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## INDEPENDENCE RECONCEIVED

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*What makes a director independent? Scholars, regulators, and investors have grappled for decades with the fleeting notion of director independence. Originally conceived as guardians of shareholder interests that could safeguard a corporate board's ability to check management's power, independent directors have become a marquee feature of modern corporate governance. But do the corporate actions of directors that are considered "independent" under current standards comport with what we think independence requires? In many cases, the answer would seem to be "no." From a lack of observable financial impact to the unabated flow of corporate scandals, independent directors seem to keep failing at the job they were championed to do.*

*This Article addresses this puzzling tension, offering a novel theoretical and practical reframing of the decades-old discourse around independent directors. The historical focus on the classical managerial agency costs paradigm emphasized that directors who lack ties to the management team can prevent managerial slack or value extraction. However, this approach overlooks the critical role directors also have in curbing managerial overzealousness. In today's*

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*governance ecosystem, directors are not only tasked with preventing managerial slack. They are increasingly tasked with preventing managerial overreach and misconduct even when such overreach or misconduct is compatible with promoting shareholder value. This has important theoretical and practical implications.*

*This Article makes two key contributions to the literature. First, it reframes the question of what makes directors independent by supplementing the focus on agency costs as the driver for independence. By identifying a need to prevent boards from rubber-stamping managerial actions—even those taken in good faith—this Article suggests that a simple lack of ties to management fails as a litmus test for independence. Second, by reconceiving independence, this Article also provides tangible credence to the value of diversity on boards, the value and perils of hedge fund activism, and to the emerging discourse regarding ESG and stakeholderism.*

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## I. INTRODUCTION

Stephen Sanger is one of America’s preeminent executives and directors. Sanger served as chairman and chief executive officer of General Mills, Inc. for the final thirteen years of his thirty-four-year career with the company.<sup>1</sup> During his tenure as CEO, the company’s net sales nearly tripled from \$5 billion to \$14 billion, and its global workforce grew from 10,000 to 30,000 employees.<sup>2</sup> Considered perhaps his greatest legacy at General Mills, he fostered a culture that attracted and developed great leaders.<sup>3</sup> The company was regularly listed among Fortune’s Most Admired Companies, and in 2007 and 2009 it was ranked No. 6 and No. 3, respectively, in Fortune’s list of the top global companies for the development of leaders.<sup>4</sup>

Not surprisingly, Mr. Sanger was a highly sought-after director, serving as a director at Target Corporation and Pfizer.<sup>5</sup> Mr. Sanger also served as a director at Wells Fargo and was entrusted with leading the company’s non-management directors as Lead Independent Director.<sup>6</sup>

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<sup>1</sup> *Our History & Founders*, MICH. ROSS SANGER LEADERSHIP CTR., <https://sanger.umich.edu/history/> [perma.cc/U9UR-5WK9] (last visited Dec. 4, 2023).

<sup>2</sup> *Id.*

<sup>3</sup> *Id.*

<sup>4</sup> *Id.*

<sup>5</sup> *Id.*

<sup>6</sup> Letter from Michael S. Gibson, Dir., Div. of Supervision & Regul., Bd. of Governors of the Fed. Rsrv. Sys., to Stephen Sanger, Lead Indep. Dir., Wells Fargo & Co. (Feb. 2, 2018),

Yet, on Mr. Sanger's watch in September of 2016, one of America's most reputable banks failed to maintain that reputation. Wells Fargo, a Fortune 100 company, faced \$185 million in fines for opening over 1.5 million bank accounts and 500,000 credit cards on behalf of its customers, without consent, to boost its sales figures.<sup>7</sup> The aftermath was shocking: Wells Fargo settled all further civil and criminal liability in connection with this misconduct for an additional \$3 billion and fired 5,300 employees.<sup>8</sup>

Even harder to believe, the Office of the Comptroller of the Currency found that the Wells Fargo board had known about fudged sales numbers for *eleven years* before the scandal broke.<sup>9</sup> The Federal Reserve placed direct blame on Mr. Sanger, stating in a letter to him that "you did not appear to lead the independent directors in pressing firm management for more information and action, even after you were aware of

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<https://www.federalreserve.gov/newsevents/pressreleases/files/enf20180202a3.pdf> [<https://perma.cc/67FS-T744>].

<sup>7</sup> Matt Egan, *5,300 Wells Fargo Employees Fired Over 2 Million Phony Accounts*, CNN BUS. (Sept. 9, 2016, 8:08 AM), <https://money.cnn.com/2016/09/08/investing/wells-fargo-created-phony-accounts-bank-fees/index.html> [<https://perma.cc/6TZT-GJ88>]; *Wells Fargo Company Profile*, FORTUNE 500 (last revised Aug. 2, 2023), <https://fortune.com/company/wells-fargo/fortune500/> [<https://perma.cc/Z6BN-AHHD>].

<sup>8</sup> Press Release, Dep't of Just., Wells Fargo Agrees to Pay \$3 Billion to Resolve Crim. and Civ. Investigations into Sales Prac. Involving the Opening of Millions of Accounts Without Customer Authorization (Feb. 21, 2020), <https://www.justice.gov/opa/pr/wells-fargo-agrees-pay-3-billion-resolve-criminal-and-civil-investigations-sales-practices> [<https://perma.cc/5EB2-DGF4>]; Egan, *supra* note 7.

<sup>9</sup> OFF. OF ENTER. GOVERNANCE AND THE OMBUDSMAN, OFF. OF THE COMPTROLLER OF THE CURRENCY, LESSONS LEARNED REVIEW OF SUPERVISION PRACTICES AT WELLS FARGO 5 (2017) ("Since 2005, the bank's Board received regular Audit & Security reports indicating the highest level of EthicsLine internal complaint cases . . . related to sales integrity violations."); Danielle Ivory, *Wells Fargo's Regulator Admits It Missed Red Flags*, N.Y. TIMES (Apr. 19, 2017), <https://www.nytimes.com/2017/04/19/business/dealbook/wells-fargo-fraud-office-of-comptroller-currency.html?searchResultPosition=1> [<https://perma.cc/4KMP-A2NH>].

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the seriousness of the problems[.]”<sup>10</sup> and that “[a] lead independent director is appointed to . . . provide an alternative view of, and (when necessary) check on, executive directors of the board and the management of the firm. Your performance in that role is an example of ineffective oversight[.]”<sup>11</sup>

While Mr. Sanger and several other directors resigned in the aftermath of the scandal,<sup>12</sup> a central question remained: what caused the board of a reputable, established, highly regulated enterprise to overlook a scandal in the making for over a decade? In other words, investors and regulators alike pondered: “[w]here were the Independent Directors?”<sup>13</sup>

The story of Wells Fargo and the failures of Mr. Sanger and the rest of its independent directors is particularly pertinent in light of the growing move towards independent directors in the U.S. Nowadays, around 85% of public company directors are independent<sup>14</sup>—that is, lacking clear financial or relational ties to company management and the company itself.<sup>15</sup> This is a dramatic change from the 1960s, when

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<sup>10</sup> Press Release, Bd. of Governors of the Fed. Rsrv., Accountability as Lead Independent Director of Wells Fargo & Company Board of Directors (Feb. 2, 2018), <https://www.federalreserve.gov/newsevents/pressreleases/files/enf20180202a3.pdf> [<https://perma.cc/969B-TMQS>].

<sup>11</sup> *Id.*

<sup>12</sup> Bradley Keoun, *Wells Fargo Directors Exiting After Federal Reserve Slams Governance*, STREET. (Mar. 2, 2018), <https://www.thestreet.com/markets/corporate-governance/wells-fargo-directors-retire-after-federal-reserve-slams-governance-14508322> [<https://perma.cc/M6YL-V3U5>].

<sup>13</sup> Priya Huskins, *Naming and Shaming: The Fed Publicly Admonishes Wells Fargo’s Former Lead Director*, WOODRUFF SAWYER (Apr. 24, 2018), <https://woodruffswayer.com/do-notebook/wells-fargo-director/> [<https://perma.cc/7TV2-3L32>].

<sup>14</sup> THE CONF. BD., CORPORATE BOARD PRACTICES IN THE RUSSELL 3000, S&P 500, AND S&P MIDCAP 400 26 (2021), <https://www.conference-board.org/pdfdownload.cfm?masterProductID=36996> [<https://perma.cc/2YZX-PFZY>].

<sup>15</sup> Yaron Nili, *Out of Sight Out of Mind: The Case for Improving Director Independent Disclosure*, 43 J. CORP. L. 35, 39 (2017) [hereinafter *Out of Sight*] (discussing the importance of directors).

boards were mostly comprised of insiders (i.e., either direct employees, or close advisors or capital providers with a vicarious financial interest).<sup>16</sup> The ensuing corporate scandals started a push towards independence that continues today. Majority-independent boards are now the norm, and in some contexts are legally required.<sup>17</sup>

Why was director independence thought to be desirable? The standard answer is that managers might be tempted to help themselves rather than their companies, and directors whose ties to management are too strong might let them.<sup>18</sup> But majority-independent boards not infrequently go along with what in retrospect, and even in prospect, are bad managerial decisions. Importantly, the decisions at issue often do not reflect managerial advantage-taking. They might reflect a determination to preserve or enhance market share without a full appreciation of the possible costs involved, as apparent in Boeing's production and sale of the 737-MAX aircraft,<sup>19</sup> or as in Wells Fargo, which turned a blind eye to inflated accounts in order to sustain share growth. Or they might reflect an ambitious acquisition strategy intended to keep the company fresh and innovative, a characterization that arguably applies to HP's ill-fated acquisition of Autonomy.<sup>20</sup> In these cases, the managers might have been good (economic) agents, acting in what they reasonably believed were the interests of the company. Yet, as the *Boeing*, *Wells Fargo*, and *HP* cases demonstrate, the results were nevertheless detrimental to shareholders and to society.

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<sup>16</sup> See Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1473–76 (2007).

<sup>17</sup> See generally *Out of Sight*, *supra* note 15; Yaron Nili, *The "New Insiders": Rethinking Independent Directors' Tenure*, 68 HASTINGS L.J. 97 (2016) [hereinafter *New Insiders*].

<sup>18</sup> See *Out of Sight*, *supra* note 15, at 42, 54.

<sup>19</sup> See *infra* notes 240 and 242 and accompanying text; see also *In re Boeing Co. Derivative Litig.*, No. 2019-0907-MTZ, 2021 WL 4059934 (Del. Ch. Sept. 7, 2021).

<sup>20</sup> See *infra* notes 206–08 and accompanying text; see also *In re HP Sec. Litig.*, No. 3:12-cv-05980-CRB, 2015 WL 12990170 (N.D. Cal. Nov. 16, 2015).

Even where straightforward managerial (or controlling shareholder) agency costs are at issue, independent directors may not act as independently as their status might suggest.<sup>21</sup> This is so even for directors selected precisely when independence is most needed, such as when a controller is promoting a deal<sup>22</sup> that clearly presents a conflict.<sup>23</sup> *Southern Peru*<sup>24</sup> and *CBS*<sup>25</sup> serve as cautionary tales: deals were approved on terms favorable to the conflicted party by both companies, notwithstanding the involvement of the respective independent special committees. Moreover, even independent directors without close relationships to managers seem to go along too readily with decisions that prove harmful to the corporation and sometimes the broader society. A recent example is WeWork, a company whose board went along for many years with reckless business plans and alleged self-dealing by the CEO.<sup>26</sup> Rather than being passive and refraining from asking the necessary questions, independent directors adopting a more active stance would better serve the corporation's and society's interests.

All of this casts significant doubt on the standard formulation of the problem that director independence is supposed to address, as well as the standard answer: the focus on lack of formal ties to corporate management. The problems that independence would seem appropriately situated to address go well beyond managerial agency costs, and the solution of independence-as-ties, while perhaps doing a plausible job with some classic managerial agency costs, has significant shortcomings. As presently defined, independence

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<sup>21</sup> See *Out of Sight*, *supra* note 15, at 39.

<sup>22</sup> See, e.g., *In re S. Peru Copper Corp. S'holder Derivative Litig.*, 52 A.3d 761, 763–64 (Del. Ch. 2011).

