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The Uneasy Case for the Inside Director

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ABSTRACT: In the wake of recent scandals and the economic meltdown, there is nearly universal support for the notion that corporations must have independent directors. Conventional wisdom insists that independent directors can more effectively monitor the corporation and prevent or otherwise better detect wrongdoing. As the movement to increase director independence has gained traction, inside directors have become an endangered species, relegated to holding a minimal number of seats on the corporate board. This Article questions the popular trend away from inside directors by critiquing the rationales in favor of director independence, and assessing the potential advantages of inside directors. This Article argues that the value of independent directors has been overstated, while the value of inside directors has been under-appreciated and under-examined. This argument rests on three critical points. First, independent directors are constrained in their ability to perform their monitoring functions, and many of these constraints may be insurmountable—particularly as we increase independent directors' responsibilities. Second, inside directors can make valuable, and often overlooked, contributions to board governance. Third, reliance on independent directors as a substitute for external regulation is inappropriate and potentially costly. To this end, this Article suggests that inside directors may serve an important signaling function, underscoring the need for enhanced regulation, while ensuring that corporate monitors are subject to appropriate liability and therefore have increased incentives to perform their responsibilities.

To be sure, the case for the inside director is not an easy one, particularly given that any benefits such directors bring to the board come with costs, including the potential for self-dealing and overreaching. However, before we render inside directors extinct, we first should determine whether their costs are outweighed by their benefits.

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I. INTRODUCTION

The inside director—a director currently employed with the corporation on whose board she serves—is a dying breed.[1] Although the inside director once dominated corporate boards,[2] today the inside director has been painted as biased, untrustworthy, and generally antithetical to the best interests of shareholders and the corporation.[3] As a result, inside directors have been banished altogether from many board committees and reduced to holding a minimal number of seats on the board as a whole.[4]

This virtual elimination of inside directors' role on corporate boards is inextricably linked to the overwhelming consensus that boards should be dominated by "independent" directors.[5] Such consensus stems from a belief that independent directors are better equipped to monitor the corporation, detect fraud, and protect shareholders' interests.[6] Pursuant to this majority view, independent directors appear to represent the perfect solution to the corporate-agency problem because they can oversee corporate affairs in a manner that prevents corporate managers from shirking their responsibilities or otherwise abusing their authority. As a result, reforms often "trumpet" the enhanced director independence as a response to corporate-governance failures, both prompting and requiring corporations to populate their boards and committees with independent directors.[7] And

1. *See* Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921, 921 (1999) (noting that insiders hold relatively few seats on the boards of most large, American public companies).

2. *See id.* ("In the 1960s, most [public companies] had a majority of inside directors.").

3. *See* Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231, 231 (2002); William B. Chandler III, *On the Instructiveness of Insiders, Independents, and Institutional Investors*, 67 U. CIN. L. REV. 1083, 1084 (1999); Ira M. Millstein, *The Evolution of the Certifying Board*, 48 BUS. LAW. 1485, 1485 (1993).

4. Thus, various federal statutes ensure that inside directors do not serve on the board's audit, nominating, or compensation committees. *See infra* Part II.B (discussing federal reforms). Moreover, recent studies reveal that, on average, inside directors hold no more than two seats, and in many cases only one seat, on corporate boards. *See* Bhagat & Black, *supra* note 1, at 921; SPENCER STUART, 2009 SPENCER STUART BOARD INDEX 4, *available at* http://content.spencerstuart.com/sswebsite/pdf/lib/SSBI2009.pdf; THE KORN/FERRY INST., 34TH ANNUAL BOARD OF DIRECTORS STUDY 4 (2008), *available at* http://www.kornferryinstitute.com/files/pdf1/Board_Study07_LoRez_FINAL.pdf.

5. *See* Robert A. Prentice & David B. Spence, *Sarbanes-Oxley as Quack Corporate Governance: How Wise Is the Received Wisdom?*, 95 GEO. L.J. 1843, 1864 (2007) (noting the "near consensus" in the world that corporate best practices demand increased director independence); *see also* Bhagat & Black, *supra* note 1, at 921 (noting that "[m]ost commentators applaud the trend toward greater board independence" and identifying various groups that recommend such independence, including the National Association of Corporate Directors, the Business Roundtable, and CalPERs). As discussed in Part II.A, despite this consensus, there is no uniform definition of "independent."

6. *See* Bhagat & Black, *supra* note 3, at 232; Chandler, *supra* note 3, at 1094.

7. *See* Usha Rodrigues, *The Fetishization of Independence*, 33 J. CORP. L. 447, 455–58 (2008).

in the current economic downturn, the pressure for increased director independence has escalated.

In addition to reducing agency costs, independent directors are thought to enable the corporation to engage in a form of self-regulation. Believing that they are better positioned to critically assess corporate conduct, regulators and courts give significant discretion to independent directors.[8] That discretion ensures that there is rarely any substantive review of decisions made or sanctioned by independent directors. Hence, in various settings, the installation of independent directors serves as a substitute for external regulation, particularly with respect to "high risk" transactions.[9]

The assumption that independent directors represent the ideal solution to the agency problem and an appropriate substitute for external regulation has negative implications for inside directors. This is because, while there is no clear consensus with respect to the definition of an "independent director," it is clear that an inside director is excluded from that definition.[10] Legislators and governance experts presume that inside directors lack the impartiality necessary to appropriately monitor the corporation. Therefore, as corporations have embraced greater independence on their boards, the inside director has become almost obsolete.

In light of this phenomenon, this Article seeks to determine what role, if any, insiders should play on the corporate board. Focusing primarily on Delaware law,[11] as well as federal rules encompassed in the Sarbanes–Oxley Act of 2002 ("SOX")[12] and corresponding federal reforms, this Article concludes that, despite the normative appeal of the independent director, insiders can and should play a pivotal role on the corporate board. In fact, this Article reveals that the independent director's value has been vastly overstated, while the inside director has been under-appreciated and under-

8. *See* E. Norman Veasey, *Should Corporation Law Inform Aspirations for Good Corporate Governance Practices—or Vice Versa?*, 149 U. PA. L. REV. 2179, 2182 (2001); *see also* Irwin Borowski, *Corporate Accountability: The Role of the Independent Director*, 9 J. CORP. L. 455, 457–58 (1984) (stating that the independent director is held primarily accountable for corporate conduct).

9. *See infra* Part II.D. This Article uses the term "high-risk transaction" to describe those transactions that have a particularly high probability of managerial or director infidelity, such as conflict-of-interest transactions, derivative suits, or takeover transactions.

10. *See* Rodrigues, *supra* note 7, at 455 (noting the presumption that insider status precludes director independence).

11. This Article focuses on Delaware law because most public corporations incorporate in Delaware, and hence Delaware plays a prominent role in shaping corporate law. *See* Renee M. Jones, *Rethinking Corporate Federalism in the Era of Corporate Reform*, 29 J. CORP. L. 625, 632 (2004); Hillary A. Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 456, 457 (2004) (referring to Delaware as the "mother" of all corporation law).

12. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, 29 U.S.C.).

examined. This revelation has important implications for corporate governance and our system of external regulation.

This revelation rests on three premises. First, there exist significant limitations on independent directors' ability to fulfill their monitoring role, and it is very difficult to overcome those limitations, especially as independent directors' responsibilities increase. While others have recognized the defects associated with independent directors' ability to perform their monitoring function, most nevertheless contend that those defects can be mitigated. This Article questions the legitimacy of that contention, while further amplifying the reasons why independent directors may prove ineffective.

Second, insiders can add value to the corporate board because they have the information, knowledge, and resources that not only increase corporate performance, but also may enable them to more accurately monitor and police the actions of other insiders. Importantly, this Article demonstrates that the line between insider status and independent status is significantly blurry, at least as it relates to potentially compromising ties, undermining the notion that insiders should be viewed as categorically incapable of behaving in an objective fashion.

Third, this Article highlights the flawed reliance upon independent directors as substitutes for external regulation. Particularly with respect to high-risk transactions, there is little reason to trust *either* inside or outside directors to make appropriate decisions, and hence our regulatory regime has inappropriately favored the independent director. In this regard, it may be that embracing insiders on the board could serve an important signaling function, decreasing courts' willingness to defer to *any* director in the context of high-risk transactions. This could prompt a corresponding increase in the likelihood that corporate misconduct can be appropriately analyzed, regulated, and sanctioned. Moreover, it may increase the deterrent function of external regulation.[13]

Part II of this Article reveals the manner in which the corporate landscape has shifted to exclude inside directors from the board, and the rationale for that shift. Part III pinpoints the limits of independent directors' ability to be truly independent and to effectively perform their monitoring role, while highlighting the difficulties associated with overcoming those limitations. This Part also examines the empirical evidence on independent directors' impact. Part IV makes the affirmative case for the inside director and then analyzes the principal drawbacks associated with reliance on such

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13. *See* Lisa M. Fairfax, *Spare the Rod, Spoil the Director?: Revitalizing Directors' Fiduciary Duty Through Legal Liability*, 42 HOUS. L. REV. 393, 438–39 (2005) (noting that, under the existing regulatory regime, legal sanctions have very little deterrent value because of the relatively low risk that directors will be subjected to such sanctions); *see also* Hillary A. Sale, *Independent Directors as Securities Monitors*, 61 BUS. LAW. 1375, 1379 (2006) (pinpointing the dearth of SEC actions against independent directors).

directors. In particular, this Part grapples with the limits of inside directors' role in the context of self-dealing transactions and fraud detection, while emphasizing that those limitations may not be overcome through reliance on independent directors. This Part also wrestles with the difficulties of relying on insiders who are subordinates and hence may find it difficult to objectively critique their superiors or otherwise challenge their superiors' decisions. Part V offers some concluding thoughts.

II. THE VIRTUAL DISAPPEARANCE OF THE INSIDE DIRECTOR

This Part demonstrates how inside directors essentially have been replaced with outside, so-called "independent," directors. Before engaging in such demonstration, Subpart A better defines the term "inside director." Subpart B pinpoints the manner in which independent directors have displaced inside directors, while Subparts C and D explain the rationales for such displacement.

A. DEFINING INDEPENDENCE: INSIDERS VS. THE WORLD

Despite its prominence in corporate and securities law, the term "independent director" has no uniform definition; instead judges and legislators define the term differently.[14] Moreover, the term is used differently in various contexts.[15]

Notwithstanding these differences, however, all definitions are uniform in their exclusion of "inside directors"—directors who are currently employed by the corporation on whose board they serve.[16] At the federal level, SOX and various federal listing standards define an independent director by reference to a bright-line test that excludes inside directors. For example, under New York Stock Exchange ("NYSE") and NASDAQ Stock Market ("NASDAQ") rules, no director can qualify as independent if she has

14. *See* Donald C. Clarke, *Three Concepts of the Independent Director*, 32 DEL. J. CORP. L. 73, 78 (2007); *see also* Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 598–99 (1982) (noting that the concept of director independence "does not carry a clear meaning for many of its proponents or the same meaning for all of its proponents").

15. *See* Rodrigues, *supra* note 7, at 466–67 (noting the distinction between independence with respect to federal law and Delaware law); *see also* Clarke, *supra* note 14, at 78 (noting that jurisdictions use different terms to define directors who may be deemed independent, and that those terms describe different roles).

16. *See* Clarke, *supra* note 14, at 79 (adopting the term "non-management" director because it captures the one element common to all definitions—that the so-called independent director is not a member of the company's management team); *see also* Jill E. Fisch, *Taking Boards Seriously*, 19 CARDOZO L. REV. 265, 279 (1997) (arguing that, by labeling employees "insiders" and non-employees "independent," many studies use a superficial criteria to distinguish between independent and inside directors).

a material relationship with the company.[17] The first such disqualifying material relationship is serving as an employee of the company.[18] Similarly, SOX automatically excludes from the definition of "independent" any director who receives direct compensation from the company on whose board she sits.[19] In this regard, an "inside director" is distinguished from an "outside director" who does not have an employment position with the company. Being an outside director is a prerequisite for being considered independent under these categorical rules.[20]

In contrast to this bright-line test for independence at the federal level, Delaware courts define "independence" contextually.[21] As an initial matter, Delaware courts distinguish between a "disinterested director" and an "independent director." A disinterested director is a director who will not benefit financially from a transaction other than a benefit enjoyed by shareholders more generally.[22] Hence, disinterest is narrower than independence. Moreover, a director's disinterest is a necessary, but not sufficient, condition for independence.[23] Thus, in addition to demonstrating that a director is disinterested, proving independence requires showing that a director has no ties to a particular interested individual and is not otherwise controlled by that individual in a manner that compromises her ability to make objective decisions with respect to the

17. *See* NYSE, Listed Company Manual § 303A.08 (2010), http://nysemanual.nyse.com/LCM/Sections/; NASDAQ, Marketplace Rules r. 4200(a)(15) (2004), *available at* www.nasdaq.com/about/MarketplaceRules.pdf.

18. *See* NYSE, *supra* note 17, § 303A.02(b)(i); NASDAQ, *supra* note 17, at r. 4200(a)(15). Directors also cannot be deemed independent if one of their immediate family members is employed by the corporation. *See* NYSE, *supra* note 17, § 303A.02(b)(i); NASDAQ, *supra* note 17, at r. 4200(a)(15).

19. To qualify as "independent," the director cannot accept any "consulting, advisory, or other compensatory fee" from the issuer or any of its subsidiaries, other than in his or her capacity as a board member. *See* 15 U.S.C. § 78-1(m)(3)(B) (2006).

20. Thus, independence is not synonymous with outsider status but rather encompasses that status. *See* Clarke, *supra* note 14, at 99–100. This Article therefore uses the term "independent director" to encompass outside directors. Interestingly, despite the prohibition on inside directors, a person who is a former employee of the corporation can be deemed an outside and independent director. Thus, under the NYSE and NASDAQ rules, a director could be deemed independent three years after the end of her employment relationship with the corporation. *See* NYSE, *supra* note 17, § 303A.02(b); NASDAQ, *supra* note 17, at r. 4200(a)(15). Indeed, it is often the case that former executives serve on their corporation's board.

21. This is due primarily to the fact that Delaware courts define "independence" with respect to specific transactions. *See* Clarke, *supra* note 14, at 102.

22. *See* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (noting that a director is interested in a transaction when she expects to derive a personal financial benefit from the transaction that does not devolve upon the corporation or stockholders more generally).

23. *See* Rodrigues, *supra* note 7, at 466 (noting that interest can be viewed as a "subspecies—perhaps the most archetypal example—of independence").

individual.[24] Delaware's situational approach to independence means that a director's independence cannot be determined ex ante; instead a director's independence can be determined only after examining the specific transaction at issue and the directors or officers impacted by the transaction.[25]

Like the definition of "independence" at the federal level, Delaware courts inevitably have concluded that inside directors cannot be independent. This is because even when such directors are not interested because they do not have financial ties to the underlying transaction, courts presume that their managerial position within the company undermines their ability to make objective decisions with regard to other officers or directors.[26] Hence, inside directors are not viewed as independent even under Delaware's more nuanced assessment of director independence.

As this analysis reveals, while there may be differences with respect to the manner in which courts and regulators define independence, the common thread running through all of these definitions is the notion that insider status disqualifies a director from being independent.[27] In this regard, a director's insider status appears to both distinguish her and set her apart from all other directors.

B. The Convergence Toward Independent Directors

Historically, inside directors played a dominant role on corporate boards, holding most of the seats.[28] While their numbers gradually declined from the 1930s to the 1950s, inside directors still held some 50% of board seats.[29] Moreover, as recently as 1989, it was rare for a board to have fewer than three inside directors.[30]

In recent years, insiders' early dominance has diminished completely. By the 1990s, independent directors began holding an increasingly larger portion of corporate board seats.[31] The most recent Korn/Ferry study on

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24. *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 362 (Del. 1993); *see also Aronson*, 473 A.2d at 812 (stating that a disinterested director can neither anticipate a personal gain nor be involved on more than one side of a transaction).

25. Veasey, *supra* note 8, at 2180–82; *see* Rodrigues, *supra* note 7, at 466.

26. *See* Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1044 (Del. 2004) (presuming the lack of independence of an inside director who also served as vice president).

27. *See* Rodrigues, *supra* note 7, at 465 (noting the "blanket assumption that outsider status—that is, lack of financial or familial ties to the company—is the best indicator for independence").

28. *See* Bhagat & Black, *supra* note 1, at 921.

29. *See* Kenneth Lehn et al., Determinants of the Size and Structure of Corporate Boards: 1935–2000 (Nov. 2003) (unpublished manuscript), http://ssrn.com/abstract=470675.

30. *See* 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, 1476 (2007).

31. *See id.* at 1565.

corporate boards found that, on average, 80% of directors are independent.[32] This figure has remained unchanged for at least a decade.[33] Then too, by 2004, 91% of companies had boards with two or fewer insiders.[34] In 2009, half of S&P 500 companies had only one inside director, the CEO.[35] Hence, the typical corporation has a supermajority of independent directors with a corresponding minimal number of inside directors.[36] These statistics reveal that board composition has undergone a virtual sea change over the past several decades.

In recent years, this change has been accelerated by federal legislation. SOX essentially requires that a board have an audit committee, and that the audit committee be comprised entirely of independent directors.[37] SOX also requires each national securities exchange and national securities association to adopt rules compatible with SOX.[38] Pursuant to this requirement, listing agencies such as the NYSE and NASDAQ not only adopted rules requiring each member of the audit committee to be independent, but also mandated that each member of the nominating and compensation committee be independent.[39] Finally, the NYSE and NASDAQ require their listed companies to have a majority of independent directors on their boards.[40] Federal rules passed in the wake of the recent financial meltdown also incorporate director-independence provisions. For example, the most recent financial-reform bill requires compensation committee members to be independent.[41] Federal rules already required

32. THE KORN/FERRY INST., *supra* note 4, at 4 (noting that on average, only two out of ten directors are full-time employees). In 2009, 82% of S&P 500 directors were independent, up from 78% in 1999. SPENCER STUART, *supra* note 4, at 8.

33. *See* KORN/FERRY INT'L, 31ST ANNUAL BOARD OF DIRECTORS STUDY 11 (2004) (revealing that the average number of outside directors on the corporate board has remained constant since 1990). A Spencer Stuart study reveals that over the past ten years there has been a 5% increase in independent directors at S&P 500 companies. SPENCER STUART, *supra* note 4, at 8.

34. Gordon, *supra* note 30, at 1476; *see* KORN/FERRY INT'L, *supra* note 33, at 10; *cf.* Bhagat & Black, *supra* note 3, at 239 (explaining the decrease in inside directors from 1970 to 1997).

35. SPENCER STUART, *supra* note 4, at 4.

36. *See* KORN/FERRY INT'L, *supra* note 33, at 10.

37. *See* Sarbanes-Oxley Act of 2002 § 301, 15 U.S.C. § 78j-1(m) (2006).

38. *See id.* § 78j-l(m)(1)(A).

39. *See* NYSE, *supra* note 17, § 303A.06 (audit committee); *id.* § 303A.05 (compensation committee); *id.* § 303A.04 (nominating committee); NASDAQ, *supra* note 17, at r. 4350(d) (audit committee); *id.* at r. 4350(c) (compensation and nominating committees); *see also* NYSE Amex, Company Guide § 803 (2010), http://wallstreet.cch.com/AMEX/CompanyGuide/ (audit committee); *id.* § 804 (requiring all nominating committee members to be independent); *id.* § 805 (requiring all compensation committee members to be independent).

40. *See* NYSE, *supra* note 17, § 303A.08; NASDAQ, *supra* note 17, at rr. 4200(a)(15), 4350(c); *see also* NYSE Amex, *supra* note 39, § 802 (stating that the majority of directors on a board must be independent).

41. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 952, 124 Stat. 1376, 1900 (2010) (to be codified at 15 U.S.C. 78j-3).

that the compensation committees of companies receiving funding pursuant to the Troubled Asset Relief Program ("TARP") be comprised of independent directors.[42] By mandating the presence of independent directors, these rules hastened the shift away from inside directors.[43]

However, even before the enactment of SOX, corporate-governance norms had been trending away from inside directors. Indeed by the 1990s, most corporate-governance bodies had come to embrace the view that independent directors should dominate corporate boards.[44] Reflecting this embrace, as of 2001, some 75% of companies listed on the NYSE or NASDAQ had a majority of independent directors.[45] A 2000 study similarly revealed that independent directors had begun to hold a majority of seats on many board committees.[46] As a result, by the time of SOX's enactment, most public corporations had displaced their inside directors in favor of independent directors.

