STRANGERS IN THE HOUSE: RETHINKING SARBANES-OXLEY AND THE INDEPENDENT BOARD OF DIRECTORS

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ABSTRACT

This article argues that the corporate governance paradigm for boards of directors is inverted: shareholder-owners should be in the majority and independent directors should be in the minority. The Sarbanes-Oxley Act gives short shrift to the role and efficacy of independent directors by focusing on the independence of auditors and internal controls. In reviewing the history of boards of directors, the authors suggest that boards represent an intermediary process to "buffer" corporate managers from the shareholder-owners to whom they are supposedly accountable. The authors researched 254 public companies across 50 industries and found, consistent with other significant econometric research in the area, inconclusive evidence that boards dominated by independent directors increase financial performance for shareholders. Consequently, the authors propose three reforms to Sarbanes-Oxley that would facilitate the participation of larger, longstanding owners, "oversight shareholders," serving on boards of directors and include safe harbors for insider trading liability and controlling party liability. Additionally, the authors propose that Sarbanes-Oxley be amended to facilitate the ability of these oversight shareholders to call shareholder meetings, which would serve as the most effective check and balance on management.

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I. INTRODUCTION

The Sarbanes-Oxley Act of 2002[1] is supposed to make company managers more accountable. But accountable to whom? Certainly, Section 302[2] and Section 906[3] certifications expose certain officers to greater potential civil and criminal liability. Accordingly, Sarbanes-Oxley deters corporate malfeasance by these officers. It is no longer an acceptable response for a high-ranking corporate officer to claim, "I didn't know what was going on and I assumed my subordinates were taking care of it."[4]

Sarbanes-Oxley, while imposing stiffer sanctions, ultimately will be ineffective in preventing corporate scandals in the future. This ineffectiveness remains because Sarbanes-Oxley does not address the pivotal issue of *real* accountability to the owners of the business—the shareholders. Obviously, corporate managers should be accountable to the shareholders.[5] But even after Sarbanes-Oxley, managers are accountable to shareholders only in the most extenuated "financial market" way. If shareholders are

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[1]Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, & 29 U.S.C.) [hereinafter Sarbanes-Oxley].

[2]Sarbanes-Oxley required the Securities and Exchange Commission (SEC) to promulgate rules requiring the principal executive officer and principal financial officer to certify in their company's quarterly and annual reports that they have reviewed the report, the report is true and accurate, it presents the financial information fairly, and the officers have established, maintained, and disclosed any concerns with internal controls. *Id.* § 302 (codified at 15 U.S.C. § 7241 (Supp. IV 2000)). The Act also requires a second certification that is within the jurisdiction of the U.S. Department of Justice rather than the SEC, the content of which is substantially similar to the certification required under Section 302. *See id.* § 906 (codified at 18 U.S.C. § 1350 (Supp. IV 2000)).

[3]The Section 906 certification requires the chief executive officer and chief financial officer of a company to certify that the periodic report filed for the company fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, and the information in the report fairly presents the financial condition and results of operations of the company. *Id.* § 906(a)-(b) (codified at 18 U.S.C. § 1350(a)-(b) (Supp. IV 2000)). There are criminal penalties for willfully filing a false report. *See id.* § 906(c) (codified at 18 U.S.C. § 1350(c) (Supp. IV 2000)).

[4]The Senate Banking Committee Report on Senate Bill 2673 stated that the Committee believed that "management should be held responsible for the financial representations of their companies." COMM. ON BANKING, HOUS., & URBAN AFFAIRS, 107TH CONG., PUBLIC COMPANY ACCOUNTING REFORM AND INVESTOR PROTECTION ACT OF 2002, S. REP. NO. 107-205, at 25 (2002), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=107_cong_reports&docid=f:sr205.107.pdf. The Committee stated that the Senate bill clearly establishes that a company's chief executive and chief financial officers are responsible for the presentation of the information in the company's financial reports. *See id.*

[5]*See infra* note 111. *See also* Edward S. Adams, *Corporate Governance After Enron and Global Crossing: Comparative Lessons for Cross-National Improvement*, 78 IND. L.J. 723, 726-27 (2003) (briefly discussing the effect of stock price as an external control on management in the hostile takeover context).

dissatisfied with corporate manager performance, they "vote with their feet" and sell their shares.[6] Yet these "sell" decisions have little impact on the day-to-day lives of the managers, except in the most dramatic cases.[7]

What is the best way to have the corporate managers be accountable to the shareholders? Seemingly, it would be to have greater shareholder involvement on the boards of directors; that is, to have on the boards long-standing and substantial shareholders who have a demonstrable vested interest to act like owners, as opposed to passive investors.[8]

Sarbanes-Oxley leaves the composition of the boards of directors to the corporate governance policies of the Stock Exchanges.[9] Each of the Stock Exchanges has required that the majority of a listed company's board of directors consist of independent directors.[10] However, there is no predicate, either in logic or in experience, to suggest that a majority of independent directors on a board will guarantee good corporate governance or better financial returns for shareholders. Further, the econometric research on whether independent directors enhance financial performance for the shareholders is, at best, inconclusive.[11]

Sarbanes-Oxley will do little to prevent scandals in the future because company managers, while having substantially more personal risk,

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[6]*See* LOUIS LOWENSTEIN, WHAT'S WRONG WITH WALL STREET: SHORT-TERM GAIN AND THE ABSENTEE SHAREHOLDER 91 (1988); Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 534 (1990); Irwin Borowski, *Corporate Accountability: The Role of the Independent Director*, 9 J. CORP. L. 455, 458 (1984); D. Gordon Smith, *Corporate Governance and Managerial Incompetence: Lessons from Kmart*, 74 N.C. L. REV. 1037, 1132 (1996); Anvar Bhide, *Efficient Markets, Deficient Governance*, HARV. BUS. REV., Nov-Dec. 1994, at 128, 132; Anat R. Admati & Paul Pfleiderer, *The 'Wall Street Walk' as a Form of Shareholder Activism* 1 (Stan. L. & Econ. Olin Working Paper No. 315, 2005), *available at* http://ssrn.com/abstract=849744; Robert Parrino et al., *Voting with Their Feet: Institutional Investors and CEO Turnover* (Jan. 3, 2002), http://www.mccombs.utexas.edu/aimcenter/Working%20Papers/Parrino2.pdf; Dan Ackman, *Walter Hewlett Makes His Case*, FORBES.COM, Apr. 26, 2002, *available at* http://www.forbes.com/2002/04/26/0426topnews_print.html.

[7]*See, e.g.*, Black, *supra* note 6, at 526-30 (acknowledging the insubstantial voting power of any one shareholder, but recognizing the potential collective power of institutional shareholders).

[8]We term these shareholders "oversight shareholders." *See infra* Part VII.

[9]This article refers to the New York Stock Exchange (NYSE) and Nasdaq Stock Market, Inc. (NASDAQ) generally as the "Stock Exchanges."

[10]N.Y. Stock Exch., Inc., Listed Company Manual § 303A.01 (2003), *available at* http://www.nyse.com/lcm/lcm_section.html [hereinafter NYSE Manual]; NASDAQ Stock Market, Inc., Marketplace Rules, R. 4350(c) (2004), *available at* http://www.nasdaq.com/about/marketplacerules.pdf [hereinafter NASDAQ Rules]. *See also* discussion *infra* Part III (discussing the evolution of director independence standards following the passage of Sarbanes-Oxley). The NYSE summarized its corporate governance rules into one document, which can be found on its website. *See* N.Y. Stock Exch., Inc., Final NYSE Corporate Governance Rules (2003), *available at* http://www.nyse.com/pdfs/finalcorpgovrules.pdf.

[11]*See infra* Part V.

are still not accountable to the owners of the business.[12] Under the current regime, company managers are accountable to independent directors who have vastly less information about what is occurring inside the company than the company's managers. Given the uneven informational advantage, company managers will continue to influence boards of directors without any real accountability to the owners.[13]

History will likely show that Sarbanes-Oxley will serve to increase the personal cost of corporate malfeasance with little impediment. It will also provide managers with the predicate to increase greatly their compensation in light of the enhanced risk.[14] Look for executive

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[12]*See* Michael C. Jensen & Joseph Fuller, *What's A Director To Do?*, *in* BEST PRACTICES: IDEAS AND INSIGHTS FROM THE WORLD'S FOREMOST BUSINESS THINKERS 2 (Rosabeth Moss Kanter ed., 2003), *available at* http://ssrn.com/abstract=357722 (suggesting that "[t]he recent wave of corporate scandals provides continuing evidence that boards have failed to fulfill their role as the top-level corporate control mechanism"); Margaret M. Blair & Lynn A. Stout, *Director Accountability and the Mediating Role of the Corporate Board*, 79 WASH. U. L.Q. 403, 406 (2001); Lucian A. Bebchuk, *Making Directors Accountable*, HARV. MAG., Nov.-Dec. 2003, at 29, 29, *available at* http://s162044184.onlinehome.us/lib/03nd/pdf/1103-29.pdf; Robert A.G. Monks, President, Inst'l Shareholder Servs., Inc., *Growing Corporate Governance: From George III to George Bush*, Address at the NAPF Investment Conference (Feb. 22, 1990), transcript available at http://www.lens-library.com/info/napf2.html ("There should be no doubt, however, that accountability to ownership in the United States is only a polite fiction.").

[13]The Stock Exchanges are sometimes accused of promoting the interests of their listed companies over those of investors. *See, e.g.*, Letter from the Association for Investment Management and Research, *in* REPORT OF THE N.Y. STOCK EXCH. CORPORATE ACCOUNTABILITY AND LISTING STANDARDS COMM. (June 6, 2002) at A-13, A-14, *available at* http://www.nyse.com/pdfs/corp_govreport.pdf [hereinafter NYSE CORPORATE ACCOUNTABILITY REPORT] ("Often stock exchanges, and the NYSE is no exception, are perceived to be advocates for their corporate clients, rather than the ultimate investors who use exchanges to invest.").

[14]As the risks and cost of malfeasance increase, so do the "rents" to the perpetrator, if a demand-side market exists. *See* STEVEN D. LEVITT & STEPHEN J. DUBNER, FREAKONOMICS: A ROGUE ECONOMIST EXPLORES THE HIDDEN SIDE OF EVERYTHING 105 (2005) (using research on a drug selling operation in Chicago to show that "criminals, like everyone else, respond to incentives"). Where an illegal opportunity to raise more capital was coupled with a heightened chance of loss of life, higher compensation was demanded for the additional risk taken. *See id.* at 102-07. This mirrors the potential high rent extraction by corporate CEOs for their punishment in the form of a jail sentence. *See also* Roy Radner, *Hierarchy: The Economics of Managing*, 30 J. ECON. LIT. 1382, 1405-07 (1992) (explaining why rational agents will shirk their duties to their principal); Douglas M. Branson, *Enron—When All Systems Fail: Creative Destruction or Roadm.ap to Corporate Governance Reform?*, 48 VILL. L. REV. 989, 989-1021 (2003) (providing evidence that despite conflicts of interest and the risks of and consequences to being sued, unethical business deals were entered into nevertheless where those involved believed in the "good deal exemption" or that a "rising tide floats all boats"); Andrew F. Kirkendall, Comment, *Filling in the GAAP: Will the Sarbanes-Oxley Act Protect Investors from Corporate Malfeasance and Restore Confidence in the Securities Market?*, 56 SMU L. REV. 2303, 2321 (2004) (suggesting that "even if caught, the punishment [for corporate malfeasance] will be minimal compared to the potential attainable wealth"); Robert Tracinski, *The War on CEOs*, THE AYN RAND INSTITUTE, July 15, 2002, http://www.aynrand.org/site/News2?Page=NewsArticle&id=7370 ("[Under Sarbanes-Oxley] CEOs will now bear with criminal responsibility for the fraud committed by any

compensation to skyrocket further than today's lofty levels.[15] Shareholders may be left wondering about the true legacy of Sarbanes-Oxley, particularly if it results in (1) dramatically increased internal costs for Section 404 compliance; (2) dramatically increased CEO and CFO compensation to offset their personal risk of compliance; and (3) little reduction in corporate scandalhood.[16] All three are a strike out for the shareholders, but these adverse consequences can be averted by making managers truly accountable to shareholders, the constituency to whom they are supposed to be accountable in the first place.

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employee in the accounting department. Expect them to demand higher pay in return for this enormous added risk.").

[15] *See The Boss's Pay: The Wall Street Journal/Mercer 2005, CEO Compensation Survey*, WALL ST. J., Apr. 10, 2006, at R7 ("Salaries and bonuses of surveyed chief executives [in 2005] rose 7.1% after zooming 14.5% in 2004 and advancing 7.2% in 2003."); Andrew Countryman, *Board Pay Trickles Up*, CHI. TRIB., Apr. 30, 2006, Business, at 5 ("This proxy season a *Chicago Tribune* review of a random sample of 50 Standard & Poor's 500 companies shows 60 percent increased pay compared with a year earlier . . . .").

[16] *See* BRIAN MORAN, THE 2005 OVERSIGHT SYSTEMS REPORT ON CORPORATE FRAUD 2 (2005), http://www.oversightsystems.com/whitepapers/Oversight_Systems_Survey_on_Fraud.pdf (finding that sixty-seven percent of people questioned believed that "institutional fraud is more prevalent today than it was five years ago"). When questioned whether or not a cultural change had been witnessed following the wake of accounting scandals such as Enron, thirty-nine percent responded that this initial, reactive interest will have faded within five years. *Id. See also* Paula Rausch, *Fraud, Deception*, UNIV. FLA. NEWS, July 30, 2003, at paras. 1-2, http://www.napa.ufl.edu/2003news/corporateboards.htm:

> [O]utside board members . . . may actually exacerbate an already massive problem of directors being too cozy with the very people they're supposed to be overseeing. Simply putting someone on a board who's an outsider who has some status because of political or business connections or whatever, doesn't ensure stockholder representation. . . . The appearances are such that it does, but our research shows that's not the case.

The Way We Govern Now, ECONOMIST, Jan. 11, 2003, at 62, *available at* http://www.economist.com/business/PrinterFriendly.cfm?Story_ID=1522755:

> In the United States, claims against directors have been rising both in number and in size. And insurance cover is becoming both narrower and more expensive. Not surprisingly, the average size of the board of a large American company has fallen from 15 to 11 over the past ten years.

Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, (U. Ill. L. & Econ. Working Paper No. LE02-008, 2002), *available at* http://ssrn.com/abstract=332681; A FRAMEWORK FOR CORPORATE CULTURE AND INTEGRITY, GLOBAL COMPLIANCE SERVICES 3 (2004), http://www.globalcompliance.com/pdf/GCS FrameworkforCorporateCultureandIntegrity.pdf ("Despite the continual increase in legislation, reports of corporate fraud are still on the rise. In their 2003 Fraud Survey, KPMG Forensic documented that seventy-five percent of companies surveyed report they experienced an instance of fraud—13 percentage points more than in 1998."); *Corporate Law Fraud on Trial: What Have We Learned?*, KNOWLEDGE@WHARTON, Mar. 30, 2005, at para. 17, http://omegans.knowledgeatwharton.com/index.cfm?fa=viewArticle&ID=1131 ("The 'big truth' . . . is that there is only so much we can gain from corporate compliance programs and corporate governance. . . . The devious behavior of men and women knows no bounds.") (internal quotation marks omitted).

This article seeks to examine the purpose of the independent director and whether this notion continues to make sense. It is essential that our public companies thrive in today's global environment. This article attempts to answer the question of whether board dominance by the independent director is an impediment to our public companies. It also makes a modest proposal for returning governance of public companies to the shareholder-owners who incontrovertibly have the most motivation to enhance an enterprise's overall competitiveness and profitability.

II. HISTORY OF THE DEVELOPMENT OF THE INDEPENDENT DIRECTOR

There is little doubt historically that early corporations were owner-managed.[17] The first corporations, however, were typically chartered by the crown[18] or by the state.[19] Only a charter by one of these authorities could give an entity a separate life and existence and limit enterprise liability against the investors.[20] The major investors served on the boards of directors and managed the policy and strategy of the business.[21] As corporations got larger and the industrial revolution progressed, a managerial class arose.[22] Managers were hired on an agency basis to oversee the efficient discharge of the management of the businesses on behalf of the owners.[23] With their superior inside information and knowledge, managers soon had the upper hand. Absentee owners could no longer compete with managers on the playing field of information, strategy, and

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[17]Adam Winkler, *"Other People's Money": Corporations, Agency Costs, and Campaign Finance Law*, 92 GEO. L.J. 871, 906 (2004). For substantive manuscripts on the origins of corporate boards of directors, see Franklin A. Gevurtz, *The European Origins and the Spread of the Corporate Board of Directors*, 33 STETSON L. REV. 925 (2004) [hereinafter Gevurtz, *European Origins*], and Franklin A. Gevurtz, *The Historical and Political Origins of the Corporate Board of Directors*, 33 HOFSTRA L. REV. 89 (2004) [hereinafter Gevurtz, *Historical Origins*].

[18]*See* Gevurtz, *Historical Origins*, *supra* note 17, at 111-15.

[19]*Id.* at 108-09.

[20]*See id.* at 109 (discussing New York's 1811 act, the country's first general incorporation act).

[21]In essence, these original corporations were functionally indifferent from closely-held corporations today. *See generally id.* at 102 (discussing the overlap of shareholders and the board in closely-held corporations). For a more nuanced discussion on this overlap, see Gevurtz's exposition on the English trading companies' influence on corporate board governance. *Id.* at 115-29.

[22]*See* Gevurtz, *Historical Origins*, *supra* note 17, at 116 (discussing the increased role stockholders took in managing the Russia Company).

[23]*Id.* at 119 ("The board turned from a regulatory body, which preserved an exclusive franchise on behalf of a group of merchants who conducted individual businesses, into a supervisory body, which had overall responsibility for running a business.").

tactics. Managers began to appoint their own nominees to serve on boards of directors.[24] Over time, a process developed whereby managers became accountable largely to their own handpicked board. Stated differently, a process of intermediation occurred whereby the managerial class promoted and supported their own boards between the owners and themselves.[25] Ironically, many boards function not as the shareholders' board, but as the managers' board.[26] Boards, therefore, are only theoretically shareholder advocates; in reality, boards frequently serve as a "process buffer" between the managers and the owners.[27]

III. SARBANES-OXLEY AND THE EVOLVING ROLE OF THE INDEPENDENT DIRECTOR

A. *Congress's Role*

Sarbanes-Oxley does not itself impose any obligations on companies to have independent directors.[28] In fact, the surrounding congressional debate is almost devoid of discussion of board composition or the role of the independent director.[29] There is little discussion, for instance,

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[24]Gevurtz suggests the East India Company's charter may have been the first to grant its board this power. *Id.* at 118.

[25]Gevurtz, *European Origins*, *supra* note 17, at 928-29.

[26]*Id.*; Gevurtz, *Historical Origins*, *supra* note 17, at 95 ("[T]he overwhelming practice is for the board to appoint the chief executive officer and other senior corporate officials.").

[27]*See* Lynne L. Dallas, *The New Managerialism and Diversity on Corporate Boards of Directors*, 76 TUL. L. REV. 1363, 1367 (2002) ("The power of directors is present in their ability to manage the business enterprise without the direct interference of shareholders."). *See also* AFSCME, Comment, SHAREHOLDER ACCESS TO THE PROXY: INCREASING DEMOCRACY AND ACCOUNTABILITY IN CORPORATE GOVERNANCE 8-11 (June 2003), *available at* http://www.afscme.org/wrkplace/proxy2003.pdf (discussing the shortcomings with this current system and advocating the benefits of direct proxy access to the director selection process).

[28]*See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, & 29 U.S.C.); *see also* Kirkendall, *supra* note 14, at 2312 (describing the accounting and auditing focus of Sarbanes-Oxley).

[29]*See, e.g.*, 148 CONG. REC. S6763-65 (daily ed. July 15, 2002) (statement of Sen. McCain) ("Board members should be independent and 'ask tough questions.' . . . To get the incentives right, directors must be selected by vigorously participating shareholders, most especially institutional shareholders, from a slate of demonstrably independent people who, although well compensated, have reputations worth protecting.") (quoting Irwin M. Stelzer, *Big Business's Bad Behavior*, WEEKLY STANDARD, July 22, 2002, at 22, 22, 25. *See also* Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 115 YALE L.J. 1521, 1549-68 (2005) (discussing why "[t]he corporate governance mandates were neither a principal nor a subsidiary focus of legislative consideration" by examining the House and Senate debates throughout the passage of Sarbanes-Oxley); Note, *The Case for Federal Threats in Corporate Governance*, 118 HARV. L. REV. 2726, 2741 (2005) ("The content of the House and Senate debates on Sarbanes-Oxley reveals Congress's lack of interest in maximizing shareholder

regarding what is expected of the independent director or what Congress means by "independence."[30] A few members of Congress refer generally to the importance of independent directors, but these references come primarily in the debate on the independence of auditors and the composition of a company's audit committee.[31]

The paucity of discussion of director independence[32] is inconsistent with earlier findings that lack of director independence and the oversight of the company's auditor were judged to be factors in the collapse of Enron.[33] The Permanent Subcommittee on Investigations of the Senate Committee on Governmental Affairs found that financial ties between the company and some board members compromised the independence of the Enron board.[34] The Subcommittee also stated that the board failed to recognize the signs of the collapse and to adequately protect Enron's shareholders.[35] Early versions of the legislation included a provision mandating a Securities and Exchange Commission (SEC) study into

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value . . . .").

[30]*See* Romano, *supra* note 29, at 1575-76 (briefly discussing testimony from experts on corporate governance regarding the need for independent directors).

[31]*See, e.g., id.* at 1577 ("In the House hearings, only a few witnesses raised the issue of audit committee independence, and none advocated requiring a majority of independent directors on the board."). *See also* William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953, 967 (2003) (stating that the definition of "director independence" post-Enron "is embodied in the proposed Exchange Rules rather than in Sarbanes-Oxley").

[32]*See* Note, *supra* note 29, at 2741 (suggesting that "the hasty enactment of Sarbanes-Oxley" may have had a role in the oversight).

[33]*See* PERMANENT SUBCOMM. ON INVESTIGATIONS OF THE SENATE COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., THE ROLE OF THE BOARD OF DIRECTORS IN ENRON'S COLLAPSE, S. REP. NO. 107-70, at 3, 54-57 (2002), *available at* http://www.senate.gov/~gov_affairs/070902enronboardreport.pdf. *See also id.* at 24 (describing the Enron board's conduct regarding its CFO "highly unusual and disturbing"):

> Despite clear conflicts of interest, the Enron Board of Directors approved an unprecedented arrangement allowing Enron's Chief Financial Officer to establish and operate the LJM private equity funds which transacted business with Enron and profited at Enron's expense. The Board exercised inadequate oversight of LJM transaction and compensation controls and failed to protect Enron shareholders from unfair dealing.

[34]*See id.* at 54-57.

[35]*Id.* at 3. *See also* WILLIAM C. POWERS, JR., ET AL., REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP. 148 (2002), *available at* http://news.findlaw.com/hdocs/docs/enron/sicreport/sicreport020102.pdf (stating that the "Board put many controls in place, but the controls were not adequate, and they were not adequately implemented" and that it "was denied important information that might have led it to take action, but the Board also did not fully appreciate the significance of some of the specific information that came before it").

director independence,[36] but these provisions were not included in the final bill. The final bill, however, did require the SEC to direct the national securities exchanges to adopt new listing rules that would bring public companies into compliance with Sarbanes-Oxley.[37] The SEC rules promulgated under Sarbanes-Oxley outlined the minimum director independence requirements, but they do not impose any independence obligations on companies.[38]

B. *The Stock Exchanges' Role*

In June 2002, the New York Stock Exchange (NYSE) Listing Standards Committee published a report with recommendations to the NYSE's Board of Directors and other institutions regarding changes in listing standards and governance practices.[39] The recommendations included requiring listed companies to have a majority of independent directors under a tightened definition of "independent director."[40] Shortly after Sarbanes-Oxley was passed, the Stock Exchanges submitted to the SEC new listing standards that included requirements related to director independence.[41] Both Stock Exchanges' standards require companies to

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[36]*See* COMM. ON FIN. SERVS., 107TH CONG., CORPORATE & AUDITING ACCOUNTABILITY, RESPONSIBILITY, & TRANSPARENCY ACT OF 2002, H. REP. NO. 107-414 (Apr. 22, 2002), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=107_cong_reports &docid=f:hr414.107.pdf. Section 15 of this Act directed the SEC "to conduct a study and review of corporate governance standards . . . to determine whether they serve the best interests of shareholders." *Id.* at 44. This study included analyzing "whether the rules, standards and practices relating to determining whether independent directors are in fact independent are adequate." *Id.* at 45.

[37]Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 301, 116 Stat. 745, 775-77 (codified at 15 U.S.C. § 78j-*l*); Daniele Marchesani, *The Concept of Autonomy and the Independent Director of Public Corporations*, 2 BERKELEY BUS. L.J. 315, 324 (2005).

[38]17 C.F.R. § 240.10A-3(b)(1) (2004); Marchesani, *supra* note 37, at 324. As discussed in this part, the Stock Exchanges have been the developers of the director independence standards for public companies.

[39]*See* NYSE CORPORATE ACCOUNTABILITY REPORT, *supra* note 13, at 1.

[40]*Id.* at 6-7. The pre-existing listing standards required three independent directors on each listed company's board. *Id.* at 6 n.2. It also defined "'independence' solely for audit committee members." *Id.* at 7 n.3.

[41]The NYSE filed proposed revisions to its listing standards with the SEC in August 2002. *See* N.Y. STOCK EXCH., INC., CORPORATE GOVERNANCE RULE PROPOSALS REFLECTING RECOMMENDATIONS FROM THE NYSE CORPORATE ACCOUNTABILITY AND LISTING STANDARDS COMMITTEE AS APPROVED BY THE NYSE BOARD OF DIRECTORS, AUG. 1, 2002 (2002), http://www.nyse.com/pdfs/corp_gov_pro_b.pdf [hereinafter NYSE PROPOSED RULES]. The NASDAQ filed its proposals shortly thereafter in October 2002. *See* SR-NASD-2002-141: Board Independence and Independent Committee (proposed Oct. 9, 2002), *reprinted as amended in* 68 Fed. Reg. 14,451 (Mar. 25, 2003).

have a majority of independent directors on their boards.[42] Although there was generally widespread support for the new listing standards, the NYSE reported that smaller businesses had voiced concern about the requirement for majority-independent boards.[43] In cases of companies controlled by a shareholder or parent company (controlled companies),[44] the majority-independent board requirement would deprive a majority shareholder of its shareholder rights, and further, the requirement was unnecessary because the NYSE's other listing standards adequately protected minority shareholders.[45] The NYSE addressed these concerns by exempting controlled companies from the majority-independent board requirement.[46]

The NYSE listing standards, as approved by the SEC, state that "[e]ffective boards of directors exercise independent judgment in carrying out their responsibilities," and that "[r]equiring a majority of independent directors will increase the quality of board oversight and lessen the possibility of damaging conflicts of interest."[47] The NYSE, however, does not cite any empirical research to support its assumption that independent director majorities will increase the quality of board oversight or enhance shareholder returns. The rationale of the NASDAQ Stock Market in imposing its director independence requirements is similar:

> Independent directors . . . play an important role in assuring investor confidence. Through the exercise of independent judgment, they act on behalf of investors to maximize shareholder value in the companies they oversee and guard against conflicts of interest. Requiring that the board be composed of

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[42]*See* NYSE Manual, *supra* note 10, § 303A.01; NASDAQ Rules, *supra* note 10, R. 4350(c)(1).

[43]*See Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants or Others*, *in* NYSE PROPOSED RULES, *supra* note 41, at 18, 18 [hereinafter *Self-Regulatory Statement*].

[44]The NYSE defines "controlled company" as a "company of which more than 50% of the voting power is held by an individual, a group or another company." NYSE Manual, *supra* note 10, § 303A.00.

[45]*Self-Regulatory Statement*, *supra* note 43, at 18-19. One controlled company was also concerned that the majority-independent board requirement would cause it to lose the benefits associated with owning a controlling stake in a subsidiary, which would force it to transfer the controlled company to a third party to prevent losing that control. *Id.* at 19.