<sup>23</sup> See, e.g., *In re CBS Corp. S'holder Class Action & Derivative Litig.*, No. CV 2020-01111-JRS, 2021 WL 268779, at \*1 (Del. Ch. Jan. 27, 2021).

<sup>24</sup> *In re S. Peru Copper*, 52 A.3d at 763–64.

<sup>25</sup> *In re CBS*, 2021 WL 268779 at \*1.

<sup>26</sup> See generally ELIOT BROWN & MAUREEN FARRELL, *THE CULT OF WE: WEWORK, ADAM NEUMANN, AND THE GREAT STARTUP DELUSION* (2021).

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is much more compatible with passivity and deference than it should be.

This Article offers a novel theoretical and practical reframing of the decades-old discourse around independent directors. The historical focus on the classical managerial agency costs paradigm focuses on mitigating managerial slack or value extraction, while overlooking the critical role directors also have in curbing managerial overzealousness.<sup>27</sup> For instance, management might pursue profits without sufficient regard for potential risks in the short and the long term and the downside possibilities for both shareholders and other stakeholders. Recognizing that, in today's governance ecosystem, directors are tasked less with preventing managerial slack and more with preventing managerial overreach has important implications.

This Article develops a theoretical reconception of the role and importance of director independence, and therefore also a reconception of what should make a director "independent." While managerial agency costs are important, the continuing emphasis on independence as the absence of ties to management unduly centers such costs' importance in the analysis. It detracts from a broader and more holistic view that considers the value of truly independent thought and perspective in the boardroom, deployed for the benefit of both corporations and society.<sup>28</sup>

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<sup>27</sup> We define managerial overzealousness as actions taken by managers that are efforts to promote corporate value but suffer from overaggressive beliefs or lack of proper weighing of the associated risks of such actions.

<sup>28</sup> There is literature a) casting doubt on the empirical case for the value of independent directors (as traditionally defined); b) arguing that whatever value independent directors may bring, they also carry a cost; and c) arguing that independent directors who are good at monitoring will be bad at advising given the conflicts between the two tasks. A conclusion sometimes considered is that perhaps the move away from insiders on boards was not a good one. This is not a debate we engage, except to note that the distinction between monitoring and advising is much more nebulous than such an account suggests. We posit that board independence in some form is and will continue to be sought. See *infra* Part IV for a discussion of this issue.



Our arguments have practical implications as well. They lend support to the growing calls for diversity on boards, to the increased emphasis on director expertise, and to the pro-stakeholder proponents in the emerging debate on stakeholderism. No consensus exists as to the extent to which corporations should seek to further the social good above and beyond what is required for shareholder wealth maximization. While we do not propose to extensively engage with that debate here, we note that present developments, such as pressures from shareholders, regulators, and others towards CSR and ESG, blur the line between corporate good and societal good. Similarly, compliance as it is practiced, with a penumbra extending well beyond the law into reputational consequences and ethical transgressions, enlarges this grey area.<sup>29</sup> Thus, even within the shareholder-profit-maximization paradigm, there is an opening for a broader conception of corporate purpose.

How can the reconception we argue for be achieved? Many forces seem to be combining felicitously to this end. Dynamics favoring board passivity and deference may be changing.<sup>30</sup> *Boeing*, which settled after plaintiffs' case survived a motion to dismiss, was ultimately about the independent board having gone along with management's disregard of safety.<sup>31</sup> Decisions in *Southern Peru* and *CBS* notably include dicta criticizing independent directors for not acting sufficiently

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<sup>29</sup> PRINCIPLES OF THE LAW, COMPLIANCE, RISK MGMT. AND ENFT FOR ORGS., §§ 1.01(h), 1.01(n) (AM. L. INST., Tentative Draft No. 1, 2019); *see also* Claire A. Hill, What Risks Should *Caremark* Encompass? (unpublished manuscript) (on file with author); Claire A. Hill, *Caremark as Soft Law*, 90 TEMP. L. REV. 681 (2018).

<sup>30</sup> Kobi Kastiel & Yaron Nili, "Captured Boards": *The Rise of "Super Directors" and the Case for a Board Suite*, 2017 WIS. L. REV. 19, 26 [hereinafter *Captured Boards*]; Yaron Nili, *Servants of Two Masters? The Feigned Hysteria over Activist-Paid Directors*, 18 U. PA. J. BUS. L. 509 (2016).

<sup>31</sup> *In re Boeing Co. Derivative Litig.*, No. 2019-0907-MTZ, 2021 WL 4059934, at \*1 (Del. Ch. Sept. 7, 2021).

independently.<sup>32</sup> While the *Southern Peru* directors were not found liable, in the *CBS* case, after the case survived a motion to dismiss, the parties settled, with the defendants agreeing to pay \$167.5 million.<sup>33</sup> These decisions will presumably reverberate and inform how directors see their duties, and how they are chosen.

The increasing attention to the composition of the board of directors should be helpful as well. The effects of joint and long board tenure are being explored; there is recognition that independent board members who serve together for long periods on the same board may lose objectivity.<sup>34</sup> Structural solutions one of the authors has raised in the past relating to board composition, such as limits on director tenure, the establishment of a “board suite,” and truly empowering the independent chair or the lead independent director, are all important elements that can help with realigning independence.<sup>35</sup> Additionally, boards could be encouraged or required to have a “contrarian,” a director designated as such for a time-limited term.<sup>36</sup> Some felicitous structural changes such as a focus on expertise<sup>37</sup> are already occurring, and others seem possible, if not likely. Relevant, too, is the increasing presence of non-management board members,

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<sup>32</sup> *In re S. Peru Copper Corp. S’holder Derivative Litig.*, 52 A.3d 761, 798 (Del. Ch. 2011) (noting that “the Special Committee fell victim to a controlled mindset and allowed Grupo Mexico to dictate the terms and structure of the Merger.”); *In re CBS Corp. S’holder Class Action & Derivative Litig.*, No. CV 2020-0111-JRS, 2021 WL 268779 at 41\* (“By assenting to the NAI Parties’ constraints on their mandate without protest, each member of the CBS Committee evidenced their inability to push back against the asserted will of the controller.”).

<sup>33</sup> *In re CBS Corp. Stockholder Class Action and Derivative Litigation*, No. 2020-0111-SG, 2023 WL 5817795 (Del.Ch. Sep. 07, 2023); Paramount Global, Current Report (Form 8-K) (Apr. 18, 2023).

<sup>34</sup> *New Insiders*, *supra* note 17, at 120.

<sup>35</sup> *Captured Boards*, *supra* note 30, at 56–57.

<sup>36</sup> Claire A. Hill & Dana Brakman Reiser, Rotating Contrarians (June 11, 2023) (unpublished outline) (on file with authors).

<sup>37</sup> Yaron Nili & Roy Shapira, *Expert Directors*, 41 YALE J. ON REG. (forthcoming 2024).

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notably hedge fund designees, and the specter of more such people, through pressure or even the proxy access process.<sup>38</sup>

The increasing push for boards to be less homogeneous on a variety of dimensions should be helpful as well, introducing new perspectives and limiting the effect of conformist group dynamics of familiar structural biases and of self-interest encouraging undue deference and passivity.<sup>39</sup> Not only can diversity yield more viewpoints, but it can also limit the effect of pernicious group dynamics; all of this could yield boards that far better serve their corporations and the broader society. Thus, our reconception of independent directors as *independent in thought and perspective* also has a bearing on the ongoing push for board diversity, bolstering the case for diversity without relying on rationales such as the need for boards to be more “representative” of the society, or criteria such as demonstrable effects on profits.

This Article proceeds as follows. Part II explores the trajectory by which boards went from insider-dominated to independent-director-dominated, and articulates the rationale for the change. It discusses how independence is defined and used under federal securities law and under state (Delaware) corporate law, and the emergence and use of additional practices tending to bolster the power and influence of independent directors.

Part III explores the evidence as to how well independence works, summarizing the literature on the results of director independence on boards. Notably, the literature does *not* establish a causal link, or even a correlation, between board independence and corporate financial success. The Part briefly discusses other correlations that have been measured, including those between board independence and risk-taking. It considers the criteria by which success should be measured, arguing that for an important component of director

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<sup>38</sup> *Captured Boards*, *supra* note 30, at 20–21.

<sup>39</sup> Jared L. Landaw, *Maximizing the Benefits of Board Diversity*, THE CONFERENCE BOARD (Director Notes, June 2020), <https://www.conference-board.org/pdfdownload.cfm?masterProductID=20869> [<https://perma.cc/3RTS-NC2E>].

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performance, monitoring for *Caremark* issues, success would not necessarily be reflected in the corporation's financial performance.

Part IV introduces our reconception of independence. We begin with the classic economic account of independence as intended to address managerial agency costs, contrasting it with a more colloquial understanding of independence as it has sometimes been used in critiques of corporate boards. Independence is closely related to monitoring: boards were thought to need greater independence when their roles as monitors assumed more importance. The Part sets forth a taxonomy of what is to be monitored: (a) traditional managerial agency costs; (b) mixed motive cases, where a manager believes, perhaps genuinely, that a course of action is good for the company, (e.g., a high-profile acquisition or a successful product launch enabled by expedited regulatory review) but the manager's own interests may be particularly salient; and (c) cases where the manager has a genuine belief that the course of action (or inaction) is good for the company, but for any of a number of reasons (limited perspective; insufficiently understood past experience), the actions could benefit from critical oversight.<sup>40</sup> It further considers obstacles to monitoring, anchoring the discussion in the extensive behavioral and management literature on the subject. One upshot of this Part's analysis is a blurring of familiar lines between the monitoring and advising functions of the board. The traditional perspective is that the former is adversarial while the latter is more cooperative, such that more and better monitoring is at the expense of more and better advising. However, an alternative picture seems better supported, in which monitoring and advising often blur together, with both

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<sup>40</sup> The disastrous attempt to eliminate "sales" (at discounted prices) at J.C. Penney comes to mind as an idea based on insufficiently understood past experience. Interestingly, the idea was pushed by a hedge fund's hand-picked CEO. See Suzanne Kapner, Emily Glazer & Joann S. Lublin, *Ackman Resigns From J.C. Penney's Board*, WALL ST. J. (Aug. 13, 2013), <https://www.wsj.com/articles/ackman-resigns-from-jc-penneys-board-1376391255> [https://perma.cc/GS3T-BNP5].

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benefiting from a truly independent and non-deferential perspective.

Finally, Part V first discusses how a reconception of independence might be achieved, identifying factors relevant to that end such as judicial exhortations, high-visibility scandals, and moves toward, and proposals for, changes in board composition. It also discusses the policy implications of our reconceptualized director independence framework. In particular, we explain how such a framework gives independent credence and justification to several present-day debates on corporate purpose, CSR/ESG, shareholder activism, and board diversity. In doing so, we hope to open a new line of inquiry into the role of the board in the changing governance environment.

## II. WHAT IS INDEPENDENCE?

“The now-conventional understanding of boards of directors in the diffusely held firm is that they reduce the agency costs associated with the separation of ownership and control. Elected by shareholders, directors are supposed to “monitor” the managers in view of shareholder interests.”<sup>41</sup>

How, and why, did this become the ‘now-conventional’ understanding?

Early in the twentieth century, the board’s primary role was to serve in an advisory capacity to management. Directors provided insight, guidance, and networking opportunities to management.<sup>42</sup> Boards commonly consisted of a majority of insiders (the corporation’s senior officers) and a handpicked selection of outside directors.<sup>43</sup> But over the last several decades, American corporate boards have undergone a gradual but dramatic change. In the 1960s, most had a majority of inside directors (company executives).<sup>44</sup> Today,

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<sup>41</sup> Gordon, *supra* note 16, at 1468.

<sup>42</sup> *Out of Sight*, *supra* note 15, at 43.

<sup>43</sup> Gordon, *supra* note 16, at 1468.