C. *Independent Directors as a Cure for the Corporate-Agency Problem*

The shift away from the inside director is prompted by the belief that independent directors are better monitors than inside directors and hence represent the perfect response to the corporate-agency problem. In the corporation, shareholders (or those perceived to "own" the corporation) are distinct from directors and officers (or those charged with managing the

42. *See* TARP Standards for Compensation and Corporate Governance, 31 C.F.R. pt. 30 (2009).

43. Other rules also encouraged a shift towards greater director independence. Under the Internal Revenue Code, for example, compensation committee members must qualify as outside directors in order to preserve the deductibility of certain compensation paid to executive officers. *See* Treas. Reg. § 1.162-27(e)(3)(i) (1995).

44. *See* Bhagat & Black, *supra* note 3, at 232–33 (noting an agreement by groups including the Council of Institutional Investors, Business Roundtable, Conference Board, and American Law Institute that corporations should populate their boards with independent directors).

45. *See* Press Release, Investor Responsibility Res. Ctr., IRCC Data Guides New Listing Rules for NYSE (Mar. 7, 2002), *available at* http://www.thefreelibrary.com/IRRC+Data+Guides+New+Listing+Rules+for+NYSE.-a087473214; *see also* Bhagat & Black, *supra* note 1, at 921 (noting that most public companies had a majority of independent directors as of 1997); Lawrence E. Mitchell, *The Trouble with Boards* 21 (George Washington Univ. Law Sch. Pub. Law & Legal Theory Research Paper Series, Paper No. 159, 2005), *available at* http://ssrn.com/abstract=801308 (noting that by the early 1970s, outside directors constituted the majority at most public companies).

46. A 2000 study indicated that 90% of directors on compensation committees were independent, while 64% of boards were comprised of audit committees with completely independent directors. *See* Press Release, Investor Responsibility Res. Ctr., IRRC Releases 2000 Board Practices Report (Dec. 1, 2000), *available at* http://www.thefreelibrary.com/IRRC+Releases+2000+Board+Practices+Report-a067495393. Similarly, Spencer Stuart data reveals that, in 1999, 93% of directors on the audit committee were independent, while 95% of directors on the compensation committee were independent and 69% of directors on the nominating committee were independent. *See* SPENCER STUART, *supra* note 4, at 9.

corporation).[47] The separation of ownership and control in the corporation means that while corporate officers have tremendous discretion to make decisions, there exist few mechanisms to hold them accountable for those decisions and hence to ensure that they use their discretion in a manner that benefits the corporation and its shareholders.[48] Importantly, there is nothing to prevent corporate officers from self-dealing—that is, engaging in transactions that benefit themselves at the expense of the corporation.[49] Therefore, corporate law's perpetual challenge has been to develop mechanisms that can reduce agency costs.[50]

The principle corporate-governance response to the agency problem has been the independent director.[51] The independent director's primary function is to monitor the corporation and its officers with an eye towards ensuring that managers do not abuse their authority by engaging in self-dealing or fraud, or otherwise shirking their responsibilities.[52] Independent directors' monitoring role encompasses several functions. Such directors guard against self-dealing by closely examining conflict-of-interest transactions to ensure that they benefit the corporation.[53] Independent directors also are supposed to detect and prevent fraud because their active oversight decreases managers' ability to engage in wrongdoing.[54] In addition, such directors should prevent managerial shirking and thus enhance corporate performance because they can proactively examine corporate affairs, not only to ensure that managers are productive, but also to ensure that managers make the most efficient and effective decisions.

Thus, independent directors' monitoring role should enhance performance throughout the corporation. In the audit committee, for example, their presence should ensure that managers deliver unbiased accounting information to shareholders and other stakeholders. In the

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47. *See* ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 84–89 (1932); William W. Bratton, *Berle and Means Reconsidered at the Century's Turn*, 26 J. CORP. L. 737 (2001); Dalia Tsuk, *From Pluralism to Individualism: Berle and Means and 20th-Century American Legal Thought*, 30 LAW & SOC. INQUIRY 179 (2005). *But see* Theresa A. Gabaldon, *Like a Fish Needs a Bicycle: Public Corporations and Their Shareholders*, 65 MD. L. REV. 538, 538 (2006) (noting that the notion of shareholders as owners is a myth).

48. *See* BERLE & MEANS, *supra* note 47; Bratton, *supra* note 47, at 755–58.

49. *See* Bratton, *supra* note 47, at 760.

50. *See* Michael C. Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, *in* FOUNDATIONS OF CORPORATE LAW 7, 7 (Roberta Romano ed., 1993).

51. *See* Clarke, *supra* note 14, at 81.

52. *See* James D. Cox, *Managing and Monitoring Conflicts of Interests: Empowering the Outside Directors with Independent Counsel*, 48 VILL. L. REV. 1077, 1082 (2003); Mitchell, *supra* note 45, at 33–34 (noting endorsement of the monitoring model of the corporate board).

53. Cox, *supra* note 52, at 1079–80.

54. This fraud-detection role includes independent directors' role as securities monitor, pursuant to which such directors assess the adequacy and accuracy of corporate disclosures. *See* Sale, *supra* note 13, at 1380–88.

compensation committee, their presence should ensure that compensation structures are aligned in a way that encourages managers to focus on the interests of shareholders and the corporation. Independent directors also should promote transparent and accurate disclosures because their oversight should prevent managers from withholding or otherwise distorting information.[55] In these ways, independent directors' monitoring roles help align managerial authority with corporate interests and encourage responsible decision making.

Importantly, it is believed that in order for directors to perform this monitoring function effectively, directors must be independent from management and the corporation. Their independence ensures that directors do not feel beholden to managers and hence can monitor them without unwarranted influences. In other words, a director's independence means that she can be trusted to critically examine decisions made by officers, as opposed to simply rubber-stamping those decisions.

Conventional wisdom dictates that inside directors cannot be characterized as independent directors because they are inherently partial to corporate managers and other directors. Inside directors are presumed to lack independence because they are employed and compensated by the company, and thus their concern for retaining their jobs will ensure that they cannot be objective.[56] Inside directors also are presumed to lack independence because their position as insiders and managers means they cannot be trusted to act objectively with respect to decisions made by other managers. This is especially true for insiders who are subordinate to the CEO and therefore, presumably, would feel uncomfortable making decisions negatively impacting the CEO or otherwise sharply criticizing the CEO's policies and practices. Furthermore, the CEO's historical role as chairman of the board prevented insiders from being viewed as unbiased monitors. Anecdotal evidence appears to support this proposition, revealing the propensity of inside directors to acquiesce in managerial misconduct.[57] Given these limitations, the independent director was viewed as the perfect counter to inside directors.[58]

Relying on these understandings, corporate-governance reforms typically focused on increasing director independence on corporate boards. Indeed, corporate wrongdoing is often viewed as a failure of the corporate monitoring system. Over the past few decades, a belief emerged that the independent director could rectify this failure and serve as a check on

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55. *See id.*

56. *See* Michael Abramowicz & M. Todd Henderson, *Prediction Markets for Corporate Governance*, 82 NOTRE DAME L. REV. 1343, 1370 (2007) (noting that employees can be especially risk-averse about losing their job, and this concern may cause them to acquiesce or participate in corporate misconduct).

57. *See* Rodrigues, *supra* note 7, at 456.

58. *See* Borowski, *supra* note 8, at 457–59.

managerial abuses of authority. Thus, widespread corporate misconduct in the 1970s prompted corporate-governance experts to insist upon greater independence for corporate directors.[59] Corporate malfeasance in the 1980s renewed the push for director independence.[60]

Interestingly, each corporate-governance scandal not only highlighted the need for enhanced managerial accountability, but also illuminated the flaws associated with the manner in which "independence" was defined.[61] Thus, each wave of corporate reforms focused not only on increasing the number of independent directors on the board, but also on tightening the standards for measuring independence. SOX's corporate-governance reforms both mirrored and extended these trends, centering on increasing the number of independent directors on the board and certain critical committees, as well as tightening the criteria for determining director independence.[62] More recent federal reforms follow this same pattern.[63] Collectively, these reforms embrace the view that independent directors represent an ideal solution to the corporate-agency conundrum, helping to reduce corporate malfeasance and enhance corporate performance.

The growing consensus that independent directors represent the ideal check on managerial misconduct has negative implications for the inside director. Because the independent director is by definition an outside director, this consensus necessitates a corresponding decline in, if not elimination of, the role and presence of inside directors.

D. INDEPENDENT DIRECTORS AS SUBSTITUTE FOR EXTERNAL REGULATION

Courts and regulators historically have embraced the view that they are not in the best position to judge the conduct of corporate officers and directors for at least two reasons. The first is that they are not businesspeople and hence are ill-equipped to judge business decisions.[64] Indeed, given the

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59. *See id.* at 455–56 (noting the role of former SEC Chairman Harold Williams in advocating for increased director independence as a response to the corporate-accountability problem); Brudney, *supra* note 14, at 597–98.

60. *See* Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U. L. REV. 898, 899–900 (1996).

61. *See* Borowski, *supra* note 8, at 458–60 (discussing defaults related to the concept of an independent director and proposed reforms).

62. *See* Elizabeth Cosenza, *The Holy Grail of Corporate Governance Reform: Independence or Democracy?*, 2007 BYU L. REV. 1, 5–6.

63. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 952, 124 Stat. 1376, 1900 (2010) (to be codified at 15 U.S.C. 78j-3).

64. This notion is perhaps best exemplified in the 1919 case of *Dodge v. Ford Motor Co.*, 170 N.W. 668, 684–85 (Mich. 1919), in which the court refused to interfere with the Ford Motor Company's proposed business expansion on the premise that judges are not business experts and hence were not in the best position to determine the future impact of that expansion. *See also* Brehm v. Eisner, 746 A.2d 244, 263 (Del. 2000) (noting that courts are ill-equipped to judge ex post the appropriateness of business decisions (citing Lewis v. Vogelstein, 699 A.2d 327, 336 (Del. Ch. 1997))); Clarke, *supra* note 14, at 79–80.

inherent risk associated with business decisions, judges' ex post analysis of those decisions may discourage directors from engaging in appropriate, though risky, behavior.[65] Moreover, courts should preference the decisions of directors because such directors (and not judges) were elected by shareholders to govern.[66] The second reason courts and regulators have been reluctant to intervene in business decisions is that they cannot be proactive in monitoring corporate decisions—at best they serve as an ex post check on board behavior.[67] This reluctance is exemplified by the standard pursuant to which courts review most corporate conduct. This standard, known as the "business judgment rule," presumes that directors' decisions are made in the best interests of the corporation and requires shareholders to overcome a tremendous hurdle in order to hold directors liable for such decisions.[68] Importantly, however, courts and regulators recognize that the deference afforded corporate decisions is only appropriate if they can be assured that those decisions will be made free from inappropriate influences.

1. Independent Directors and Ordinary Business Decisions

The independent director is seemingly the perfect solution to this quandary. Not only are they better suited to judge the actions of corporate managers, but also they can be proactive in a manner that courts cannot. Then too, courts and regulators believe that independent directors are the most appropriate arbiters of corporate conduct because they have been chosen by shareholders and thus have the requisite authority to make decisions on behalf of the shareholders.[69] Most importantly, directors' independence ensures that they will impartially assess the actions of the corporation. Hence, independent directors are viewed as superior to, and an ideal substitute for, external regulators.[70] As one governance expert notes, the focus on independent directors decreases "the need for government to

65. *See* Lawrence A. Cunningham, *Beyond Liability: Rewarding Effective Gatekeepers*, 92 MINN. L. REV. 323, 341, 352–57 (2007) (questioning the effectiveness of liability and proposing a system of rewards to promote effective capital gatekeeping); Julian Velasco, *Structural Bias and the Need for Substantive Review*, 82 WASH. U. L.Q. 821, 831 (2004).

66. *See* Velasco, *supra* note 65, at 832–33.

67. *See* Borowski, *supra* note 8, at 457–58.

68. *See* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984). Given the extreme deference afforded to directors under the business judgment rule, some have referred to the rule as a policy of non-review. *See* Williams T. Allen et al., *Function over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 26 DEL. J. CORP. L. 859, 870 (2001); Lyman Johnson, *The Modest Business Judgment Rule*, 55 BUS. LAW. 625, 625 (2000).

69. *See* Velasco, *supra* note 65, at 832–33.

70. *See* Clarke, *supra* note 14, at 79–80.

play a significant role in the area of [corporate] accountability."[71] Instead, that role has been ceded to the independent director.

Courts and legislatures defer to decisions made by independent directors not just with respect to ordinary transactions, but also with respect to transactions that pose particular risks of managerial abuse.[72] This deference is reflected in at least two areas discussed below: conflict-of-interest transactions and shareholder derivative actions.[73]

2. Independent Directors and Conflict-of-Interest Transactions

A conflict-of-interest transaction is a transaction pursuant to which a director or officer receives a benefit that is not shared equally with others in the corporation.[74] Courts recognize that these transactions are inherently risky because a corporate actor "cannot be expected to exercise his or her independent business judgment without being influenced by the . . . personal consequences resulting from the decision."[75] Given the risk of self-dealing associated with such transactions, conflict-of-interest transactions historically were voidable by the shareholder.[76] Recognizing, however, that these transactions may benefit the corporation, courts abandoned this voidability rule in favor of one requiring a heightened standard of review.[77] That review, known as the "entire fairness" test, encompasses a requirement that such transactions be fair to the corporation.[78] Such a standard is decidedly more rigorous, and hence less deferential, than the business

71. Borowski, *supra* note 8, at 455; *see also* Mitchell, *supra* note 45, at 58 (pointing out that independent directors enable courts to ignore reviewing the substance of corporate decisions).

72. *See* Lawrence E. Mitchell, *Structural Holes, CEOs, and Informational Monopolies: The Missing Link in Corporate Governance*, 70 BROOK. L. REV. 1313, 1345 (2005); *see also* Stephen M. Bainbridge, *Independent Directors and the ALI Corporate Governance Project*, 61 GEO. WASH. L. REV. 1034, 1043–44 (1993) (noting that the manner in which courts review derivative actions should result in greater insulation of board decisions from judicial intervention).

73. This deference also can be seen in the corporate-takeover context. *See* Mitchell, *supra* note 45, at 58 (noting the "sanitizing effect" of independent directors in the takeover context); *see also* Borowski, *supra* note 8, at 467–69 (stating that courts generally do not apply the business judgment rule to situations involving conflicts of interest).

74. *See* Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1049 (Del. 2004) (noting that a person's interest is shown by demonstrating the receipt of a personal benefit); Rales v. Blasband, 634 A.2d 927, 936 (Del. 1993); Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983) (stating that a conflict results from appearance on both sides of a transaction).

75. *Rales*, 634 A.2d at 936; *see also* Gottlieb v. Heyden Chem. Corp., 90 A.2d 660, 663 (Del. 1952) (noting that we cannot presume that directors will be competent decision makers when decisions come at their own personal expense).

76. *See* Cox, *supra* note 52, at 1079.

77. *See id.*; Velasco, *supra* note 65, at 837.

78. *See* Paramount Commc'ns, Inc. v. QVC Network, Inc., 637 A.2d 34, 42 n.9 (Del. 1994) (stating that, when self-interest is present, courts will apply exacting scrutiny); *Weinberger*, 457 A.2d at 710 (requiring a demonstration of utmost good faith and the most scrupulous bargaining).

judgment rule.[79] However, if the transaction is approved by independent directors, courts reinstate review under the business judgment rule, thereby abandoning the more heightened standard of the entire fairness test.[80] Independent directors therefore enable courts to afford substantial deference to self-dealing transactions, despite the risk of misconduct such transactions present.[81]

3. Independent Directors and Shareholder Derivative Actions

Courts similarly defer to independent directors in the context of shareholder derivative actions. A shareholder derivative action refers to an action brought by the shareholder in the name of the corporation.[82] Shareholders must bring a derivative action against directors and officers in order to hold them liable for breaching their fiduciary duties.[83] Independent directors play a prominent role in these suits.

First, independent directors play a critical role in preventing shareholders from even bringing a derivative action before the court. Before shareholders can bring a derivative action, they must make demand on the board or demonstrate demand futility.[84] Shareholders show demand futility by referencing *Aronson v. Lewis*, which requires that they raise a reasonable doubt either that (1) a majority of the board upon whom shareholders would have made a demand lacked independence, or (2) the transaction was not a valid exercise of the business judgment rule.[85] Given the deference afforded directors under the business judgment rule, establishing demand futility under the second prong is particularly difficult. Consequently, if the directors on whom demand is made are independent, it is difficult to demonstrate demand futility. In this way, the presence of independent directors reduces shareholders' ability to avoid making a demand. When shareholders make a demand, such demand gives the board an opportunity

79. *See* Velasco, *supra* note 65, at 835.

80. *See* Cox, *supra* note 52, at 1080. In Delaware, this change is essentially codified by statute. *See* DEL. CODE ANN. tit. 8, § 144 (2006).

81. *See* Clarke, *supra* note 14, at 80 ("[E]ven the apparently fundamental and unobjectionable idea that transactions between a corporation and a director should be on terms that are fair to the corporation is not imposed on corporations . . . if the corporation's board has disinterested directors . . . .").

82. *See, e.g.*, Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261, 286 (1986); Donald E. Schwartz, *In Praise of Derivative Suits: A Commentary on the Paper of Professors Fischel and Bradley*, 71 CORNELL L. REV. 322, 339–40 (1986); Carol B. Swanson, *Juggling Shareholder Rights and Strike Suits in Derivative Litigation: The ALI Drops the Ball*, 77 MINN. L. REV. 1339, 1349–50 (1993).

83. *See* Fischel & Bradley, *supra* note 82, at 286; Schwartz, *supra* note 82, at 339–40; Swanson, *supra* note 82, at 1349–50.

84. *See* Aronson v. Lewis, 473 A.2d 805, 807–08 (Del. 1984).

85. *See id.* at 814.

to resolve shareholder claims without resorting to the courts.[86] Hence, the demand process encourages self-regulation and the use of intracorporate remedies.[87] Because that process relies on independent directors, it highlights the manner in which such directors are used as a substitute for external regulation. Moreover, it highlights the manner in which independent directors serve to ensure that shareholder derivative actions, including those that may have some merit, do not get their day in court.

The second way in which independent directors play a pivotal role in shareholder derivative actions is much similar to the first, but in a different context. Thus, in the demand-required context, courts continue to give substantial deference to independent directors' decisions to terminate derivative actions, even when such directors are named as potential defendants.[88] On the one hand, after shareholders make demand, independent directors can choose to terminate their action altogether.[89] Courts will not disturb the board's termination decision unless it is deemed wrongful.[90] On the other hand, even if demand is excused as futile under *Aronson*, independent directors can dismiss the action. Indeed, the interested board has the freedom to establish a committee of independent directors, and such committee similarly has authority to terminate a shareholder lawsuit.[91] Courts review the committee's termination decision under *Zapata Corp. v. Maldonado*, which has two prongs: the first focuses on whether the committee was independent and acted in good faith, while the second allows the court to make its own determination regarding whether the action should be dismissed.[92] While *Zapata* enables courts to review the termination decision on its merits, courts generally defer to the committee's decision.[93]

As this discussion reveals, whether demand is made or excused, independent directors have tremendous power over the fate of a shareholder's derivative action. That power underscores the extent to which courts rely on such directors to supplant their own regulation. To be sure, courts traditionally defer to board decisions. However, such deferral is arguably not warranted in the context of shareholder suits alleging

86. *See id.* at 812 (noting that the demand requirement is aimed at ensuring that shareholders exhaust intracorporate remedies, thereby providing an alternative dispute mechanism, while adhering to the "fundamental precept that directors manage the business and affairs of corporations").

87. *See id.*

88. *See id.* at 815 (noting that the mere threat of personal liability stemming from being named in a complaint for approving a transaction, standing alone, is insufficient to rebut a director's independence).

89. *See* Zapata Corp. v. Maldonado, 430 A.2d 779, 784 (Del. 1981).

90. *See id.*

91. *See id.* at 788.

92. *See id.* at 788–89.

93. *See id.* at 784.

misconduct by the board. Indeed, the derivative suit represents the primary mechanism pursuant to which shareholders can challenge corporate decisions and seek to hold officers and directors accountable for those decisions.[94] By giving independent directors the power to control, and even terminate, derivative suits, courts have ensured that independent directors control the corporate-accountability process. Moreover, by deferring to the decisions of independent directors in this area, courts basically have abdicated any role they may have played in the accountability process.[95]

Independent directors play a critical role in the corporate-governance landscape. That role is premised on the belief that such directors reduce agency costs by effectively and efficiently monitoring the corporation. It is also premised on the belief that such directors are preferable to external regulation, even with respect to transactions that involve a high risk of managerial malfeasance. Because independent directors must be outside directors, the increased reliance on, and deference to, such directors has corresponded with a reduction in the role of inside directors. Therefore, before establishing the case for inside directors, the next Part will examine the appropriateness of the reliance on, and deference afforded to, independent directors.

