

The Holy Grail of Corporate Governance Reform: Independence or Democracy?

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I. INTRODUCTION

Widely known in business and academic circles as a corporate governance guru, Robert Clark, a professor and former dean of Harvard Law School, recently found himself in the middle of a boardroom imbroglio.¹ Mr. Clark joined the board of directors of media conglomerate Time Warner Inc. ("Time Warner") in January 2004 as an independent member. In May 2005, Mr. Clark also joined, as an independent member, the board of directors of Lazard Ltd. ("Lazard"), an advisory investment banking firm whose chief executive officer ("CEO"), Bruce Wasserstein, was a longstanding business associate and personal friend of Mr. Clark.² Shortly after Mr. Clark's appointment to the Lazard board, Lazard began advising financier Carl C. Icahn and a group of dissident shareholders in a proxy battle to replace a majority of the board of directors of Time Warner.³

Although Mr. Clark's membership on the Lazard and Time Warner boards was in full compliance with the recently enacted regulatory reforms relating to director independence, his personal and professional

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1. See Gretchen Morgenson, *One Degree of Separation on the Board*, N.Y. TIMES, Dec. 4, 2005, at C3.

2. See Andrew Ross Sorkin, *Director Chooses Time Warner over Lazard Amid Proxy Fight*, N.Y. TIMES, Dec. 7, 2005, at C9 [hereinafter Sorkin, *Director Chooses Time Warner*]; Andrew Ross Sorkin, *One Director, Two Boards and a Fight at Time Warner*, N.Y. TIMES, Dec. 1, 2005, at C1.

3. See Morgenson, *supra* note 1; Sorkin, *Director Chooses Time Warner*, *supra* note 2. The impetus for the Icahn-led dissident group's proxy battle was Time Warner's disastrous 2000 merger with America Online, which has since left the merged company with a languishing share price. See Richard Siklos & Andrew Ross Sorkin, *For Icahn, Fielding a Team May Be as Tough as Playing the Game*, N.Y. TIMES, Jan. 16, 2006, at C1. The media speculated that Icahn's plans to form a dissident slate in anticipation of a proxy fight at Time Warner's annual meeting in May 2006 had been stagnating. See *id.*

relationship with Mr. Wasserstein, as well as the proxy battle between the two companies, raised serious questions about his ability to serve concurrently as a truly independent member of both boards.⁴ In December 2005, Mr. Clark resigned from the board of directors of Lazard to avoid any perception of a conflict of interest.⁵ The dilemma that led to his resignation is instructive. Mr. Clark is preeminent within both the business and academic communities as a corporate governance expert, thereby making him a seemingly ideal candidate for membership on any board of directors. More importantly, however, his resignation informs the ongoing debate regarding the desirability and practicability of independence-centered governance reform in the United States.⁶

Part II of this Article presents an intentionally selective list of the reforms enacted by Congress and the self-regulatory organizations (“SROs”) relating to director independence following the corporate scandals of 2001 and 2002. The reforms proscribe primarily employment

4. Mr. Clark’s business relationship with Bruce Wasserstein dates back to 1993 when Mr. Clark joined the board of Maybelline, a cosmetics company taken private by Wasserstein-Perella and subsequently spun off to the public in 1992. *See* Morgenson, *supra* note 1. In 1994, Mr. Clark became a director of Collins & Aikman, an automotive supplies maker whose co-chairman of the board at the time was Mr. Wasserstein. *Id.* Later, Mr. Clark joined the board of American Lawyer Media Holdings, another company run by Mr. Wasserstein. *Id.* In addition, Mr. Clark was a founding director at American Lawyer, a private company and publisher of *The National Law Journal* and *The American Lawyer*, both of which Mr. Wasserstein created. *Id.* In June 2003, Mr. Wasserstein and eleven alumni made a \$5.1 million contribution to Harvard Law School in Mr. Clark’s name as he stepped down from the deanship of the school after fourteen years of service. *Id.*

5. *See* Sorkin, *Director Chooses Time Warner*, *supra* note 2.

6. *See* Perry E. Wallace, *Accounting, Auditing, and Audit Committees After Enron, et al.: Governing Outside the Box Without Stepping off the Edge in the Modern Economy*, 43 WASHBURN L.J. 91, 102–03 (2003); *see also* E. Norman Veasey & Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance from 1992–2004? A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399, 1411 (2005) (“A number of definitions [of corporate governance] have emerged since that term became prominent in the United States during the 1980s.”). In its broadest sense, corporate governance has been defined as “the mechanisms, both legal and practical, that regulate the relationship[s]” among shareholders, management (led by the chief executive officer), and the board of directors. *See* Mark J. Loewenstein, *The SEC and the Future of Corporate Governance*, 45 ALA. L. REV. 783, 815 n.1 (1994); Veasey & Di Guglielmo, *supra*, at 1411. Professor John Farrar offered an interesting definition of corporate governance when he wrote, “The etymology of ‘governance’ comes from the Latin words *gubernare* and *gubernator*, which refer to steering a ship and to the steerer or captain of a ship. . . . The word ‘governance’, which has a rather archaic ring to it, comes from the old French word ‘gouvernance’ and means control and the state of being governed. . . . Thus we have from the etymology of the word a useful metaphor—the idea of steering or captaining a ship. We have references to control and also to good order, which is more than simply being on course: it is also being shipshape and in good condition.” JOHN FARRAR, *CORPORATE GOVERNANCE IN AUSTRALIA AND NEW ZEALAND* 3 (Rosie Adams ed., 2001).

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and other financial relationships between directors and management that many experts believe impair independence. Using the facts surrounding Robert Clark's recent high-profile resignation from the Lazard board, this Part explores whether independence represents a state of mind inherently invulnerable to corporate legislation or regulation, rather than being measurable by a director's job status or the existence of a financial relationship. With this conception of independence as a framework, Part II exposes the limitations of the existing statutory and regulatory landscape and casts doubt on the propriety of independence as the centerpiece of modern corporate governance reform in the United States.

The enactment of governance reform requires an understanding of the history of the debate concerning the appropriate role, if any, for an independent directorate in corporate governance. To that end, Part III of this Article sets forth the arguments that have been advanced both in favor of and against independent directors, as well as the theoretical predicate underlying the reforms' emphasis on independence. This Part frames the debate around the question of whether the statutory and regulatory reforms favor cosmetic form over functionality and thereby empower independent directors beyond their utility. Part III also considers the structural bias theory and cautions against overly simplistic generalizations relating to director bias.

While the federal reforms have elevated the issue of independence to the forefront of the corporate governance debate, recent Delaware jurisprudence has also sharpened the focus on the role of board composition generally—and in particular, on independent directors—for corporate governance reform.⁷ Part IV of the Article analyzes recent Delaware jurisprudence on director independence in both the special litigation committee ("SLC") and demand futility contexts.⁸ Providing a

7. See *infra* Part IV; Carl W. Mills, *Breach of Fiduciary Duty as Securities Fraud*: SEC v. Chancellor Corp., 10 FORDHAM J. CORP. & FIN. L. 439, 450 (2005). Given that most Fortune 500 and NYSE-listed companies are incorporated in Delaware, Delaware courts are considered the leading arbiters of corporate governance matters.

8. Delaware corporate jurisprudence is authoritatively framed in part by the Delaware Supreme Court and in part by the Delaware Court of Chancery. See Veasey & Di Guglielmo, *supra* note 6, at 1401, 1408–09 (commenting that the Delaware Supreme Court offers the authoritative final word on corporate jurisprudence). The tumultuous atmosphere of 2001 and 2002, typified by the Enron and WorldCom scandals as well as the resulting legislative and regulatory activity at the national level, provoked increased litigation in both Delaware courts concerning the appropriate conception of director independence for the corporate enterprise. See *id.* at 1407 (stating that Delaware law, influenced by a variety of norms and aspirational standards for corporate governance, offers a delicate balance between respecting the norms of common-law decision-making by deciding

qualitatively different approach to director independence than the current statutory and regulatory regimes, Delaware decisional law examines the subtle, textured relationships that develop among directors and management without subscribing to any rigid, rule-based conception of independence.⁹ Part IV concludes by considering whether, despite Delaware's flexible approach to evaluations of board composition, Delaware law places undue emphasis on director independence.

Finally, in light of the concerns surrounding the appropriate role, if any, for an independent directorate in corporate governance reform, Part V of the Article addresses the practical limitations that undermine the monitoring integrity of the corporate board.¹⁰ Reflecting the normative vision that the board's principal role is to monitor management, director independence has achieved the status of conventional wisdom for the enforcement of the board's monitoring paradigm. Foremost among the practical limitations on director independence (and the board's monitoring effectiveness) is management's continued dominance over the director electoral process through its control of the corporate proxy statement. To the extent that management controls the electoral process by nominating all of the candidates for election to a company's board of directors, even ostensibly independent directors will have little incentive to monitor management. In view of the board passivity resulting from the continued managerial appointment of directors, Part V proposes that the democratization of the corporate electoral process through increased shareholder access to the corporate proxy statement—rather than independence (as traditionally conceived)—should represent the Holy Grail of corporate governance reform in the United States.¹¹

only the case before the court and the need to provide an authoritative view on issues of significant import).

9. See *id.* at 1472 (noting that bright line rules are antithetical to Delaware's contextual approach to corporate regulation).

10. See Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 601–02 (1982); Jonathan H. Gabriel, *Misdirected? Potential Issues with Reliance on Independent Directors for Prevention of Corporate Fraud*, 38 SUFFOLK U. L. REV. 641, 646 (2005).

11. See Gabriel, *supra* note 10, at 646.

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II. THE REFORMS

A. Background on the Reforms

Following the now infamous scandals at Enron, WorldCom, Tyco, Global Crossing, Adelphia, and others, the federal government enacted ostensibly sweeping reform¹² to the American corporate governance system, particularly in the area of director independence.¹³ Rather than allowing companies to make discretionary structural changes to their corporate governance systems by correcting perceived deficiencies through an internal curative process or permitting states to fulfill their traditional role of spearheading reforms, the federal government's chosen

12. Although the recently enacted reforms do not supplant the states' traditional regulation of independence, they mark a significant shift in the locus of power concerning corporate governance regulation. See Mills, *supra* note 7, at 439 (commenting that for some, "[t]he shift in regulatory power [points to the federal government's] slow awakening to the fundamental failure of market forces and state regulatory regimes to adequately protect shareholders and the public" from corporate wrongdoing). For others, the shift is an overblown response to recent corporate scandals and represents an unwarranted intrusion into the states' regulatory domains. 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, 390 (2005).

13. According to some scholars, "a soberly apolitical view" of the statutory and regulatory reforms following the corporate collapses of 2001 and 2002 sees them "as more sweep than reform." Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Just Might Work)*, 35 CONN. L. REV. 915, 917-18 (2003) ("These codifications do little more than shine a spotlight on some best practices, an important function but hardly reform of any sort, sweeping or otherwise."). Describing the reform-less reforms, Professor Cunningham observed,

On the one hand, Congress may have understood that the visible debacles did not show chronic epidemics but discrete pathologies and that their root causes were market psychology beyond its regulatory reach (hence a reform-less Act). On the other hand, Congress knew that the public perceived an acute systemic crisis of power abuse they had no responsibility for creating (hence the "sweeping" rhetoric).

Id. at 922; see also Robert Wright, *Enron: The Ambitious and the Greedy*, 16 WINDSOR REV. LEGAL & SOC. ISSUES. 71, 90 (2003) (maintaining that the reforms represent "the showmanship of cosmetic adjustment"). Most scholars agree that the reforms codified in a new federal guise merely reiterate existing federal regulations, state laws, stock exchange rules, and securities industry practices. See Stephen M. Bainbridge, *A Critique of the NYSE's Director Independence Standards*, 30 SEC. REG. L.J. 370 (2002) (calling the reforms "old wine in new bottles"); Cunningham, *supra*, at 918; see also William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953, 957 (2003) (speculating that the reforms were enacted not because they would have prevented the recent scandals but because they appeased the public's need for far-reaching reform); Charles M. Elson & Christopher J. Gyves, *The Enron Failure and Corporate Governance Reform*, 38 WAKE FOREST L. REV. 855, 878-79 (2003) (characterizing the reforms as a "restatement with the force of federal law" (quoting Cunningham, *supra*, at 987)); Gabriel, *supra* note 10, at 647 (noting that the reforms represent an expedient federalization of existing practices proved inadequate by the corporate scandals that occasioned them).

solution was the imposition of its own prophylactic governance regime on all U.S.-domiciled listed companies, subject to certain exceptions.¹⁴ At the statutory level, Congress enacted the Sarbanes-Oxley Act of 2002 (“the Act”) on July 29, 2002.¹⁵ Further, in accord with the goals of the Act, the Securities and Exchange Commission (“SEC”) authorized the SROs—specifically the New York Stock Exchange (“NYSE”) and the National Association of Securities Dealers (“NASD”) through its subsidiary, the NASDAQ Stock Market, Inc. (“NASDAQ”)—to promulgate changes to their respective listing standards (together, the “Revised Listing Standards”).¹⁶

At the core of these statutory and regulatory reforms was a focus on increasing independence within the boards of directors of publicly traded corporations.¹⁷ Fundamentally, independence refers to the nature of the relationship between directors—as representatives of the shareholders—and management.¹⁸ In practical terms, independence suggests that directors are free of inappropriate entanglements with the management of the companies on whose boards they serve so that they can monitor management objectively.¹⁹ The reforms’ emphasis on independence likely stems from a belief that poorly performing corporate boards,

14. See Fairfax, *supra* note 12, at 388.

15. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 301, 116 Stat. 745, 776 (codified as amended at 15 U.S.C. § 78j-1(m)(3)(B) (2005)); see James D. Cox, *Reforming the Culture of Financial Reporting: The PCAOB and the Metrics for Accounting Measurements*, 81 WASH. U. L.Q. 301, 302 (2003); Gabriel, *supra* note 10, at 644 (“Until SOX, corporate governance law was largely state-dominated. State corporation law vests in the board of directors the responsibility to select a company’s management team and monitor its activities State law does not, however, provide guidance on board composition beyond the means by which directors may be elected and removed.”); see also Richard A. Epstein, *Sarbanes Overdose*, NAT’L L.J., Jan. 27, 2003, at A17 (noting that the “ability to fine-tune a board is beyond the power of Congress to achieve—but it is within the power of Congress to destroy”).

16. See Wallace, *supra* note 6, at 104–05.

17. Benjamin E. Ladd, *A Devil Disguised as a Corporate Angel?: Questioning Corporate Charitable Contributions to “Independent” Directors’ Organizations*, 46 WM. & MARY L. REV. 2153, 2154 (2005).

18. 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, 798 (2001).

19. See Ira M. Millstein & Paul W. MacAvoy, *The Active Board of Directors and Performance of the Large Publicly Traded Corporation*, 98 COLUM. L. REV. 1283, 1292–93 (1998). More expansive conceptions of independence contemplate directors who are not solely overseers of management on behalf of shareholders but who represent, and have loyalties to, specific constituencies other than shareholders. *Id.* at 1306 (quoting Timothy J. Sheehan, *To EVA™ or Not to EVA™: Is That the Question?*, J. APPLIED CORP. FIN., Summer 1994, at 85, 86).