<sup>44</sup> *Id.* at 1473–75.

almost all have a majority (usually a large majority) of outside directors, most have a majority (often a large majority) of independent directors, and an increasing number have only one inside director—the CEO.<sup>45</sup>

Indeed, as required by NYSE and NASDAQ listing standards, all listed company boards are at least majority-independent, with some board committees being 100% independent.<sup>46</sup> Moreover, guidelines adopted by the Council of Institutional Investors call for at least 2/3 of a company's directors to be independent;<sup>47</sup> guidelines adopted by the California Public Employees Retirement System and by the National Association of Corporate Directors call for boards to have a “substantial majority” of independent directors.<sup>48</sup> American corporate governance experts and institutional investors are now exporting this conventional wisdom around the world. It has only an occasional dissenting voice.<sup>49</sup> Even the Business Roundtable (an organization of large-firm CEOs), which once opposed proposals for more independent boards, now recommends that boards have a “substantial

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<sup>45</sup> See *infra* notes 98–105 and accompanying text.

<sup>46</sup> Gordon, *supra* note 16, at 1482–83; see N.Y.S.E. LISTED CO. MANUAL, § 303A.01–.05, <https://nyse.wolterskluwer.cloud/listed-company-manual/09013e2c85c00744> [<https://perma.cc/PM5W-5MY6>] (last visited Dec. 5, 2023); NASDAQ STOCK MKT. LLC RULES §§ 5605(a)(2), (c)(3) and (d)(2), <https://listingcenter.nasdaq.com/rulebook/nasdaq/rules/nasdaq-5600-series> [<https://perma.cc/D65X-NCWH>] (last visited Dec. 5, 2023).

<sup>47</sup> *Policies on Corporate Governance*, COUNCIL OF INSTITUTIONAL INVESTORS, [https://www.cii.org/corp\\_gov\\_policies#:~:text=2.3%20Independent%20Board%3A%20At%20least,or%20any%20other%20executive%20officer](https://www.cii.org/corp_gov_policies#:~:text=2.3%20Independent%20Board%3A%20At%20least,or%20any%20other%20executive%20officer) [<https://perma.cc/4FZL-4ZYY>] (last updated Mar. 6, 2023).

<sup>48</sup> *CalPERS' Governance & Sustainability Principles*, CALPERS, <https://www.calpers.ca.gov/docs/forms-publications/governance-and-sustainability-principles.pdf> [<https://perma.cc/ZH6N-SM2M>] (last revised Sept. 2019).

<sup>49</sup> Kelli A. Alces, *Beyond the Board of Directors*, 46 WAKE FOREST L. REV. 783, 789 (2011); see also *Captured Boards*, *supra* note 30, at 22.

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majority” of independent directors.<sup>50</sup> And independence is an important concept in state law as well, considered by courts in determining how to proceed in cases brought by plaintiff shareholders in the name of their companies, and how much deference to accord to transactions that may involve conflicts.

Why was independence thought to be needed? As companies became larger, so did their shareholder bases. As Adolf Berle and Gardiner Means observed, shareholders were dispersed; given their small stakes, they lacked the incentive to monitor management.<sup>51</sup> Managers of course had the incentive to be bad agents, serving themselves, even at the expense of the corporation and its shareholders. If they did not fear being monitored, they were better positioned to act on this incentive. Dispersed ownership and the lack of shareholder incentive to supervise management effectively led to a managerial controlled corporate structure<sup>52</sup> and agency costs.<sup>53</sup> Thus, management needed to be monitored by someone sufficiently outside of the corporation—an independent director.

#### A. The Genesis of Independent Directors

The board of directors is one of the core components of the modern corporation.<sup>54</sup> While corporate boards originated to

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<sup>50</sup> Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231, 233 (2002).

<sup>51</sup> ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 6–7 (1932).

<sup>52</sup> *See Out of Sight*, *supra* note 15, at 41–42.

<sup>53</sup> Agency costs can be defined as the “costs of structuring, monitoring, and bonding a set of contracts among agents with conflicting interests.” Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 304 (1983).

<sup>54</sup> Melvin Aron Eisenberg, *Legal Models of Management Structure in the Modern Corporation: Officers, Directors, and Accountants*, 63 CALIF. L. REV. 375, 376 (1975).

serve a mostly advisory role to managers,<sup>55</sup> director responsibility has since expanded, and boards have been entrusted with several important roles in the governance of the corporation.<sup>56</sup> Boards are a resource for management to utilize for insight, advice, and networking; they are actively involved with key corporate decisions, notably mergers, stock issuance, and change of corporate governance; and they are charged with a monitoring role over management to ensure shareholder interests are properly being served. In the past few decades, the board's role, especially in public companies, has largely shifted to include, and by many accounts, emphasize, monitoring company management.<sup>57</sup> As the functions and responsibilities of boards have expanded, boards have gone from being mostly comprised of insiders to being mostly comprised of directors meeting the criteria for independence.<sup>58</sup>

Recounting the history in more detail, in the 1950s, as the U.S. economy boomed in the aftermath of World War II, "boards were largely passive instruments of the CEO, chosen by him and strongly disinclined to challenge his decisions or authority."<sup>59</sup> Boards were viewed as an extension of, and advisors to, management.<sup>60</sup> It was critical that a CEO trust

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<sup>55</sup> See MELVIN ARON EISENBERG, *THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS* 139–41 (1976) (discussing the practices of the corporate board); Stephen M. Bainbridge & M. Todd Henderson, *Boards-R-Us: Conceptualizing Corporate Boards*, 66 *STAN. L. REV.* 1051, 1053, 1062 (2014) ("[S]tate law [now] requires boards to mediate the relationship between ownership and control of the corporation."); Dalia Tsuk Mitchell, *Status Bound: The Twentieth Century Evolution of Directors' Liability*, 5 *N.Y.U. J.L. & Bus.* 63, 136–38 (2009).

<sup>56</sup> See STEPHEN BAINBRIDGE, *CORPORATE GOVERNANCE AFTER THE FINANCIAL CRISIS* 45 (2012) (discussing management's role in running a business).

<sup>57</sup> *Id.* at 43–44.

<sup>58</sup> See Gordon, *supra* note 16, at 1472–73 (suggesting the shift to independent directors comes from U.S. political economy); see also *New Insiders*, *supra* note 17, at 108–14 (discussing the shift in board structure towards independence).

<sup>59</sup> Gordon, *supra* note 16, at 1511.

<sup>60</sup> *Id.* at 1514.



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the board; the board's "trust in the CEO" was not really at issue.<sup>61</sup> Outside directors were therefore selected based on their economic relationships with the corporation (they were bankers or lawyers of the banks or firms working for the corporation, for instance) or they were handpicked by the CEO, generally on the basis of a close professional or personal relationship.<sup>62</sup> People with such close relationships, it was thought, would serve as a useful sounding board for providing expertise to the CEO.<sup>63</sup>

The 1970s saw a slow but steady change in the composition of the boardroom and the rise of the monitoring board concept. The unexpected collapse of the Penn Central Transportation Company highlighted various issues surrounding board structure and responsibilities. In the early 1970s, the board of Penn Central approved a \$100 million dividend,<sup>64</sup> unaware of, or perhaps unconcerned by, the deteriorating working capital, increasing indebtedness, and generally bad financial condition of the company,<sup>65</sup> making no effort to become adequately informed.<sup>66</sup> Other corporate collapses, such as those of Equity Funding, LTV, Ampex, and Memorex,<sup>67</sup> indicated that the problem was far broader than Penn Central. Boards should have been doing more to monitor their companies.<sup>68</sup> The Special Prosecutor's investigation of the Watergate scandal uncovered hundreds of public corporations

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<sup>61</sup> *Id.* at 1511.

<sup>62</sup> *Id.* at 1511–13.

<sup>63</sup> *Id.*

<sup>64</sup> *Id.* at 1515.

<sup>65</sup> JOSEPH R. DAUGHEN & PETER BINZEN, *THE WRECK OF THE PENN CENTRAL* 256, 336 (1971).

<sup>66</sup> *Id.* at 303. Directors were responsible because they were unaware of the factual picture of the company, they took their fees, and they never attempted to uncover the true financial picture. See Robert Townsend, *The Wreck of the Penn Central*, N.Y. TIMES (Dec. 12, 1971) <https://www.nytimes.com/1971/12/12/archives/the-wreck-of-the-penn-central-by-joseph-r-daughen-and-peter-binzen.html> [<https://perma.cc/67EH-S3LR>].

<sup>67</sup> Gordon, *supra* note 16, at 1515.

<sup>68</sup> *Id.* at 1516.

that made illegal campaign contributions, unbeknownst to the outside directors.<sup>69</sup> These scandals highlighted the growing need to have corporate boards focus more on monitoring, and to include more independent directors into board decision-making processes.<sup>70</sup>

The shift towards boards with greater director independence and greater monitoring responsibilities was not inexorable. Some saw the moves as a tactical concession by management and inside directors to forestall more extensive legislative and boardroom reforms.<sup>71</sup> Industry deregulation and a booming economy in the 1980s made the economic landscape ripe for mergers and acquisitions. The constant threat of takeovers and hostile transactions bolstered the case for a more independent board of directors. Independent directors' decisions to accept or reject takeover bids would presumably be unbiased, while management or inside directors' decisions might not be.<sup>72</sup> Throughout the decade, independent directors' role on corporate boards continued to gain prominence. In the 1990s, influential guidelines were promulgated in support of director independence. In 1992, the American Law Institute's *Principles of Corporate Governance* "recommended that the board of a public corporation 'should have a majority of directors who are free of any significant relationship with the corporation's senior executives.'" <sup>73</sup> The *Principles* use a variety of criteria to determine whether a director is independent.<sup>74</sup> A director is viewed as being independent if she is neither employed by the corporation nor

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<sup>69</sup> *Id.*

<sup>70</sup> *Id.* at 1518; see generally MEL EISENBERG, *THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS* (1976) (highlighting the need for reconceptualization of the board).

<sup>71</sup> Gordon, *supra* note 16, at 1520.

<sup>72</sup> *Id.* at 1522–23.

<sup>73</sup> *Id.* at 1481 (quoting AM. L. INST., *PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS* § 3A.01 (1994) (as adopted and promulgated in 1992)).

<sup>74</sup> Stephen M. Bainbridge, *Independent Directors and the ALI Corporate Governance Project*, 61 *GEO. WASH. L. REV.* 1034, 1035 n.6 (1993).

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controlled by insiders.<sup>75</sup> Control is measured by examining if the director has any significant relationships with management, senior executive officers, or inside directors.<sup>76</sup>

The *Principles* were ambitious in encouraging replacement of the “traditional minimalist advisory approach” of directors with an active monitoring approach. They recommended that the board of directors be constituted by a majority of independent directors, and that independent directors should not have any external employment or financial commitments that would otherwise interfere with their board duties.<sup>77</sup> Monitoring responsibilities have the effect of forcing directors to take a more active role. Monitoring requires evaluation of management performance, consistent with leaving managers as the primary day-to-day decision-makers.<sup>78</sup> The *Principles* called for the formation of an audit committee.<sup>79</sup> All audit committee members were to be outsiders; however, only a majority of the committee was to consist of independent directors.<sup>80</sup> The *Principles* also recommended creation of a nomination committee to review factors which could undermine director independence.<sup>81</sup>

The movement towards boardroom independence in the years immediately preceding the early 2000s was mainly driven by the market rather than any significant legislation or regulation.<sup>82</sup> However, the WorldCom and Enron scandals

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<sup>75</sup> *Id.*

<sup>76</sup> *Id.*; see Gordon, *supra* note 16, at 1481 (identifying common relationships as principal outside law firm and investment banking businesses, customer/supplier relationships, and other financial arrangements crossing a \$200,000 threshold).

<sup>77</sup> Bainbridge, *supra* note 74, at 1037–40.

<sup>78</sup> *Id.* at 1037–38.

<sup>79</sup> See *id.* at 1040 (citing AM. L. INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 3A.01, § 3A.04(a), and § 3.05 (1994) (as adopted and promulgated in 1992)).

<sup>80</sup> *Id.* at 1040, 1040 n.36.

<sup>81</sup> *Id.* at 1040 n.35; Gordon, *supra* note 16, at 1481–82.

