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ARTICLE

INDEPENDENT DIRECTORS AND CONTROLLING SHAREHOLDERS

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Independent directors are an important feature of modern corporate law. Courts and lawmakers around the world increasingly rely on these directors to protect

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This Article is part of the research of the Controlling Shareholders Project of the Harvard Law School Program on Corporate Governance. The Article was partly written while Hamdani was a visiting professor at Harvard Law School during the fall of 2015. As detailed below, during the years 2006–2008 and 2011–2012, the authors contributed to reforming Israeli corporate law in directions advocated in this Article, and this Article draws on the authors' work and experience in connection with those reforms.

We have benefitted from presenting this Article at the American Law and Economics Association Meeting, Boston University, University of Delaware, Harvard Law School, and Michigan Law School. We would like to thank John Armour, Jesse Fried, Larry Hamermesh, Scott Hirst, Hans-Christoph Hirt, Reinier Kraakman, Demetrio Maltese, Ted Mirvis, and Mark Roe for

investors from controlling shareholder opportunism. In this Article, we argue that the existing director-election regime significantly undermines the ability of independent directors to effectively perform their oversight role. Both the election and retention of independent directors normally depend on the controlling shareholders. As a result, these directors have incentives to go along with controllers' wishes, or, at least, have inadequate incentives to protect public investors.

To induce independent directors to perform their oversight role, we argue, some independent directors should be accountable to public investors. This can be achieved by empowering investors to determine or at least substantially influence the election or retention of these directors. These "enhanced-independence" directors should play a key role in vetting "conflicted decisions," where the interests of the controller and public investors substantially diverge, but not have a special role with respect to other corporate issues. Enhancing the independence of some directors would substantially improve the protection of public investors without undermining the ability of the controller to set the firm's strategy.

We explain how the Delaware courts, as well as other lawmakers in the United States and around the world, can introduce or encourage enhanced-independence arrangements. Our analysis offers a framework of director election rules that allows policymakers to produce the precise balance of power between controlling shareholders and public investors that they find appropriate. We also analyze the proper role of enhanced-independence directors as well as respond to objections to their use. Overall, we show that relying on enhanced-independence directors, rather than independent directors whose elections fully depend on the controller, can provide a better foundation for investor protection in controlled companies.

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INTRODUCTION

In 2012, Google adopted a controversial recapitalization plan that allowed it to issue a new class of nonvoting stock.[1] This plan enabled Google to continue raising capital without weakening its founders' control over the company. To address the concern that the plan would benefit the company's controlling shareholders at the expense of its public investors, Google formed a special committee of independent directors to negotiate and approve the terms of the recapitalization.[2] Furthermore, in the settlement of the litigation over the

1 *See* Simon C.Y. Wong, *Google's Stock-Split Plan Would Replace Stewardship with Dictatorship*, HARV. BUS. REV. (Apr. 18, 2012), https://hbr.org/2012/04/googles-stock-split-plan-would [https://perma.cc/8UK4-PVCS] ("[Google's] recent proposal to effect a 2-for-1 stock split by issuing non-voting shares is an abhorrent idea . . . ."); *see also* Steven Davidoff Solomon, *Thorny Side Effects in Silicon Valley Tactic to Keep Control*, N.Y. TIMES, Sept. 4, 2013, at B8 ("Google proposed last year that the company issue a new class of shares with no voting rights.").

2 *See* Paul Lee, Note, *Protecting Public Shareholders: The Case of Google's Recapitalization*, 5 HARV. BUS. L. REV. 281, 284 (2015) (noting that the special committee of independent directors "negotiated certain protections" for other shareholders before voting on the plan).

recapitalization, Google's independent directors were assigned an important ongoing role to enforce certain restrictions on the company's founders.[3]

If a company, like Google, has a controlling shareholder, a main concern of corporate law is to address potential conflicts of interest between the controller and public investors.[4] Corporate law has long relied on oversight by independent directors—directors who have no ties to the controller or the company other than their service on the board—over corporate decisions where the interests of the controller substantially diverge from those of the company or its public investors (hereinafter "conflicted decisions").[5] Both courts and lawmakers have sought to use independent directors to safeguard against such controller opportunism.[6]

As we explain in this Article, the existing arrangements for electing directors undermine the effectiveness of independent director oversight. Because these arrangements provide controllers with decisive power to appoint independent directors and decide whether to retain them, independent directors have significant incentives to side with the controller and insufficient countervailing incentives to protect public investors in conflicted decisions. Thus, independent directors currently relied upon to contain controllers' conflicts cannot be expected to be effective guardians of public investors' interests.

We also show how the rules governing the appointment of independent directors could be refined to make their oversight more effective. To improve the effectiveness of independent directors in cases of controllers' conflicts, some directors should be elected in ways that would make them at least somewhat accountable to public investors. These directors, which we call "enhanced-independence directors," should play a key role in approving self-dealing transactions. We develop a framework of alternative legal rules for obtaining enhanced independence without undermining the controller's ability to determine business strategy in nonconflicted decisions. We also explain how

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3 *See In re* Google Inc. Class C S'holder Litig., No. 7469-CS, 2013 WL 5949928, at *2 (Del. Ch. Nov. 6, 2013) (incorporating the parties' settlement agreement, which amended the Transfer Restriction Agreement to include that it could not be waived or modified without consideration and approval by a committee of at least two independent directors); *see also* Revised Stipulation of Compromise and Settlement at 8, *In re* Google Inc. Class C S'holder Litig., No. 7469-CS, 2013 WL 5949928 (Del. Ch. Nov. 6, 2013), https://www.sec.gov/Archives/edgar/data/1288776/000119312514116482/d699828dex404.htm? [https://perma.cc/K49D-BYJ8].

4 We analyze in detail the corporate governance problems of controlled companies in Lucian A. Bebchuk & Assaf Hamdani, *The Elusive Quest for Global Governance Standards*, 157 U. PA. L. REV. 1263 (2009) [hereinafter Bebchuk & Hamdani, *Elusive Quest*].

5 Drawing the line between ordinary business decisions and those that should be treated as conflicted decisions is a complicated task. *See infra* note 112. In this Article, we do not take a view on this question.

6 While independent director oversight is widely accepted, some writers have expressed concerns about the extent to which independence is undermined by the power controllers have over independent directors. For such writings, see, for example, María Gutiérrez & Maribel Sáez, *Deconstructing Independent Directors*, 13 J. CORP. L. STUD. 63 (2013), and Donald C. Clarke, *The Independent Director in Chinese Corporate Governance*, 31 DEL. J. CORP. L. 125, 170-71 (2006).

courts, regulators, and investors could require or encourage companies to introduce enhanced-independence directors.

Consider again the Google example. Suppose that minority shareholders had the right to elect, or at least veto the appointment of, two independent directors. Such enhanced-independence directors would have had greater incentives to resist a recapitalization plan that benefitted the controller at the expense of public investors. The approval of the plan by such independent directors would have been a more meaningful signal than approval by independent directors who serve only at the controller's will.

The enhanced-independence approach that we put forward can address longstanding dilemmas with which the Delaware courts have been wrestling.[7] In well-known decisions involving freezeout transactions, Delaware courts have recognized the structural problems afflicting independent directors, choosing not to defer to the approval of freezeouts by such directors and, instead, to grant judicial deference only to transactions also approved by a majority vote of minority shareholders. Outside the freezeout context, however, the Delaware courts have not always followed such an approach, and some decisions have granted significant cleansing power to independent director approval in cases of controller conflicts.

For example, Delaware courts substantially rely on independent directors to make decisions regarding derivative actions against the controller. Such judicial decisions might be due to concerns about the costs of alternatives. For courts influenced by such concerns, enhanced-independence directors can offer a workable alternative within the existing framework of corporate law doctrine.

We do not argue in this Article that independent directors *should* play a key role in protecting public investors at controlled companies. Some may believe that market forces—such as reputation—will prevent controlling shareholders from expropriating public investors. Others may find other measures—such as public enforcement or approval by minority shareholders—to be necessary or effective in enhancing investor protection. This Article takes as a given that corporate law, both in the United States and in many countries around the world, has long relied substantially on independent directors in controlled companies to protect public investors in cases of controller conflicts. Given this pervasive reliance on independent directors, our contribution is twofold. First, we show that, by itself, approval by independent directors who serve at the pleasure of the controller cannot serve as an effective device for vetting conflicted decisions.

7 For a more detailed account of the Delaware cases described in the text above, see discussion *infra* Section II.B.

Second, we analyze how to turn independent directors into more effective guardians of the interests of public investors in conflicted decisions.[8]

Our analysis proceeds as follows. Part I provides background on controlled companies and independent directors. Controlled companies constitute a sizeable minority of large, publicly traded firms in the United States, including well-known companies such as Facebook, Google, News Corp, and Viacom. Controlled companies are even more prevalent outside the United States, dominating public capital markets in Europe and in most countries around the world.

In widely held firms, the chief governance concern is to prevent professional managers from behaving opportunistically at the expense of investors. In controlled companies, by contrast, controllers have both the incentives and the power to police management, but they may use their power to divert value at the expense of public investors.[9] In these companies, therefore, a primary governance concern is to protect public investors from controller opportunism and value diversion. Corporate law commonly addresses this concern by requiring or encouraging the use of independent directors and relying on such directors to vet self-dealing transactions and other conflicted decisions.

Part II explains the fundamental shortcoming of this approach. Under existing arrangements, controlling shareholders normally play a decisive role in the appointment and retention of independent directors. Even independent directors, therefore, are inherently dependent on the controller for their election and retention as board members. This regime incentivizes independent directors to favor the controller, and it fails to provide them countervailing incentives to protect public investors.

Learning from widely held firms reinforces our critique. The CEOs of such firms once wielded substantial influence over independent directors' appointments. Today, however, there is widespread recognition that, to enable independent directors to monitor the CEO effectively, we should both limit the CEO's influence over their appointments and make these directors accountable to public investors. This recognition underlies the litany of reforms focused on director elections at widely held firms, including placing director selection in the hands of nominating committees composed solely of independent directors,

8 Our view is that a majority-of-the-minority vote can be a useful and effective tool in many contexts for guarding the interests of public investors. However, the question of when such a vote should be used in conjunction with or instead of enhanced-independence directors is outside the scope of this Article. In addition, we do not consider in this Article how to define self-dealing and other cases of controller conflicts. Nor do we discuss the proper test for deciding whether a company is controlled. The U.S. corporate law system has answers to these questions, as do other systems, and we take those as given for the purpose of our analysis. Finally, we do not consider in this Article when having a controlling shareholder is desirable; we take as given for the purposes of our analysis that some companies have a controlling shareholder that can shape the strategic direction of the company.

9 *See infra* notes 17–21.

providing for majority voting, and enabling proxy access.[10] If CEOs' informal influence over the selection of independent directors compromises their ability to contain CEO opportunism, controlling shareholders' absolute control over the appointment and retention of independent directors is all the more problematic.

Part II concludes by introducing our proposed approach for making independent directors more effective guardians of the interests of public investors in controlled companies. Such companies, we argue, should have some directors who (i) lack the incentives produced by the controller's decisive influence over the directors' appointment and retention and (ii) have some incentives that flow from making the directors accountable to public investors. A regime of such *enhanced-independence* directors requires measures that will limit controllers' power over the appointment of these directors while providing public investors with some degree of influence over this appointment. Such measures, we show, are not an ivory-tower idea without real-world precedent. The American Stock Exchange (AMEX) required them for dual-class companies that went public during a certain period, and they have been recently introduced in the United Kingdom, Italy, and Israel.

Part III develops a framework for designing enhanced-independence rules with the desired balance between enhancing independence to limit controller opportunism and controllers' legitimate interests in making business decisions. Public investors may participate in three stages of director elections: initial appointment, reelection, and termination. For each stage, we identify different degrees of public investors' input rights and evaluate the impact of these rights on investor protection. Public investors, we argue, should at least have veto rights over the initial appointment, reelection, and termination of enhanced-independence directors. We also explain, however, that there are good reasons to consider going beyond veto rights—for example, by empowering public investors to determine whether enhanced-independence directors are reelected and terminated.

Part IV focuses on the strategies for implementing an enhanced-independence approach. Regimes based on judge-made law, such as in Delaware, can encourage the use of enhanced-independence directors by according significant cleansing powers only to the approval of conflicted decisions by such directors. By contrast, regimes based on legislative or regulatory mandates can require the appointment of some enhanced-independence directors and the approval of certain conflicted decisions by such directors.

We also discuss the desirable number and role of enhanced-independence directors. To protect public investors, these directors should play a dominant role in—and only in—vetting self-dealing transactions and other conflicted decisions. To preserve controllers' ability to set the company's business

10 *See infra* notes 25–31, 49–50 and accompanying text.

strategy, however, such directors should not play a dominant role in other corporate affairs, and they should therefore not constitute a substantial fraction of the members of the board.

Part V considers potential objections to an enhanced-independence approach. We address claims that enhanced-independence directors would be harmful by interfering with the controller's ability to run the company, undermining the board's collegiality and cohesiveness, or facilitating abuse by some opportunistic minority shareholders. We also consider claims that such directors would not add significantly to the protection of public investors. We show that these objections do not undermine the case for enhanced-independence directors.