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which were complacent at best and malfeasant at worst, facilitated the large-scale corporate failures of 2001 and 2002.²⁰

Even before the collapses of Enron, WorldCom, and other market giants, publicly traded corporations had increasingly adopted the practice of majority-independent boards of directors.²¹ By 2001, an estimated seventy-five percent of all listed companies had boards comprised of a majority of independent directors.²² The institutionalization of the independent directorate pointed to corporate America's belief in independent directors' ability to reduce management's influence in the

20. See Gabriel, *supra* note 10, at 641. Some scholars argue that the regulatory reforms concerning independent boards of directors consume the corporate governance debate at the expense of acknowledging a broader, and perhaps more serious, phenomenon. See Marianne M. Jennings, *A Primer on Enron: Lessons from a Perfect Storm of Financial Reporting, Corporate Governance, and Ethical Culture Failures*, 39 CAL. W. L. REV. 163, 258 (2003). According to these scholars, corporate cultures are hyper-competitive environments where actors have an "inexhaustible capacity for self-rationalization, fueled by boundless ambition." Donald C. Langevoort, *The Organizational Psychology of Hyper-Competition: Corporate Irresponsibility and the Lessons of Enron*, 70 GEO. WASH. L. REV. 968, 971 (2002) (quoting ROBERT JACKALL, *MORAL MAZES: THE WORLD OF CORPORATE MANAGERS* 203 (1988)); see also Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 9 (2002) ("[T]he new breed [of managers] appear to be Machiavellian, narcissistic, prevaricating, pathologically optimistic, free from self-doubt and moral distractions, willing to take great risk as the company moves up and to lie when things turn bad, and nurtured by a corporate culture that instills loyalty to insiders, obsession with short-term stock price, and intense distrust of outsiders."). Particularly in times of market euphoria, as the late 1990s were, the inclinations to rationalize dishonest or unethical behavior become exaggerated, and even external norms, such as the law or shareholder primacy and gatekeeper intermediaries, fail to constrain corporate irresponsibility. See John C. Coffee, Jr., *What Caused Enron? A Capsule Social and Economic History of the 1990s*, 89 CORNELL L. REV. 269, 293 (2004) (contending that in market bubbles, gatekeepers adopt a competitive strategy of being as acquiescent and as low-cost as possible); Langevoort, *supra*, at 972. Proponents of this bleak view maintain that additional regulations and statutory reforms are misguided responses to the problems of corporate misconduct. See, e.g., Jennings, *supra*, at 261. Indeed, they point to the fact that the frauds occurred after more than seventy years of securities regulation as an argument for the futility of additional regulation. See Ribstein, *supra*, at 3 (discussing the disadvantages of additional regulation, including deterring beneficial transactions, increasing the adversarial nature of corporate governance, diverting managerial talent to non-regulated companies such as closely held firms, and reducing managers' incentives to increase firm value).

21. See Jeffrey N. Gordon, *Governance Failures of the Enron Board and the New Information Order of Sarbanes-Oxley*, 35 CONN. L. REV. 1125, 1127 (2003) ("[A] reliable corporate governance system ought to catch [fraudulent transactions] before [they] become[] pathological and carr[y] such destructive consequences . . .").

22. *Developments in the Law—Corporations and Society*, 117 HARV. L. REV. 2169, 2182 (2004) (citing Press Release, Investor Responsibility Research Center, IRRRC Data Guides New Listing Rules for NYSE (Mar. 7, 2002), http://www.irc.org/company/06062002_NYSE.html).

boardroom.²³ Taken together, therefore, the Act and the Revised Listing Standards reenacted already-existing corporate governance practices in “a new federal guise.”²⁴

B. The Sarbanes-Oxley Act

Neither Congress nor the SROs have provided an affirmative definition of independence.²⁵ Instead, Congress set forth a list of relationships that would *preclude* a determination of independence and limited the application of those relationships to the composition of a board’s audit committee.²⁶ Section 301 of the Act imposes the requirement, with certain limited exceptions, that “[e]ach member of the audit committee of the issuer shall be a member of the board of directors of the issuer, and shall otherwise be independent.”²⁷ The Act’s definition of independence excludes from membership on an audit committee any director who (1) is an affiliate of the listed issuer or any subsidiary thereof²⁸ or (2) accepts, directly or indirectly, any consulting, advisory, or other compensatory fee from the issuer or any of its subsidiaries, provided that those fees do not represent the receipt of fixed amounts for

23. See Brudney, *supra* note 10, at 621.

24. See Gabriel, *supra* note 10, at 659 (arguing that the current regulatory regime is a formalization of extant best practices); see also Cunningham, *supra* note 13, at 918 (maintaining that the Act “reenact[ed] in a new federal guise” existing state laws, federal regulations, stock exchange rules, and securities industry practices).

25. See Chandler & Strine, *supra* note 13, at 967.

26. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 301, 116 Stat. 745, 776 (codified as amended at 15 U.S.C. § 78j-1(m)(3)(B) (2005)); see also Joel Seligman, *A Modest Revolution in Corporate Governance*, 80 NOTRE DAME L. REV. 1159, 1170 (2005).

27. 15 U.S.C. § 78j-1(m)(2).

The audit committee of each issuer, in its capacity as a committee of the board of directors, shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or related work, and each such registered public accounting firm shall report directly to the audit committee.

28. See § 78j-1(m)(3)(B)(ii). Under pre-existing federal law, the definition of “affiliated person” referenced in the Securities Exchange Act of 1934 (the “Exchange Act”) indicated that a director who controls, or is affiliated with any stockholder who controls, five percent or more of the company’s shares would be ineligible to serve as a voting member of the audit committee. See 15 U.S.C.A. § 78j-1(m)(3)(B)(i)–(ii) (West Supp. 2003). Consistent with Rule 12b-2 of the Exchange Act and Rule 144 of the Securities Act, Rule 10A-3 of the Exchange Act establishes a safe harbor that excludes persons who own, or are affiliated with entities that own, less than ten percent and who are not executive officers or directors of the company. See 17 C.F.R. § 240.10A-3(e)(1)(i)–(ii) (2003).

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prior service under a retirement plan (including deferred compensation).²⁹

C. The Revised Listing Standards

Following the implementation of the Act, the SEC concurrently approved new NYSE and NASDAQ corporate governance listing standards.³⁰ Reflecting both an enhanced substantive definition of independence (albeit through an articulation of disqualifying relationships) and its application beyond membership on an audit committee, the Revised Listing Standards³¹ require that, with certain exceptions,³² the boards of directors of U.S.-domiciled listed companies

29. See 15 U.S.C.A. § 78j-1(m)(3)(B)(i). Pursuant to section 301 of the Sarbanes-Oxley Act, on April 9, 2003, the SEC adopted Rule 10A-3 under the Exchange Act, whose principal objective was “to direct, by rule, the national securities exchanges and national securities associations (or “SROs”) to prohibit the listing of any security of an issuer that is not in compliance with several enumerated standards regarding issuer audit committees.” Standards Relating to Listed Company Audit Committees, Securities Act Release No. 8220, Exchange Act Release No. 47,654, Investment Company Act Release No. 26,001 (Apr. 9, 2003), available at <http://www.sec.gov/rules/final/33-8220.htm>.

30. See Lyman P.Q. Johnson & David Millon, *Recalling Why Corporate Officers Are Fiduciaries*, 46 WM. & MARY L. REV. 1597, 1599–600 nn.7–8 (2005). On August 16, 2002, the NYSE filed with the SEC, pursuant to section 19(b)(1) of the Exchange Act and Rule 19b-4 thereunder, a proposed rule change (SR-NYSE-2002-33) to amend its Listed Company Manual (the “NYSE Manual”). On October 9, 2002, the NASD, through its subsidiary, the NASDAQ, filed with the Commission, pursuant to section 19(b)(1) of the Exchange Act and Rule 19b-4 thereunder, a proposed rule change (SR-NASD-2002-141) to amend NASD 4200 and 4350(c) and (d) to modify requirements relating to board independence and independent committees. See Order Approving NYSE and NASD Proposed Corporate Governance Amendments, Exchange Act Release No. 48,745, 68 Fed. Reg. 64,154 (Nov. 4, 2003) [hereinafter Rules of Corporate Governance]; NYSE Proposed Corporate Governance Amendment, Exchange Act Release No. 47,672, 68 Fed. Reg. 19,051 (Apr. 11, 2003); see also THE NASDAQ STOCK MARKET, INC., MARKETPLACE RULES R. 4200 (2004), <http://www.nasdaq.com/about/MarketplaceRules.pdf> [hereinafter NASDAQ MARKETPLACE RULES]; NYSE Listed Company Manual Section 303A, Corporate Governance Listing Standards, Frequently Asked Questions (Feb. 13, 2004), <http://www.nyse.com/pdfs/section303Afaqs.pdf> [hereinafter NYSE Section 303A FAQs].

31. See NASDAQ MARKETPLACE RULES, *supra* note 30, at R. 4350(c); NYSE Group, Listed Company Manual § 303A.01 (Nov. 4, 2003), <http://www.nyse.com/FrameSet.html?nyseref=&displayPage=/lcm/1078416930882.html?archive=no> [hereinafter NYSE Listed Company Manual].

32. Section 303A of the NYSE Listed Company Manual applies to all companies listing common equity securities with certain exceptions for controlled companies, limited partnerships, companies in bankruptcy, closed-end and open-end funds, foreign private issuers, and other entities, including passive business organizations and derivatives and special purpose securities. See NYSE Listed Company Manual, *supra* note 31, § 303A.

consist of a majority of independent directors.³³ In light of the similarities between the NYSE and NASDAQ independence standards, the following section sets forth the NYSE corporate governance listing standards and, where applicable, highlights material differences between the NYSE and NASDAQ rules.

Pursuant to section 303A(2) of the NYSE Manual, no director will qualify as independent unless the board affirmatively determines that the director has no material relationship with the company either directly or as a partner, shareholder, or officer of an organization that has a relationship with the company.³⁴ To that end, section 303A(2)(b) enumerates those material relationships that disqualify a person from serving as an independent member of a company's board of directors.³⁵

33. See Rules of Corporate Governance, *supra* note 30; NYSE Proposed Corporate Governance Amendment, *supra* note 30; see also NASDAQ MARKETPLACE RULES, *supra* note 30; NYSE Section 303A FAQs, *supra* note 30. Prior to the enactment of the Revised Listing Standards, the NYSE treated a director as independent unless (1) the director was employed by the listed issuer or its affiliates in the previous three years; (2) the director had an immediate family member who, during the previous three years, was employed by the issuer or its affiliates as an executive officer; (3) the director had a direct business relationship with the company (including commercial, banking, consulting, legal, and accounting relationships); or (4) the director was a partner, controlling shareholder, or executive officer of an organization that had a business relationship with the issuer, unless the issuer's board determined in its business judgment that the relationship did not interfere with the director's exercise of independent judgment. See NYSE Listed Company Manual, *supra* note 31, § 303A.02. Substantively, the NYSE required that all listed companies have at least three independent directors. *Id.* § 303A.04-07. In addition, audit committees had to be comprised solely of independent directors, all of whom had to be "financially literate." *Id.* § 303A.07.

34. Material relationships can include commercial, banking, industrial, legal, consulting, accounting, charitable, and familial relationships. See NYSE, Inc., Corporate Governance Rule Proposals Reflecting Recommendations from the NYSE Corporate Accountability and Listing Standards Committee as Approved by the NYSE Board of Directors, Aug. 1, 2002, at 3, http://www.nyse.com/pdfs/corp_gov_pro_b.pdf [hereinafter NYSE 2002 Standards]. The NYSE does not consider ownership of even a significant amount of stock to be a *per se* bar to a finding of independence. *Id.* § 303A(2). The basis for a board's determination of independence must be disclosed in the company's annual proxy statement or, if the company does not file an annual proxy statement, in the company's annual report on Form 10-K. See NYSE Listed Company Manual, *supra* note 31, § 303A.02(a). A board may adopt categorical standards to assist it in making independence determinations and may make a general statement that the independent directors meet those standards. *Id.* In the event that a director who does not satisfy those standards is determined to be independent, a board must explain the basis for its determination. *Id.* The NASDAQ definition of independence requires the director to have no "relationship, which, in the opinion of the company's board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director." NASDAQ MARKETPLACE RULES, *supra* note 30, at R. 4200(a)(15). NASDAQ's definition of independence is somewhat more expansive than the NYSE definition because it addresses relationships that potentially might not be precluded under the traditional economically focused definition of materiality. *Id.*

35. NYSE 2002 Standards, *supra* note 34, § 303A(2)(b).

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“First, a director who is an employee, or whose immediate family member³⁶ is an executive officer, of the company would not be independent until three years after the end of such employment relationship.”³⁷ “Second, a director who receives, or whose immediate family member receives, more than \$100,000 per year in direct compensation from the listed company, except for certain permitted payments³⁸ [including board or committee fees or specified types of deferred compensation], would not be independent until three years after [such director] ceases to receive more than \$100,000 per year in [direct] compensation.”³⁹ Unlike its NYSE counterpart, the NASDAQ disqualifies from independent service on a board of directors any director who receives, or whose immediate family member receives, more than \$60,000 from the listed issuer in direct compensation during the prior three fiscal years.⁴⁰ “Third, a director who is affiliated with or employed by, or whose immediate family member is affiliated with or employed in a professional capacity by, a present or former internal or external auditor of the [listed] company would not be independent until three years after the [termination of such relationship].”⁴¹ The similar NASDAQ provision limits the reach of this rule by disqualifying only those directors or directors’ family members who are current partners of the company’s outside auditor or were partners or employees of the company’s outside auditor *and* actually worked on the company’s audit during the prior three-year period.⁴² Fourth, a director who is employed,

36. Pursuant to section 303A.02(b) of the NYSE Listed Company Manual, “[a]n ‘immediate family member’ includes a person’s spouse, parents, children, siblings, mothers and fathers-in-law, sons and daughters-in-law, brothers and sisters-in-law, and anyone (other than domestic employees) who shares such person’s home.” NYSE Listed Company Manual, *supra* note 31, § 303A.02(b) gen. cmt.

37. Rules of Corporate Governance, *supra* note 30, at 64,157 (“[R]eferences to ‘company’ [in the listing standards] would include any parent or subsidiary in a consolidated group with the company.”).

38. “Permitted payments would include director and committee fees and pension or other forms of deferred compensation for prior service, provided such compensation is not contingent on continued service.” NYSE Listed Company Manual, *supra* note 31, § 303A.02(b)(ii). “In addition, compensation received by a director for former service as an interim Chairman or CEO” or “compensation received by an immediate family member for service” as a non-executive employee would be considered permitted payments. *Id.*

39. Rules of Corporate Governance, *supra* note 30, at 64,157 (footnotes omitted).

40. *Developments in the Law—Corporations and Society*, *supra* note 22, at 2189.

41. Rules of Corporate Governance, *supra* note 30, at 64,157.

42. See NASDAQ MARKETPLACE RULES, *supra* note 30, at R. 4200(a)(15)(F). The NASDAQ rule appears not to apply to former employees of external auditors unless the employees worked on the company’s audit, although current partners appear to be disqualified irrespective of

or whose immediate family member is employed, as an executive officer of another company where any of the listed company's present executives serve on that other company's compensation committee would not be independent until three years after the end of such employment.⁴³ Finally, a director who is an executive officer or an employee, or whose immediate family member is an executive officer, of a company that makes payments to, or receives payments from, the listed issuer in an amount which, in any single fiscal year, exceeds the greater of \$1 million or two percent of such other company's consolidated gross revenues, would not be independent until three years after falling below such threshold.⁴⁴ In contrast, the corresponding NASDAQ provision defines as "not independent" any director who is currently a partner, controlling shareholder, or executive officer of any organization (including a non-profit)⁴⁵ that receives payments from the listed company in an amount that, in the current or past three fiscal years, "exceeds 5% of the recipient's consolidated gross revenues, or \$200,000, whichever is more."⁴⁶

In addition to setting forth a list of disqualifying relationships, section 303A(3) of the NYSE Manual requires non-management directors (including inside directors)⁴⁷ to convene regularly in executive

whether they have worked on the company's audit. *Id.* The provision also does not apply to directors "affiliated with" the listed company's auditors other than as partners or employees. *Id.*

43. See Rules of Corporate Governance, *supra* note 30, at 64,157.

44. *Id.* In applying the test set forth in section 303A.02(b)(v), "both the payments and the consolidated gross revenues to be measured shall be those reported in the last completed fiscal year." NYSE Listed Company Manual, *supra* note 31, § 303A.02(b)(v) cmt. The three-year look-back provision for this test applies only to the financial relationship between the listed company and the director or immediate family member's current employer; a listed company is not required to consider the former employment of the director or immediate family member. *See id.*

45. NASDAQ MARKETPLACE RULES, *supra* note 30, at R. 4200(a)(15)(D). The NASDAQ interpretive manual explicitly states that charitable organizations are included in this provision. *See id.*

46. *See id.* The NASDAQ provision thus disqualifies more types of organizations than the NYSE, "but only applies if the director is in a position to exert some control over the other organization," such as a partner, controlling shareholder, or executive officer could. *See Developments in the Law—Corporations and Society*, *supra* note 22, at 2190. In contrast to the NYSE rule, "the NASDAQ provision also considers the impact of a payment on whichever entity receives it (rather than on the outside company alone)" *Id.* "Further, the NASDAQ [rule] is not dispositive [sic], because it maintains that other suspect relationships should be considered despite a director's compliance with the stated test." Ladd, *supra* note 17, at 2169.