III. THE ELUSIVE QUEST FOR DIRECTOR INDEPENDENCE

Independent directors face several obstacles that impede their ability to be effective monitors of the corporation. This Part highlights those obstacles, and in contrast to many experts, takes serious issue with the contention that they can be overcome.

A. THE INTRACTABILITY OF COMPROMISING TIES: SOCIAL BONDS, STRUCTURAL BIAS, AND FINANCIAL REWARDS

Conventional wisdom suggests that in order for directors to be effective monitors, they must be free from all compromising ties to the corporation. In fact, prior scandals have revealed that even directors considered independent because they lacked employment relationships with a corporation nevertheless received advisory or similar fees from the corporation, or otherwise had significant relationships with the corporation or its board that jeopardized their ability to be impartial.[96] As a result,

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94. *See* Bainbridge, *supra* note 72, at 1046 (noting that, for many corporate-governance experts, shareholder litigation represents "*the* [primary means] of enforcing management accountability"); Borowski, *supra* note 8, at 464–65; John C. Coffee, Jr. & Donald E. Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261, 264–65 (1981).

95. *See* Borowski, *supra* note 8, at 465.

96. *See* RICHARD C. BREEDEN, RESTORING TRUST: REPORT TO THE HON. JED S. RAKOFF ON CORPORATE GOVERNANCE FOR THE FUTURE OF MCI, INC. 817–18 (2003), *available at* http://

reform efforts have focused on eliminating those relationships and thereby strengthening the definition of "director independence." Notwithstanding those efforts, the current conception of director independence continues to fall short of capturing all of the ties that compromise a director's ability to be objective. This Part indicates that this failure may be impossible to rectify in a manner that enhances directors' ability to be truly impartial.

1. Social Ties

All of the recent reforms define "independence" with reference to the financial ties between a director and the corporation. Thus, SOX excludes from the definition of "independent director" anyone who receives compensation from the corporation.[97] Along these same lines, the NYSE and NASDAQ's definition of independence essentially filters out compromising financial relationships between the corporation and the director.[98] New financial reforms also focus on financial ties, determining independence by reference to the source of a person's compensation.[99] Then too, while Delaware's independence definition appears to capture more than just financial relationships, Delaware courts historically have defined independence in a manner that fails to give significant weight to anything but financial ties.[100]

By contrast, the current definition of director independence does not in any meaningful manner encompass social or professional ties between directors and the corporation. Outside of familial ties, federal rules do not

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www.concernedshareholders.com/CCS_MCI_BreedenReport.pdf (detailing financial and other ties among board members and managers that impeded their ability to be effective monitors).

97. *See* Sarbanes-Oxley Act of 2002 § 301, 15 U.S.C. § 78j-1(m)(3)(B) (2006).

98. Both the NYSE and NASDAQ exclude from the definition of independent any director who receives compensation from the corporation other than her director fees. Thus, NYSE rules exclude from the independence definition anyone who received, during any twelve-month period within the last three years, more than $120,000 in direct compensation (other than compensation related to director service). *See* NYSE, *supra* note 17, § 303A.02(b)(ii). NASDAQ rules also exclude directors who receive any non-fee-related compensation in excess of $60,000 during the past three fiscal years. *See* NASDAQ, *supra* note 17, at r. 4200(a)(15)(B). The listing agencies also exclude from the independence definition a director who has ties to any entity that gives to, or receives funds from, the corporation on whose board the director sits. Thus, the NYSE rules also exclude any director that is employed with a company that has made payments to or received payments from the corporation in any of the last three fiscal years that exceeds the greater of $1,000,000 or 2% of such company's consolidated gross revenue. *See* NYSE, *supra* note 17, § 303A.02(b)(v). NASDAQ has a similar rule that excludes from the definition of independent any director that is currently a partner, controlling shareholder, or executive officer of a company that receives or has received payments from the corporation on whose board the director sits in excess of the greater of 5% of the receiving company's gross revenues or $200,000. *See* NASDAQ, *supra* note 17, at r. 4200(a)(15)(D).

99. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 952, 124 Stat. 1376, 1900 (2010) (to be codified at 15 U.S.C. 78j-3).

100. *See infra* notes 102, 104 (explaining courts' traditional reluctance to consider social ties).

consider social or professional connections in the independence inquiry.[101] Similarly, Delaware courts essentially have dismissed allegations of social ties from the independence analysis. To be sure, on the heels of the 2002 corporate-governance scandals, it appeared that Delaware courts would allow social ties to play a significant role in the independence inquiry.[102] Thus, two lower Delaware court cases affirmatively recognized the impact that social and professional ties could play in a director's ability to be independent.[103] In so doing, Delaware courts acknowledged that such recognition represented a departure from earlier cases that failed to consider the compromising nature of social relationships.[104] However, recent decisions have retreated from this recognition, making clear that a director's social or professional relationships would play a minimal role in the independence inquiry.[105] That role means that in most cases such ties would not impact the independence analysis.[106] To this end, the Delaware Supreme Court emphasized that evidence regarding social, professional, or business relationships would normally be insufficient to discredit a director's independence.[107] As a result, even lengthy friendships or professional

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101. Federal rules define independence to exclude other problematic relationships. Thus, a director will not fit the definition of independent if she is (or within the last three years has been) an executive officer at a company during the time when the corporation's current executive officers served on such company's compensation committee. *See* NYSE, *supra* note 17, § 303A.02(b)(iv). The rules also exclude people who have certain affiliations with the company's auditors. *See id.* § 303A.02(b)(iii). Neither of these relationships, however, affirmatively encompasses purely social or professional connections.

102. *See* Lisa M. Fairfax, *Sarbanes-Oxley, Corporate Federalism, and the Declining Significance of Federal Reforms on State Director Independence Standards*, 31 OHIO N.U. L. REV. 381, 399–403 (2005) (discussing the *Oracle* and *Beam* cases in the context of Delaware courts' willingness to consider social and professional ties in the independence inquiry).

103. *See* Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 833 A.2d 961, 979–82 (Del. Ch. 2003) (focusing on social and professional ties); *In re* Oracle Corp. Derivative Litig., 824 A.2d 917, 938–39 (Del. Ch. 2003) (insisting that the independence analysis should pay heed to personal and social relationships among directors and finding that such relationships negated directors' independence).

104. *See In re Oracle Corp.*, 824 A.2d at 938–39.

105. *See* Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1051–52 (Del. 2004).

106. Thus, the Delaware Supreme Court indicated that, at least with respect to attacking directors' independence in the context of shareholder derivative suits, social and professional ties would only be relevant in the *Zapata* inquiry. *See id.* at 1054–55; *see also* Cosenza, *supra* note 62, at 32 n.123 (noting that the Delaware court limited the *Oracle* examination to the SLC context, as opposed to the pre-suit demand context). However, shareholders are not guaranteed to proceed to the *Zapata* inquiry. In fact, because it is difficult to prove demand futility, many shareholders do not proceed to the *Zapata* stage of the analysis. The Delaware Supreme Court seemed to acknowledge that limiting the consideration of social ties to *Zapata* essentially eliminated consideration of those ties with respect to the independence inquiry in derivative actions. *See Beam*, 845 A.2d at 1055 (noting that the procedural distinction between *Aronson* and *Zapata* may be "outcome-determinative on the issue of independence").

107. *See Beam*, 845 A.2d at 1051–52.

interactions among directors are not alone given serious consideration when analyzing a director's independence.[108] For example, in the litigation involving the inappropriateness of Walt Disney President Michael Ovitz's compensation package, it was established that Ovitz and Michael Eisner, the CEO of Walt Disney, had been friends for twenty-five years before Eisner recruited Ovitz to serve as president and director.[109] Yet the Delaware court reasoned that such friendship did not impact Eisner's ability to be deemed independent for purposes of assessing the derivative action against Ovitz.[110] Other Delaware courts also have ignored lengthy social or business relationships when assessing director independence.[111] Illuminating Delaware's stance on this issue, former Delaware Supreme Court Justice Norman Veasey has noted that courts should not focus on "friendship, golf companionship, and social relationships" when determining whether a director qualifies as independent under Delaware law.[112]

Of course, some discount the impact of social ties on a director's objectivity, and hence independence. Accordingly, judges and corporate-governance experts alike have insisted that it would be a mistake to presume that directors would subordinate their professional reputation and business

108. *See* Cal. Pub. Emps.' Ret. Sys. v. Coulter, No. Civ.A 19191, 2002 WL 31888343, at *9 (Del. Ch. Dec. 18, 2002); Kohls v. Duthie, 765 A.2d 1274, 1284 (Del. Ch. 2000) (stating that director independence is not compromised by personal friendship); Benerofe v. Cha, No. 14614, 1998 WL 83081, at *3 (Del Ch. Feb. 20, 1998) (same for allegations of lifelong friendship). Anecdotal evidence abounds regarding the social connections between board members. For example, former Massachusetts governor and presidential candidate Mitt Romney recently announced that he would be rejoining the board of Marriott International. He previously had served for ten years prior to stepping down in 2002. According to the *Washington Post*, "[t]he Marriott and Romney families, both active in the Mormon church, have been close for decades, and they have summer homes nearby each other on Lake Winnipesaukee in New Hampshire." Michael S. Rosenwald, *Romney Rejoins Marriott Board: Former Presidential Candidate To Head New Financial Panel*, WASH. POST, Jan. 8, 2009, at D04. Given the current understanding of director independence, it is likely that Romney would be deemed independent notwithstanding these long-standing ties with the Marriott family.

109. *See In re* Walt Disney Co. Derivative Litig., 731 A.2d 342, 352 (Del. Ch. 1998). Although Eisner encouraged Disney directors to hire Ovitz, directors became dissatisfied with Ovitz's performance almost immediately and fired him after roughly fourteen months of employment. *See id.* Ovitz's severance package enabled him to receive $140 million upon his termination. *See id.* at 350. The staggering sum prompted many shareholder lawsuits.

110. *See id.* at 355.

111. *See, e.g.*, Litt v. Wycoff, No. Civ.A 19083-NC, 2003 WL 1794724, at *4 (Del. Ch. Mar. 28, 2003) (noting that even longstanding personal friendships would not impede a director's independence); Crescent/Mach I Partners, L.P. v. Turner, 846 A.2d 963, 980–81 (Del. Ch. 2000) (stating that a fifteen-year personal relationship is insufficient to impact an independence inquiry).

112. *See* E. Norman Veasey, *The Defining Tension in Corporate Governance in America*, 52 BUS. LAW. 393, 405 (1997).

judgment in order to favor the interests of friends or business associates.[113] Instead, we should presume that other considerations, particularly professional reputation, will eclipse any potential for bias stemming from social ties.[114]

This presumption, however, seems dubious for at least three reasons. First, it is not clear that directors' business and professional reputations suffer as a result of "favoring" the social relationships they have with managers and board members. Indeed, anecdotal and empirical evidence indicates that directors may not experience significant harm when they make decisions based on such social relationships. At least some studies reveal that directors continue to hold board seats and be accepted within the business community even after evidence that they may have acquiesced in large frauds.[115]

Second, favoring these social relationships might enhance a director's reputation in business circles. Indeed, not only does being a board member often depend upon one's social and professional connections, but remaining on the board also depends upon ensuring that those connections are not damaged. Thus, directors have strong incentives to behave in ways that ensure their continued presence on the board, and such behavior often includes compliance with norms against questioning managerial policies.[116]

Third, social-science research and other prevailing evidence regarding board conduct indicate that social ties can have a profound impact on a person's ability to behave objectively. Anecdotal evidence from corporate scandals reflects the compromising nature of social ties. For example, congressional investigations regarding Enron and WorldCom found that directors had extensive social and professional ties with corporate officers and their fellow directors that compromised their ability to be impartial and undermined their ability to provide an adequate check on directors' and officers' conduct.[117] Then too, even some Delaware judges have recognized the fallacy in assuming that corporate directors' independence would not be

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113. *See* Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1052 n.32 (Del. 2004); Veasey, *supra* note 112, at 406 (indicating that it was "dubious" to presume that directors' friendship would compromise their decision).

114. *See Beam*, 845 A.2d at 1052 n.32; Veasey, *supra* note 112, at 405–06.

115. *See* Anup Agrawal et al., *Management Turnover and Governance Changes Following the Revelation of Fraud*, 42 J.L. & ECON. 309, 339–40 (1999); Eric Helland, *Reputational Penalties and the Merits of Class-Action Securities Litigation*, 49 J.L. & ECON. 365, 366 (2006); Eliezer M. Fich & Anil Shivdasani, *Financial Fraud, Director Reputation, and Shareholder Wealth*, 86 J. FIN. ECON. 306, 309–10 (2007).

116. *See* Borowski, *supra* note 8, at 461.

117. *See* BREEDEN, *supra* note 96. A special report of the Hollinger Board concluded that its CEO, Conrad Black, had longstanding social, business, and political ties with directors that undermined directors' ability to be diligent and detect the CEO's fraud. *See* SEC v. Black, No. 04-C-7377, 2009 WL 1181480, at *2 (N.D. Ill. Apr. 30, 2009); *see also* Ralph C. Ferrara, *Dealing with Private Securities Litigation*, *in* 41ST ANNUAL INSTITUTE ON SECURITIES REGULATION 1035, 1056 (2009), *available at* 1774 PLI/Corp 1035 (Westlaw) (describing report).

jeopardized as a result of social connections they have with other directors or officers.[118] In their view, such an assumption ignores the social nature of humans.[119] That nature has been documented by social-science literature, revealing that groups with strong social or personal ties experience difficulties impartially assessing one another's behavior.[120] Instead, people with strong social ties seek to avoid conflict out of concern that such conflict would undermine their friendship and "social capital"—the network of relationships they have with fellow board members.[121] Applying this literature to corporate boards, corporate-governance experts have found that when board members have strong social or professional relationships, those relationships reduce their capacity to critically scrutinize one another's conduct.[122] This finding confirms that social ties likely impact the ability of board members to impartially assess each other's actions. Other research supports the notion that business relationships undermine true independence, increasing directors' and officers' ability to engage in corporate fraud.[123]

In this regard, the failure to consider these relationships impedes directors' ability to be truly independent. This is true even if such ties may have some advantages. Indeed, some maintain that there are advantages to social ties among board members. Thus, one social psychologist who studies board behavior has argued that social ties may be beneficial in the boardroom because such ties increase trust and openness among board

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118. *See In re* Oracle Corp. Derivative Litig., 824 A.2d 917, 938 (Del. Ch. 2003).

119. In *Oracle*, the Court of Chancery of Delaware stated:

> Nor should our law ignore the social nature of humans. To be direct, corporate directors are generally the sort of people deeply enmeshed in social institutions. Such institutions have norms, expectations that, explicitly and implicitly, influence and channel the behavior of those who participate in their operation. . . . In being appropriately sensitive to this factor, our law cannot assume—absent some proof of that point—that corporate directors are, as a general matter, persons of unusual social bravery, who operate heedless to the inhibitions that social norms generate for ordinary folk.

Id.

120. *See* Brudney, *supra* note 14, at 612–13; Marleen A. O'Connor, *The Enron Board: The Perils of Groupthink*, 71 U. CIN. L. REV. 1233, 1233 (2003).

121. *See* Karen A. Jehn & Priti Pradhan Shah, *Interpersonal Relationships and Task Performance: An Examination of Mediating Processes in Friendship and Acquaintance Groups*, 72 J. PERSONALITY & SOC. PSYCHOL. 775, 778 (1997); Janine Nahapiet & Sumantra Ghoshal, *Social Capital, Intellectual Capital, and the Organizational Advantage*, 23 ACAD. MGMT. REV. 242, 245 (1998); Reed Nelson, *The Strength of Strong Ties: Social Networks and Intergroup Conflict in Organizations*, 32 ACAD. MGMT. J. 377, 380 (1989).

122. *See* O'Connor, *supra* note 120, at 1263–64.

123. *See* Hatice Uzun et al., *Board Composition and Corporate Fraud*, FIN. ANALYSTS J., May–June 2004, at 33, 41.

members, thereby promoting honest feedback.[124] Other corporate-governance scholars concur that people in close social relationships may have more candid dialogue because they feel free to criticize one another's actions.[125] A strong social relationship between directors and the CEO may be especially important because without such a relationship, directors may feel reluctant to critique such a powerful officer.[126] Then too, CEOs may be more likely to seek out advice from people with whom they are close and share strong social bonds.[127] In this regard, social relationships among board members promote better communication in the boardroom. Moreover, studies reveal that the collegiality among board members with strong social ties enhances their productivity.[128] Therefore, there may be benefits to social ties in the boardroom, though some question their strength.[129]

To be sure, these benefits do not negate the drawbacks of such ties. In fact, even those who tout the benefits of social ties acknowledge that they come at the expense of the drawbacks discussed above, some of which can be significant.[130] Courts' and regulators' failure to acknowledge those drawbacks means that the compromising nature of those ties are not appropriately examined, let alone appropriately balanced against any potential benefits. Hence, that failure impedes the extent to which any director truly can be regarded as independent.

And it is unlikely that this failure will be rectified. Indeed, regulators received evidence regarding the impact of these social ties during Congressional hearings preceding the enactment of SOX.[131] Consequently, they had the opportunity to dictate (or at least strongly recommend) that boards consider such ties, but elected not to do so. This election does not bode well for the potential to reconsider the issue. Similarly, Delaware seems to have foreclosed the potential for giving added consideration to social ties. Thus, in the aftermath of Enron and similar governance scandals, there was significant public outcry for corporate reform. In the context of this outcry, Delaware had the opportunity to shift its stance with respect to social ties. And in fact, Delaware's initial decision to analyze social ties more closely stemmed from the public's desire to see effective changes in the board's

124. *See* James D. Westpahl & Edward J. Zajac, *Defections from the Inner Circle: Social Exchange, Reciprocity and the Diffusion of Board Independence in U.S. Corporations*, 42 ADMIN. SCI. Q. 161, 163–64 (1997).

125. *See* John F. Olson & Michael T. Adams, *Composing a Balanced and Effective Board To Meet New Governance Mandates*, 59 BUS. LAW. 421, 445–46 (2004).

126. *See id.*

127. *See id.*

128. *See* Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 810 (2001).

129. *See* Velasco, *supra* note 65, at 835.

130. *See* Olson & Adams, *supra* note 125, at 446.

131. *See* BREEDEN, *supra* note 96.

monitoring function.[132] However, Delaware's decision to retreat from that analysis signaled its strong desire to adhere to the status quo.[133] Given the support in favor of change, Delaware's actions during this period underscore the low probability that Delaware will embrace consideration of social ties in the future.

Importantly, many directors have personal and professional ties with other directors prior to board service. The refusal to consider those ties may stem from a fundamental concern that such consideration would undermine the ability to view any director as objective, or at the very least, would complicate the apparently difficult task of securing qualified independent directors. Courts' reticence in this area is understandable. However, it does not negate the fact that such ties jeopardize our ability to secure truly independent directors. Instead, it confirms the relatively low probability that such ties will ever be meaningfully considered in the independence inquiry. As a result, it affirms the premise that independent directors may never sufficiently overcome the limits on their objectivity.

2. Structural Bias

Even if courts gave due consideration to social ties, the current understanding of director independence fails to consider appropriately the ramifications of structural bias. "Structural bias" refers to the bias resulting from board members' interactions with one another after joining the board.[134] This bias stems from the natural collegiality that emerges as a result of working together in a group, as well as the empathy resulting from being a part of the group.[135] As one court noted, when directors are forced to pass upon the behavior of their fellow directors, they cannot help but to approach the inquiry from a "there but for the grace of God go I" mentality, ensuring that their decisions will not be free from bias.[136]

Federal rules fail to acknowledge this structural bias at all. By comparison, Delaware has recognized the effects of structural bias in the context of shareholder derivative suits.[137] In *Zapata*, the court acknowledged the negative impact of structural bias by reserving the ability to reject the independent committees' dismissal decisions. That reservation recognizes that independent directors may find it difficult to be impartial when faced with the decision whether to allow their fellow directors or officers to be

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132. *See In re* Oracle Corp. Derivative Litig., 824 A.2d 917, 941 n.62 (Del. Ch. 2003) ("[R]ecent reforms . . . reflect a narrower conception of who [Congress and the stock exchanges] believe can be an independent director.").

133. *See* Cathy L. Reese & Kelly A. Herring, *Recent Developments in Delaware Corporate Law*, 7 DEL. L. REV. 177, 208 (2004) (noting that Delaware's decisions reaffirm its prior precedents).

