 1995); N.M. STAT. ANN. § 53-11-35 (Michie 1993); N.Y. BUS. CORP. LAW § 713(e) (McKinney 1996); N.C. GEN. STAT. § 55-8-11 (1990); N.D. CENT. CODE § 10-19.1-37 (1995); OHIO REV. CODE ANN. § 1701.60(A)(3) (Anderson 1992); OKLA. STAT. ANN. tit. 18, § 1027 (West 1986); OR. REV. STAT. § 60.334 (1988); 15 PA. CONS. STAT. ANN. § 1730 (1995); R.I. GEN. LAWS § 7-1.1-33 (1992); S.C. CODE ANN. § 33-8-111 (Law. Co-op. 1990); S.D. CODIFIED LAWS ANN. § 47-5-1 (1991); TENN. CODE ANN. § 48-18-111 (1995); UTAH CODE ANN. § 16-10a-811 (1995); VT. STAT. ANN. tit. 11a, § 8.11 (1993); VA. CODE ANN. § 13.1-683 (Michie 1993); WASH. REV. CODE ANN. § 23B.08.110 (West 1994); W.VA. CODE § 31-1-95 (1988); WIS. STAT. ANN. § 180.0811 (West 1992); WYO. STAT. 17-16-811 (1989).

61. Louisiana provides that director’s compensation may only be authorized by the articles of incorporation or bylaws. LA. REV. STAT. ANN. § 12:81(C) (West 1994). California, Maine, Maryland, Massachusetts, Nevada, Puerto Rico, and Texas do not directly address the issue of directors’ compensation. See MODEL BUSINESS CORPORATION ACT ANN. 3d § 8.11 (Supp. 1993).

62. JACKSON, *supra* note 18, at 158-60.

63. FEUER, *supra* note 18, at 169-70.

Throughout the 1960s and the early 1970s the number of companies providing regular compensation to their directors continued to grow as did the amounts of that compensation.⁶⁴ In 1962, a substantial majority of the largest American public corporations compensated their outside directors. Among manufacturing companies, the median board meeting fee was \$200, and the median annual retainer was \$2000.⁶⁵ By 1975, virtually all public companies compensated their directors and, among manufacturing companies, the median annual compensation, including fees and retainers, had grown to \$6000, with the largest companies paying a median of \$13,000.⁶⁶ However, beginning in the late 1970s, both the amount of director remuneration and the form such compensation took began to change dramatically. In an article published in the *Business Lawyer* in 1976, Professors Leech and Mundheim argued that because of the "time-consuming and dedicated service that is now being demanded of the outside director, [many] are probably not being compensated adequately."⁶⁷ The *Corporate Director's Guidebook*, published shortly thereafter by the ABA Business Law Section's Committee on Corporate Laws, stated that because "it is expected that a non-management director will devote substantial attention to the affairs of the corporation," he or she should "be compensated accordingly."⁶⁸ Consequently, the amount of cash compensation increased substantially, and other forms of remuneration began to appear.

By 1981, the median annual overall compensation paid to outside directors of the nation's most substantial public manufacturing companies was \$15,000. The largest operations paid a median of \$25,000.⁶⁹ Indeed, according to data collected by Towers Perrin, the international compensation consulting firm, the 1981 median retainer for companies in the Fortune 100 was \$15,000, with the median payment for attending board or committee meetings at \$500.⁷⁰ Additionally, a small but growing number of companies began to supplement their directors' cash compensation with varying combinations of employee-type benefits such as retirement arrangements, life insurance, travel insurance, medical insurance, and matching donations to charities of the directors' choice.⁷¹ A significant

64. Carey et al., *supra* note 1, at 3. See JOHN R. KINLEY, CONFERENCE BOARD, INC., REPORT NO. 103, CORPORATE DIRECTORSHIP PRACTICES, STUDIES IN BUSINESS POLICY (1962) [hereinafter 1962 CONFERENCE BOARD REPORT]; JEREMY BACON, CONFERENCE BOARD, INC., REPORT NO. 125, COMPENSATION AND DUTIES OF CORPORATE DIRECTORS, (1967) [hereinafter 1967 CONFERENCE BOARD REPORT].

65. 1962 CONFERENCE BOARD REPORT, *supra* note 64, at 32.

66. JEREMY BACON, CONFERENCE BOARD, INC., REPORT NO. 678, CORPORATE DIRECTORSHIP PRACTICES: COMPENSATION (1975) [hereinafter 1975 CONFERENCE BOARD REPORT].

67. Noyes E. Leech & Robert H. Mundheim, *The Outside Director of the Publicly Held Corporation*, 31 BUS. LAW. 1799, 1831-32 (1976).

68. *Corporate Director's Guidebook*, 33 BUS. LAW. 1595, 1622 (1978).

69. JEREMY BACON, CONFERENCE BOARD, INC., REPORT NO. 815, CORPORATE DIRECTORSHIP PRACTICES: COMPENSATION (1981) [hereinafter 1981 CONFERENCE BOARD REPORT].

70. Carey et al., *supra* note 1, at 3.

71. 1981 CONFERENCE BOARD REPORT, *supra* note 69, at 13.

number of corporations started offering their outside directors the opportunity to defer their compensation on a tax-favored basis (reported by 38% of the *Fortune* 100 companies in 1981).⁷² And, by 1985, median total annual compensation in the manufacturing sector had grown to \$18,900, with the median for the largest manufacturing corporations at \$31,900.⁷³ The number of companies offering the various forms of noncash compensation outlined above had also increased in the four-year-period.⁷⁴

Two factors appeared to be responsible for the change in amount and type of director compensation. The first was legal. During the 1970s, director liability became more of an issue, with shareholders bringing suit in a number of instances where they believed directors had not acted in their best interest. Professor Bishop, writing in 1981, spoke of such actions as "numerous and varied and [showing] every sign of proliferating rather than diminishing."⁷⁵ Indeed, Professors Leech and Mundheim, writing five years earlier, had argued that director compensation should "include some component adequate to cover the legal risks of serving on the board. The corporation can provide this through insurance and indemnity; failing that, the director's fees should include amounts adequate to purchase insurance."⁷⁶ This fear of increased director legal liability had a great impact on compensation practice. It led not only to larger and more varied pay packages to compensate for the increased risk of legal challenge, but to the creation of director and officer ("D & O") insurance plans to protect the directors.⁷⁷ In fact, by 1985, 85% of the nation's largest public companies offered their directors D & O coverage.⁷⁸

The second factor responsible for the change in director remuneration involved new theories on how the board should operate vis-à-vis management. The concept of the "independent" board and the "independent" director began to surface in legal and academic circles. The idea was that boards should be independent of management involvement so as to exercise proper oversight to ensure maximum corporate performance.⁷⁹ One

72. Carey et al., *supra* note 1, at 3; 1981 CONFERENCE BOARD REPORT, *supra* note 69, at 12.

73. JEREMY BACON, CONFERENCE BOARD, INC., REPORT NO. 862, CORPORATE DIRECTORS' COMPENSATION (1985) [hereinafter 1985 CONFERENCE BOARD REPORT].

74. *Id.* at 18.

75. BISHOP, *supra* note 7, § 1.01[1].

76. Leech & Mundheim, *supra* note 67, at 1832.

77. Carey et al., *supra* note 1, at 3; Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 EMORY L.J. 1155, 1158 (1990) [hereinafter Romano, *Aftermath of the Insurance Crisis*]; see also Dennis J. Block & Jonathan M. Hoff, *Protecting Outside Directors: D & O Insurance*, N.Y. L.J., Oct. 12, 1987, at 5, 7 [hereinafter Block & Hoff, *Protecting Outside Directors: D & O Insurance*]; Deborah A. DeMott, *Limiting Directors' Liability*, 66 WASH. U. L.Q. 295, 295-98 (1988); James J. Hanks, Jr., *Evaluating Recent State Legislation on Director and Officer Liability Limitation and Indemnification*, 43 BUS. LAW. 1207, 1209 (1988).

78. 1985 CONFERENCE BOARD REPORT, *supra* note 73, at 18.

79. Roberta S. Karmel, *The Independent Corporate Board: A Means to What End?*, 52 GEO. WASH. L. REV. 534, 544-56 (1984) (reviewing the history of independent director proposals and critiquing the ALI's tentative provisions and the underlying monitoring

of the major thrusts of the American Law Institute's Corporate Governance Project of the early 1980s was to alter board structure and composition to minimize management domination. Only directors with no significant relationship with management were to dominate the board's more important oversight committees, such as Audit or Compensation.⁸⁰ The kind of relationship that was considered problematic was direct employment by the company or the provision of such varied services to the business as legal or financial advice (or almost any business relationship with the corporation which provided the director with substantial financial benefit).⁸¹ While no mention was made of changing compensation practices as a result of creating the "independent" board, the financial independence from the company that the effort sought for the outside director, acted to strengthen the argument for increased compensation packages. The less connection that one had with an enterprise, the more one should be compensated for their efforts on its behalf—for how else could one be encouraged to expend the necessary time and effort in a job for which one received no other reward? Therefore, an increase in director compensation was necessary.

Although the early 1980s brought some changes in the nature and amount of director compensation, it was not until the middle part of the decade that a substantial shift in pay for outside directors began to occur. The reason for the dramatic change was, by and large, primarily legal in nature. Until 1985, there had been few challenges to director decision-making alleging violations of the directors' duty of care which had resulted in director liability. Although actions against directors for poor decisions were certainly either filed or threatened, and the possibility of liability, or at the very least adverse publicity, weighed on directors' minds in the 1970s and early 1980s, very few actions were ever successful.⁸² The duty of care proved relatively easy to satisfy. Under the tradi-

model). See Barry D. Baysinger & Henry N. Butler, *Revolution Versus Evolution in Corporation Law: The ALI's Project and the Independent Director*, 52 GEO. WASH. L. REV. 557, 561-65 (1984).

80. AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS §§ 3.03-.07 (Tentative Draft No. 2, 1984).

81. *Id.* at § 1.26.

82. Elson, *Duty of Care*, *supra* note 1, at 670; Joseph W. Bishop, Jr., *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1099 (1968). After extensive research, Professor Bishop discovered only four cases in which a court found that a director violated the duty of care, absent an allegation of self-dealing. Bishop, *supra*, at 1099-1100; see *New York Credit Men's Adjustment v. Weiss*, 110 N.E.2d 397 (N.Y. 1953); *Syracuse Television, Inc. v. Channel 9, Syracuse, Inc.*, 273 N.Y.S.2d 16 (Sup. Ct. 1966); *Clayton v. Farish*, 73 N.Y.S.2d 727 (Sup. Ct. 1947); *Selheimer v. Manganese Corp. of Am.*, 224 A.2d 634 (Pa. 1966). Even though all these decisions resulted in director liability, Bishop stated that "none of these cases carries real conviction." Bishop, *supra*, at 1100.