47. See NYSE Listed Company Manual, *supra* note 31, § 303A.03. "Non-management" directors are all those directors who are not company officers, as defined in Rule 16a-1(f) of the Securities Act of 1933, and include those directors who are not independent as a result of a material

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sessions outside the presence of management.⁴⁸ The NYSE further recommends that at each of these executive sessions, the board of directors designate a “presiding director” or “lead independent director” to run the meeting.⁴⁹ Unlike its counterpart NYSE rule, the NASDAQ explicitly limits attendance at such executive sessions to independent (rather than merely non-management) directors.⁵⁰

Under sections 303A(4)(a) and 303A(5) of the NYSE Manual, all listed companies are also required to have a compensation committee⁵¹ and a separate nomination/corporate governance committee⁵²—each composed entirely of independent directors—as well as a minimum three-person audit committee,⁵³ consisting entirely of independent

relationship, former status or family affiliation, or for any other reason the board determines disqualifies the director from independent service. *See id.*

48. *Id.*; Seligman, *supra* note 26, at 1173; Rules of Corporate Governance, *supra* note 30, at 64,157. At least one meeting per year is reserved for independent, non-management directors (excluding inside directors) if the group of non-management directors includes directors who are not independent under NYSE section 303A. *See Developments in the Law—Corporations and Society*, *supra* note 22, at 2192–93 (citing NYSE Listed Company Manual, *supra* note 31, § 303A.03).

49. *See Developments in the Law—Corporations and Society*, *supra* note 22, at 2193. If a director is selected to preside at an executive session, that director’s name must be disclosed in the company’s annual proxy statement or, if the company does not file an annual proxy statement, in the company’s annual report on Form 10-K. *See* NYSE Listed Company Manual, *supra* note 31, § 303A.03 cmt. In addition, a company may, but is not required to, disclose the process by which a presiding director is chosen for each executive session. *See id.*

50. *See* NASDAQ MARKETPLACE RULES, *supra* note 30, at R. 4350(c)(2).

51. All compensation committees must have a published charter that addresses the committee’s purpose and responsibilities and which must include (1) a review and approval of corporate goals relevant in evaluating CEO performance and determining CEO compensation, (2) a review of non-CEO compensation, (3) a review of incentive-based compensation plans and equity-based plans, and (4) a compilation of compensation committee reports on executive compensation as required by the SEC to be included in the company’s annual proxy statement or annual report on Form 10-K. *See* NYSE Listed Company Manual, *supra* note 31, § 303A.05.

52. *Id.* § 303A.04. All nomination/corporate governance committees must have a published charter. *Id.* The responsibilities of a nomination/corporate governance committee include director and board committee nominations consistent with criteria approved by the board, oversight of the evaluation of board and management performance, and development of corporate governance principles applicable to the company. *See id.* If a listed company is required, by contract or otherwise, to provide third parties with the ability to nominate directors (for instance, preferred stock rights to elect directors upon a dividend default or through shareholder or management agreements), such nominations are not subject to the nominating committee process. *See id.* § 303A.04 cmt.

53. *Id.* § 303A.07(a). All audit committees must have a published charter. The minimum responsibilities of the audit committee include (1) oversight of the integrity of the company’s financial statements, (2) compliance with legal and regulatory requirements, (3) assistance in reviewing the independent auditor’s qualifications and independence, (4) assistance in the performance of the company’s internal audit function and independent auditors, (5) preparation of an audit committee report as required by the SEC to be included in the company’s annual proxy

directors that meet the independence standards of NYSE section 303A(2) and SEC Rule 10A-3.⁵⁴

D. The Robert Clark Boardroom Experience

The reforms described above evince a distrust of directors who have certain employment and other financial relationships with the companies they oversee. Notwithstanding the practical benefits of proscribing these types of relationships, the reforms set forth an overly formulaic conception of independence. In so doing, they fail to account for independence as an inherently immeasurable state of mind. With this less rigid view of independence as a framework, consider again the Robert Clark conundrum set forth in this Article's Introduction.

Before joining the Lazard board in May 2005, Mr. Clark had served on the boards of a number of companies created by Lazard's CEO, Mr. Wasserstein.⁵⁵ In addition to numerous boardroom interlocks with Mr. Clark, Mr. Wasserstein was a benefactor of Harvard Law School, where Mr. Clark had served as Dean from 1989 to 2003. Along with ten other alumni, Mr. Wasserstein made a substantial contribution in Mr. Clark's honor when he resigned as Harvard Law School's Dean.⁵⁶ After Mr. Clark's appointment to the Lazard board, Lazard began advising the Icahn-led dissident group in its proxy battle against Time Warner.⁵⁷ Although Mr. Clark's membership on both the Lazard and Time Warner boards complied with the existing SRO rules, he resigned from the board of directors of Lazard in December 2005 to avoid any perception of a conflict of interest.⁵⁸

The view of independence as a state of mind supports the notion that even directors—like Robert Clark—who satisfy the existing formulaic standards for independence may not have the requisite uncompromised “state of mind.”⁵⁹ Those subscribing to this view would argue that any

statement, (6) evaluation of the performance of the audit committee, (7) implementation of risk assessment and risk management policies, and (8) oversight of hiring for employees or former employees of the independent auditors. *See id.* § 303A.07(c).

54. *See* 17 C.F.R. § 240.10a-3 (2003); Rules of Corporate Governance, *supra* note 30, at 64,158.

55. *See* Morgenson, *supra* note 1, at C3.

56. *See id.*

57. *See id.*

58. *See* Sorkin, *Director Chooses Time Warner*, *supra* note 2.

59. Adherents of this viewpoint would de-emphasize independence as the centerpiece of corporate governance reform. Instead, they would support a repeal of the current, prescriptive

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statutory or regulatory regime that measures independence on the existence (or nonexistence) of specific employment or financial relationships is inherently flawed. Specifically, such a regime may fail to identify those directors who, despite their compliance with the rules, do not possess a truly independent viewpoint.

While this conception of independence illustrates the potential under-inclusiveness of the existing reforms, it also underscores the potential over-inclusiveness of such reforms. With due recognition of protections that the existing governance regime provides against potential instances of director bias, Mr. Clark's boardroom predicament exposes the limitations of the current regulatory landscape. In so doing, Mr. Clark's story weakens the proposition that independence should be, as it has been since 2001, the centerpiece of corporate governance reform in the United States.

Before determining the appropriate model for governance reform, however, it is important to understand the ongoing theoretical debate concerning the merits and limitations of an independent directorate. The following Part sets forth the arguments advanced both for and against the institutionalization of the independent directorate in the United States.

III. THE UTILITY OF AN INDEPENDENT DIRECTORATE: COSMETICS VERSUS FUNCTIONALITY

Professor Brudney of Harvard Law School warned in 1982 in a seminal article on director independence that while the practice of majority-independent boards of directors offered "more promise" for improved corporate governance than other structural reforms, "logic and experience counsel[ed] something less than optimism."⁶⁰ Consistent with modern critics of independence, Professor Brudney noted that certain corporate practices—among others, continued managerial dominance over the corporate electoral process—caused him to harbor doubts about the ability of a so-called independent directorate to exercise truly

independence regime in favor of a voluntary independence regime where companies could either comply with SRO-formulated corporate governance guidelines or explain their non-compliance in an "appropriate disclosure." Many European countries have adopted a principles-based "comply or explain" approach as an alternative to the American rules-based approach to corporate governance. See Oliver Krackhardt, *New Rules for Corporate Governance in the United States and Germany—A Model for New Zealand?*, 36 VICTORIA U. WELLINGTON L. REV. 319 (2005); see also *Special Study on Market Structure, Listing Standards and Corporate Governance*, 57 BUS. LAW. 1487, 1529 (2002) (examining the role of the SROs and the SEC in corporate governance and recommending a proposal to develop best practices guidelines based on a "comply or explain" approach).

60. Brudney, *supra* note 10, at 621.

independent judgment.⁶¹ Nearly twenty years after Professor Brudney's warning, the failure of the majority-independent boards of some of America's most successful companies (including Enron⁶²) to prevent or even detect serious managerial misdeeds⁶³ lends further support to Professor Brudney's cynical view regarding the promise of an independent directorate for improved corporate governance.

With his sound advice that major structural changes to the American corporate governance system should be approached with caution rather than embraced in panic, Professor Brudney's warning takes on particular

61. *See id.* at 601.

62. The independence of Enron's board of directors was compromised by a number of financial and quasi-financial ties between outside board members and Enron. *See* Charles M. Elson, *Enron and the Necessity of the Objective Proximate Monitor*, 89 CORNELL L. REV. 496, 501 (2004). For example, Enron paid two board members—Lord John Wakeham and John A. Urquhart—consulting fees in addition to their standard board fees. *See* Wright, *supra* note 13, at 83. *See also* Elson & Gyves, *supra* note 13, at 872 (indicating that directors receiving consulting fees in addition to normal board compensation tend to acquiesce in management's decisions in order to protect the flow of consulting income). Board member Herbert Winokur was concurrently an Enron director and a board member of the National Tank Company, which recorded revenues from sales to Enron subsidiaries ranging from \$370,000 to \$1,000,000 for the years 1997–2000. *See* PERMANENT SUBCOMM. ON INVESTIGATIONS OF THE COMM. ON GOVERNMENTAL AFFAIRS, THE ROLE OF THE BOARD OF DIRECTORS IN ENRON'S COLLAPSE, S. REP. NO. 107-70, at 55 (2002) [hereinafter THE ROLE OF THE ENRON BOARD]; *see also* Elson & Gyves, *supra* note 13, at 872 (citing THE ROLE OF THE ENRON BOARD, *supra*, at 55). Board member Dr. Wendy Gramm was an employee of the Mercatus Centre of George Mason University to which Enron and Ken Lay donated more than \$50,000. *See* THE ROLE OF THE ENRON BOARD, *supra*, at 55. Two Enron board members—Drs. LeMaistre and Mendelsohn—served as President of the M.D. Anderson Cancer Centre to which the Enron Foundation and Ken Lay contributed more than \$2 million over five years. *See id.*; *see also* Elson & Gyves, *supra* note 13, at 873 (citing THE ROLE OF THE ENRON BOARD, *supra*, at 55). Board member Robert Belfer was former Chairman and Chief Executive Officer of Belco Oil and Gas, a company with which Enron had entered into a number of hedging contracts worth tens of millions of dollars. THE ROLE OF THE ENRON BOARD, *supra*, at 55. In 1997, Belco bought Enron affiliate Coda Energy. *Id.* Prior board member Charles Walker served as Chairman of the American Council for Capital Formation, a nonprofit organization that lobbies on tax issues and to which Enron had contributed \$500,000 over ten years. *Id.* at 55–56. In addition to Mr. Walker's standard board compensation, Enron paid more than \$70,000 to two firms, Walker/Free and Walker/Potter, both of which were partly owned by Mr. Walker. *Id.* Even for those directors who did not have direct financial or quasi-financial ties to the company, the length of their tenure created at least the optical impression that their board seats had become “company-sponsored sinecures.” Elson, *supra*, at 501 (citing Paul Sanjay, *Scandals of a Painful Reminder: CEOs Are Human*, GREEN BAY PRESS-GAZETTE, July 11, 2002, at 9C). Of particular note is that most of the Enron directors would have been considered independent under the then-existing SEC or NYSE rules. *See id.*

63. For a detailed account of Enron's collapse, see THE ROLE OF THE ENRON BOARD, *supra* note 62. Enron's bankruptcy was outdone in just a few months by WorldCom. *See* Neil H. Aronson, *Preventing Future Enrons: Implementing the Sarbanes-Oxley Act of 2002*, 8 STAN. J.L. BUS. & FIN. 127, 127 (2002). Nonaffiliated stockholders lost approximately \$250 billion in market value as a result of the collapses of these two companies alone. *See id.* at 127–28.

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salience in light of modern governance reform initiatives focusing on director independence.⁶⁴ The statutory and regulatory reforms imposed by Congress and the SROs, respectively, immediately following the corporate debacles of 2001 and 2002 have intensified the pitched academic debate in the United States concerning the desirability and practicability of an independent directorate.⁶⁵

A. An Independent Directorate: A Paradigm for Corporate Governance Reform?

1. The theoretical predicate for mandating majority-independent boards

Regardless of differing views on the merits (or lack thereof) of independent directors, a tacit assumption in the debate on corporate governance is that there is a model for the proper compositional structure of a board of directors.⁶⁶ Accordingly, commentators have debated the post-Enron reforms based on the value of an independent directorate as a paradigm for corporate governance reform.

Over the last forty years, corporate boards have undergone a gradual yet dramatic transformation. Whereas in the 1960s most boards had a majority of in-house, non-independent directors, most boards today have

64. See Brudney, *supra* note 10, at 601 (“The afflictions of the American corporate system for which proponents of the independent director prescribe their medicine . . . may not all be equally amenable to relief by that balm.”); see also Ribstein, *supra* note 20, at 4 (stating that additional regulation may have unintended consequences for corporate governance).

65. See Gabriel, *supra* note 10, at 645–46 (setting forth the arguments advanced for and against).

66. The prevailing view regarding an appropriate composition for boards of directors has been met with relatively little organized opposition. See Donald V. Seibert, *The Dynamics of Corporate Governance*, 9 DEL. J. CORP. L. 515, 516 (1985) (commenting that “pat formulas or proposals for massive restructuring should be suspect” and that any philosophy that encourages formulaic corporate governance “misreads the American tradition and leaves no room for large enterprises that are both free and efficient” (quoting Irving S. Shapiro, Remarks at the Fairless Lecture Series at Carnegie-Mellon University 1–2 (Oct. 24, 1979))); Seligman, *supra* note 26, at 1185 (“The genius of an effective regulatory agency, if genius there be, is the ability to modulate rules and standards over time as experience teaches us about their effectiveness.”); see also Martin Lipton & Jay W. Lorsch, *A Modest Proposal for Improved Corporate Governance*, 48 BUS. LAW. 59, 63 (1992) (noting that “the imposition of ill-considered” governance regimes could actually harm corporations); Donald E. Pease, *Outside Directors: Their Importance to the Corporation and Protection from Liability*, 12 DEL. J. CORP. L. 25, 34 (1987) (“[A] pat formula approach that requires a majority of outside directors for the board of every large publicly held corporate is questionable at best.” (citing Seibert, *supra*, at 518)); *Developments in the Law—Corporations and Society*, *supra* note 22, at 2196 (noting that some argue that companies should formulate their boards’ compositional structures based on individualized experiences and needs).

a majority of outside, independent directors.⁶⁷ The evolution of American corporate boards from homogeneous, insider-dominated clubs to majority-independent institutions underscores the understanding that a board's principal role is to monitor management, and that implicit in that role is a director's ability to exercise judgment independent from management.⁶⁸

2. Corporate law's response to the Berle/Means problem

An independent board of directors theoretically benefits the corporation by reducing the agency costs inherent in the separation of ownership and control characteristic of the modern corporation.⁶⁹ In the modern corporation, shareholders provide capital in exchange for stock in the company while professional managers run the day-to-day operations of the business.⁷⁰ Dominated by the vision of Adolf Berle and

67. See Sanjai Bhagat & Bernard Black, *The Non-correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231, 232 (2002) [hereinafter *The Non-correlation*]. Until 1970, insiders numerically dominated boards of directors. For example, in a sample of 266 large firms in 1970, Barry Baysinger and Henry Butler found 54% inside directors, 26% affiliated directors, and 20% independent directors. Barry Baysinger & Henry Butler, *Corporate Governance and the Board of Directors: Performance Effects of Changes in Board Composition*, 1 J.L. ECON. & ORG. 101, 113 (1985). By 1980, the proportion of inside directors in the Baysinger and Butler sample had declined to 43%, while the proportion of independent directors had increased to 31%. *Id.* In the 1991 sample conducted by Bhagat and Black, the median firm had an eleven member board, with three inside directors, one affiliated director, and seven independent directors. By 1997, the mean number of insider directors at S&P 500 firms had dropped from three to two, and 56% of the S&P 500 firms had only one or two inside directors. Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921, 922 (1999).

68. See Bainbridge, *supra* note 13, at 370; Ladd, *supra* note 17, at 2164–65 (advancing the notion that a board composed primarily of insiders—typically high-level executives within the company—cannot effectively oversee itself); Bhagat & Black, *The Non-correlation*, *supra* note 67, at 232; see also James M. Tobin, *The Squeeze on Directors—Inside Is Out*, 49 BUS. LAW. 1707 (1994).