134. *See* Velasco, *supra* note 65, at 861–65.

135. *See id.*

136. *See* Zapata Corp. v. Maldonado, 430 A.2d 779, 787 (Del. 1981).

137. *See id.*

sued.[138] However, before shareholders can receive the benefit of a Delaware court's substantive analysis of their suit, they must establish demand futility under *Aronson*. Because proving demand futility is difficult, most shareholder–plaintiffs do not get the benefit of a *Zapata* review. Moreover, even when shareholders do reach *Zapata*, courts overwhelmingly defer to the committees' decisions.[139] Thus, the court's role under *Zapata* may be more illusory than real, diminishing the importance of its consideration of structural bias in the independence inquiry.[140]

By contrast, psychological research confirms the prevalence of structural bias[141] and suggests that such bias is extremely relevant to the question of director independence. Thus, Professors Cox and Munsinger studied the impact of structural bias on board behavior in the context of shareholder derivative actions.[142] They concluded that structural bias can have "subtle, but powerful," effects on decision making within a boardroom, prompting directors to insulate their colleagues from legal sanctions.[143] Professor O'Connor similarly concluded that the psychological research with respect to structural bias is particularly relevant in the context of boards, highlighting the degree to which such bias undermines directors' ability to be critical of their fellow directors.[144]

The existence and impact of structural bias makes it normatively difficult to have truly independent directors. To be sure, such bias can be minimized. For example, reducing directors' length of service may reduce the effects of structural bias by minimizing the strong social affinity that hinders impartiality.[145] Furthermore, increasing board diversity could reduce the impact of structural bias because such bias is understood to flourish in homogeneous and highly cohesive groups.[146] As a descriptive matter however, the failure of courts and regulators to acknowledge the relevance of structural bias makes it difficult to implement mechanisms that could minimize such bias. More importantly, research suggests that even if such bias can be minimized, it cannot be eradicated. As a result, such bias makes it "virtually impossible for directors to be unconflicted in all meaningful respects."[147]

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138. *See id.* at 787–88.

139. *See* Velasco, *supra* note 65, at 845.

140. *See id.* at 843.

141. *See id.* at 860–65.

142. *See* James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 LAW & CONTEMP. PROBS. 83, 85 (1985).

143. *See id.*

144. *See* O'Connor, *supra* note 120, at 1263–64.

145. *See* Bhagat & Black, *supra* note 1, at 953.

146. *See* O'Connor, *supra* note 120, at 1263–64.

147. *See* Velasco, *supra* note 65, at 870.

3. Director Compensation

While courts and commentators at least acknowledge the potentially compromising nature of social ties and structural bias, they do not acknowledge the problematic ties that may stem from directors' cash compensation.[148] It should come as no surprise that directors are compensated for their board service. In 2007, the average director received some $62,000 in direct compensation[149] and $160,000 in total compensation.[150] In 2009, the average compensation of directors at S&P 500 companies was more than $200,000, with cash compensation reaching an average of about $75,000.[151] In 2007, directors in some industries (like financial institutions and pharmaceuticals) averaged $200,000 in total compensation and close to $70,000 in direct compensation.[152] A director's direct compensation consists of an annual retainer, plus meeting fees for every committee on which a director serves.[153] Directors who chair committees receive higher annual retainers and meeting fees.[154] Then too, directors' compensation increases when they serve on a committee charged with increased responsibilities not only because the annual retainer and meeting fees are higher, but also because directors meet more frequently.[155] Audit-committee chairs and members receive the highest compensation.[156] This compensation gets ignored when considering a director's independence. Hence, although federal rules provide that a director's

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148. To be sure, some attention has focused on the potentially problematic impact of equity compensation. *See* Gordon, *supra* note 30, at 1488, 1536–38 (noting the "distinct set of perverse incentives" created by stock-based compensation). In particular, companies have focused on the problems associated with awarding stock options. In fact, one study found that independent directors also engaged in option backdating. *See* Lucian Bebchuk et al., *Lucky Directors* 2 (John M. Olin Ctr. for Law, Econ. & Bus., Paper No. 573, 2007), *available at* http://papers.ssrn.com/abstract_id=952239. As a result of concerns related to stock options, boards have altered the manner in which they convey stock to their directors, favoring restricted stock awards over stock options. *See* THE KORN/FERRY INST., *supra* note 4, at 13. This focus on equity compensation does not extend to a focus on cash compensation.

149. *See* THE KORN/FERRY INST., *supra* note 4, at 14. "Direct compensation" refers to cash compensation.

150. *See id.* at 20. Total compensation includes cash compensation and equity compensation. In 2009, outside directors at Harley-Davidson received an average total compensation of $506,750 and an average cash retainer of $100,000. *See* SPENCER STUART, *supra* note 4, at 42.

151. *See* SPENCER STUART, *supra* note 4, at 30–32. The average total compensation of S&P directors was $212,750, while the average cash compensation for such directors was $75,893.

152. *See* THE KORN/FERRY INST., *supra* note 4, at 20.

153. *See id.* at 21. The average annual retainer for an audit-committee chair, for example, is about $15,583. It should be noted that according to Spencer Stuart, there is a "trend away from meeting fees to retainers for committee leadership and service" at S&P 500 companies. *See* SPENCER STUART, *supra* note 4, at 30.

154. *See* THE KORN/FERRY INST., *supra* note 4, at 21.

155. *See id.* at 14.

156. *See id.*

receipt of fees from the corporation on whose board she serves prevents her from being viewed as independent, these rules exclude board compensation.[157] Delaware courts similarly do not take board compensation into account when examining a director's independence.

This failure to account for director compensation runs counter to the clear consensus regarding the bias-producing nature of financial ties. In the independence inquiry, receipt of financial fees from the corporation is the quintessential disqualifying tie. Indeed, while courts and regulators differ on their definition of independence, they are uniform in their view that receipt of financial fees automatically disqualifies someone from being deemed independent. To be sure, not all rules treat financial compensation the same. Hence, all compensation disqualifies a director from being considered independent under SOX.[158] Yet the listing agencies only exclude directors if they receive direct compensation in excess of a certain threshold. Under NASDAQ, for example, direct compensation in excess of $60,000 disqualifies a director from being viewed as independent, while the NYSE threshold is $120,000.[159] Based on these rules, if directors' board fees were not excluded, the current amount of such fees would exclude the average director from being considered independent under both SOX and NASDAQ. On the one hand, these rules reveal that we view the potential for bias from financial fees as so strong that we categorically disqualify people from being deemed independent even if they have only a single interaction with the corporation. On the other hand, the rules' exclusion regarding director fees suggests that merely characterizing such fees as director compensation eradicates any potential for bias. Such a suggestion seems problematic at best.

To be sure, one can offer several reasons why director compensation is excluded from the independence inquiry. First, director compensation is often characterized as nominal, and hence it may not warrant serious concern. Concededly, director compensation is nowhere near the levels of executive compensation. However, it cannot be considered nominal; indeed, the fact that the average directorial compensation package exceeds the thresholds for independence under federal rules reflects this. Second, the fact that directors have other sources of compensation may reduce any concern that their board compensation may jeopardize their impartiality. Indeed, many independent directors have full-time jobs,[160] and when compared against their salary at those jobs, their board fees may be relatively

157. *See supra* notes 97–98 and accompanying text.

158. *See supra* note 97 and accompanying text.

159. *See* NASDAQ, *supra* note 17, at r. 4200(a)(15). The NYSE disqualifies directors only if they receive direct compensation in excess of $120,000. *See* NYSE, *supra* note 17, § 303A.02.

160. *See* THE KORN/FERRY INST., *supra* note 4, at 18 (demonstrating that most boards have directors who serve as CEOs and COOs of other companies); SPENCER STUART, *supra* note 4, at 13 (demonstrating that most new independent directors are active executives or professionals).

insignificant. Then too, other independent directors are former executives and hence may be independently wealthy.[161] To be sure, the existence of other sources of funding does not appear to have any bearing on the independence analysis for other individuals. Also, consultants and advisors likely have additional sources of income but nevertheless are excluded from the definition of independence if they receive funds from the corporation on whose board they sit.[162] This fact undercuts the theory that an outside director's alternative source of income minimizes the compromising nature of director compensation.

Of course, the most pragmatic rationale behind the failure to consider board fees in the independence inquiry is that such consideration would result in no one being viewed as independent. Hence, such compensation cannot be used to measure a director's independence. In light of the compromising nature of financial ties, however, the fact that we cannot consider those ties underscores the inherent limitations in the quest for true director independence.

4. Climate Changes

When viewed in context of the current demands on independent directors, the prospects for meaningfully minimizing any of the aforementioned ties seem bleak. Such ties, particularly those resulting from structural bias and director fees, are an inevitable feature of board service. Moreover, as we increase our reliance on independent directors, such ties deepen. Thus, as directors have greater responsibility, they inevitably spend more time together, thereby increasing their social interactions. Hence, this current climate increases the likelihood that there will be enhanced social ties and structural bias. Then too, independent directors are being paid more.[163] This is because it is difficult to increase directors' responsibilities without a corresponding increase in compensation.[164] Indeed, because many directors are paid on a per-meeting basis, their compensation increases with the frequency of their meetings. Therefore, like social ties and structural bias, these financial ties not only appear to be an inevitable feature of board service, but also are likely to increase as we continue to rely on independent directors. Hence, as we increase our dependence on

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161. *See* THE KORN/FERRY INST., *supra* note 4, at 18 (revealing that many directors are retired executives).

162. *See supra* note 97 and accompanying text (indicating that the federal rules cover anyone compensated by the corporation).

163. *See* THE KORN/FERRY INST., *supra* note 4, at 13. Spencer Stuart did note a 2% decline in overall director compensation at S&P 500 companies from 2008–2009, along with a 1% increase in annual cash retainers. SPENCER STUART, *supra* note 4, at 30, 32. Of course even if such compensation is increasing at a relatively smaller rate, the amount still appears significant enough to warrant concern regarding its potential to impact a director's objectivity.

164. *See* THE KORN/FERRY INST., *supra* note 4, at 13.

independent directors, we reduce our ability to minimize these compromising ties, thereby reducing the extent to which independent directors can be characterized as truly independent.

B. Selection Bias

The current director-selection process in public corporations also undermines a director's ability to be truly independent and perform her monitoring roles with sufficient rigor. In public corporations, shareholders vote by proxy, which means that they vote without being physically present at the annual meeting.[165] In order to vote by proxy, a proxy statement that includes the names of the directorial candidates must be distributed to all shareholders.[166] Hence, the corporation annually distributes a proxy statement to its shareholders so that they can vote on directorial candidates.[167] Currently, only the names of candidates supported by incumbent managers and directors appear on a corporation's proxy statement; corporations can and do exclude the names of candidates supported by shareholders.[168] This exclusion means that although shareholders can nominate their own candidates, the only way that those candidates can be voted upon is if shareholders distribute their own proxy statement. The expenses associated with such a distribution can be prohibitive, making it extremely difficult for most shareholders to nominate and elect candidates of their choice.[169] Shareholders' inability to nominate their candidates on the corporation's proxy statement means that the vast majority of directors are chosen by other directors and run unopposed.[170]

165. *See* ROBERT C. CLARK, CORPORATE LAW 360 (1986).

166. *See* Exchange Act Rule 14a-3, 17 C.F.R. § 240.14a-3(a)(8) (2010). The proxy statement also contains information about the candidates to be voted on.

167. *See id.*

168. *See* Exchange Act Rule 14a-8, 17 C.F.R. § 240.14a-8(i)(8) (2010) (providing exclusions for shareholder proposals related to election of directors).

169. *See* Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 856 (2005); Melvin Aron Eisenberg, *Access to the Corporate Proxy Machinery*, 83 HARV. L. REV. 1489, 1499 (1970). The SEC has recognized that the tremendous costs associated with proxy campaigns mean that such campaigns are not really feasible. *See* Re-Examination of Rules Relating to Shareholder Communications, 42 Fed. Reg. 23,901 (Apr. 28, 1977).

170. Indeed, historically, proxy contests have been rare. *See* Bebchuk, *supra* note 169, at 865 (noting that outside of the hostile-takeover context, there are roughly eleven proxy contests a year). While such contests recently have increased, they nevertheless remain expensive and hence limited when viewed against the thousands of directors selected each year. *See id. But see* Martin Lipton & William Savitt, *The Many Myths of Lucian Bebchuk*, 93 VA. L. REV. 733, 737–38 (2007) (questioning Bebchuk's claims regarding the dearth of proxy contests based on his failure to pinpoint the optimal number of proxy contests).

Recently, the SEC implemented an e-proxy system aimed at reducing the costs of distributing proxy statements and thus increasing the ability of shareholders to engage in proxy contests. *See* Internet Availability of Proxy Materials, 72 Fed. Reg. 4,148 (Jan. 29, 2007) (codified in scattered sections of 17 C.F.R.). That system enables shareholders to distribute the proxy statement electronically, thereby reducing the substantial printing and mailing costs

This process undermines director independence and the corresponding monitoring function. The shareholder franchise is supposed to enhance managerial accountability.[171] In other words, shareholders' ability to vote directors out of office or refuse to elect them into office should prompt directors to pay heed to their monitoring responsibilities.[172] Moreover, shareholders' power to replace directors should encourage them to make decisions beneficial to shareholders.[173] However, the director-selection process means that such power does not exist in any meaningful respect. Instead, directors may feel beholden to their fellow directors because those directors nominate them and therefore control their ability to remain on the board.[174] In fact, studies reveal that CEOs often dominate the director-nomination process, causing directors to feel beholden to CEOs.[175] Thus, the director-selection process does little to incentivize effective monitoring and instead increases the potential for managerial and CEO capture.[176] Then too, this process enhances the structural bias within the boardroom because it increases the extent to which directors view their fate as linked with their fellow directors. Therefore, the director-selection process impedes the ability of directors to be truly independent.[177]

Recognizing the potential for managerial and CEO capture inherent in the director-selection process, reforms have not only required boards to create nominating committees, but also have required that those committees be comprised of independent directors.[178] A nominating committee is charged with locating and nominating qualified directorial candidates.[179] Separate nominating committees are designed to ensure that directors locate qualified candidates without unwarranted influence from management in general and the CEO in particular.[180] The belief was that eliminating managers and CEOs from the selection process would ensure

associated with delivering proxy materials. While it is too soon to determine if those rules will have an impact on the rate of proxy campaigns, early evidence suggests that it may have disenfranchised some voters.

171. *See* Bebchuk, *supra* note 169, at 851.

172. *See id.*

173. *See id.*

174. *See id.* at 856; Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 310 (1999); Cosenza, *supra* note 62, at 43–45; Eisenberg, *supra* note 169, at 1504.

175. *See* Bebchuk, *supra* note 169, at 856; Borowski, *supra* note 8, at 460 (noting that the "fatal flaw" in board structure is the ability of corporate managers to select directorial candidates); Cosenza, *supra* note 62, at 49–50.

176. *See* Bebchuk, *supra* note 169, at 856; Borowski, *supra* note 8, at 460.

177. *See* Brudney, *supra* note 14, at 621; Cosenza, *supra* note 62, at 43–45.

178. *See* Gordon, *supra* note 30, at 1498 (discussing reforms).

179. *See id.*

180. *See* Bainbridge, *supra* note 72, at 1038.

the independence of directors, realigning directors' interests with shareholders and enhancing the efficacy of their monitoring.[181]

Unfortunately, this solution may not alleviate the capture problem. First, notwithstanding the creation of independent nominating committees, evidence reveals that CEOs continue to influence the director-nomination process through informal consultations and recommendations of directorial candidates.[182] Hence, boards continue to appoint people with social and professional connections to the CEO and other managers. And because our definition of independent director fails to consider these social ties, these directors are deemed independent. Second, even if nominating committees alleviate the concerns associated with managerial and CEO capture, they fail to ensure that directors are free from bias with respect to other directors. Thus, evidence reveals that directors have substantial social and professional ties with their fellow directors.[183] In fact, even when boards rely on search firms, they gravitate towards candidates with whom they have some shared history or relationships.[184] At best, therefore, we have exchanged managerial capture for board capture. As a result, nominating committees do not alleviate concerns that directors will feel beholden to their fellow directors when making decisions regarding their conduct. Thus, those committees do not alleviate concerns about directors' impartiality and ability to monitor effectively.

Some corporate scholars contend that the ideal solution to selection bias is to increase shareholders' role in the nomination process by allowing them access to the corporation's proxy statement.[185] Such access ensures that shareholder-supported candidates have an opportunity to be included on the corporate proxy statement, increasing the chances that directors' interest will be aligned with that of the shareholders. Because it creates the real potential that shareholders can replace directors, proxy access also incentivizes all directors to pay heed to shareholder interests, thereby invigorating directors' monitoring role.

In August 2010, as this Article was going to press, the SEC passed a proxy-access rule for the first time in its history.[186] Shareholder-rights groups had been advocating for access to the proxy for decades. However, the SEC

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181. *See* Borowski, *supra* note 8, at 460.

182. *See* Uzun et al., *supra* note 123, at 41 (noting chief executives' influence in certain committees).

183. *See id.*

184. *See id.* Often search firms will have business relationships with the company. *See* Gordon, *supra* note 30, at 1498.

185. *See* Bebchuk, *supra* note 169, at 856; Cosenza, *supra* note 62, at 43.

186. *See, e.g.*, Facilitating Shareholder Director Nominations, Exchange Act Release Nos. 33-9136, 34-62764 (Aug. 25, 2010), *available at* http://www.sec.gov/rules/final/2010/33-9136.pdf; Neal Lipschutz, *'Proxy Access' Era Begins; Welcome to the Unknown*, WALL. ST. J., Aug. 25, 2010, http://online.wsj.com/article/SB10001424052748703632304575451892123490472.html?mod=WSJ_hpp_LEFTWhatsNewsCollection.

had repeatedly denied that access.[187] Thus, in the past, on each occasion that the SEC has had the opportunity to consider proxy access, the SEC has rejected it based largely on staunch opposition and criticism from business groups.[188] This occurred most recently in 2007, when the SEC considered, but then rejected, a proxy-access proposal.[189] In July 2009, the SEC once again proposed a proxy-access proposal.[190] After considerable debate and opposition, the SEC approved a rule that requires public corporations to provide proxy access to its shareholders.[191]

Even with the new rule, it is not clear if proxy access actually can improve directors' monitoring function. Recently, shareholders have been more active and thus have waged more proxy contests.[192] Empirical evidence reveals that when those contests appear likely to be successful, most directors negotiate with the shareholders to retain their board seats.[193] Hence, many proxy contests result in negotiated settlement agreements, pursuant to which the board is expanded to accommodate one or two shareholder-supported candidates.[194] Moreover, shareholders often nominate only a "short slate" of candidates.[195] That is, shareholders do not seek to replace the entire board; rather they seek to replace some percentage of the board, typically less than a majority. Thus, when shareholders successfully secure board seats via either settlement or

187. *See* Security Holder Director Nominations, Exchange Act Release No. 34-48626, 68 Fed. Reg. 60,784 (Oct. 23, 2003) (proposed proxy-access rule ultimately abandoned by the SEC); Proposed Amendments to Rule 14a-8 Relating to Proposals by Security Holders, Exchange Act Release No. 34-19135, 47 Fed. Reg. 47,420 (Oct. 26, 1982) (considering and rejecting a proposal to grant proxy access in 1982); Jayne W. Barnard, *Shareholder Access to the Proxy Revisited*, 40 CATH. U. L. REV. 37, 47 (1990) (describing the SEC's consideration and rejection of a proxy access rule in 1942).

188. *See* Barnard, *supra* note 187, at 47; Jill E. Fisch, *From Legitimacy to Logic: Reconstructing Proxy Regulation*, 46 VAND. L. REV. 1129, 1163 (1993); *see also* Amendments to Rule 14a-8 Under the Securities Exchange Act of 1934 Relating to Proposals by Security Holders, Exchange Act Release No. 34-20091, 48 Fed. Reg. 38,218 (Aug. 16, 1983) (codified at 17 C.F.R. pt. 240) (noting minimal support for Proposal III, which called for security holders to have unrestricted access to proxy statements).

189. *See* Shareholder Proposals Relating to the Election of Directors, Exchange Act Release No. 34-56914, 72 Fed. Reg. 70,450 (Dec. 11, 2007) (codified at 17 C.F.R. pt. 240).

190. *See* Facilitating Shareholder and Director Nominations, SEC Release Nos. 33-9046, 34-60089 (proposed June 10, 2009), *available at* http://www.sec.gov/rules/proposed/2009/33-9046.pdf.