Several more recent commentators have also taken the view that the duty of care was an easily satisfied standard for directors. They argued that in the few cases where the courts found a breach of the duty of care, elements of director self-interest were present. See William J. Carney, *The ALI's Corporate Governance Project: The Death of Property Rights?*, 61 GEO. WASH. L. REV. 898, 922 n.126 (1993) ("I am aware of only five cases in the history of American Corporate law that have held directors liable for breaches of the

tional duty, a director was expected to carry out his or her responsibility "with the care that an ordinary prudent person in a like position would exercise under similar circumstances."⁸³ Failure to meet this standard would result in the imposition of liability upon the slothful director. This would theoretically compel circumspect and diligent conduct in carrying out the various responsibilities of board membership. However, under the business judgment rule, a director would be found to have met this duty of care if in making a specific business decision he or she acted without self-interest, in an informed manner, and with a rational belief that the decision was in the best interests of the corporation.⁸⁴ A director who

duty of care, four of which seem tainted by conflicts of interest."); Cohn, *supra* note 4, at 591 n.1 ("Research reveals only seven successful shareholder cases not dominated by elements of fraud or self-dealing."); Alan R. Palmiter, *Reshaping the Corporate Fiduciary Model: A Director's Duty of Independence*, 67 TEX. L. REV. 1351, 1360 (1989) ("During their century-long tenure, [care] standards have produced remarkably few cases holding directors liable for unreasonable or careless decisions."); Kenneth E. Scott, *Corporation Law and the American Law Institute Corporate Governance Project*, 35 STAN. L. REV. 927, 933 (1983) ("[V]ery few cases have imposed liability solely on the basis of a violation of the duty of care."). Professor Scott also noted that "[m]any of the 'negligence' cases are tainted by the presence of some element of conflicts of interest or personal gain." *Id.* at 933 n.23 (citing *Francis v. United Jersey Bank*, 432 A.2d 814 (N.J. 1981)). See also Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461, 482 (1992) (indicating that the lack of decisions holding directors liable for violating the duty of care may signify that "American judges have followed an [a]uthority [m]odel and have therefore intended that their articulation of the duty of care be mostly hortatory").

83. Elson, *Duty of Care*, *supra* note 1, at 669-70; MODEL BUSINESS CORP. ACT ANN. § 8.30 (3d ed. Supp. 1996). The Model Business Corporation Act states the director's duty of care as follows:

A director shall discharge his duties as a director, including his duties as a member of a committee:

- (1) in good faith;
- (2) with the care an ordinary prudent person in a like position would exercise under similar circumstances; and
- (3) in a manner he reasonably believes to be in the best interests of the corporation.

MODEL BUSINESS CORP. ACT ANN. § 8.30. The American Law Institute has defined the duty of care in a similar fashion:

- (a) A director or officer has a duty to the corporation to perform the director's or officer's functions in good faith, in a manner he or she reasonably believes to be in the best interests of the corporation, and with the care that an ordinary prudent person would reasonably be expected to exercise in a like position and under similar circumstances.

AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATION § 4.01(a) (1994) [hereinafter ALI].

Approximately 42 states have adopted statutory duty-of-care provisions. See 2 MODEL BUSINESS CORP. ACT ANN. § 8.30, at 8-175. Many states have adopted a reasonable care standard. ALI, *supra*; see CAL. CORP. CODE § 309(a) (West 1990 & Supp. 1996); N.Y. BUS. CORP. LAW § 717 (McKinney Supp. 1996); *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963); 2 MODEL BUSINESS CORP. ACT ANN. § 8.30, at 8-176; see also Cohn, *supra* note 4, at 593 n.7 (discussing the evolution of a common-law duty of care and the later statutory duties of care); E. Norman Veasey & William E. Manning, *Codified Standard-Safe Harbor or Uncharted Reef? An Analysis of the Model Act Standard of Care Compared with Delaware Law*, 35 BUS. LAW. 919 (1980) (comparing the standard of care in the Model Business Corporation Act § 35 with that of the Delaware case law); KY. REV. STAT. ANN. § 271B.8-300(1)-(2) (Michie/Bobbs-Merrill 1989 & Supp. 1994).

84. Elson, *Duty of Care*, *supra* note 1, at 669 n.36. In *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984), the Delaware Supreme Court described the business judgment rule as follows:

so acted in reaching a business decision was then protected from any legal liability to his or her shareholders. As long as a director's actions were in "good faith"—that is, not self-dealing—the business judgment rule standards were easy to satisfy, and, hence, actions alleging violations of the duty rarely resulted in director liability.⁸⁵

But, in 1985, this situation changed dramatically with the Delaware Supreme Court's ruling in *Smith v. Van Gorkom*⁸⁶ which toughened the duty of care standard considerably and made director liability for slothful decision-making no longer a remote possibility. In that case, the shareholders of Trans Union Corp. brought suit after the board had approved the sale of the company at a price deemed too low. The court, after describing in great detail the board's decision-making process, found that the board had made an "uninformed" judgment, pointing to, among other things, the very brief amount of time it had deliberated on the sale⁸⁷ and its failure to obtain expert outside financial advice.⁸⁸ As a re-

[A] presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption.

Id. at 812 (citations omitted).

The American Law Institute has defined the rule in the following manner:

(c) A director or officer who makes a business judgment in good faith fulfills the duty under this [s]ection if the director or officer:

- (1) is not interested in the subject of the business judgment;
- (2) is informed with respect to the subject of the business judgment to the extent the director or officer reasonably believes to be appropriate under the circumstances; and
- (3) rationally believes that the business judgment is in the best interest of the corporation.

ALI, *supra* note 82, § 4.01(c); see *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985); see also *Teren v. Howard*, 322 F.2d 949, 952-53 (9th Cir. 1963); *Richardson v. Blue Grass Mining Co.*, 29 F. Supp. 658, 665 (E.D. Ky. 1939), *aff'd*, 127 F.2d 291 (6th Cir. 1942); *Wall & Beaver Street Corp. v. Munson Line, Inc.*, 58 F. Supp. 109, 115-16 (D. Md. 1944); *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 360 (Del. 1993); *Citron v. Fairchild Camera & Instrument Corp.*, 569 A.2d 53, 64 (Del. 1989); *Haber v. Bell*, 465 A.2d 353, 357 (Del. Ch. 1983).

Where a director has not made a business decision, such as in the case of an omission, the business judgment rule does not apply, and the director should not be judged under the reasonable care standard. *Aronson*, 473 A.2d at 813.

For a complete discussion of the difference between the ALI's formulation of the business judgment rule and that of the Delaware Supreme Court in *Aronson v. Lewis*, see Dooley, *supra* note 82, at 461.

85. See *supra* note 82 and accompanying text.

86. *Van Gorkom*, 488 A.2d at 858.

87. *Id.* at 874 (stating that the board was grossly negligent when it approved the sale of the company after only two hours of deliberation).

88. *Id.* at 876-78; Elson, *Duty of Care*, *supra* note 1, at 677 n.56. See Lucian A. Bebchuk & Marcel Kahan, *Fairness Opinions: How Fair Are They and What Can Be Done About It?*, 1989 DUKE L.J. 27, 28 (1989); Dennis J. Block & Jonathan M. Hoff, *Investment Banker Opinions and Directors' Right to Rely*, N.Y. L.J., Nov. 17, 1988, at 5; Charles M. Elson, *Fairness Opinions: Are They Fair or Should We Care?*, 53 OHIO ST. L.J. 951, 958 (1992) [hereinafter Elson, *Fairness Opinions: Are They Fair or Should We Care?*]; Robert J. Giuffra, Jr., *Investment Bankers' Fairness Opinions in Corporate Control Transactions*, 96 YALE L.J. 119, 119-20 (1986); see also *Polk v. Good*, 507 A.2d 531, 537 (Del. 1986) (finding

sult, the directors faced the potential of being held personally liable for the difference between the price actually paid for the company and what the shareholders could have received had an "informed" decision been reached.

This ruling, which still remains authoritative, had a major impact on corporate and board behavior. It was responsible for the now common use of third-party advisors to provide expert opinions to boards.⁸⁹ It also led to far more elaborate decision-making procedures involving lengthy meetings, voluminous documentation, and the like.⁹⁰ While the decision attempted to improve the actual decisions that boards made, in reality, it instead led to more form over substance, with directors spending more time than necessary wading through papers and analyses simply to provide proof that their judgment was informed.⁹¹ Nevertheless, *Van Gorkom* expanded the time and effort (if not always the diligence) that directors had to give to their job and made the threat of legal liability for not acting in an "informed" manner certainly more credible than it previously had been.⁹²

Not coincidentally, the *Van Gorkom* ruling came at a time when boards were facing even more complex business decisions than ever before. In the merger mania of the 1980s, as well as an increasingly competitive global economy, the actions that boards were being called upon to take had tremendous financial, and sometimes even social implications, not to mention the ever present threat of legal challenge. With the director's

that the board's reliance on the advice of an investment banker fulfilled its duty of good faith and reasonable investigation); *Citron v. E.I. DuPont de Nemours & Co.*, 584 A.2d 490, 512 (Del. Ch. 1990) (holding that the board's reliance on the advice of an investment banker satisfied its fiduciary duty).

89. See Douglas M. Branson, *Intracorporate Process and the Avoidance of Director Liability*, 24 WAKE FOREST L. REV. 97, 103-04 (1989) (stating that to avoid due care violations after *Van Gorkom*, directors should "make use of independent, outside experts, at least when the transaction is large enough to justify their use"); Elson, *Duty of Care*, *supra* note 1, at 678 n.57; Elson, *Fairness Opinions: Are They Fair or Should We Care?*, *supra* note 88, at 958-59; Daniel R. Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 BUS. LAW. 1437, 1453 (1985) (providing "[t]he most immediate effect of *Trans Union* will be that no firm considering a fundamental corporate change will do so without obtaining . . . documentation from outside consultants"); Giuffra, *supra* note 88, at 119-20; Jonathan R. Macey, *The Transformation of the American Law Institute*, 61 GEO. WASH. L. REV. 1212, 1220-22 (1993); Jonathan R. Macey & Geoffrey P. Miller, *Trans Union Reconsidered*, 98 YALE L.J. 127, 139 (1988).

Professor Fischel, commenting on the *Trans Union* ruling shortly after its announcement, wryly noted that the "outside consultants are the biggest winners after *Trans Union*. The decision requires their participation as a type of insurance no matter how worthless their opinion is or how much it will cost." Fischel, *supra*, at 1453.

90. Elson, *Duty of Care*, *supra* note 1, at 679-82; Carey et al., *supra* note 1, at 3-4. For a listing of steps that directors should take to ensure a judicial finding of "informed" decision making, see Branson, *supra* note 89, at 103-09; Bayless Manning, *Reflections and Practical Tips on Life in the Boardroom After Van Gorkom*, 41 BUS. LAW. 1, 8-14 (1985). See also William J. Carney, *Section 4.01 of the American Law Institute's Corporate Governance Project: Restatement or Misstatement?*, 66 WASH. U. L.Q. 239, 283-88 (1988) (discussing the judicial determination of a properly informed business decision); Macey, *supra* note 89, at 1219-21 (discussing the steps that directors should take pursuant to the ALI).