We shall use the terms "minority shareholders" or "public investors" to refer to shareholders other than the controller. We note that these shareholders sometimes hold a majority of the equity capital. This is likely to be the case when a dual-class structure, or another aspect of the corporate structure, separates voting rights from cash flow rights and enables the controller to retain a lock on control while holding a minority, even a small minority, of the company's equity.[11] A substantial body of evidence suggests that the risk of value diversion increases when controllers use dual-class or other ownership structures for separating cash flow rights from votes.[12] Thus, even those who would not support enhanced-independence directors for controlled companies in general should consider using them for dual-class companies and other structures that separate voting and cash flow rights.

I. INDEPENDENT DIRECTORS AND CONTROLLED COMPANIES

This Part sets the background for our analysis of director independence at controlled companies. Section A describes the prevalence of concentrated ownership and the governance challenges that this ownership structure creates.

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11 *See, e.g.*, 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* (examining ownership structures where a controlling shareholder retains a small fraction of the firm's cash flow rights), *in* CONCENTRATED CORPORATE OWNERSHIP 295, 297-301 (Randall K. Morck ed., 2000). Examining whether and to what extent structures that separate cash flow rights from voting rights are desirable is beyond the scope of this Article, and we take the existence of companies with such structures as given for the purposes of our analysis. For a recent contribution to the debate on dual-class firms co-authored by one of us, see generally Lucian A. Bebchuk & Kobi Kastiel, *The Untenable Case for Perpetual Dual-Class Stock* (Harvard Law Sch. John M. Olin Ctr. for Law, Econ., and Bus., Discussion Paper No. 905, 2017; Harvard Law Sch. Program on Corp. Governance, Discussion Paper No. 2017-6, 2017), https://ssrn.com/abstract=2954630 [https://perma.cc/8H6E-ZVAE].

12 For empirical evidence on the link between controllers' wedge between cash flow and voting rights and agency costs, see Marianne Bertrand et al., *Ferreting Out Tunneling: An Application to Indian Business Groups*, 117 Q. J. ECON. 121 (2002), Paul A. Gompers et al., *Extreme Governance: An Analysis of Dual-Class Firms in the United States*, 23 REV. FIN. STUD. 1051 (2010), and Chen Lin et al., *Ownership Structure and the Cost of Corporate Borrowing*, 100 J. FIN. ECON. 1 (2011).

Section B discusses corporate law's reliance on independent directors to guard public investors' interests.

A. *Preventing Controller Opportunism*

Controlled companies are important both in the United States and around the world. In the United States, they constitute a sizeable minority of large, publicly traded firms.[13] As of December 31, 2016, there were 379 Russell 3000 companies with a shareholder holding more than 30% of the company's voting shares, and 220 of these companies had one shareholder holding more than 50% of such shares.[14] Controlled companies are even more prevalent outside the United States. Public companies in Europe, Asia, and Latin America commonly have a controlling shareholder.[15]

The governance challenges at controlled companies are fundamentally different from those at widely held companies.[16] At widely held companies, the fundamental governance problem arises from the divergence of interests between managers and investors, and so corporate law and governance arrangements aim to address managerial agency costs. By contrast, the fundamental governance problem in controlled companies concerns the agency problems between controllers and public investors.

Controlling shareholders own a significant fraction of the firm's cash-flow rights, which gives them a substantial incentive to police management and

13 *See* Ronald C. Anderson & David M. Reeb, *Founding-Family Ownership and Firm Performance: Evidence from the S&P 500*, 58 J. FIN. 1301, 1302 (2003) (observing that roughly 35% of S&P 500 companies have families as dominant shareholders); Clifford G. Holderness, *The Myth of Diffuse Ownership in the United States*, 22 REV. FIN. STUD. 1377, 1378 (2009) (presenting evidence that "raise[s] doubts about whether ownership in the United States' [public firms] is . . . less concentrated than elsewhere").

14 This data was collected from Factset and ORBIS databases, and was supplemented by information from public filings on the SEC's Electronic Data Gathering, Analysis, and Retrieval (EDGAR).

15 For empirical research documenting that concentrated ownership is prevalent around the world, see M. BECHT & C. MAYER, *Introduction* to THE CONTROL OF CORPORATE EUROPE 1, 4-7 (Fabrizio Barca & Marco Becht eds., 2001); Stijn Claessens et al., *The Separation of Ownership and Control in East Asian Corporations*, 58 J. FIN. ECON. 81, 110 (2000); Mara Faccio & Larry H.P. Lang, *The Ultimate Ownership of Western European Corporations*, 65 J. FIN. ECON. 365, 378 (2002); and Rafael La Porta et al., *Corporate Ownership Around the World,* 54 J. FIN. 471, 511 (1999).

16 *See generally* Bebchuk & Hamdani, *Elusive Quest*, *supra* note 4.

enhance the company's value.[17] Controllers, however, may also use their power to divert value at the expense of the company and its public investors.[18]

Such diversion could take many forms, including selling (or purchasing) assets, goods, or services to (or from) the company they control on terms that favor them;[19] acquiring equity at below-market prices from either the company or public investors in a freezeout transaction;[20] or paying excessive compensation to the controller or family members.[21] In controlled companies, therefore, corporate law and governance arrangements should protect public investors from the controllers' value diversion.[22]

B. *The Reliance on Independent Directors*

A common approach for containing controllers' conflict is to rely on independent directors. Legal regimes in the United States and around the world require or encourage companies to appoint independent directors and assign them the task of approving self-dealing and other conflicted decisions.

1. The United States

Independent directors are an important feature of U.S. boardrooms. As Jeff Gordon has documented, the number of independent directors has

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17 *See* Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. REV. 1641, 1651 (2006) ("[A] controlling shareholder may police the management of public corporations better than the standard panoply of market-oriented techniques employed when shareholdings are widely held."); *see also* Jens Dammann, *The Controlling Shareholder's General Duty of Care: A Dogma That Should Be Abandoned*, 2015 U. Ill. L. Rev. 479, 481 (noting controlling shareholders "have strong financial incentives to make informed decisions in the best interest of their corporations").

18 Such extraction is often referred to as "tunneling." *See* Vladimir Atanasov et al., *Law and Tunneling*, 37 J. Corp. L. 1, 2 (2011). For a review of different methods of tunneling and self-dealing, see *id.* at 3, which identifies three general types of tunneling: cash flow, asset, and equity.

19 For empirical studies on diversion via related-party transactions, see Kee-Hong Bae et al., *Tunneling or Value Added? Evidence from Mergers by Korean Business Groups*, 57 J. FIN. 2695, 2698 (2002), and Guohua Jiang et al., *Tunneling Through Intercorporate Loans: The China Experience*, 98 J. FIN. ECON. 1, 2 (2010).

20 For empirical studies on diversion via equity transactions, see, for example, Jae-Seung Baek et al., *Business Groups and Tunneling: Evidence from Private Securities Offerings by Korean Chaebols*, 61 J. FIN. 2415, 2418-19 (2006), and Borja Larrain & Francisco Urzúa I., *Controlling Shareholders and Market Timing in Share Issuance*, 109 J. FIN. ECON. 661, 661-62 (2013).

21 For empirical evidence on value diversion through excessive compensation to controlling families, see Harry DeAngelo & Linda DeAngelo, *Controlling Stockholders and the Disciplinary Role of Corporate Payout Policy: A Study of the Times Mirror Company*, 56 J. FIN. ECON. 153, 154-56 (2000).

22 *See* Luca Enriques & Paolo Volpin, *Corporate Governance Reforms in Continental Europe*, 21 J. ECON. PERSP. 117, 117 (2007) ("[C]oncentrated ownership can create conditions for a new agency problem, because the interests of controlling and minority shareholders are not aligned.").

increased dramatically over time because of both judicial encouragement and federal mandates.[23]

At the federal level, the Sarbanes–Oxley Act of 2002 (SOX)[24] and the applicable stock exchange listing standards require that boards of widely held companies have a majority of independent directors.[25] These directors are responsible for key issues that might entail a conflict of interest between shareholders and management, such as executive compensation,[26] appointment of auditors,[27] and certain nomination decisions.[28] Federal rules adopt a laxer approach to director independence at controlled companies.[29] While these companies are still subject to the independent audit committee requirements, they are not required to have a majority of their directors be independent,[30] and they are exempt from the independent compensation and nomination committee requirements.[31]

State corporate law has used standards of judicial review to encourage companies to appoint independent directors and assign them a meaningful role

23 *See generally* Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465 (2007) [hereinafter Gordon, *The Rise of Independent Directors*].

24 15 U.S.C. § 7211(e)(6) (2012).

25 *See Developments in the Law—Corporations and Society*, 117 HARV. L. REV. 2169, 2187 (2004) ("The revised listing standards of both the NYSE and NASDAQ . . . require (with a few exceptions) that listed-company boards have a majority of independent directors . . . .").

26 *See* NYSE, INC., LISTED COMPANY MANUAL, § 303A.05(a) (2017), http://nysemanual.nyse.com/LCMTools/PlatformViewer.asp?selectednode=chp_1_4&manual=%2Flcm%2Fsections%2Flcm-sections%2F [https://perma.cc/6PRM-4SVJ] [hereinafter NYSE LISTED COMPANY MANUAL] (requiring a compensation committee consisting solely of independent directors); *see also* NASDAQ, STOCK MKT. INC., MARKETPLACE RULES R. 4350(c)(3)(A)–(B) (2017), https://www.sec.gov/rules/other/nasdaqllcf1a4_5/nasdaqllcamendrules4000.pdf [https://perma.cc/WWV3-WUW5] [hereinafter NASDAQ MARKETPLACE RULES] (requiring active involvement of either a wholly independent compensation committee or a majority of independent directors).

27 *See Developments in the Law—Corporations and Society*, *supra* note 25, at 2191 (2004) ("Each exchange mandates that listed companies create an audit committee . . . and every member must meet . . . rigorous independence requirements . . . .").

28 *See, e.g.*, NASDAQ MARKETPLACE RULES, *supra* note 26, R. 4350(c)(4)(A) (requiring active involvement in director nomination of either a wholly independent nomination committee or a majority of independent directors).

29 *See generally* NYSE LISTED COMPANY MANUAL, *supra* note 26, § 303A.00 (stating that controlled companies are not required to comply with the independent-director provisions of the manual); *see also* NASDAQ MARKETPLACE RULES, *supra* note 26, R. 4350(c)(5) (defining a "controlled company" as "a company of which more than 50% of the voting power [for the election of directors] is held by an individual, a group or another company").

30 *See SEC Approves NYSE and NASDAQ Proposals Relating to Director Independence*, FINDLAW, http://corporate.findlaw.com/finance/sec-approves-nyse-and-nasdaq-proposals-relating-to-director.html [https://perma.cc/6REH-6P39] (undated) (discussing recently approved standards for independent directors for controlled companies on stock exchanges).

31 *See* NYSE LISTED COMPANY MANUAL, *supra* note 26, § 303A.00 (exempting controlled companies from the nominating-committee provisions and the compensation-committee provisions of the manual).

in vetting transactions involving conflicts of interest.[32] Delaware courts, for example, have used the entire fairness standard to review certain self-dealing transactions involving controlling shareholders. Whereas the business judgment rule substantially insulates a transaction from judicial scrutiny,[33] the entire fairness standard requires the defendants to prove that the transaction was fair to public investors by showing a fair process and a fair price.[34] The active involvement of an effective, empowered special negotiation committee consisting solely of independent directors, however, can significantly alleviate the burden that defendants face.[35]

2. Around the World

Other countries are also increasingly viewing independent directors as essential to protecting public investors at controlled companies. Accordingly, these countries have adopted one or more of the following arrangements.[36] First,

32 *See* Gordon, *The Rise of Independent Directors*, *supra* note 23, at 1523-26 (reviewing the role that Delaware courts played in encouraging public companies to give more power to independent directors); Steven M. Haas, *Note*, *Toward a Controlling Shareholder Safe Harbor,* 90 VA. L. REV. 2245, 2250-70 (2004) (reviewing case law on Delaware's changing standard of review for self-dealing transactions approved by independent directors).

33 *See, e.g.*, Weinberger v. UOP, Inc., 426 A.2d 1333, 1346-47 (Del. Ch. 1981) (discussing the business judgment exercised by the board and finding that this shielded it), *rev'd*, 457 A.2d 701 (Del. 1983); *see also* Kahn v. Tremont Corp., 694 A.2d 422, 428 (Del. 1997) (describing the business judgment rule as "deferential").

34 *See, e.g.*, Ams. Mining Corp. v. Theriault, 51 A.3d 1213, 1239 (Del. 2012) (explaining that the standard of review for controlling-shareholder transactions is entire fairness and the burden falls on the defendant).

35 Such involvement can shift the burden for showing fairness back to the plaintiff. *See, e.g.*, Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1117 (Del. 1994) (stating that "approval of the transaction by either an independent committee of directors or a[] . . . majority of the minority shareholders shifts the burden" in entire fairness review from the interested party to the challenging party). In some cases, the use of both an independent special negotiating committee and approval by a majority of the minority shareholders will prevent Delaware courts from engaging in an entire fairness review. *See* Kahn v. M&F Worldwide Corp., 88 A.3d 635, 642-44 (Del. 2014) (adopting the lower court's ruling that the presence of both procedural safeguards for minority shareholders—an independent committee of directors and a majority of the minority vote—leads to application of the business judgment rule).