[46]*See id.* at 19; NYSE Manual, *supra* note 10, § 303A.00. The NASDAQ made a parallel rule. *See* NASDAQ Rules, *supra* note 10, R. 4350(c)(5).

[47]NYSE Manual, *supra* note 10, § 303A.01, commentary. On November 23, 2005, the NYSE proposed further amendments to its corporate governance listing standards covered by Rule 303A. *See* N.Y. Stock Exch., Form 19(b)(2) Proposed Rule Change by the N.Y. Stock Exch., Inc., File No. SR-NYSE-2005-81 (Nov. 23, 2005), *available at* http://www.nyse.com/pdfs/NYSE-2005-81.pdf.

> a majority of independent directors empowers such directors to carry out more effectively these responsibilities.[48]

As with the NYSE, the NASDAQ fails to cite any empirical research for this proposition. One is left with the impression that the Stock Exchanges advanced well-meaning corporate governance platitudes and assumptions in favor of majority-independent boards to assuage the tempest of public opinion in 2002.

The NYSE rules provide that a board must affirmatively determine and disclose which directors are independent and the basis for that determination.[49] Although the NYSE does not have a general definition of "independence," the relevant rule suggests it encompasses those directors with "no material relationship with the . . . company[,] either directly or as a partner, shareholder or officer of an organization that has a relationship with the company" of which the director would serve on the board.[50] The commentary to this rule also defines "material relationships" to "include commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships, among others."[51] The NYSE rules also include "bright line" tests to determine a director's independence, including past employment with the company; past compensation from the company in excess of $100,000; relationships with the company's internal and external auditors; relationships with officers on the company's compensation committee; and employment by another company with a financial relationship to the company.[52] Finally, the rules also require the nonmanagement directors to conduct regularly scheduled meetings separate from management in order to "serve as a more effective check on management."[53]

According to the NASDAQ rules, an independent director is "a person other than an officer or employee of the company or its subsidiaries or any other individual having a relationship, which, in the opinion of the company's board of directors, would interfere with the exercise of

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[48]NASDAQ Rules, *supra* note 10, R. 4350(c)(1).

[49]*See* NYSE Manual, *supra* note 10, § 303A.02(a).

[50]*Id.*

[51]*Id.* § 303A.02(a), commentary.

[52]*Id.* § 303A.02(b). These tests also apply to the director's immediate family. *Id.*

[53]NYSE Manual, *supra* note 10, § 303A.03. The commentary to this rule states that these meetings promote open discussion among the nonmanagement directors and foster better communication. *Id.* § 303A.03, commentary. The commentary defines "non-management" directors as those directors who are not executive officers or otherwise affiliated or related to the company "by virtue of a material relationship, former status or family membership, or for any other reason." *Id.*

independent judgment in carrying out the responsibilities of a director."[54] The commentary to the NASDAQ rules states that the independence requirements are important because they allow investors "to have confidence that individuals serving as independent directors do not have a relationship with the listed company that would impair their independence."[55] Like the NYSE rules, the NASDAQ rules require a board to make an affirmative determination that no relationships exist between a director and the company that would impair the director's independence, and the board must disclose that determination in its proxy or annual report.[56] The NASDAQ rules also list relationships that would impair independence, such as employment by the company or its outside auditor; certain acceptances of payments from the company in excess of $60,000; association with another organization having a threshold financial relationship with the company; and relation to executive officers of the company or officers who served on another company's compensation committee.[57]

In 1996, the National Association of Corporate Directors (NACD) recommended that boards of directors be comprised of a "substantial majority" of independent directors.[58] Under the recommendations of the NACD, public companies would be required to disclose whether they had such a majority of independent directors and, if not, establish why they did not.[59] The NACD also recommended that the audit, compensation, and nominating committees be composed entirely of independent directors.[60] No empirical evidence is cited or relied upon to support that the NACD's recommendations are in the shareholders' best financial interests.

A Business Roundtable report also addressed director independence in 1997. While the Business Roundtable recommended that boards be sufficiently independent from management, it advocated for a facts-and-circumstances approach rather than rigid adherence to a strict formula for

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[54]*See* NASDAQ Rules, *supra* note 10, R. 4200(a)(15).

[55]NASDAQ STOCK MARKET, INC., CORPORATE GOVERNANCE: RULES 4200, 4200A, 4350, 4350A, 4351, AND 4360, AND ASSOCIATED INTERPRETATIVE MATERIAL 2 (Apr. 15, 2004), http://www.nasdaq.com/about/corporategovernance.pdf [hereinafter NASDAQ INTERPRETIVE MATERIAL]. *See also* NASDAQ Rules, *supra* note 10, R. 4350(c) (listing requirements for independent directors and independent committees).

[56]*See* NASDAQ INTERPRETIVE MATERIAL, *supra* note 55, at 9; NASDAQ Rules, *supra* note 10, R. 4350(c).

[57]*See* NASDAQ Rules, *supra* note 10, R. 4200(a)(15). Like the NYSE counterpart rules, the NASDAQ rules also apply to the director's family. *See id.*

[58]*See* NAT'L ASS'N OF CORPORATE DIRS., REPORT OF THE NACD BLUE RIBBON COMMISSION ON DIRECTOR PROFESSIONALISM 9 (1996).

[59]*See id.* at 10.

[60]*See id.* at 5.

determining the independence of directors and the makeup of a board.[61] For example, if a director is not considered "sufficiently" independent, that director could nonetheless be "highly desirable (as in the case of an inside director) in the context of a board composed of a majority of [independent] directors."[62] The Business Roundtable also suggested that "[e]ach director should represent the interests of all stockholders" of the company and not the interests of a single person or interest group because this latter representation would "create factionalism and undermine the effectiveness of the board."[63] Further, the Business Roundtable found it important for directors to be substantially independent from management and recommended that "a substantial majority of directors . . . should be outside (non-management) directors."[64] The level of independence is affected by the director's personal stature and business relationships.[65] Like the Stock Exchanges and the NACD, the Business Roundtable cites no empirical evidence to support the proposition that a substantial majority of outside directors would enhance a company's financial performance.

Another argument for director independence is put forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).[66] The COSO sponsored an analysis of fraudulent financial reporting of U.S. public companies.[67] The study found that companies with more inside directors were more likely to be victims of financial fraud.[68] The study also cited the problem that the directors of companies that fell victim to such frauds had little experience as corporate monitors.[69] The COSO stated in its report that in order for a board to monitor a company effectively, the directors that comprise the board must be both independent

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[61] *See* BUS. ROUNDTABLE, STATEMENT ON CORPORATE GOVERNANCE 11 (1997), http://www.businessroundtable.org/pdf/11.pdf.

[62] *Id.* at 11.

[63] *Id.* at 8.

[64] *Id.* at 10.

[65] BUS. ROUNDTABLE, *supra* note 61, at 10 (suggesting that certain relationships with the corporation or with management may impair director independence).

[66] "COSO is a voluntary private sector organization dedicated to improving the quality of financial reporting through business ethics, effective internal controls, and corporate governance." COSO, http://www.coso.org (last visited Dec. 8, 2006).

[67] *See* MARK S. BEASLEY ET AL., COMM. OF SPONSORING ORGS. OF THE TREADWAY COMM'N, FRAUDULENT FINANCIAL REPORTING: 1987-1997—AN ANALYSIS OF U.S. PUBLIC COMPANIES 4 (1999), *available at* http://www.coso.org/publications/FFR_1987_1997.pdf (analyzing alleged instances of fraudulent financial reporting of a sample of approximately 200 public companies targeted by the SEC over an eleven-year period).

[68] *Id.* at 1. Approximately sixty percent of the directors of the cases analyzed in the study were insiders or "gray" directors, which the COSO defined as former insiders of the company or "outsiders with special ties to the company or management." *Id.* at 6.

[69] *Id.* at 24.

and experts.[70] If they are neither, the board will be unable to function as a "vigorous monitor of management."[71] The COSO noted that, although larger companies are increasingly relying on independent directors, smaller companies require a greater focus on director independence and expertise because in such companies, influence and control are usually centralized in the hands of a few individuals.[72]

In an earlier day, the role of the independent director was mostly advisory.[73] Board members were selected because they were either acquaintances or people respected by other board members or the CEO.[74] They knew the score, and their loyalty was expected. In exchange, directors received cash compensation, stock options, and social approbation.[75] In addition, they received perquisites such as board trips (with spouses frequently invited), and the use of company facilities.[76] In their advisory capacity, board members were to offer guidance, wisdom, resources, and business connections; in short, they were to be a "kitchen cabinet"[77] of resources to the CEO. They were also to function as arbiters of fairness in the event conflicts presented themselves to the board, such as CEO compensation and self-interested business deals.[78]

It is clear that the definition and role of the independent director have evolved in light of Sarbanes-Oxley and the Stock Exchanges' contemporaneous reforms. There is no doubt that the governance demands placed on independent directors are greater than in earlier years. What has not been addressed by any of these regulatory bodies, however, is a rigorous analysis

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[70]*See id.* at 44.

[71]BEASLEY ET AL., *supra* note 67, at 44.

[72]*See id.*

[73]*See generally* William L. Cary & Sam Harris, *Standards of Conduct Under Common Law, Present Day Statutes and the Model Act*, 27 BUS. LAW. 61, 64-66 (Officers' and Directors' Responsibilities & Liabilities Supp. 1972) (suggesting reasons why directors should be held to a higher standard of conduct to their company).

[74]*See id.* at 65 ("The directors selected are usually heads of prestigious concerns, with primary responsibilities of their own.").

[75]*See id.* ("Indeed, instead of finding it impossible to secure the services of able and experienced corporate directors, how many people know officers of a company who are not dying to become directors? In fact, it is the measure of their taking greater responsibility in the company.").

[76]*See, e.g.*, M. Todd Henderson & James C. Spindler, *Corporate Heroin: A Defense of Perks, Executive Loans, and Conspicuous Consumption*, 93 GEO. L.J. 1835, 1870 (2005) (describing the "culture of excess" at Enron as a "modern day French court").

[77]"An informal group of advisers to one in a position of power (as the head of a government)." WEBSTER'S NINTH NEW COLLEGIATE DICTIONARY 663 (1988).

[78]*Cf.* Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 787 (2002) (discussing the importance of reputation and its influence on outside directors today).

of whether there is an empirical predicate that majority-independent boards serve to enhance the returns of shareholders. If there is no such predicate, then Sarbanes-Oxley may have, because of scandal and political pressures, trapped companies inside of a "fairness paradigm." This paradigm may be psychologically and socially comforting,[79] but in the long term it could erode the competitiveness of our public companies.

IV. INDEPENDENCE—WHAT IS IT?

The Stock Exchanges basically define independence to mean that a board member or his family does not have a preexisting material relationship with the company whereby the company or the company's executives will be able to influence the board member's judgment.[80] They have also promulgated "bright line" tests and financial criteria for what constitutes a "material pre-existing relationship" and whether a director has "independent" status.[81] Because these tests are so specific, however, they are inherently unreliable and subject to counterexamples, false positives and false negatives. Can a director or nominee who otherwise meets or exceeds the independence criteria be nonindependent? Surely; witness a director who desires board membership due to a business need to influence other participants in the same industry as the company. Conversely, someone otherwise not meeting the tests can surely exercise "independent" judgment: witness a nominee whose business received more than $200,000 from the company over the last three years, but whose engagement was a one-time affair and an insignificant part of the nominee's overall business (e.g., a structural engineering assignment for a company's headquarters).[82] Furthermore, the tests only define what "independence" is; they do not specifically define what independence is not, except by negative inference.

If a director holds stock, is the director independent? There has been a significant movement advocating the following value proposition: If one wants to align directors' interests with the shareholders, give directors stock options.[83] But is this really the case? Do directors who hold stock or stock

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[79]For example, "independent board" sounds "fair" at a cursory glance.

[80]*See supra* Part III.B.

[81]*See* NYSE Manual, *supra* note 10, § 303A.02; NASDAQ Rules, *supra* note 10, R. 4200(a)(15). *See also supra* notes 52 & 57 and accompanying text (describing these "bright line" tests).

[82]This scenario may not necessarily trigger NYSE § 303A.02(b)(v), but would likely trigger NASDAQ R. 4200(a)(15)(D).

[83]*See* Dan R. Dalton & Catherine M. Daily, *Director Stock Compensation: An Invitation to a Conspicuous Conflict of Interests?*, 11 BUS. ETHICS Q. 89, 90 (2001); Charles M. Elson, *Director Compensation and the Management-Captured Board—The History of a Symptom and*

options make decisions with the shareholders' best interests or their own financial interests in mind?[84] If a director has pressing financial problems, will a director vote in favor of short-term expedience and financial gain or in the best long-term interests of the shareholders? Frequently, the answer to this question is the latter because the director's financial interest in the company is normally small relative to his or her net worth[85]—what we call the "directors are not petty, venial people" defense. We have found no data to support this reasoning and no psychological data to suggest that a financial interest, even a small financial interest, does not affect complex corporate decision making.[86] Unfortunately, human experience is replete with instances where even the most "blue-chip" directors are shockingly and conspicuously petty and venial.[87]

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a Cure, 50 SMU L. REV. 127, 164-73 (1996); Timothy Annett, *Better Option: Charles Elson's Prescription for Ailing Boards*, WALL ST. J. ONLINE, Dec. 19, 2002, at para. 2, *available at* http://online.wsj.com/ad/article/SB1040065921103989553.html. *See also* Richard H. Wagner & Catherine G. Wagner, *Recent Developments in Executive, Director, and Employee Stock Compensation Plans: New Concerns for Corporate Directors*, 3 STAN. J.L. BUS. & FIN. 5 (1997) (exploring the implications of stock-based compensation plans); Garry Emmons, *Bad Times for Business: Trouble in Corporate America*, HARV. BUS. SCH. BULL. ONLINE, Dec. 2002, at para. 4, http://www.alumni.hbs.edu/bulletin/2002/december/badtimes.html ("[O]ptions were the rocket fuel that blew the cracks wide open, with some disastrous results.").