91. Elson, *Duty of Care*, *supra* note 1, at 682-87.

92. Carey et al., *supra* note 1, at 3-4.

position increasingly viewed as a "hot seat," companies became extremely concerned with the impact of these developments on director recruitment and retention.⁹³ Their response was to provide much richer and more varied pay packages, along with greater D & O insurance coverage and other indemnification arrangements.⁹⁴

93. *Id.* at 4.

94. *Id.* In response to the *Van Gorkom* decision, a number of state legislatures took action to reduce a director's risk of personal liability for actions taken while a board member. Delaware was the first state to enact a statute that allowed the placement into the corporations' certificate of incorporation by shareholder vote of a clause limiting or eliminating director liability for a breach of the duty of care. Block & Hoff, *Protecting Outside Directors: D & O Insurance*, *supra* note 77, at 5, 7. The Delaware statute provides that a certificate of incorporation may contain the following:

A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or knowing violation of law; (iii) under § 174 of the title; or (iv) for any transaction from which the director derived an improper personal benefit.

DEL. CODE ANN. tit. 8, § 102(b)(7) (1991). "Within two years" following enactment of the Delaware statute, some 41 states similarly amended their corporations statutes to limit director liability. Romano, *Aftermath of the Insurance Crisis*, *supra* note 77, at 1160. Most of these statutes tracked the Delaware approach, but there were some variations. Some states increased the level of culpability necessary to find personal liability. *See, e.g.*, IND. CODE ANN. § 23-1-35-1(e) (Burns 1995) (requiring "willful misconduct or recklessness"); OHIO REV. CODE ANN. § 1701.59(D) (Anderson 1992) (requiring "deliberate intent" or "reckless disregard"); WIS. STAT. ANN. § 180.0828(1)(a)-(d) (West 1993) (requiring "wilful failure to deal fairly," "violation of criminal law," "improper personal profit," or "wilful misconduct"). At least one state simply limited the amount of damages for which a director may be liable. VA. CODE ANN. § 13.1-692.1(A)(2) (Michie 1993) (capping the liability at the greater of \$100,000 or the amount of compensation received from the corporation during the last 12 months). For further discussion on the different approaches state legislatures used to limit director liability, *see* JOSEPH W. BISHOP JR., *LAW OF CORPORATE OFFICERS AND DIRECTORS: INDEMNIFICATION AND INSURANCE* §§ 6.36-.86 (1994); Block & Hoff, *Protecting Outside Directors: D & O Insurance*, *supra* note 77, at 5, 7; DeMott, *supra* note 77, at 295; Hanks, *supra* note 77, at 1208-09; Romano, *Aftermath of Insurance Crisis*, *supra* note 77, at 1160-68.

These statutes, however, have not necessarily eliminated the potential for, or the director's fear of, personal liability. *See* Leo Herzel et al., *Next-to-Last Word on Endangered Directors*, 87 HARV. BUS. REV. 38, 43 (1987) (stating that courts can circumvent the new Delaware statute because "[w]ith only a little effort, courts could find directors liable for disloyalty where before they would have found them liable for negligence"); Romano, *Aftermath of the Insurance Crisis*, *supra* note 77, at 1161 (questioning the effectiveness of the legislative response to director liability because "the statutes in most states do not exempt from liability claims for breach of the duty of loyalty, violation of federal securities laws, and breach of the duty of care by directors who are also officers"); Roberta Romano, *What Went Wrong with Directors' and Officers' Liability Insurance?*, 14 DEL. J. CORP. L. 1, 32 (1989) (stating that limited liability statutes are ineffective because "plaintiffs will, in all likelihood, be able to redraft their complaints to continue to bring lawsuits; for example, instead of alleging negligence they will allege reckless behavior").

In addition to reducing directors' exposures by limiting personal liability, some states increased director indemnification rights. *See, e.g.*, LA. REV. STAT. ANN. § 12:83E (West 1994); N.Y. BUS. CORP. LAW § 721 (McKinney Supp. 1996); Block & Hoff, *Protecting Outside Directors: D & O Insurance*, *supra* note 77, at 5, 7; DeMott, *supra* note 77, at 317-22; Hanks, *supra* note 77, at 1221-24; Romano, *Aftermath of the Insurance Crisis*, *supra* note 77, at 1162-63. This approach, however, has also proved problematic. *See* Dennis J. Block et al., *Advising Directors on the D & O Insurance Crisis*, 14 SEC. REG. L.J. 130, 146-

By 1989, median total annual director compensation for the leading publicly traded manufacturing companies had reached \$24,000,⁹⁵ and the largest corporations paid a median of \$40,250.⁹⁶ Of particular note were the compensation practices of the *Fortune* 100 companies. By 1989, their median annual retainer had risen to \$25,000, up from \$20,000 in 1985. Board and meeting fees were also on the rise, with the median board fee in 1989 at \$1000, double the 1981 level.⁹⁷

Additionally, corporations were now providing a multitude of noncash compensation schemes for their outside directors. The director retirement program, by which directors were entitled to substantial pensions following their retirement from the board (typically at their preretirement annual fee level), practically nonexistent among U.S. companies in the early 1980s, had become the norm in the *Fortune* 100 by 1989. Sixty-nine percent of those companies were now providing director retirement plans, up from just eight percent in 1981.⁹⁸ In addition, most companies offered their directors D & O liability insurance, and a substantial number were providing travel insurance, matching charitable donation programs, accidental death insurance, life insurance, and even medical coverage.⁹⁹

Today, the typical director receives a multifaceted package consisting of many or all of the following items:

1. annual retainer, generally in cash, plus supplements for chairing any board committee;
2. fees for attending board and committee meetings;
3. defined benefit retirement arrangements;
4. life insurance/medical insurance;
5. charitable contribution arrangements (where the corporation makes sizeable donations to the charity of the board member's choice, either through direct contributions or the purchase of a life insurance policy on the director's life);¹⁰⁰
6. opportunities to defer cash compensation on a tax-favored basis; and
7. stock options or grants.¹⁰¹

47 (1986); Theodore D. Moskowitz & Walter A. Effross, *Turning Back the Tide of Director and Officer Liability*, 23 SETON HALL L. REV. 897, 912-13 (1993); John F. Olson, *The D & O Insurance Gap: Strategies for Coping*, LEGAL TIMES, Mar. 3, 1986, at 25, 33 (stating that "[indemnification is] only as good as the assets of the corporation"); see also MICHAEL SCHAEFTLER, *THE LIABILITIES OF OFFICE: INDEMNIFICATION AND INSURANCE OF CORPORATE OFFICERS AND DIRECTORS* 143-45 (1976) (listing several instances where indemnification does not protect directors).

95. JEREMY BACON, CONFERENCE BOARD, INC., REPORT NO. 922, *CORPORATE DIRECTORS' COMPENSATION 3* (1989) [hereinafter 1989 CONFERENCE BOARD REPORT].

96. *Id.* at 4.

97. Carey et al., *supra* note 1, at 4.

98. *Id.*

99. 1989 CONFERENCE BOARD REPORT, *supra* note 95, at 25.

100. NACD REPORT, *supra* note 11, at 33.

101. Carey et al., *supra* note 1, at 4; NACD REPORT, *supra* note 11, at 15.

In addition, some companies also pay substantial consulting fees, sometimes amounting to six-figure sums, to directors for providing counsel on particular issues.¹⁰² Finally, although not technically considered compensation, most directors are reimbursed for expenses associated with their board service and are indemnified by the company for any liability that they might incur as a result of their actions.

In 1995, according to the Conference Board, the median total annual director compensation among the nation's most substantial manufacturing companies was \$31,000.¹⁰³ The largest companies paid a median of \$60,000, with a range of \$35,000-\$95,000.¹⁰⁴ In fact, compensation consultants Pearl, Meyer & Partners found that the average pay of directors at America's 200 largest industrial companies for 1995 was \$68,300.¹⁰⁵ These figures, however, did not include the value of the other assorted benefits given directors, including pension plans and charitable contributions, which substantially increased the averages.¹⁰⁶ Indeed, the various benefits in the typical package increased the total compensation considerably. For example, a director who retired at age sixty-five with a pension equal to his or her annual retainer of, say, \$30,000, might expect to receive anywhere from \$200,000 to \$400,000 over his or her lifetime.¹⁰⁷ And, through the charitable giving programs in place at a number of large U.S. corporations, directors are afforded the opportunity to direct substantial amounts of corporate funds to the charities of their choice; indeed, the sums donated on each director's behalf could exceed \$1,000,000

102. NACD REPORT, *supra* note 11, at 15. *Forbes* recently reported on the following director consulting arrangements:

Donald McHenry, former Ambassador to the United Nations and a director of Coca-Cola, got \$185,000, through his company, in fees last year from Coca-Cola for consulting on international affairs.

Harold Brown, another former Defense Secretary, got \$50,000 from Cummins Engine for advice on technology issues. James D. Robinson III, through his consulting company, got \$250,000 from MacAndrews & Forbes, one of Ronald Perelman's holdings. . . . Freeport-McMoRan, the natural resources company, is paying twice for the services of former Secretary of State Henry Kissinger. The New Orleans firm paid Kissinger Associates \$200,000 for its advice on global developments last year—and another \$400,000 for Mr. Kissinger's personal advice "on international matters."

Linden et al., *The Cosseted Director*, *supra* note 2, at 171, 172.

103. KAY WORRELL, CONFERENCE BOARD, INC., REPORT NO. 1140-95-RR, CORPORATE DIRECTORS' COMPENSATION 1 (1996) [hereinafter 1996 CONFERENCE BOARD REPORT].

104. *Id.* at 12.

105. Linden et al., *The Cosseted Director*, *supra* note 2, at 169. According to *Forbes*:

Cash is only one of the incentives, but it is substantial. PepsiCo paid its directors \$70,000 for fulfilling their responsibilities last year. General Electric paid its directors an average of \$81,000; at Bristol-Myers Squibb the figure was \$77,000, at Chemical Bank, \$88,000. PepsiCo also gives every director \$30,000 in stock each year. GE gives options for 3,000 shares and Freeport-McMoRan options for 10,000 shares. Thus GE's 15 directors got an estimated \$14,700 in cash and stock for each of the nine director meetings they attended.

Id. at 170.

106. *Id.*

107. Carey et al., *supra* note 1, at 5.

per board member.¹⁰⁸ Lifetime free medical and dental insurance was not uncommon.¹⁰⁹ Additionally, gifts in kind of free company services were sometimes granted to the outside board members. These could include new automobiles, unlimited first-class air travel, free long distance telephone service, or even computer equipment, adding many thousands of dollars in value to each director's annual compensation package.¹¹⁰ And, when special consulting arrangements were provided to selected board members, their total compensation could well exceed \$250,000 per year.¹¹¹ Today's rich director compensation packages constitute much more than token payments and are a far cry from the era when remuneration consisted at the most of a shiny twenty-dollar gold piece.