191. *See* Facilitating Shareholder Director Nominations, *supra* note 186; Zach Goldfarb, *SEC Votes To Allow Proxy Access*, WASH. POST, Aug. 25, 2010, http://voices.washingtonpost.com/market-cop/2010/08/sec_votes_to_allow_proxy_acces.html; Lipschutz, *supra* note 186.

192. *See* INSTITUTIONAL S'HOLDER SERVS., 2006 POSTSEASON REPORT: SPOTLIGHT ON EXECUTIVE PAY AND BOARD ACCOUNTABILITY 6, 27 (2006), *available at* http://www.riskmetrics.com/system/files/private/2006PostSeasonReportFINAL.pdf (describing increase in shareholder proposals).

193. *See* SHARKREPELLENT, STUDY OF ACTIVISTS CAMPAIGNS 2008 (on file with author).

194. *See id.*

195. *See id.*

successful election, their actions do not result in the wholesale displacement of management candidates. This suggests that proxy access is not likely to reverse the status quo, pursuant to which boardrooms are largely populated with directors selected by management as opposed to shareholders. As a result, proxy access may not decrease the number of people on the board that may be impacted by selection bias, except indirectly. Moreover, the evidence suggests that once shareholder-supported candidates secure election to the board, they tend to adapt to board culture rather than becoming forceful advocates for shareholders.[196] In other words, the nature of their selection does not negate the bias that occurs as a result of being a board member.[197] Given the literature related to structural bias, this result should not be surprising. Consequently, while increased access to the proxy may result in increased director independence at the margins, it does not significantly reduce the bias of board members, and thus may not significantly enhance directors' monitoring abilities.

C. Informational Asymmetries

Informational asymmetries inherent in the role of independent directors further limit such directors' ability to be effective monitors. In order for a director to be effective, she needs accurate information.[198] As one scholar acknowledges, "Uninformed independence has limited value . . . ."[199] However, the fact that independent directors are outsiders, and hence not engaged in the daily affairs of the corporation, means that they are dependent on the insiders that they must monitor to supply them with the information necessary to discharge their responsibilities.[200] To the extent we are concerned that insiders may inappropriately filter or otherwise manipulate the information, independent directors may not alleviate this concern. This is because such directors' outsider status makes it difficult for them to verify the accuracy of the information, and thus difficult to be effective monitors.

The primary corporate-governance response to the informational-asymmetry problem has been reliance on "gatekeepers" such as advisors,

196. *See id.*

197. *See* Borowski, *supra* note 8, at 462 ("It is unlikely that changing the method of selection of board members will alter significantly the tendency of independent board members to favor management.").

198. *See* Melvin Aron Eisenberg, *Legal Models of Management Structure in the Modern Corporation: Officers, Directors and Accountants*, 63 CALIF. L. REV. 375, 404 (1975) (noting the importance of obtaining accurate and objective information); *see also* Bainbridge, *supra* note 72, at 1055–56 (noting that those with decision-making power must have information that is not distorted).

199. *See* Gordon, *supra* note 30, at 1541.

200. *See* Cox, *supra* note 52, at 1082.

attorneys, and accountants.[201] These gatekeepers should reduce the problems associated with informational asymmetries by providing independent directors with an alternate and impartial source of information, thereby ensuring that they are not wholly dependent on insiders. Moreover, these gatekeepers are supposed to verify the integrity of the information provided by company insiders.

However, reliance on gatekeepers does not necessarily reduce the problem of informational asymmetries, nor does it adequately enhance the efficiency of corporate monitoring. First, even gatekeepers depend upon insiders for their supply of information.[202] Thus, gatekeepers' presence does not negate the insider's ability to dominate, and therefore potentially manipulate, the flow of information. Second, gatekeepers may be unreliable because they are subject to their own conflicts of interest that could lead them to manipulate data or otherwise rubber-stamp decisions made by managers.[203] The unreliability of gatekeepers reflects one of the principal insights of the corporate-governance scandals of 2002.[204] Those scandals also indicated that when gatekeepers fail in their responsibility, independent directors are unable to take up the slack, not only because such directors cannot monitor gatekeepers to ensure their impartiality, but also because such directors cannot ensure the integrity and clarity of financial reporting without the assistance of gatekeepers.[205] Third, evidence suggests that these gatekeepers are also impacted by structural bias and therefore find it difficult to be truly objective.[206] Indeed, such gatekeepers come to view themselves as a part of the managerial team, reducing their ability to

201. *See id.* at 1082–83; Cunningham, *supra* note 65, at 327–29 (noting the gatekeepers' role in certifying information).

202. *See* Eisenberg, *supra* note 198, at 404.

203. *See* Lawrence A. Cunningham, *Choosing Gatekeepers: The Financial Statement Insurance Alternative to Auditor Liability*, 52 UCLA L. REV. 413, 419 (2004) (noting that auditors face inherent conflicts and capture that impair the efficacy of their reporting).

204. *See id.*; *see also* John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 318–33 (2004) (explaining why gatekeepers should have detected the accounting irregularities in the 2001–2002 cases but did not); Gordon, *supra* note 30, at 1538.

205. *See* Gordon, *supra* note 30, at 1538–39; *see also* Arthur E. Wilmarth, Jr., *Conflicts of Interests and Corporate Governance Failures at Universal Banks During the Stock Market Boom of the 1990s: The Cases of Enron and WorldCom*, *in* CORPORATE GOVERNANCE IN BANKING: A GLOBAL PERSPECTIVE 97, 100–20 (Benton E. Gup ed., 2007) (chronicling banks' role in the downfall of Enron and WorldCom, as well as the conflicts and other factors that caused banks to acquiesce to, and participate in, corporate misconduct).

206. *See* Barry D. Baysinger & Henry N. Butler, *Corporate Governance and the Board of Directors: Performance Effects of Changes in Board Composition*, 1 J.L. ECON. & ORG. 101, 109–10 (1985); Charles M. Elson & Christopher J. Gyves, *The Enron Failure and Corporate Governance Reform*, 38 WAKE FOREST L. REV. 855, 872–73 (2003).

criticize that team.[207] Hence, reliance on gatekeepers does not overcome directors' informational disadvantage.

Another solution to the informational-asymmetries problem focuses on public disclosure of corporate information.[208] Indeed, over the last fifty years, the SEC has sought to require better and more accurate disclosure from public companies.[209] Such disclosure is aimed at ensuring that directors are not wholly dependent on insiders, but instead can rely on the disclosure regime to ensure the accuracy and integrity of corporate information. To the extent the disclosure regime imparts accurate information, that regime ensures that independent directors will not be at an informational disadvantage.[210] According to Professor Gordon, the disclosure regime ensures that the stock market is well-informed, increasing the informativeness of stock price.[211] As a result, Professor Gordon argues that the disclosure regime ameliorates the independent directors' information deficit and thus enhances such directors' ability to perform their oversight functions.[212]

However, this argument appears flawed for a variety of reasons. First, many scholars maintain that stock price is not accurate. Instead, the price incorporates noise.[213] Consequently, many have asserted that stock price fails to reflect fundamental value, but rather may be irrational.[214] The existence of noise undermines the informativeness of stock price and thus undermines the reliability of the information such price imparts to independent directors. Second, the focus on short-term stock price encourages independent directors to acquiesce in management's price-manipulation practices for at least two reasons. The first is because independent directors come to view stock price as a measure of success and thus have incentives to ensure that the measure remains high. The second is that the increase in stock-based compensation for directors increases directors' bias in favor of practices that augment, if not manipulate, stock

207. *See* Baysinger & Butler, *supra* note 206, at 109–10; Elson & Gyves, *supra* note 206, at 872–73.

208. *See* Gordon, *supra* note 30, at 1541–43 (noting that the disclosure regime has aligned the interests of the independent director and shareholders).

209. *See id.* at 1548–51.

210. *See id.* at 1542–43.

211. *See id.*

212. *See id.* at 1541.

213. *See* Fischer Black, *Noise*, 41 J. FIN. 529, 529–30 (1986); Erik F. Gerding, *The Next Epidemic: Bubbles and the Growth and Decay of Securities Regulation*, 38 CONN. L. REV. 393, 398 (2006); Donald C. Langevoort, *Theories, Assumptions and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851, 858–72 (1992); *see also* Lynn A. Stout, *Are Stock Markets Costly Casinos?: Disagreement, Market Failure, and Securities Regulation*, 81 VA. L. REV. 611, 628–29 (1995) (noting that investors are not necessarily irrational, but that markets nevertheless produce prices that depart from fundamental value).

214. *See* Black, *supra* note 213, at 529–30; Gerding, *supra* note 213, at 398; Langevoort, *supra* note 213, at 858–72; Stout, *supra* note 213, at 628–29.

price.[215] Hence, evidence reveals that independent directors not only were complicit in stock-based fraud such as option backdating, but also that they benefited from them through the receipt of opportunistically timed stock-option grants.[216] In this regard, the focus on stock price may undermine independent directors' objectivity, while the potential for fraud undermines the integrity of information reflected by the stock price.

Third, even if a stock price conveys accurate information, it is not narrowly tailored enough to assist independent directors in making or monitoring strategic decisions.[217] Thus, the information it conveys may be too general to surmount its informational disadvantage. Finally, the notion that the disclosure regime overcomes the independent directors' informational disadvantages is somewhat circular. In order for the disclosure regime to overcome independent directors' informational disadvantage, the regime must convey accurate information. However, the conveyance of accurate information depends upon the independent director's ability to verify the accuracy and integrity of such information. In other words, independent directors can only verify the accuracy of the information by reliance on the disclosure regime, which in turn relies upon the directors for its efficiency. The circularity of this problem illuminates the flaws in the presumption that the disclosure regime overcomes the informational-asymmetries problem.[218]

As this discussion reveals, informational asymmetries may significantly curtail independent directors' effectiveness as monitors. Because the solutions aimed to overcome this problem are flawed at best, independent directors' monitoring abilities may also be flawed at best.

D. The Knowledge Deficit

The fact that the current conception of an independent director fails to consider the necessary expertise of a director further undermines the directors' ability to be effective. Except in the audit committee, no reform focuses on the affirmative skills or knowledge directors need in order to properly perform their responsibilities.[219] Thus, studies reveal that while

215. *See* Bebchuk, *supra* note 148, at 1; Gordon, *supra* note 30, at 1536–37.

216. *See* sources cited *supra* note 215.

217. *See* Abramowicz & Henderson, *supra* note 56, at 1362–63 (noting the significant disadvantages of relying on stock prices to reduce agency costs, particularly the fact that such prices are too blunt). Professors Abramowicz and Henderson maintain that prediction markets may provide an alternate source of information that could enhance directors' monitoring role. *See id.* at 1375–76.

218. This circularity also may provide tentative support for Professors Abramowicz and Henderson's case for the reliance on prediction markets in corporate governance. Such reliance may be more effective than reliance on the disclosure regime because those markets represent an alternate source of information and do not necessarily depend upon independent directors for their accuracy and integrity. *See id.* at 1350–60.

219. *See* Sarbanes-Oxley Act of 2002 § 407, 15 U.S.C § 7265 (2006).

many directors have knowledge about general business matters, few have knowledge regarding the particular industry on whose board they sit, and even fewer have knowledge about the specific company on whose board they sit.[220] Indeed, even when former executives sit on a board, their knowledge is limited to the historical practices at the company. Thus, they do not have knowledge of current affairs or events.

This knowledge deficit is troubling. Recently, scholars have argued that corporate-governance literature has largely ignored the knowledge resources necessary to enhance corporate governance.[221] Such scholars maintain that a monitoring system that relies on people without sufficient knowledge is not only inefficient, but potentially damaging.[222] In other words, even if directors received accurate and adequate information, they may lack the ability to understand that information, and thus they may also lack the ability to detect deficiencies with respect to that information.[223] Corporate-governance scandals tend to confirm that many directors lack the knowledge and expertise to sufficiently appreciate the complexities associated with their business, and that such lack of knowledge impedes the effectiveness of their oversight.[224] The knowledge deficit also increases the likelihood that independent directors will acquiesce in managerial decisions because their lack of knowledge will prompt inappropriate deference.

Then too, independent directors are limited in their ability to overcome this knowledge deficit. As an initial matter, a director's independence ensures that she has other commitments and hence cannot devote an inordinate amount of time to her board duties. Indeed, even though directors increase the amount of time they spend on board matters, they nevertheless are limited in the time they can commit to gaining knowledge about company affairs.[225] Moreover, most corporations are large and decentralized with widespread activities, enhancing the difficulties with

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220. *See* Margaret A. Bancroft, *Knowledge Is Power: What Went Wrong in the Mutual Fund Industry*, 1 J. BUS. & TECH. L. 145, 155 (2006) (noting that independent directors do not have even experience relevant to the industry, let alone specific experience related to the company on whose board they serve).

221. *See* Érica Gorga & Michael Halberstam, *Knowledge Inputs, Legal Institutions and Firm Structure: Towards a Knowledge-Based Theory of the Firm*, 101 NW. U. L. REV. 1123, 1125 (2007).

222. *See id.* at 1164.

223. *See* Olson & Adams, *supra* note 125, at 431 (noting that a lack of familiarity with a corporation's business and its risks has the potential to reduce a director's ability to detect misconduct).

224. *See* Report of the Investigation in the Matter of Sterling Homex Corp., Exchange Act Release No. 34-11516 (July 2, 1975), 1975 WL 163038 (noting that independent directors lacked sufficient grasp of the company's practices to make informed decisions); Charles Forelle & James Bandler, *How Did UnitedHealth's McGuire Get Same Options Twice?*, WALL ST. J., Oct. 20, 2006, at B1 (noting directors did not fully understand option transaction).

225. *See* THE KORN/FERRY INST., *supra* note 4, at 10, 27. Board members spend more time at their duties, averaging sixteen hours per month. To be sure, that is about a half an hour per day.

gaining sufficient knowledge about those activities.[226] Finally, the complexities involved with many of today's business transactions handicap directors' ability to become proficient in their company's affairs.[227] Taken as a whole, the fact that independent directors are not actively engaged in management "limits what it [is] reasonable for the board to know."[228] In this regard, the knowledge deficit may prove difficult to surmount.

Some corporate experts contend that this knowledge deficit may prove beneficial. Thus, Professor Gordon argues that independent directors' lack of firm-specific knowledge enables them to bring an important external perspective to board decision making.[229] It also decreases the extent to which such directors rely on insiders or otherwise give unwarranted deference to insiders.[230] For example, Professor Gordon claims that directors' knowledge deficit, at least with respect to firm-specific information, may be advantageous.

However, this claim is debatable. As an initial matter, anecdotal evidence suggests that the knowledge deficit may in fact enhance board deference because board members may feel uncomfortable challenging decisions that they do not understand.[231] Then too, directors' knowledge deficit may decrease the value of any external perspective they bring, while increasing the extent to which directors engage in inappropriate herd behavior. In other words, when directors do not have sufficient knowledge to understand the nature of transactions in which their companies engage, their external perspective is uninformed.[232] Moreover, without sufficient knowledge about a company's internal practices, directors may not use outside performance signals to critically analyze those policies, but instead may rely on such signals to validate the appropriateness of those practices. Hence, directors' lack of knowledge encourages them to engage in herd-like behavior pursuant to which directors acquiesce in practices merely because other companies also engage in those practices. This reveals that while external perspectives may have value, such perspectives can be counterproductive when outsiders lack sufficient expertise.

To be sure, some corporations have sought to overcome the knowledge deficit by focusing on director expertise during recruitment. However, this focus is difficult in light of the requirements for director independence.

226. *See id.* (noting the difficulties with harnessing knowledge in decentralized firms where employees have highly specialized knowledge and hence enhanced discretion).

227. *See* James P. Holdcroft & Jonathan R. Macey, *Flexibility in Determining the Role of the Board of Directors in the Age of Information*, 19 CARDOZO L. REV. 291, 294–95 (1997).

228. *See* Mitchell, *supra* note 45, at 41–42.

229. *See* Gordon, *supra* note 30, at 1563.

230. *See id.* (noting that looking to outside indicators ensures that independent directors are "less captured by internal perspective").

231. *See supra* notes 223–24.

232. *See* Gorga & Halberstam, *supra* note 221, at 1164.

Those requirements not only limit the overall pool of qualified directors, but also limit the pool of candidates with needed industry expertise, since such candidates are most likely to be insiders.

E. Independent Director Liability, or Lack Thereof

This section contends that the reluctance to impose liability on independent directors may also reduce their effectiveness. Indeed, the law imposes an increasing amount of responsibilities on independent directors but essentially fails to impose any legal sanctions on such directors for their failure to adhere to those responsibilities. This failure significantly reduces the extent to which independent directors are held accountable. It also significantly reduces the extent to which independent directors are deterred from shirking their obligations. Indeed, one critical purpose of legal sanctions is to deter misconduct by making the costs of such conduct outweigh its benefits.[233] However, if there is no significant risk of liability, then such liability has very little deterrent value.[234] Consequently, the virtual failure to impose legal sanctions on independent directors means that such directors may not be properly motivated to carry out their responsibilities. As a result, that failure undermines their effectiveness.

In an effort to ensure adherence to their various monitoring duties, the law imposes various fiduciary duties on directors. At the state level, those duties encompass the duty of care, which demands that directors make decisions in the best interest of the corporation,[235] and the duty of loyalty, which regulates director conduct when there is some conflict of interest.[236] Delaware recently made clear that the duty of loyalty includes the duty of oversight, encompassing the obligation to effectively monitor the actions of officers and directors.[237] The federal securities laws also impose obligations on independent directors, holding them responsible for accurate and

233. *See, e.g.*, Darryl K. Brown, *Street Crime, Corporate Crime, and the Contingency of Criminal Liability*, 149 U. PA. L. REV. 1295, 1325 (2001); William J. Chambliss, *Types of Deviance and the Effectiveness of Legal Sanctions*, 1967 WIS. L. REV. 703; Kenneth G. Dau-Schmidt, *An Economic Analysis of the Criminal Law as Preference-Shaping Policy*, 1990 DUKE L.J. 1, 5; Richard A. Posner, *An Economic Theory of the Criminal Law*, 85 COLUM. L. REV. 1193, 1205–06 (1985).

234. *See* Raymond Paternoster & Sally Simpson, *Sanction Threats and Appeals to Morality: Testing a Rational Choice Model of Corporate Crime*, 30 LAW & SOC'Y REV. 549, 578–79 (1996); *Penalties for White Collar Crime: Are We Really Getting Tough on Crime?: Hearing Before the S. Comm. on the Judiciary*, 107th Cong. (2002), *available at* http://judiciary.senate.gov/hearings/testimony.cfm?id=310&wit_id=711 (statement of Professor John C. Coffee, Jr.).

235. *See* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); *see also* Smith v. Van Gorkom, 488 A.2d 858, 872–73 (Del. 1985) (discussing informed business judgment as a component of the duty of care).

236. *See* Marciano v. Nakash, 535 A.2d 400, 403 (Del. 1987).

237. *See* Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006) (noting that the fiduciary duty violated by an oversight failure is the duty of loyalty).

reliable disclosures.[238] All of these duties are aimed at ensuring that independent directors carry out their jobs in a diligent fashion and do not place their interests ahead of corporate interests. However, independent directors rarely face liability, either civil or criminal, for breaching their duties.

1. Liability in the Civil Context

Confirming this point with respect to civil liability, Professors Black, Cheffins, and Klausner conducted an extensive investigation of outside-director liability.[239] The investigation revealed that while there are thousands of suits involving corporate- or securities-law violations filed each year, those suits rarely name independent directors as defendants.[240] Even when such directors are named defendants, they rarely face trial. Professor Black and his co-authors only discovered eight securities trials and twelve direct shareholder suits where independent directors were defendants when the trial commenced.[241]

Even when they go to trial, independent directors are rarely found liable and that liability almost never results in out-of-pocket damages. Thus, their research only found one case where outside directors paid damages after trial.[242] That case, *Smith v. Van Gorkom*, is well-known in corporate circles as the one major example of independent directors being held liable for breaching their fiduciary duties.[243] Independent directors' virtual absence from the liability regime results primarily from a combination of insurance, indemnification, and statutory protections that make it nearly impossible to extract monetary damages from independent directors.[244] Indeed, those statutory protections ensure that a *Van Gorkom*-type action will no longer result in out-of-pocket liability.[245] In this respect, *Van Gorkom* is the exception that proves the rule disfavoring independent-director liability. Other studies confirm this pattern. Thus, a five-year study of SEC enforcement actions found that while the SEC had filed over five hundred actions against some seven hundred corporate defendants, none of those defendants were independent directors.[246]

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238. *See* Sale, *supra* note 13, at 1383–88 (explaining independent directors' role as securities monitors).