36 In 2005, the European Commission recommended that member states adopt governance standards that require directors to be independent of controlling shareholders. *See* Commission Recommendation 2005/162/EC of 15 Feb. 2005, 2005 O.J. (L 52) 52, 63, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32005H0162&from=EN [http://perma.cc/X4B8-QM4M] (recommending "[t]he presence of independent representatives on the board, capable of challenging the decisions of management," and describing what such independence entails). However, some countries' definitions of independence overlook ties between directors and controllers. See, for example, the German approach described in Paul Davies et al., *Boards in Law and Practice: A Cross-Country Analysis in Europe*, *in* CORPORATE BOARDS IN LAW AND PRACTICE: A COMPARATIVE ANALYSIS IN EUROPE 30 & n.120 (Paul Davies et al. eds., 2013), submitting that "in Europe, independent directors are being used for the wrong purposes." *See also* Gutiérrez & Sáez, *supra* note 6, at 74-75 (noting that "European jurisdictions

public company boards are expected to include some fraction of independent directors. Second, independent directors must serve on committees that play an active role in monitoring management and controlling shareholders. Third, many countries specifically require that independent directors play an active role in scrutinizing self-dealing transactions. Below we review some examples of the increasing reliance on independent directors to police controlling shareholders.

In Europe, independent directors are often expected, if not required, to serve on the corporation's audit committee, and they often constitute a significant fraction of the audit committee's members.[37] Japan, India, Korea, and Russia have adopted similar requirements.[38] In Brazil, Japan, and some European countries, independent directors play an important role in nomination and remuneration committees.[39] Their presence on the audit, compensation, and nomination committees provides them with better access to information and the means to monitor value diversion by controlling shareholders.[40]

Some countries specifically require that independent directors play an active role in the vetting of related-party transactions in controlled companies.[41] In

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have failed to make [the] distinction" between "independent directors in corporations with concentrated ownership" and independent directors in other corporations).

37 Some countries (such as Germany) require the appointment of only one independent director. Guido Ferrarini & Marilena Filippelli, *Independent Directors and Controlling Shareholders Around the World* 23 & n.25 (European Corp. Governance Inst. (ECGI), Working Paper No. 258/2014, May 2014). Others require a majority or two-thirds of independent members. *Id.* at 23-24, n.26. Still others require that all members of the committee be independent. *Id.* at 24, n.27.

38 For studies discussing such requirements in various jurisdictions, see Donald C. Clarke, *Three Concepts of the Independent Director*, 32 DEL. J. CORP. L. 73, 99-102 (2007); A.C. Pritchard, *Monitoring of Corporate Groups by Independent Directors*, 9 J. KOREAN L. 1, 16 (2009); Colleen R. Stumpf, Comment, *Diverse Economies—Same Problems: The Struggle for Corporate Governance Reform in Russia and the United States*, 24 PENN ST. INT'L L. REV. 897, 908 (2006); and Umakanth Varottil, *Evolution and Effectiveness of Independent Directors in Indian Corporate Governance*, 6 HASTINGS BUS. L.J. 281, 308-21 (2010).

39 *See, e.g.*, Roberto Barontini et al., *Directors' Remuneration Before and After the Crisis: Measuring the Impact of Reforms in Europe* (analyzing "the impact of recent reforms," including those related to independence in remuneration practices, "on directors' remuneration"), *in* BOARDS AND SHAREHOLDERS IN EUROPEAN LISTED COMPANIES: FACTS, CONTEXT AND POST-CRISIS REFORMS 251 (Massimo Belcredi & Guido Ferrarini eds., 2013).

40 *See* Paul Krüger Andersen & Dorthe Kristensen Balshøj, *Directors' Conflicts of Interests: A Contribution to European Convergence* (describing the value of independent directors on such committees), *in* BOARDS OF DIRECTORS IN EUROPEAN COMPANIES: RESHAPING AND HARMONISING THEIR ORGANISATION AND DUTIES 63-74 (Hanne S. Birkmose, Mette Neville & Karsten Engsig Sørensen eds., 2013).

41 *See* Gerard Hertig & Hideki Kanda, *Related Party Transactions* (discussing how major jurisdictions regulate related-party transactions, including "Japan and much of continental Europe," which "mandate approval by disinterested board members"), *in* THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 101, 105-09, 128-30 (Reinier Kraakman et al. eds., 2004) (discussing how major jurisdictions regulate related party transactions).

Italy, for instance, significant related-party transactions require the approval of an independent committee of the board.[42]

II. THE LIMITS OF INDEPENDENT DIRECTORS

Empowering independent directors to review self-dealing and other conflicted decisions might offer public investors at controlled companies some degree of protection. For example, the incentives of directors to go along with the preferences of the controller might be less powerful when they have no ties to the controller other than through their service on the board. Indeed, academic studies on reforms in Korea, Taiwan, India, China, and other countries provide evidence suggesting that the appointment of independent directors at controlled firms can enhance share value.[43]

In this Part, we argue that independent directors in controlled companies still have incentives to favor controllers, which undermine their effectiveness in overseeing controller conflicts. For independent directors to vet conflicted decisions well, they should have adequate incentives to do so. However, the prevailing regime that governs director elections provides independent directors with incentives to favor controlling shareholders and with few countervailing incentives to protect public investors from self-dealing and other forms of value diversion.

We would like to clarify at the outset that we do not argue that directors are exclusively motivated by their desire to get elected or reelected to the board. Directors' sense of professionalism and integrity, and fiduciary duties and norms, may have significant influence on how directors act. Yet corporate law has chosen, and we believe correctly, not to rely exclusively on such factors. If we could exclusively rely on them, many key corporate law rules as well as financial incentive schemes would be unnecessary.

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42 *See* Guido Ferrarini et al., *Corporate Boards in Italy* (describing measures regarding related-party transactions required by the Italian Civil Code), *in* CORPORATE BOARDS IN LAW AND PRACTICE: A COMPARATIVE ANALYSIS IN EUROPE, *supra* note 36, at 367, 400-05.

43 For empirical studies suggesting that introducing independent directors benefitted public investors in various countries, see Bernard S. Black & Vikramaditya S. Khanna, *Can Corporate Governance Reforms Increase Firm Market Values? Event Study Evidence from India*, 4 J. EMPIRICAL LEGAL STUD. 749, 751 (2007); Bernard Black & Woochan Kim, *The Effect of Board Structure on Firm Value: A Multiple Identification Strategies Approach Using Korean Data*, 104 J. FIN. ECON. 203, 225 (2012); Jay Dahya et al., *Dominant Shareholders, Corporate Boards, and Corporate Value: A Cross-Country Analysis*, 87 J. FIN. ECON. 73, 75 (2008); and Yin-Hua Yeh & Tracie Woidtke, *Commitment or Entrenchment?: Controlling Shareholders and Board Composition*, 29 J. BANKING & FIN. 1857, 1862-63 (2005). For a study finding that firms with high percentages of independent directors tend to "have a smaller magnitude of manipulated transfer prices," see Agnes W.Y. Lo et al., *Can Corporate Governance Deter Management from Manipulating Earnings? Evidence from Related-Party Sales Transactions in China*, 16 J. CORP. FIN. 225, 226 (2010).

Section A explains how recent developments concerning director independence at widely held firms should inform our assessment of controlled companies. In Section B, we discuss the structural incentives of independent directors at controlled companies. In Section C, we turn to examine how to make independent director oversight more effective.

A. *Learning from Widely Held Firms*

At widely held companies, director independence reinforces the accountability created by public investors' right to elect directors. Although lawmakers and investors had focused on regulating director independence, they have increasingly adopted reforms that enhance public investors' role in director elections.

Public investors at widely held companies have the power to elect members to the board. This power arguably makes directors accountable to shareholders and incentivizes members of the board to keep shareholders satisfied with their performance.[44] In fact, courts have relied on shareholders' ability to displace underperforming directors as a reason for deferring to directors' business decisions.[45]

Independence requirements strengthen these market incentives by ensuring that directors have no conflicts that could undermine their effectiveness as monitors of management.[46] For example, a director whose livelihood depends on her business ties with the company might fear that refusing to accept the CEO pay demands would provoke retaliation. Many investors and lawmakers, however, believe that such independence alone may not ensure directors' accountability because management's influence over the appointment of directors can also undermine the effectiveness of those directors as monitors. Even an independent director might fear that adopting a skeptical approach toward the CEO, for example, would reduce her chances of reappointment. Moreover, to the extent that the CEO is involved in appointment decisions, directors may develop a sense of gratitude and

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44 *But see* Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 688-94 (2007) (discussing the impediments to electoral challenges even when shareholder discontent with the board actions and decisions are significant).

45 *See, e.g.*, *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 698 (Del. Ch. 2005) ("The redress for [directors'] failures . . . must come . . . through the action of shareholders . . . and not from this Court."); *see also* Hilton Hotels Corp. v. ITT Corp., 978 F. Supp. 1342, 1351 (D. Nev. 1997) ("One of the justifications for the business judgment rule's insulation of directors from liability . . . is that unhappy shareholders can always vote the directors out of office." (internal quotation marks omitted) (quoting Shoen v. AMERCO, 885 F. Supp. 1332, 1340 (D. Nev. 1994))).

46 *See* NYSE LISTED COMPANY MANUAL, *supra* note 26, § 303A.02; NASDAQ MARKETPLACE RULES, *supra* note 26, R. 5605(2).

obligation to accommodate the CEO's preferences.[47] These concerns underlie the post-Enron requirement that independent directors control the board nomination process, thereby taking from managers the formal power to influence the process—and thus the outcome—of director elections.[48]

Proposed reforms have gradually gone beyond director independence and extended to measures that enhance public investors' influence over director election. The majority voting regime for electing directors, for example, makes it easier for shareholders to prevent the company's candidates from joining the board.[49] Commentators and activist shareholders have called for additional reforms that would give a majority of shareholders the power to elect and fire directors. These include providing shareholders with access to the ballot and dismantling staggered boards.[50]

These developments offer two important lessons for controlled companies. First, controllers' absolute control over the election of independent directors undermines those directors' effectiveness as monitors. Second, enabling public investors to influence the election of independent directors would provide these directors with incentives to guard public investors' interests.

B. *Director Independence at Controlled Firms*

At controlled companies, independent directors are expected to exercise oversight to prevent the controller from expropriating value from public investors. Yet, the same election method that holds directors accountable to

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47 *See, e.g.*, Anil Shivdasani & David Yermack, *CEO Involvement in the Selection of New Board Members: An Empirical Analysis*, 54 J. FIN. 1829, 1851 (1999) (observing that "when CEOs are involved in director selection, companies choose new directors who are less likely to monitor aggressively").

48 *See* NYSE LISTED COMPANY MANUAL, *supra* note 26, § 303A.04(a) ("Listed companies must have a nominating/corporate governance committee composed entirely of independent directors."); *see also* Michael E. Murphy, *The Nominating Process for Corporate Boards of Directors: A Decision-Making Analysis*, 5 BERKELEY BUS. L.J. 131, 148 (2008) (noting that "NYSE rules . . . require the nominating committee to be composed entirely of independent directors").

49 For reviews of majority voting regimes, see Stephen J. Choi et al., *Does Majority Voting Improve Board Accountability?*, 83 U. CHI. L. REV. 1119, 1127 (2016), which notes that "[m]any commentators have argued that majority voting enhances director accountability to shareholders," and William K. Sjostrom, Jr. & Young Sang Kim, *Majority Voting for the Election of Directors*, 40 CONN. L. REV. 459, 463 (2007), which explains how majority voting "affords shareholders, in effect, veto power over managements' candidates." Vanguard, for instance, has emphasized majority voting in its company engagements. *See Our Governance and Executive Compensation Principles*, VANGUARD, https://about.vanguard.com/vanguard-proxy-voting/corporate-governance [https://perma.cc/D5JL-QVG7HRMZ-4SQK] (stating that "directors should be subject to annual elections by majority vote").

50 The proxy access reform allows certain shareholders to include their own nominees on the company's ballot. *See generally* Lucian Arye Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43, 47 (2003) (arguing that proxy access is a moderate step toward improving board accountability); Brett H. McDonnell, *Shareholder Bylaws, Shareholder Nominations, and Poison Pills*, 3 BERKELEY BUS. L.J. 205, 211 (2005) (identifying proxy-access bylaws as a way of challenging management control of the board of directors).

public investors at widely held companies currently also holds them accountable to the controller at controlled companies. Controlling shareholders have decisive power over director appointment. Directors at firms with controlling shareholders—including independent directors—cannot be elected or reelected following their initial term—unless the controlling shareholder supports their candidacies. Nor will they stay in office once the controlling shareholder decides to end their service on the board.[51]

This regime provides directors with substantial incentives to keep the controller satisfied. And incentives aside, social norms often lead individuals who are placed in a position by a given individual to feel some sense of gratitude toward that individual.[52] The existing election regime also fails to provide independent directors with adequate countervailing incentives to protect public investors. Independent directors do not owe their service on the board to public investors, who can neither elect them nor remove them from office. If the controller so wishes, these directors would serve on the board even if a majority of public investors would be happy to see them leave. Directors' initial election and retention solely depend on the controller.