[84]*See, e.g.*, Amy D. Marcus, *Tyco Directors to Get More Than 90% of Cash Compensation in Stock Options*, WALL ST. J., Nov. 4, 1999, at A6 (discussing Tyco's plan to pay the bulk of its $65,000 annual director cash fee with Tyco shares or options or a combination of the two), and *Tyco Paid Director a Fee of $10 Million*, N.Y. TIMES, Jan. 29, 2002, at C2 (reporting Tyco's $20 million payment in compensation and charitable contributions to one of its outside directors who helped arrange a merger for the company).

[85]*See* Peter J. Wallison, *All the Rage: Will Independent Directors Produce Good Corporate Governance?*, AM. ENTER. INST. PUB. POLICY RESEARCH 2 (2006), http://www.aei.org/doclib/20060106_19454FSOJan_06_g.pdf.

[86]*See id.*:

> [S]tudies have not shown that boards with a supermajority of independent directors are superior at monitoring, either. . . . [M]any advocates of corporate governance reform seem to believe that providing stock options to directors as a form of compensation encourages the preparation of overly optimistic financial reports and is thus inconsistent with the very purpose of requiring that boards be composed of a supermajority of independent directors.

[87]*See, e.g.*, John A. Byrne, *Extra Helpings on the Gravy Train*, BUS. WK. ONLINE, Apr. 22, 2002, http://www.businessweek.com/magazine/content/02_16/b3779062.htm (discussing the financial benefits and potential windfalls available to CEOs given tracking stocks); BRUCE KUSHICK, EXEC. DIR., NEW NETWORKS INST., REGIONAL BELL (RBOC) SENIOR MANAGEMENT COMPENSATION: A PRIMER IN CORPORATE GREED (2002), http://www.teletruth.org/docs/compensationFIN.pdf (summarizing the salaries and executive compensation packages for the Bell Companies); Gary Strauss, *Tyco Events Put Spotlight on Directors' Role*, USA TODAY, Sept. 15, 2002, *available at* http://www.usatoday.com/money/industries/manufacturing/2002-09-15-tyco-direct_x.htm (discussing the various perks given to the directors at Tyco and other companies).

Generally, directors are recruited by nominating committees of boards of directors.[88] In effect, these nominating committees work similarly to membership committees of private clubs. Business associates and friends of these committee members nominate candidates. As anyone who has ever served on a board of directors knows, boards of directors frequently choose other board members because of their "star" quality to attract the interest and adulation of Wall Street and hopefully support the stock price, if not increase it. Public companies compete for "A-list" board members much like academy award parties vie for "A-list" celebrities.[89] Candidates are then put through a "rigorous" series of interviews and dinners/lunches. Also, some due diligence is done. The most important qualification is whether the CEO believes that the prospective board member will be "on the same page" philosophically and will have the appropriate loyalties due to the nature of the board.[90] CEOs will vigorously

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[88]*See* Jayne W. Barnard, *Shareholder Access to the Proxy Revisited*, 40 CATH. U. L. REV. 37, 49-50 (1990) (discussing the futility of the nominating committee).

[89]*See* MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION 171-72 (1976) (commenting that most directors are "closely tied to the chief executive . . . [because] they have been selected and indoctrinated by the chief executive and hold their seats at his pleasure"); ROBERT AARON GORDON, BUSINESS LEADERSHIP IN THE LARGE CORPORATIONS 143 (U. Cal. Press 1966) (1945) ("[T]he board of directors in the typical large corporation does not actively exercise an important part of the leadership function."); MYLES L. MACE, DIRECTORS: MYTH AND REALITY 107 (1986) (finding that most of the outside directors interviewed "believed that the prestige names and titles of outside directors were critically important, principally to enhance the public image of the company—as it was colorfully put by one, as 'attractive ornaments on the corporate Christmas tree'"); Branson, *supra* note 14, at 1015 ("Directors who serve on six, eight or more boards simply are not capable of the monitoring required. They are there for window dressing, or because they are glad-handers or back-slappers."); Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 875 (1991) (suggesting that because a clear majority of independent directors serving on corporate boards are actually CEOs of other companies, "[t]hese directors are unlikely to monitor more energetically than they believe they should be monitored by their own boards"); Myles L. Mace, *Directors: Myth and Reality: Ten Years Later*, 32 RUTGERS L. REV. 293, 302 (1979) (finding his conclusions had not essentially changed in ten years); Mark E. Brossman & Gregory S. Weiss, *Shareholder Activism Aimed at Executive Compensation*, INT'L FOUND. EMP. BENEFIT PLANS—BENEFITS & COMP. DIG., Dec. 2005, at 40, 40 ("Corporate boards are like 'parsley on the fish—decorative but useless.'"); Stephen P. Ferris et al., *Too Busy to Mind the Business? Monitoring By Directors with Multiple Board Appointments* 4 (U. Mich. L. Sch., Working Paper No. 99-013; CORI Working Paper No. 2001-02), *available at* http://ssrn.com/abstract=167288 ("[D]irectors of large firms might be attractive as candidates for other boards because of the networking contacts they represent to these firms.").

[90]*See* STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 193 (2002) (discussing the supervisory nature of the board); Gevurtz, *Historical Origins*, *supra* note 17, at 106 (noting that the board of directors has been reduced "to an institution which, despite its formal role as the supreme governing body of the corporation, in fact, does very little"); Rausch, *supra* note 16, at para. 12 ("These boards . . . often act like they are members of the emperor's court . . . either approving the CEO's actions or not being terribly interested in what the CEOs do, so long as they are able to hold on to their board status and pay.") (internal quotation marks omitted). *See*

resist nominations of board candidates with whom they do not see eye-to-eye, and for good reason.[91] CEOs and other board members do not want a fractious board environment.[92] Fractious board environments lead to legal polarization very quickly. A fractious board also interferes with consensual decision making and turns board rooms into uncomfortable debating societies.[93] Even if a director meets the bright-line tests for independence, the enculturation of the recruitment process, plus the societal approbation that comes with board service, coupled with the board room interpersonal dynamics of loyalty and friendship, serve to shear the director of true independence very quickly.[94]

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also The Way We Govern Now, *supra* note 16, at 62 (quoting an address given by Kenneth Lay, then chief executive of Enron, in 1999 to the Centre for Business Ethics, University of St. Thomas in Houston, Texas):

> What a CEO really expects from a board is good advice and counsel both of which will make the company stronger and more successful; support for those investments and decisions that serve the interests of the company and its stakeholders; and warnings in those cases in which investments and decisions are not beneficial to the company and its stakeholders.

Wallison, *supra* note 85, at 4 (stating that the lack of access to vital information and the additional efforts for independent directors to uncover manipulated information makes the idea these directors will do so "seem[] largely to be an idealization of reality"); Alan Greenspan, Chairman, Fed. Reserve Bd., Remarks at the 2003 Conference on Bank Structure and Competition, Chicago (May 8, 2003) ("The vast majority of corporate share ownership is for investment, not for operating control of the company."). For a discussion into giving shareholders this particular power, see Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735 (2006) [hereinafter Bainbridge, *Shareholder Disempowerment*]; Lucian Arye Bebchuk, *Letting Shareholders Set the Rules*, 119 HARV. L. REV. 1843 (2006).

[91]*See generally* Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 843-47 (2005) (describing the current prevailing system where the board controls all major corporate decisions); Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 605 (2003) (arguing that the board has the power and the "right to exercise decisionmaking fiat" and acts as "a sort of Platonic guardian serving as the nexus of the various contracts making up the corporation").

[92]Branson, *supra* note 14, at 989 (suggesting that disagreement between the board and management would not lead to a board member resigning "because being a director of a large United States corporation remained true to Lord Boothby's dictum in mid-Victorian England that being a company director is akin to a nice warm bath").

[93]*See* Gevurtz, *Historical Origins*, *supra* note 17, at 105 ("[T]he board's role largely falls to approval of such strategies and decisions as officers bring before the board. Even in the context of approving strategies and decisions made by the corporations' officers, however, the board's effective control tends to be marginal.") (citation omitted); Bayless Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477, 1483-85 (1983) (discussing the character, scope, and setting of the board's agenda).

[94]We offer Hollinger International, Inc. (now known as Sun-Times Media Group, Inc.) as an example of blue chip directors who perhaps were encultured not to probe too much. In 2000, the Hollinger board members were Conrad M. Black, John A. Boultbee, Frederick A. Creasey, F. David Radler, Daniel W. Colson, Barbara Amiel Black, Dwayne O. Andreas (Chairman Emeritus of Archer Daniels Midland Company), Richard R. Burt (former U.S.

V. 254 EXAMPLES

If majority-independent directors are the preferred governing precept, then surely there must be econometric data to support the proposition that their decision making leads to superior financial returns for shareholders. We conducted our own research to determine whether independent directors enhance a company's financial performance for the benefit of shareholders. While we have not commissioned a scientific or statistically significant study, we checked the returns on equity for 254 public companies during 2000 across fifty separate industries and across small, medium and large equity capitalizations.[95] We used return on equity (ROE) as a barometer of a company's financial returns to the shareholder because it measures net income (the profits of the business) divided by the stockholder's equity. As such, ROE measures the company's internal financial performance, detached from the vagaries of share price fluctuations and market risk.

Our methodology was straightforward. We reviewed the best ROE performer and the worst ROE performer across fifty separate industries, i.e., we examined the extreme points of each of fifty industries across three separate "bandwidths" of market capitalizations. Our hypothesis was that if supermajority-independent boards really make a difference to financial

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Ambassador to Germany), Raymond G. Chambers, Henry A. Kissinger, Marie-Josee Kravis, Shmuel Meitar, Richard N. Perle (former Assistant Secretary of Defense to Ronald Reagan), Robert S. Strauss (former Ambassador to the Soviet Union), A. Alfred Taubman, James R. Thompson (former Governor of Illinois), Lord Weidenfeld, and Leslie H. Wexner (Chairman/CEO of Limited Brands). *See* Hollinger Int'l Inc. Annual Report (Form 10-K), at 43-44 (Apr. 2, 2001).

On November 15, 2004, the SEC filed an enforcement action alleging that, from 1999 through 2003, Conrad Black, F. David Radler, and Hollinger, Inc. "engaged in a fraudulent and deceptive scheme to divert cash and assets from Hollinger International, Inc. . . . and concealed their self-dealing from Hollinger International's public shareholders." *See* SEC v. Black, Litig. Release No. 18,969 (Nov. 15, 2004), *available at* http://www.sec.gov/litigation/litreleases/lr18969.htm; Compl. ¶ 1, SEC v. Black, No. 04-CO-3761 (N.D. Ill. Nov. 15, 2002), *available at* http://www.sec.gov/litigation/complaints/compl88969.pdf. *See also* SEC, Release No. 2004-155; SEC Files Fraud Charges Against Conrad Black, F. David Radler and Hollinger Inc. (Nov. 15, 2004), *available at* http://www.sec.gov/news/press/2004-155.htm (summarizing the action). Subsequently, in November and December 2005, criminal charges were brought against Mr. Black for fraud, racketeering, obstruction of justice, tax evasion, and wire fraud. *See* Second Superceding Indictment at 9-68, United States v. Black, No. 05-CR-727 (N.D. Ill.), *available at* http://www.usdoj.gov/usao/iln/indict/2005/us_v_black2.pdf. The crux of the criminal allegations involve self-dealing, conflict of interest, and raiding of the company treasury, presumably areas that a "watchdog" board would theoretically monitor. *See id.* Mr. Black has publicly proclaimed his innocence, and the board has maintained they have no civil or criminal liability. *See* Geraldine Fabrikant, *Lord Black is Indicted By U.S.*, N.Y. TIMES, Nov. 18, 2005, at C1.

[95]Small-cap companies have market capitalizations under $1 billion; medium-cap companies have between $1-5 billion; and large-cap companies have over $5 billion.

returns, then the "end points" would and should show it. We utilized data from the year 2000 because it was prior to the adoption of Sarbanes-Oxley in July 2002 and, presumably, nominating committees at that time believed they had somewhat more flexibility with respect to independent director representation.

We compared the percentage of independent directors to the total number of directors for each of the companies in our data universe. For purposes of our study, we identified a director as "independent" only if the director or any family member had no current or former ties whatsoever with the company, whether by employment, business, consulting or otherwise and beneficially owned less than one percent of the company's fully-diluted shareholders' equity.[96] We then examined for each company the percentage of independent directors who possessed industry-specific knowledge, and the percentage of independent directors who were retired. We looked within each category of market capitalization for correlations between ROE performance and independent board dominance (meaning more than sixty-seven percent of board composition, "supermajority-independent boards"). We then looked further to determine correlations between (1) ROE performance and supermajority-independent boards, (2) ROE performance and percentage participation of independent board members with specific industry-related experience, and (3) ROE performance and percentage participation of retiree board members.

We hoped to find correlations showing whether or not the best ROE performers have higher percentages of independent directors than the worst ROE performers, or whether the best ROE performers have more independent directors with relevant industry knowledge or fewer independent members who are retirees. If the best ROE performers have a greater percentage of independent directors or more independent directors with relevant industry knowledge, then this would lend econometric credibility to the notion that it makes sense to entrust the governance of our public companies to boards controlled by independent directors.