<sup>82</sup> State law has developed to require the approval of self-dealing transactions by disinterested directors, often independent directors. This

in the early 2000s led to a sea of legislative changes and regulatory reforms, including the Sarbanes-Oxley Act (“SOX”).<sup>83</sup> The 2008 financial crisis led to a similar legislative reaction: the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”).<sup>84</sup> These legislative acts led to a number of federal and state regulatory changes, as well as changes to stock exchange listing standards, all of which solidified the “shift in board composition into a mandatory one” and increased the overall responsibilities of independent directors.<sup>85</sup>

The principal objective of SOX was to protect the integrity of financial disclosures. Management ineffectiveness in ensuring gatekeeper integrity was brought to light,<sup>86</sup> and empowerment of the board, through independent directors, was needed to ensure board effectiveness in monitoring management.<sup>87</sup> In addition to SOX directly regulating several

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requirement along with the need for special independent committees pushed companies to include more independent directors in their board room. *See* Gordon, *supra* note 16, at 1473 n.9 (showing a decrease in the percentage of inside directors from 49% in 1950, to 21% in 1995, to 16% in 2000, well before the SOX requirements were put in place).

<sup>83</sup> SOX directly regulated several aspects of the audit committee of the board, essentially requiring listing agencies, such as the NYSE and NASDAQ, to amend their listing standards so that a board has an audit committee, and that the audit committee be comprised entirely of independent directors. *See* 17 C.F.R. § 229 (2012); 17 C.F.R. §§ 240.10.A-3, 240.0C-1 (2023); 17 C.F.R. § 249 (2012); 17 C.F.R. § 274 (2012).

<sup>84</sup> § 952 of the Dodd-Frank Act and Rule 10C-1 of the Securities Exchange Act of 1934 direct the national securities exchanges to adopt new listing standards applicable to compensation committees. *See* 15 U.S.C. 78j-3(a); 17 C.F.R. § 240.10C-1 (2012). The SEC rules and the proposed listing requirements of the stock exchanges require boards to take into consideration the following when assessing the independence of compensation committee members: (1) the source of compensation of the director, including any consulting, advisory, or other compensatory fee paid by the issuer to the director; and (2) whether the director is affiliated with the issuer, its subsidiaries or their affiliates. 17 C.F.R. § 240.10C-1 (2012).

<sup>85</sup> *New Insiders*, *supra* note 17, at 108.

<sup>86</sup> Gordon, *supra* note 16, at 1536.

<sup>87</sup> *New Insiders*, *supra* note 17, at 108–10.

aspects of the requirements of the audit committee,<sup>88</sup> the NYSE and NASDAQ stock exchanges amended their listing requirements to mandate that a majority of the members of the board of directors of listed companies be independent of management and that each member of the nominating committee be independent.<sup>89</sup> The NYSE further implemented other changes, such as a “financial literacy” requirement of independent directors on the audit committee, regularly scheduled non-management director meetings, and the establishment of both a nominating and corporate governance committee, and a compensation committee, both comprised of solely independent directors.<sup>90</sup> While no number of regularly scheduled non-management director meetings is required, NASDAQ expects such meetings will regularly occur at least twice a year.<sup>91</sup> The SEC amended its disclosure rules to require the disclosure of: (1) whether each director nominee is independent of management, (2) whether there is any relationship between any director and management which could compromise director independence, and (3) the names of directors nominated to the audit, nomination and corporate governance, or compensation committees who are not independent.<sup>92</sup> All of these post-Enron regulations and reforms significantly expanded the role and responsibility of independent directors.

In the aftermath of the 2008 financial crisis, Congress enacted Dodd-Frank, seeking to reform various aspects of the financial industry, including the shadow banking system,

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<sup>88</sup> *See id.* at 109.

<sup>89</sup> *Out of Sight*, *supra* note 15, at 45, 49.

<sup>90</sup> *New Insiders*, *supra* note 17, at 109–11; N.Y.S.E. LISTED COMPANY MANUAL, *supra* note 46, § 303A.04–05.

<sup>91</sup> NASDAQ STOCK MKT. LLC RULES, *supra* note 46, § 5605-2.

<sup>92</sup> Press Release, SEC, SEC Votes to Adopt Changes to Disclosure Requirements Concerning Executive Compensation and Related Matters (July 26, 2006), <https://www.sec.gov/news/press/2006/2006-123.htm> [<https://perma.cc/Y925-A4NA>].

derivative trading, and whistleblowing.<sup>93</sup> The reforms address compensation committee independence, including the committee's authority to retain and assume direct responsibility for consultants and advisers, its analysis of the independence of compensation consultants and advisers, and the disclosure of any conflicts of interest concerning the compensation of consultants and advisers.<sup>94</sup> Pursuant to Dodd-Frank, securities exchanges' listing standards must condition listing on meeting these and other rules.<sup>95</sup> In addition to any independence tests stock exchanges require, the new SEC listing rules require boards to consider the following factors when assessing director independence: "(1) the source of compensation of the director, including consulting, advisory, or other fees paid to the director, and (2) whether the director has an affiliation with the issuer, its subsidiaries or their affiliates."<sup>96</sup> As a result of these legislative, regulatory, and stock exchange listing rules, director independence has taken a central role in corporate governance.

In recent years, heightened public and regulatory attention has spurred investors and regulators alike to encourage boards to have more independent directors or to

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<sup>93</sup> For a critique of the Dodd-Frank Act, see generally STEPHEN BAINBRIDGE, *CORPORATE GOVERNANCE AFTER THE FINANCIAL CRISIS* 15 (2012). For a more general critique of legislation in the wake of a crisis, see Roberta Romano, *Regulating in the Dark and a Postscript Assessment of the Iron Law of Financial Regulation*, 43 *HOFSTRA L. REV.* 25, 29–30 (2014) (discussing how the legislative reform dealt with various issues that were unrelated to one another).

<sup>94</sup> See 17 C.F.R. 240 § 10C-1 (2012).

<sup>95</sup> On September 25, 2012, NYSE and NASDAQ each filed proposed listing rules with the SEC to implement the requirements of Rule 10C-1, pursuant to 17 C.F.R. § 240.10C-1 (2012) which directs the SEC to require the national securities exchanges and associations to adopt listing rules that implement the requirements of Rule 10C-1. Proposed Rule Change by NASDAQ, Exchange Act Release No. 68013, 77 Fed. Reg. 62563 (Oct. 15, 2012); Proposed Rule Change by New York Stock Exchange, Exchange Act Release No. 68011, 77 Fed. Reg. 62541 (Oct. 15, 2012).

<sup>96</sup> *Out of Sight*, *supra* note 15, at 50.

give such directors more power.<sup>97</sup> In 2016, a coalition of corporate leaders released the Commonsense Principles of Corporate Governance,<sup>98</sup> which emphasized the critical role of director independence in corporate America.<sup>99</sup> In 2020, ISS and Glass Lewis recommended an Independent Chair or other independent leadership position, such as a Lead Independent Director.<sup>100</sup> Investors have increasingly asked that boards not only have sufficient numbers of independent directors, but also that the power dynamics in the boardroom allow the board to act independently from management.<sup>101</sup> Recognizing that most companies' Chairman is also the CEO, and that CEOs wield enormous power in the boardroom, most institutional investors now recommend that this power be broken up through an Independent Chair or a Lead Independent Director.<sup>102</sup> These positions are intended to serve as the "independent counter-balance to the chair."<sup>103</sup> As a result of this push for director independence, the CEO often has become the sole remaining "insider in most boardrooms."<sup>104</sup> While 49% of directors were company insiders in the 1950s, by 2005 only 25% of directors remained insiders.<sup>105</sup>

And it is not just the board: it is committees as well, those charged with auditing, picking subsequent board nominees, and executive compensation, all functions that implicate

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<sup>97</sup> See Yaron Nili, *Board Gatekeepers*, 72 EMORY L.J. 91 (2022) [hereinafter *Board Gatekeepers*].

<sup>98</sup> See *Out of Sight*, *supra* note 15, at 36–37.

<sup>99</sup> *Id.* at 37.

<sup>100</sup> *Board Gatekeepers*, *supra* note 97, at 104.

<sup>101</sup> *Id.*

<sup>102</sup> *Id.* at 122.

<sup>103</sup> Marion Plouhinec, *The Role of the Lead Independent Director*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Nov. 25, 2018) [hereinafter *Role of LID*], <https://corpgov.law.harvard.edu/2018/11/25/the-role-of-the-lead-independent-director/> [<https://perma.cc/XME8-SXN7>].

<sup>104</sup> *Board Gatekeepers*, *supra* note 97, at 103; see *Out of Sight*, *supra* note 15.

<sup>105</sup> *Out of Sight*, *supra* note 15, at 45.

possible managerial misbehavior. These committees have become fully or mostly comprised of independent directors.<sup>106</sup>

## B. Federal law

Based on SOX and Dodd Frank, both the NYSE and NASDAQ require companies to have majority-independent boards and 100% independent audit and compensation committees as a condition of being listed on their exchanges.<sup>107</sup> Moreover, federal securities law requires exchanges to only list public companies if they have 100% independent audit committees.<sup>108</sup> NYSE requires a 100% independent nominating/governance committee while NASDAQ's requirement as to the independence of the nominating/governance committee is slightly less stringent.<sup>109</sup> Federal securities law also requires that public companies disclose which of their directors are independent, and whether the definition of independence is the NYSE or NASDAQ definitions for companies listed thereon, or whatever other definition is applicable to the company.<sup>110</sup> Also relevant to

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<sup>106</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, 1900-01 (2010); *see generally* Victor I. Lewkow, *Compensation Committees and Adviser Independence under Dodd-Frank*, HARV. L. SCH. F. ON CORP. GOVERNANCE (July 16, 2012), <https://corpgov.law.harvard.edu/2012/07/16/compensation-committees-and-adviser-independence-under-dodd-frank/> [<https://perma.cc/F837-8FVN>].

<sup>107</sup> N.Y.S.E. LISTED CO. MANUAL, *supra* note 46, § 3.03A.01 (requirement of independence); § 3.03A.02 (definition of independence) and §§ 3.03A.04, 3.03A.05 and 3.03A.07 (concerning, respectively, independence of directors on nominating/governance committees, compensation committees and audit committees). *See* NASDAQ STOCK MKT. LLC RULES, *supra* note 46 §§ 5605; 5601(b)(1) (board majority independent); 5605(c)(2) (audit committee independence); 5605(d)(2) (compensation committee independence); 5605(e) (nominating committee independence).

<sup>108</sup> 17 C.F.R. § 240.10A-3 (2021).

<sup>109</sup> NASDAQ STOCK MKT. LLC RULES, *supra* note 46, § 5605. Any nominating committee must consist exclusively of independent directors; alternatively, director nominees can be selected by "Independent Directors constituting a majority of the Board's Independent Directors in a vote in which only Independent Directors participate." *Id.*

<sup>110</sup> 17 C.F.R. § 229.407 (2019).



independence is § 229.407(h), which requires disclosure as to whether a public company requires the roles of chairman of the board and chief executive officer to be held by different people, and if the company has a lead independent director—and if so, what role the director plays.<sup>111</sup> Finally, NASDAQ Rule 5605 requires the independent directors to have regularly scheduled sessions (“executive sessions”) attended only by independent directors.<sup>112</sup>

How is independence defined for federal law purposes? The federal definitions have been characterized as “bright line” given their specificity in terms of relationships, timing, and amounts at issue.<sup>113</sup> For instance, if the director or an immediate family member has been an employee of the listed company within the last three years, they cannot be considered independent.<sup>114</sup> Similarly, if the director or immediate family member received more than \$120,000 in direct compensation from the company in any 12-month period during the last three years, they will not be considered independent.<sup>115</sup> But the NYSE and NASDAQ tests of independence are not simply mechanical; each has a residual

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<sup>111</sup> *Id.*

<sup>112</sup> NASDAQ STOCK MKT. LLC RULES, *supra* note 46, § 5605, IM-5605-2 (“Regularly scheduled executive sessions encourage and enhance communication among Independent Directors. It is contemplated that executive sessions will occur at least twice a year, and perhaps more frequently, in conjunction with regularly scheduled board meetings.”).