There have been extreme cases in which controllers made explicit threats to fire independent directors that did not go along with their wishes.[53] And while such instances highlight the undesirable incentives produced by the controller's power over director election, we should stress that such incentives exist even when the controller makes no such threat. A well-lawyered controller would likely cite other reasons when removing a director that resists the controller's wishes. Even without explicit threats, directors' structural dependence is always present.

Delaware courts have long expressed concerns about the potential dependence of all directors in controlled companies on controllers.[54] Yet, as

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51 The authority to remove a director generally lies with shareholders, though some states allow for the board to remove one of its members under certain conditions. *See, e.g.*, NEW YORK BUSINESS CORPORATION LAW § 706(a) (specifying conditions under which a director may be removed by action of the board). While removing a director during her term in office may be burdensome, as it requires a special shareholder meeting, the controller can simply decide not to nominate a director for another term.

52 *See* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 80-83 (2006) (arguing that CEO influence on the appointment of independent directors might lead to their having a sense of obligation and loyalty toward the CEO that can contribute to a tendency to go along with CEO pay wishes).

53 *See, e.g.*, *In re* Dole Food Co., Inc. Stockholder Litig., No. 8703, 2015 WL 5052214, at *13-15 (Del. Ch. Aug. 27, 2015) (describing threats that a controlling shareholder made against a director who opposed a transaction proposed by the controller).

54 *See, e.g.*, *In re* Ezcorp Inc. Consulting Agreement Derivative Litig., No. 9962, 2016 WL 301245, at *41 (Del. Ch. Jan. 25, 2016) ("[D]elaware decisions have long worried about a controller's potential ability to take retributive action against outside directors if they did not support the

explained below, the Delaware courts have yet to fully recognize the scope and implications of this structural dependence.

In the context of freezeout transactions, courts have concluded that approval by a special committee of independent directors does not suffice to eliminate the need for judicial review.[55] In doing so, they have explained their reluctance to grant full cleansing power to such a committee by expressly invoking controlling shareholders' decisive power to appoint independent directors. In an influential article, then–Vice Chancellor Leo Strine analogized the controller to "an 800-pound gorilla [that] wants the rest of the bananas" and the independent directors to "little chimpanzees" who "cannot be expected to stand in the way, even if the gorilla putatively gives them veto power."[56]

Outside the freezeout context, however, Delaware courts have stopped short of adopting a similar approach to independent director approval. For example, although derivative suits against the controller involve a significant divergence of interest between the controller and public investors, Delaware courts defer to independent directors' decisions about the fate of these derivative actions.[57] In the seminal *Aronson* case, the court held that for plaintiffs to establish the futility of making a demand on the board to sue the controller, "it is not enough to charge that a director was nominated by or elected at the behest of those controlling the outcome of a corporate election."[58]

Delaware courts have relied on decisions of special litigation committees consisting of independent directors to dismiss claims against controlling shareholders.[59] Some Delaware decisions have also displayed deference to compensation arrangements between public companies and their controllers that

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controller's chosen transaction and whether it could cause them to support a deal that was not in the best interests of the company or its stockholders.").

55 *See, e.g.*, Kahn v. M&F Worldwide Corp., 88 A.3d 635, 642 (Del. 2014) (noting that approval by a Special Committee "of a merger with a buying controlling stockholder" only shifts the burden of proof under the entire fairness standard).

56 Leo E. Strine, Jr., *The Inescapably Empirical Foundation of the Common Law of Corporations*, 27 DEL. J. CORP. L. 499, 509 (2002); *see also In re* Pure Res., Inc., S'holders Litig., 808 A.2d 421, 436 (Del. Ch. 2002) (using the same analogy).

57 Aronson v. Lewis, 473 A.2d 805, 816 (Del. 1984).

58 *Id.*; *see also* Friedman v. Dolan, No. 9425, 2015 WL 4040806, at *6 (Del. Ch. June 30, 2015) (stating that "[t]he mere fact that one [director] was appointed by a controller" does not suffice to overcome the presumption of her independence); Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1051 (Del. 2004) (holding that ninety-four percent voting power was not enough to create reasonable doubt of independence).

It is worth noting that, in a recent opinion, Vice Chancellor Laster insightfully highlighted the tension between the *Aronson* line of cases and the recognition in other cases that structural incentives afflict director decisions. *See Ezcorp*, 2016 WL 301245, at *90-91.

59 *See* Pompeo v. Hefner, 1983 WL 20284, at *1-2 (Del. Ch. Mar. 23, 1983) (holding that, by itself, the appointment of the sole member of a special litigation committee by the controller-defendant does not automatically require judicial scrutiny such director's independence); *see also* Biondi v. Scrushy, 820 A.2d 1148, 1164, 1165 n.41 (Del. Ch. 2003) (reiterating this point).

were approved by a special committee of independent directors.[60] In other cases involving controller conflicts, Delaware court decisions have been mixed. Some court decisions granted substantial cleansing power to independent director approval while other decisions declined to do so.[61]

To be sure, Delaware courts have often examined whether directors had some additional ties that provided them with incentives to go along with the controller. For example, Delaware courts have declined to defer to independent directors who co-owned a plane with the controller,[62] who provided consulting services to the controller,[63] or who served as an employee of a company over which the controller had considerable influence.[64] We agree that such ties might strengthen the incentives of directors to go along with the wishes of the controller. However, our key point is that, even without such additional ties to the controller, service on the controlled company's board produces by itself a structural incentives problem.

Independent directors whose service on the board fully depends on the controller do not have adequate incentives to guard the interests of public investors in the face of controllers' conflicts. Using Leo Strine's metaphor, if independent directors cannot be expected in the freezeout context to oppose the big gorilla when it seeks the rest of the bananas, we should not expect them to resist the big gorilla when it pursues a peach, a mango, or any other fruit that it might fancy. Thus, we argue, courts and lawmakers should not

60 *See Friedman*, 2015 WL 4040806, at *5-8 (applying the business judgment rule to the determination of executive pay and noting that "[e]ntire fairness is not the default standard for compensation awarded by an independent board or committee, even when a controller is at the helm of the company"); *In re* Tyson Foods, Inc. Consol. S'holder Litig., 919 A.2d 563, 587-88 (Del. Ch. 2007) (applying the business judgment rule to dismiss a claim about a consulting contract with a member of the controlling family).

61 For a systematic and careful review of cases going in different directions, see Vice Chancellor Laster's opinion for the court in *Ezcorp*, 2016 WL 301245, at *12-15. Vice Chancellor Laster's analysis highlights the structural incentives that independent directors in controlled companies have, *id.* at *16, and we hope that his analysis will prove influential.

62 *See* Sandys v. Pincus, No. 157,2016, 2016 WL 7094027, at *4 (Del. Ch. Dec. 5, 2016) (noting that co-ownership of a private plane "is suggestive of the type of very close personal relationship that, like family ties, one would expect to heavily influence a human's ability to exercise impartial judgment").

63 *See In re* Emerging Commc'ns, Inc. S'holders Litig., No. 16415, 2004 WL 1305745, at *34 (Del. Ch. June 4, 2004) (finding a lack of independence when a director provided and was compensated for financial advisory services to the controlled company).

64 *See* Del. Cty. Emps. Ret. Fund v. Sanchez, 124 A.3d 1017, 1019 (Del. 2015) (holding that a director was not independent of controller when he had a close friendship of over half a century with the controller and his primary employment was as an executive of a company over which the controller had substantial influence); *see also In re* Orchard Enters., Inc. Stockholder Litig., 88 A.3d 1, 21, 26 (Del. Ch. 2014) (holding that the question of a director's independence created issues of fact for trial when the director had a close relationship and expected future employment with the controller); *In re* Loral Space & Commc'ns Inc., 2008 WL 4293781, at *20-21 (Del. Ch. Sept. 19, 2008) (finding a lack of independence when a director had a long-standing relationship with the controller and solicited an investment from the controller during the special committee negotiations).

grant substantial cleansing power to decisions made by independent directors who serve on the board at the controller's pleasure.[65]

C. *Toward Enhanced Independence*

Legal systems that substantially rely on independent directors to vet conflicted decisions, we argue, should weaken their incentives to favor the controller and provide them with affirmative incentives to protect public investors. Weakening directors' incentives to favor controlling shareholders requires measures that would limit the controller's power to appoint and terminate directors. Providing directors with affirmative incentives to protect public investors requires that the latter have a say in director election and termination.

In the next Part, we develop a conceptual framework that can guide policymakers who wish to turn independent directors into effective monitors of controllers without undermining controllers' ability to run their companies. As we explain below,[66] one could take power away from the controller without giving any power to public investors. The approach we find best, however, is to grant public investors at least some power over director election and termination, as this power is vital for providing directors with affirmative incentives to protect public investors.

We do not suggest that public investors have power to influence the election of *all* directors or even all independent directors. Rather, we believe that the election of some directors—*enhanced-independence directors*—should not be dictated by the controller. The controller should retain the power to appoint a majority of board members and run the company through its representatives on the board. Enhanced-independence directors should play an active role when a conflict arises between the interests of the controller and those of public investors. At the very least, public investors should have the right to veto the controller's candidates for an enhanced-independence director position. As we explain below, however, public investors should wield even greater influence over these directors' election.

Before discussing our framework in detail, we should note that several legal regimes—one of them with our active involvement—have adopted reforms in the direction that we advocate. Below we discuss the regimes adopted by the AMEX stock exchange in the United States, Italy, the United Kingdom, and Israel. Because each of these regimes provided public investors

65 We do not discuss the claim, which is beyond the scope of this Article, that approval by independent directors, despite its limitations, might provide public investors with some protection and should therefore assist the controller in some way in defending against challenge to a conflicted decision. Our focus is on showing that any significant deference now accorded to such approval by independent directors should be reserved only for approval by enhanced-independence directors.

66 *See infra* Section IV.D.

with rights to influence the selection of independent directors, they suggest that the use of such directors is not merely an "ivory tower" idea but a practical real-world option.

AMEX: In 1976, when the New York Stock Exchange (NYSE) did not allow companies to use the dual-class share structure, AMEX decided to allow dual-class companies to list on the exchange subject to certain guidelines. These AMEX guidelines required that shares with inferior voting rights (normally, public investors) have the power to elect at least one quarter of the board.[67] Although these AMEX requirements have not been in effect since the mid-1980s, a recent study found twenty-six dual-class companies, including *The New York Times* and Dillard, with a governance structure that complies with this AMEX requirement.[68]

Italy: Controlled companies dominate Italy.[69] Italian law requires public companies to provide public investors with the power to elect at least one member to the board.[70] Companies must use the slate system for electing directors:[71] Shareholders who meet minimum shareholding criteria may submit their own slate to compete against the company's slate.[72] Whereas the candidates who obtain the highest number of votes are elected, at least one director is elected from the minority slate that receives the most votes.[73] A 2013 study found that minority slates were submitted in forty percent of director elections.[74]

United Kingdom: In response to a growing number of listings by controlled firms, in 2014 the United Kingdom's Financial Conduct Authority adopted new

67 *See* Joel Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 GEO. WASH. L. REV. 687, 704 n.90 (1986) ("The limited voting class of the common must have the ability—voting as a class—to elect not less than 25% of the board of directors.").

68 *See* Kobi Kastiel, *Against All Odds: Hedge Fund Activism in Controlled Companies*, 2016 COLUM. BUS. L. REV. 60, 92, 126-27, 127 n.212 (2016) (noting that twenty-six Delaware dual-class firms had proportional voting for directors in 2012, including the New York Times Company and Dillard's, Inc.).

69 Massimo Belcredi & Luca Enriques, *Institutional Investor Activism in a Context of Concentrated Ownership and High Private Benefits of Control: The Case of Italy* 4 (European Corp. Governance Inst. (ECGI), Working Paper No. 22/2013, 2014) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2325421 [https://perma.cc/TKA7-TMZ7].

70 *See id.* at 8 (describing that "minority shareholders' power to . . . have at least one [director] candidate appointed" as a "peculiar feature of current Italian corporate governance regulation").

71 *See id.* (describing the introduction and operation of slate voting in Italy); *see also* Ferrarini et al., *supra* note 42, at 392-93 (reviewing slate voting in Italy, which requires "at least one director [to] be elected from the minority slate of directors").

72 The percentage ownership required to submit a slate cannot exceed 2.5% of outstanding shares. Barontini et al., *supra* note 39, at 381.

73 This holds true "provided that [the minority slate] has no link—even indirect—with the majority slate." Ferrarini et al., *supra* note 42, at 392.