Our findings show that the worst ROE performers in each of fifty industries have approximately the same percentage of independent directors as the best ROE performers in each industry. No pattern emerges to suggest that it makes any difference at all to shareholders' financial return whether a board has a higher or lower percentage of independent directors. In some industries, the worst ROE companies have more independent directors than the best; in other industries the reverse is true. Across small-cap companies generally, the worst ROE performers have more

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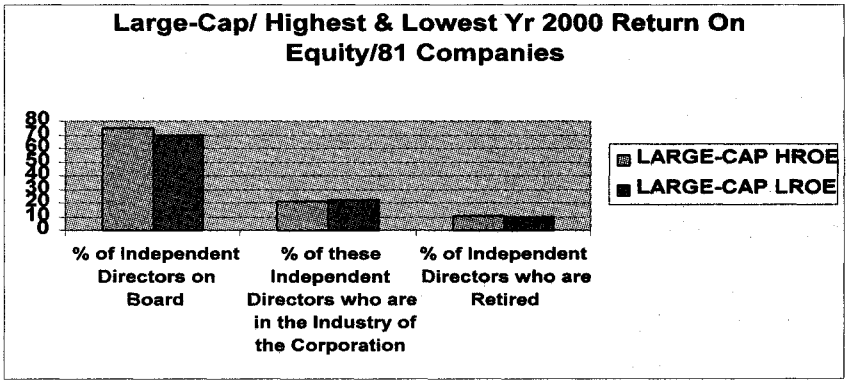
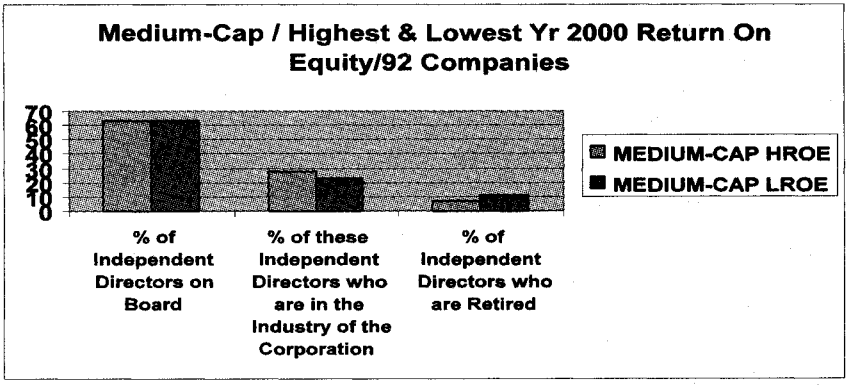
[96]For example, a former CEO of a company who served on the board was not considered "independent" for purposes of our study.

independent directors with relevant industry knowledge than the best ROE performers; for large- and medium-cap companies, the reverse is true. The percentage of retirees who serve as independent directors appears to have no correlation with ROE performance at all. Retirees constitute approximately ten percent of the independent board members across all three levels of market capitalization. Our data is graphically summarized below.

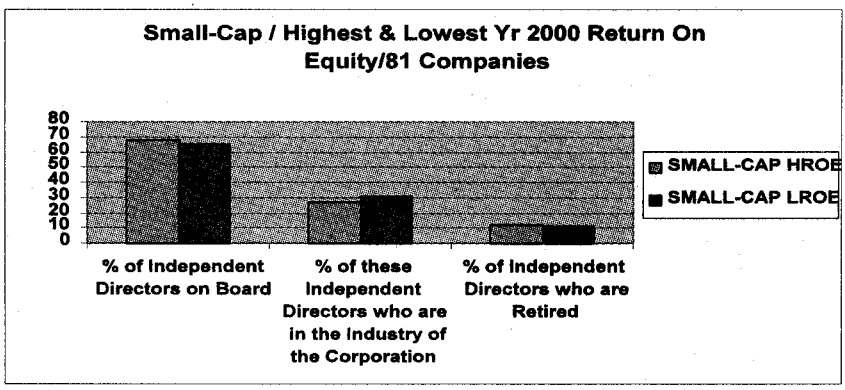
Large-Cap/Highest and Lowest Year 2000 Return On Equity/81 Companies



Medium-Cap/Highest and Lowest Year 2000 Return On Equity/92 Companies



Small-Cap/Highest and Lowest Year 2000 Return On Equity/81 Companies



Our findings are consistent with other research that shows that board independence does not necessarily translate into enhanced long-term performance.[97] Professors Sanjai Bhagat and Bernard Black have

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[97]*See* Paul W. MacAvoy et al., *ALI Proposals for Increased Control of the Corporation by the Board of Directors: An Economic Analysis*, *in* STATEMENT OF THE BUSINESS ROUNDTABLE ON THE AMERICAN LAW INSTITUTE'S PROPOSED "PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS," at C-1, C-26 to C-45 (1983) (performing an empirical evaluation at the mechanism proposed by the American Law Institute (ALI) to increase corporate fiduciary responsibility and concluding that "there is no sound economic justification for the ALI's model"); Anup Agrawal & Charles R. Knoeber, *Firm Performance and Mechanisms to Control Agency Problems Between Managers and Shareholders*, 31 J. FIN. & QUANTITATIVE ANALYSIS 377, 389-94 (1996) (finding an inverse relationship between independence and company performance); Stephen M. Bainbridge, *A Critique of the NYSE's Director Independence Listing Standards*, 30 SEC. REG. L.J. 370, 372 (2002) (arguing that the NYSE Committee's proposals are not supported by evidence and that in many situations director independence is undesirable); Barry D. Baysinger & Henry N. Butler, *Corporate Governance and the Board of Directors: Performance Effects of Changes in Board Composition*, 1 J.L. ECON. & ORG. 101, 115-22 (1985) (arguing that there is no linear relationship between profits and board independence); Lucian Arye Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Further Findings and a Reply to Symposium Participants*, 55 STAN. L. REV. 885, 888-99 (2002) (arguing that independent boards do not necessarily "do the right thing" for shareholders); Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231, 233 (2002) [hereinafter Bhagat & Black, *Non-Correlation*] (finding that a public company's long-term financial performance has no correlation with board member independence); Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921, 921-32 (1999) [hereinafter Bhagat & Black, *Uncertain Relationship*] (explaining there is weak support for the trend of increasing the number of independent directors on the board); Bernard Black, *Does Corporate Governance Matter? A Crude Test Using Russian Data*, 149 U. PA. L. REV. 2131,

2133-34 (2001) (describing the statistically insignificant effect a board's independence has on the company's performance); Rajeswararao S. Chaganti et al., *Corporate Board Size, Composition and Corporate Failures in Retailing Industry*, 22 J. MGMT. STUD. 400, 414 (1985) (finding no relationship between the ratio of inside to outside directors and corporate failure); John E. Core et al., *Corporate Governance, Chief Executive Officer Compensation, and Firm Performance*, 51 J. FIN. ECON. 371, 404 (1999) (finding that independent directors do not create a more effective board); James D. Cox, *The ALI, Institutionalization, and Disclosure: The Quest for the Outside Director's Spine*, 61 GEO. WASH. L. REV. 1233, 1239 (1993) (explaining that few studies have found increased performance resulting from greater board independence); Dan R. Dalton et al., *Meta-Analytic Reviews of Board Composition, Leadership Structure, and Financial Performance*, 19 STRATEGIC MGMT. J. 269, 282 (1998) (concluding that there is "virtually no evidence of a systematic relationship" between board composition and financial performance); Harold Demsetz & Belen Villalonga, *Ownership Structure and Corporate Performance*, 7 J. CORP. FIN. 209, 209 (2001) ("We find no statistically relation between ownership structure and firm performance."); Robert W. Hamilton, *Corporate Governance in America 1950-2000: Major Changes But Uncertain Benefits*, 25 J. CORP. L. 349, 371 (2000) (finding that more independent directors do not detectably increase shareholder wealth); Benjamin E. Hermalin & Michael S. Weisbach, *The Effect of Board Composition and Direct Incentives on Firm Performance*, 20 FIN. MGMT. 101, 111 (1991) (finding no relation between board composition and financial performance and concluding that if a relation does exist, it has little economic significance); Benjamin E. Hermalin & Michael S. Weisbach, *Boards of Directors as an Endogenously Determined Institution: A Survey of the Economic Literature*, 9 FED. RES. BANK N.Y. ECON. POL'Y REV. 7, 20 (2003), *available at* http://www.newyorkfed.org/research/epr/03v09n1/0304herm.pdf (finding no correlation between board composition and corporate performance and surveying the economic research); April Klein, *Firm Performance and Board Committee Structure*, 41 J.L. & ECON. 275, 277 (1998) (finding no significant relation between firm performance and percentage of inside directors but finding a positive correlation between insiders on certain committees and stock market performance); Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U. L. REV. 898, 961-67 (1996) (concluding that not enough evidence exists to link director independence to financial improvement but finding that board independence serves other important functions); John A. Wagner III et al., *Board Composition and Organizational Performance: Two Studies of Insider/Outsider Effects*, 35 J. MGMT. STUDIES 655, 655 (1998) (explaining that both the increase of inside as well as outside directors increases corporate performance); Sanjai Bhagat & Bernard Black, *The Board Game*, CHIEF EXEC. MAG., Oct. 1997, at 82 (finding the proposition of independent directors has no consistent effect on stock price or financial performance); *but see* Ira M. Millstein & Paul W. MacAvoy, *The Active Board of Directors and Performance of the Largely Traded Corporation*, 98 COLUM. L. REV. 1283, 1318 (1998) (finding a "substantial and statistically significant correlation between an active, independent board and superior corporate performance"). *See also* Charles Evans & Kenneth Dion, *Group Cohesion and Performance: A Meta-Analysis*, 22 SMALL GROUP RES. 175, 180-82 (1991) (finding a positive relationship between group cohesion and performance but cautioning that the study included groups "unlikely to question performance goals"). *See generally* Steven N. Kaplan & David Reishus, *Outside Directorships and Corporate Performance*, 27 J. FIN. ECON. 389 (1990) (finding that managers perceived as "better" or more "efficient" are selected as outside directors, and the "top executives of companies that reduce their dividends are approximately 50% less likely to receive additional outside directorships than are top executives of companies that do not reduce their dividends"). For an argument cautioning against blind application of independent directors but with no analysis of the financial performance aspect, see Bevis Longstreth, *Corporate Governance: There's Danger in New Orthodoxies*, J. PORTFOLIO MGMT., Spring 1995, at 47.

conducted empirical research on this topic,[98] concluding that "there is no convincing evidence that increasing board independence, relative to the norms that currently prevail among large American firms, will improve firm performance."[99] In fact, they believe companies with supermajority-independent boards may perform worse than those with fewer independent directors, and companies with more inside directors than independent directors perform about the same as those "with majority- (but not supermajority-) independent boards."[100] They also suggest there may be benefits in terms of financial performance for companies with a reasonable number of inside directors.[101] Inside directors are familiar with the company's business and understand the company's strengths and weaknesses better than the independent directors, which leads to better decision making.[102]

Professor Laura Lin extensively surveyed evidence regarding outside director effectiveness.[103] She is in accord with Bhagat and Black's research and ours. She concludes that "it would be premature to draw any hard-and-fast conclusions from this mixed body of evidence" and that it is hard to isolate the effect of the composition of the board on a company's financial performance.[104]

Thus, there is no conclusive evidence to suggest that a board having a greater number of independent directors will yield better financial returns for shareholders than those with a lower percentage. Additionally, some of our greatest entrepreneurial companies evolved under the stewardship of founding families without the managerial governance of supermajority-independent directors.[105] Many of these families stay in control by having a class of super voting stock. Detractors state that the dual-class structure hurts minority shareholders because the founding families are loathe to deploy capital, which they view as their "own money," into basic research and development.[106] It could be the case that companies at different stages

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[98]Bhagat & Black, *Non-Correlation*, *supra* note 97, at 233.

[99]Bhagat & Black, *Uncertain Relationship*, *supra* note 97, at 950 (emphasis omitted).

[100]*Id.*

[101]*Id.*

[102]*Id.*

[103]*See* Lin, *supra* note 97, at 902.

[104]*Id.* at 925.

[105]For example, witness *The New York Times*, *The Washington Post*, Comcast, Microsoft, and the Ford Motor Company.

[106]*See* Lucian Arye Bebchuk et al., *Stock Pyramids, Cross-Ownership and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights*, *in* CONCENTRATED CORPORATE OWNERSHIP 295, 302-18 (Randall K. Morck ed., 2000), *available at* http://ssrn.com.abstract=147590 (explaining that large stockholders internalize decisions

of development perform better with different types of board compositions. Bhagat and Black hypothesize that board composition is "endogenous—different firms need different types of boards."[107]

If financial performance is not affected by the percentage of independent directors on a board, then what is the true role of the independent director? It seems to us, as many other commentators have noted, that independent directors are best utilized as referees to sort out corporate conflicts of interest and executive compensation.[108] However, it does not take a majority of the board to constitute a panel of referees. At

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raising agency costs); Paul A. Gompers et al., *Incentives vs. Control: An Analysis of U.S. Dual-Class Companies* 1 (NBER Working Paper No. W10240, 2004), *available at* http://ssrn.com/abstract=492353 ("Our evidence is consistent with an entrenchment effect of voting control that leads managers to underinvest . . . ."); *see also* Linda Gorman, *Dual-Class Companies*, NBER, July 2004, http://www.nber.org/digest/jul04/w10240.html (summarizing the findings in Gompers et al., *supra*); *Capital Market Apartheid*, WHARTON ENTREPRENEURIAL PROGRAMS, Winter 2005, http://www.wep.wharton.upenn.edu/newsletter/winter05/apartheid.html (arguing that dual-class stock systems create "capital-market apartheid").

[107]Bhagat & Black, *Uncertain Relationship*, *supra* note 97, at 949.