69. See ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932); Millstein & MacAvoy, *supra* note 19, at 1291. Agency costs are the sum of monitoring and bonding costs in addition to any residual loss incurred by principals to curb shirking by agents. See Bainbridge, *supra* note 13, at 386–88; see also Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 304 (1983). Shirking includes any action by a member of a production team that deviates from the interests of the group as a whole. Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461, 464–65 (1992) (referring to such shirking as “opportunism”). “In other words, shirking is simply the inevitable consequence of bounded rationality and opportunism within agency relationships.” Stephen M. Bainbridge, *The Board of Directors as Nexus of Contracts*, 88 IOWA L. REV. 1, 25 n.108 (2002).

70. Millstein & MacAvoy, *supra* note 19, at 1291.

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Gardiner Means, the central tenet of agency theory is that managers, who are not themselves owners but who act as agents on behalf of the owners, might pursue their own interests at the expense of shareholder-owner interests.⁷¹ It follows from this theory that the absence of checks on managerial discretion may result in a growing divergence between manager and shareholder interests.⁷²

Scholars have searched for a mechanism to bridge the chasm between shareholder-owner and manager interests since Berle and Means first identified the agency costs inherent in the separation of ownership and control.⁷³ Corporate law has devised a series of accountability mechanisms designed to constrain these agency costs. Chief among them is the board of directors.⁷⁴ Ideally, the board of directors acts as an agent for the shareholders and monitors management to assure that administrative decisions reflect the best interests of the shareholders.⁷⁵ To serve as effective monitors, conventional wisdom dictates that

71. See BERLE & MEANS, *supra* note 69, at 69–118. Even before Berle and Means, Adam Smith presaged that managers will be less vigilant in the protection of owners' interests than if they themselves were the owners. According to Smith,

[T]he directors of such [joint stock] companies, . . . being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.

ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 264–65 (Edwin Cannan ed., 1976).

72. See John A. Wagner III et al., *Board Composition and Organizational Performance: Two Studies of Insider/Outsider Effects*, 35 J. MGMT. STUD. 655, 657 (1998).

73. See Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 873 (1991) (describing the search for a mechanism that bridges the separation between ownership and control as the "corporate equivalent of the Holy Grail").

74. See Ribstein, *supra* note 20, at 36 (explaining that a significant benefit of entrusting the monitoring responsibility to non-owner directors is the specialization of the ownership and management functions, which permits scattered, passive shareholders to invest in diversified portfolios).

75. See Frank H. Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540, 555 (1984) (commenting that directors, as passive evaluators of management performance, must initiate changes to the managerial team if performance falls below an acceptable threshold or managers' interests are not aligned with shareholders' interests); see also Mills, *supra* note 7, at 443 ("In the ideal corporate model, directors are diligent in fulfilling their duties and maintain an attitude of 'constructive skepticism' to the information and recommendations presented by management, even asking 'incisive, probing questions' and requiring 'honest answers.'").

directors must not have inappropriate ties to management that compromise their objectivity in evaluating corporate performance.⁷⁶

B. The Empirical Support for Independence: Decidedly Mixed Results

Shifting the focus from *a priori* speculation about whether the independent directorate will perform adequately in its monitoring role to a post-hoc examination of the experience that independent directors have had in this role produces mixed, if not unfavorable, results. The empirical studies on independence grow out of various conceptual analyses which suggest that, by monitoring management performance, the board of directors has ultimate responsibility for a company's success or failure.⁷⁷ Although the post-Enron statutory and regulatory reforms are premised on the notion that board independence is an unalloyed good that benefits shareholders, a number of empirical studies have failed to demonstrate a link between independence and improved corporate performance.⁷⁸ For example, in a recent attempt to empirically validate the importance of independent boards for corporate performance, Sanjai Bhagat and Bernard Black concluded that a substantial inverse correlation exists between enhanced corporate performance and board independence.⁷⁹ Other studies have further undermined the relationship between corporate performance and independence by noting that improved corporate performance (measured by investor returns or relative standing of the company within its industry) results from the expertised knowledge of inside directors more than any other compositional characteristic of the board of directors.⁸⁰ While nothing in the empirical

76. See Gabriel, *supra* note 10, at 646 (noting that corporate reformers have viewed independence as "crucial to the board's effectiveness in monitoring corporate affairs").

77. Wagner et al., *supra* note 72, at 655–56.

78. Studies measure performance by using investor returns. See Benjamin E. Hermalin & Michael S. Weisbach, *The Effects of Board Composition and Direct Incentives on Firm Performance*, 20 FIN. MGMT. 101, 111 (1991) ("[I]f such a relation does exist, it is small, with little economic significance."). Other scholars have concluded that, even in the absence of conclusive empirical proof, the linkage between independence and the maximization of the corporation's wealth is intuitive. See, e.g., Millstein & MacAvoy, *supra* note 19, at 1297–98 (arguing that, while the search for empirical proof that relates independence to corporate performance may be futile, "Darwin's logic still carries—the performing board is the grain in the balance of survival in the long run, but significant quantitative effects have not yet been experienced").

79. See Bhagat & Black, *The Non-correlation*, *supra* note 67, at 263.

80. Rajeswararao S. Chaganti et al., *Corporate Board Size, Composition, and Corporate Failures in Retailing Industry*, 22 J. MGMT. STUD. 400, 406–07 (1985) ("[C]orporate performance measured in terms of return on investment, stock appreciation, or relative standing of the firm in its industry, may be associated more with technical expertise and managerial experience of inside

literature suggests that there is something wrong with independent directors or that they do not deserve a place at the boardroom table, the results of the studies demonstrate that the existing reforms may place undue emphasis on the importance of independent directors.⁸¹

directors than any other attribute of the boardroom.”). Despite the lack of empirical support for the linkage between independence and the maximization of a corporation’s wealth, some scholars have demonstrated a correlation between independence and improved performance on specific board responsibilities, including the removal of underperforming corporate managers. *See, e.g.,* Ribstein, *supra* note 20, at 26–27 (noting that while independent directors are correlated with worse corporate performance, they tend to be better than non-independent directors at certain tasks, including the removal of poorly performing corporate managers).

81. *See* Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U. L. REV. 898, 927 (1996) (citing to studies in which outsider-dominated boards were found to be significantly more likely to remove under-performing CEOs than insider-dominated boards). Apart from the empirical studies, which contradict the link between corporate performance and independence, the anecdotal evidence also casts doubt on whether director independence is the *sine qua non* of good corporate governance. For instance, the Enron board’s failure to interdict the large-scale managerial misconduct that led to the company’s bankruptcy in 2001, despite having eleven independent directors on its fourteen-member board, weakens the theoretical support for majority-independent boards of directors. Bhagat & Black, *The Non-correlation*, *supra* note 67, at 233. Although independent directors theoretically are better positioned to monitor management than non-independent directors, the focus on independence as a criterion for evaluating board composition may place undue emphasis on the monitoring function of the corporate board at the expense of the board’s other relational roles, including its management role. *See* Jill E. Fisch, *Corporate Governance: Taking Boards Seriously*, 19 CARDOZO L. REV. 265, 267 (1997) (maintaining that the adoption of a normative vision of independence imposes both costs and benefits on corporations); *see also* *Developments in the Law—Corporations and Society*, *supra* note 22, at 2200. Some commentators, however, have lamented that the increased focus on oversight of management may breed distrust between management and independent directors, thereby causing management to decrease cooperation with the board by, for example, withholding information, thus compromising both the board’s oversight and strategic roles. *See* Ribstein, *supra* note 20, at 41–43 (contending that mandating independence creates an adversarial relationship between independent and non-independent directors that may reduce the quality of information received by independent directors and thereby compromise overall strategic decision-making); *see also* Brudney, *supra* note 10, at 632–38 (describing the natural inconsistency between boards’ managerial and monitoring functions). Traditionally, the board of directors has represented the ultimate managerial authority in the corporation. Fisch, *supra*, at 272. Its responsibilities include advising the CEO, participating in strategic decision-making, and designing and reviewing corporate transactions. *Id.* Originally, boards composed predominantly of executives carried out these functions, but now, corporate outsiders, who lack both the time and familiarity with the company to make decisions relating to the management of corporate affairs, carry out these critical tasks. *Id.* at 272–74; *see also* Lin, *supra*, at 914–15 (noting that outside directors lack both the firm-specific expertise and time to evaluate the management of companies they oversee). Even assuming equal levels of information relating to the decision at hand (a questionable assumption at best), independent directors, not having made investments in firm-specific human capital and often lacking the specialized knowledge relating to the business of the company, are less equipped to participate meaningfully in the board’s managerial function than inside directors. *See* Bainbridge, *supra* note 13, at 382. On this logic, an increase in the number of independent directors at the expense of inside directors compromises the corporate board’s overall effectiveness. *See* Easterbrook, *supra* note 75, at 555–56.

*C. Practical Impediments to Directors' Ability To Exercise
Independent Judgment*

1. Informational asymmetries

Practical constraints on the board's monitoring effectiveness potentially account for the failure of the empirical literature to prove a relationship between independence and enhanced corporate performance. These constraints include, among others, informational asymmetries and misaligned incentive structures.⁸²

Unlike inside directors, who have direct access to information by virtue of being employees or having other close ties to the corporation, independent directors rely upon the reports of others for the information necessary to discharge their monitoring duties.⁸³ In particular, management filters the information reaching the independent directors. To that extent, the directors' understanding of the advantages and disadvantages of various corporate transactions is only as complete as the information they are given.⁸⁴ Thus, even if a director satisfies all of the statutory or regulatory requirements for independence, the informational disadvantages stemming from an independent director's status as an outsider of the company may hinder his or her ability to evaluate management performance effectively.⁸⁵

To be certain the argument is not overstated, however, it is important to recognize that there are significant checks and balances in the

82. Lynne L. Dallas, *Proposals for Reform of Corporate Boards of Directors: The Dual Board and Board Ombudsperson*, 54 WASH. & LEE L. REV. 91, 103 (1997); *Developments in the Law—Corporations and Society*, *supra* note 22, at 2192 (acknowledging the “stifling influence of ‘boardroom norms’” for independence); Jill E. Fisch, *The New Federal Regulation of Corporate Governance*, 28 HARV. J.L. & PUB. POL’Y 39, 42 (2004); Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1283 (1982).

83. James D. Cox, *Managing and Monitoring Conflicts of Interest: Empowering the Outside Directors with Independent Counsel*, 48 VILL. L. REV. 1077, 1082 (2003).

84. *But see* Tobin, *supra* note 68, at 1751 (“The Business Roundtable describes outside directors as ‘the windows on the world who provide a protection against insularity and lack of vision.’” (quoting The Business Roundtable, *The Role and Composition of the Board of Directors*, 33 BUS. L. 2083, 2107 (1978))).

85. Cox, *supra* note 83, at 1089; *see* Wallace, *supra* note 6, at 114 (“Independent directors do not have a full-time stake in the fortunes of the business. Often they . . . know little of the technical side of the business and are immersed in their own businesses and lack sufficient time for the board and company in a time of crisis.” (omission in original) (quoting Richard A. Epstein, *Sarbanes Overdose*, NAT’L L.J., Jan. 27, 2003, at A17)); *see also* Ribstein, *supra* note 20, at 42 (discussing how independence reduces access to information and consequently reduces the efficiency of day-to-day management).

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information filtering system.⁸⁶ The foremost check is the certification function performed by various independent gatekeeper intermediaries.⁸⁷ For instance, independent auditors verify a company's financial performance and position, investment bankers appraise the fairness of a specific transaction, and lawyers review the accuracy of disclosure concerning that transaction. Similarly, debt-rating agencies evaluate a company's creditworthiness, and analysts assess a company's business and financial prospects.⁸⁸ Admittedly, the corporate collapses of 2001 and 2002, aided in part by the confluence of various gatekeeper failures, point to the limitations of any certification system to prevent (or even identify in certain instances) financial obfuscation.⁸⁹ Regardless of these limitations, however, scholars continually regard certification systems as the best counterweights to informational disadvantages experienced by independent board members.

2. *Directorial compensation*

In addition, director compensation regimes fail to align directors' interests with shareholders' interests and thereby undermine the corporate board's monitoring effectiveness.⁹⁰ Many independent directors own small amounts of their company's shares and receive

86. See Cox, *supra* note 83, at 1090.

87. See Coffee, *supra* note 20, at 279.

88. See Cox, *supra* note 83, at 1082.

89. See *id.* In particular, Arthur Andersen and Vinson & Elkins LLP, the outside accounting and law firms representing Enron, both failed in their gatekeeper functions. "Arthur Andersen served not only as the external auditor for Enron, but also as an internal auditor and consultant." Wright, *supra* note 13, at 83. There are both practical and optical problems when a company's "independent" auditor also provides consulting services for the same company. See Elson & Gyves, *supra* note 13, at 864; see also Coffee, *supra* note 20, at 291 (remarking that the ability to cross-sell consulting services allows auditors to treat such services as a "portal of entry into [a] lucrative client"). Enron paid Arthur Andersen \$5.7 million to structure the LJM transactions, making it difficult for Andersen's auditors later to criticize its own firm's work in designing these transactions. See Elson & Gyves, *supra* note 13, at 865. Despite the absence of an empirical link between the provision of consulting services and failed audits, there is a public perception that the audit process is compromised by an auditor's interest in protecting large consulting fees. *Id.* Enron paid Arthur Andersen \$25 million for its audit work and an additional \$27 million for its non-audit, consulting, and tax work. See Jennings, *supra* note 20, at 213; see also Milton C. Regan, Jr., *Teaching Enron*, 74 *FORDHAM L. REV.* 1139 (2005) (detailing Vinson & Elkins LLP's failures).

90. See *Developments in the Law—Corporations and Society*, *supra* note 22, at 2203 (arguing that reputational constraints may provide sufficient incentives for independent directors to monitor management).

compensation instead through large cash payments.⁹¹ The stakes of independent directors in the enterprises they oversee therefore do not reflect “the performance-based concerns of ownership, but rather the interests of . . . highly salaried company employee[s].”⁹² The debate surrounding stock-based director compensation reflects two views. On the one hand, the majority view suggests that equity ownership enhances the board’s vigor in the oversight of management by aligning director interests with shareholder interests through a shared pecuniary goal.⁹³ Those subscribing to this view have observed that independent directors lack the appropriate incentives to monitor management in the absence of significant equity ownership.⁹⁴ Consistent with Delaware decisional law, an incentive system in which independent directors have a financial stake as common shareholders in the company’s success will motivate directors to monitor management in order to protect their financial interests (as well as those of the shareholders).⁹⁵

The minority perspective, on the other hand, maintains that by aligning director compensation with a corporation’s stock price or profits, director ambivalence about exposing unfavorable facts that will reduce a company’s share price may increase.⁹⁶ Acknowledging the possibility that an equity-based compensation system might generate incentives for short-term stock price manipulation, recent proposals to increase independent director equity compensation have also called for placing restrictions on the sale of stock until after the director’s departure

91. The directors of Enron represented an exception to this general rule. Most of the Enron directors owned stock in the company, and some in significant amounts. See Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233, 1241 (2002); see also Elson & Gyves, *supra* note 13, at 871; Louis Lavelle, *The Best & Worst Boards*, BUS. WK., Oct. 7, 2002 (noting that to increase director incentives to monitor, Computer Associates International Inc. prohibits directors from selling stock until they leave the board).

92. Charles M. Elson, *Director Compensation and the Management-Captured Board—The History of a Symptom and a Cure*, 50 SMU L. REV. 127, 164 (1996).

93. The majority view is often referred to as the “convergence-of-interests theory.” *Id.* at 172 (suggesting a demonstrable link between director equity ownership and improved management monitoring); Gordon, *supra* note 91, at 1242; Lin, *supra* note 81, at 918.

94. See Elson & Gyves, *supra* note 13, at 881 (arguing that independence without equity ownership leads to objectivity without incentive); see also Elson, *supra* note 92, at 164 (“Directors whose remuneration is unrelated to corporate performance have little personal incentive to challenge their management benefactors. . . . [because they are] eager not to ‘bite the hand that feeds them’ . . .”).

95. See Chandler & Strine, *supra* note 13, at 992; see also Elson, *supra* note 92, at 135–36.

96. See Gordon, *supra* note 91, at 1242.

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from the board.⁹⁷ The goal of the resale restriction is to minimize adverse incentives for the inflation of stock prices during the director's tenure in office.⁹⁸ Despite certain concerns regarding how best to structure an appropriate compensation regime, both the majority and the minority perspectives embrace the same goal: enhancing the corporate board's monitoring integrity through an incentive system that aligns directors' compensation structures with shareholder interests.