At the turn of the century, a director's compensation essentially consisted of the value he received from the enhancement of his equity investment through the exercise of a watchful eye. As companies became vast economic enterprises no longer dominated by the equity owners, management assumed control and brought their own appointees to corporate boards. Having little connection with the enterprise, other than a relationship with the appointing management, it was now necessary that the nonmanagement board member director be compensated for his services—hence the origins of director compensation. Management domination of the modern corporation was thus responsible for the creation of director remuneration which, by the early 1990s, had grown to substantial proportions. Given the current state of outside director compensation, two questions are raised: Does the present amount and form of director remuneration pose any harm to the effective functioning of the modern board; and, if so, what should be done about it?

II. THE CONSEQUENCES OF THE PRESENT COMPENSATION SYSTEM

There is nothing inherently wrong with compensating corporate directors for the efforts that they expend on behalf of the corporation. Compensation serves two functions: rewarding past works and encouraging future efforts. Service on the modern public corporate board requires great effort and skill. Monitoring the management of a multibillion dollar, multinational operation to ensure maximum corporate operating efficiencies entails amassing a detailed knowledge of the operation and industry and close observation of how current management handles its responsibilities. The amount of time that is necessary to devote to one's duties as director, to do the job properly, is not inconsequential and should be compensated appropriately to ensure the full devotion of one's energies and talents to the task. Giving an individual little or nothing for services rendered will encourage little or nothing in return. Therefore,

108. Linden et al., *The Cosseted Director*, *supra* note 2, at 170.

109. *Id.* at 170.

110. *Id.* at 170-71.

111. *Id.* at 173.

director compensation is a necessary component in the modern corporate structure. The problem with today's board remuneration is not necessarily with its existence or significant amount, but with its form.

Director compensation evolved in this country because individuals who served on boards, but otherwise had no interest in the underlying company, would not serve for free; they needed to be compensated for the time and effort they expended. As the required effort became increasingly more demanding as companies grew in size and complexity, and as the potential for crippling legal liability for ill-performed services grew, greater compensation was expected and paid. This development was perfectly natural and, in and of itself, not troublesome. What was problematic was that at the same time compensation amounts were growing, board passivity continued unabated and grew even more prevalent, creating substantial oversight-driven productivity declines in many of our nation's largest business enterprises.

As was noted earlier, with the evolution of the management-controlled enterprise, directors were appointed by management.¹¹² The board of directors, theoretically composed of representatives of various shareholder groups, was instead comprised of individuals selected by management. The board was thus not representative of any one shareholder or shareholder group, but was instead responsive to the leading officers of the corporation. This phenomenon may be described as the "captured board" syndrome.¹¹³ The directors on a captured board, responsible for oversight, are generally the officers themselves, individuals performing various professional services for the corporation such as lawyers and investment bankers, and, finally, those with no real professional attachment to the enterprise other than board membership.¹¹⁴ The first two groups,

112. See *supra* notes 37-44 and accompanying text.

113. See MELVIN A. EISENBERG, *THE STRUCTURE OF THE CORPORATION* § 11.1 (1976); see also Stephen M. Bainbridge, *Independent Directors and the ALI Corporate Governance Project*, 61 GEO. WASH. L. REV. 1034, 1058, 1058 n.127 (1993) (examining the shirking of the duty to monitor management by "independent" directors who, because of composition and constraints on time and information, simply "rubberstamp" management decisions); Gilson & Kraakman, *supra* note 3, at 873 ("All too often . . . outside directors . . . turn out to be more independent of shareholders than they are of management.").

114. The first two groups of directors—the corporate officers and those who perform services for the corporation—are respectively known as "inside" directors and inside "outside" directors. Alternatively, those directors with no connection to the corporation other than board membership are known as "outside" directors. See Avery S. Cohen, *The Outside Director—Selection, Responsibilities, and Contribution to the Public Corporation*, 34 WASH. & LEE L. REV. 837, 837 (1977) (classifying directors as "inside directors," "non-independent outside directors," and "independent outside directors"); see also WILLIAM L. CAREY & MELVIN A. EISENBERG, *CASES AND MATERIALS ON CORPORATIONS* 156-57 (concise 6th ed. 1988) (noting that inside directors and outside directors who perform services for the corporation are unable to exercise independent oversight because they have strong professional and economic ties to the corporation and are therefore likely to acquiesce to the decisions of the chief executive); Bainbridge, *supra* note 113, at 1059 (questioning the independence of outside directors); *CEO Pay: How Much Is Enough?*, *supra* note 10, at 131 (comments of Ralph V. Whitworth, proposing that if one wants truly independent directors then the question should be how they obtained their position on the board and not whether they worked for the corporation). But see ALI, *supra* note 82, § 1.34 (abandoning the use of labels, but stating that a director has a "significant relationship"

because of their employment or financial relationship to management, may find it difficult to exercise independent oversight. The third group will rarely challenge management prerogative either, although there have been recent exceptions.¹¹⁵ Such board members are usually selected either by the chairman or other senior management, and they possess extensive professional and personal ties to the officers that compromise their effectiveness as monitors.¹¹⁶ These directors are often officers of other public corporations¹¹⁷ and frequently ask their counterparts, whom

with a corporation's senior executives when, among other things, he is employed by the corporation, a member of the immediate family of an officer, or affiliated in a professional capacity with a law firm that is the primary legal advisor to the corporation).

115. Recently, outside directors have become emboldened and have challenged management in several notable cases. For example, in October 1992, the outside directors of General Motors ousted their CEO Robert Stempel in response to the company's lackluster performance. Paul Ingrassia, *Board Reform Replaces the LBO*, WALL ST. J., Oct. 30, 1992, at A14. Similarly, James D. Robinson, III, was removed from his position as chief executive of American Express in a move orchestrated by outside directors in January 1993. Chief executives at Westinghouse and IBM met similar fates as a result of director revolts led by outside directors, many of whom were former CEOs. See Julie A. Lopez, *Management: CEOs Find That Closest Chums on Board Are the Ones Most Likely to Plot a Revolt*, WALL ST. J., Mar. 26, 1993, at B1; see also Eben Shapiro, *Philip Morris CEO Resigns Under Pressure*, WALL ST. J., June 20, 1994, at A3 (examining the resignation of Philip Morris CEO Michael A. Miles in the wake of the company's loss of more than \$30 billion in stock market value in two years and mounting criticism of his leadership from the board and institutional investors); Thomas A. Stewart, *The King is Dead*, FORTUNE, Jan. 11, 1993, at 34 (discussing the recent firings and forced resignations of CEOs at several of the nation's largest corporations).

While these cases demonstrate a board's ability to dispose of an ineffective chief executive, some commentators argue that such board action occurs too infrequently and often only after serious damage to the corporation:

Cases like RJR-Nabisco, General Motors, and American Express, among others, show us that if the situation gets bad enough, directors will do the right thing. However, they also show us that current board structures impose substantial obstacles to doing it sooner and more consistently. For example, the financial press heralded the board of IBM for pushing out CEO John Akers in January 1993. Yet this action took place after the company had lost over \$80 billion in market value in just a couple of years. Where was the board during that period?

Nell Minow & Kit Bingham, *The Ideal Board*, CORP. BOARD, July-Aug. 1993, at 11; see also Martin Lipton & Jay W. Lorsch, *A Modest Proposal for Improved Corporate Governance*, 48 BUS. LAW. 59, 59 (1992) ("Directors eventually may act . . . but their actions are often late, after the shareholders have lost value, employees jobs, and the corporation its competitive market position.").

116. See DEREK BOK, *THE COST OF TALENT* 98 (1993) (arguing that the selection of new directors is frequently dominated by senior executives); CAREY & EISENBERG, *supra* note 114, at 157; GRAEF S. CRYSTAL, *IN SEARCH OF EXCESS* 224-30 (1991) (discussing factors that lead to ineffective compensation committees); EDWARD S. HERMAN, *CORPORATE CONTROL, CORPORATE POWER* 31 (1981) (discussing the "transitory" and "guestlike" nature of an outside directorship); MONKS & MINOW, *supra* note 5, at 77-79 (1991) (stating that many directors are picked, not for their business acumen, but for their "business or personal relationship[s]" with management); Gilson & Kraakman, *supra* note 3, at 884 (noting that the way in which outside directors are selected leads to a lack of incentive for corporate governance); Minow & Bingham, *supra* note 115, at 12 (comparing shareholder elections of directors to elections held by the communist party of North Korea in that management selects the candidates and counts the votes).

117. The most common selection for an outside director is the chief executive of another corporation. JAY W. LORSCH & ELIZABETH MACIVER, *PAWNS OR POTENTATES: THE REALITIES OF AMERICA'S CORPORATE BOARDS* 18 (1989) (noting that "63% of all

they oversee, to serve as members of their own boards. Cross-directorships are not uncommon.¹¹⁸ While such board composition may lead to affable board gatherings, the oversight function may be severely compromised. Board passivity in regard to management monitoring is the result of this compositional structure.¹¹⁹ Consequently, the outside directors have little incentive to engage in effective management oversight other than fiduciary duty, which has, given oversight-driven corporate disasters of the last several years, proven ineffective in creating the necessary incentive.¹²⁰

Board passivity is extraordinarily detrimental to the well-being of the entire corporate enterprise. It robs the corporation and its owners, the shareholders, of the necessary independent oversight, guidance, and reasoned control vital to the entity's health. Theoretically, under the traditional legal model, the board is responsible for the overall direction of the enterprise. It should manage the corporation's business and set general policy.¹²¹ Management is engaged to carry out that policy and operate the company on a day-to-day basis. The board is expected to monitor

board members are CEOs of other corporations"); J. Spencer Letts, *Corporate Governance: A Different Slant*, 35 BUS. LAW. 1505, 1515 (1980). "For a CEO, the most highly coveted board members are CEOs of other companies. A startling two-thirds of all corporate directors are CEOs." *CEO Pay: How Much Is Enough?*, *supra* note 10, at 132 (comments of Ralph V. Whitworth). "One wonders, however, if the person among all who is most likely to be generally supportive of the chief executive isn't another chief executive." Letts, *supra*, at 1515; see also Linda J. Barris, *The Overcompensation Problem: A Collective Approach to Controlling Executive Pay*, 68 IND. L.J. 59, 76 (1992) (discussing the lack of impartiality of outside directors). Such directors are deemed to be "outside" directors despite their close personal and professional ties to the executives of the company on whose board they sit. For a definition of "outside directors," see *supra* note 114. However, Martin Lipton and Jay Lorsch would "not view as independent an executive of another company on the board of which an executive of the company serves." Lipton & Lorsch, *supra* note 115, at 67-68. Lipton and Lorsch propose that the exclusion of these otherwise "outside" directors would lead to a more independent and active board. See *id.* at 68 n.32 (citing Kenneth A. Macke, *The Board and Management: A New Partnership*, DIRECTORSHIP, July-Aug. 1992, at 8 ("The composition of the board is critical to how well it functions. We like to make sure that everything is geared toward making the board as independent and active as possible.")).