[108]*See, e.g.*, PAUL W. MACAVOY & IRA M. MILLSTEIN, THE RECURRENT CRISIS IN CORPORATE GOVERNANCE 113-19 (2003); RICHARD F. VANCIL, PASSING THE BATON: MANAGING THE PROCESS OF CEO SELECTION 24-31 (1987); Seth W. Ashby, *Strengthening the Public Company Board of Directors: Limited Shareholder Access to the Corporate Ballot vs. Required Majority Board Independence*, 2005 U. ILL. L. REV. 521, 540-45 (2005); Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 597-600 (1982); Charles M. Elson & Christopher J. Gyves, *The Enron Failure and Corporate Governance Reform*, 38 WAKE FOREST L. REV. 855, 856 (2003); Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233, 1241 (2002) ("[T]he appropriate remedy for the problem of the potentially self-interested or incompetent managerial team is said to be the monitoring board . . ., [including] independent directors, and specialized committees . . . consisting exclusively of independent directors to perform crucial monitoring functions . . . ."); Lin, *supra* note 97, at 921-39; Lynn A. Stout, *The Shareholder as Ulysses: Some Empirical Evidence on Why Investors in Public Corporations Tolerate Board Governance*, 152 U. PA. L. REV. 667, 672-89 (2003); James M. Tobin, *The Squeeze on Directors—Inside is Out*, 49 BUS. LAW. 1707 (1994); Note, *Beyond Independent Directors: A Functional Approach to Board Independence*, 119 HARV. L. REV. 1553, 1557-59 (2006); Richard H. Fosberg, *Outside Directors and Managerial Monitoring*, AKRON BUS. & ECON. REV., Summer 1989, at 24, 29; Arthur J. Goldberg, *Debate on Outside Directors*, N.Y. TIMES, Oct. 29, 1972, at F1; William H. Donaldson, Chairman, SEC, Remarks Before the Independent Directors Council (Oct. 21, 2004), transcript available at http://www.sec.gov/news/speech/spch102104whd.htm; Pawan Agarwalla, *Can Independent Non-Executive Directors Become the Directing Mind and Will of the Corporation?*, LEGAL SERVICES INDIA.COM, http://www.legalservicesindia.com/articles/cor.htm ("I don't care how talented you are, you can't be a good watchdog if you're only on patrol three times a year.") (quoting SEC Chairman Arthur Levitt); Jay W. Lorsch & Krishna G. Palepu, *Corporate Governance, Leadership and Values* (Workshop Series, Harv. Bus. Sch., Nov. 2001) (on file with The Delaware Journal of Corporate Law). *See also* Ari Weinberg, *Get Your Independent Directors Now*, FORBES.COM, Apr. 30, 2004, http://www.forbes.com/2004/04/30/cx_aw_0430ipoboards.html (discussing the "formidable" restrictions Sarbanes-Oxley has put on companies planning to go public and how it has "ushered in a new era in director search for private companies").

most, it would take a panel of three. Why, then, do we think, and more to the point, why do the Stock Exchanges believe, that boards should consist of a majority of independent directors? Why do some think that boards dominated by independent directors would produce superior financial returns over boards dominated by shareholder-owners?[109] In the absence of financial data proving their preeminence as corporate governors and decision makers, what value do independent directors bring to boards other than as conflict of interest referees and related party referees? Given that global competition is dramatically increasing the complexity and scale of corporate decision making and decreasing response time, these questions are critical to the competitiveness of our most important companies. We believe the common sense solution is to encourage the most efficient "profit maximizers" to serve on the board. These would be the owners of the company, the shareholders. To accomplish this goal, certain legal barriers and impediments to this service, such as trading liability, controlling party liability and communication liability, must first be liberalized and reformed.

VI. THE PROCESS OF INTERMEDIATION

The simple truth is that we as human beings and as managers do not like to be accountable to anyone.[110] Corporate managers have used their gigantic informational advantage to intermediate the independent board of directors between themselves and the shareholder-owners. The result is that the corporate managers are notionally accountable to a board of strangers. Given the managers' gigantic informational advantage, however,

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[109]A pre-Sarbanes-Oxley example illustrates this point. *See* Robert W. Lear, *Boards on Trial—Five Best and Five Worst Corporate Boards for the Year*, THE CHIEF EXECUTIVE, Oct. 2000, at para. 44, *available at* http://www.findarticles.com/p/articles/ mi_m4070/is_2000_Oct/ ai_66811889 (citing Enron's as one of the top five boards that "made an effort to accomplish something important on the corporate governance front and, therefore, stands as a role model for other corporations to follow"). Lear adds, "While somewhat concerned with the large board size (18) the number of insiders (six), and the presence of a very active executive committee (10 meetings), we are heartened by the overall corporate governance structure and by its governance guidelines, which call for regular evaluation of director and executive performance." *Id.* at para. 57.

[110]*See What is Good Governance?*, CORPORATE BD. MEMBER ACAD. COUNCIL, EMERGING TRENDS IN CORPORATE GOVERNANCE 12, 14 (2002), http://www.boardmember.com/ network/cbm_acssupp02.pdf ("CEOs do not want to have a boss. This is exactly why they worked hard all their business careers to be the CEO.") (quoting William T. Allen); *The Prime of Ms. Nell Minow*, CFO MAG., Mar. 1, 2003, at para. 24, *available at* htto://www.cfo.com/article. cfm/3008442/c_3046587?f=magazine_featured ("[B]oards [of directors] are like sub-atomic particles—they behave differently when observed . . . .") (quoting Nell Minow).

the managers are really accountable to no one.[111] It is only through this process of intermediation that one can begin to explain the runaway compensation of many CEOs, despite many efforts to reign it in.[112]

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[111]*See* EISENBERG, *supra* note 89, at 172; Ashby, *supra* note 108, at 539 ("The directors' power to control and manage the public company becomes virtually obsolete once they have been elected to the board . . . ."); Borowski, *supra* note 6, at 458; Donald C. Dowling, Jr., *How Does Europe Regulate Power Within its Corporations? What Might the Answer Mean for the U.S.? An Essay and Review of EUROPEAN COMPANY LAWS: A COMPARATIVE APPROACH*, 12 NW. J. INT'L L. & BUS. 601, 603 (1992) ("Corporations determine far more than any other institution the air we breathe, the quality of the water we drink, even where we live. Yet they are not accountable to anyone.") (quoting the cover of A.G. MONKS & NELL MINOW, POWER AND ACCOUNTABILITY (1991)); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 306-07 (1976); Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 812 (2001); Marleen A. O'Connor, *The Enron Board: The Perils of Groupthink*, 71 U. CIN. L. REV. 1233, 1238-39 (2003); Andrei Schleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737, 741 (1997); Robert B. Thompson & D. Gordon Smith, *Toward a New Theory of the Shareholder Role: "Sacred Space" in Corporate Takeovers*, 80 TEX. L. REV. 261, 284 (2001) (arguing that the judiciary, under *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985), is "incapable of policing management entrenchment"). *See generally* KENNETH ARROW, THE LIMITS OF ORGANIZATION 68-70 (1974) (examining the consensus theory when groups agree and authority models when group's interests diverge); Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461, 467 (1992) ("[W]here information and interests differ, the . . . [decision makers] will no longer either be able or inclined to reach decisions that are in the best interests of their group."); Philip Tetlock et al., *Social and Cognitive Strategies for Coping with Accountability: Conformity, Complexity and Bolstering*, 57 J. PERSONALITY & SOC. PSYCHOL. 632, 639-40 (1989) (suggesting that those persons accountable to others tend to research, present, and make decisions to please their audience).

[112]Bebchuk et al., *supra* note 78, at 754, 756 ("As a result of . . . deviations from optimal contracting, executives can receive pay in excess of the level that would be optimal for shareholders; this excess pay constitutes rents. . . . [M]anagers have an incentive to obscure and legitimize—or, more generally, to camouflage—their extraction of rents."); Lucian A. Bebchuk & Yaniv Grinstein, *The Growth of Executive Pay*, 21 OXFORD REV. ECON. POL'Y 283 (2005); Gordon, *supra* note 108, at 1234-35; Franklin G. Snyder, *More Pieces of the CEO Compensation Puzzle*, 28 DEL. J. CORP. L. 129, 130 (2003); Edward J. Zajac & James D. Westphal, *Accounting For Explanations of CEO Compensation: Substance and Symbolism*, 40 ADMIN. SCI. Q. 283, 283 (1995); Lucian Arye Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem*, J. ECON. PERSP., Summer 2003, at 71, 77; Michael K. Ozanian & Elizabeth MacDonald, *Paychecks on Steroids*, FORBES, May 9, 2005, at 134; Aaron Hoover, *Charismatic CEOs More Effective . . . at Snaring Higher Pay*, U. FLA. NEWS, July 2, 2002, at para. 4, http://www.napa.ufl.edu/2002news/ceocharisma.htm; Thomas R. Piper, *Summary: Executive Compensation* (Harv. Bus. Sch. Workshop Series, Oct. 2002) (on file with The Delaware Journal of Corporate Law); Chester S. Spatt, Chief Economist & Dir., Office of Econ. Anal., Keynote Address at the Carnegie Mellon University-Jones Day Conference: Governance, The Board and Compensation (June 9, 2005), *available at* http://www.sec.gov/news/ speech/spch060905.htm. *See also* Ivan E. Brick et al., *CEO Compensation, Director Compensation, and Firm Performance: Evidence of Cronyism*, 12 J. CORP. FIN. 403, 421 (2006) (modeling CFO and director compensation through analysis of CEO and firm characteristics and other governance variables); *Smelling the Smoke*, *in* EMERGING TRENDS IN CORPORATE GOVERNANCE, *supra* note 110, at 4, 11 ("[W]e have created a culture of greed in too many places in the business community

What do we expect from independent directors? Certainly, business savvy, wisdom, integrity, experience, and judgment are all desired traits.[113] It is a well-known adage that one should never invest one's own capital in a business or industry that one knows nothing about. If this is the case, why do we expect strangers, even wise strangers, to be corporate governors of our nation's most valuable businesses?

What do we expect independent directors to do? What is their job? First, it is to be guardians and fiduciaries for the shareholders generally.[114]

. . . .") (quoting Jay W. Lorsch); Maya Rooney, *It Paid to Cheat*, FORBES, May 9, 2005, at 134, *available at* http://www.forbes.com/forbes/2005/0509/138.html (presenting examples of the benefits reaped by CEOs of companies that later revealed accounting problems); Donald J. Johnston, *Better Values for Better Governance*, OECD OBSERVER, Oct. 2002, at paras. 2, 5, *available at* http://www.oecdobserver.org/news/fullstory.php/aid/804/Better_values_for_better_governance.html:

> [S]ome corporate managers have ceased to see themselves as stewards of other people's money. Rather, they prefer to see themselves as partners entitled to huge "entrepreneurial" rewards for doing what they are already extremely well paid to do. . . . Hence 'you scratch my back, I scratch yours' becomes the basis for ratcheting up executive remuneration to levels far beyond the dreams of avarice.

Paul S. Atkins, Comm'r, SEC, Open Meeting Statement, *Proposed Revisions to the Executive Compensation and Related Party Disclosure Rules* (Jan. 17, 2006), *available at* http://www.sec.gov/news/speech/spch011706psa.htm (discussing the reasons why stock options initially increased and warning of other unintended consequences as a result of new regulations); JOHN ALEXANDER BURTON & CHRISTIAN E. WELLER, SUPERSIZE THIS: HOW CEO PAY TOOK OFF WHILE AMERICA'S MIDDLE CLASS STRUGGLED, CENTER FOR AMERICAN PROGRESS 1, http://www.americanprogress.org/kf/ceo_pay_web_final.pdf ("CEO pay in other industrialized countries is only about one-third of what American CEOs make"). *See generally* John M. Abowd & Michael L. Bognanno, *International Differences in Executive and Managerial Compensation*, *in* DIFFERENCES AND CHANGES IN WAGE STRUCTURES 67, 95-96 (Richard B. Freeman & Lawrence F. Katz eds., 1995) (noting an increasing trend in CEO compensation with U.S. CEOs receiving higher compensation than their foreign counterparts); Hamid Mehran, *Executive Compensation Structure, Ownership and Firm Performance*, 38 J. FIN. 163 (1995) (analyzing the relationship between executive compensation and firm performance); Charles A. O'Reilly III et al., *CEO Compensation as Tournament and Social Comparison: A Tale of Two Theories*, 33 ADMIN. SCI. Q. 257 (1988) (examining economic and psychological theories to explain CEO compensation).

[113]*See* The Business Roundtable, *Principles of Corporate Governance*, *in* NYSE CORPORATE ACCOUNTABILITY REPORT, *supra* note 13, at A-29, A-38 ("The Business Roundtable believes that having directors with relevant business experience and industry experience is beneficial to the board as a whole. Directors with such backgrounds can provide a useful perspective on significant risks and competitive advantages and an understanding of the challenges facing the business.").

[114]*See* Arthur Levitt, Chairman, SEC, The "Numbers Game," Remarks at the N.Y.U. Center for Law and Business (Sept. 28, 1998), at paras. 47, 50, *available at* http://www.sec.gov/news/speech/speecharchive/1998/spch220.txt ("[Q]ualified, committed, independent and tough-minded audit committees represent the most reliable guardians of the public interest . . . and function as the ultimate guardian of investor interests and corporate accountability."); *see also* Caroline J. Dillon, *Do You Get What You Pay For? A Look at the High Fee and Low Protections*

This means that independent directors are expected to represent and protect the shareholders' interests on the board. However, when one "peels back the onion," this ostensibly facile proposition becomes anything but facile. Shareholders come in different classes and different stripes. There are preferred stock shareholders and common shareholders who have different rights and preferences and different classes. Some shareholders are longer-term investors and some shareholders are arbitrageurs and shorter-term investors. Sometimes different classes of shareholders have competing interests. For instance, arbitrageurs and shorter-term investors are usually interested in maximizing profits today. Longer-term investors are interested in the redeployment of capital for research and development to generate profits tomorrow.

Another area that we expect independent directors to mediate is conflicts of interest between management and the shareholders or board members and the shareholders.[115] Typically, when potential conflicts are presented to the board, a committee consisting of independent directors is formed to assess the situation. In these cases, the committee will generally retain its own advisors and consultants to advise them, as is the case with fairness opinions.[116]

An area of potential conflict pertains to CEO compensation. It is very difficult for a director to be adverse to a sitting CEO. In the case of executive compensation, independent board members have all but abdicated their responsibility.[117] Lucian Bebchuk, Jesse Fried, and David Walker argue that managerial power influences executive compensation more so than a board's attempts to structure compensation so as to maximize shareholder value.[118] Management's bargaining power with compensation committees is not at arm's length, and, for the most part, boards are unwilling to constrain levels of executive pay.[119] Bebchuk, Fried, and Walker also argue that managers are able to use their influence and leverage to cause companies to deviate from optimal contracting

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of Mutual Funds, 2006 COLUM. BUS. L. REV. 281, 284 (framing these same duties in the context of a mutual fund investment advisor).

[115]*See* Robert W. Hamilton, *The Crisis in Corporate Governance: 2002 Style*, 40 HOUS. L. REV. 1, 40 (2003) (mentioning how European boards engage in this compound strategy).

[116]*See generally* Lucian Arye Bebchuk & Marcel Kahan, *Fairness Opinions: How Fair Are They and What Can Be Done About It?*, 1989 DUKE L.J. 27 (discussing the problems with, potential conflicts of information in issuing, and a judicial approach to handling fairness opinions).

[117]*See* Bebchuk et al., *supra* note 78, at 789.

[118]*See id.* at 753-54.