74 *See* Barontini et al., *supra* note 39, at 389. For a systematic analysis documenting the effect of this election regime on directors' dissent in the boardroom, see Piergaetano Marchetti et al., *Dissenting Directors* (European Corp. Governance Inst. (ECGI), Working Paper No. 332/2016, 2016).

listing rules aimed at improving investor protection in premium-listed controlled companies.[75] This rule requires a dual-voting structure for the election and reelection of independent directors in controlled companies.[76] Under this regime, the independent director's election or reelection requires approval by both a majority of shareholders and a majority of minority shareholders.[77]

Israel: Finally, Israeli corporate law requires public companies to have at least two "external directors" on their boards.[78] These directors, who must be independent of the controlling shareholder, serve for three years and can be reelected to two additional three-year terms.[79] While public investors do not have the power to elect these directors, they hold veto rights over their election.[80] Moreover, based on the recommendations of a committee in which we took part, a recent amendment provides public investors with the power to reelect an "external director" to the board even against the controller's objection.[81]

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75 *See* Fin. Conduct Auth., Listing Rules (Listing Regime Enhancements) Instrument 2014, FCA 2014/33, at 12, https://www.handbook.fca.org.uk/instrument/2014/FCA_2014_33.pdf [https://perma.cc/8XCU-2N3D] [hereinafter Listing Rules Instrument 2014] ("[The rules are] intended to ensure that the protections afforded to holders of equity shares by the premium listing requirements are meaningful." (emphases omitted)). For a review of these rules, see generally Simon Witty et al., *Enhancing the Effectiveness of The UK Listing Regime—Implementation*, HARV. L. SCH. F. CORP. GOVERNANCE & FIN. REG. (June 1, 2014), http://blogs.law.harvard.edu/corpgov/2014/06/01/enhancing-the-effectiveness-of-the-uk-listing-regime-implementation [https://perma.cc/4392-ZAHM].

76 *See* Listing Rules Instrument 2014, *supra* note 75, at 19 (requiring a listed company with a controlling shareholder "to have in place at all times . . . a constitution that allows the election and re-election of independent directors to be conducted in accordance with [the dual-voting structure] provisions set out in LR 9.2.2ER and LR 9.2.2FR" (emphasis omitted)).

77 If the results of these two votes conflict, the election of the director in question may be decided by way of another, single (ordinary) majority vote at a meeting to be held at least ninety but not more than 120 days after the original vote. *See* Listing Rules Instrument 2014, *supra* note 75, at 20-21.

78 Companies Law, 5759-1999, § 239, 44 (1999-119) (as amended). We have been involved in the development of the Israeli law governing the power of public investors in controlled companies to influence the election of some external directors. During 2006–2008, Assaf Hamdani chaired, and Lucian Bebchuk served as an advisor to, a government committee that recommended reforms to Israel's corporate law to empower minority shareholders to appoint directors. Subsequently, during 2011–2012, Lucian Bebchuk served as the outside-expert advisor to Israel's Economic Concentration Committee whose recommendation led to further enhancing the power of the minority shareholders to elect directors in a subset of Israeli controlled companies.

79 *Id.* § 245.

80 *Id.* § 239(b).

81 Similarly, we should note that Swedish corporate law provides public investors with influence over the nomination of some directors in a subset of controlled companies. The Swedish Code of Corporate Governance sets forth the procedure for establishing a nomination committee for board members, and typically representatives of the three to five largest shareholders in the company are appointed members of the committee. Even when the company has a dominant shareholder, at least one member of the committee must be independent of the company's largest shareholder. *See* Rolf Skog & Erik Sjöman, *Corporate Governance in Sweden, in* THE NORDIC CORPORATE GOVERNANCE MODEL 247 app. D at 260-62 (Per Lekvall ed., 2014). When the dominant shareholder owns less than fifty percent of the voting power, such shareholder must cooperate with other public shareholders in order to secure a majority vote at the annual general meeting. *See* Rolf H. Carlsson, *Swedish Corporate Governance and Value Creation: Owners Still in the Driver's Seat*, 15 CORP. GOVERNANCE 1038, 1049-50 (2007).

III. ENHANCED INDEPENDENCE: BUILDING BLOCKS

Turning independent directors into enhanced-independence directors raises complex issues of legal design. In Section A, we develop a framework of specific measures that can make enhanced-independence directors more accountable to public investors and less dependent on the controller. In Section B, we argue that public investors at controlled firms should have *at least* veto rights over enhanced-independence directors' initial appointment, reelection, and termination. In Section C, we explain why even this minority-veto regime leaves enhanced-independence directors too dependent on controlling shareholders. Thus, we call for a regime that requires support from controllers and public investors for the initial election of enhanced-independence directors, but leaves controllers with no say over the reelection and termination of these directors.

Providing public investors with a say in director elections raises a host of complementary questions that are not directly related to the election regime's structure. We leave the analysis of these questions to the next Part.

A. *Dimensions*

A regime of director elections consists of many specific rules addressing issues that may seem technical or mundane. The cumulative impact of these rules, however, determines the boundaries of the power held by controlling shareholders, public investors, and members of the board. In this Section, we unpack the important dimensions of any director-election regime and identify the different degrees of influence that public investors can enjoy with respect to each dimension. Shareholders generally make three decisions concerning director elections:

- Election of a new candidate to the board (*initial appointment*);
- Reelection of an incumbent director for another term (*reelection*); and
- Removal of an incumbent director before her term ends (*termination*).[82]

[82] The regime governing director termination is important in our framework for two reasons. First, without restrictions on its ability to terminate enhanced-independence directors, the controller can circumvent public investors' influence over enhanced-independence directors' election. This is consistent with the general rule that only the party who nominates a director can fire her. *See, e.g.*, 8 DEL. CODE ANN. tit. 8, § 141(k) (2016) (limiting the ability to remove directors with no cause to the holders of the class of shares electing them). Second, placing limits on enhanced-independence directors' termination can weaken these directors' dependence on the controller even when public investors have no say on director elections. Perhaps the weakest regime in our context would be to retain the controller's existing rights to elect directors, but to marginally insulate enhanced-independence directors by preventing the controller from firing them, without public investors' consent, before the end of their predetermined terms. This rule would leave intact directors' bond of loyalty stemming from their initial election and from their desire for reelection. But an independent director—or a group of directors—who rises against abuses by the controller would not automatically face the threat of an immediate dismissal.

The powers of the controller and of public investors over each of these dimensions will determine the extent to which enhanced-independence directors are accountable to the latter and insulated from the former.[83] For each of the initial appointment, reelection, and termination decisions, public investors can wield one of the following degrees of influence:[84]

- No say in directors' initial appointment, reelection, and termination. The controller alone has the power to determine the outcome of the vote (the *controller-election rule*). This is the historical norm for director election.[85]
- Power to veto the controller's decisions (the *minority-veto rule* or the *veto-rights rule*).
- Exclusive power to make a decision even against the controller's objection (the *minority-election rule*).

The degree of influence held by controllers and private investors does not have to be the same for each type of decision. Policymakers can vary public investors' degree of influence across dimensions (choosing from among at least twenty-seven specific combinations) to produce the precise balance of power between controlling shareholders and public investors that they find optimal. For example, granting public investors more power over reelection than initial appointment decisions can create an appropriate balance between the need to make enhanced-independence directors accountable to public investors and the concern about undermining the controller's ability to manage the company.

At the same time, policymakers should be aware that adopting one regime to govern one dimension may affect another dimension. Granting public investors a say over initial appointment decisions, for example, will not have much impact if the controlling shareholder has the unlimited power to fire directors at will. Finally, note that lawmakers can take power away from the controller without increasing the degree to which public investors can influence director elections. For example, one could restrict the ability of controllers to fire directors by setting mandatory terms limits without providing public investors with the power to elect or veto directors.

Table A summarizes the options that are available for policymakers vis-à-vis the prevailing regimes in the United States, the United Kingdom, Israel, and Italy.

Although rare, there are cases in which directors decide to confront the controlling shareholder. *See, e.g.*, *In re* Dole Food Co., Inc. Stockholder Litig., No. 8703, 2015 WL 5052214, at *12 (Del. Ch. Aug. 27, 2015) (describing two outside directors' opposition to a self-tender proposed by the controller).

83 A director election regime often addresses other dimensions, such as directors' term limits and the right to nominate directors. We address these dimensions below. *See infra* Sections IV.C–D.

84 We assume for now that public investors make decisions through a majority-of-minority vote. We discuss cumulative voting in subsection III.C.4.

85 *See supra* Section II.B.

Table A: Director Election Regimes

	Controller-Election Rule	Veto Rights	Minority Power
Initial Appointment	United States	United Kingdom, Israel	Italy, AMEX
Termination	United States, United Kingdom, Italy	Israel	AMEX
Renewal	United States	United Kingdom	Israel, AMEX

The gray-shaded column represents the prevailing U.S. regime. As explained in Part II, the default regime in the United States, as in many other countries, follows the controller-election rule for all dimensions: that is, the controlling shareholder has the exclusive power to make initial appointment, reelection, and termination decisions. Public investors have no say over these decisions. A shareholder with a majority of the votes can elect all board members, decide whether to renew their terms, or fire them at will.

Both the old AMEX guidelines and the Italian regime adopt the minority-election rule with respect to directors' initial election decisions.[86] These regimes empower public investors to appoint some fraction of board members even against the controller's objection. The United Kingdom's new listing regime and Israeli corporate law adopt the veto rights rule to govern enhanced-independence directors' initial appointments.[87] Under the UK regime, for example, the appointment of independent directors requires not only a majority of the votes cast at the meeting but also a majority-of-minority shareholder vote.[88]

Israel and the United Kingdom, however, provide public investors with different degrees of influence over director reelection decisions. While the United Kingdom adopts the minority-veto rule, Israeli law adopts the minority-election rule, under which public investors can decide to reelect an incumbent enhanced-independence director even against the controller's objections.

B. *Veto Rights*

In this Section, we argue that public investors should have at least veto rights over enhanced-independence directors' initial appointment, reelection, and termination. Although it will not eliminate these directors' dependence

86 *See supra* text accompanying notes 68–73.
87 *See supra* text accompanying notes 75–77, 79–80.
88 *See supra* text accompanying note 77.

on the controller, this regime offers a compromise between the need to make enhanced-independence directors accountable to public investors and the concern that the minority-election rule will disrupt the controller's ability to run the company.[89]

1. Benefits

For enhanced-independence directors to be accountable to public investors, these investors should have at least veto rights over the directors' initial appointment and reelection. In other words, the minority-veto rule is the threshold requirement for enhanced-independence directors. To prevent the controlling shareholder from circumventing the regime by firing directors who do not favor its own interests, public investors' veto power should also extend to enhanced-independence directors' termination. Under this regime, however, public investors cannot appoint enhanced-independence directors to whom the controlling shareholder objects.

This minority-veto regime offers a compromise between the need to make enhanced-independence directors accountable to public investors and the concern that denying the controller any say over director election would undermine its ability to run the company. Public investors cannot appoint enhanced-independence directors or reelect them against the controller's will, but they can prevent the appointment of an enhanced-independence director who is clearly beholden to the controller or whose reputation suggests that she will not adequately safeguard public investors' interests. Thus, while this regime will not eliminate enhanced-independence directors' dependence on the controller, these directors still need public investors' support for their initial appointment and reelection.

Public investors' veto power is perhaps most effective in the decision to reelect an incumbent enhanced-independence director. Public investors will presumably decide how to vote on the basis of the director's past performance on the board.[90] A director who favored the controller's interests over those of the company or its public investors might be voted out of office. This, then,

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89 *See* Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE L.J. 560, 594-605 (2016) (proposing a theory stressing the value of enabling controlling shareholders to set the firm's strategic direction).

90 For instance, Institutional Shareholder Services (ISS) examines the accountability, responsiveness, composition, skills, and independence of each director and the board as a whole. A combination of poor company performance and poor accountability may lead to a negative vote, as may a lack of proper attendance and sitting on an excessive number of other boards. INSTITUTIONAL S'HOLDER SERVS., UNITED STATES SUMMARY PROXY VOTING GUIDELINES: 2015 BENCHMARKS POLICY RECOMMENDATIONS 11-15 (2015), http://www.issgovernance.com/file/policy/1_2015-us-summary-voting-guidelines-updated.pdf [https://perma.cc/53TM-LTFG].

provides enhanced-independence directors with an incentive to cater to public investors' interests.

Critics may argue that this regime leaves the controller with too much power. As we explain below, controllers are more likely than public investors to make effective use of their veto rights, thereby undermining the accountability incentives generated by the minority-veto rule. By contrast, supporters of this regime may argue that it introduces a significant degree of accountability to public investors while addressing the concern that the minority-election rule will excessively interfere with the controller's ability to determine the company's business strategy.

2. Implementing Veto Rights

The principal mechanism for granting public investors veto rights over an enhanced-independence director's initial appointment and reelection is requiring that the director be approved by a majority of votes cast by public investors—that is, shareholders unaffiliated with the controller—in addition to an ordinary majority of shareholders. For example, assume that the controlling shareholder holds sixty percent of the company's voting rights. To be elected under the minority-veto rule, an enhanced-independence director would have to be approved by an ordinary majority (the controller) and by a majority of the forty percent not affiliated with the controller.[91]

Granting public investors influence over enhanced-independence director elections raises the issue of nomination rights. In other words, who will have the power to nominate candidates for an enhanced-independence director position? One can think of two approaches. Under one approach, only the controlling shareholder (or the company or its nomination committee) can put forward candidates for an enhanced-independence director position, and public investors can only approve or reject the nominated candidate. Alternatively, public investors (holding a certain percentage of shares) as well as the controller can nominate candidates for the enhanced-independence director position.

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91 In controlled companies with a one-share-one-vote structure, another mechanism that could be considered is requiring that enhanced-independence directors be approved by a supermajority of the votes—say sixty-six percent. Such a rule has two benefits. First, it relieves companies and courts of the complicated task of classifying shares into those affiliated and those unaffiliated with the controller. Second, it provides a relatively simple mechanism for allowing controllers with larger control blocks to have greater influence in electing enhanced-independence directors. Such an effect is arguably desirable because controllers' incentives to divert resources become weaker as their equity stake increases.