239. *See* Bernard Black et al., *Outside Director Liability*, 58 STAN. L. REV. 1055, 1062–63 (2006) (describing study).

240. *See id.* at 1064.

241. *See id.* at 1065–67.

242. *See id.* at 1066.

243. *See* Mark J. Roe, *Corporate Law's Limits*, 31 J. LEGAL STUD. 233, 243 (2002).

244. *See* Black et al., *supra* note 239, at 1059.

245. *See id.*

246. *See* Sale, *supra* note 13, at 1379.

Independent-director liability resulting from settlements is also extremely rare. Most cases do not go to trial but instead result in settlement.[247] However, independent directors have no significant presence in this arena. Thus, of the thousands of settled cases over the past twenty-five years, only twelve cases involved independent directors.[248] In most of those cases, the settlements involved nominal amounts.[249] Most of the cases involving significant amounts were also the most recent and the most infamous, including Tyco, WorldCom, and Enron.[250] According to Professor Black and his co-authors, the circumstances that made liability possible in those cases are unlikely to reoccur.[251] Hence, they concluded that directors would continue to have a significantly low risk of liability for money damages in settlements.

2. Liability in the Criminal Context

A similar pattern emerges with respect to criminal prosecutions. Historically, very few actions have been brought against white-collar criminals.[252] Moreover, even if such actions are brought, corporate actors rarely face trial and seldom face any significant criminal penalties or jail time.[253] After the corporate scandals of 2002, criminal prosecutions and convictions involving corporate actors rose dramatically. However, none of those actions have involved independent directors. For example, the five-year anniversary report from the Department of Justice Corporate Fraud Task Force revealed that such Task Force had secured more than 1200 convictions against various corporate officers, directors, and affiliates.[254] None of these convictions involved independent directors. Hence, even in today's climate of enhanced focus on white-collar crime, independent directors have escaped liability. This escape ensures that independent directors face a relatively low risk of liability.

3. A Closer Analysis of Director Culpability

To be sure, independent directors' virtual absence from the liability regime may indicate simply that they are less culpable than other actors. In

247. *See* Black et al., *supra* note 239, at 1067.

248. *See id.* at 1060.

249. *See id.* at 1068.

250. *See id.* at 1068–70.

251. *See id.* at 1128–29 (describing the WorldCom and Enron cases as "perfect storms" that are unlikely to occur again and thus do not signal a significant change in the risk of liability facing outside directors).

252. *See* Fairfax, *supra* note 13, at 440–41; *see also supra* text accompanying note 13 (noting that legal sanctions have very little deterrent value).

253. *See* Fairfax, *supra* note 13, at 440–41.

254. *See* Press Release, U.S. Dep't of Justice, Fact Sheet: President's Corporate Fraud Task Force Marks Five Years of Ensuring Corporate Integrity (July 17, 2007), http://www.justice.gov/opa/pr/2007/July/07_odag_507.html.

other words, it could be the case that independent directors do not engage in corporate wrongdoing, at least in any significant respect. And, in fact, most cases reveal that such directors are not the primary actors in corporate fraud.[255] Instead, their involvement is limited to their oversight (or lack of oversight) of such fraud.[256] However, those cases suggest that while independent directors may not have committed the fraud at issue, they may have failed to perform their oversight responsibilities with sufficient rigor.[257] Thus, such cases reveal instances where independent directors failed to sufficiently monitor other officers and directors, thereby failing to detect or prevent corporate misconduct.[258] From this perspective, there is a seeming disconnect between directors' lack of liability and their conduct.

This disconnect is best explained by the affirmative decision to give greater leeway to independent directors.[259] For example, under Delaware law, outside of self-dealing cases, the standard for holding independent directors liable is extremely high, making it extremely difficult to find such directors liable for breaching their duties.[260] Thus, when directors make seemingly inappropriate decisions, courts analyze those decisions under the business judgment rule, pursuant to which courts presume that the actions of independent directors are carried out in good faith and in the best interests of the corporation.[261] The rule focuses on the process, rather than the substance, of board decisions and is designed to prevent second-guessing of corporate decisions.[262] Overcoming the rule's presumption requires proving that there is no rational basis for the directors' decision or that the

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255. *See* Sale, *supra* note 13, at 1388.

256. *See id.* at 1382–84 (describing directors' role as securities monitors).

257. *See In re* Walt Disney Co. Derivative Litig., 825 A.2d 275, 289 (Del. Ch. 2003) (noting that directors had adopted a "we do not care about the risks" attitude); Black et al., *supra* note 239, at 1121 (noting reports that WorldCom directors utterly failed in their oversight); Charles Forelle & James Bandler, *The Perfect Payday*, WALL ST. J., Mar. 18, 2006, at A1 (noting that directors' oversight failures enabled option-backdating to occur); Mitchell, *supra* note 45, at 61 (noting that *Disney* reflected an example of a very low level of directorial oversight).

258. *See In re Walt Disney Co.*, 825 A.2d at 289; Black, *supra* note 239, at 1121; Mitchell, *supra* note 45, at 61.

259. *See* Mitchell, *supra* note 45, at 29 (noting that the monitoring-board structure is aimed at shielding directors from liability).

260. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985) (explaining the court's reluctance to substitute its judgment for that of the board); Stuart R. Cohn, *Demise of the Director's Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule*, 62 TEX. L. REV. 591, 591 (1983) (finding only seven cases holding directors liable for breaching the duty of care); Charles Hansen, *The ALI Corporate Governance Project: Of the Duty of Due Care and the Business Judgment Rule, a Commentary*, 41 BUS. LAW. 1237, 1239–40 (1986) (noting that the business judgment rule demands minimal interference from courts).

261. *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360–61 (Del. 1993); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

262. *See* cases cited *supra* note 261.

decision was otherwise not based on an informed process.[263] Thus, liability attaches only if directors' decisions are significantly uninformed or directors engage in conduct perceived to be egregious conduct or a severe abuse of discretion.[264] As one former SEC official noted, "[T]he business judgment rule is essentially designed to immunize corporate business decisions from accountability through the judicial process."[265] That rule explains why independent directors' behavior rarely results in liability.

Perhaps more troubling, while independent directors' primary role is oversight, the Delaware Supreme Court recently announced that proving liability based on an oversight failure is the most difficult action under which a director can be held liable.[266] Courts distinguish between cases where directors make decisions, and hence their actions are covered by the business judgment rule, and those cases in which directors fail to act under circumstances where they have a monitoring responsibility.[267] These latter cases implicate oversight liability. Establishing such liability requires demonstrating that directors "utterly failed" to implement any reporting system, information system, or controls; or "consciously failed" to monitor or oversee its operations.[268] In other words, liability will be found only when directors consciously disregarded their responsibility by intentionally failing to act in the face of a known duty to act.[269] Delaware courts acknowledge that the test for oversight liability is deliberately "quite high."[270] Because independent directors engage primarily in monitoring, they are most likely to be subject to actions alleging breaches of oversight. Thus, Professor Black's study revealed that the vast majority of fiduciary-duty claims against

263. *See* cases cited *supra* note 261. As one court notes, Delaware courts give "great deference to the substance of the directors' decision and will not invalidate the decision, will not examine its reasonableness, and 'will not substitute [its] views for those of the board if the latter's decision can be "attributed to any rational business purpose."'" Paramount Commc'ns, Inc. v. QVC Network, 637 A.2d 34, 45 n.17 (Del. 1994) (quoting *Unocal*, 493 A.2d at 949).

264. *See Paramount*, 637 A.2d at 45.

265. *See* Borowski, *supra* note 8, at 468; *see also* Bainbridge, *supra* note 72, at 1041 (noting that later drafts have retreated from emphasizing judicial review to the position held today); Black et al., *supra* note 239, at 1090 ("[E]stablishing even nominal liability against an outside director for a duty of care breach is exceedingly difficult.").

266. *See* Stone v. Ritter, 911 A.2d 362, 372 (Del. 2006) (referring to the oversight action as "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment").

267. *See id.* at 369.

268. *See id.* at 370.

269. *See id.* at 369; *see also* Desimone v. Barrows, 924 A.2d 908, 933 (Del. Ch. 2007) (noting that oversight liability requires a finding that actions amounted to a "knowing abdication of their directorial duties"); Guttman v. Huang, 823 A.2d 492, 506 (Del. Ch. 2003) (noting that the *Caremark* decision "premises liability on a showing that the directors were conscious of the fact that they were not doing their job").

270. *See Stone*, 911 A.2d at 372; *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 971 (Del. Ch. 1996).

independent directors involved oversight claims.[271] The difficulty associated with proving such claims confirms the relatively low risk of liability facing independent directors.

4. A Closer Look at the Connection Between Liability and Effective Monitoring

This lack of liability potentially reduces the effectiveness of independent directors. Indeed, legal liability in the form of criminal and civil sanctions is aimed at ensuring an actor's fidelity to her fiduciary obligations, particularly through deterrence. Thus, such liability is aimed at ensuring that independent directors perform their monitoring role with sufficient rigor by deterring suboptimal conduct.[272] The lack of such liability, therefore, reduces that assurance.

Some corporate scholars are unconcerned about the lack of liability imposed on independent directors because they believe such liability has no impact on their performance. Such scholars point to empirical evidence indicating that legal sanctions have very little deterrent value.[273] They also pinpoint the various legal sanctions that existed before, but apparently failed to deter, the corporate scandals of 2002.[274] In this regard, these scholars question the wisdom of relying on legal sanctions to constrain or deter independent director conduct and thus are unconcerned with the virtual absence of such sanctions.

This lack of concern is misguided—there are studies revealing the importance of legal sanctions in curbing misconduct.[275] Moreover, such

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271. *See* Black et al., *supra* note 239, at 1060, 1074.

272. *See* Gordon, *supra* note 30, at 1484 (noting that monetary liability fosters attention to the affairs of the corporation).

273. *See* John Braithwaite & Toni Makkai, *Testing an Expected Utility Model of Corporate Deterrence*, 25 LAW & SOC'Y REV. 7, 29 (1991) (concluding that criminal sanctions failed to deter the conduct of nursing-home managers in Australia); Sally S. Simpson & Christopher S. Koper, *Deterring Corporate Crime*, 30 CRIMINOLOGY 347, 369 (1992) (finding little support for the proposition that deterrence theory applies to antitrust violators).

274. *See* Geraldine Szott Moohr, *An Enron Lesson: The Modest Role of Criminal Law in Preventing Corporate Crime*, 55 FLA. L. REV. 937, 955 (2003) (questioning the ability of severe penalties to deter corporate misconduct); Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 34 (2002) (noting that instances of fraud suggest corporate officials' "willing[ness] to proceed in the face" of liability, and hence it is unclear how more liability will produce additional constraints on behavior).

275. *See* Richard C. Hollinger & John P. Clark, *Deterrence in the Workplace: Perceived Certainty, Perceived Severity, and Employee Theft*, 62 SOC. FORCES 398, 414 (1983) (finding that increased certainty and severity deterred employee theft); Steven Klepper & Daniel Nagin, *Tax Compliance and Perceptions of the Risks of Detection and Criminal Prosecution*, 23 LAW & SOC'Y REV. 209, 237–38 (1989) (finding that a greater risk of detection and prosecution deterred people from cheating on their taxes); Raymond Paternoster & Sally Simpson, *Sanction Threats and Appeals to Morality: Testing a Rational Choice Model of Corporate Crime*, 30 LAW & SOC'Y REV. 549, 579–80 (1996)

studies suggest that legal sanctions are generally ineffective in deterring improper conduct when there is decreased certainty regarding their implementation.[276] That suggestion may explain why our current liability regime has failed to deter corporate misconduct. In other words, the relatively low risk of liability faced by independent directors may undermine the ability of such liability to deter or shape their behavior. In this regard, empirical evidence reveals that if sanctions are certain, they have a powerful impact on conduct.[277] Therefore, there is support for the notion that such sanctions can constrain independent directors' behavior if properly implemented. Such support refutes the notion that legal sanctions have no deterrent value, while suggesting that the current legal liability scheme fails to encourage optimal behavior on the part of independent directors.

Other scholars insist that legal sanctions are unnecessary to curtail director misconduct or otherwise ensure that directors pay heed to their responsibilities because other mechanisms exist that ensure director compliance. As an initial matter, these scholars insist that reliance on legal sanctions could have decidedly negative consequences.[278] Thus, such liability could reduce optimal decision making by making directors risk-averse.[279] Thus, such scholars contend that we should rely on other mechanisms, notably the capital markets and reputational sanctions.[280] First, these scholars insist that capital markets adequately regulate director behavior, deterring directors from taking actions that would harm the corporation because those actions would have a negative impact on stock price.[281] That impact jeopardizes both the corporation and independent directors. In this respect, the markets encourage directors to effectively monitor. However, widespread corporate scandals reflect examples of

(concluding that threats of criminal and civil sanctions serve as an effective deterrent to corporate crime). *But see* Simpson & Koper, *supra* note 273, at 369.

276. *See* Klepper & Nagin, *supra* note 275, at 237–38; Paternoster & Simpson, *supra* note 275, at 579–80; Simpson & Koper, *supra* note 273, at 366–67.

277. *See* Klepper & Nagin, *supra* note 275 (revealing the importance of certainty in deterrence); *see also* Hollinger & Clark, *supra* note 275, at 399 (concluding that perceived certainty and punishment impact behavior).

278. *See* David M. Phillips, *Principles of Corporate Governance: A Critique of Part IV*, 52 GEO. WASH. L. REV. 653, 673 (1984) (arguing that extra-legal incentives already regulate conduct, making legal regulation unnecessary and undesirable); Ribstein, *supra* note 274, 47–48 (noting a preference for market-based regulation over legal regulation because of the costs associated with the latter).

279. *See* Phillips, *supra* note 278, at 683–84; Ribstein, *supra* note 274, at 39.

280. *See* Phillips, *supra* note 278, at 681–82; Ribstein, *supra* note 274, at 21–22.

281. *See* Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1263 (1982) (noting regulatory impact of markets); Sean J. Griffith, *Deal Protection Provisions in the Last Period of Play*, 71 FORDHAM L. REV. 1899, 1937–38 (2003) (noting that corporate officers and directors are constrained by various markets); Phillips, *supra* note 278, at 673–82 (emphasizing the impact of the market on corporate behavior).

market failure.[282] Liability regimes are necessary precisely because of the potential for such failure, encouraging managers to act faithfully when such failure occurs.[283] Hence, it is inappropriate to believe that markets can fully shape director behavior.

Second, scholars insist that reputational sanctions appropriately encourage independent directors' fidelity to their monitoring duties. This rationale points out that independent directors are enmeshed in the business community. Their desire to protect their reputation in that community ensures their compliance with their responsibilities.[284] Yet studies have found reputational sanctions to be ineffective in altering director behavior.[285] Thus, it is not appropriate to place undue reliance on such sanctions. The fact that we do not impose significant liability on independent directors means that we are significantly dependent on reputational sanctions to encourage independent directors. As a result, we rely on an ineffective method for aligning their behavior with corporate interests.

5. Concluding Thoughts on Liability

Because independent directors rarely face liability for their actions, the focus on independent directors means that the corporate-monitoring system depends upon the least accountable actors in the corporate regime. While some contend that markets and reputational sanctions can ensure that independent directors are accountable for their actions (or lack thereof), this contention is flawed. Still others suggest that liability risks cannot encourage directors to adhere to their responsibilities, but studies contradict that suggestion. Hence, the failure to ensure that independent directors face some credible risk of liability means we may have no serious accountability process for those directors. This makes reliance on such directors particularly problematic.

F. The Mixed Empirical Evidence

The empirical evidence on the benefits associated with director independence is mixed at best. First, the weight of the empirical evidence tilts against the proposition that independent directors enhance overall corporate performance. Some empirical studies support the notion that independent directors improve corporate performance.[286] But many more contradict that notion, suggesting that there is no correlation between

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282. *See* Ribstein, *supra* note 274, at 61.

283. *See* Bainbridge, *supra* note 72, at 1074.

284. *See* Jayne W. Barnard, *Reintegrative Shaming in Corporate Sentencing*, 72 S. CAL. L. REV. 959, 966–67 (1999).

285. *See* Fich & Shivdasani, *supra* note 115, at 309–10; Helland, *supra* note 115.

286. *See* Prentice & Spence, *supra* note 5, at 1866.

corporate performance and the percentage of independent directors on the board.[287] Second, the overall evidence with respect to discrete tasks fails to demonstrate a strong correlation between independent directors and improved corporate performance in particular areas. Hence, while some studies find that independent directors perform better at particular tasks, such as firing a poorly performing CEO[288] or detecting fraud,[289] others refute those results.[290] Moreover, studies indicate that independent directors are not more effective at discrete tasks such as monitoring companies in financial distress[291] or curtailing CEO compensation.[292] A similar pattern emerges with respect to the presence of such directors on particular committees. Thus, some studies reveal that greater independence on the audit committee improves financial reporting.[293] By contrast, a study of nominating, audit, and compensation committees found little evidence that total independence on those committees positively impacted a company's performance.[294] Then too, no study exists supporting the proposition that better performance will emerge if boards are comprised of a supermajority of independent directors.[295]

Taken together, the empirical evidence at least calls into question the contention that independent directors are more effective monitors than insiders. A 1999 article by Professors Bhagat and Black comprehensively surveyed the available empirical data on independent directors to determine whether the trend toward enhanced independence rested on "sound

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287. *See* Bhagat & Black, *supra* note 1, at 921–22; Eric M. Fogel & Andrew M. Geier, *Strangers in the House: Rethinking Sarbanes-Oxley and the Independent Board of Directors*, 32 DEL. J. CORP. L. 33, 52 (2007) ("No pattern emerges to suggest that it makes any difference at all to shareholders' financial return whether a board has a higher or lower percentage of independent directors."); April Klein, *Firm Performance and Board Committee Structure*, 41 J.L. & ECON. 275, 277 (1998).

288. *See* Michael S. Weisbach, *Outside Directors and CEO Turnover*, 20 J. FIN. ECON. 431, 440–41 (1988).

289. *See* Uzun et al., *supra* note 123, at 38–39.

290. *See* Bhagat & Black, *supra* note 1, at 924–26; Eliezer M. Fich & Lawrence J. White, *CEO Compensation and Turnover: The Effects of Mutually Interlocked Boards*, 38 WAKE FOREST L. REV. 935, 936 (2003). One study found no correlation between board independence and the incidences of managerial engagement in illegal acts. *See* Idalene F. Kesner, Bart Victor & Bruce T. Lamont, *Board Composition and the Commission of Illegal Acts: An Investigation of Fortune 500 Companies*, 29 ACAD. MGMT. J. 789, 794–96 (1986). Another study found that independent directors may have acquiesced in options backdating. *See* Bebchuk et al., *supra* note 148, at 3. Other studies reveal that the presence of independent directors has no impact on the corporation's ability to control financial fraud. *See* Bhagat & Black, *supra* note 3, at 235; Bhagat & Black, *supra* note 1, at 933.

291. *See* Bhagat & Black, *supra* note 1, at 932–33.

292. *See* Bhagat & Black, *supra* note 3, at 235.

293. *See* Prentice & Spence, *supra* note 5, at 1872–73.

294. *See* Klein, *supra* note 2877, at 283.

295. *See* Bhagat & Black, *supra* note 3, at 235; Bhagat & Black, *supra* note 1, at 922 (noting that the movement towards supermajority boards has "entirely outstripped research").

empirical footing," and concluded that it did not.[296] When Professors Bhagat and Black performed a follow-up study in 2002, their conclusion remained unchanged.[297] Moreover, the conclusion was consistent with their own study, which found that companies with more independent directors on their boards do not perform better than others.[298] While other scholars disagree with respect to the weight that should be given to various studies, they nevertheless acknowledge that the empirical evidence on the ability of independent directors to sufficiently perform their monitoring functions is mixed, if not "weak at best."[299]

In fact, a few studies indicate that independent directors may perform worse than their inside counterparts.[300] Those studies reveal that inside directors may outperform independent directors both with respect to overall corporate performance and with respect to certain discrete tasks. Thus, some studies found a negative correlation between the presence of independent directors and corporate performance.[301] Others revealed that having inside directors on particular committees correlated with improved performance.[302] Still others found a negative correlation between outside directors and fraud detection.[303] These studies collectively suggest that inside directors may have a positive influence on corporate affairs in general, as well as within specific committees or otherwise with respect to areas of particular concern to the public.

Taken as a whole, the empirical evidence does not convincingly prove that independent directors necessarily lead to more effective and efficient monitoring. That lack of proof is consistent with the hypothesis that such directors may be constrained in their ability to perform their functions with the requisite rigor. Moreover, it sets the stage for further exploration of an enhanced role for inside directors within the corporate arena.