D. The Theory of Structural Bias

The various arguments for the maintenance of imperfectly fashioned certification systems, as well as the proposed changes to the director compensation regime, are bottomed upon continuing concerns over the effect of structural bias on the achievement of real, and not merely *pro forma*, independence.⁹⁹ The conclusion that the more independent directors there are on a board, the more likely it is that the board will monitor management, "assumes that the independent directors are independent in nature rather than in name only."¹⁰⁰ The structural bias theory explains the non-independence of putatively independent directors by suggesting that even in the absence of employment and other financial ties between directors and the companies on whose boards they serve (the traditional criteria for determinations of independence), institutional pressures, generated through interlocking social, charitable, and

97. See *Developments in the Law—Corporations and Society*, *supra* note 22, at 2202; Elson & Gyves, *supra* note 13, at 882; Wright, *supra* note 13, at 83.

98. See *Developments in the Law—Corporations and Society*, *supra* note 22, at 2202; Wright, *supra* note 13, at 83; see also Elson & Gyves, *supra* note 13, at 882 (recommending that directors own stock in meaningful amounts and be restricted in their ability to sell their stock while serving on the company's board). Recent director equity compensation proposals also specifically discourage remuneration in the form of stock options. See Gordon, *supra* note 91, at 1242. Opponents of stock option remuneration emphasize that to the extent directors receive stock options, they have inappropriate incentives to engage in short-term, rather than long-term, stock price maximization. See Wright, *supra* note 13, at 93 (calling for the prohibition of stock option compensation which allows exercisers to benefit from short-term stock inflation irrespective of how the company is managed); see also Coffee, *supra* note 20, at 297–98 (describing the deregulatory reforms of the 1990s, which relaxed the rules under section 16(b) of the Exchange Act by permitting directors to exercise stock options and sell the underlying shares without holding the shares for the previously required six-month holding period).

99. Tobin, *supra* note 68, at 1723; see also Gabriel, *supra* note 10, at 653 ("The biggest hurdle for compliance-conscious corporations is electing directors who are truly, rather than facially, independent of management.").

100. Ladd, *supra* note 17, at 2165.

professional relationships, may compromise director independence.¹⁰¹ According to the structural bias theory, the “natural empathy and collegiality” shared by most directors and managers spawns a corporate culture in which directors tend to reflect the underlying ideology and ethos of the management-dominated institutions they oversee.¹⁰² By considering the impact of less obvious, non-pecuniary conflicts of interest, the theory of structural bias recognizes the porosity of both the statutory and regulatory approaches to director independence.¹⁰³ Evidence of structural bias arises most conspicuously in the context of special litigation committees and demand futility in shareholder derivative actions.¹⁰⁴ Charged with determining the culpability of their

101. See Brudney, *supra* note 10, at 611–12; Kenneth B. Davis, Jr., *Structural Bias, Special Litigation Committees, and the Vagaries of Director Independence*, 90 IOWA L. REV. 1305, 1308 (2005). According to Professor Brudney, “No definition of independence yet offered precludes an independent director from being a social friend of, or a member of the same clubs, associations, or charitable efforts as, the persons whose compensation or self-dealing transaction he is asked to assess.” Brudney, *supra* note 10, at 613.

102. Julian Velasco, *Structural Bias and the Need for Substantive Review*, 82 WASH. U. L.Q. 821, 824 (2004) (quoting James D. Cox, *Searching for the Corporation’s Voice in Derivative Suit Litigation: A Critique of Zapata and the ALI Project*, 1982 DUKE L.J. 959, 962); see Erica Beecher-Monas, *Corporate Governance in the Wake of Enron: An Examination of the Audit Committee Solution to Corporate Fraud*, 55 ADMIN. L. REV. 357, 380 (2003) (discussing the behavioral theory of groups to explain the homogeneity of corporate boards and the concomitant effect on group decision-making); see also *Developments in the Law—Corporations and Society*, *supra* note 22, at 2186–87 (arguing that directors must be free not only of financial conflicts of interest but also of psychological pressure that constrains their willingness to voice opposition to management); Gilson & Kraakman, *supra* note 73, at 875 (suggesting that independent directors share an ideological disposition in favor of management because they too often are chief executives of other public companies). Beyond the intra-group cohesiveness fostered by directors’ participation in a common social and cultural milieu, the “‘economic[] or psychological[] dependen[cy] upon or tie[s] to the corporation’s executives, particularly its chief executive’ and the ‘process of director selection and socialization, which incumbent management dominates,’” further restrict the ability of directors to exercise independent judgment. Velasco, *supra*, at 824 (alterations in original) (quoting 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, 283 (1981)).

103. Velasco, *supra* note 102, at 870.

104. In its 1979 decision of *Auerbach v. Bennett*, the New York Court of Appeals became one of the first state courts of last resort to consider when, if ever, an SLC could reassert control over derivative litigation in demand-excused cases. See 393 N.E.2d 994 (N.Y. 1979). The court considered whether the business judgment rule should apply “in its full vigor” to the decision of the three-person committee of GTE’s board not to pursue the derivative action in question. *Id.* at 1001. The court asserted that the SLC’s decision comprised two separate elements: (1) the process by which the decision was reached and (2) the substantive decision itself. *Id.* at 1002. The court concluded that while it was free to examine the SLC’s decision-making process, the business judgment rule protected the substance of the SLC’s decision from judicial review. *Id.* (“To permit judicial probing of such issues would be to emasculate the business judgment doctrine as applied to the actions and determinations of the special litigation committee.”). However, the court did not

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fellow directors or officers in these contexts, directors are believed to be reluctant to assign blame to colleagues for poor performance or malfeasance.¹⁰⁵ A sense of “there but for the grace of God go I” is said to be a likely response to litigation against fellow directors and officers.¹⁰⁶

Although a majority of courts have dismissed allegations of structural bias as an oversimplified attempt to circumvent the shareholder’s burden to offer tangible evidence of director bias in the form of pecuniary conflicts or other specific bias-producing relationships, a minority of courts have found that such allegations may sufficiently negate a board’s independence.¹⁰⁷ In considering whether

foreclose any inquiry into the disinterestedness or independence of the SLC members, noting that the doctrine only shields the decisions of SLC members if those members exhibit a “disinterested independence” such that they can exercise unprejudicial judgment. *Id.* at 1001. In summary, unless a plaintiff raises a reasonable doubt regarding either the independence of the SLC or the reasonableness of its investigatory process, the court may not review the SLC’s substantive decision.

Subsequent to the development of the *Auerbach* rule, which gives substantial deference to the decisions of SLCs to terminate derivative actions, the Delaware Supreme Court fashioned its own response to the question of whether, and to what extent, courts should defer to the decisions of SLCs during pending derivative lawsuits. *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981). In *Zapata Corp. v. Maldonado*, a shareholder filed a derivative action against the board of directors and certain officers of Zapata Corporation alleging breaches of their fiduciary duties. *Id.* at 780. The appointed two-member SLC concluded that pursuit of the litigation was contrary to the corporation’s best interests and recommended that the company seek dismissal of the suit. *Id.* at 781. The Delaware Supreme Court articulated the well-established principle that, in general, the decision whether to pursue litigation on behalf of the corporation belongs to the board of directors. *Id.* at 787. However, unlike the *Auerbach* court, the Delaware Supreme Court maintained that courts should give some degree of scrutiny to the substantive decision of the SLC, if only because even independent directors reviewing an allegation of wrongdoing by their fellow directors may be inclined to be sympathetic toward their colleagues. *See id.* Thus, to achieve a balance between protecting the business judgment of the board and its duly-appointed SLC on the one hand and protecting shareholder interests on the other, the court adopted a two-pronged standard for judicial review in the derivative context. *Id.* at 788–89. The first prong of the standard is to determine the independence and good faith of the committee and the reasons supporting its conclusion to terminate a derivative lawsuit. *Id.* at 788. The burden of proving independence and good faith rests with the corporation. *Id.* If the court determines that the committee has met its burden of establishing its independence and good faith, the second prong of the *Zapata* analysis is triggered. *Id.* at 789. Under this second prong, the court is free to apply its own business judgment regarding whether the motion should be granted. *Id.* (citing *Maldonado v. Flynn*, 413 A.2d 1251, 1263 (Del. 1980)).

105. Indeed, it is apparent that special litigation committees side with the defendants in an overwhelming number of cases, as evidenced by the small number of reported cases where an SLC actually recommended suing the corporation. *See Joy v. North*, 692 F.2d 880, 884 (2d Cir. 1982) (settlement); *see also In re Cont’l Ill. Sec. Litig.*, 732 F.2d 1302, 1305 (7th Cir. 1984) (advising corporation to sue three former officers).

106. *Zapata Corp.*, 430 A.2d at 787.

107. *See Hasan v. Clevetrust Realty Investors*, 729 F.2d 372, 377 (6th Cir. 1984).

structural biases have an effect on the independence of corporate boards, Delaware courts have employed a functional approach.¹⁰⁸ That approach evaluates, on a case-by-case basis, relationships—apart from specific statutorily- or SRO-proscribed relationships—which compromise a director’s ability to exercise independent judgment.¹⁰⁹ Representing a practical point of departure with the recently enacted reforms, Delaware courts reject the federal system’s formulaic template for measuring director independence.¹¹⁰ Delaware courts instead embrace the need for flexibility and stability without rigidity.¹¹¹ Part IV analyzes recent Delaware law relating to director independence in both the demand futility and SLC contexts. This Part also considers whether Delaware law’s evaluation of board composition and its effect on the board’s monitoring role places undue emphasis on director independence.

With this framework in mind, it is easy to appreciate the negative impact that structural bias may have had on some of the supposedly independent boards that were the subject of the above-referenced empirical studies. Defining independence appropriately for the purpose of these studies is difficult. Currently, many studies rely on superficial criteria in characterizing directors as independent. For instance, some treat employees as insiders and non-employees as independent rather than scrutinizing more subtle, non-pecuniary bias-producing relationships or institutionally generated bias.¹¹² Under such formalistic definitions of independence, which focus on simple job status, many directors who lack a true monitoring orientation are nevertheless classified as independent, thereby clouding the empirical data.¹¹³ Read in this light, such studies point to a narrower conclusion than the one their authors seem to reach: putting independent directors on boards is unlikely to have an effect on a company’s financial performance if not

108. Fisch, *supra* note 82, at 45.

109. *See id.*; Fisch, *supra* note 81, at 289.

110. Fisch, *supra* note 82, at 45.

111. *See* Veasey & Di Guglielmo, *supra* note 6, at 1412 (“Life in the boardroom is not black and white; directors and officers make decisions in shades of gray all the time.”); *see also* Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. CIN. L. REV. 1061, 1064 (2000) (“Delaware lawmaking offers Delaware corporations a variety of benefits, including flexibility, responsiveness, insulation from undue political influence, and transparency.”).

112. *See* Fisch, *supra* note 81, at 279.

113. *See* Langevoort, *supra* note 18, at 799.

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accompanied by procedures to counteract the structural bias constraints that may paralyze facially independent boards.¹¹⁴

IV. RECENT DELAWARE JURISPRUDENCE AND ITS IMPLICATIONS FOR AMERICAN CORPORATE GOVERNANCE

A. The Beam/J.P. Morgan Chase & Co./Oracle Troika in Delaware Law

I. Beam v. Stewart

Following the corporate scandals of 2001 and 2002, Delaware courts focused on the meaning of independence and its role in ensuring the monitoring effectiveness of the corporate board. Despite certain doctrinal anomalies, the courts' interpretation of independence reflects the theoretical belief that independent directors are in a better position to monitor management performance than non-independent directors.

Under Delaware law, a plaintiff who alleges demand futility must satisfy the test set forth in *Aronson v. Lewis* and its progeny.¹¹⁵ The

114. One such procedure is the democratization of the corporate electoral process through increased shareholder access to the corporate proxy. Corporate democracy and its implications for governance reform are discussed *infra* Part IV.

115. *Aronson v. Lewis*, 473 A.2d 805, 814 (Del. 1984), *overruled by* *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000) (overruling *Aronson* on a point of law unrelated to the proposition for which this case is cited). Before a shareholder can bring a derivative action on behalf of the corporation, the shareholder must make a pre-suit demand on the corporation's board of directors. *See* Lin, *supra* note 81, at 907 (citing Dennis Block et. al, *Derivative Litigation: Current Law Versus the American Law Institute*, 48 BUS. LAW. 1443, 1451 (1993)); *see also* RALPH C. FERRARA ET AL., SHAREHOLDER DERIVATIVE LITIGATION: BESIEGING THE BOARD § 3.01 (1995). The demand requirement originates from the fundamental proposition of corporate law—that the management of the corporation, including the decision to pursue litigation, rests solely in the discretion of the board of directors. *See id.* § 3.02. Understood in this light, the purpose of a pre-suit demand is to allow the board of directors the opportunity to evaluate the shareholder's complaint before submitting the controversy to costly litigation. *See id.* (commenting that the demand requirement provides that shareholders must exhaust all intra-corporate remedies before pursuing derivative litigation). By giving the board an opportunity to assess the merits of a shareholder's claim and to exercise its authority in determining whether the requested action serves the best interests of the corporation, the demand requirement reconciles shareholders' rights to sue on behalf of the corporation with the well-established mandate given by statute to the board to manage and control the affairs of the corporation. *See id.* Most jurisdictions have carved out a futility exception from the general demand requirement. *See id.* § 6.01. In some cases, a plaintiff may be able to show that a majority of the directors has a vested interest in the matters raised in the demand. *See id.* As a result, a plaintiff may contend that the board would be incapable of exercising proper business judgment with respect to those matters, thereby rendering any demand futile. *See id.* In those instances where courts indeed

Aronson test considers whether “under the particularized facts alleged, a reasonable doubt is created that: (1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment.”¹¹⁶ The two prongs of this test are disjunctive: “if either prong is satisfied, demand is excused.”¹¹⁷

In *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, a shareholder in Martha Stewart Omnimedia, Inc. brought a derivative action against Martha Stewart and other directors and officers, alleging breaches of fiduciary duty stemming from the sale of ImClone stock in December 2001.¹¹⁸ The Court of Chancery dismissed the plaintiff’s claims on the ground that the plaintiff did not adequately allege pre-suit demand futility.¹¹⁹ In affirming the lower court’s decision, the Delaware Supreme Court noted that directors are “entitled to a *presumption* that they were faithful to their fiduciary duties” and that the “burden is upon the plaintiff in a derivative action to overcome that presumption.”¹²⁰ If, however, “the Court determines that the pleaded facts create a reasonable doubt that a majority of the board could have acted independently in responding to the demand,” the presumption is shifted and demand excused.¹²¹

The plaintiff in *Beam* alleged that a structural bias existed because of the directors’ friendship and social interaction with each other and with Martha Stewart.¹²² While the court conceded that friendships could disrupt the independence of an otherwise disinterested director, the court observed that “without specific factual allegations to support such a

determine that demand is futile, the shareholder-plaintiff may be permitted to sustain a derivative suit without first making a demand on the board. See Lin, *supra* note 81, at 907.

116. *Aronson*, 473 A.2d at 814.

117. *Brehm*, 746 A.2d at 256.

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

119. See *id.* at 1044; see also DEL. CH. CT. R. 23.1 (providing the demand requirements for initiation of derivative suits by stockholders). See generally *Rales v. Blasband*, 634 A.2d 927, 932 (Del. 1993). As a result of the demand requirement, shareholder-plaintiffs may bring suit under two circumstances: (1) where demand on the board was made and wrongfully refused; and (2) where demand, if made, would have been futile. See Ladd, *supra* note 17, at 2172 (quoting Elizabeth A. Wilburn, *Beyond Aronson: Recent Delaware Cases on Demand Futility*, 20 DEL. J. CORP. L. 535, 537 (1995)).

120. *Beam*, 845 A.2d at 1048–49.

121. *Id.* at 1049. The court went on to state that the “complaint of a stockholder-plaintiff must create a reasonable doubt that a director is not so ‘beholden’ to an interested director (in this case Stewart) that his or her ‘discretion would be sterilized.’” *Id.* at 1050.