The right to nominate directors is rather consequential for widely held firms,[92] but may not be as important under the veto-rights rule. Even when both public investors and the controlling shareholder have the same nominal power to put a candidate up for election, the controller is more likely to use its nomination right. Collective action problems that discourage dispersed public investors from nominating candidates to the board. This disincentive is exacerbated when it is clear that no director can be elected against the controller's objection. Nevertheless, we believe that public investors should have the right to nominate candidates, as it would improve their bargaining position vis-à-vis the controller.

Finally, one may argue that the veto rights regime can lead to a deadlock in which the controller and public investors cannot agree on a candidate. We believe, however, that this is not a significant concern. Even if a director nominated by the company occasionally fails to get elected, the controller and public investors will ultimately agree on a candidate, and the law could design mechanisms for ensuring continuity in the interim.[93] Moreover, the deadlock threat would discourage controllers from nominating candidates whom public investors are reasonably likely to reject.

C. *Beyond Veto Rights?*

The preceding Section presented the case for providing public investors with at least a veto right over enhanced-independence directors' initial appointment, reelection, and termination. In our work for the Israeli government, however, we recommended the adoption of a regime that went beyond veto rights to provide public investors with the exclusive power to appoint enhanced-independence directors. In this Section, we explain why the veto rights regime, by itself, is unlikely to make enhanced-independence directors effective monitors of controlling shareholders. Based on this analysis, we present the case for a regime under which public investors have at least the exclusive power at least over reelection and termination decisions.

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92 Nomination rights also would be important under the minority-election rule that we discuss in the next Section.

93 Another question is whether shareholders would use their power to vote on director elections. This in turn may depend on whether institutional shareholders are required to cast a vote. *See* Assaf Hamdani & Yishay Yafeh, *Institutional Investors as Minority Shareholders*, 17 REV. FIN. 691, 701 (2012) (finding that institutional investors in Israel do not vote on director elections even when the law grants them the power to veto the controller's candidates); *see also* Belcredi & Enriques, *supra* note 69, at 9 ("[N]o Italian institutional investor is under a legal obligation to exercise its voting rights in investee companies.").

1. Veto Rights May Not Be Enough

In theory, the veto-rights rule would make enhanced-independence directors equally accountable to public investors and controlling shareholders. However, in practice, inevitable differences between public investors and controlling shareholders make this regime tilted in favor of the latter.

First, controllers enjoy a clear informational advantage over public investors. Evaluating a new candidate for an enhanced-independence director position requires information about the candidate's qualifications and past performance on other boards. Public investors suffer from collective action problems, and they may lack incentives to acquire the information needed for evaluating candidates.[94] The controlling shareholder, in contrast, holds a sufficiently large stake to provide it with the incentive to acquire that information. This informational asymmetry between controllers and public investors becomes stronger with respect to reelection and termination decisions, as the controlling shareholder has superior access to nonpublic information about the incumbent director's past board performance.

Second, collective action problems may undermine public investors' ability to make effective use of their veto rights. As explained earlier,[95] dispersed public investors are less likely than the controller to nominate a candidate to an enhanced-independence director position, especially when the controller retains the right to nominate its own candidates to the board. To be sure, a minority blockholder may find it worthwhile to incur the costs associated with nominating a candidate, but, for the most part, public investors will tend not nominate a candidate.

To summarize, these differences would undermine the effective exercise of the powers bestowed on public investors by the veto-rights regime. Public investors are most likely to use veto rights only to prevent the appointment of clearly unqualified directors or the reelection of directors whose past performance demonstrates a willingness to disregard public investors' interests. By contrast, the controller will likely effectively exercise its powers over director nomination, election, and reelection. Even under this regime, therefore, enhanced-independence directors would likely remain more accountable to the controller than to public investors.

2. Public Investors' Election Rights

The minority-election regime provided a stronger measure for making enhanced-independence directors accountable to public investors. This regime

94 *See* Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 584-91 (1990) (discussing rational apathy and the dynamics of shareholders' incentives to become informed).

95 *See supra* subsection III.B.2.

provides public investors with the right to elect enhanced-independence directors over the objections of the controlling shareholder. As with veto rights, this regime provides enhanced-independence directors with incentives to protect public investors, as these directors will depend on public investors' support to be elected. Unlike veto rights, however, a minority-election regime does not provide enhanced-independence directors with incentives to favor the controller, whose support is not required for their continued service on the board. Such a regime could eventually facilitate a market for professional enhanced-independence directors whom public investors will nominate and elect.[96]

An effective minority-election rule requires that public investors, at least occasionally, use their rights to appoint their own representatives to the board. Moreover, eliminating incentives to favor the controller requires that the controller be unable to exert influence over the election of enhanced-independence directors. However, the experience with widely held firms in the United States demonstrates that even insiders who lack formal power to nominate directors may exert considerable influence over director elections through their de facto control over the nomination process. Therefore, the ultimate impact of the minority-election rule will depend both on the rules governing director nominations and on the degree to which public investors will use their election and nomination rights.

First, consider director nomination rules. Even if public investors have the right to nominate enhanced-independence directors, the likelihood that public investors will do so depends on the preconditions for making nominations. If the percentage of shares required to nominate directors is too high, for example, dispersed public investors may find it too costly to organize and put forward a list of candidates. Thus, unless the company has a minority blockholder with enough at stake, controlling shareholders will continue to influence director nominations.

Next, consider the extent to which public investors are likely to use their nomination rights. Rules that facilitate director nomination by public investors will eliminate the controller's de facto control over the process only to the extent that public investors actually use their power. This in turn may depend on the degree of shareholder activism by institutional investors or on the presence of activist hedge funds in each country.

At any rate, empowering public investors to nominate candidates does not mean that those investors should always use that right. If they trust the controller, public investors may vote for the controller's candidates rather than nominate their own. Yet, the mere power to nominate their own candidates provides public investors with an important check on the controller.

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96 For a proposal for creating a market of professional directors appointed by institutional investors, see Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors,* 43 STAN. L. REV. 863 (1991).

The analysis thus far has addressed the concern that even the minority-election rule would leave controllers with de facto influence over director elections. Another potential objection to this rule, however, is that it provides public investors with too much power. Allowing public investors to elect directors, so the argument goes, would interfere with controlling shareholders' ability to exercise appropriate control over the corporation. Furthermore, it might be argued, this interference would be counterproductive for public investors, who generally benefit from the controllers' monitoring of management.[97]

We consider these objections in Section V.A below. As we explain there, enhanced-independence directors would have an important role only in those cases where the legal system recognizes the need to protect public investors from controllers' conflicts. However, even those who are genuinely concerned that providing public investors with full election rights would interfere with the controller's ability to manage the firm should accept a regime under which public investors have exclusive power only over reelection and termination decisions. We discuss this regime in the next subsection.

3. Reelection and Termination

Under this regime, both public investors and the controller have veto rights at the initial appointment stage. At the reelection stage, however, the minority-election rule applies and public investors can reelect an incumbent director regardless of the controller's position. To prevent controllers from circumventing this reelection power, public investors should also have at least veto rights over termination decisions. This regime addresses the concerns underlying both the minority-veto rule, discussed in Section III.B., and the minority-election regime, discussed in the preceding subsection.

First, the controller's veto right at the initial election stage removes the concern that the minority-election rule will interfere with the controller's ability to run the company or lead to the appointment of unfit directors. After all, by supporting the directors' initial election, the controlling shareholder has signaled its judgment that these directors are qualified to join the board. Even those who believe that the controller should have the power to veto candidates can agree that from this point on, enhanced-independence directors should be most concerned about the views of public investors.

Second, compared to the veto-rights rule, this regime bolsters enhanced-independence directors' accountability to public investors. Because the controller has no formal say over reelection and termination, directors will not depend on the controller for the continuation of their service on the board and, therefore,

97 For an analysis of the potential cost of providing public investors at controlled companies with excessive protection, see Goshen & Hamdani, *supra* note 89, at 595-98.

have no significant incentive to accommodate the controller's interests after their initial appointment.

Third, this regime prevents controllers from circumventing any rules against firing directors. A director who knows that her reelection depends on the controller's support may decide to resign if she feels that the controller is unlikely to support her.[98] With just a hint of the controller's intentions, the director might resign to save herself the embarrassment of not getting reelected or nominated. By giving public investors sole authority for termination decisions, the minority-election rule would preclude such measures.

Finally, this regime can be beneficial for legal systems wishing to pursue a gradual approach to director-election reforms at controlled companies. For example, countries where public investors currently have no say in enhanced-independence director elections may want to start with a regime that grants public investors some limited powers without denying the controller any role.

To be sure, this intermediate regime leaves controllers with considerable influence over enhanced-independence directors. Directors will remain dependent on the controller for their initial appointment, and, as under the prevailing regime, they might feel gratitude towards the shareholder who appointed them—in other words, "You dance with the one who brought you to the party." As we explained above, however, this regime alleviates any concerns that eliminating the controller's ability to conduct initial screening of candidates would prove counterproductive.[99]

4. Cumulative Voting

The analysis has thus far assumed that the mechanism for providing public investors with election rights is subjecting enhanced-independence director election to a majority-of-minority vote. Another way to allow public investors to elect directors is with a cumulative voting system.

Cumulative voting essentially provides for proportional board representation, in which a sufficiently large minority can elect one or more board members.[100] Under "straight" voting, shareholders hold a separate vote for each seat. Thus, a

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98 *See* Michaël Dewally & Sarah W. Peck, *Upheaval in the Boardroom: Outside Director Public Resignations, Motivations, and Consequences*, 16 J. CORP. FIN. 38, 51 (2010) ("[D]irectors resign when they feel they can no longer monitor the CEO.").

99 One can think of complex or intermediate versions of this regime. For example, a regime under which the controller has to elect a list of candidates (say twice the number of open enhanced-independence director positions on the board) from which public investors will have to choose. We do not discuss such complex variations in this Article.

100 For a formal analysis of the likely outcomes of cumulative voting under different patterns of share ownership, see Arthur T. Cole, Jr., *Legal and Mathematical Aspects of Cumulative Voting,* 2 S.C.L.Q. 225 (1950), and Amihai Glazer et al., *Cumulative Voting in Corporate Elections: Introducing Strategy into the Equation*, 35 S.C. L. REV. 295, 299-308 (1984).

shareholder with a majority of the votes can elect all board members. In a cumulative voting system, shareholders vote for candidates as a group: each share entitles its owner to as many votes as there are directors to be elected, and shareholders can allocate their votes among candidates as they choose.[101]

Cumulative voting can, in some cases, enable public investors to elect directors. It might thereby be superior to the prevailing regime, under which the controller alone elects all board members.[102] Nevertheless, we find cumulative voting to be overall inferior to the minority-election rule.

First, cumulative voting cannot be used to produce some of the intermediate regimes designed to balance public investor protection against controller rights. For example, it would be quite challenging to use this mechanism to provide public investors with different degrees of influence over different decisions concerning director election say, one that applies the minority-veto rule to initial appointments but the minority-election rule to reelection and termination decisions.

Second, cumulative voting is difficult to combine with a regime that assigns special tasks to enhanced-independence directors. Enhanced-independence directors should play an active role in monitoring controllers' conflicts, such as vetting self-dealing transactions, but under cumulative voting, it may be difficult to

101 *See* Jeffrey N. Gordon, *Institutions as Relational Investors: A New Look at Cumulative Voting*, 94 COLUM. L. REV. 124, 127 n.8 (1994) (describing the features of cumulative voting). Another regime that would enable public investors to appoint at least some representatives to the board is "list voting." For an analysis of this regime and a proposal to adopt it even for companies without controlling shareholders, see Marco Ventoruzzo, *Empowering Shareholders in Directors' Elections: A Revolution in the Making,* 8 EUR. COMPANY & FIN. L. REV. 105 (2011).

102 Cumulative voting offers two advantages over the majority-of-minority regime. First, it obviates the need to engage in the complicated task of identifying shareholders unaffiliated with the controller. Second, it provides controllers with greater influence. Assume that the board has ten members. A controller with fifty-one percent of the votes would be able to elect at least five board members; a controller with eighty percent of the votes, in contrast, would be able to elect at least eight board members. This outcome is consistent with the view that public investors' protection should become weaker as the percentage of the controller's economic ownership increases. *See* Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911, 1947-49 (1996) (arguing that cumulative voting can give "large minority shareholders a place on the board and a voice in board actions"); *see also* Bernard Black et al., *Corporate Governance in Korea at the Millennium: Enhancing International Competitiveness: Final Report and Legal Reform Recommendations to the Ministry of Justice of the Republic of Korea*, 26 J. CORP. L. 537, 589-90 (2001) (recommending that Korea strengthen cumulative voting to protect large minority shareholders); Pritchard, *supra* note 38, at 21-22 (arguing that making cumulative voting mandatory would allow institutional investors in Korea "to have an effective voice" on board composition). Cumulative voting is common in Chile. *See* WORLD BANK, REPORT ON THE OBSERVANCE OF STANDARDS AND CODES (ROSC): CORPORATE GOVERNANCE COUNTRY ASSESSMENT: CHILE 4 (2003), https://openknowledge.worldbank.org/bitstream/handle/10986/14493/350180CL0Corporate0governance0rosc1chlcg.pdf [https://perma.cc/4UBP-V7WM]. In Brazil, cumulative voting is a right of "shareholders holding at least 10% of the common shares." Bernard S. Black et al., *Corporate Governance in Brazil*, 11 EMERGING MARKETS REV. 21, 29 (2010).

identify the directors whom public investors actually elected. Third, cumulative voting can enable a minority shareholder with a substantial stake to appoint a director of whom the majority of public investors disapprove. In contrast, a majority-of-minority requirement ensures that such a minority blockholder will be able to get a director on the board only if the majority of public investors support her; the requirement thus addresses the concern that the blockholder would be able to use the director to its benefit at the expense of the majority of public investors.[103]

IV. DESIGN AND IMPLEMENTATION

In the remainder of this Article, we use the term *enhanced-independence directors* to refer to independent directors whose appointment, reelection, and termination are at least subject to the minority-veto regime. In this Part, we turn to discuss how policymakers could implement reforms designed to promote enhanced-independence directors.