118. Barris, *supra* note 117, at 76, 78 n.113. A recent study of 788 of the nation's largest public companies conducted by Directorship, a consulting firm located in Westport, Connecticut, found that in 39 of the companies surveyed, the leaders of those businesses served on one another's boards in a "cross-directorship" phenomenon. The study further detailed that in five of those companies, the cross-directorships involved the board's compensation committees. Alison L. Cowan, *Board Room Back-Scratching?*, N.Y. TIMES, June 2, 1992, at C1. The five compensation committee cross-directorships were B.F. Goodrich Co. and Kroger Co.; Conagra, Inc. and Valmont Industries, Inc.; Kellogg Co. and Upjohn Co.; Sonoco Products Co. and NationsBank Corp.; and Allergan, Inc. and Beckman Instruments, Inc. *Id.* In order to be truly independent, The National Association of Corporate Directors' Blue Ribbon Commission on Executive Compensation recommends that compensation committees exclude "any interlocking directorates, particularly among CEOs." Joann S. Lublin, *Panel Adopts a Tough Line on CEO Pay*, WALL ST. J., Feb. 10, 1993, at B1; see also HERMAN, *supra* note 116, at 43 (suggesting that the cross-directorships are the result of the directors' trusting each other to be truly "outside" directors).

119. See Elson, *Duty of Care*, *supra* note 1, at 659 n.19.

120. *Id.* at 659.

121. See CAREY & EISENBERG, *supra* note 114, at 154-57. The American Law Institute has established general duties for boards of directors:

continually corporate performance and management effectiveness in maintaining optimal business operation and carrying out board policy.¹²² If management performs substandardly, the board, as an effective monitor, must either provide executives with new direction or replace them.

The active monitoring role of the board of directors is not only central to the traditional legal model of the corporation, but critical to ensuring the success of the enterprise. Management operates; boards monitor. When the monitoring function of the board becomes compromised for any reason, the corporation may be destined for disaster.¹²³ The benefits to be achieved by effective board supervision of management are obvious. Thoughtful, judicious management is encouraged; unnecessarily

(1) Select, regularly evaluate, fix the compensation of, and, where appropriate, replace the principal senior executives;

(2) Oversee the conduct of the corporation's business to evaluate whether the business is being properly managed;

(3) Review and, where appropriate, approve the corporation's financial objectives and major corporate plans and actions;

(4) Review and, where appropriate, approve major changes in, the determinations of other major questions of choice respecting, the appropriate auditing and accounting principles and practices to be used in the preparation of the corporation's financial statements; [and]

(5) Perform such other functions as are prescribed by law, or assigned to the board under a standard of the corporation.

ALI, *supra* note 82, at § 3.02(a); see also LORSCH & MACIVER, *supra* note 114, at 8-12 (examining the historical concept of the burden of proof); MONKS & MINOW, *supra* note 5, at 182-84 (examining the board of directors' duties).

However, in reality, the traditional legal model of the corporation serves only as a starting point for the study of corporate structure and governance. "It has become increasingly clear that in practice the board rarely performs either the management or policymaking functions." CAREY & EISENBERG, *supra* note 114, at 155. Consequently, most of the power supposedly vested in the board is actually held and exercised by management. *Id.* at 156.

Discussing this current view of the board's role, Chancellor William Allen of the Delaware Court of Chancery stated:

The conventional perception is that boards should select senior management, create incentive compensation schemes and then step back and watch the organization prosper. In addition, board members should be available to act as advisors to the CEO when called upon and they should be prepared to act during a crisis.

Chancellor William T. Allen, Address at the Ray Garret, Jr., Corporate & Securities Law Institute, Northwestern University, Chicago (Apr. 1992), in Lipton & Lorsch, *supra* note 115, at 62.

122. See CAREY & EISENBERG, *supra* note 114, at 154-57. "[T]he board of directors is the linchpin of our system of corporate governance, and the foundation for the legitimacy of actions taken by management in the name of the shareholders." SEC Chairman Richard Breeden, Address at the Town Hall of California (June 1992), in Lipton & Lorsch, *supra* note 115, at 62. Actively monitoring corporate performance and management in an informed manner is foremost among the responsibilities of the board of directors.

Outside directors should function as active monitors of corporate management, not just in crisis, but continually; they should have an active role in the formulation of the long-term strategic, financial, and organizational goals of the corporation and should approve plans to achieve these goals; they should as well engage in the periodic review of short and long-term performance according to plan and be prepared to press for correction when in their judgment there is need.

Allen, *supra* note 121.

123. See *supra* note 2 and accompanying text.

risky or imprudent behavior is discouraged.¹²⁴ The potentially dilatory impact of the unproductive, foolish, or felonious is lessened by a vigilant board. On the other hand, the pernicious impact of the absence of active board oversight is equally obvious. Without effective board monitoring, the corporation becomes, in effect, a runaway stagecoach likely to do greater damage to those within and to its owners who watch in horror from the sidelines.

The primary consequences of board passivity created by management capture is decreased management monitoring. But why does management control over board appointments necessarily create board passivity? Why would nonmanagement, outside directors on such captured boards, be unwilling to challenge management prerogative and engage in active oversight? There are three problems with a management-appointed board that lead to ineffective oversight. First, personal and psychic ties to the individuals who are responsible for one's appointment to a board make it difficult to engage in necessary confrontation. It is always tough to challenge a friend, particularly when the challenging party may one day, as an officer of another enterprise, end up in the same position. Sec-

124. The board's preeminent duty is to monitor management and "prevent crisis." Minnow & Bingham, *supra* note 115, at 15. "The board's most important function is to ask tough questions, listen to responses from management, and work together to find the right answers." *Id.* at 11. If directors perform their monitoring function, "they may prevent a significant portion of the long-term erosion of corporate performance that has plagued many once successful U.S. corporations." Lipton & Lorsch, *supra* note 115, at 62.

In order to fulfill this monitoring obligation, boards must be comprised of individuals with "the financial and strategic expertise and time to do the job." Robert A.G. Monks, *To Change the Company, Change the Board*, WALL ST. J., Apr. 27, 1993, at A20. In short, the keystone of a vital public corporation must be a "reformed and revitalized [board] of directors willing to monitor management and capable of mustering the courage and will to conduct themselves with a fiduciary conscience." Johnson, *supra* note 6, at 55. In order to effectuate the establishment of independent boards of directors, Elmer Johnson, a former General Motors Board member, has suggested removing retired CEOs from the boards of their former companies, limiting the size of boards to as few as seven directors, requiring directors to own a "significant" number of the company's shares, and compensating management with shares of the corporation's stock. *Id.* at 54-55. As Johnson puts it, "Patient capital is the foundation on which long-lived, wealth-creating institutions rest. But since patient capital is helpless capital unless it has a voice, its prerequisite is a properly functioning board of directors." *Id.* at 46; *see also* Lipton & Lorsch, *supra* note 115, at 62 (quoting Chancellor Allen, who stated that the board's "most basic responsibility [is] the duty to monitor the performance of senior management in an informed way"); The Working Group on Corporate Governance, *A New Compact for Owners and Directors*, 69 HARV. BUS. REV. 141, 142 (1991) (suggesting that "outside" directors should evaluate the performance of the chief executive regularly against established goals and strategies).

Professor Cox notes that empirical evidence demonstrates that outside directors may "help to shield the corporation from managers' self-dealing or overreaching conduct." James D. Cox, *The ALI, Institutionalization, and Disclosure: The Quest for the Outside Director's Spine*, 61 GEO. WASH. L. REV. 1233, 1234, 1242 (1993). Examining the relationship between board compensation and the termination of poorly performing management, Cox points to data that show that the "likelihood that a board will terminate an underperforming executive increases as the board's overall size increases" and continues to increase with the proportion of outside directors. *Id.* at 1241 (citing Donald L. Helmich, *Organizational Growth and Succession Patterns*, 17 ACAD. MGMT. J. 771, 774 (1974)); Michael S. Weisbach, *Outside Directors and CEO Turnover*, 20 J. FIN. ECON. 431 (1988); Joann S. Lublin, *More Chief Executives Are Being Forced Out by Tougher Boards*, WALL ST. J., June 6, 1991, at A1.

ond, conflict with a manager who is also a member of one's own board may lead to future retribution on one's own turf, thus reducing the incentive to act. Third, and most important, when one owes one's own board position to the largesse of management, any action taken that is inimical to management may result in a failure to be renominated to the board, which—given the large fees paid to directors (and the great reputational advantage of board membership)—may function as an effective club to stifle dissension. This is why the development of substantial director compensation, a consequence of management control, has acted to stifle board oversight of management and has, in fact, enhanced management domination. But it is not the fact of compensation in and of itself that created the problem, it is the *form* that compensation now takes.

Today's director compensation with its emphasis on substantial cash payments and employee-type benefits, including insurance and retirement programs, acts to align the interests of the outside directors with current management rather than with the shareholders, making necessary management oversight an almost impossible task. Why? Because the outside directors are compensated in a way that makes them, in effect, salaried employees of the corporation—or, in reality, the management—rather than the representatives and fiduciaries of the corporation's owners, the stockholders. Most board members receive substantial annual salaries for their services and large fees based simply on meeting attendance. Even though part-timers, they are entitled to the kinds of benefit programs rank-employees receive, including insurance programs and generous pensions upon retirement. Pensions are particularly problematic because they reward board longevity, controlled by management, rather than the quality of service. The message of this benefit to the director would seem to be not to rock the boat, so as to remain aboard long enough to be entitled to his or her pension—a great reward for what is essentially part-time employment.¹²⁵

This situation is only made worse by the prevalent use of director consulting and employment arrangements, and charitable contribution programs whereby the company makes substantial donations to the director's favorite charity, both of which are created and administered by management.¹²⁶ They serve no real purpose other than to further link the directors' fortunes to management, rather than the company's overall

125. See Lublin, *supra* note 12, at B1; Joann S. Lublin, *Management: More Big Companies Reconsider Lavish Pensions for Directors*, WALL ST. J., Sept. 7, 1995, at B1 [hereinafter Lublin, *Management*]. Many "[c]ritics contend that lucrative pensions unduly enrich outside directors, encourage them to stay too long and affect their ability to be independent." Lublin, *Management*, *supra*, at B1; NACD REPORT, *supra* note 11, at 16-18; Carey et al., *supra* note 1, at 10.