<sup>113</sup> *See, e.g.*, PUB. CO. ADVISORY GRP., WEIL, GOTSHAL & MANGES LLP, REQUIREMENTS FOR PUBLIC COMPANY BOARDS INCLUDING IPO TRANSITION RULES 4 (Nov. 2016), [https://www.weil.com/~media/files/pdfs/2016/160916\\_pcag\\_public\\_company\\_chart\\_v4.pdf](https://www.weil.com/~media/files/pdfs/2016/160916_pcag_public_company_chart_v4.pdf) [<https://perma.cc/W9WY-MQ4B>]; Arthur H. Kohn, *Update on Director Independence*, CLEARY M&A AND CORP. GOVERNANCE WATCH (Nov. 6, 2019), <https://www.clearymawatch.com/2019/11/update-on-director-independence/> [<https://perma.cc/ZLJ3-SMYJ>].

<sup>114</sup> N.Y.S.E. LISTED CO. MANUAL, *supra* note 46, § 303A.02(b)(i) (“[A] director is not independent if . . . [t]he director is, or has been within the last three years, an employee of the listed company.”).

<sup>115</sup> *Id.* § 303A.02 (b)(ii) (A director is not independent if “[t]he director has received . . . during any twelve-month period within the last three years, more than \$120,000 in direct compensation from the listed company.”).

test for other relationships that might compromise independence.<sup>116</sup> The definitions refer to independence from “the listed company” but are principally directed at independence from management.<sup>117</sup>

### C. State Law

Independence is an important concept for state law as well. The definitions are similar (albeit not the same), but the concept is different, in important ways. Our discussion of “state law” below is of Delaware law, the most important corporate law for public companies.

In some, if not many, cases, the federal and state determinations would yield the same result. That being said, Delaware law is increasingly taking into consideration social ties and “networks” of ties, yielding a greater readiness than federal law to characterize a director as not independent. And in some instances, state law would find a director to be independent when federal law would not.<sup>118</sup>

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<sup>116</sup> *Id.* § 303A.02 cmt. (“It is not possible to anticipate, or explicitly to provide for, all circumstances that might signal potential conflicts of interest, or that might bear on the materiality of a director’s relationship to a listed company . . . . Accordingly, it is best that boards making ‘independence’ determinations broadly consider all relevant facts and circumstances.” The commentary expressly notes that the concern is independence from management.”); *see also* NASDAQ STOCK MKT. LLC RULES, *supra* note 46, § 5605(a)(2) cmt. (“It is important for investors to have confidence that individuals serving as Independent Directors do not have a relationship with the listed Company that would impair their independence. The board has a responsibility to make an affirmative determination that no such relationships exist through the application of Rule 5605(a)(2).”).

<sup>117</sup> N.Y.S.E. LISTED CO. MANUAL, *supra* note 46, § 303A.02 cmt.; NASDAQ STOCK MKT. LLC RULES, *supra* note 46, § 5605(a)(2) cmt.

<sup>118</sup> *See generally* Noam Noked, *Director Independence: Interplay Between Delaware Law and Exchange Rules*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Oct. 7, 2013), <https://corpgov.law.harvard.edu/2013/10/07/director-independence-interplay-between-delaware-law-and-exchange-rules/> [<https://perma.cc/8GDM-9JJR>]; *see also in re* Walt Disney Co. Derivative

The federal determination is as to a status: a director is independent, or she is not. Independent directors are needed and desirable for the corporation to function as it should, in its shareholders' interest (and not in the managers' interests).<sup>119</sup> The state determination is contextual: a director is independent, or not, as to particular courses of action or decisions.<sup>120</sup> As discussed further below, a court makes its inquiry into director independence to determine whether a case can be brought or continued in the name of the corporation—that is, whether a plaintiff can bring a derivative suit against a director on behalf of the corporation—what level of scrutiny to give to a decision or transaction, and whether a director acted in accordance with her fiduciary duties. The federal determination formally relates to

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Litig., 731 A.2d 342, 355–56 (Del. Ch. 1998) (establishing that Michael Eisner, CEO of Walt Disney, had been friends with Ovitz for twenty-five years before he recruited the latter to serve as president and director, but finding that such friendship did not impact Eisner's independence for purposes of assessing the derivative action against Ovitz), *aff'd in part, rev'd in part sub nom.* Brehm v. Eisner, 746 A.2d 244 (Del. 2000); see Sandys v. Pincus, 152 A.3d 124, 133 (Del. 2016) (“The bottom line under the NASDAQ rules is that a director is not independent if she has a ‘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.’ . . . [Delaware] law is based on the sensible intuition that deference ought to be given to the business judgment of directors whose interests are aligned with those of the company’s stockholders.”).

<sup>119</sup> See, e.g., N.Y.S.E. LISTED CO. MANUAL, *supra* note 46, § 303A.01 cmt. (“Effective boards of directors exercise independent judgment in carrying out their responsibilities. Requiring a majority of independent directors will increase the quality of board oversight and lessen the possibility of damaging conflicts of interest.”).

<sup>120</sup> See, e.g., *In re Tesla Motors, Inc. S’holder Litig.*, Consolidated C.A. No. 12711-VCS, 2018 WL 1560293, at \*17 (Del. Ch. Mar. 28, 2018) (“Even an independent, disinterested director can be dominated in his decision-making by a controlling stockholder.”). On the differences between federal and state determinations, see Usha Rodrigues, *The Fetishization of Independence*, 33 J. CORP. L. 447 (2008); Claire A. Hill & Brett McDonnell, *Reconsidering Board Oversight Duties After the Financial Crisis*, 2013 U. ILL. L. REV. 859; Claire A. Hill & Brett McDonnell, *Sanitizing Interested Transactions*, 36 DEL. J. CORP. L. 903, 911–12 (2011).

independence from “the listed company”<sup>121</sup> whereas the state determination can be as to independence from the managers, other directors, or controlling shareholders, depending on the context.

#### D. Different State Law Contexts

Some state law determinations relate to a plaintiff shareholder’s ability to bring or continue a derivative lawsuit on behalf of the company. Insofar as the cause of action is an injury to the company, the decision to bring the suit initially belongs to the company. Thus, to be permitted to proceed, the plaintiff must successfully argue that demanding that the company bring the suit would be futile because the board is not sufficiently independent to make a decision based on the suit’s merits.<sup>122</sup> Another related context is whether a company can decide to discontinue an existing derivative suit when there has been some showing of lack of director independence.

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<sup>121</sup> NASDAQ STOCK MKT. LLC RULES, *supra* note 46, § 5605(a)(2). Importantly, though, note that Commentary to N.Y.S.E. LISTED CO. MANUAL § 303A.02 characterizes the concern as being independence “from management.” More broadly, NASDAQ § 5605(a)(2) states that a director is not independent if he has a relationship that would interfere with his exercise of independent judgment in his capacity as a director. *See also* N.Y.S.E. LISTED CO. MANUAL, *supra* note 46, § 303A.02 cmt. (“Accordingly, it is best that boards making ‘independence’ determinations broadly consider all relevant facts and circumstances. In particular, when assessing the materiality of a director’s relationship with the listed company, the board should consider the issue not merely from the standpoint of the director, but also from that of persons or organizations with which the director has an affiliation. Material relationships can include commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships, among others.”).

<sup>122</sup> *See* *Aronson v. Lewis*, 473 A.2d 805, 816 (Del. 1984) (“Independence means that a director’s decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences.”); *see also* *United Foods & Com. Workers Union v. Zuckerberg*, 262 A.3d 1034, 1057–59 (Del. 2021) (adopting a new test for demand excusal and replacing both *Aronson* and the other Delaware test, *Rales*, typically used in the *Caremark* context to deal with board inaction).

Director independence is also an important facet of determining the level of scrutiny given to a transaction involving a controlling shareholder or a director or officer. The former type of transaction, and in some cases, the latter, might be subject to “entire fairness,” generally the strictest type of review the courts use, and one which requires both fair price and fair dealing. A transaction that might otherwise be subject to entire fairness review, with the burden on the defendant, can either be subject to such review with the burden on the plaintiff, or the court might review the case under the deferential business judgment standard, if, among other things, the directors making the relevant inquiries and decisions are independent.<sup>123</sup> In the paradigmatic contexts, the court is called upon to consider whether a particular director is or is not independent with respect to the matter at issue. But independence is sometimes also considered in contexts other than the determination with respect to a particular director— notably, whether one or more members of a special committee, or the committee as a whole, acted independently, such that the burden with respect to entire fairness is shifted from defendant to plaintiff, or whether business judgment will be the applicable standard given the procedural protections that have “cleansed” the “taint.”

#### E. The Delaware Factors

While there are no mechanical tests for independence under state law, the starting points are factors such as financial, professional, or familial relationships with those— notably, management—from whom they are supposedly independent. In the well-known *Oracle* case, then-Vice Chancellor Strine, finding that the “independent” committee members seeking to terminate a lawsuit against certain Oracle directors and officers were not sufficiently

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<sup>123</sup> See generally *In re MFW S'holders Litig.*, 67 A.3d 496 (Del. Ch. 2013); see also *Flood v. Synutra Int'l, Inc.*, 195 A.3d 754 (Del. 2018).

independent,<sup>124</sup> articulated his approach to understanding independence.

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. *Homo sapiens* is not merely *homo economicus*. We may be thankful that an array of other motivations exist that influence human behavior; not all are any better than greed or avarice, think of envy, to name just one. But also think of motives like love, friendship, and collegiality, think of those among us who direct their behavior as best they can on a guiding creed or set of moral values. Nor should our law ignore the social nature of humans. To be direct, corporate directors are generally the sort of people deeply enmeshed in social institutions. Such institutions have norms, expectations that, explicitly and implicitly, influence and channel the behavior of those who participate in their operation. Some things are “just not done,” or only at a cost, which might not be so severe as a loss of position, but may involve a loss of standing in the institution. In being appropriately sensitive to this factor, our law also cannot assume—absent some proof of the point—that corporate directors are, as a general matter, persons of unusual social bravery, who operate heedless to the inhibitions that social norms generate for ordinary folk.<sup>125</sup>

*Oracle* involved a special committee which sought to terminate a lawsuit in circumstances in which demand was, or would be, excused because of doubt successfully cast on director independence. In such cases, the burden is on the special committee to show its independence. The language of *Oracle* suggests that the burden may be difficult to meet as to people who, notwithstanding their lack of canonical familial or professional ties, nevertheless have the sorts of ties Strine’s

<sup>124</sup> *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, 948 (Del. Ch. 2003).

<sup>125</sup> *Id.* at 938.

opinion envisions, although subsequent opinions have sometimes nevertheless characterized as independent SLC member-directors who might seem to have problematic ties with the defendants. Indeed, in *Diep v. Trimaran*:

[A]ll three members of the SLC were invited to join the board *by the defendants* with the knowledge they would likely play key roles in passing judgment on the defendants' conduct, and neither the majority, nor the dissent, took issue with that fact. This has come up before . . . [in both] the *Flood v. Synutra*, and the *WeWork* [cases]. . . new board members were recruited in contemplation of blessing tainted transactions, *by the conflicted persons themselves*, and yet no one cast doubt on their impartiality.<sup>126</sup>

The burden to cast doubt on independence in a typical derivative case not involving an SLC, where there was simply an allegation that demand was futile, is on the plaintiffs. Traditionally, this burden has been hard for plaintiffs to meet.<sup>127</sup> Nevertheless, in a series of recent derivative cases not involving an SLC, including *Sandys v. Pincus*,<sup>128</sup> *Delaware County Employees Retirement Fund v. Sanchez*,<sup>129</sup> and

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<sup>126</sup> Ann Lipton, *They Had One Job*, L. PROFESSOR BLOGS NETWORK (July 2, 2022), [https://lawprofessors.typepad.com/business\\_law/2022/07/they-had-one-job.html](https://lawprofessors.typepad.com/business_law/2022/07/they-had-one-job.html) (on file with the Columbia Business Law Review) (quoted with permission). The case is *Diep v. Trimaran*, 280 A.3d 133, 146–147 (Del. 2022) (finding independent directors who were selected by, and had ties with, one of the defendants).

<sup>127</sup> One notable case is *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 833 A. 2d 961 (Del. Ch. 2003) (finding directors who were close personal friends of Martha Stewart, a board member and 94% shareholder, were independent, and contrasting the inquiry applicable for derivative suits to that in *Oracle*, a case involving a special litigation committee (SLC), discussed in note 103 and accompanying text, noting that far more scrutiny was appropriate in a case involving an SLC), *aff'd*, 845 A.2d 1040 (Del. 2004); *see also* Yaron Nili, *The Fallacy of Director Independence*, 2020 WIS. L. REV. 491, 500–01 [hereinafter *Fallacy of Director Independence*].