[119]*See id.* at 787.

practices.[120] They express skepticism that compensation committees composed of independent directors are able to limit escalating executive pay.[121]

With respect to executive compensation, an "information vacuum" has been filled by compensation consultants who survey comparable public companies and categorize compensation into upper and lower quartiles.[122] Most compensation committees, believing that their companies deserve only the best CEOs, routinely award their CEOs compensation in the top quartile.[123] Mathematically, these top quartiles become next year's average or lower quartiles. By offering up ever higher levels of executive compensation, these consulting firms achieve what is most important to them: getting hired for the next year's assignment.[124] The system thus perpetuates itself.[125] As a result, monumental CEO compensation is awarded, far

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[120]*See id.* at 768-88.

[121]*See* Bebchuk et al., *supra* note 78, at 765-66. We completely agree with Bebchuk, Fried, and Walker's analysis, and recent levels of executive pay seem to validate their doubts. *See supra* note 15.

[122]*See* Bebchuk & Fried, *supra* note 112, at 79 (explaining generally how compensation consultants collect and gauge data); *see also* GRAEF S. CRYSTAL IN SEARCH OF EXCESS: THE OVERCOMPENSATION OF AMERICAN EXECUTIVES 214-40 (1991) (discussing compensation committees and their role in executive compensation and offering personal anecdotes).

[123]*See* Bebchuk & Fried, *supra* note 112, at 79.

[124]CRYSTAL, *supra* note 122, at 218 ("In reality, if those recommendations [of the compensation consultant] did not cause the CEO to earn more money than he was earning before the composition consultant appeared on the scene, the latter was rapidly shown the door."); Bebchuk & Fried, *supra* note 112, at 79 ("Providing advice that hurts the CEO's pocketbook is hardly a way to enhance the consultant's chances of being hired in the future by this firm or, indeed, by any other firms.").

[125]*See* CRYSTAL, *supra* note 122, at 50:

> [T]hink also about the fact that many of the compensation committee members may be the personal friends of the CEO. And think about the fact that it is the CEO who suggests to the board members how much they should pay themselves. In saying this, I don't mean to suggest that compensation committee members and board members are dishonest people who are willing to sell themselves for a few bucks. Rather, I am only observing that there is a climate of friendship and trust operating here, rather than the more cautious attitude that one usually presents toward someone who is trying to sell you something that will cost you quite a bit of money.

See also Bebchuk & Fried, *supra* note 112, at 78 ("The incentives of compensation consultants—and the evidence regarding their use—suggest that these consultants are often used to justify executive pay rather than to optimize it."); Bebchuk et al., *supra* note 78, at 756 ("[T]he extensive use of compensation consultants . . . [can] be seen as a means of justifying and legitimizing pay . . . . [The] concept of camouflage . . . [via the use of compensation consultants is] useful in explaining many of the patterns and puzzles provided by the executive compensation landscape."); *id.* at 791 (summarizing a study that presented "some evidence that companies use pay consultants and surveys strategically in justifying executive compensation to outsiders"); Brossman & Weiss, *supra* note 89, at 40 ("[G]etting boards to question enormous executive pay

outstripping CEO compensation for comparable companies of other countries.[126] It cannot be questioned that the exorbitant compensation that is paid to the CEOs of American corporations and management generally affects our competitiveness globally.[127] All this compensation largess has developed and continues to occur right under the noses of the independent outside directors.[128] As Bebchuk, Fried, and Walker correctly state, managers use the compensation consultants as "camouflage" to extract

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is like expecting well-behaved guests to start 'belching at the dinner table.'"); *Smelling the Smoke*, *supra* note 112, at 10 ("I'm sure how many compensation committees are ready to stand up and say to the CEO, 'You are getting paid too much money and this incentive system has to work both ways.'") (quoting Jay Lorsch).

[126]*See, e.g.*, CRYSTAL, *supra* note 122, at 241 ("U.S. senior executives are paid far in excess of their counterparts in the other industrialized countries. And the gap is growing, not shrinking . . . .").

[127]*See* SARAH ANDERSON ET AL., EXECUTIVE EXCESS 2005: 12TH ANNUAL CEO COMPENSATION SURVEY, INST. FOR POL'Y STUDIES/UNITED FOR FAIR ECON. 2 (2005), http://www.faireconomy.org/press/2005/EE2005.pdf (summarizing the 431-to-1 CEO-worker pay gap and stating that "[i]f the minimum wage had risen as fast as CEO pay since 1990, the lowest paid workers in our country would be earning $23.03 an hour today, not $5.15 an hour"); John M. Abowd & David S. Kaplan, *Executive Compensation: Six Questions That Need Answering*, J. ECON. PERSP., Fall 1999, at 145; Lars Osberg & Timothy Smeeding, *An International Comparison of Preferences for Leveling*, http://www.princeton.edu/~csdp/events/pdfs/osberg.pdf; Roel C. Campos, Comm'r, SEC, Remarks before ASIC Summer School (Feb. 13, 2006), transcript available at http://www.sec.gov/news/speech/spch021306rcc.htm (suggesting that "[a]lthough internationally there has been a trend toward increased 'U.S.- style' pay, . . . the same [CEO-employee] ratio in other heavily developed nations was 25:1 in the case of the [United Kingdom], 16:1 in France, 11:1 in Germany and as low as 10:1 in Japan (as compared to 531:1 in the [United States] in that same year)'"); Eric Wahlgren, *Spreading the Yankee Way of Pay*, BUS. WK. ONLINE, Apr. 18, 2001, *available at* http://www.businessweek.com/careers/content/apr2001/ca20010419_812.htm (revealing the globalization of excessive executive pay but noting that the United States is still in the lead).

[128]For example, RJR Nabisco shareholders bought twenty-four country club memberships for their CEO Ross Johnson. Jensen & Fuller, *supra* note 12, at 1. *See also* Lawrence H. Gennari, *Executive Pay and Perks—Compensation Committees on the Hot Seat in 2006*, MASS HIGH TECH: J. NEW ENG. TECH., Jan. 27, 2006, http://masshightech.bizjournals.com/masshightech/stories/2006/01/30/editorial3.html (noting the vast discrepancy in pay for executives and the general workforce); Louis Lavelle & Ronald Grover, *Exec Perks: An Ugly Picture Emerges*, BUS. WK. ONLINE, Apr. 27, 2005, at paras. 3, 7, *available at* http://www.equilar.com/NewsArticles/042705_BusinessWeek.pdf (describing how Viacom "reimbursed" two of its executives for staying in their secondary residences during business trips); Bruce Mayerson, *CEO Perks Popular But Often Hidden*, DAILY OAKLAND PRESS, Apr. 26, 2004, at para. 5 (revealing that executive perks can include items like "$6000 shower curtains and $2 million toga parties," referring to perks allegedly taken by Tyco CEO, Dennis Kozlowski); Robert Trigaux, *CEOs Return to Days of Runaway Pay Perks*, ST. PETERSBURG TIMES (FLA.), Apr. 6, 2005, at 1D (explaining dramatic increases in executive compensation in recent years); Sandra Jones, *Those Very Friendly Skies*, CHIC. BUS., Mar. 27, 2006, at para. 4, *available at* http://www.chicagobusiness.com/cgi-bin/news.pl?id=19976 (explaining that some perks previously afforded executives, like personal aircraft, are now subject to formal disclosure).

premium rents from the compensation committee.[129]

Professor Lynn A. Stout posits two potential theories for why investors of public companies accept the traditional corporate structure that inserts the board of directors between the investor and the company.[130] First, she suggests that shareholders tolerate the board of directors because it acts as a more effective monitor of the corporate managers than the shareholders themselves could be.[131] Shareholders generally own only a small piece of a large public company and have little time to devote to understanding fully a company's business or its expertise in the industry.[132] Therefore, it is inefficient for the shareholders to manage and monitor the company's business, and such management is better left to a smaller group of individuals in the form of a board of directors.[133] This is the "monitoring" theory.[134] Second, Stout suggests that shareholders tolerate the board because the board is a beneficial mediator separating ownership of the corporation's assets from the control of the shareholders.[135] Under this arrangement, the shareholders benefit by diminishing the opportunity to cede power from other constituents by turning over management to an outside party, the board of directors.[136] This is the "mediation" theory.[137] Stout notes that public companies typically eschew reforms that would enhance shareholder primacy, and because they avoid doing so, this indicates that the parties involved view the board as advantageous.[138]

The "mediation" theory, although elegantly presented by Professor Stout, does not comport with reality. Shareholders have not delegated their powers to the board to "mediate" for the greater good of the overall corporate enterprise. Shareholders never got the chance to do so because the managers have usurped them. It is the managers who heavily influence the nominating process and cause the selection of board members in their own image or to their own liking.[139] Managers are able to do this because of their huge informational leverage and control over the nominating

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[129]Bebchuk et al., *supra* note 78, at 790 ("[M]anagers use compensation consultants primarily to justify executive pay rather than to optimize it.").

[130]*See* Stout, *supra* note 108, at 667.

[131]*See id.* at 673-75.

[132]*See id.* at 673.

[133]*See id.* at 673-74.

[134]*See* Stout, *supra* note 108, at 669.

[135]*See id.* at 670, 686.

[136]*See id.*

[137]*See id.* at 690.

[138]*See* Stout, *supra* note 108, at 671.

[139]*See supra* notes 89-90 and accompanying text.

process machinery.[140] We are not suggesting by any means that managers are disingenuous or conspiratorial. Rather, we are suggesting that managers have acted cohesively over the decades by following the "invisible hand" of their own self-interest.

Professor Bainbridge argues against the "shareholder primacy" model advanced by Professor Lucian Bebchuk, and he favors a traditional "director primacy" model of separation of ownership and control embodied in the board of directors.[141] Professor Bainbridge asserts that a "board" or "director primacy" is and should be maintained as the default rule in corporate law.[142] To bolster his case, Bainbridge cites the "staying power" of director primacy, and the disinterestedness of institutional investors in general.[143] He states that mutual funds, bank trust departments, private pension plans, and insurance companies are essentially "not interested" in shareholder activism because of the high costs and uncertain outcomes of insurgency.[144] In addition, he correctly notes that they can be "bought off" rather easily through the influence peddling of the larger corporate issuers.[145] He notes that most shareholder insurgencies come from unions and state and local pension plans, which have self-interested agendas and whose insurgencies enjoy limited success.[146] His thesis is that shareholders are not disempowered, but are "rationally apathetic."[147]

Bainbridge fails to analyze the systemic reasons for this apathy, and instead assumes that shareholders are apathetic as a result of some time-honored, well-considered, rational, market-driven compact. This is not the case. While shareholders have not been disempowered, the costs of participation are exceedingly high and the outcomes are uncertain.[148] Both costs and uncertainty stem from legal barriers to participation that have been erected over the years with enthusiastic sponsorship from the corporate managers, making shareholder involvement risky. These legal barriers include (1) a byzantine, expensive and time-consuming communi-

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[140]Implicitly, anyone who has ever been asked by a CEO or CEO designee to step off a board would understand this dynamic.

[141]Bainbridge, *Shareholder Disempowerment*, *supra* note 90, at 1735.

[142]*See id.* at 1736.

[143]*See id.* at 1751.

[144]*Id.* at 1752-54.

[145]Bainbridge, *Shareholder Disempowerment*, *supra* note 90, at 1754.

[146]*Id.* at 1754-55.

[147]*Id.* at 1751.

[148]*See, e.g.*, ROBERT C. CLARK, CORPORATION LAW 94-95, 389-94 (1986) (discussing the problems of free-rider, fairness, and rational apathy that shareholders face when given proxy materials).

cation process that is fraught with litigation risk,[149] (2) derivative controlling party liability for noncompliance decisions made by others,[150] and (3) trading and Section 16[151] "short-swing" profit liability. These barriers are enough to deter any rational actor and inhibit widescale shareholder activism. Thus, shareholders have not made an invisible fiat with the company, defaulted to a corporate law delegation mechanism, or consciously or unconsciously decided to become "rationally apathetic" as a tacit admission that the corporate law default mechanism is the most efficient governance mechanism. Only insurgents with the strongest self-interested agendas (such as unions, corporate raiders who make a living at plying insurgencies), and "one-off" disaffected types with strong relational ties to a company like Roy E. Disney[152] and Walter Hewlett,[153] will gear up and run headlong into these legal ramparts erected by the corporate managers. The only way shareholders can hold managers accountable is if these legal barriers are liberalized and reformed.

VII. A MODEST PROPOSAL

The current paradigm traps shareholders, making it very difficult for even sizeable ones to monitor efficiently their investments and hold managers accountable. Over the years, corporate managers have germinated and encouraged huge legal barriers to thwart effective shareholder oversight and have intermediated friendly boards of directors to act as a process buffer between themselves and the shareholders they ultimately should serve.[154] These legal barriers include trading liability, controlling party liability, and very costly and risky shareholder communication rules.[155] The issuer-friendly and manager-dominated Stock Exchanges have also helped the managers' cause. Today, boards of directors are expected to serve as caldrons of social engineering, fairness, and diversity.[156] These worthy goals further serve the managers' self-

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[149] *See, e.g.*, *id.* at 394-96 (describing the limitations of a proxy contest).

[150] *See, e.g.*, *id.* at 396-406 (describing a derivative suit or takeover as better alternatives).

[151] 17 C.F.R. §§ 240.16a-1 to .16e-1 (2006).

[152] *See* Marc Gunther, *Eisner's Last Act*, FORTUNE, Mar. 8, 2004, at 123, *available at* http://money.cnn.com/magazines/fortune/fortune_archive/2004/03/08/363669/index.htm.

[153] *See* Benjamin Pimentel, *The Hewlett-Packard Compaq Deal War of Words*, S.F. CHRON., Feb. 12, 2002, at B1, *available at* http://www.sfgate.com/cgi-bin/article.cgi?file=/chronicle/archive/2002/02/12/BUHP12.DTL.

[154] *See supra* Part VI.

[155] *See supra* notes 148-51 and accompanying text.

[156] *See* Chandler & Strine, *supra* note 31, at 978 (acknowledging the flexibility boards must have).

interest to intermediate themselves from the owners.[157] The board of directors' most important function, however, is being a check and balance on managerial authority and discretion, especially given the managers' huge information advantage.[158] The most effective check and balance on management are the shareholders themselves and the threat of shareholder activism.