126. Linden et al., *The Cosseted Director*, *supra* note 2, at 170. Directors may either be employed directly by the company as consultants for "special" projects or find that their own employers are used to supply services to businesses such as law firms or banks. *Id.* at 170-72.

productivity.¹²⁷ It is management who decides who gets to consult and for how much, and it is management who decides how much to give to the director's charity of choice and when to give it. These arrangements seem to function more as side-bribes than legitimate furtherances of the corporate purpose. Appointed to the board by management, subject to easy termination because of management control of the proxy process,¹²⁸ and compensated in a manner determined by, or at the least, under the influence of management, the outside director has become a mere retainer rather than watchful fiduciary.

It has been argued that these special forms of director compensation are necessary to retain the services of the highest caliber individuals.¹²⁹ Perhaps, but they also have certainly acted to compromise outside director independence from management and further fueled the board passivity that has resulted in minimal management oversight and poor corporate performance.¹³⁰ As noted, today's board compensation treats the outside director as an employee of management, rather than a fiduciary.

127. See NACD REPORT, *supra* note 11, at 16-18; G. Bruce Knecht & Joann S. Lublin, *American Express Bars Using Directors As Paid Consultants*, WALL ST. J., Apr. 12, 1995, at A3.

128. See *supra* notes 17-19 and accompanying text.

129. See *supra* note 12 and accompanying text; Carey et al., *supra* note 1, at 4.

130. It is illustrative to note the dramatic change in compensation practices that occurred between 1979 and 1993 at the following U.S. corporations who experienced particularly severe oversight driven difficulties in the last few years:

American Express

1979:

- \$8000 annual fee, \$400 per board meeting attended, and \$300 per committee meeting attended.
- In addition, chairs of the Compensation and Audit Committees received an extra \$2000 while all other chairs received an extra \$1000. AMERICAN EXPRESS CO., MAR. 21, 1979 PROXY STATEMENT (1979).

1993:

- \$48,000 annual fee, but if attendance at board meetings was below 75%, then only \$36,000; no per meetings fees.
- In addition, all committee chairs received an extra \$7500.
- Retirement Plan: After five years of service, 100% final annual fee paid for the same number of years served or death, whichever is earlier. AMERICAN EXPRESS CO., MAR. 12, 1993 PROXY STATEMENT 5-14, 16-23 (1993).

General Motors

1979:

- \$15,000 annual fee plus \$500 per board meeting attended with 12 board meetings per year.
- In addition, members of the Finance Committee got an extra \$12,000 and the members of the Bonus/Salary, Audit, Public Policy, and Nominating Committees got an extra \$10,000. Committee chairs received an extra \$1000. GENERAL MOTORS, APR. 12, 1979 PROXY STATEMENT (1979).

1993:

- \$22,000 annual fee plus \$1000 per board meeting attended with 12 board meetings per year.
- In addition, all committee members received an extra \$12,000. GENERAL MOTORS, May 21, 1993 PROXY STATEMENT 9 (1993).

IBM

1979:

ary of the shareholders. The outside board member's stake in the enterprise is not one reflecting the performance-based concerns of ownership, but rather the interests of a highly salaried company employee. Directors whose remuneration is unrelated to corporate performance have little personal incentive to challenge their management benefactors. Eager not to "bite the hand that feeds them," particularly when such an action may lead to discharge from a lucrative position, it is little wonder that boards have become so passive and subject to management domination. Director compensation is clearly partly to blame for this phenomenon.

III. COMPENSATION AS THE CURE TO BOARD PASSIVITY

As board compensation practices may have acted to compound the problem of board passivity, they may also form the basis for its solution. To loosen management's grip on the board and stimulate real oversight,

-
- \$15,000 annual fee plus \$300 per board meeting attended with 11 board meetings per year.
 - In addition, Committee chairs received an extra \$2000 per annum. INTERNATIONAL BUSINESS MACHINES CORP., MAR. 21, 1979 PROXY STATEMENT (1979).

1993:

- \$55,000 annual fee; no per meeting fees with 13 board meetings per year.
- Committee chairs received an extra \$5000 per annum.
- One hundred shares of stock per annum.
- Retirement Plan: After five years of service, 50% of last annual retainer paid for life. INTERNATIONAL BUSINESS MACHINES CORP., MAR. 15, 1993 PROXY STATEMENT 10-19 (1993).

Morrison-Knudsen

1979:

- \$8000 annual fee plus \$1000 per board meeting attended with five board meetings per year. MORRISON-KNUDSEN, MAR. 26, 1979 PROXY STATEMENT (1979).

1993:

- \$20,000 annual fee plus \$1000 per day for board meetings and \$500 per committee meetings with four board meetings per year.
- Committee chairs received extra \$3000 per annum.
- Retirement Plan: At age of 55+ with at least five years of service or at any age with at least 15 years of service, 100% of last annual compensation paid for numbers of years served. MORRISON-KNUDSEN, MAR. 17, 1993 PROXY STATEMENT (1993).

Westinghouse

1979:

- \$12,000 annual fee plus \$500 per board meeting attended with 11 board meetings per year.
- Executive Committee members received an extra \$2000 per annum and any committee chair received an extra \$1000 per annum. WESTINGHOUSE ELECTRIC CORP., MAR. 2, 1979 PROXY STATEMENT (1979).

1993:

- \$22,000 annual fee plus \$1200 per board meeting attended with 12 board meetings per year.
- Committee chairs received an extra \$2000 per annum.
- Retirement Plan: After five years of service, 100% of last annual retainer paid for as many years served up to 10 with payments starting at age 70. WESTINGHOUSE ELECTRIC CORP., MAR. 8, 1993 PROXY STATEMENT (1993).

an appeal must be made to that same sense of director self-interest that created the problem in the first place. There is nothing inherently wrong with a management-appointed board.¹³¹ The problem arises when a management-sponsored director fails to exercise appropriate oversight because of loyalty to the appointing party. The outside directors must be motivated to view management not from the perspective of a loyal employee fearful of discharge, but from the viewpoint of an owner, concerned with overall corporate profitability. How can this be accomplished? To ensure that directors will examine executive initiatives in the best interest of the business, the outside directors must become substantial shareholders. To facilitate this, directors' fees should be paid primarily in company stock that is restricted as to resale during their term in office. No other form of compensation, which serves to compromise their independence from management, should be permitted. The goal is to create within each director a personally based motivation to actively monitor management in the best interest of corporate productivity and to counteract the oversight-inhibiting environment that management appointment and cash-based/benefit-laden fees create.¹³²

Equity ownership would counter the pressures placed on outside directors because of management appointment and domination. It is very hard to resist the demands of individuals to whom one owes one's position when one's involvement in the venture is limited to the fee one receives for one's service, and the continuance of that fee is subject to the will of management. Possessing an actual, substantial stake in the venture itself considerably alters the nature of this relationship. In addition to considering that the active monitoring of management may lead to replacement, an outside director must also consider that the failure to exer-

131. Elson, *Duty of Care*, *supra* note 1, at 665-67.

132. The salutary effects of directors' ownership of a substantial amount of stock have been well documented. See, e.g., MACE, *supra* note 10, at 61-65 (noting that outside directors who own substantial amounts of stock in their companies are more likely to ask discerning questions than their nonstockholding counterparts); Elson, *Board Pay Affects Executive Pay*, *supra* note 1, at 7-11 (stating that directors with substantial equity in companies are more inclined to keep pay tied to performance); James J. Fitzsimmons, *A Better Approach to Director Pay*, DIRECTORS & BOARDS, Spring 1992, at 48, 49-50 (concluding that directors paid in stock are more closely aligned with shareholders and in a better position to ensure that management is paid based upon performance); Edmund W. Littlefield, *A Stake with Restricted Stock*, DIRECTORS & BOARDS, Spring 1985, at 51, 52 (stating that "[p]aying directors in meaningful amounts of restricted stock gives them a common stake with the shareholders"); Joann S. Lublin, *Director's Cut*, WALL ST. J., Apr. 13, 1994, at R5 (stating that companies are increasingly turning to stock options as compensation for outside directors); David J. McLaughlin, *The Director's Stake in the Enterprise*, DIRECTORS & BOARDS, Winter 1994, at 53-59 (studying the relationship between outside director stock ownership and corporate performance); Pearl Meyer, *The Rise of the Outside Director as an Equity Owner*, DIRECTORS & BOARDS, Spring 1986, at 41 (observing that, historically, directors owned a large amount of stock and that they may be returning to this compensation scheme); Robert Stobaugh, *Director Compensation: A Lever to Improve Corporate Governance*, DIRECTOR'S MONTHLY, Aug. 1993, at 1-4 (comparing the performance of companies with a high degree of stock ownership by its directors with companies whose directors' stockholdings are relatively small). See generally Elson, *Board-Based Solution*, *supra* note 1, at 981-96 (stating that the key to independent and dutiful outside directors is not simply stock ownership, but substantial stock ownership).

cise effective oversight may result in the diminution of his or her personal wealth. Under such an arrangement, it would not be so easy to acquiesce to the demands of management. This scheme creates a more balanced relationship between management and equity-holding outside directors and, in turn, encourages the kind of oversight presently lacking in the traditional management-dominated board.

On June 19, 1995, in what commentators termed a major development in American corporate governance, the National Association of Corporate Directors' Commission on Director Compensation released a report calling for a radical overhaul of the compensation system for U.S. public company directors.¹³³ Focusing on greater board equity ownership, the Commission, comprised of prominent senior executives, academics, shareholder activists, and compensation consultants,¹³⁴ made a series of recommendations designed to improve corporate performance by changing board pay practices to more closely align "the interests of shareholders and directors."¹³⁵ Finding that equity-holders function as better directors, the panel called upon companies to do the following:

1. pay directors primarily in stock, with equity representing up to one hundred percent of the total;
2. set a substantial stock ownership target and deadline for each director;
3. abolish all benefits programs for board members, including pension plans, because they "often reward longevity rather than performance;"¹³⁶
4. ban outside directors or their firms from providing professional or financial services to the company; and
5. fully disclose each director's pay and prerequisites in their proxy statements.¹³⁷

133. See *supra* note 14 and accompanying text.

134. Members of the Commission included: Robert Stobaugh (Professor, Harvard Business School) (Commission Chair); William W. Adams (Former CEO, Armstrong World Industries); Michael L. Davis (Principal, Towers Perrin); Albert J. Dunlap (Chairman & CEO, Scott Paper Co.); Charles M. Elson (Professor, Stetson University College of Law); Edward H. Fleischman (Linklaters & Paines); Hon. Barbara Hackman Franklin (Former U.S. Secretary of Commerce); James E. Heard (President, Institutional Shareholder Services, Inc.); J.W. Lorsch (Senior Associate Dean, Harvard Business School); William L. MacDonald (President & CEO, Compensation Resource Group, Inc.); James E. Marley (Chairman, AMP Incorporated); Ira M. Millstein (Senior Partner, Weil, Gotshal & Manges); Nell Minow (Principal, Lens, Inc.); Robert K. Mueller (Director, Arthur D. Little Ltd. (U.K.)); J.E. Richard (Senior Managing Partner, J. Richard & Co.); Jean Head Sisco (Partner, Sisco Associates and Chairman, National Association of Corporate Directors); William R. Smart (Vice President, Cambridge Strategic Management Group); Ralph V. Whitworth (President, Whitworth & Associates and Former President, United Shareholders Association); Andrew R. Zaleta (Partner, The Heidrick Partners, Inc.); and John M. Nash (President, National Association of Corporate Directors) (Ex Officio Member). NACD REPORT, *supra* note 11, at iii.