IV. THE UNEASY CASE FOR THE INSIDER DIRECTOR

This Part demonstrates that inside directors can respond to some of the deficiencies of independent directors and thus can be valuable members of the board. This Part also grapples with some of the drawbacks associated

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296. Bhagat & Black, *supra* note 1, at 921–22.

297. Bhagat & Black, *supra* note 3, at 233.

298. *See id.*

299. *See* Gordon, *supra* note 30, at 1500; *see also* Prentice & Spence, *supra* note 5, at 1864, 1867. Prentice and Spence note that the evidence is "decidedly mixed," and thus "one cannot claim the empirical evidence clearly indicates that more independent boards will produce better financial results." *Id.*

300. *See* Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1530 (2005) (suggesting that the trend towards increased independence may lead to suboptimal results).

301. *See* Bhagat & Black , *supra* note 3, at 236–37.

302. *See* Klein, *supra* note 287, at 300.

303. *See id.*

with reliance on inside directors and considers ways in which those concerns can be resolved.

A. *The Case for the Inside Director*

1. A Director by Any Other Name . . .

The fact that independent and inside directors are both constrained in their ability to be objective undermines the rationale for favoring one category of director over the other. To be sure, the distinguishing feature between an independent director and an inside director is that the inside director owes her job, and hence her livelihood, to the corporation and those in charge. As a result, we have presumed that such insiders would be incapable of being objective monitors.

However, that presumption sweeps too broadly. Indeed, the selection bias currently endemic to independent directors means that such directors owe their positions to the corporation, its directors, and in some cases, its CEO. In this respect, independent directors depend upon the corporation and its board for their directorial positions and the fees that result from it. Such dependence increases the probability that they will feel beholden to the corporation and its directors in some of the same ways that insiders may feel beholden to the corporation. That dependence, coupled with the social ties and structural bias common among directors, significantly hinders independent directors' ability to be impartial. From this perspective, although the nature and extent of the constraints faced by each type of director may be different, such constraints all have the effect of impeding directors' impartiality. This blurs the distinction between independent and inside directors, while weakening the case for preferring independent directors over inside directors. The weakness of that case is confirmed by much of the empirical evidence suggesting that there may be no difference between the effectiveness of inside directors and independent directors.[304] Thus, the fact that independent directors and inside directors are subject to ties that compromise them in similar ways indicates that inside directors may perform no worse than independent directors with respect to monitoring the corporation.

Then, too, it is possible that recent reforms have enhanced inside directors' ability to be effective monitors. Indeed, much of the literature with respect to the ineffectiveness of inside directors presumes that such directors cannot be effective because of the CEO's dominance.[305] In other words, the fact that inside directors are subordinate to the CEO means that they will acquiesce in her policies or otherwise be disinclined to seriously

304. *See* Bhagat & Black, *supra* note 1, at 922.

305. *See* Rodrigues, *supra* note 7, at 456.

criticize those policies.[306] To be sure, the evidence reveals that independent directors may face similar impediments with respect to the CEO.[307] However, recent reforms may have reduced the CEO's influence in the boardroom. Thus, companies have been pressured to separate the CEO and board chair position.[308] As a result, close to half of S&P 1500 companies have adopted such a board structure.[309] Then, too, the overwhelming majority of corporations that combine the board chair and CEO positions have lead directors, whose role is to preside over discussions outside of the presence and influence of the CEO.[310] These reforms seek to reduce the CEO's influence in the boardroom. It is too soon to tell if they will have their desired result or if CEOs will continue to indirectly influence board discussions. However, these reforms may make it easier for other inside directors to engage in candid discussions, while undermining the extent to which such directors may feel forced to defer to the positions of the CEO. As a result, they increase the potential for insiders to be effective monitors.

2. Inside Directors and Incentives

Inside directors may be especially motivated to act in ways that advance corporate interests. Indeed, corporate scholars recognize that directors who are not incentivized cannot perform their oversight role effectively because they lack the motivation to engage in actions beneficial to the corporation.[311] Independent directors' independence from the corporation means that they have no direct tie to the corporation and thus may not have incentives to advance corporate and shareholder interests.[312] Recognizing this problem, corporate-governance scholars have focused on methods for creating those incentives.[313] The primary method of incentivizing independent directors has been to ensure that they own stock in the corporation on whose board they sit.[314] A recent study revealed that some

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306. *See id.*

307. *See supra* text accompanying note 182 (noting the problems with CEO capture).

308. *See* Olson & Adams, *supra* note 125, at 447 (discussing recommendations for American public corporations to consider separation of functions between the CEO and the board chair).

309. *See* RISKMETRICS GRP., BOARD PRACTICES: TRENDS IN BOARD STRUCTURE AT S&P 1,500 COMPANIES 3 (2008), *available at* http://www.riskmetrics.com/sites/default/files/BP2009.pdf.

310. *See* THE KORN/FERRY INST., *supra* note 4, at 7 (noting that eighty-four percent of companies in which the CEO is also the chair has a lead director).

311. *See* Bhagat & Black, *supra* note 3, at 265 (pinpointing evidence supporting the premise that directors' incentives impact firm performance).

312. *See* Cosenza, *supra* note 62, at 25 (noting the need for an incentive system for independent directors to align their interests with shareholders).

313. *See* Bebchuk, *supra* note 169, at 860; Cosenza, *supra* note 62, at 25; Joseph P. Farano, *How Much Is Too Much? Director Equity Ownership and Its Role in the Independence Assessment*, 38 SETON HALL L. REV. 753, 769 (2008).

314. *See* Bebchuk, *supra* note 169, at 860; Cosenza, *supra* note 62, at 25; Farano, *supra* note 313, at 769.

eighty percent of directors are *required* to own company stock.[315] This ownership is designed to provide independent directors with some tangible connection to the corporation and its shareholders, thereby encouraging them to comply with their monitoring obligations. However, such ownership has not yielded its desired result, potentially undermining independent directors' effectiveness.[316] More importantly, creating such an incentive structure is unnecessary for inside directors. Inside directors have "their human capital, and often most of their financial capital, committed to their company."[317] Thus, unlike independent directors, who require artificial methods for incentivizing their commitment to the corporation, inside directors are extremely motivated to act in ways that benefit the corporation. Consequently, insiders' lack of independence may be beneficial.

To be sure, inside directors' desire to enhance corporate welfare can have damaging consequences. This is because the human and financial capital they have invested in the corporation may cause them to overreach. Thus, the fact that inside directors may be especially incentivized proves too much, highlighting the fact that they are uniquely vulnerable to self-dealing or other forms of corporate malfeasance. However, that problem is certainly no longer unique to inside directors. Instead, while independent directors' stock ownership increases their incentives to advance corporate interests, it also increases the likelihood that such directors will acquiesce or participate in misconduct that has the effect of enhancing stock price.[318] From this perspective, any incentive structure creates a double-edged sword. Therefore, an appropriate balance must be found between incentives and restraints on those incentives. As Part IV.C discusses, reinvigorating external regulation may enable us to reap the benefits of inside directors' greater motivation while minimizing the costs associated with that motivation, thereby avoiding a wholesale elimination of their role on the board.

3. Bridging the Information and Knowledge Divide

Inside directors can add value to the board because they are better informed and more knowledgeable than independent directors. Inside directors' decisions are more likely to be informed because of their informational advantage over independent directors.[319] Inside directors invest considerable time and resources into the corporation, which translates into superior knowledge about the company. This knowledge means that they are likely to make better decisions even as compared to an

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315. *See* THE KORN/FERRY INST., *supra* note 4, at 28.

316. *See supra* text accompanying note 314 (explaining mixed incentives created by stock ownership).

317. *See* Bhagat & Black, *supra* note 3, at 264.

318. *See* Bebchuk, *supra* note 169, at 851; Farano, *supra* note 313, at 770.

319. *See* Bainbridge, *supra* note 72, at 1056.

independent director who receives similar information because inside directors can put the information in a broader, more nuanced context.[320] In addition, inside directors may be better equipped to monitor than independent directors because they have sufficient information and knowledge to better determine if information has been corrupted or misconduct has occurred.

Some may contend that the insiders' informational advantage and expertise may be harnessed by simply inviting them to present to the board. However, this may prove ineffective for several reasons. First, as noted above, inside directors may add value as monitors because they may have a better perspective and understanding of corporate affairs. This means that insiders must participate in the oversight function and thus be members of the board. Second, independent directors may not be able to sufficiently absorb the information being presented to them.[321] Along these lines, Professors Gorga and Halberstam note that decentralized corporations make knowledge transfer and coordination especially difficult.[322] This difficulty hampers the ability of corporations to adequately convey corporate information to directors who lack knowledge about the company, while hampering such directors' ability to sufficiently understand that information.[323] Bringing more insiders on the board alleviates this problem because they can more readily grasp and process information about the company.[324] Third, inside directors may add more value when they actively participate in board discussions and thus play an active role in shaping board decisions. Indeed, insiders' interactions with other directors inevitably will be different and more robust if they are members of the board rather than invited guests (who can be uninvited).[325] Thus, as board members, insiders will have a distinctly different and more valuable role than invited guests who merely impart information.

Empirical evidence appears to support the theory that inside directors make valuable contributions to the board.[326] Studies also confirm that having board members with intimate knowledge of the business may generate better informed decision making.[327]

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320. *See id.*

321. *See* Gorga & Halberstam, *supra* note 221, at 1134–35, 1163 (discussing how efforts to reduce agency costs by employing knowledge substitutes are misguided).

322. *See id.* at 1132, 1163.

323. *See id.*

324. *See id.* at 1132.

325. *See* Bhagat & Black, *supra* note 3, at 264.

326. *See* Klein, *supra* note 287, at 277 (indicating that inside directors outperform independent directors in certain areas).

327. *See* Olson & Adams, *supra* note 125, at 446–47; Jeffrey Sonnenfeld, *What Makes Great Boards Great*, HARV. BUS. REV., Sept. 2002, at 106.

To be sure, the concern is not that inside directors are inferior to independent directors with respect to their informational and knowledge advantage, but rather that inside directors will use that advantage to corrupt the information. The challenge is to generate methods of reducing or minimizing that possibility. Instead, current governance trends have simply reduced or minimized the role of inside directors, thereby eliminating any advantages that those directors confer on the board. That trend needs to be reconsidered.

4. Board Diversity and the Inside Director

Increasing the presence of inside directors on the board also may enable corporations to increase board diversity—the number of women and people of color on the board. While the number of women and directors of color has grown over the past thirty years,[328] these groups nevertheless still appear to be underrepresented in the boardroom. In 2007, 85% of *Fortune* 1000 companies had at least one woman on their boards, while 78% of such companies had at least one person of color on their boards.[329] Of course, this means that 15% of companies continue to have an all-male board and more than 20% of companies have an all-white board. In addition, the overall percentage of board seats held by diverse groups is still relatively small. For example, women hold roughly 16% of board seats despite comprising 46% of the U.S. labor force and 50% of all managerial and professional positions.[330] People of color hold less than 9% of available board seats[331] while holding approximately 30% of the labor force and some 21% of all management, professional, and related jobs.[332] Hence, organizations have expressed concern with the current level of diversity in the boardroom.[333]

Board diversity has several advantages. Given the number of women and people of color in the population and workforce,[334] increasing board

328. *See* THE KORN/FERRY INST., *supra* note 4, at 6–7. In 1973, only 11% of companies had women on their boards, while only 9% of companies had a person of color on their boards.

329. THE KORN/FERRY INST., *supra* note 4, at 6–7.

330. *See* U.S. BUREAU OF LABOR STATISTICS, U.S. DEPT. OF LABOR, WOMEN IN THE LABOR FORCE: A DATABOOK 28 tbl.11 (2005), *available at* http://www.bls.gov/cps/wlf-databook-2005.pdf.

331. *See* Carol Hymowitz, *Corporate Boards Lack Gender, Racial Equality*, WALL ST. J., July 7, 2003.

332. *See infra* note 335; *see also* OFFICE OF EMP'T AND UNEMPLOYMENT STATISTICS, U.S. BUREAU OF LABOR STATISTICS, LABOR FORCE CHARACTERISTICS BY RACE AND ETHNICITY, 2009, at 14 tbl.6 (2010), *available at* http://www.bls.gov/cps/cpsrace2009.pdf (listing household data annual averages).

333. *See* THE KORN/FERRY INST., *supra* note 4, at 6.

334. *See* POPULATION INFO. STAFF, U.S. CENSUS BUREAU, POPULATION ESTIMATES FOR STATES BY RACE AND HISPANIC ORIGIN (1999), *available at* http://www.census.gov/population/estimates/state/srh/srh99.txt (indicating that people of color comprised about 30% of the

diversity may be important not only because it ensures that boards reflect the larger community, but also because it reflects the corporation's commitment to eradicating subtle biases that may prevent women and people of color from achieving success at the highest levels. Such diversity also may impact the corporate bottom line. Indeed, several scholars recently have argued that corporations should encourage board diversity because such diversity not only increases the overall effectiveness of the board, but also enhances a corporation's profitability.[335] In fact, social-science research suggests that board homogeneity impedes directors from considering alternative views and engaging in the critical thinking necessary to make informed decisions or serve as active monitors.[336] Board diversity may counteract this problem, thereby ensuring that directors more appropriately perform their managerial and monitoring duties. Other scholars have asserted that board diversity can have a positive impact on the corporation's bottom line by improving a corporation's ability to interact with its increasingly diverse employees, customers, and clients.[337] To be sure, some may have overstated the extent to which board diversity can be economically beneficial to the corporation.[338] However, such diversity nevertheless may translate into improved corporate performance under the right circumstances. Some tentative empirical support exists for this assertion.[339] Moreover, many corporations have embraced such a rationale for board

population in 2000); Jon Meacham, *The New Face of Race*, NEWSWEEK, Sept. 18, 2000, at 40 (estimating that people of color will comprise more than half of the U.S. population by 2050).

335. *See, e.g.*, Lynne L. Dallas, *The New Managerialism and Diversity on Corporate Boards of Directors*, 76 TUL. L. REV. 1363, 1403–04 (2002); O'Connor, *supra* note 120, at 1306–08 (stating that diversity may enhance board effectiveness); Steven A. Ramirez, *A Flaw in the Sarbanes-Oxley Reform: Can Diversity in the Boardroom Quell Corporate Corruption?*, 77 ST. JOHN'S L. REV. 837, 853 (2003) [hereinafter Ramirez, *A Flaw*]; Steven A. Ramirez, *Diversity and the Boardroom*, 6 STAN. J.L. BUS. & FIN. 85, 90–109 (2000) [hereinafter Ramirez, *Boardroom Diversity*] (arguing that diversity can improve American businesses generally, and boards of directors in particular); Janis Sarra, *The Gender Implications of Corporate Governance Change*, 1 SEATTLE J. FOR SOC. JUST. 457, 494 (2002) (stating that diversity can enhance corporate governance). For a general discussion on the impact of group homogeneity, see Taylor H. Cox et al., *Effects of Ethnic Group Cultural Differences on Cooperative and Competitive Behavior on a Group Task*, 34 ACAD. MGMT. J. 827, 839 (1991); Donald C. Hambrick & Phyllis A. Mason, *Upper Echelons: The Organization as a Reflection of Its Top Managers*, 9 ACAD. MGMT. REV. 193, 202–03 (1984); Susan E. Jackson, *Consequences of Group Composition for the Interpersonal Dynamics of Strategic Issue Processing*, 8 ADVANCES STRATEGIC MGMT. 345, 354 (1992).

336. *See* O'Connor, *supra* note 120, at 1306.

337. *See* Dallas, *supra* note 335; Ramirez, *A Flaw*, *supra* note 335; Ramirez, *Boardroom Diversity*, *supra* note 335.

338. *See* Lisa M. Fairfax, *The Bottom Line on Board Diversity: A Cost Benefit Analysis of the Business Rationales for Diversity on Corporate Boards*, 2005 WIS. L. REV. 795, 811–38.

339. *See* CATALYST, THE BOTTOM LINE: CONNECTING CORPORATE PERFORMANCE AND GENDER DIVERSITY 1–2 (2004), *available at* http://www.catalyst.org/publication/82/the-bottom-line-connecting-corporate-performance-and-gender-diversity; David A. Carter et al., *Corporate Governance, Board Diversity, and Firm Value*, 38 FIN. REV. 33, 44–51 (2003), (finding a positive correlation between the number of women and people of color on the board and firm value).

diversity.[340] As a result, corporations have at least professed a commitment to enhancing board diversity.

Many presumed that the focus on independent directors would increase board diversity,[341] but that presumption has proven to be inaccurate. Indeed, a recent Korn/Ferry Study reveals that the number of women and people of color on corporate boards essentially has remained static over the last several years, roughly correlating to the enactment of SOX.[342] The study indicates that such groups' board representation may have reached a plateau.[343]

While federal reforms may not have caused this plateau, their focus on director independence may have exacerbated efforts to increase diversity. One oft-cited rationale for the relatively low percentage of diverse board members is the "pool problem"—the notion that there are not enough qualified candidates from which to choose.[344] A focus on independent directors may exacerbate the pool problem. When seeking an independent director, corporations often focus on people who are CEOs or former CEOs.[345] Given the relatively small number of women and people of color among that population, it is little wonder that boards have found it difficult to secure diverse directors. Indeed, to overcome this problem, boards tend to seek out the same few women and people of color to serve as directors.[346] Thus, one *Forbes* survey revealed that while many other directors had reduced their board seats over the last few years, most women and people of color had either retained the number of board seats they held or increased them.[347] In this regard, the focus on independence may be counterproductive because it has encouraged diverse directors to overextend themselves, and that overextension appears to undermine a director's effectiveness.

A practical solution to this problem could be to encourage boards to expand their criteria to include people with backgrounds beyond chief

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340. *See* THE KORN/FERRY INST., *supra* note 4, at 7 ("With the U.S. Census Bureau projecting that minorities will represent more than half of the U.S. population by 2050, it would seem that increasing ethnic diversity would, like gender diversity, offer a strategic benefit in reflecting the makeup of customers, shareholders and employees.").

341. *See* Fairfax, *supra* note 338, at 804–07.

342. *See* THE KORN/FERRY INST., *supra* note 4, at 6–7.

343. *See id.* at 6.

344. *Id.* (noting that the supply of high-quality women directorial candidates is strained).

345. *See id.* at 18.

346. Dan Ackman, *Black Directors: Diversity Without Diversity*, FORBES.COM, Aug. 8, 2002, http://www.forbes.com/2002/08/08/0808blackdirectors.html (noting that the high number of multiple board seats held by people of color means that there is no real diversity in the diversity of corporate board members).

347. *See* Virginia Citrano, *Still Overworked, but Not as Much*, FORBES.COM, July 11, 2003, http://www.forbes.com/2003/07/11/cx_vc_0711directors.html (finding that only five individuals hold five or more directorships and four of them are black).

executive experience. While this may be an appropriate strategy, it may have negative implications for women and people of color. First, it may encourage corporations to recruit directors without sufficient business expertise, thereby putting diverse directors at an informational disadvantage. Second, studies reveal that directors may give less credence to the opinions of those that are perceived to have limited business expertise.[348] Consequently, expanding the criteria could lead to marginalization of diverse directors because it increases the potential that such directors may not command the same level of respect as others in the boardroom.

Alternatively, if corporations recruit more inside directors, women and people of color should benefit from their recruitment efforts. Indeed, while the number of people on corporate boards is relatively small, they are better represented in managerial positions. For example, studies indicate that there are a considerable number of women managers below the top level.[349] While such managers may not be perceived to have the expertise to serve on other boards, they have the firm-specific knowledge that could make them valuable additions to their own board. In this regard, corporations could secure board members from that population without significant difficulties. In so doing, corporations can ensure that diverse directors are not at an informational disadvantage. This strategy has the added benefit of giving diverse directors quality board experience so that they may knowledgeably serve as directors at other corporations, thereby increasing the pool of qualified candidates. In this respect, shifting the focus to inside directors enhances opportunities to increase the number of diverse directors on the board and harness any benefits that result from their membership.

Focusing on inside directors also may reduce some of the drawbacks associated with board diversity. First, many proponents of diversity insist that corporations and their boards cannot reap the benefits of diversity unless boards have a significant number or "critical mass" of diverse directors.[350] This is because without such a critical mass, diverse directors may be less likely to express divergent views, undermining their ability to facilitate the consideration of broader perspectives on the board.[351] Board studies reveal that most corporations do not have a critical mass of diverse directors.[352]

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348. *See* Lin, *supra* note 60, at 951.