122. *Id.* at 1050–51.

conclusion,” claims of friendship alone would not cause it to harbor reasonable doubt about whether a director can appropriately consider demand.¹²³ The court noted that “[a]llegations that Stewart and the other directors moved in the same social circles, attended the same weddings, developed business relationships before joining the board, and described each other as ‘friends,’ even when coupled with Stewart’s 94% voting power, are insufficient, without more, to rebut the presumption of independence.”¹²⁴ Rather, the court required particularized facts “that would support the inference that because of the nature of a relationship or additional circumstances other than the interested director’s stock ownership or voting power, the non-interested director would be more willing to risk his or her reputation than risk the relationship with the interested director.”¹²⁵ Finding no particularized facts supporting such an inference, the court rejected the plaintiff’s argument of structural bias on the basis that it “presupposes that the professional and social relationships that naturally develop among members of a board impede independent decision-making.”¹²⁶

123. *Id.* at 1050 (quoting *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 833 A.2d 961, 979 (Del. Ch. 2003), *aff’d*, 845 A.2d 1040, 1044 (Del. 2004)). In reaching its decision, the *Beam* court specifically distinguished the independence analysis in the *Oracle* SLC context from that present in the pre-suit demand futility context. *Id.* at 1054–55. Describing a special litigation committee as a “unique creature,” the court argued that “[u]nlike [in] the demand-excusal context, where the board is presumed to be independent, [a special litigation committee] has the burden of establishing its own independence by a yardstick that must be ‘like Caesar’s wife’—‘above reproach.’” *Id.* at 1055 (quoting *Lewis v. Fuqua*, 502 A.2d 962, 967 (Del. Ch. 1985)). Although the court reserved judgment on whether the substantive standard for independence is the same in an SLC case as in a pre-suit demand case, it strongly suggested that it was not adopting the test enunciated in *Oracle* to evaluate demand excusal in derivative actions. *Id.* However, the court provocatively added that “[a]s a practical matter, the procedural distinction relating to the diametrically-opposed burdens and the availability of discovery into independence may be outcome-determinative on the issue of independence.” *Id.* Substantively, the *Oracle* decision seems to be at considerable odds with the Delaware Supreme Court’s view that the friendship between Martha Stewart—the company’s ninety-four percent shareholder—and the other directors did not raise a reasonable doubt about the directors’ ability to consider demand impartially. *See Veasey & Di Guglielmo, supra* note 6, at 1471 (questioning whether under the same facts as *Oracle*, the *Beam* court would have found the allegations to be sufficient to rebut the presumption of independence for purposes of pre-suit demand).

124. *Beam*, 845 A.2d at 1051.

125. *Id.* at 1052.

126. *Id.* at 1050–51 (citing DENNIS J. BLOCK ET AL., *THE BUSINESS JUDGMENT RULE* 1765 (5th ed. 1998)).

2. *In re J.P. Morgan Chase & Co. Shareholder Litigation*

The Delaware Court of Chancery recently extended the *Beam* analysis in *In re J.P. Morgan Chase & Co. Shareholder Litigation*, a case decided in April 2005.¹²⁷ In that case, Vice Chancellor Lamb ruled that allegations of normal business relationships, charitable associations, or familial affinity alone are insufficient to raise a significant question about a director's independence.

On January 14, 2004, J.P. Morgan Chase & Co. ("JPMC") and Bank One Corporation ("Bank One") announced a proposed merger that had been approved unanimously by their respective boards of directors.¹²⁸ Under the merger agreement, JPMC and Bank One agreed to an exchange ratio of JPMC's common stock shares for Bank One common stock at a premium (fourteen percent more than the closing price of Bank One common stock as of the merger announcement date).¹²⁹ The merger agreement also set forth JPMC's CEO succession plan: upon the merger's completion, JPMC's CEO, William B. Harrison, Jr., would remain in that role for two more years, after which time the CEO of Bank One, James Dimon, would succeed Harrison and become CEO of JPMC.¹³⁰ On May 25, 2004, the shareholders of JPMC approved the merger, which eventually closed on July 1, 2004.¹³¹ On June 27, 2004, *The New York Times* printed an article that described the preliminary negotiations between Mr. Harrison and Mr. Dimon leading up to the merger.¹³² According to two unnamed sources cited in the article, "Mr. Dimon, always the tough deal maker, offered to do the deal for no premium if he could become the chief executive immediately."¹³³

After learning that Mr. Dimon allegedly had been willing to accept the deal at no premium, the plaintiffs filed a class action lawsuit against JPMC and its board of directors, arguing that the board of JPMC breached its fiduciary duties by approving a merger exchange ratio that paid a premium to Bank One shareholders.¹³⁴ According to the

127. *In re J.P. Morgan Chase & Co. Shareholder Litig.*, 906 A.2d 808 (Del. Ch. 2005), *aff'd*, 906 A.2d 766 (Del. 2006).

128. *Id.* at 812.

129. *Id.*

130. *Id.*

131. *Id.* at 813.

132. See Landon Thomas, Jr., *The Yin, the Yang, and the Deal*, N.Y. TIMES, June 27, 2004, § 3, at 1.

133. *Id.*

134. *In re J.P. Morgan*, 906 A.2d at 813.

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complaint, a majority of the board of directors was beholden to Mr. Harrison as a result of various professional, charitable, and familial relationships.¹³⁵ These relationships, argued the plaintiffs, prompted the directors to accept a deal that was unfavorable to the corporation in exchange for extending Mr. Harrison's tenure as CEO of JPMC.¹³⁶ The defendant directors moved to dismiss the complaint on the basis that the plaintiffs had failed to make a pre-suit demand on the board where demand was not excused.¹³⁷ In addition to their procedural claim, the defendants contended that the board was composed of a majority of independent and disinterested directors and that, accordingly, the board's substantive decision to approve the merger was governed by the business judgment rule.¹³⁸

The plaintiffs maintained "that demand [was] excused under the first prong of the *Aronson* test because at least eight of the twelve directors on the board" allegedly were not independent and disinterested.¹³⁹ According to the plaintiffs, the "directors were so positioned, as a result of various business, charitable, or family relationships, that they were disabled from exercising independent judgment."¹⁴⁰ The plaintiffs argued that the network of ties—many of which were non-pecuniary—between the directors and Mr. Harrison ultimately resulted in a board unable to act independently of Mr. Harrison's influence.¹⁴¹

135. *Id.* at 813–14.

136. *Id.* at 815–16.

137. *Id.* In addition to the demand futility issue, the court considered whether the plaintiffs' claims were derivative or direct. *See id.* at 817–19. Under Delaware law, this question is governed by *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031 (Del. 2004). In *In re Syncor International Corp. Shareholders Litigation*, the court noted that *Tooley* instructs Delaware courts to determine "(1) who suffered the alleged harm (the corporation or the suing stockholders, individually); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually)." 857 A.2d 994, 996 (Del. Ch. 2004) (quoting *Tooley*, 845 A.2d at 1033). Returning to *In re J.P. Morgan Chase & Co. Shareholder Litigation*, the court reasoned that had JPMC paid cash instead of stock for Bank One, plaintiffs' claims would have been derivative because the corporation would have suffered the direct injury stemming from a reduced cash payment. 906 A.2d at 818–19. In determining that plaintiffs' argument elevated form over substance, the court stated, "The fact that this transaction was effectuated by issuing stock and not by paying cash does not change the result. The harm, if any, was still suffered by JPMC." *Id.* at 818. Accordingly, the court concluded that under the first prong of *Tooley*, plaintiffs' claims were derivative. *See id.* at 819. Turning to the second prong of *Tooley*, the court held that the plaintiffs were "unable to demonstrate why they, and not JPMC, should receive the benefit of any remedy." *Id.*

138. *In re J.P. Morgan*, 906 A.2d at 813.

139. *Id.* at 820.

140. *Id.* at 821.

141. *See id.* at 814. Before analyzing the specific allegations of inappropriate ties between the directors and Mr. Harrison, the court considered the overall structure of the JPMC board. *See id.* at

While the court conceded that philanthropic and professional relationships could compromise a director's independence, it found that the plaintiffs failed to provide sufficient "particularized facts that would lead to the conclusion" that the relationships between Mr. Harrison and the directors in question "had any influence over" those directors.¹⁴² In the court's view, the relationships between the directors and Mr. Harrison entailed no reciprocity that might hinder the directors' ability to act independently of Mr. Harrison.¹⁴³ Finding that a majority of

821. The court observed: "The board is dominated by outsiders. Eleven of the twelve directors are not employees of JPMC. Harrison cannot fire any of them. Additionally, Harrison is not a controlling stockholder of JPMC and therefore has no power to oust them as directors through a stockholder vote. On the contrary, it is the eleven outside directors who collectively have the power to dismiss Harrison and the rest of his management team. The plaintiffs allege that the defendant directors are beholden to Harrison, but they fail to demonstrate why that is so." *Id.* The court's assessment of the board's composition, particularly its refusal to consider the contextual nature of the relationships among the directors, revealed its deprecation of the plaintiffs' structural bias allegations.

The court also examined some specific allegations of independence-compromising relationships of particular salience. The court considered the plaintiffs' claims that certain members of the JPMC board of Directors had business ties with JPMC through corporations for which they worked. The court rejected this argument, noting that "JPMC is a national commercial and investment bank. That it provided financing to large American companies should come as no shock to anyone. Yet this is all that the plaintiffs allege." *Id.* at 822. The court determined that this allegation alone was insufficient to raise a significant question about the directors' ability to exercise impartial judgment. *See id.* The court also noted that a majority of the directors on JPMC's board were deemed independent pursuant to the New York Stock Exchange's Corporate Governance listing standards. *See id.* 813, 823 n.49 (quoting NYSE Listed Company Manual, *supra* note 31, § 303A.02(b)(i)).

A second group of outside directors was affiliated with the American Museum of Natural History. Again, the plaintiffs averred that these directors were unable to exercise independent judgment because JPMC, over the years, had made substantial donations to the Museum. *Id.* at 822–23. Noting that the plaintiffs had failed to demonstrate how JPMC's donations to the Museum had impaired these directors' independence, or even what percentage of the Museum's total contributions were made by JPMC, the court rejected this contention as well. *Id.* at 822.

Finally, the court considered the nature of the relationship between JPMC and an outside director who was the President and CEO of the United Negro College Fund. *Id.* at 823–24. The plaintiffs alleged that since 1990, JPMC and its employees had contributed more than \$18 million to the United Negro College Fund. *Id.* at 815. Even more significant, according to the plaintiffs, was that Mr. Harrison had for a time served as treasurer of that organization. *Id.* at 824. Significantly, the court noted that the complaint failed to plead that Mr. Harrison was the treasurer of the United Negro College Fund during the relevant period when the merger was being considered or approved. *Id.*

142. *Id.* at 824 (quoting *In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275, 286 (Del. Ch. 2003)).

143. *See id.* at 824–25.

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JPMC's directors were independent, the court concluded that the plaintiffs had failed to satisfy the first prong of the *Aronson* test.¹⁴⁴

3. In re Oracle Derivative Litigation

The Delaware Court of Chancery's decision in *In re Oracle Derivative Litigation* shifted the focus of the independence inquiry by broadening it beyond the statutory and regulatory requirements set forth by Congress and the SROs.¹⁴⁵ In *Oracle*, the court denied a motion by the SLC of Oracle's board of directors to dismiss derivative claims alleging that certain members of Oracle's board had engaged in insider trading by selling some of their holdings prior to an unfavorable earnings announcement.¹⁴⁶ The defendants included Oracle's CEO, Lawrence Ellison, and two outside directors, Donald Lucas and Michael Boskin.¹⁴⁷ The SLC consisted of two Stanford University professors, Hector Garcia-Molina and Joseph Grundfest, both of whom had been appointed to the board following the commencement of other litigation relating to the insider trading allegations.¹⁴⁸ Oracle's SLC moved to terminate the derivative action, concluding that the defendants did not possess material, non-public information at the time of the stock sales.¹⁴⁹

Pursuant to *Zapata Corp. v. Maldonado*, the SLC bears the burden of persuasion in the Delaware Court of Chancery.¹⁵⁰ The *Zapata* court articulated a bipartite test when evaluating an SLC's motion to dismiss a

144. See *id.* at 824. Despite not having to consider the second prong of *Aronson*'s test, the court nonetheless determined that the plaintiffs failed to raise a reasonable doubt concerning whether "the challenged transaction was otherwise the product of a valid exercise of business judgment." *Id.* at 820 (citing *Aronson v. Lewis*, 473 A.2d 805, 814 (Del. 1984)). The court found that

[w]ith regard to the honesty and good faith of the board, the plaintiffs [did] not allege any facts that directly call[ed] into question the acts of the directors. . . . The only allegation in the complaint [was] that somehow, due to their financial, charitable, or personal relationship to Harrison, the individual director defendants were beholden to Harrison, allegations that [had] already been found to be insufficient.

Id. at 824. "Due to the absence of particularized factual allegations calling into question" the director defendants' honesty and good faith, the court ruled that the "complaint [did] not give rise to a reason to doubt whether the decision of the board of directors of JPMC to approve the Merger Agreement [was] entitled to the protection of the business judgment rule." *Id.* at 825.

145. *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, 920 (Del. Ch. 2003).

146. See *id.*

147. See *id.* at 921.

148. *Id.* at 923.

149. *Id.* at 928; see Davis, *supra* note 101, at 1312.

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

shareholder derivative suit.¹⁵¹ “First, the court should inquire into the independence and good faith of the committee and the bases supporting its conclusions.”¹⁵² If the court finds that the committee was not independent or did not articulate reasonable bases for its conclusions, or if the court is otherwise dissatisfied with the committee’s decision-making process (including but not limited to reasons relating to the good faith of the committee), the court must deny the corporation’s motion for dismissal.¹⁵³ If, however, the court is satisfied that the SLC was independent and was able to demonstrate reasonable bases for its findings and recommendations, the court may, subject to its own discretion, proceed to the second-step of the analysis.¹⁵⁴ Under the second step of the *Zapata* analysis, the court applies its own independent “business judgment” in order to determine whether the motion should be granted.¹⁵⁵

Applying a self-described “contextual approach,” the Delaware Court of Chancery in *Oracle* noted,

two SLC members—both of whom [were] professors at Stanford University—[were] being asked to investigate fellow Oracle directors who [had] important ties to Stanford, too. Among the directors who [were] accused . . . of insider trading [were]: (1) another Stanford professor, who taught one of the SLC members when the SLC member was a Ph.D. candidate and who serve[d] . . . alongside that SLC member at the Stanford Institute for Economic Policy Research or “SIEPR”; (2) a Stanford alumnus who [had] directed millions of dollars . . . to Stanford during recent years, [and had] serve[d] as Chair of SIEPR’s Advisory Board . . . ; and (3) Oracle’s CEO, who [had] made millions of dollars in donations to Stanford¹⁵⁶

151. *Id.* at 788.

152. *Id.*

153. *Id.*

154. *Id.* at 789.

155. *See* Ladd, *supra* note 17, at 2174.

156. *In re Oracle Corp.*, 824 A.2d at 920–21, 941. The court detailed the relationships with individual directors that it found troubling: (1) SLC member Professor Hector Garcia-Molina—a tenured professor—is Chairman of the Computer Sciences Department at Stanford, *id.* at 923; (2) SLC member Professor Joseph Grundfest—a tenured professor at Stanford who had also received his J.D. from Stanford Law School and completed postgraduate studies in economics at Stanford—is the W.A. Franke Professor of Law and Business at Stanford, *id.* at 924; (3) Michael J. Boskin—a director, Chairman of the Compensation Committee, and member of the Finance and Audit Committee of Oracle Corp.—was an Economics professor at Stanford who taught Grundfest when he was a Ph.D candidate at Stanford, *id.* at 931 (noting additionally that Boskin and Grundfest were

The court acknowledged that “much of” Delaware jurisprudence “focuses the bias inquiry on whether there are economically material ties between the interested party and the director whose impartiality is questioned.”¹⁵⁷ Rejecting a purely economic analysis, however, the *Oracle* court framed the appropriate test for independence as “whether a director is, *for any substantial reason*, incapable of making a decision with only the best interests of the corporation in mind.”¹⁵⁸ In considering the ability of Oracle’s SLC to exercise impartial judgment, the court noted that “[h]omo sapiens is not merely homo economicus.”¹⁵⁹ Rather, the court posited that “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.”¹⁶⁰ Determining that Stanford constituted a community, the *Oracle* court held that the social norms and pressures on the SLC members as a result of their participation in that community, which also included the persons under investigation, precluded a finding of independence.¹⁶¹ Consistent with the first step of the *Zapata* analysis, the court ruled that the “ties among the SLC, the [parties under investigation], and Stanford [were] so substantial that they [raised a] reasonable doubt about the SLC’s ability to impartially consider whether the [defendants] should face suit.”¹⁶²

senior fellows and steering committee members of the SIEPR); (4) Ronald Lucas—a director, Chairman of the Executive Committee, and Chairman of the Finance and Audit Committee of Oracle Corp.—obtained both his undergraduate and graduate degrees from Stanford and serves as Chairman and Director of the Richard M. Lucas Foundation named for his brother who died of cancer, which has donated \$11.7 million to Stanford since 1981, *id.* at 931–32; and (5) Lawrence Ellison—Chairman of the board, Chief Executive Officer, and Oracle’s largest shareholder—made substantial contributions to Stanford University and is the sole director of the Ellison Medical Foundation, which has awarded Stanford approximately \$10 million in grants. *Id.* at 932–33. The court also noted other aspects of the close relationship between Oracle and Stanford; namely, that Oracle had established the “Help Us Help Foundation” and had named Stanford University the “appointing authority” to appoint four of the seven directors of the Foundation, *id.* at 933, and Ellison considered creating the Ellison Scholars Program at Stanford to be modeled after the Rhodes Scholar Program at Oxford. *Id.*

157. *Id.* at 936.