<sup>128</sup> 152 A.3d 124 (Del. 2016).

<sup>129</sup> 124 A.3d 1017 (Del. 2015).

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*Marchand v. Barnhill*,<sup>130</sup> then-Chief Justice Strine reversed Chancery Court rulings as to particular directors' independence by taking a more searching look at personal, financial, and professional relationships beyond the canonical ones. Strine found in *Sanchez* that plaintiffs had met their pleading burden when they "pled that the director had a fifty-year friendship with the [chairman of the board, and owner of the company involved in the challenged transaction, and that] the director's primary employment (and that of his brother) was as an executive of a company over which the interested party had substantial influence."<sup>131</sup> In *Sandys*, among the relationships that led to the finding that plaintiffs had met their pleading burden as to a director's lack of independence was that "the controlling stockholder and the director and her husband co-own an unusual asset, an airplane, which is suggestive of an extremely intimate personal friendship between their families."<sup>132</sup> In *Marchand*, the director was a recently-retired employee of the parent company who "owed his entire career" to the current CEO (Kruse)'s father; the Kruse family had led "a campaign that raised over \$450,000 to name a building at the local university after [the director]."<sup>133</sup>

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<sup>130</sup> 212 A.3d 805 (Del. 2019).

<sup>131</sup> *Sandys*, 152 A.3d at 138 (Valihura, J., dissenting). *See also id.* at 126 ("[T]he plaintiff pled a powerful and unusual fact about one director's relationship to Zynga's former CEO and controlling stockholder which creates a reasonable doubt that she can impartially consider a demand adverse to his interests. That fact is that the controlling stockholder and the director and her husband co-own an unusual asset, an airplane, which is suggestive of an extremely intimate personal friendship between their families. Second, the plaintiff pled that two other 2 directors are partners at a prominent venture capital firm and that they and their firm not only control 9.2% of Zynga's equity as a result of being early-stage investors, but have other interlocking relationships with the controller and another selling stockholder outside of Zynga."). Interestingly, the board had determined that the two directors in question were not independent under NASDAQ rules.

<sup>132</sup> *Id.* at 126.

<sup>133</sup> *Marchand*, 212 A.3d at 808.



In many contexts, notably whether demand is excused, as discussed above, the starting presumption is director independence, and plaintiffs have the burden of casting reasonable doubt on the validity of that presumption. Where there has been a special litigation committee to consider whether a case should go forward even though demand is excused, the burden is on the committee to show independence, as well as that the committee proceeded with a sound basis and in good faith. There is ample room for a court to consider whether the committee proceeded ‘independently’—not controlled, dominated, or supine.

Transactions that might be subject to entire fairness review provide another important example. In those circumstances, special committees are scrutinized, as are their workings: in such cases, courts consider not only whether the directors are independent, but also whether their conduct vis-à-vis the matter at issue reflects independence. “Even ‘an independent, disinterested director can be dominated in his decision-making by a controlling stockholder,’ resulting in directors who are ‘more independent in appearance than in substance.’”<sup>134</sup> There is a significant line of cases making this point, including several articulating the importance that boards not be “supine.”<sup>135</sup> Importantly for our purposes, while the focus is on the directors’ behavior in not acting independently rather than the ties that might have led to that result, the overarching context is a failure to be independent in the face of managerial or controlling shareholder self-interest. In some of these cases, notably *CBS*,

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<sup>134</sup> *In re Viacom Inc. S’holders Litig.*, No. 2019-0948-JRS, 2020 Del. Ch. LEXIS 373, at \*61 (Del.

Ch. Dec. 29, 2020) (a case brought by the Viacom shareholders in the CBS/Viacom merger) (quoting

*In re EZcorp.* C.A. No. 9962-VCL, 2016 Del. Ch. LEXIS 14, at \*21 (Del. Ch. Jan. 25, 2016)).

<sup>135</sup> *City of Warren Gen. Emp.’ Ret. Sys. v. Roche*, No. 2019-0740-PAF, 2020 WL 7023896, at \*15 (Del. Ch. Nov. 30, 2020); *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1280 (Del. 1989); *In re Mindbody Inc. S’holders Litig.*, No. 2019-0442-KSJM, 2020 WL 5870084, at \*13 (Del. Ch. Oct. 2, 2020).

director liability is at issue; in others, directors' conduct in not acting independently yields scrutiny for the transaction and perhaps liability for the person or people deemed responsible for the influence that the director did not sufficiently ward off.

Interestingly, in several recent cases, including *Southern Peru* and *CBS*, courts have offered significant criticism of independent director conduct, on grounds that the directors did not act nearly as independently as the court thought truly independent directors should have. The directors at issue in *Southern Peru* were all ultimately characterized as independent, and that status was not disputed. But in both cases, the directors were supposed to represent the corporation's interest in a conflict transaction; in one case, the transaction was found to be unfair to the corporation,<sup>136</sup> and in the other, there were allegations to that effect that survived a motion to dismiss.<sup>137</sup> So, why didn't the directors act more independently? Despite having directors that were independent, competent, well qualified individuals given the resources to hire outside advisors, they "fell victim to a controlled mindset"<sup>138</sup> and "did not insist on the right to look at alternatives[.]"<sup>139</sup> Another case, *Hsu*, critiqued "more subtle influences, such as a network of relationships with the controller which, in the aggregate, raises doubts."<sup>140</sup> An early case along the same lines is *Kahn v. Tremont*, decided well before transactions otherwise subject to entire fairness could get business judgment deference using the *MFV* factors. The issue in that case was whether the burden of showing entire fairness had shifted. Reversing the Chancery Court, the

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<sup>136</sup> *In re S. Peru Copper Corp. S'holder Derivative Litig.*, 52 A.3d 761, 813 (Del. Ch. 2011).

<sup>137</sup> *In re CBS Corp. S'holder Class Action & Derivative Litig.*, No. CV 2020-01111-JRS, 2021 WL 268779, at \*49 (Del. Ch. Jan. 27, 2021).

<sup>138</sup> *Franchi v. Firestone*, C.A. No. 2020-0503-KSJM, 2021 WL 5991886, at \*6 (Del. Ch. May 10, 2021).

<sup>139</sup> *In re S. Peru Copper Corp. S'holder Derivative Litig.*, 52 A.3d 761 at 798.

<sup>140</sup> *Frederick Hsu Living Trust v. Oak Hill Cap. Partners III, L.P.*, No. 12108-VCL, 2020 Del. Ch. LEXIS 173, at \*100 (Del. Ch. May 4, 2020).

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Delaware Supreme Court held that: “[t]he record amply demonstrates that neither Stafford nor Boushka possessed the ‘care, attention and sense of responsibility’ necessary to afford them the status of independent directors.”<sup>141</sup>

Notably, most entire fairness cases do talk about ties that might compromise decision-making even if the ties do not preclude “independent” status. But some cases, including *CBS*, present a situation where directors might lack any sort of problematic tie and yet act deferentially.

#### F. The Caremark Doctrine

One last set of cases that should be noted is *Caremark* cases. The *Caremark* doctrine<sup>142</sup> has been, until quite recently, “possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment.”<sup>143</sup> It has nevertheless been enormously influential. This influence has extended far beyond the original and paradigmatic *Caremark* facts, which involve a corporation’s violation of a law or regulation. *Caremark* imposes liability when “directors completely fail to implement any reporting or information system or controls, or, having implemented such a system or controls, consciously fail to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention.”<sup>144</sup> In a string of recent cases, courts have found *Caremark* types of violations—implicating the board’s failure to place sufficient monitoring and control system or following up on red flags these systems

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<sup>141</sup> See *Kahn v. Tremont, Corp.* 694 A.2d 422, 430 (Del. 1997) (“Although the three men were deemed ‘independent’ for purposes of this transaction, all had significant prior business relationships with Simmons or Simmons’ controlled companies.”).

<sup>142</sup> *In re Caremark Int’l Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996).

<sup>143</sup> *Id.* at 967.

<sup>144</sup> *Marchand v. Barnhill*, 212 A.3d 805, 821 (Dec. 2019) (quoting *Stone v. Ritter*, 911 A.2d 362, 370–72 (Del. 2006)) (brackets omitted).

have brought up.<sup>145</sup> Indeed, as we noted earlier, the Federal Reserve placed direct blame on Wells Fargo's lead independent director after the bank's false accounts scandal, stating that he did not lead the independent directors in pressing firm management for more information and action, even after being aware of the seriousness of the problems.<sup>146</sup>

Generally, *Caremark* cases are not state-law independence cases. There are occasional cases in which a board member's relationship with an officer who was involved in the wrongdoing might be at issue, but generally, the state law analysis is as to whether the directors are "interested" on account of their own potential liability. Still, the cases importantly concern independence: why wasn't the director more vigilant? Why did the board 'go along'?

### III. HOW WELL DOES "INDEPENDENCE" WORK?

#### A. Director Independence and (Im)measurable Impact on Firm Performance

The push for board independence reflects an assessment by investors, courts, and regulators that director

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<sup>145</sup> See, e.g., *id.*; *In re Clovis Oncology, Inc. Derivative Litig.*, 2019 Del. Ch. LEXIS 1293, at \*3 (Del. Ch. Oct. 1, 2019); *Hughes v. Xiaoming Hu*, No. 2019-0112-JTL, 2020 Del. Ch. LEXIS 162, at \*38 (Del. Ch. Apr. 27, 2020); *Teamsters Local 443 Health Servs. & Ins. Plan v. Chou*, No. 2019-0816-SG, 2020 Del. Ch. LEXIS 274, at \*1–2 (Del. Ch. Aug. 24, 2020); *In re Boeing Co. Derivative Litig.*, No. 2019-0907-MTZ, 2021 Del. Ch. Lexis 197, at \*66–67 (Del. Ch. Sep. 7, 2021). For a full review, see, e.g., Edward B. Micheletti, *The Risk of Overlooking Oversight: Recent Caremark Decisions From the Court of Chancery Indicate Closer Judicial Scrutiny and Potential Increased Traction for Oversight Claims*, INSIGHTS: THE DELAWARE EDITION (Dec. 15, 2021), <https://www.skadden.com/insights/publications/2021/12/insights-the-delaware-edition/the-risk-of-overlooking-oversight> [<https://perma.cc/NG97-57DH>].

<sup>146</sup> Letter to Stephen Sanger from Michael S. Gibson, Director, Bd. Of Governors of the Fed. Rsrv., regarding *Accountability as Lead Independent Director of Wells Fargo & Company Board of Directors* (Feb. 2, 2018), <https://www.federalreserve.gov/newsevents/pressreleases/files/enf20180202a3.pdf> [<https://perma.cc/969B-TMQS>].

independence is good for corporations. But quantifying the benefit (if any) that independent directors provide to corporations has remained a challenge for many reasons, an important one being that any attempt to do so assumes a clear definition of independence.

Corporate finance literature has tried to measure the impact of independent boards on firm performance. Are companies with independent boards more profitable? If so, is the result attributable to their board composition? Not surprisingly, measuring the impact of independent boards on firm performance is very difficult. First, one must assume that the appropriate definition of director independence is the designation given by companies based on the stock exchange rules, an assumption open to serious question.<sup>147</sup> Second, and equally importantly, one must tie the presence of independent directors to firm performance, correcting for the myriad of other possible influences, while also demonstrating a causal link.

It is therefore not surprising that the conventional wisdom favoring highly independent boards as directly impacting corporate performance (defined as share price) lacks a solid empirical foundation.<sup>148</sup> Indeed, thirty years of research have failed to produce a convincing link between independent boards and financial performance,<sup>149</sup> or, for that matter, show that supermajority independent boards necessarily outperform simple majority independent boards.<sup>150</sup> Moreover,

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<sup>147</sup> *Out of Sight*, *supra* note 15, at 39.

<sup>148</sup> See Rodrigues, *supra* note 120, at 450.

<sup>149</sup> See Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U.L. REV. 898, 902 (1995–96) (describing the few studies of board composition and firm performance).

