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Douglas, William O., *Directors Who Do Not Direct*, 47 Harv. L. Rev. 1305 (1934).

Douglas' famous article about problems in corporate governance is an important re-read as we consider how to improve the conduct of officers and directors of corporations. It is also a depressing read, because it shows how little progress has been made over the last 70 years.

He begins by referencing criticisms of corporate governance quality,

> "symptomatic of indignation and disapproval of many different abuses and malpractices disclosed in recent years. Recent court records and Senate hearings are replete with specific and illustrative material – secret loans to officers and directors, undisclosed profit-sharing plans, timely contracts unduly favorable to affiliated interests, dividend policies based on false estimates, manipulations of credit resources and capital structures to the detriment of minority interests, pool operations, and trading in securities of the company by virtue of inside information, to mention only a few."

He then goes on to conclude,

> "All of which means that business and its legal advisers, have shown great ineptitude in appreciating and appraising the social importance on significance of many of their activities. Also, it means that considerable refashioning of codes of conduct – in business as well as in law – must be effected if the next cyclical trend is not to produce as many malpractices and abuses as has the current one."

The notion of the separation of ownership and control was relatively new in 1934 and its significance was only beginning to be appreciated. Douglas discusses at length the problem of providing minority shareholders an effective voice in corporate affairs and the need for true outside directors. He deplores management directors, whom he refers to as "shirtsleeve directors", and is concerned that most corporate boards are dominated by management.

As an example of the problems in corporate affairs, he reviews the Stockholders' Investigating Committee of the Texas Corporation (later Texaco), which was empanelled to review the affairs of that company after a bitter fight had arisen between two factions of the board. Those who think the conduct of the current cohort of corporate officers particularly egregious will find that things were no better, and in some sense worse, in 1934.

Douglas discusses the English Companies Act as a source of ideas for regulation of corporate governance under our then-new securities laws. But, he finds the U.K. example less than satisfactory.

The proxy system and the qualifications of nominees for corporate directorships were of particular concern to Douglas. There were, at that time, inefficiencies in the proxy system and lack of any effective information disclosure system. Interlocking directorates and conflicts of interest were also a problem. I think Douglas believed that addressing these problems and incorporating a majority of independent directors on corporate boards would solve the problem. At the time, Douglas clearly thought that incorporation would be federalized, something which, of course, has not come to pass.

Yet, although the proxy and information disclosure systems are immeasurably better than they were in 1934, and the interlocking directorate and conflict of interest problems have been addressed if not thoroughly resolved, the performance of corporate boards has not improved much. The true problem is that even though insiders may now be a numerical minority on most boards, they are still dominant. Outside directors simply do not have nearly enough information to contribute meaningfully to corporate decision making. The board is almost totally reliant on information supplied by management. Until the quality and quantity of information available to the board improves, its effectiveness will be limited.

In support of his argument for independent directors as opposed to "experts" engaged by management to advise the board, Douglas says,

> "power will never be present in experts who have no vote and who are called in by the managers, who work for the managers, and who are limited by the desires of the managers."

Douglas' comments about "experts" seem to point directly to the essential problem with the audit system. The auditors are experts with no authority, who are retained by and work for management, and whose tasks are defined by management.

The current practice of management preparing the financial statements, which are then audited by firms retained by and answerable to management, and ultimately certified by the management that prepared them and employed the auditors to review them, is absurd.

Instead, auditors should be retained by the audit committee of the board and the financial statements should be certified by the Chairman of the Board and the Head of the Audit Committee, not the CEO and CFO. Under this system, the board – representatives of the shareholders – would engage and supervise the officers. As part of that duty, the board would engage auditors to review the information received from those officers, and the board's senior members – the Chairman and the Head of the Audit Committee – would then certify that it had done its job (relying on the information they receive from the auditors and in their capacity as directors with no other changes to "business judgment rule" jurisprudence). Finally, since auditors generally know a good deal about the operations of the company and its businesses – certainly more than the board, although not as much as management – the board would have an independent source of better information and would be better able to assist and advise management.