158. *Id.* at 920 (quoting *Parfi Holding AB v. Mirror Image Internet, Inc.*, 794 A.2d 1211, 1232 (Del. Ch. 2001), *rev’d on other grounds*, 817 A.2d 149 (Del. 2002)).

159. *Id.* at 938.

160. *Id.* (“Delaware law should not be based on a reductionist view of human nature that simplifies human motivations on the lines of the least sophisticated notions of the law and economics movement.”).

161. *Id.* at 940.

162. *Id.* at 942.

By focusing on the contextual nature of independence, the *Oracle* court expanded the inquiry of director independence from considerations of material economic ties between a director and an interested party to personal, professional, philanthropic, or social ties that might impede a director's exercise of independent judgment.¹⁶³ Although the court disputed that the ruling established a new substantive definition of independence, the decision articulated an expanded "facts and circumstances test," which necessarily made the inquiry into independence a situational one.¹⁶⁴ Therefore, the practical result of such a contextual analysis was that directors might have to prove a degree of independence beyond the foundational requirements set forth by Congress and the SROs.¹⁶⁵

4. Delaware jurisprudence: residual ambiguity

While Delaware jurisprudence has sharpened the focus on the role of board composition, it has also resulted in some residual ambiguity regarding the standards for director independence.¹⁶⁶ Whereas the *Oracle* decision portended a significant expansion of the independence inquiry to take account of the potential for structural bias, both the *Beam* and *J.P. Morgan* decisions appeared either to limit the scope of *Oracle*'s independence analysis or to enunciate a less stringent standard for measuring director independence. Synthesizing the *Oracle* decision with the *Beam* and *J.P. Morgan* decisions is therefore a challenge, especially given that the decisions in *Beam* and *J.P. Morgan* refuse to take specific issue with the *Oracle* court's reasoning. Whether the decisions in *Beam* and *J.P. Morgan* indicate a view that structural bias posed no realistic threat to a director's ability to exercise independent judgment, or whether the procedural distinction between SLC and demand futility litigation served as a mere pretext for the practical accommodation of boardroom control over the decision to disburse corporate resources to derivative litigation remains uncertain.

163. *Id.* at 939 n.55; Jeremy J. Kobeski, Comment, In re Oracle Corporation Derivative Litigation: *Has a New Species of Director Independence Been Uncovered?*, 29 DEL. J. CORP. L. 849, 866 (2004).

164. Kobeski, *supra* note 163, at 866.

165. *See id.* at 875.

166. *See* Mills, *supra* note 7, at 466–67 (noting that the perceived failure of directors to monitor management on behalf of the shareholders led to the increased focus on director independence).

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Despite certain doctrinal anomalies, a deepened emphasis on director independence is the thread running through Delaware jurisprudence following the corporate disasters of 2001 and 2002.¹⁶⁷ Consistent with the federal reforms, this emphasis reflects the theoretical belief that independent directors—because they are free of inappropriate employment and financial and other relationships with management—are in a better position to monitor management performance than non-independent directors.¹⁶⁸ Notwithstanding this theoretical predicate, the following Part considers whether practical experience refutes the propriety of such focus.¹⁶⁹ Using the facts surrounding the resignation of one of Enron's independent directors from the board in 2001, Part V explores how management's continued dominance over the corporate electoral process—a practice which remains unaddressed by both the federal reforms and Delaware law—compromises the efficacy of any so-called independence regime.¹⁷⁰

V. CORPORATE DEMOCRACY: THE HOLY GRAIL OF CORPORATE GOVERNANCE REFORM

A. Jerome Meyer's Experience on Enron's Board of Directors Illustrates the Futility of Independence-Centered Corporate Governance Reform Initiatives

Jerome Meyer was an independent member of the Enron board of directors under both the federal rules and the expanded *Oracle* standard¹⁷¹ from August 1997 to February 2001. He had neither an impermissible employment/financial relationship with Enron nor any professional, charitable, or social association with any of Enron's other directors or management.¹⁷² Jeffrey Skilling, Enron's CEO at the time of

167. See Veasey & Di Guglielmo, *supra* note 6, at 1404–06.

168. See Ribstein, *supra* note 20, at 55–56.

169. See Brudney, *supra* note 10, at 601; see also Gabriel, *supra* note 10, at 646.

170. See Final Report of Neal Batson, Court-Appointed Examiner, app. D, *In re Enron Corp., 30 Employee Benefits Cas. (BNA) 2057* (Bankr. S.D.N.Y. 2003) (No. 01-16034), available at <http://www.enron.com/corp/por/examinerfinal.html> [hereinafter Batson Report, Appendix D]; Brudney, *supra* note 10, at 601.

171. See Enron Corp., Proxy Statement (Form Def 14A) (Mar. 28, 2000), <http://www.sec.gov/Archives/edgar/data/1024401/0000950129-00-001279.txt>.

172. See Batson Report, Appendix D, *supra* note 170, at 33, 38–44. The Examiner did not include any reference to Mr. Meyer in his discussion about Enron directors who may have had their independence compromised. *Id.*

Mr. Meyer's departure from the board, asked Mr. Meyer not to stand for re-election to the board after the expiration of his term.¹⁷³ On the board and within management circles, Mr. Meyer was known for being an exhaustive questioner and for expressing disagreement with Mr. Skilling, particularly with respect to the development of Enron's broadband business.¹⁷⁴ During the company's bankruptcy proceedings, Mr. Meyer testified that he did not stand for re-election because Mr. Skilling thought he was too "negative" in his questioning.¹⁷⁵

Mr. Meyer's boardroom experience exposes the problems of corporate governance reform focused on traditional conceptions of independence. At the time of its bankruptcy, eleven of the fourteen directors serving on Enron's board satisfied either then-existing regulatory rules relating to independence or widely accepted best practices in corporate governance.¹⁷⁶ Yet, neither the Enron board's compliance with those regulatory rules nor its adherence to best practices prevented the widespread financial duplicity that led to the company's demise.

Mr. Meyer's boardroom situation demonstrates that attempts to regulate independence and thereby improve the monitoring effectiveness of corporate boards could prove futile if management continues to control the electoral process by nominating all of the candidates for election to a company's board of directors.¹⁷⁷ For example, while independent directors can express concerns and raise difficult questions in their oversight of management, they may be removed from the board merely for discharging the monitoring duties that proponents of independence have long claimed for them if they raise the ire of the corporation's senior management in the process. Motivated by the desire to retain their positions, even independent directors will have weak

173. *See id.* at 90 n.430.

174. *See id.*

175. *See id.* Mr. Meyer offered not to stand for re-election and Ken Lay accepted the offer saying, according to Meyer, "Jeff thinks you're one of a couple of directors that are too negative in your questioning and he thinks we need some folks that maybe have a background much more aligned with the trading business." *Id.*

176. *See* Bhagat & Black, *supra* note 67, at 232-33.

177. *See* DIV. OF CORP. FIN., U.S. SECURITIES AND EXCHANGE COMM'N, STAFF REPORT: REVIEW OF THE PROXY PROCESS REGARDING THE NOMINATION AND ELECTION OF DIRECTORS (July 15, 2003), <http://www.sec.gov/news/studies/proxyreport.pdf> [hereinafter SEC STAFF REPORT]; *see also* Lewis J. Sundquist III, Comment, *Proposal To Allow Shareholder Nomination of Corporate Directors: Overreaction in Times of Corporate Scandal*, 30 WM. MITCHELL L. REV. 1471, 1479 (2004).

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incentives to monitor those to whom they owe their directorial positions. Thus, unless accompanied by efforts to democratize the director appointment system through increased shareholder access to the corporate proxy statement, independence alone will be insufficient to enforce the monitoring paradigm of the corporate board.

B. The Corporate Electoral Process for Directors

No statute explicitly gives management the authority to nominate directors for election to the board. However, Rule 14a-8(i)(8) of the Exchange Act allows management to exclude from the company's proxy materials any shareholder proposal "relate[d] to an election for membership on the company's board of directors or analogous governing body."¹⁷⁸ Management's effective control over the corporate proxy materials thereby undermines shareholders' exclusive right to elect the board of directors.¹⁷⁹

Because of management's control over the corporate proxy materials, shareholders who wish to participate in the director electoral process have three options.¹⁸⁰ First, any shareholder may conduct an election contest at his or her own expense. To do so, such shareholder must prepare and disseminate proxy materials that comply with the SEC's proxy rules.¹⁸¹ The prohibitive cost of conducting an election contest, however, deters shareholders from pursuing this option.¹⁸² Second, shareholders may nominate candidates at the company's annual meeting, "subject to compliance with applicable state law[s]" and "the company's governing instruments."¹⁸³ Other practical constraints limit the effectiveness of this option. In particular, shareholders generally vote through the grant of a proxy before the annual meeting, thereby making it difficult for a candidate nominated at the meeting to garner sufficient support for election to the board.¹⁸⁴ Finally, shareholders may recommend nominees to the company's nominating committee or other

178. 17 C.F.R. § 240.14a-8(i)(8) (2003).

179. See Melvin A. Eisenberg, *Access to the Corporate Proxy Machinery*, 83 HARV. L. REV. 1489, 1504-06 (1970).

180. SEC STAFF REPORT, *supra* note 177, at 5.

181. *Id.*; see also Sundquist, *supra* note 177, at 1479.

182. See Stephen M. Bainbridge, *Redirecting State Takeover Laws at Proxy Contests*, 1992 WIS. L. REV. 1071, 1078 ("Proxy contests are enormously expensive.").

183. See SEC STAFF REPORT, *supra* note 177, at 5.

184. See *id.*

designated body performing the same role.¹⁸⁵ Like the previous two alternatives, this option has yielded little success because the nominating committee, under the supervision of management, rarely nominates those candidates recommended by the shareholders.¹⁸⁶

Although there have been exceptional cases in which shareholders have successfully advanced their own nominees, as opposed to management advanced nominees, even these aberrational cases expose the incumbent bias of the system.¹⁸⁷ Therefore, to the extent that management continues to nominate all of the candidates for election to the board, directors will have weak incentives to voice opposition to management or pursue any action that is inimical to management's interests.¹⁸⁸ While the post-Enron implementation of significant structural changes—such as the selection of director candidates by a nominating committee or other designated body composed solely of independent directors—has dispelled some of the optical impressions that directors serve at the pleasure of the CEO, directors remain reliant on management's largesse for their continued tenure on the board.¹⁸⁹

The managerial appointment of directors thus results in the creation and perpetuation in the director ranks of mere figureheads rather than watchful fiduciaries. This provides the impetus for the ongoing debate regarding the practicability and desirability of increased shareholder activism in the corporate electoral process, which has focused on both the removal of existing regulatory barriers to electoral participation by

185. See *id.* at 3, 5 (positing that any rule permitting direct shareholder access to a company's proxy statement arguably could violate state law because state law bestows nominations on the board); Sundquist, *supra* note 177, at 1475 (advancing the argument that substantive corporate law is a state law function and that the SEC should regulate corporate disclosure only).

186. See SEC STAFF REPORT, *supra* note 177, at 5; see also Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187, 230 (1991).

187. See Chandler & Strine, *supra* note 13, at 999 (noting that even when shareholder activists succeeded in replacing a majority of the members serving on the board of ICN Pharmaceuticals, Inc., the contest took over two years and the activists incurred millions of dollars in costs).

188. See Loewenstein, *supra* note 6, at 788 n.22 (maintaining that, while no statute explicitly gives management the authority to nominate directors, management, as a practical matter, has the exclusive right to nominate directors because it controls the proxy statement). The candidates nominated by management often are officers of other public corporations and frequently ask the managers, whom they oversee, to serve as directors of their own boards. See Elson, *supra* note 92, at 158–59. The resultant cross-directorships compromise the board's oversight functions. See *id.* at 159; see also Wallace, *supra* note 6, at 113 (noting that board membership can be a valuable source of status, business contacts, and income).

189. See Elson & Gyves, *supra* note 13, at 857.

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shareholders as well as the implementation of procedural protections for an open election process.¹⁹⁰

C. The SEC's Consideration of Electoral Process Reform

On a number of occasions, the SEC has considered proposals to remove the regulatory impediments to shareholder access to the corporate electoral process. The SEC first addressed the issue of shareholder access in 1942 when it proposed (but later did not adopt) revisions to the proxy rules to provide that “minority stockholders be given an opportunity to use the management’s proxy material in support of their own nominees for directorships.”¹⁹¹ In 1977, the SEC again revisited the issue of shareholder access when it considered whether “shareholders [should] have access to management’s proxy soliciting materials for the purpose of nominating persons of their choice to serve on the board of directors.”¹⁹² Although the SEC did not adopt any amendments to the then-existing proxy rules relating directly to providing shareholders access to company proxy materials, the SEC began to require companies to state whether they had a nominating committee and, if so, whether that committee would consider shareholder recommendations for director candidates.¹⁹³ “In the broad proxy revisions adopted in 1992, the [SEC] briefly revisited the [shareholder] nominee issue in connection with amendments to the bona fide nominee rule set out in Exchange Act Rule 14a-4.”¹⁹⁴ Rule 14a-4 “provides that no person shall be deemed a bona fide nominee ‘unless he has consented to being named in the proxy statement and to serve if elected.’”¹⁹⁵ When adopting the amendments to Exchange Act Rule 14a-4, the SEC commented on “the difficulty experienced by shareholders in gaining a

190. This debate balances the efficient deployment of corporate resources against the utility of a genuinely open election process.

191. Security Holder Director Nominations, 68 Fed. Reg. 60,784, 60,785 (proposed Oct. 23, 2003) (quoting Securities Act Release No. 2887, Securities Exchange Act Release No. 3347, Public Utility Holding Company Act Release No. 3988, Investment Company Act Release No. 417 (Dec. 18, 1942)).

192. *See id.* (alteration in original) (quoting Re-Examination of Rules Relating to Shareholder Communications, Securities Exchange Act Release No. 13482, Public Utility Holding Company Act Release No. 20008, Investment Company Act Release No. 9740 (Apr. 28, 1977)).

193. *Id.*

194. *Id.* (footnote omitted).

195. *Id.* (quoting 17 C.F.R. § 240.14a-4(d)(4) (2003)).

voice in determining the composition of the board of directors.”¹⁹⁶ Instead of requiring a universal ballot, “the Commission revised the bona fide nominee rule to allow [shareholders] seeking minority board representation [in a non-control context] to ‘fill out’ a partial or ‘short’ slate with management nominees”¹⁹⁷

“Reflecting concern over corporate scandals and the account-ability of corporate directors,” the SEC proposed Exchange Act Rule 14a-11 in 2003, which contained extensive revisions to the proxy rules.¹⁹⁸ Pursuant to proposed Exchange Act Rule 14a-11, companies would be required, under certain circumstances, to include shareholder nominees for directors as well as specified information regarding those nominees in a company’s proxy materials.¹⁹⁹ In conjunction, the SEC discussed several “triggering events” that need to occur prior to granting shareholders access to a company’s proxy.²⁰⁰ Among the proposed triggering events were (1) a company’s failure “to act on a shareholder proposal that received a majority of votes”²⁰¹ or (2) “an election where a director

196. *Id.* (quoting Regulation of Communications Among Shareholders, Securities Exchange Act Release No. 31326, Investment Company Act of 1940 Release No. 19031 (Oct. 16, 1992)).

197. *Id.* at 60,786.

198. *Id.* at 60,784.

199. *See id.* at 60,784–85. Under proposed Exchange Act Rule 14a-11, the company would be required to include information regarding the [shareholder] nominee in the company’s proxy statement that it sends to its security holders, including the Web site address on which the nominating [shareholder] or nominating [shareholder] group intends to solicit in favor of its nominee, and include the name of the nominee on the company’s proxy card that is included in those materials.