<sup>150</sup> Shams Pathan & Robert Faff, *Does Board Structure in Banks Really Affect Their Performance?*, 37 J. BANKING & FIN. 1573, 1575–76, 1581 (2013); David Finegold, George S. Benson & David Hecht, *Corporate Boards and Company Performance: Review of Research in Light of Recent Reforms*, 15 CORP. GOVERNANCE INT'L REV. 865, 867 (2007) (overview of empirical studies that show no consistent positive correlation between percentage of board

there is evidence that having a majority of independent directors on a board of directors does not result in more effective monitoring.<sup>151</sup> While a few studies have found a positive correlation, noting that director independence is linked to better financial performance or outcomes for shareholders when compared to companies with less director independence,<sup>152</sup> other studies have found the opposite: director independence is negatively correlated with a company's financial success.<sup>153</sup> This negative correlation might reflect that a firm with more independent directors necessarily has fewer insider directors, and that insiders are best at other board functions, advising, providing institutional memory, and networking, such that what the firm gains in monitoring it more than loses in the value of the advice it now does not get.<sup>154</sup> Relatedly, perhaps the firm gains in some

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independence & firm performance); Bhagat & Black, *supra* note 50, at 235 (“Furthermore, even if firms perform better on some tasks when they have a majority of independent directors, it is not clear that having a supermajority (substantially more than 50%) of independent directors will further improve board performance.”).

<sup>151</sup> S. Burcu Avcı, Cindy A. Schipani & H. Nejat Seyhun, *The Elusive Monitoring Function of Independent Directors*, 21 UNIV. PA. J. BUS. L. 235, 237 (2018).

<sup>152</sup> James F. Cotter, Anil Shivdasani & Marc Zenner, *Do Independent Directors Enhance Target Shareholder Wealth During Tender Offers?*, 43 J. FIN. ECON. 195 (1997); Jay Dahya, Orlin Dimitrov & John J. McConnell, *Dominant Shareholders, Corporate Boards, and Corporate Value: A Cross-Country Analysis*, 87 J. FIN. ECON. 73 (2008); Ira M. Millstein & Paul W. MacAvoy, *The Active Board of Directors and Performance of the Large Publicly Traded Corporation*, 98 COLUM. L. REV. 1283 (1998); Bang Dang Nguyen & Kasper Meisner Nielsen, *The Value of Independent Directors: Evidence from Sudden Deaths*, 98 J. FIN. ECON. 550 (2010).

<sup>153</sup> Olubunmi Faleye, *The Costs of a (Nearly) Fully Independent Board*, 32 J. EMPIRICAL FIN. 49 (2015); David Yermack, *Higher Market Valuation of Companies with a Small Board of Directors*, 40 J. FIN. ECON. 185 (1996); Ronald W. Masulis & Emma Jincheng Zhang, *How Valuable Are Independent Directors? Evidence from External Distractions*, 132 J. FIN. ECON. 226, 249–50 (2019).

<sup>154</sup> Olubunmi Faleye, Rani Hoitash & Udi Hoitash, *The Costs of Intense Firm Monitoring*, 101 J. FIN. ECON. 160, 162 (2011); *see also In re Toys “R” Us, Inc. S’holder Litig.*, 877 A.2d 975, 1004 n.42 (Del. Ch. 2005).

monitoring spheres, but the effect on others is neutral or negative.<sup>155</sup> Ultimately, a large number of studies have found that the presence of independent directors has had no measurable impact on the financial performance of the company.<sup>156</sup>

The absence of a positive empirical link does not necessarily mean that independent directors' effect on corporate performance is not good. There are many reasons why measuring the financial value of director independence might be difficult. First, it is likely that the definition of independence, as currently used, is not truly capturing independence, perhaps because of ties "too subtle to be captured in [the] 'customary definitions.'"<sup>157</sup> Second, other factors such as a director's age, how long they have served on the board, whether the board as a whole has served together

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<sup>155</sup> See, e.g., Volker Laux, *Board Independence and CEO Turnover*, 46 J. ACCT. RSCH. 137 (2007) (Arguing that "shareholders are better off if the board of directors lacks some independence." A low-quality CEO may be more readily terminated but is better able to use his private information for his own benefit before he is removed. "The model predicts that a trend toward greater board independence is associated with subsequent trends toward higher CEO turnover, more generous severance packages, and larger stock option grants.").

<sup>156</sup> Bernard S. Black & Sanjai Bhagat, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921, 923 (1999); Bhagat & Black, *supra* note 50; Eric M. Fogel & Andrew M. Geier, *Strangers in the House: Rethinking Sarbanes-Oxley and the Independent Board of Directors*, 32 DEL. J. CORP. L. 33 (2007); Dan R. Dalton, Catherine M. Daily, Alan E. Ellstrand & Jonathan L. Johnson, *Meta-Analytic Reviews of Board Composition, Leadership Structure, and Financial Performance*, 19 STRATEGIC MGMT. J. 269 (March 1998); Renée B. Adams, *Boards, and the Directors Who Sit on Them*, in THE HANDBOOK OF THE ECONOMICS OF CORPORATE GOVERNANCE. 291 (Benjamin Hermalin & Michael Wiesbach eds. 2017); Urska Velikonja, *The Political Economy of Board Independence*, 92 N.C.L. REV. 855, 859 (2014); see Lisa M. Fairfax, *The Uneasy Case for the Inside Director*, 96 IOWA L. REV. 127, 175 (2010); Olubunmi Faleye, *The Downside to Full Board Independence*, 58 MIT SLOAN MGMT. REV. 87 (2017).

<sup>157</sup> Bhagat & Black, *supra* note 50, at 266; Theo Francis & Joann S. Lublin, *Boards Get More Independent, but Ties Endure*, WALL ST. J. (Jan. 19, 2016), <https://www.wsj.com/articles/boards-get-more-independent-but-ties-endure-1453234607> [<https://perma.cc/93PX-EDY6>].

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for a long time, their service on other boards, and their knowledge about the company or the industry are all important factors that arguably compromise independence. Third, boards are not made equal, and the homogeneity of the board reflects on a number of dimensions; their interaction and group behavior may all have an impact on what is essentially a group dynamic—not an individually measured outcome.<sup>158</sup> Fourth, boards are only one dimension in the corporate decision-making process. There may be important differences in the management of each corporation. Perhaps a dominant CEO is less willing to listen to an independent board and, indeed, works to fill the board with directors who are definitionally independent, but not independent in spirit. Perhaps the CEO and the management team take a larger than appropriate share of the decision making. In all, the elusiveness of what makes directors independent, as well as the fact that boards are dynamic bodies working within even more dynamic organizational structure, all but prevent empirical inference regarding their value on corporate bottom line.

## B. Other Ways of Measuring Director Independence

New, and arguably better, ways of measuring independence are increasingly being used. A new line of recent research, focusing on the relative power of independent directors and utilizing proxies for financial performance, has led to more tangible results. Power for this purpose means “social power,” measured so as to take into account greater access to information and greater social influence. Recent research has found a correlation between “powerful” independent directors and higher shareholder valuations.<sup>159</sup> Powerful independent directors were seen as beneficial to a corporation by preventing value-decreasing M&A, keeping

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<sup>158</sup> Bhagat & Black, *supra* note 50, at 266–67.

<sup>159</sup> Kathy Fogel, Liping Ma & Randall Morck, *Powerful Independent Directors*, 50 FIN. MGMT. 935, 936 (2021) (surveying data between 1998 through 2009).



errant CEOs in check by using performance-based incentive compensation to motivate CEOs and replacing underperforming CEOs, and more efficiently controlling stable earnings generation and cash flow usage.<sup>160</sup> This finding is consistent with data from other studies which have found a direct correlation between independent directors' sudden deaths and drops in share price, indicating that shareholders value powerful or highly-visible independent directors.<sup>161</sup> Similarly, firms whose boards are formally and socially independent award a significantly lower level of compensation, exhibit stronger pay-performance sensitivity, and exhibit stronger turnover-performance sensitivity than firms whose boards are only conventionally independent.<sup>162</sup>

Thus, metrics other than share price may be useful to measure the effect of independent directors. These studies measure structural governance mechanisms that should ideally translate to better long-term performance. Getting rid of a CEO who doesn't perform well and paying a CEO who performs better, where performance is measured by profitability, should translate into profitability. That directors are doing these things is evidence that they are value-adding.

More importantly the "how well does independence work" question has thus far been approached as though the ultimate gauge was a company's stock price. But director independence has been more consistently shown to be of measurable value when examining more direct aspects of corporate governance. For instance, some studies have examined the relationship between director independence and corporate misconduct.<sup>163</sup> They support the claim that director independence helps deter

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<sup>160</sup> *Id.*

<sup>161</sup> See Bang Dang Nguyen & Kasper Meisner Nielsen, *The Value of Independent Directors: Evidence from Sudden Deaths*, 98 J. FIN. ECON. 550, 550–51 (2010).

<sup>162</sup> See generally Byoung-Hyoun Hwang & Seoyoung Kim, *It Pays to Have Friends*, 93 J. FIN. ECON. 138 (2009).

<sup>163</sup> See generally Francois Neville, Kris Byron, Corinne Post & Andrew Ward, *Board Independence and Corporate Misconduct: A Cross-National Meta-Analysis*, 45 J. MGMT. 2538 (2019).

and limit corporate misconduct.<sup>164</sup> Limiting corporate misconduct protects corporate reputation, increases employee retention, and helps prevent shareholder losses.<sup>165</sup> In a similar vein to corporate misconduct, studies have analyzed whether director independence has any correlation to incidences of corporate fraud, and have found a relationship between board composition and incidences of fraud. These studies provide evidence that greater board independence is linked to fewer incidents of fraud.<sup>166</sup> Other studies have found that the monitoring function of independent directors decreases firm risk, with more conservative operating decisions being made when independent directors are present on the board.<sup>167</sup> Recent studies have also found connections between director independence and willingness to adopt corporate social responsibility (“CSR”) initiatives.<sup>168</sup> Some evidence suggests that independent directors act more to further the discretionary aspects of CSR initiatives than do non-independent directors.<sup>169</sup> This data comes on the heels of increasing calls for greater social responsibility from corporations, as evidenced by a recent pledge by top CEOs to work to redefine the purpose of a corporation.<sup>170</sup>

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<sup>164</sup> See *id.* at 2559.

<sup>165</sup> See *id.* at 2554.

<sup>166</sup> See generally Hatice Uzun, Samuel H. Szewczyk & Raj Varma, *Board Composition and Corporate Fraud*, 60 FIN. ANALYSTS J. 33 (2004).

<sup>167</sup> Yang Ni & Lynnette Purda, *Does Monitoring by Independent Directors Reduce Firm Risk?* 2 (Mar. 25, 2012) (unpublished manuscript) (available at SSRN: <https://ssrn.com/abstract=1986289>).

<sup>168</sup> Maretno A. Harjoto & Hoje Jo, *Corporate Governance and CSR Nexus*, 100 J. BUS. ETHICS 45, 50–52 (2011).

<sup>169</sup> See Nabil A. Ibrahim, Donald P. Howard & John P. Angelidis, *Board Members in the Service Industry: An Empirical Examination of the Relationship between Corporate Social Responsibility Orientation and Directorial Type*, 47 J. BUS. ETHICS 393, 397 (2003).

<sup>170</sup> Business Roundtable, *Statement on the Purpose of the Corporation*, (Aug. 19, 2019), <https://s3.amazonaws.com/brt.org/BRT-StatementonthePurposeofaCorporationOctober2020.pdf> [<https://perma.cc/AXM4-2SBD>].

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The evidence that independent directors are associated with firm profitability is thus mixed. Moreover, and as we will discuss in the next Part, some things we want firms to do may not always be associated with profitability, such as obeying the law, and perhaps taking interests of third-party stakeholders into account. Profitability and obeying the law are important aims; whether third party stakeholder interests, beyond what contributes to profitability, also is an aim is hotly debated.

#### IV. A NEW CONCEPTION OF INDEPENDENCE

The mixed evidence regarding the measurement of director independence and corporate performance suggests a deeper question. How should independence of directors benefit a company? We argue that the answer is not, and should not be, that they merely monitor for classic managerial agency costs and therefore focus on curbing CEO opportunism, slack, and self-dealing. Beyond that, what else? Below, we discuss in detail the shortcomings of the present conception of independence, and then set forth a taxonomy of what is to be monitored for and what the obstacles are to monitoring.