Section A focuses on legal regimes—most notably Delaware's corporate law—that use judicial review standards for encouraging the use of independent directors. We explain that, in such regimes, courts can similarly encourage the use of enhanced-independence directors by according substantial deference to director approval of conflicted decisions only when the approval is made by enhanced-independence directors. Section B in turn considers regimes that use legislation, regulations, or listing standards to require publicly traded companies to appoint independent directors and have them play a role in vetting conflicted decisions. We explain that, in such regimes, it would be desirable to replace substantial reliance on independent directors with reliance on enhanced-independence directors.

The remainder of this Part discusses implementation issues that both regimes need to consider. Section C examines the number of enhanced-independence directors that should be on a board and the role that they should play. Section D considers the role of term limits in supplementing enhanced-independence director election rules. Section E discusses whether enhanced-independence directors should be independent from minority blockholders.

103 Another difficulty with cumulative voting is that it requires complicated adjustments for companies with a staggered board, for companies with a dual-class voting structure, or for companies whose shareholders have special election rights. *See* McDonough v. Copeland Refrigeration Corp., 277 F. Supp. 6, 7-8 (E.D. Mich. 1967) (discussing an attempt to evade mandatory cumulative voting rules by staggering the board).

For completeness, we should also note that cumulative voting has the advantage of making it unnecessary to identify shareholders unaffiliated with the controller. Still, for the reasons explained above, we view cumulative voting to be overall inferior to the minority-election regime.

A. *Regimes Based on Judicial Review*

For concreteness, we shall focus below on Delaware, the most well-known regime that is based on judicial review. Delaware's corporate statute does not require companies to appoint independent directors. Rather, Delaware's courts use standards of judicial review to encourage companies to appoint independent directors and to assign them a role in approving conflicted decisions.[104]

As we explained above, however, directors whose appointment, retention and termination are solely determined by the controller cannot be relied on to guard against controller opportunism. Therefore, Delaware courts should not grant any substantial cleansing power to approval of conflicted decisions by independent directors. Courts can encourage the use of enhanced-independence directors by according substantial deference to director approval of conflicted decisions only when the approval is made by enhanced-independence directors. Reliance on enhanced-independence to guard against controller opportunism would be far superior to reliance on independent directors who are completely dependent on the controller for their appointment.

Indeed, adopting the enhanced-independence approach might, in some cases, provide an option to avoid more costly interventions. Some Delaware court decisions, such as the recent decision by Vice Chancellor Laster in *EzCorp*, have expressed reluctance to defer to approval of self-dealing transactions by independent directors appointed by the controller.[105] Under this approach, any self-dealing transaction by the controller, however small in scale, would be subject to close judicial scrutiny if challenged unless approved by a majority-of-the-minority shareholder vote. Either route would involve significant costs. Enhanced-independence directors offer an alternative route with a cleansing device that some might deem to be sufficiently effective to forgo such interventions.

Finally, we should note that the judicial approach considered in this Section would encourage rather than require companies to have enhanced-independence directors. Controllers could decide not to have enhanced-independence directors if they viewed them as too costly. In such a case, the controller would have to

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104 *See supra* text accompanying notes 32–34. The analysis here applies to any legal system that relies on courts to encourage companies to appoint independent directors and entrust them with reviewing self-dealing transactions. For a thoughtful analysis of the role of judicial review in regulating self-dealing transactions, see Zohar Goshen, *The Efficiency of Controlling Corporate Self-Dealing: Theory Meets Reality*, 91 CALIF. L. REV. 393 (2003).

105 *See In re* Ezcorp Inc. Consulting Agreement Derivative Litig., No. 9962, 2016 WL 301245, at *11 (Del. Ch. Jan. 25, 2016) ("Under current law, the entire fairness framework governs any transaction between a controller and the controlled corporation in which the controller receives a non-ratable benefit."); T. Rowe Price Recovery Fund, L.P. v. Rubin, 770 A.2d 536, 552 (Del. Ch. June 23, 2000) ("[B]oth the Supreme Court and this court explicitly held that the entire fairness standard of review applies in the non-merger context to interested transaction involving controlling stockholders.").

either avoid self-dealing transactions and other conflicted decisions or bear the costs of having them subject to judicial scrutiny.

B. *Regimes Based on Legislation or Regulation*

As explained above, jurisdictions in other parts of the world have legal rules requiring controlled companies to have independent directors and requiring that these directors approve certain conflicted decisions.[106] Our analysis indicates that it would be preferable for these jurisdictions to replace their substantial reliance on independent directors with substantial reliance on enhanced-independence directors.

To implement the enhanced-independence approach, such jurisdictions would have to adopt their own system of rules that address the aspects of the enhanced-independence regime that we discuss in this Article. Among other things, such a jurisdiction would have to specify the required number of enhanced-independence directors; the type of input rights that public investors would have at the initial election, retention, and termination stages; and the type of corporate decisions that enhanced-independence directors would have to approve. The framework that we provide in this Article could be useful for the design of the necessary rules and regulations.

C. *Number and Role of Enhanced-Independence Directors*

Our analysis thus far has focused on the director election regime. In this Section, we discuss the supplementary arrangements required to ensure that, once elected, enhanced-independence directors will be able to play a meaningful role in vetting conflicted decisions. Our analysis aims to highlight the principal considerations that should guide policymakers. A full analysis of these issues is beyond the scope of this Article.

Enhanced-independence directors cannot protect public investors unless they hold sufficient power over conflicted decisions. At the same time, providing these directors with too much power might undermine the controller's ability to run the firm. Thus, enhanced-independence directors should play a dominant role in reviewing conflicted decisions but take a backseat with respect to other corporate affairs.

1. Role

On the one hand, as enhanced-independence directors become more accountable to public investors, the controller and the directors it puts in place might try to marginalize enhanced-independence directors. Even if they are

106 *See supra* text accompanying notes 36–42.

genuinely accountable to public investors, enhanced-independence directors cannot adequately safeguard public investors' interests if such directors lack the power to veto self-dealing and other tunneling transactions.[107]

On the other hand, providing enhanced-independence directors with overly broad powers can interfere with the controller's ability to run the company even when its interests align with those of public investors. Practically, the controller exercises its control by appointing its representatives to the board. As directors become less dependent on the controller for their election, the controller's ability to exert influence over the company's direction declines. Under the minority-election regime, for example, public investors can elect directors even against the controller's objection. These minority-elected directors may have their own views concerning the direction that the company should take, thereby interfering with the controller's ability to exercise control.[108]

Therefore, lawmakers should not grant enhanced-independence directors too much power over issues that raise no conflict between the controller and public investors. As a matter of principle, the role of enhanced-independence directors should track the fundamental distinction between business and self-dealing transactions. These directors should play a critical role in decisions that raise concerns about a conflict of interest between the controller and public investors. They should thus have the power to review, negotiate, and approve freezeouts and other self-dealing transactions involving the controlling shareholder.[109] But the controller-elected directors should be able to decide such issues as the firm's business strategy even over enhanced-independence directors' objections.[110]

107 *See, e.g.*, Donald C. Clarke, *The Independent Director in Chinese Corporate Governance*, 31 DEL. J. CORP. L. 125, 209-10 (2006) (noting, with respect to Chinese corporate law, that "[c]orporate officers and fellow directors have few incentives to listen to independent directors because independent directors have little in the way of veto power over corporate actions").

108 One of us has recently argued that controllers may find it difficult to convey to independent directors the value of their vision for the company. *See* Goshen & Hamdani, *supra* note 89, at 601 ("[A]symmetric information and differences of opinion could prevent the controller-entrepreneur from credibly communicating her idiosyncratic vision . . . .").

109 Should enhanced-independence directors play a role in monitoring financial disclosure? While a full analysis of this question is outside the scope of this Article, we are inclined to answer this question in the negative for two reasons. First, although controllers may occasionally have reasons to mislead public investors (when they raise capital, for example), it seems that financial disclosure is not a pervasive source of conflicts between controllers and public investors. Second, given the severe legal and reputational sanctions associated with misreporting, it is unclear that making directors accountable to minority investors would play a meaningful role in inducing independent directors to ensure accurate reporting.

110 Drawing the line between conflicted and nonconflicted decisions regarding the public investors' interests is not always easy. For discussions of the difficulties involved in drawing this line, see Luca Enriques, *Related Party Transactions: Policy Options and Real-World Challenges (With a Critique of the European Commission Proposal)*, 16 EUR. BUS. ORG. L. REV. 1, 2 (2014); and Goshen & Hamdani, *supra* note 89, at 606-08. As noted earlier, this Article does not seek to contribute to the identification of the corporate decisions that the law should regard as conflicted.

2. Number

Because enhanced-independence directors should play an important role in evaluating and approving conflicted decisions, we believe that companies should appoint at least two such directors.[111] At the same time, enhanced-independence directors should not constitute a majority of the board. As we explained above, granting these directors too much say over corporate affairs may undermine the controller's ability to set the strategic direction of the firm. Were enhanced-independence directors to constitute a majority of the board, they would have the power to set the firm's direction and make other decisions over the objections of the controller's representatives, even in the absence of any conflict of interest. Thus, limiting enhanced-independence directors to a minority of the board offers a reasonable balance between controller management and minority protection.

D. *Length of Appointment*

Arrangements concerning directors' terms in office can supplement rules concerning their elections. The need for term limits and tenure requirements generally arises when the director election regime leaves even enhanced-independence directors somewhat dependent on the controller, such as under the minority-veto rule. As we explain in this Section, however, this need may arise for other reasons, including when public investors have substantial influence over director elections.

Consider first the prevailing regime, under which the controller-election rule applies and companies do not have enhanced-independence directors. Although independent directors are not accountable to public investors, subjecting them to both term limits and minimum-tenure requirements limits controllers' ability to terminate them and, consequently, weakens their dependence on the controllers. To be sure, these directors will depend on the controller for their initial appointment and reelection. Yet, limiting how many years they can serve constrains the controller's ability to "reward" directors with reelection.[112] At some point, these directors will have to leave the board

111 As described above, the regime in Italy requires only one enhanced-independence director. *See* Belcredi & Enriques, *supra* note 69, at 8; *see also supra* text accompanying notes 70–73.

112 Note that Delaware courts have not taken the view that an especially long time of board service at a controlled company categorically undermines director independence. *See, e.g.*, Friedman v. Dolan, No. 9425, 2015 WL 4040806, at *6 (Del. Ch. June 30, 2015) (holding that "[n]either long-term board service nor the mere fact that one was appointed by a controller suffices" to subvert independence (citations omitted); *In re* BJ's Wholesale Club, Inc. S'holders Litig., No. 6623, 2013 WL 396202, at *6 n.63 (Del. Ch. Jan. 31, 2013) (explaining that allegations of "'nearly twenty years of Board service alongside [one director] and a long-term relationship with [another director]' . . . [did] not raise a reasonable doubt as to . . . independence under Delaware law" (quoting Verified Consolidated Second Amended Class Action Complaint ¶ 68, BJ's Wholesale Club, Inc. S'holders Litig., No. 6623, 2013 WL 396202 (Del. Ch. Jan. 31, 2013) (No. 6623))). For a thorough analysis of the effect of director tenure on

regardless of the controller's satisfaction with their service. Similarly, requiring that directors serve for some predetermined number of years before they can be replaced ensures that the controller would not be able to displace directors who do not cater to its interests.[113]

Now consider a regime that adopts the minority-election rule, in which public investors can appoint enhanced-independence directors against the controller's objection. Under this regime, term limits are unnecessary and even harmful. These enhanced-independence directors will be accountable to public investors and have no dependence on the controller. Without any term limits, they will face ongoing incentives to act in a manner that will be beneficial for public investors.

Finally, consider the regime in which public investors have only veto rights over an enhanced-independence director's initial appointment but can reelect that director even against the controller's objections. In this case, term limits may be required to protect the controller. This regime's underlying premise is that the controller's support for a director at the initial appointment stage ensures that this director is qualified to serve on the board. Yet, without term limits, public investors could permanently force a director on the majority shareholder simply because of that shareholder's initial consent to her appointment. Indeed, Israeli corporate law, which adopts this regime, imposes a limit on the number of years that these directors can serve on the board.[114]

E. *Independence from Minority Blockholders*

Should enhanced-independence directors be independent from public investors, especially from significant blockholders who nominated them?[115] We do not take a firm position on this question but would like to flag it. Policymakers should consider this issue, especially where enhanced-independence arrangements provide public investors with full election rights.