As owners, the shareholders bear the responsibility to hold management accountable. The securities laws of this country, however, have made it very difficult for large shareholders to take part actively in the oversight of the companies that they own.[159] For instance, shareholders who become board members have to worry about personal liability for trading their shares and controlling party liability in addition to ERISA, and other tax and securities law violations. In short, it has become far easier, with fewer legal entanglements, for large shareholders to vote with their feet and sell their shares than to supervise actively the companies that they own.[160] The system thus perpetuates itself, and by virtue of this ultimate lack of accountability, it has made American companies less competitive in the world.

As previously suggested, three reforms to the securities laws would facilitate "oversight shareholders" to be on the board of directors.[161] First, oversight shareholders who become directors would file "trading plans" akin to Section 12b-1 plans with the company and the SEC. In exchange, these oversight shareholders can probe management by asking questions and serving on director committees without liability for trading in a

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[157]*See* Steven A. Ramirez, *Games CEOs Play and Interest Convergence Theory: Why Diversity Lags in America's Boardrooms and What To Do About It*, 61 WASH. & LEE L. REV. 1583, 1611 (2004) (suggesting that diverse boards will help avoid pre-Enron-type problems and enhance CEO scrutiny).

[158]*See* BUS. ROUNDTABLE, *supra* note 61, at 2 ("The 'soft,' subjective factors in corporate governance—such as the quality of directors and the personalities of CEOs and directors—receive less attention from scholars and journalists but are critical in the real world of corporate behavior.").

[159]At least two articles have been written on this issue. *See* Eric M. Fogel et al., *Public Company Shareholders Acting as Owners: Three Reforms—Introducing the "Oversight Shareholder,"* 29 DEL. J. CORP. L. 517, 519 (2004); Daniel M. Taitz & Lance J. Gotko, *Shareholder Communications*, *in* DOING DEALS 1997, at 133, 138-39 (Steven H. Shapiro et al. eds., 1997).

[160]*See supra* note 6.

[161]*See* Fogel et al., *supra* note 159, at 519-20. Significant, or "oversight," shareholders, who hold more than one percent of the outstanding shares and who have been shareholders for more than six months, should be encouraged to seek election to boards of directors. *Id.* These can be individual shareholders or groups of shareholders. *Id.* at 519 n.6. Sarbanes-Oxley should be amended to facilitate this recommendation. Portions of this analysis were adapted from *id.* at 521-44.

preprogrammed way upon material nonpublic information. They would also be exempt from the "short swing" profit rules of Section 16 of the 1934 Act.[162] For instance, an oversight shareholder can file a trading plan that specifies that a certain percentage of its portfolio will be sold if the stock rises above a certain price point, and that a certain number of shares will be purchased if the stock drops below a certain price point. Likewise, the plan can specify that shares will be sold short if the price rises by a certain percentage within a certain period of time. In short, the trading plan can consist of mathematical algorithms that the oversight shareholder locks into for a twelve-month period. Trading plans will be reviewed and revised every year. The company, on behalf of the oversight shareholder, would monitor the account and file the appropriate Form 4s to disclose trading activity on behalf of the oversight shareholder.

Second, the oversight shareholder needs the unfettered ability to communicate freely with fellow shareholders without incurring the costly expenses of complying with the proxy solicitation process of Section 14A of the 1934 Act.[163] The ultimate check and balance that oversight shareholders will have on management is the ability to galvanize shareholders for a shareholder vote. Currently, as many commentators have noted, the shareholder meeting machinery and proxy solicitation rules are heavily slanted in management's favor.[164] Proponents of the current system would argue that it minimizes distraction to the company so that the company's managers can get on with the business of running the company.[165] As anyone knows who has tried to galvanize a shareholder vote to challenge management, it is a very costly process that is fraught with litigation risk and political risk.[166] This process in and of itself is enough to deter all but the most impassioned, stalwart, and financially capable insurgent. If the

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[162] 17 C.F.R. §§ 240.16a-1 to .16e-1 (2006).

[163] *Id.* § 240.14a-1 to -101 (2006).

[164] *See, e.g.*, AFSCME, *supra* note 27, at 8-11 (summarizing the difficulty a shareholder faces in electing alternative board members).

[165] *Cf. id.* ("It is easy to forget, given how entrenched the practice of exclusive incumbent access is, that in other electoral settings[,] candidates bear their own costs of campaigning and all those who run for office appear on the ballot.").

[166] First, an insurgent shareholder must solicit enough votes to call a shareholders' meeting. Under most corporations' bylaws, only a shareholder or shareholders holding at least ten percent of the corporations' shares may call a shareholder meeting. An insurgent shareholder holding less than ten percent would have to aggregate enough votes to call a meeting. To do so, the shareholder is required to solicit proxies from his fellow shareholders and comply with the complicated and costly provisions of Section 14 of the Securities Exchange Act of 1934 and the proxy solicitation rules Regulation 14A. *See* Securities Exchange Act of 1934, 15 U.S.C. § 78n (Supp. IV 2000); *see also* 17 C.F.R. §§ 240.14a-1 to -101 (2006) (outlining the various steps a shareholder must follow when soliciting proxies).

insurgent is able to aggregate enough votes to call a shareholders' meeting, then the inside shareholders must file a Section 14A solicitation document that will be extensively reviewed by the SEC and most likely critiqued "in court" by the company's management.[167] It could very well take the insurgent over a year of effort to bring a matter to a shareholders' vote. In practicality, the shareholder proposal rules of Rule 14a-8,[168] whereby an insurgent shareholder may request that a proposal be brought before the shareholders at the annual meeting of shareholders, have largely displaced shareholder activism in this regard.[169] But this process is cumbersome, and frequently results in SEC involvement, and usually results in "watered-down" shareholder proposals. Very few real insurgent challenges have been mounted via these Rule 14a-8 proposals.

Oversight shareholders need a real-time, modern, effective, fast, and cost-efficient way to communicate with other shareholders. Any oversight shareholder who has filed a trading plan and has opted into the safe harbor provisions for material, nonpublic information should have the ability to communicate freely with other shareholders without the liability of running afoul of solicitation laws. Likewise, if the shareholder can aggregate more than ten percent of the issued and outstanding shares to call a meeting, a meeting should be noticed and called within ninety days. Proxy solicitation materials would be disseminated by both the insurgents and management within sixty days. Management may not bring lawsuits to tie up or delay the shareholder meeting except in the presence of manifest and egregious fraud or misrepresentations. The regulatory posture of the SEC should be to permit these exercises in corporate democracy to proceed as quickly and expeditiously as possible. To prevent oversight shareholders from calling a series of shareholder meetings, oversight shareholders would be restricted to only one special meeting within any twelve-month period. This would be in addition to the annual shareholders' meeting.

This reform is crucial to "leveling the playing field" and having corporate mangers accountable to their owners. Only the threat of quick and decisive shareholder action will persuade corporate managers that the shareholders are their boss. This reform will effectively maximize the chances to root out fraud, waste, inefficiency, lack of competitiveness, corporate malfeasance, lack of disclosure, and dishonesty. Oversight

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[167] *See* 17 C.F.R. §§ 240.14a-1 to-101 (2006).

[168] *See id.* § 240.14a-8.

[169] *See* Darnley D. Stewart, *Cracking Cracker Barrel . . . The 1998 Amendments to the Shareholder Proposal Rule*, INST'L INVESTOR ADVOCATE, Winter 1999, at 1, 3, *available at* http://www.blbglaw.com/advocate/AdvV1Q4.pdf; Lucian Arye Bebchuk, ed., *Symposium on Corporate Elections* 1-28 (Harv. L. & Econ. Discussion Paper No. 448, 2003), *available at* http://ssrn.com/abstract=471640.

shareholders will form board committees to monitor the basic corporate functionalities of finance, compensation, audit, strategic planning, marketing and distribution, and law. These committees will permit the board members to be truly informed and permit companies to avail themselves of the board members' advice and insight.[170] This corporate machinery will enhance the value of public companies and result in shareholders investing with increased confidence because they know there are oversight shareholders "minding the store." Indeed, public companies that have greater involvement of oversight shareholders should be deemed to be more credible and more investment worthy by serious investors than those companies with fewer or no oversight shareholders.

Third, Sarbanes-Oxley would be amended to create a safe harbor for oversight shareholders to be exempt from the controlling party liability provisions of the securities laws,[171] ERISA, tax codes, and environmental regulations, to name a few. Currently, directors are subject to personal fines, penalties, and criminal liability if the company fails to comply with these regulations. Oversight shareholders will serve on boards for the primary purpose of asking questions of management and keeping management accountable to the owners. If the managers fail to pay a tax bill, clean up an environmentally sensitive site, or divert funds to pay themselves as opposed to pension plans, they would be held personally responsible—not the oversight shareholders (unless the managers are directly "ordered" not to comply by the oversight shareholders). Accordingly, there should be an exemption for oversight shareholders who serve as directors to encourage their participation on boards of directors.

To recapitulate, we need to shift our paradigm. Instead of boards of directors consisting of a majority of independent directors, the shareholder-owners should be in the majority. The current system is inverted; independent directors, who really function as referees in the face of conflicts of interest, should be in the minority. Having mangers directly accountable to the owners, without intermediaries, is good, healthy, and competitive. Sarbanes-Oxley should be amended to facilitate these changes.

Some have argued that the concept of shareholders serving on boards of directors is antiquated. These commentators suggest that shareholders in pension plans, mutual funds, hedge funds, endowments, and trusts are simply different types of shareholders with different types of agendas and

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[170]Arguably, this is what the board members are supposed to provide in the first instance.

[171]*See* Securities Exchange Act of 1934, 15 U.S.C. § 78t(a) (2000).

time frames.[172] These commentators argue that corporate governance of significant public companies needs to be in the hands of disinterested, professional directors, like Plato's philosopher-kings, and that corporate governance has become too complex for shareholders with their petty financial interests to manage. While it is true that shareholders have different perspectives, the same can be said for directors. This statement does not, however, militate against the notion that companies would benefit by having the most efficient profit-maximizers, the owners, on the boards of directors and making the managers accountable to them.

VIII. DISINTERMEDIATION

What will the board of the future look like? The answer is that there may not be any boards in the future; at least, not as we know them today. High-speed electronic and wireless communication may enable cyber shareholder meetings instead of traditional ones.[173] Managers will have to account to the owners, and the owners will have the opportunity to probe and "talk among themselves," through instant messenger programs or otherwise—all in real time with equal access for all.[174] Lorsch has noted

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[172]*See* Langevoort, *supra* note 111, at 814 (explaining that in the mutual fund industry, "traditional checks on managerial overreaching, such as vigorous shareholder voting and hostile tender offers, do not exist").

[173]*See, e.g.*, George Ponds Kobler, *Shareholder Voting Over the Internet: A Proposal for Increasing Shareholder Participation in Corporate Governance*, 49 ALA. L. REV. 673, 674 (1998) (discussing the possibility and effects on corporate governance from shareholder voting over the Internet); Steve Hemmerick, *Internet Helps Link Shareholders*, PENSIONS & INVS., July 27, 1998 (discussing how shareholders are using the Internet to communicate shareholder issues); Emmons, *supra* note 83, at para. 18 ("[W]e're in the midst of a larger technological and information-driven transformation . . . ."); Amy Feldman, *Shareholders of the World, Unite!*, MONEY.COM, May 2000, at para. 10, *available at* http://www.kellogg.northwestern.edu /news/hits/0005m.htm ("In cyberspace, it's easier and a lot cheaper because you can post a message or set up a website and let like-minded shareholders find you."); Commentary, *Corporate Governance in the Internet Age*, CORPORATE GOVERNANCE, http://www.corpgov.net/forums/ commentary/CG&Internet.html (explaining how the Internet enables shareholders to communicate and hold directors accountable).

[174]For an example of a current move towards increased real-time talk, see, e.g., GM FastLane Blog, http://fastlane.gmblogs.com (providing an online forum for GM executives to discuss the company). *See also* Feldman, *supra* note 173 ("[I]ndividuals, unable to pool their power, have rarely had an impact. . . . It had been an insurmountable problem—until the Internet.") (internal quotation marks omitted); Dominic Jones & Pam Agnew, *Why Corporate Boards Should Blog*, IR WEB REPORT, Jan. 11, 2005, at para. 3, http://www. irwebreport.com/ perspectives/2005/boardblogs1.htm (suggesting that blogging establishes a dialogue between shareholders and directors that can be used to discuss issues and obtain feedback); Dominic Jones, *Get Ready for the Mobile Investor Web*, IR WEB REPORT, Apr. 3, 2006, at paras. 1-2, http://www.irwebreport.com/perspectives/2006/apr/dotmobi.htm (suggesting that online mobile access provides additional means for companies and investors to stay connected); *New Fund*

that the future is a complex one for corporate boards, which can only be addressed by redesigning the way they function.[175] We suggest that boards could very well become relics of the past, except in perhaps an advisory capacity. Companies who do not change or who are slow to change to this reality will be penalized in their stock prices. It would bode well for public companies to be "ahead of the curve" and advocate implementation of these processes as they become available.

IX. CONCLUSION

We are not advocating that there is no role for the independent director. Rather, what we are proposing is that these types of directors be in the minority on the board as opposed to the majority and that they act in the role they are best suited for; namely, as referees for conflicts of interest and affiliated transactions. To maintain the competitiveness of our most valuable companies, we must reintroduce the common sense notion that owners should be legally and socially encouraged to supervise their own companies, not strangers. Owners must be given the freedom to probe actively the companies they own without fear of legal "trap doors." Owners must be encouraged and have the legal freedom to communicate with each other effectively and efficiently without fear of running afoul of a gaggle of shareholder communication rules. We must reverse the paradigm trap that no owner is to be trusted without the supervision of strangers. The reality is that independent directors are strangers with their own "agendas," which are typically to serve the prevailing order of the board and perpetuate the system of intermediation between owners and their managers. Our leading companies might be overtaken by foreign competitors if we do not take measures to invert the current board paradigm and encourage broader board participation by those who incontrovertibly have the greatest stake in profit maximization and accountability; namely, the shareholder-owners.

Advances Activism via the Internet, INVESTOR RELATIONS BUS., Feb. 21, 2000, at 15 (reporting that one mutual fund planned for its board trustees to be chosen directly by the online investors in the future).

[175]Martha Lagace, *How to Build a Better Board*, HARV. BUS. SCH. WORKING KNOWLEDGE (Dec. 22, 2003), http://hbswk.hbs.edu/item/3834.html.