Id. at 60,786.

In addition to required disclosures related to each director candidate, companies may wish to include statements in the proxy statement supporting [management] nominees and/or opposing [shareholder nominees]. . . . [I]f the company includes [statements in opposition of shareholder nominees], other than a mere recommendation to vote in favor of or withhold votes from specified candidates, a nominating [shareholder] or nominating [shareholder] group would be given the opportunity to include . . . a statement of support for the [shareholder nominee], of a length not to exceed 500 words.

With regard to the company’s proxy card, . . . the company could identify any [shareholder] nominees . . . and recommend that [shareholders] vote against, or withhold votes from, those nominees [and/or bolster support for management’s nominees on the proxy form]. The company must otherwise present the nominees in an impartial manner

Id. at 60,800.

200. *See* Sundquist, *supra* note 177, at 1481.

201. *Id.* Shareholder access would be triggered if [a shareholder] proposal submitted pursuant to Exchange Act Rule 14a-8 providing that the company become subject to the [shareholder] nomination procedure in proposed Exchange Act Rule 14a-11(a) was submitted for a vote of [shareholders] at an annual

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candidate received a significant number of abstention or ‘withhold’ votes.”²⁰² Because proposed Exchange Act Rule 14a-11 would operate only upon the occurrence of specified triggering events, a company subject to the rule would have to provide notice to its shareholders of the occurrence of such events in its periodic disclosure reports.²⁰³

“Equally important to the determination of *when* [a shareholder should have access to the company’s proxy statement] is the issue of *who* should qualify to receive such access.”²⁰⁴ The SEC suggested that both amount and length of ownership requirements should inform the determination of shareholder eligibility. Under proposed Exchange Act Rule 14a-11, a shareholder or shareholder group must “[b]eneficially own . . . more than 5% of a company’s securities” in order to vote for prospective directors.²⁰⁵ Restricting the use of the nomination procedure to those contexts in which a shareholder or shareholder group is not seeking control of the company, the SEC further proposed that “a company [must] include one [shareholder] nominee if the total number of [board members] is eight or fewer, two [shareholder] nominees if the number of [board members] is greater than eight and less than 20 and three [shareholder nominees] if the number of [board members] is 20 or more.”²⁰⁶

meeting of [the shareholders] held after January 1, 2004 by a [shareholder or shareholder group] that held more than 1% of the company’s [shares] entitled to vote on the proposal for one year as of the date the proposal was submitted and provided evidence of such holding to the company; and (b) [the proposal] received more than 50% of the votes cast on that proposal [at the annual meeting].

Security Holder Director Nominations, 68 Fed. Reg. at 60,789.

202. Sundquist, *supra* note 177, at 1481. Under proposed Exchange Act Rule 14a-11, shareholder access would be triggered if

[a]t least one of the company’s nominees for the board of directors for whom the company solicited proxies received ‘withhold’ votes from more than 35% of the votes cast at an annual meeting of [shareholders] held after January 1, 2004 at which directors were elected (provided, that this event may not occur in the case of a contested election to which Exchange Act Rule 14a-12(c) applies or an election to which the proposed shareholder nomination procedure in Exchange Act Rule 14a-11 applies).

See Security Holder Director Nominations, 68 Fed. Reg. at 60,790 (footnotes omitted). While the SEC has acknowledged that the implementation of “triggering events” might add further complexity to a democratized corporate electoral process, in its view, limiting shareholder access to certain predetermined circumstances would best advance the goals of corporate democracy. *See* Sundquist, *supra* note 177, at 1481.

203. Security Holder Director Nominations, 68 Fed. Reg. at 60,792.

204. Sundquist, *supra* note 177, at 1482 (emphasis added).

205. Security Holder Director Nominations, 68 Fed. Reg. at 60,794.

206. *Id.* at 60,797. The proposed rule contemplated “a separate standard for companies with classified or ‘staggered’ boards of directors.” *Id.*

Despite the practical and theoretical appeal of the proposed rule (particularly for its enhancement of the board's accountability to shareholder interests), lingering procedural questions relating to triggering events and shareholder eligibility thresholds, as well as concerns over the development of special interest constituencies, have stalled shareholder access reform proposals.²⁰⁷ Expressing concern that shareholder access could empower institutional investors—holders of large blocks of stock—to advance their own collateral agendas at the expense of other shareholder interests, some commentators have warned that shareholder democracy ironically could disenfranchise a large number of shareholders.²⁰⁸ To obviate concerns relating to special interest directorships, however, the SEC has proposed standards of independence between the nominee and the shareholder or shareholder group.²⁰⁹ In addition, the fact that directors typically require a plurality

207. See Mark J. Roe, *Delaware's Politics*, 118 HARV. L. REV. 2491, 2523 (2005) (expressing concern that shareholder access could empower institutional investors to advance their own collateral agendas—agendas that might not even be tied to corporate profitability and productivity). Without the legal obligation charged to directors under the law, shareholders could nominate candidates with their sole interests in mind, thereby further disenfranchising a large number of shareholders. See Sundquist, *supra* note 177, at 1492. However, the fact that directors typically need a plurality of votes to be elected minimizes the extent of the special interest argument. See *id.* at 1493–94.

208. See Sundquist, *supra* note 177, at 1493–94.

209. Security Holder Director Nominations, 68 Fed. Reg. at 60,795–96. Under proposed Exchange Act Rule 14a-11, each nominee would be required to meet the following independence standards:

[1] If the nominating [shareholder or shareholder group] is a natural person, the nominee [may not be] the nominating [shareholder], [shareholder group,] or a member of the immediate family of the nominating [shareholder or shareholder group];

[2] If the nominating [shareholder or shareholder group] is an entity, neither the nominee nor any immediate family member of the nominee [may be] an employee of the nominating [shareholder or shareholder group] during the then-current calendar year nor during the immediately preceding calendar year;

[3] Neither the nominee nor any immediate family member of the nominee [may], during the year of the nomination or the immediately preceding calendar year, accept[] directly or indirectly any consulting, advisory, or other compensatory fee from the nominating [shareholder or shareholder group] or any affiliate of any such [shareholder or shareholder group], provided that compensatory fees would not include the receipt of fixed amounts of compensation under a retirement plan (including deferred compensation) for prior service with such [shareholder or shareholder group] (provided that such compensation is not contingent . . . on continued service);

[4] The nominee [may not be] an executive officer, director (or person fulfilling similar functions) of the nominating [shareholder or shareholder group], or of an affiliate of the [nominating shareholder or shareholder group]; and

[5] The nominee [may] not control the nominating [shareholder] or any member of the nominating [shareholder] group (or in the case of a [shareholder] or member that is a

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of votes for election to the board further diminishes the extent of the special interest or collateral agenda argument.²¹⁰

D. A Proposal for the Democratization of the Corporate Electoral Process

While most corporate reform proposals—past and present—have advocated increasing the independence of directors vis-à-vis management, this Article proposes, consistent with the above-described Exchange Act Rule 14a-11, increasing the *dependence* of directors on shareholders through shareholder access to the corporate proxy statement.²¹¹ As noted above, shareholder access to the corporate proxy

fund, an interested person of such [shareholder] or any such member as defined in Section 2(a)(19) of the Investment Company Act).

Id.

210. Sundquist, *supra* note 177, at 1493–94. Many companies elect directors using the plurality voting method (i.e., a candidate is elected regardless of (i) the number of “withhold” votes cast against that candidate, or (ii) the failure of the candidate to receive a majority of votes cast). See Patty M. DeGaetano, *The Shareholder Direct Access Teeter-Totter: Will Increased Shareholder Voice in the Director Nomination Process Protect Investors?*, 41 CAL. W. L. REV. 361, 390–91 (2005).

211. See Gilson & Kraakman, *supra* note 73, at 865. In the early 1990s, Professors Gilson and Kraakman of Stanford and Harvard Law Schools, respectively, proffered a revolutionary agenda for the institutionalization of a professional director core in the United States. Pursuant to the Gilson/Kraakman proposal, institutional investors would elect a critical mass of full-time outside professional directors (e.g., twenty-five percent of the directors on a board) to serve on the boards of directors of a combination of portfolio companies. See *id.* at 879–80. “[Existing] prior to, and apart from, the election of [traditional outside directors],” these professional directors would continue to have financial independence from management, but unlike traditional outside directors, they would serve full-time on a combination of boards to which they had been elected. See *id.* at 884. By serving full-time on a number of boards, professional directors would eschew the incentive problems common to traditional outside directors because they would (1) devote sufficient time to understanding the business of their portfolio companies, thereby mitigating some of the informational asymmetries experienced by traditional outside directors; (2) be financially independent of the management of any one company; and (3) depend on the support of the shareholders, as opposed to management, for their continued tenure on the boards to which they had been elected. See *id.* at 886. To effectuate the Gilson/Kraakman proposal, institutional investors would have to coordinate their voting efforts as well as conduct potentially expensive proxy contests. See *id.* at 886–91. This would not be unduly onerous, however, because institutional investors typically have aggregated shareholdings in which the costs of collective action, though still significant, are manageable. According to their proposal, the coordination of voting efforts and proxy contests could occur either through the pioneering efforts of a single large investor, who would target the boards of a number of companies during proxy season and enlist the informal support of other shareholders, or through an organizationally distinct clearinghouse charged with recruiting professional directors and performing the administrative tasks that coordinated action among institutional investors would require. See *id.* at 886–88. A centralized organization could enhance the effectiveness of a professional director core by negotiating with the managements of individual corporations on behalf of institutional investors and monitoring professional directors

statement does not depend on regulatory support. Shareholders may conduct their own proxy contests at their own expense, nominate candidates at the company's annual meeting, or recommend candidates to the company's nominating committee. However, the SEC's removal of regulatory barriers to cooperative electoral action by shareholders would facilitate the democratization of the electoral process both by minimizing the costs of shareholder participation and increasing the likelihood of electing shareholder-nominated candidates.²¹² Although procedural questions relating to both triggering events and shareholder eligibility thresholds would need to be addressed further, allowing companies to include a shareholder's nominees for director in the company's proxy statement or provide a place on the company's proxy card for shareholders to vote for such nominees would reduce director dependence on management's electoral support and, accordingly, increase the monitoring effectiveness of the corporate board.²¹³

Consistent with proposed Exchange Act Rule 14a-11, a shareholder access reform proposal might contemplate that, subject to predetermined eligibility thresholds and triggering events, shareholders would be permitted to nominate a significant, though less than majority, percentage of the candidates (e.g., no more than twenty-five percent) to appear on the company's proxy card. These shareholder-nominees would exist prior to, and apart from, traditional independent directors nominated by management. Within this bipartite board structure, the shareholder-nominated directors would be in a better position than traditional independent directors to pose hard questions to management and to evaluate management's performance with critical objectivity. In this role, however, shareholder-nominated directors could draw

after they have been elected to office. Inevitably, even with the introduction of professional directorships, the problems associated with the separation of ownership and control, and the consequent loss of accountability, would persist—narrowed, though not eliminated. *See id.* at 892. However, both the desirability of a professional directorship and the ability of institutional investors to remove an underperforming director would create sufficient incentives for directors to monitor management. *See id.* at 905. At the end of their article, Professors Gilson and Kraakman acknowledged the limitations of their proposal by referring to a conversation they had with a colleague. *See id.* In that conversation, the colleague rhetorically inquired why “institutional investors [had] not already begun to implement [this proposal].” *Id.* Professors Gilson and Kraakman responded that they “could not think of a reason.” *Id.*

212. Rule 14(a)-(8)(i)(8) of the Exchange Act does not require a company to include a shareholder's nominees for director in the company's proxy statement or to provide a place on the company's proxy card for shareholders to vote for such nominees. *See* 17 C.F.R. § 240.14a-8(i)(8) (2003).

213. *See id.*

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traditional independent directors into policy-driven discussions regarding company policies and, in so doing, elicit the rejection of management's views when warranted. Thus, the introduction of shareholder-nominated directors would create an institutional environment in which traditional independent directors would have the opportunity to display the independence and monitoring integrity incumbent to their role. In addition to promoting a board ethos that is consistent with the board's monitoring paradigm, this board structure would foster a more cooperative relationship between management and shareholders because management's success would now depend on the support of shareholder-nominated directors.

The remaining operational issue is whether shareholder-nominated directors could sustain the motivation to discharge their monitoring duties effectively. Unlike traditional independent directors who have incentives *not* to criticize management so as not to jeopardize their positions on the board, shareholder-nominated directors would have more incentive to monitor management to ensure that shareholders would support them for re-election to the board. Paradoxically, for both the traditional independent directors and the shareholder-nominated directors, the desire to maintain their positions on the board would produce divergent incentives to monitor management.

Beyond election-driven incentives to monitor management, shareholder-nominated directors would have fewer practical limitations on their ability to oversee management performance. For instance, the addition of shareholder-nominated directors to corporate boards (especially given their mandate to challenge unsatisfactory management performance) would reduce the informational asymmetries typically experienced by boards composed solely of traditional independent directors. Because management's success would depend on the support of those directors whose election prospects it did not control, it would be in management's best interests to provide credible information to shareholder-nominated directors in order to defend its decisions and policies. Of particular significance, these shareholder-nominated directors could provide relevant information to their constituencies, which, in turn, could mitigate the informational disparities between shareholder-owners and management. In addition to reduced informational asymmetries, the introduction of shareholder-nominated directors to the board could diminish the incentive problems associated with compensation structures, which currently do not align the interests of directors and shareholders, because shareholder-nominated directors

likely would have a financial stake in the companies they were overseeing. Furthermore, shareholder access to the corporate proxy process would minimize the potential for structural bias. Given that under the proposed regime a significant percentage of the directors would be nominated by the shareholders instead of management, the board would no longer reflect an institutional bias in favor of management interests. Although in some instances shareholder-nominees might be co-opted by management nominees or management itself, their introduction onto the corporate board would represent a major step forward in dispelling structural bias and improving the monitoring effectiveness of the corporate board.

Regardless of whether a shareholder access reform proposal follows the proposed SEC model or some other paradigm, the circumstances surrounding the failure of the majority-independent boards to prevent serious managerial misconduct has cast doubt on the propriety of traditional independence-centered reform initiatives. Notwithstanding significant enhancements to the independence standards to correct the underlying deficiencies of the corporate board's monitoring paradigm, the existing electoral process compromises the efficacy of any so-called independence-based reform regime. As long as directors depend on management for their continued tenure on the board, even ostensibly independent directors will have weak incentives to monitor management.²¹⁴ Thus, the democratization of the corporate electoral process through increased shareholder access to the corporate proxy—rather than independence (at least as traditionally conceived)—should serve as the cornerstone of modern corporate governance reform in the United States.

VI. CONCLUSION

In the corporate governance debate, all arguments ultimately converge on the role of the board of directors in general and on the role of independent directors in particular. Ever since Adolf Berle and Gardiner Means identified the problem associated with the separation of ownership and control characteristic of the modern corporation, scholars have searched for the corporate equivalent of the Holy Grail: a mechanism to bridge the separation by holding non-owner managers accountable for their performance. Conventional wisdom dictates that

214. See SEC STAFF REPORT, *supra* note 177, at 5; see also Sundquist, *supra* note 177, at 1479.

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independent directors will solve the accountability problem because they are free of inappropriate entanglements that compromise their objectivity in the oversight of management. As a result, independent directors will monitor management effectively to ensure that a company maintains its shareholder-owner's long-term interests.

However, the emphasis on independence by both the federal reforms and Delaware law—while qualitatively different—has proven analytically unsatisfying. On the one hand, Robert Clark's recent boardroom experience highlights the potential under- and over-inclusiveness of any regulatory or statutory regime that evaluates independence on the basis of employment or other financial ties. On the other hand, although the Delaware courts provide a more productive framework for evaluations of board composition than the existing federal regime, their conception of director independence likewise has proven to be of limited value in developing standards of independence that are consistent with the board's monitoring paradigm.

The traditional solution of introducing independent directors to bridge the separation between ownership and control, therefore, has dramatic limitations. To the extent that management controls the electoral process by nominating all candidates for election to a company's board of directors, even independent directors—like Jerome Meyer—will have weak incentives to monitor management. In light of the board passivity and reduced monitoring effectiveness occasioned by the continued managerial appointment of directors, the democratization of the corporate electoral process through increased shareholder access to the corporate proxy system—though not a panacea for all of corporate America's ills—should represent the Holy Grail of corporate governance reform in the United States.