349. *See, e.g.*, CATALYST, WOMEN AND MEN IN U.S. CORPORATE LEADERSHIP: SAME WORKPLACE, DIFFERENT REALITIES? 4 (2004), *available at* http://www.catalyst.org/file/74/women%20and%20men%20in%20u.s.%20corporate%20leadership%20same%20workplace,%20different%20realities.pdf; CATALYST, WOMEN IN U.S. CORPORATE LEADERSHIP 1–2 (2003), *available at* http://www.catalyst.org/file/52/women%20in%20u.s%20corporate%20leadership%202003.pdf.

350. *See* O'Connor, *supra* note 120, at 1309.

351. *See id.* at 1310.

352. *See* Carter et al., *supra* note 339, at 11.

Instead, many only have one or two such directors.[353] Thus, the current focus on independent directors has not translated into the development of a critical mass. By contrast, focusing on the more robust pool of potential inside candidates could enable corporations to develop such a critical mass.

Second, while some studies indicate that diversifying the board can prove beneficial, they also indicate that such diversity could involve costs. Thus, research indicates that greater diversity could reduce collegiality in the boardroom, thereby reducing productivity.[354] As current members of the corporation whose managerial positions suggest that they have been successful in the corporation, inside directors may be better equipped to interact with directors at their company, decreasing the potential for conflicts or divisiveness that could reduce a board's productivity. Professors Carbado and Gulati have noted that the corporation's promotion system typically screens out people of color who may challenge the status quo and are not palatable.[355] However, the possibility that promoting from within could lead to diverse directors who are less inclined to be critical can be reduced if there is a critical mass of such directors.[356] Hence, securing a diverse director from inside the corporation may enable corporations to harness the benefits of diversity while avoiding some of its pitfalls.

Recognizing that independent directors, like inside directors, may be constrained in their ability to be effective monitors opens the door for a critical discussion of the potential benefits associated with inside directors. As Subpart A reveals, inside directors may have better incentives than their outside counterparts and may be better equipped than outside directors to bridge the information and knowledge divide. Recruiting inside directors has the added advantage of potentially increasing board diversity. In these ways, the inside director may have a positive impact in the corporate boardroom and beyond. Of course, that impact must be balanced against any potential negative repercussions that stem from an increased focus on inside directors. Subpart B discusses those repercussions.

B. The Unease

1. Self-Dealing Reconsidered

The primary concern with insiders as monitors centers around the possibility that they will use their inside advantage to enrich themselves, and

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353. *See id.*

354. *See* TAYLOR COX JR. & CAROL SMOLINSKI, MANAGING DIVERSITY AND GLASS CEILING INITIATIVES AS NATIONAL ECONOMIC IMPERATIVES (2004), *available at* http://digitalcommons.ilr.cornell.edu/cgi/viewcontent.cgi?article=1119&context=key_workplace; Dallas, *supra* note 335, at 1393; Jackson, *supra* note 335, at 361–62.

355. *See* Devon W. Carbado & Mitu Gulati, *The Law and Economics of Critical Race Theory*, 112 YALE L.J. 1757, 1798–802 (2003) (book review).

356. *See id.*

thereby engage in self-dealing transactions. As indicated in previous sections, this concern creates a corporate-governance challenge. Our response to this concern has been to prefer independent directors over inside directors. Even those skeptical of the value of independent directors maintain that they have a role to play in overseeing conflict-of-interest transactions.[357]

However, that response is problematic for at least two reasons. First, independent directors are not necessarily effective at monitoring conflicts of interest. Instead, as discussed above, structural and other biases impede their objectivity and ability to critically examine such transactions. As a result, evidence confirms their tendency to acquiesce in managerial self-dealing. Second, inside directors add value to the corporation, and hence substantially reducing their role on the board seems to sweep too broadly. The corporate-governance solution to the self-dealing problem should not be a continued reliance on this flawed response. Instead, we should seek an alternate response to the challenge.

One potential response is to reinvigorate the role of external regulations, at least with respect to conflicts of interest and other high-risk transactions. As a general matter, the rationale for deference to directors' business judgment is not altogether convincing. While judges are not businesspeople, they nevertheless intervene in a host of other areas where they lack expertise.[358] This rationale is particularly troubling in the context of self-dealing transactions. Courts clearly recognize the risk associated with those transactions but defer to independent directors based on the presumption that such directors are not also biased in ways that impede their objectivity. Given the flaws with that presumption, their deference in the context of these transactions is inappropriate. Consequently, courts should embrace an approach of more rigorous review for those transactions.

Indeed, the preference in favor of independent directors may be more troubling in the context of self-dealing transactions because it ensures that most high-risk transactions will continue to receive little or no substantive review from courts. To this end, insiders' presence on boards may serve an important signaling function, thereby increasing the potential for such review. This is because independent directors ensure deference from the courts, while inside directors prompt more exacting review. Thus, inside directors' presence may be necessary to ensure that courts appreciate the importance of analyzing these transactions more thoroughly.

2. Financial Fraud

Some scholars contend that when you disaggregate the studies related to independent directors, it reveals strong support for the proposition that

357. *See* Fogel & Geier, *supra* note 287, at 72.
358. *See* Bainbridge, *supra* note 72, at 1073.

independent directors do a better job of detecting and preventing fraud, particularly financial fraud.[359] Indeed, several studies find a negative correlation between financial-reporting fraud and the presence of independent directors.[360] In particular, recent studies show that director independence on the audit committee correlates with improved financial reporting and fewer earnings restatements.[361]

These studies may merit particular attention because fashioning a mechanism to better detect financial fraud may have been the primary purpose behind federal reforms.[362] In other words, those reforms grew out of governance scandals involving financial fraud and hence were aimed at providing effective mechanisms for preventing and detecting such fraud in the future. Therefore, studies focused on financial fraud may be the most relevant measure of independent directors' value. To the extent such studies reveal that the presence of independent directors positively correlates with fewer incidences of fraud, they support the broader trend in favor of such directors and away from inside directors.

However, even disaggregated, the evidence with respect to financial fraud remains mixed. Hence, some studies find no correlation between director independence and the detection of financial fraud.[363] Others find a positive correlation between the two, indicating that in some cases, independent directors may increase the potential for fraud.[364] Still others indicate that independent directors may have acquiesced in, and benefited from, such fraud.[365]

Moreover, the correlation between director independence and enhanced fraud detection may be explained by factors unconnected to a director's status as independent. First, it could be that the empirical results reflect the impact of enhanced rules surrounding auditors, rather than the effect of director independence. Companies with independent audit committees and a majority of independent directors also tend to be companies that must comply with SOX's requirements related to auditor

359. *See* Prentice & Spence, *supra* note 5, at 1868.

360. *See* MARK S. BEASLEY ET AL., COMM. OF SPONSORING ORGS. OF THE TREADWAY COMM'N, FRAUDULENT FINANCIAL REPORTING: 1987–1997: AN ANALYSIS OF U.S. PUBLIC COMPANIES 4 (1999), *available at* http://www.coso.org/publications/FFR_1987_1997.pdf (finding that companies with more inside directors are more likely to be victims of financial fraud); Uzun et al., *supra* note 123, at 33–39.

361. *See* Prentice & Spence, *supra* note 5, at 1872–77.

362. *See id.* at 1868.

363. *See* Bhagat & Black, *supra* note 3, at 235; Kesner, Victor & Lamont, *supra* note 290, at 789.

364. *See* Henry L. Tosi et al., *Why Outsiders on Boards Can't Solve the Corporate Governance Problem*, 32 ORGANIZATIONAL DYNAMICS 180 (2003).

365. *See* Bebchuk et al., *supra* note 148, at 1; Steve Stecklow, *Outside Directors' Options Role Is Cited in Backdating Study*, WALL ST. J., Dec. 18, 2006, at B3.

independence.[366] Given that some of these studies regarding fraud were conducted post-SOX, the increased accountability and liability of such auditors may explain the decreased incidences of fraud.

Second, the empirical results could reflect the effectiveness of the additional requirements imposed on audit committee members. In fact, the strongest and most robust evidence indicating that directors have a positive impact on reducing fraud has emerged in the context of such directors' role on the audit committee.[367] Thus, as opposed to the generally mixed empirical results in other areas, the evidence concerning the impact of audit committee independence appears more clear-cut.[368] However, that evidence may reflect the impact of other factors. In addition to independence, members of the audit committee also must have financial expertise.[369] While SOX requires that only one director on the audit committee have financial expertise, listing agencies require all directors to have financial acumen.[370] In this respect, directors' enhanced expertise, rather than their independence, may account for their enhanced ability to detect fraud. Alternatively, the evidence may reveal the importance of independence coupled with expertise. In this respect, directors on the audit committee may be uniquely positioned to overcome the knowledge deficit. This is not only because the responsibilities associated with the audit committee make it the most time-intensive committee on which to serve, but also because knowledge of financial and accounting issues requires specialized expertise. That expertise enhances directors' ability to understand and process the information provided to them. This suggests that the benefits of independence may be unique to the audit committee not only because the reforms ensure the necessary expertise that directors need, but also because that expertise overcomes the traditional limitations on directors' effectiveness.

Indeed, the evidence about independent directors' impact on fraud detection does not negate other evidence suggesting that independent directors may be ineffective in enhancing overall corporate performance and in performing other discrete tasks. Given that independent directors bear responsibility for performing more than one task, it may be

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366. *See* Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (and It Just Might Work)*, 35 CONN. L. REV. 915, 942–47 (2003).

367. *See* Prentice & Spence, *supra* note 5, at 1872–75.

368. *See id.* at 1875.

369. Section 407 of SOX required the SEC to promulgate rules that require issuers to disclose "whether or not, and if not, the reasons therefor[e], the audit committee of that issuer is comprised of at least [one] member who is a financial expert." Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745, 790. This requirement is now embodied in Item 401(h) of Regulation S-K of the Exchange Act. 17 C.F.R § 229.401(h) (2010).

370. *See* NYSE Amex, *supra* note 39, § 121; NYSE, *supra* note 17, § 303; NASDAQ, *supra* note 17, at r. 4200(a)(15).

inappropriate to use evidence related to a single task to support the preference in favor of director independence more broadly.

3. Breaking the Chain of Command

Another concern associated with inside directors is the potential that such directors, particularly those subordinate to other directors with whom they may serve, may feel beholden to their superiors in a way that undermines their ability to be objective. Some subordinate insiders may fear retaliation if they criticize or otherwise contradict their superiors. Others may view their service as an opportunity to curry favor with their subordinates and hence may simply rubber-stamp their actions. In this regard, inside directors who owe their livelihood to other directors may not be in the best position to serve as independent monitors. In fact, when asked to consider this issue, courts simply assume without discussion that subordinate directors are incapable of being considered independent for purposes of actions involving their superiors.[371] Any reform that embraces inside directors must be mindful of this potential phenomenon.

However, there may be ways in which this phenomenon can be mitigated. First, it may be prudent to ensure that inside directors have similar levels of seniority. Second, we should avoid having inside directors serving together when they are in the same chain of command, that is, when one insider is a direct subordinate of the other. Third, given the CEO's dominance over other employees, any increase in the role of inside directors likely must include decreases in the role of the CEO. Evidence reveals that CEOs remain a forceful presence on the board. Indeed, not only is the CEO often the board chair, but the CEO is often the only inside director.[372] However, shareholder activists have been advocating for corporations to separate the role of board chair and CEO, and the number of companies who have separated such roles is rising.[373] Then too, in companies where such roles are not separated, there is an increased reliance on lead or presiding directors who conduct meetings without the CEO being present.[374] An increased reliance on lead directors may alleviate some of the concerns associated with subordinate insiders because it enables those insiders to engage in decision making outside of the CEO's presence, thereby increasing the potential that such subordinates may feel comfortable exercising their independent judgment.

371. *See* Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1044 (Del. 2004).

372. *See* SPENCER STUART, *supra* note 4, at 4.

373. *See id.*; THE KORN/FERRY INST., *supra* note 4, at 7.

374. *See* sources cited *supra* note 373.

4. The Reality of Perception

Even if inside directors add value to the board, the prevailing perception that independent directors are better equipped to monitor corporate affairs cannot be ignored. Indeed, businesses, legislators, and the public alike have embraced the norm in favor of director independence.[375] Moreover, this embrace may have an impact on firm value. Studies find that stock prices increase when a company appoints an independent director.[376] In this regard, the ship in favor of director independence appears to have sailed, and it may be counterproductive to focus on reforms aimed at increasing the presence of inside directors on the board.

However, notwithstanding the difficulties with such a campaign, it is important to support the role that inside directors can play on the board, particularly when weighed against the drawbacks of independent directors. Such support could help alter the perception about the drawbacks of inside directors.

C. The Optimal Mix and External Regulation

Inside directors add value in terms of enhanced information, knowledge, and resources. Focusing on such directors also could enable corporations to better diversify their boards and harness the benefits of such diversity in the boardroom and corporation. Insiders have incentives to pay heed to corporate performance.

Concerns about inside directors' effectiveness and impartiality can be allayed, even if only in part, by the evidence related to independent directors' effectiveness. That evidence indicates that such directors are limited in their ability to be impartial and thus perform their monitoring role with sufficient rigor, and that those limitations may be difficult to overcome—at least in this current environment. In many ways, therefore, independent directors may be as conflicted as inside directors, undermining the rationale for favoring such directors over inside directors. In this regard, the biases that plague inside directors should not translate into a categorical exclusion of those directors on the board, especially given the advantages inside directors can bring to the boardroom.

Nevertheless, there is reason to be uneasy about increasing the number of inside directors on the corporate board. This unease stems not only from the prospects of adopting a strategy that runs counter to the overwhelming corporate-governance trend, but also from the more robust evidence concerning independent directors' impact on fraud detection, particularly with respect to the audit committee. Moreover, focusing on inside directors reopens the issue of oversight for self-dealing transactions. As a

375. *See supra* note 5.

376. *See* Bhagat & Black, *supra* note 3, at 237; Prentice & Spence, *supra* note 5, at 1867.

consequence, we may be more comfortable with seeking an optimal mix of inside and independent directors. This is because while we may have reservations about embracing boards dominated by insiders, we also should be uneasy with completely eradicating such directors from the boardroom.

Importantly, some of our concerns may be alleviated by reinvigorating the role of external regulation, particularly with respect to judicial oversight of high-risk transactions. Such oversight ensures that transactions with the most risk of managerial self-dealing are reviewed by those more impartial than either independent or inside directors. Such oversight not only increases the opportunities to hold corporate actors accountable, but also increases the potential that the legal regime can have a deterrent effect on board behavior.

In fact, imposing liability on inside directors may be a more realistic solution. As compared to independent directors, inside directors are more likely to face liability for overreaching and thus breaching their fiduciary obligations.[377] Regulators and judges appear to be more comfortable with holding inside directors accountable, possibly because of their increased time commitment and increased knowledge about corporate affairs. Because the legal regime is more likely to hold inside directors accountable for their misbehavior, it provides at least one important check on their potential to overreach. Such a check does not exist for independent directors. The availability of such sanctions may provide better assurance that we can achieve an optimal balance between incentives and accountability, especially when compared to independent directors. Indeed, courts' greater willingness to impose sanctions on inside directors may increase the likelihood that such sanctions can deter conduct because it increases the certainty of those sanctions. Such an increase in certainty, in turn, may reduce inside directors' willingness to be complicit in corporate misconduct by altering their individual risk assessment. In this respect, even if legal sanctions have an impact only at the margins, the fact that inside directors are more likely to be subject to such sanctions may provide support for relying on inside directors.

To be sure, external regulation is not a panacea. First, too much regulation can produce suboptimal results by deterring otherwise beneficial conduct. However, in light of the historical reluctance to impose liability on white-collar criminals, it is not clear that an increase in this area would be

377. *See* Sale, *supra* note 13, at 1379; U.S. Dep't of Justice, *supra* note 254. As compared to independent directors, inside directors are more likely to be named in actions, face trials, and be held liable for money damages than independent directors. *See* Sale, *supra* note 13, at 1379. Also, in the past few years, the SEC has routinely brought enforcement actions against inside directors while completely ignoring independent directors. *See* U.S. Dep't of Justice, *supra* note 254. Moreover, in the past few years, inside directors have been subjected to criminal prosecutions and convictions, while independent directors have managed to avoid such prosecutions and convictions. *See id.*

unwarranted. Second, our governance system also should focus on incentives because rewards can and do ensure that corporate actors conform their behavior to their fiduciary obligations.[378] In fashioning such incentives, attention should focus on enhancing whistleblower protections. Those protections recognize that insiders are the most likely to detect and prevent fraud, but that they require incentives because whistle-blowing can have negative consequences—most notably job loss.[379] By enhancing the protections afforded to whistleblowers, we may minimize those consequences, thereby encouraging inside directors to be effective monitors. Although SOX incorporates some protection for whistleblowers,[380] recent studies reveal that those protections may be insufficient and thus require enhancement.[381]

Third, some may contend that external regulation in the form of liability is not likely to have an impact on inside directors for at least two reasons. The first is that such legal penalties exist, but they have failed to deter misconduct by inside directors. This failure is underscored by the fact that the legal regime is more likely to penalize such directors for their behavior, increasing the certainty and potential deterrent value of those penalties. However, that regime also enables independent directors to shield inside directors from the impact of their conduct, dramatically reducing inside directors' risk of liability.[382] Consequently, the presence of independent directors may have decreased the deterrent effect of legal liability for inside directors. Appropriately reinvigorating external regulation removes that shield, increasing the certainty of liability and thereby increasing the chances that such liability will have a meaningful impact on inside directors' behavior.

The second reason for skepticism regarding the impact of external regulation is that inside directors may be especially risk-averse, such that their desire to protect their jobs may cause them to acquiesce or even participate in misconduct. Of course, this is likely to occur regardless of whether or not independent directors have a role in monitoring, and it is not clear that such directors would have the information and expertise to detect such actions. In this regard, we must depend upon a combination of

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378. *See* Cunningham, *supra* note 65, at 353–85 (outlining a model of incentive rewards for gatekeepers and emphasizing the limits of liability threats).

379. *See* Terry M. Dworkin, *SOX and Whistleblowing*, 105 MICH. L. REV. 1757, 1765–66 (2007); Richard E. Moberly, *Unfulfilled Expectations: An Empirical Analysis of Why Sarbanes-Oxley Whistleblowers Rarely Win*, 49 WM. & MARY L. REV. 65, 76–78 (2007); Mary Kreiner Ramirez, *Blowing the Whistle on Whistleblower Protection: A Tale of Reform Versus Power*, 76 U. CIN. L. REV. 183, 189–91 (2007).

380. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 806, 116 Stat. 745.

381. *See* Dworkin, *supra* note 379, at 1757; Moberly, *supra* note 379, at 65; Ramirez, *supra* note 379, at 183.

382. *See* Mitchell, *supra* note 45, at 42 (pinpointing the liability-shielding features of the modern monitoring board).

rewards and appropriate sanctions, which may alter inside directors' risk calculus. Even if this alteration occurs only at the margins, it may be more reliable than depending on independent directors—who are neither appropriately incentivized nor particularly accountable—to weed out wrongdoing.[383]

V. CONCLUSION

Currently, inside directors play a relatively minor role on the corporate board. The consensus view is that independent directors are better equipped to monitor the corporation to prevent corporate misconduct and enhance corporate performance. This view rests primarily on the contention that such directors' independence from the corporation enables them to impartially—but effectively—oversee the corporation and its officers. By contrast, inside directors' status as insiders prevents them from performing such a role and therefore justifies their near exclusion from the corporate boardroom.

This Article demonstrates that our understanding of both independent directors and inside directors is flawed and therefore makes the case for increased reliance on inside directors. That case rests not only on the fact that independent directors face significant hurdles that may not be easily overcome, but also on the fact that reliance on independent directors has been inappropriately used to substitute for rigorous external regulation.

The insights of this Article clearly have implications for corporate governance. First, they demonstrate that independence is not an inherent value and thus should not drive the debate about the appropriate model for board oversight. Second, the Article highlights the importance of external regulation. In fact, our fears that such regulation could discourage directors from seeking board seats or otherwise stifle appropriate risk-taking have blinded us to the important role that regulation plays in ensuring an effective accountability system. Moreover, our over-reliance on director independence has lulled us into accepting a governance system with very little external oversight. To be sure, we may have reservations about the case for the inside director. However, critically examining the inside directors' role on the board may prompt us to have a broader and more realistic conversation about directors, corporate boards, and the development of more appropriate structures for enhancing corporate monitoring.

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383. *See* Bhagat & Black, *supra* note 3, at 265 ("A priori, it is not obvious that independence (without knowledge or incentives) leads to better director performance than knowledge and strong incentives (without independence).").