135. *Id.*

136. *Id.* at 6.

137. *Id.* at iii. The Commission recommended that in setting director compensation, companies should adopt the following "Five Principals":

1. Director compensation should be determined by the board and disclosed completely to shareholders.

The Commission was particularly harsh in its criticism of the director benefit programs that had proliferated throughout the 1980s. It argued that these programs worked against the alignment of director and shareholder interests, noting:

[B]y their very value, generous benefit programs may actually create incentives for directors to oppose actions that could benefit shareholders, if such actions would mean challenging management. This is especially true when a term of service is required before the benefits vest. In such cases, prior to vesting, directors have even more to lose in a tussle.¹³⁸

Insofar as paying fees and retainers to directors for professional or financial services, the Commission strongly discouraged companies from engaging in such practices:

Boards of directors should hire directors to be directors and service providers to provide services. If the director's primary value to the company is as a consultant or advisor, the individual should be brought on as such and paid as such, not brought on as a director but paid as a consultant. The director's role is distinct and separate from that of a consultant; both roles can be severely compromised through commingling.¹³⁹

But it was clear from comments made by panel members following the report's release that the most significant (and controversial) result of the group's efforts was its recommendations on director equity ownership and compensation. According to Albert J. Dunlap, panel member and chairman and chief executive officer of Scott Paper Co.:

What kind of contribution will the directors ever make if they don't have a vested interest in the company's financial success? They've

-
2. Director compensation should be aligned with long-term interests of shareholders.
 3. Compensation should be used to motivate director behavior.
 4. Directors should be adequately compensated for their time and effort.
 5. Director compensation should be approached on an overall basis, rather than as an array of separate elements.

Id. And based on these "Principals," the Commission recommended the following "Best Practices":

1. Establish a process by which directors can determine the compensation program in a deliberative and objective way.
2. Set a substantial target for stock ownership by each director and a time period during which the target is to be met.
3. Define the desirable total value of all forms of director compensation.
4. Pay directors solely in the form of equity and cash—with equity representing a substantial portion of the total up to 100 percent; dismantle existing benefit programs and avoid creating new ones.
5. Adopt a policy stating that a company should not hire a director or a director's firm to provide professional or financial services to the corporation.
6. Disclose fully in the proxy statement the philosophy and process used in determining director compensation and the value of all elements of compensation.

Id.

138. *Id.* at 17.

139. *Id.* at 18.

got to show that they believe in the company, that they're willing to stand behind their choices Any director who isn't willing to be paid [one hundred] percent in stock doesn't believe in the company.¹⁴⁰

The Commission's recommendations were in part based upon a growing body of empirical evidence that suggested that director stock ownership resulted in more effective management oversight and hence better corporate performance. In its report, the Commission cited a recent study that I conducted which indicated that the greater the stockholdings of the outside directors, the better the performance of the corporation.¹⁴¹ Annually, *Fortune* magazine conducts a survey to determine America's most and least admired companies.¹⁴² In 1992, the survey included 311 companies in 32 different industries.¹⁴³ To determine a company's ranking, the survey examined such reputational attributes as long-term investment value, use of corporate assets, quality of management, and quality of products or services.¹⁴⁴ Assuming that the companies most admired by the corporate and financial communities were more effectively managed and possessed better board monitoring than those that were not, this survey provided an excellent starting point for an examination of the link between good corporate results and outside director stock ownership. Of the 311 companies examined in the *Fortune* study, I reviewed 110 companies on either extreme of the survey—either receiving the highest or the lowest ratings for overall admiration. I found that those companies with superior reputations, and hence performance, were much more likely to be run by boards with substantial shareholdings than those with poor reputations and results, whose outside directors tended to hold little company stock.¹⁴⁵ Similar studies conducted by Professor Robert Stobaugh of the Harvard Business School and David McLaughlin, a noted management consultant, yielded essentially the same results.¹⁴⁶ In an earlier

140. ALBERT J. DUNLAP, *MEAN BUSINESS* 218 (1996).

141. Elson, *Duty of Care*, *supra* note 1, at 700-06.

142. Jennifer Reese, *America's Most Admired Corporations*, *FORTUNE*, Feb. 8, 1993, at 44.

143. The 32 industries included the following: mining, crude-oil production; petroleum refining; utilities; forest & paper products; pharmaceutical; chemicals; textiles; metals; building materials; rubber and plastics products; metal products; electronics, electrical equipment; computers, office equipment; scientific, photographic, and control equipment; publishing, printing; apparel; soaps, cosmetics; retailing; furniture; diversified service; life insurance; diversified financial; commercial banking; savings institutions; food; beverages; tobacco; aerospace; motor vehicles and parts; industrial and farm equipment; transportation; and transportation equipment. *Id.*

144. The eight attributes included were the following: quality of management; financial soundness; quality of products or services; ability to attract, develop, and keep talented people; use of corporate assets; value as long term investment; innovativeness; and community and environmental responsibility. *Id.* at 46.

145. Elson, *Duty of Care*, *supra* note 1, at 703-06.

146. *Id.* at 700-01. The first of these studies was conducted by Professor Robert Stobaugh of the Harvard Business School. See Stobaugh, *supra* note 132, at 1-4. Stobaugh found that compensating directors in stock resulted in improved corporate performance. *Id.* at 4. The study examined and compared investors' returns from two groups of corporations. The first group was comprised of nine companies that "were corporate governance

study on executive compensation, I found that companies the financial community considered to have overpaid their executives were much more likely to be controlled by boards with insubstantial equity holdings. Conversely, companies considered to have compensated their executives reasonably were more often run by boards with substantial company stockholdings.¹⁴⁷ These studies suggested the existence of a causal link between substantial stock ownership and effective management oversight by the outside directors. An alignment of directors' interests with those of the shareholders, rather than management, through the possession by directors of large shareholding positions, would explain the phenomenon.

Even prior to the official release of the NACD Commission's report, it appeared that the institutional investor community had taken a great interest in the panel's proposals. In the 1995 proxy season, proposals relating to either ending director pensions or to creating director stock compensation programs appeared on almost forty major public company ballots, including IBM, B.F. Goodrich, GTE, and Philip Morris.¹⁴⁸ They received significant support, ranging from twenty to fifty percent of the total vote cast.¹⁴⁹

The financial press widely reported the Commission's findings, noting that many U.S. companies were already voluntarily moving in the direction of the panel's recommendations.¹⁵⁰ At the time of the report's issuance, Scott Paper, Travelers Group, and Alexander & Alexander already had adopted equity-based director compensation plans.¹⁵¹ In fact, Scott Paper's stock jumped three percent in value on the date that its equity plan was made public.¹⁵² IBM had announced that it was switching from

'targets' of at least three shareholder groups," and the second group consisted of the nine highest ranked companies on the *Fortune* list of "most admired companies." *Id.* at 2. Professor Stobaugh discovered that the average stockholding of the directors at the "most admired" companies was much greater than that of the directors of the poorly performing companies. *Id.* As a result of his study, Stobaugh concluded that there was an apparent correlation between corporate performance and stockholding by members of the board of directors. *Id.* at 2-3. Consequently, he recommended paying half of a director's annual compensation in company stock until "stock ownership by corporate directors . . . increased to a level at which the value of the director's stock ownership is perhaps ten times the director's annual compensation." *Id.* at 4.

David J. McLaughlin, the president of a Connecticut management consulting firm, conducted the second of these studies. See McLaughlin, *supra* note 132, at 53-59. McLaughlin's study examined the stock holdings of outside directors at 70 companies, comparing the performance of the director stock ownership. *Id.* at 54. The study found that the companies with the highest degree of director stock ownership "delivered a return of 174% to their shareholders over five years from 1988 to 1992, while those with the lowest delivered only a 73% return." *Id.*

147. Elson, *Board-Based Solution*, *supra* note 1, at 990-95.

148. Lublin, *supra* note 12, at B1; *1995 Shareholder Proposals Checklist*, *supra* note 17, at 21-22.

149. *1995 Shareholder Proposals Checklist*, *supra* note 17, at 21-22.

150. See *supra* note 14 and accompanying text.

151. Lublin, *supra* note 12, at B1; John A. Byrne, *How Much Should it Take to Keep the Board on Board?*, *BUS. WK.*, Apr. 17, 1995, at 41; Glenn Collins, *Scott Paper to Pay Directors Shares*, *N.Y. TIMES*, Aug. 31, 1994, at D3.

152. Collins, *supra* note 151, at B3. See Jacqueline M. Graves, *While Directors Get Stock*, *FORTUNE*, Oct. 3, 1994, at 18.

a primarily cash-based to a fifty percent equity, fifty percent cash director compensation package and that it was scaling back its board pension program.¹⁵³ American Express and W.R. Grace agreed to eliminate director consulting arrangements.¹⁵⁴ Additionally, shortly after the Commission's findings were issued, the Securities and Exchange Commission announced proposed rule changes to expand public disclosure of board compensation, which appeared in line with the Commission's recommendations.¹⁵⁵

In the year following the NACD Commission's report, the number of companies adopting the Commission's recommendations on director stock ownership and elimination of director pensions grew dramatically to include some of the nation's largest and most respected corporate institutions.¹⁵⁶ That trend accelerated considerably with the approach of the 1996 proxy season as the Investor Rights Association of America (IRAA), a small-shareholder advocacy group, announced that it was proposing over 120 shareholder resolutions calling for the elimination of director pension plans and the adoption of outside director stock-based

153. Lublin, *supra* note 12, at B1; INTERNATIONAL BUSINESS MACHINES CORP., MARCH 14, 1995 PROXY STATEMENT 5 (1995) [hereinafter IBM 1995 PROXY].

154. Knecht & Lublin, *supra* note 127, at A3.

155. See *infra* Securities and Exchange Commission Release No. 33-7184 6-7 (June 27, 1995).

156. The companies adopting equity-based director compensation plans as of April 30, 1996, were as follows: Alexander & Alexander; Angelica; American Express; AMP; Archer-Daniels-Midland; Armstrong World Industries; Asarco; Bankers Trust; Bausch & Lomb; Baxter International; CSX; Campbell Soup; Chase Manhattan; Chrysler; Digital Equipment; Eastman Kodak; El Paso Natural Gas; Estee Lauder; Florida Progress; Gillette; IBM; ITT; James River; Kaufman & Broad; Kellogg; McGraw-Hill; May Department Stores; Melville; NationsBank; NYNEX; Occidental Petroleum; Philip Morris; Phillips Petroleum; Sara Lee; Scott Paper; Texas Instruments; Time/Warner; Travelers Group; Union Pacific; United Technologies; Westinghouse Electric; Woolworth; and Yellow Corp. Elson, *Major Shifts Seen in Director Pay*, *supra* note 1, at 3; Lyons, *supra* note 15, at 4; 1995 BOARD INDEX, *supra* note 11, at 38-43; IRRRC CORPORATE GOVERNANCE BULLETIN, April-June, 1996, at 8, 9.