To illustrate, assume that the controller owns sixty percent of the company's shares and that the minority-election rule applies. In this regime, public investors have the exclusive right to appoint enhanced-independence directors regardless of the controller's view. Assume further that a large investor, owning eight percent of the shares, nominates an enhanced-independence

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director independence, see generally Yaron Nili, *The "New Insiders": Rethinking Independent Directors' Tenure*, 68 HASTINGS L.J. 97 (2016).

113 *See, e.g.*, *In re* Dole Food Co. Stockholder Litig., 2015 WL 5052214, at *1528 (Del. Ch. Aug. 27, 2015) (describing how a controlling shareholder and one of his senior executives forced an outside director who opposed a self-tender offer proposed by the controller to resign).

114 They can serve no more than three terms of three years. *See* Israeli Companies Law, 5759–1999, § 245, 44 (1999-119).

115 For a discussion raising concerns about directors who are not independent of the minority shareholders that nominated them, see Gutiérrez & Sáez, *supra* note 6, at 91.

director. Clearly, this director should be independent of the controller and the company. But should she be independent from the blockholder who put forward her candidacy?

The case *against* this new independence requirement relies on the premise that shareholders with a significant equity stake have an incentive to monitor corporate insiders for the benefit of the company and its public investors. Having blockholders' representatives on the board will enable them to monitor corporate insiders more effectively. Indeed, studies have found that the presence of blockholders on the board tends to improve pay practices and CEO accountability.[116] Moreover, unlike controlling shareholders under the majority-election rule, blockholders in our setting (i.e., minority shareholders with a significant equity stake) cannot dictate the outcome of a shareholder vote. Rather, a blockholder-nominated candidate will join the board only if a majority-of-minority shareholders support her candidacy.[117] This majority-of-minority requirement alleviates the concern that blockholders might appoint directors in order to pursue their own agendas.[118]

The case *for* requiring extra independence focuses on the concern that blockholders who nominate directors may pursue their own agendas to extract private benefits or disrupt the controller's ability to run the firm. Directors with no ties to a blockholder are more likely to advance the interests of the company and its public investors even when that blockholder nominated them for the position.[119]

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116 *See* Lucian A. Bebchuk et al., *Lucky CEOs and Lucky Directors*, 65 J. FIN. 2363, 2365 (2010) (finding that having a compensation committee that is both independent and includes at least one blockholder reduces the likelihood of "lucky" option grants to corporate executives); *see also* Anup Agrawal & Tareque Nasser, Blockholders on Boards and CEO Compensation, Turnover and Firm Valuation 26 (Sept. 1, 2012) (Am. Fin. Ass'n 2012 Chi. Meetings Paper, 2012), https://ssrn.com/abstract=1443431 [https://perma.cc/G4GC-97EA] (finding that CEOs of firms with blockholder directors tend to have lower pay and higher turnover-performance sensitivity).

117 As we explained earlier, the need to prevent blockholders from having the power to appoint directors not supported by a majority of minority investors is an important reason to disfavor cumulative voting. *See supra* subsection III.C.4.

118 Some of the issues that we analyze here arise also in the context of widely held firms, where the question is whether directors nominated by activist investors should be independent from these investors. For a discussion of these issues in the latter context, see generally Matthew D. Cain et al., *How Corporate Governance Is Made: The Case of the Golden Leash,* 164 U. PA. L. REV. 649 (2016), and Yaron Nili, *Servants of Two Masters? The Feigned Hysteria over Activist-Paid Directors,* 18 U. PA. J. BUS. L. 509 (2016).

119 Note that the need for independence from a nominating blockholder is significantly reduced when the controller can veto public investors' candidates to the board. The controller would presumably use its veto power to prevent the appointment of a director whose goal is to enable blockholders to extract private benefits of control.

V. Objections

This Part considers potential objections to our proposals. Section A addresses the claim that providing public investors—that is, minority shareholders—with a say over director elections will undermine the controller's ability to run the company. Section B considers the claim that enhanced-independence directors might undermine board effectiveness and collegiality. Section C discusses the claim that granting public investors a say over director elections might enable minority blockholders to extract private benefits. Section D explains why enhanced-independence directors improve investor protection even when self-dealing transactions are subject to a vote by public investors.

Before considering these objections, we would like to note that our framework accommodates many different degrees of public investor influence. Thus, even if one finds any of the following objections convincing, the appropriate response may be to choose a regime that provides a different balance between public investors and the controller's power to appoint enhanced-independence directors.

A. *Undermining Control*

The first objection we address is that allowing public investors to elect directors will interfere with the controlling shareholders' ability to exercise control over the corporation. On this view, minority shareholders in a controlled company have accepted, and might indeed prefer, that the controller will determine the strategic and business path of the company. We have discussed this objection at several points above, so our analysis in this Section can be brief. Ultimately, enhanced-independence directors would not undermine the controller's ability to determine business decisions that do not involve a conflict.

Recall that our analysis focuses on regimes that chose to rely on independent directors to contain controllers' opportunism. The goal of encouraging companies to appoint enhanced-independence directors is to provide at least some directors with incentives to stand up to the controller when undesirable self-dealing takes place. The question, however, is whether directors who are genuinely accountable to public investors will disrupt the controller's ability to make other business decisions or determine the company's direction. For the reasons we explain below, we believe that enhanced-independence directors will not necessarily interfere with the controller's ability to make business decisions.

First, note that controlling shareholders occasionally grant minority blockholders the right to board representation.[120] Having these representatives

120 *See* J. Travis Laster & John Mark Zeberkiewicz, *The Rights and Duties of Blockholder Directors*, 70 BUS. LAW. 33, 60 (2014/2015) (arguing that both majority and minority constituency directors should

on the board, however, does not necessarily undermine the controllers' ability to run the company. Our framework can be viewed as granting dispersed public investors rights similar to those that minority blockholders may receive.

Second, as explained in subsection IV.C.2, policymakers should ensure that enhanced-independence directors remain a minority of board members and play a key role only when the controller is conflicted. Ensuring that enhanced-independence directors can veto only a limited subset of decisions would address disruption concerns while preserving the directors' incentives to protect public investors. Indeed, as public investors have more power over director elections, policymakers should take greater care to ensure that enhanced-independence directors can block only those transactions in which a clear conflict of interest exists.

Third, the concern that the minority-election rule undermines the controller's ability to run the firm should not necessarily preclude public investors from having a say over director elections. At most, this concern suggests that the veto-rights rule should govern initial appointment decisions; that is, controllers should have veto power over initial appointments while the minority-election rule applies to reelection and termination decisions.

Finally, note that we do not argue that legal systems *should* rely on independent directors to monitor conflicted decisions. Those who believe that enhanced-independence directors would impose an excessive burden on corporate decisionmaking should consider replacing independent director approval with other measures for addressing controller opportunism. However, as we have shown in this Article, they should not place substantial reliance on independent-director vetting of conflicted decisions.

B. *Loss of Collegiality and Cohesiveness*

The second objection we consider focuses on the unique nature of the board's work. An effective board requires an environment that facilitates cooperation among board members and fosters trust between the board as a whole and corporate insiders. Having even a few directors who represent public investors, so the argument goes, would interfere with board cohesiveness and undermine the trust between the board and corporate insiders, as directors will become adversarial and uncooperative when seeking reelection by public investors.

compromise to ensure a balance of rights); Simone M. Sepe, *Intruders in the Boardroom: The Case of Constituency Directors*, 91 WASH. U. L. REV. 309, 365-77 (2013) (taking the position that current fiduciary rules should be reformed to keep constituency directors in check); E. Norman Veasey & Christine T. Di Guglielmo, *How Many Masters Can a Director Serve? A Look at the Tensions Facing Constituency Directors*, 63 BUS. LAW. 761, 774-75 (2008) (arguing that the current standards of fiduciary duty and liability are sufficient to ensure that constituency directors act on behalf of all shareholders).

We would first like to note that objections of this type arise, even at widely held companies, against any form of external intervention in the boards' work or composition, including the fundamental requirement for independent directors and even director liability.[121] Yet, as recent developments in the U.S. regime governing widely held companies demonstrate, the goal of incentive alignment prevails over collegiality concerns. Indeed, there are those who believe that external intervention is necessary to overcome the reluctance of individual directors to challenge group consensus.[122] Moreover, board cohesiveness may not be desirable when a genuine conflict arises between controllers and public investors.

C. *Public Investor Passivity*

We have thus far addressed arguments that enhanced-independence directors would overburden public companies and their controllers. One may argue, however, that enhanced-independence directors would provide public investors with insufficient protection, because public investors are likely to remain passive. Rationally apathetic investors, the argument goes, would fail to make an effective use of their power to elect directors. This, in turn, would make enhanced-independence directors too favorable to the controller and insufficiently attentive to the interests of the minority shareholders.

This concern is clearly inconsistent with market conditions in the United States and other developed markets where shareholder activists, institutional investors, and proxy advisory firms are prominent. Even in less developed capital markets, however, this claim does not undermine the case for our proposed regime.

The proposed regime introduces an important safety valve that can bolster investor protection even when public investors largely remain passive. Public investors may decide to use their election rights when controllers divert value on a large scale or when an activist shareholder emerges. The prospect of public investors rejecting that shareholder's candidate or nominating their own candidates (under the minority-election regime) will thus have some deterrent effect on controlling shareholders.

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121 *See, e.g.*, Stephen M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1, 49-50 (2002) (arguing that judicial review might destroy the "interpersonal relationships" that foster internal board governance); Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 800 (2001) (arguing that "too much true independence in the boardroom . . . [can] reduc[e] the level of trust that comes from closer or less adversarial relationships, [] chill[] communication . . . and interfere[] with the board as a productive team in all its capacities, including monitoring").

122 *See generally* Marleen A. O'Connor, *The Enron Board: The Perils of Groupthink*, 71 U. CIN. L. REV. 1233, 1237 (2003) (explaining the role of social psychology in the Enron Board's actions).

At any rate, the introduction of enhanced-independence directors would be an improvement over the prevailing regime of director election. Concern over public investors' passivity, however, may require policymakers to supplement the proposed regime with other measures of investor protection, such as private or public enforcement.

D. *Public Investor Opportunism*

One may argue that minority shareholders holding relatively large blocks of shares might opportunistically use veto rights or the minority-election regime to blackmail the controller to extract private benefits.[123] Under the minority-election rule, for example, these blockholders might deliberately nominate people who would threaten to disrupt the board's work to blackmail the controller.

We find this critique unconvincing. A strategy of disrupting value-enhancing projects will harm not only the controller but also public investors. Thus, an opportunistic minority blockholder—one who nominates board candidates for the sole purpose of blackmailing the controller—is unlikely to secure the public investor votes required to appoint its candidate. Moreover, it is now commonly believed that significant controller-backed self-dealing transactions should be subject to a vote by public investors, i.e., a majority of minority shareholders.[124] Such votes already provide an opportunistic minority blockholder with at least the same power to extract private benefits as would public investor votes on director elections.

Finally, enhanced-independence directors could be required to be independent from blockholders who put forward their nomination. This requirement, in turn, would address concerns that blockholders may use their influence over director nominations to extract private benefits.

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123 *See, e.g.*, Feedback Statement: Summary of Responses to the Commission Green Paper on the EU Corporate Governance Framework 16 (Nov. 15, 2011), http://ec.europa.eu/internal_market/company/docs/modern/20111115-feedback-statement_en.pdf [https://perma.cc/VKR9-YVAE] (explaining that many people believe granting minority shareholders additional rights to help them represent their interests could increase the potential for the abuse of those rights and would be "contrary to shareholder equality").

124 *See, e.g.*, *In re* MFW S'holders Litig., 67 A.3d 496, 500-05, 520-36 (Del. Ch. 2013) (noting that "the majority-of-the-minority vote condition qualifies as a cleansing device under traditional Delaware corporate law principles"); Simeon Djankov et al., *The Law and Economics of Self-Dealing*, 88 J. FIN. ECON. 430, 461 (2008) (surveying the prevalence of majority-of-minority shareholder approval for self-dealing transactions in a large number of jurisdictions, and emphasizing this requirement's crucial role in protecting public investors).

Conclusion

Corporate law has long relied on independent directors to protect public investors from controller opportunism in conflicted decisions. In this Article, however, we have shown that independent directors whose election and retention is fully dependent on the controller cannot be relied upon to adequately perform their oversight role.

To make independent directors more effective in overseeing conflicted decisions, we have argued, public investors should have the power to influence the election or retention of some "enhanced-independence" directors. These enhanced-independence directors should play a key role in vetting conflicted decisions, but they should not be able to prevent the controller or their fellow directors from making other corporate decisions.

We have discussed how the Delaware courts, as well as other lawmakers in the United States and around the world, can introduce enhanced-independence arrangements. In Delaware, judicial doctrines encouraging the introduction of enhanced-independence directors can address challenges that courts have faced in reviewing conflicted decisions in controlled companies. We have identified alternative mechanisms for providing public investors with a say over the appointment or retention of enhanced-independence directors, and we have analyzed the tradeoffs that these mechanisms entail. We have also discussed the desirable role of such directors and have responded to a number of objections to their use. Our hope is that the approach and framework of analysis we have put forward in this Article will serve courts and lawmakers in improving investor protection in controlled companies.