The companies eliminating director pension programs as of April 30, 1996, were as follows: Aetna Life and Casualty; Alexander & Alexander; Allstate; ALCOA; American Express; AMP Inc.; AMR; Anheuser-Busch; Archer-Daniels-Midland; Armco; Armstrong World Industries; Asarco; B.F. Goodrich; BankAmerica; Bay View Capital; Baxter International; Bell Atlantic; Bristol-Myers Squibb; Brunswick; Burlington Resources; Campbell Soup Company; Ceridian Corp.; Chase Manhattan; Chrysler; Columbia Gas; Cooper Industries; Colgate-Palmolive Co.; Cray Research; Dexter Corp.; Digital Equipment; Dominion Resources; Dover; Eastern Enterprises; Eaton Corp.; Eli Lilly; First Chicago; General Motors; Goodyear; Household International; IBM; Illinois Tool Works; Inland Steel; International Paper; Interpublic Group; ITT; James River; Johnson & Johnson; Kaufman & Board; Kellogg; Kmart; May Department Stores; McDonalds; McGraw-Hill; Mead Corp.; Melville; Merck; MidAmerican Energy Corp.; Minnesota Mining and Manufacturing; Motorola; NationsBank; Nicor; Norfolk Southern; NYNEX; NYSEG; Oryx Energy; Pacific Telesis; Pfizer; Philip Morris; Pittston Brinks; Public Service Enterprise; Rockwell International; Sears Roebuck; Southern New England Tel.; Sun Co.; Tambrands Inc.; Tenneco; Texaco; Texas Instruments; Time/Warner; USAir; Union Pacific; Upjohn Corp.; United Technologies; Variety; Warner-Lambert; Wells Fargo & Co.; Westinghouse Electric Corp.; Woolworth; and Xerox. Elson, *Major Shifts Seen in Director Pay*, *supra* note 1, at 3.

The above listings are not exclusive as many corporations have approved or are in the process of approving such governance changes, but have not yet publicly announced their action.

compensation.¹⁵⁷ With widespread coverage of the IRAA's efforts by the national financial press and given the group's success in the previous year in attracting substantial shareholder support for their efforts,¹⁵⁸ a number of companies voluntarily adopted the director compensation changes requested by the organization in exchange for the withdrawal of their shareholder proposals.¹⁵⁹ As Thomas Flanagan, president of the IRAA stated, "[d]irectors become better fiduciaries of shareholders if they are shareholders themselves."¹⁶⁰

Several large companies announced that they would be complying with some or even all of the NACD Commission's recommendations without IRAA involvement. AMP Inc., Armstrong World Industries, Brunswick Corp., and ITT, for example, all agreed to take such steps without direct pressure from investors.¹⁶¹ In fact, Campbell Soup announced in its 1995 Proxy Statement that its board of directors had fully endorsed all of the "Best Practices" recommended by the Commission.¹⁶²

The companies adopting stock-based director compensation have not settled on a single approach to the issue. Some have replaced all forms of cash compensation with simple stock grants.¹⁶³ Others have blended stock and cash in a range from fifty percent stock, fifty percent cash¹⁶⁴ to seventy-five percent stock, twenty-five percent cash.¹⁶⁵ The form of equity granted has also varied. While many simply have given their directors restricted stock, others have developed option schemes, deferred stock grants, or even phantom stock payments.¹⁶⁶ Much more common, however, is the simple payment of the fee in stock that is restricted as to

157. See *supra* note 16 and accompanying text. See 1995 BOARD INDEX, *supra* note 11, at 38-43.

158. A shareholder resolution proposing the elimination of director pensions received 48.7% of the votes at B.F. Goodrich. Lublin, *Management*, *supra* note 125, at B1. See also 1995 Shareholder Proposals Checklist, *supra* note 17, at 21-22 (stating that the Investor Responsibility Research Center (IRRC) reported the following selected voting results on 1995 shareholder proposals to restrict nonemployee director pensions: Baltimore Gas & Electric (36%); Chase Manhattan (27.2%); Dime Bancorp (40.7%); EG & G (40.8%); GTE (33.2%); IBM (26.0%); Merck (25.8%); NYNEX (29.4%); Pacific Telesis Group (30.2%); Philip Morris (24.6%); and Warner-Lambert (29.5%)).

159. Westinghouse Electric, Kaufman & Broad, NYNEX, Anheuser-Busch, and Sun Co., among other companies, agreed to change their director compensation policies apparently in exchange for the withdrawal of the IRAA's resolutions prior to their annual meetings. Lublin, *supra* note 16, at A4; Selz, *supra* note 16, at B2; see Decker, *supra* note 16, at 6.

160. Selz, *supra* note 16, at B2; see also Thomas E. Flanagan, *Director's Pensions—One Shareholder's View*, in DIRECTORSHIP—SIGNIFICANT ISSUES FACING DIRECTORS, 8-4, 8-4 to 8-5 (1996).

161. Lublin, *Management*, *supra* note 125, at B1; Lublin, *supra* note 16, at A4; Auerbach, *supra* note 15, at R6.

162. CAMPBELL SOUP COMPANY, OCT. 6, 1995 PROXY STATEMENT 20 (1995).

163. An example is Scott Paper Company. *Scott Paper Board to Be Compensated Solely in Company Stock*, SCOTT NEWS, Aug. 30, 1994, at 1; Collins, *supra* note 151, at B3.

164. For example, IBM. IBM 1995 PROXY, *supra* note 153, at 5.

165. An example is Florida Progress. FLORIDA PROGRESS FEB. 29, 1996 PROXY STATEMENT 11-12 (1996).

166. See Elson, *Major Shifts Seen in Director Pay*, *supra* note 1, at 3; Carey et al., *supra* note 1, at 12; Lyons, *supra* note 15, at 1, 4.

resale during the director's term in office. These differences in the mechanics of equity delivery do not reflect any substantive concern with equity in general, but appear to be purely taxation-driven. Individual boards may have varying financial circumstances that require customized equity programs to produce the best possible returns for the recipients from a taxation standpoint.¹⁶⁷

Regardless of the form that the equity payments to directors have been taking, what has been particularly striking is the sheer number of companies shifting compensation from cash to equity and eliminating director pension programs. Ann Mule, corporate secretary of Sun Co., the Philadelphia oil refiner, upon announcing Sun's change in board compensation policy, stated that the company's action "accomplishes the goal of more closely aligning director compensation to the long-term interest of shareholders,"¹⁶⁸ a sentiment with which much of corporate America, through its latest actions, seems to be in agreement. If current trends continue, within a year, equity-based director compensation will have become the norm for most of America's largest corporations.

This dramatic shift in director compensation practice is a watershed development and represents the beginning of a sea change in American corporate governance. For many years, the board passivity occasioned by management appointment and capture has resulted in lax management oversight and decreased corporate productivity. Equity-based director compensation will create a tremendous counter-weight to this problem and energize previously complacent outside directors. The empirical data demonstrating heightened corporate performance and more reasonable executive compensation in tandem with substantial outside director equity holdings suggests a link between stock ownership and improved management monitoring by the board. If, by altering director compensation practice, director stock ownership can be increased and financial links to management decreased, then significantly improved board oversight will result. A director's stake in the enterprise will no longer reflect the fee-based interests of a management retaineé, but will reflect the performance-based concerns of ownership. As one prominent corporate critic and former CEO noted upon his company's adoption of an equity-based compensation plan, "[O]ur shareholders loved it because the board members began thinking like shareholders. They were no longer just picking up a check at the end of a meeting."¹⁶⁹

This shift to equity-based director compensation promises to fundamentally alter a decades-old norm of American corporate governance: the separation of ownership and control. By placing, through changes in

167. *Id.*

168. Selz, *supra* note 16, at B2.

169. Dunlap, *supra* note 140, at 219. Indeed, William Steiner, founder of the IRAA, in commenting on his organization's shareholder proposal efforts, noted, "What we try to do is to get companies to pay their outside directors at least 50[%] in stock. . . . Tying directors much more directly to the fortunes of outside shareholders has real merit." Decker, *supra* note 16, at 6.

compensation practice, substantial equity in the hands of management-appointed directors, we may return the board to its original role as owners, representing other owners, overseeing corporate performance. In so doing, we will have at last reunited ownership with control and replaced board passivity with truly effective oversight and heightened corporate performance.

IV. CONCLUSION

Traditionally, corporate boards were comprised of major stockholders who represented the interests of their fellow owners in overseeing the operation of the enterprise. But with the rise of the large-scale public corporation, with its attendant dispersed shareholdings, professional managers took control of their operations and replaced owner-directors with board members of their own choosing. The new breed of director had little connection with the enterprise other than their relationship with the appointing management, and it was soon recognized that these individuals needed to be compensated for their efforts—hence the development of regular director compensation.

As largely appointees of management and subject to management approval in relation to retention, the directors' interests become more aligned with the group that selected and retained them than with the shareholders. Boards became captives of management and this was the real origin of the board passivity vis-à-vis management oversight that we grapple with today. If a director owed his or her position to management largesse and that position entailed considerable compensation and prestige, the director had little personal incentive to challenge the appointing party. This trend became increasingly more pronounced throughout the 1980s with changes in board compensation practices that came to include substantial cash payments and extraordinarily generous benefit programs. Director compensation, originally resulting from management control, had become instrumental in its very maintenance and further fueled board passivity that resulted in minimal management oversight and poor corporate performance.

However, as compensation practices may have acted to compound the problem of board passivity, they may also form the basis for its solution. By altering the compensation format to include primarily equity, we will make directors substantial stockholders and create within each board member a personally based motivation to actively monitor management in the best interest of corporate productivity and to counteract the oversight-inhibiting environment that management appointment and cash-based fees create. This is why the current corporate movement towards equity-based compensation is of such significance. While director compensation was an outgrowth of the separation of ownership and control, it may also result in their reunification. By changing the form of compensation to include primarily equity, we will make the directors owners of the corporation once again and perhaps have finally found the solution to the

conundrum Berle and Means identified many decades ago. With board control back in the hands of owner-directors, boards should become more active management monitors and the oversight-driven problems resulting from board passivity will become much less prevalent. A quiet revolution has begun. Reformulating board compensation to focus on stock-based pay will energize previously passive boards and create the effective oversight and performance that shareholders and the American public demand.