##### A. The Shortcomings of the Old Conception

As we discussed, the push towards board independence, culminating in the fact that all public company boards are now majority-independent, reflected the increasing importance of the board's role as a monitor; big corporate scandals that revealed insufficient or defective monitoring of managerial self-interest or incompetence fueled the push.<sup>171</sup>

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<sup>171</sup> Penn Central is a seminal scandal in this history. Associated Press, *\$21-million Fraud at Penn is Charged to 3*, N.Y. TIMES (Jan. 5, 1972), <https://www.nytimes.com/1972/01/05/archives/21million-fraud-at-penn-central-is-charged-to-3-bevan-exfinance.html> [https://perma.cc/S72E-Q7ME]. On the monitoring model, see Principles of Corporate Governance: Analysis and Recommendations § 3.02 (Am. L. Inst. 1994). This is not to say monitoring, even by independent board members, has been thought to

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Insiders presumably could not monitor their own colleagues or superiors properly; thus, “outsiders” were necessary. At the same time, these outsiders needed to be independent from those they were supposed to be monitoring: the management.<sup>172</sup> Thus, director independence generally requires an absence of familial, financial, employment, and for some purposes, social, ties with a company (generally, its management). The definition focuses on the negative: absent ties, it is thought, there should be no obstacle to a director’s ability to monitor.

But a focus on lack of ties should not be, and is not, the right measure for director independence. Starting with the original motivation for independent directors, managerial agency costs, independence as currently construed falls short.

Ostensibly, and consistent with the objection to a dominance of inside directors that has led to the push for non-inside directors, independent directors are meant to curb managerial agency costs—managers helping themselves when they should be helping the corporation. But even as to the agency cost story, the lack of ties to management is a flawed proxy for the independence required for good monitoring. Ties to management are both under and overinclusive in capturing independence. Underinclusivity has been much discussed; one important illustration is structural bias. A director needn’t have any ties to management to see the world through a manager’s eyes or to benefit from the deference to management being reinforced as

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suffice. See Harvey J. Goldschmid, Commissioner, S.E.C., *A Lawyer’s Role in Corporate Governance: The Myth of Absolute Confidentiality and the Complexity of the Counseling Task* (Nov. 17, 2023), <https://www.sec.gov/news/speech/spch111703hjj.htm>

[<https://perma.cc/86TR-AGNZ>]. For the history, see generally Gordon, *supra* note 16; STEPHEN BAINBRIDGE, *ADVANCED CORPORATION LAW* 54–112 (2020).

<sup>172</sup> See Gordon, *supra* note 16, at 1468 (“The now-conventional understanding of boards of directors in the diffusely held firm is that they reduce the agency costs associated with the separation of ownership and control.”). But, as we discuss, independence can also or alternatively mean independence from the company and from its controlling shareholders. See *infra* Part III.

a precedent. Director tenure, compensation, and service on other boards have all been raised as obstacles to independence.<sup>173</sup> And there are other obstacles, often psychological, to an “independent” director fully engaging her critical faculties, such as a “controlled” mindset that can enable her to justify supporting a deeply problematic transaction.<sup>174</sup> Indeed, in some opinions, courts have discussed a motivation for the *Revlon* doctrine, providing for enhanced scrutiny where shareholders are about to lose the chance to realize on their investment or share in a control premium: the concern that a “supine board” might be “under the sway of an overweening CEO[.]”<sup>175</sup>

Overinclusivity, less discussed, is at issue where, for instance, a director’s innate ability and temperament (and sometimes an incentive, perhaps in the form of stock ownership) to call out managerial misconduct can overcome preexisting ties.<sup>176</sup> Charles Elson provides an excellent example. He was an independent director of Sunbeam, on the board because he’d been asked by his friend and corporate governance “role model,” the Sunbeam CEO, Al Dunlap. Nevertheless, Elson took an active role in the termination of Dunlap after Dunlap could not respond satisfactorily to some

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<sup>173</sup> *Out of Sight*, *supra* note 15, at 56.

<sup>174</sup> *In re S. Peru Copper Corp. S’holder Derivative Litig.*, 52 A.3d 761, 798 (Del. Ch. 2011); J. Travis Laster, *Cognitive Bias in Director Decision-Making*, 20 CORP. GOVERNANCE ADVISOR 1, 3 (Nov./Dec. 2012); *see also In re CBS Corp. S’holder Class & Deriv. Litig.*, C.A. No. 2020-0111-JRS, 2021 WL 268779, at \*40 (Del. Ch. Jan. 27, 2021).

<sup>175</sup> *See In re Toys “R” Us, Inc. S’holder Litig.*, 877 A.2d 975, 1002 (Del. Ch. 2005) (discussing *Revlon v. MacAndrews & Forbes Holdings*, 506 A.2d 173 (Del. 1986)).

<sup>176</sup> Note, however, that one of us has argued that directors’ share ownership can be problematic. *See Fallacy of Director Independence*, *supra* note 127, at 505. Certainly, insofar as managers may be gaming various measures of financial results to increase stock price, directors with significant stock price holdings may face competing incentives, including incentives to go along with the gaming, especially if their time horizons are short.

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troubling allegations.<sup>177</sup> Thus, even as to managerial agency costs, independence, defined as a lack of certain ties to management, has significant shortcomings. Our discussion of overinclusivity here is intended in significant part to show the disconnect between independence-as-ties, and what true independence could and should yield by way of monitoring.

Critically, the issues with the current construction of director independence aren't solved by trying to find directors who are ideally suited to ferret out managerial agency costs. Some of the most notable monitoring failures of contemporary boards don't reflect failure or unwillingness to monitor for such costs: quite the contrary. Classic managerial agency costs involve managers helping themselves at the expense of their corporations. Directors who are independent in the canonical sense of that term should not countenance such conduct—they should not put a manager's benefit ahead of the corporation's benefit. But the monitoring failures we are discussing relate to behavior that helps the managers, but also helps the corporation. They reflect a willingness to accept managerial attempts to maximize shareholder returns, perhaps accomplished by pushing the envelope as to legal or financial risk-taking, or at least vigorous pursuit of objectives without properly considering the possible downsides. An excellent example is the Boeing board's conduct in going forward with the MAX airplanes, which led to significant loss of life when two such planes crashed. The Boeing example is discussed in Section IV.B below.

The focus on agency cost misses the fact that sometimes, perhaps often, managers are not trying to benefit themselves at the company's expense. Rather, they are trying to benefit the company: to get a competitive advantage, figure out a cheaper way to deal with regulations, cut corners, motivate revenue growth, etc. If the law and markets were perfect, the net expected cost of this conduct would be fully reflected in the

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<sup>177</sup> Robert Trigaux, *Innocence Lost with Chainsaw Al's Fall*, TAMPA BAY TIMES (Sept. 15, 2005), <https://www.tampabay.com/archive/1998/06/21/innocence-lost-with-chainsaw-al-s-fall/> [https://perma.cc/Y59G-CV8L].

company's stock price. But law and markets are not perfect—much arguably illegal behavior in which corporations might be tempted to engage would probably have an expected benefit to the corporation. The same could be said of a business strategy or practice that is in a grey area. For instance, a computation of expected value for envelope-pushing sales practices might yield a positive number, failing to fully capture the potential costs to the corporation or to society at large.

Thus, a manager might reasonably believe *ex ante* that she was acting as a good agent from an economic perspective in allowing or even encouraging such practices.<sup>178</sup> But the computation might not sufficiently take into account the potential downsides, rendering the decision undesirable even from the perspective of shareholder profit maximization. And equally important, from a broader societal and legal perspective, managers should abide by their legal duties, and under the law, they are bad agents if they do not do so. There is little reason to think that the absence of ties would correlate with vigilance in the type of monitoring required in these cases. Indeed, some of the most notable decriers of managerial agency costs, hedge funds, might be even more apt to be aggressive about law-skirting than the managers are, given their emphasis on demonstrable financial results.<sup>179</sup>

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<sup>178</sup> That monitoring for *Caremark* compliance is different from other director monitoring, including in not being squarely about managerial agency costs, has been discussed in the literature. See, e.g., Elizabeth Pollman, *Corporate Oversight and Disobedience*, 72 VAND. L. REV. 2013, 2015 (2019); Elizabeth Pollman, *Corporate Disobedience*, 68 DUKE L.J. 709, 716 (2019); John Armour, Jeffrey N. Gordon & Geeyoung Min, *Taking Compliance Seriously*, 37 YALE J. REGUL. 1, 7 (2020) [hereinafter *Taking Compliance Seriously*]; John Armour, Brandon Garrett, Jeffrey Gordon & Geeyoung Min, *Board Compliance*, 104 MINN. L. REV. 1191, 1196 (2020) [hereinafter *Board Compliance*].

<sup>179</sup> See generally Claire Hill & Alessio M. Paces, *The Neglected Role of Justification under Uncertainty in Corporate Governance and Finance*, 3 ANNALS CORP. GOVERNANCE 1 (2018) (discussing emphasis on demonstrable results). The demonstration is looked for in the short term; the results are in part achieved by cost-cutting, and compliance costs are an obvious target.

Those touting their ability to curtail managerial agency costs and bring increased discipline and critical perspective to managerial decision-making probably do improve monitoring on that front. But they might not seek to: curtail managerial tendencies to bolster the bottom line through aggressive cost-cutting or creative accounting practices; curtail collusive behavior;<sup>180</sup> prevent externalizing risk on markets or consumers; or energetically seek to ferret out questionable behavior or even illegality to that end, making the promotion of director independence after, and as a response to, *Caremark*-type crises somewhat ironic. Another arguable irony is that one uncontroversial focus of monitoring is for illegality, but many sorts of illegality are intended to serve corporate ends, and are hence not, as an economic matter, agency costs. For example, some argue that hedge fund appointed directors may focus on minimizing managerial slack, but encourage practices that tend to bolster short-term profits.<sup>181</sup>

Before continuing, we should clarify a terminological point. As is common in the literature, we have framed the aim of independence as relating to monitoring; our discussion has hence been of how to make directors be better monitors. Scholars typically distinguish between a board's monitoring function and its advising function. In contrast to monitoring, advising is more conceptual and forward-looking.<sup>182</sup> On this

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<sup>180</sup> See Yaron Nili, *Horizontal Directors*, 114 NW. U. L. REV. 1179 (2020).

<sup>181</sup> *Captured Boards*, *supra* note 30, at 49.

<sup>182</sup> "The monitoring function requires the board to play a 'watchdog' role in order to align the incentives of the management with the interests of the shareholders. In the advisory function, however, the board takes a more hands-off approach regarding monitoring and uses the expertise of its members to counsel management in establishing corporate strategies and policies." Dong Chen, *The Monitoring and Advisory Functions of Corporate Boards: Theory and Evidence 1* (Aug. 1, 2008) (unpublished article), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1327066](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1327066). See also Olubunmi Faleye, Rani Hoitash, & Udi Hoitash, *The Costs of Intense Board Monitoring*, 101 J. FIN. ECON. 160 (2011); Kyonghee Kim, Elaine Mauldin & Sukesh Patro, *Outside Directors and Board Advising and Monitoring*



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account, monitoring requires independence—presumably, independence from management—and advising requires information, deep knowledge, and connections, and thus, some argue, is better done by insiders. On this view, monitoring is adversarial, but boards also need to be advisors, something which is cooperative rather than adversarial. Better monitoring thus risks worse advising. What companies gain in monitoring they (more than) lose in advising.

Notwithstanding our use of the term monitoring, we think the distinction is very much overstated. Advising may indeed benefit more from information than independence (although long-standing directors, and directors with certain sorts of expertise, may have considerable information, as some literature argues, and CEO dominance or something else may make independence quite valuable even as to the purest kinds of advising).<sup>183</sup> But the line between the two functions is often much blurrier than a binary categorization may indicate. Would deciding on a business strategy—for instance, as to acquisitions, product development, or marketing—be considered advising, while putting the strategy into practice would be an instance of monitoring? What about decisions regarding compliance and risk management? All of these functions would seem to involve both monitoring and advising.<sup>184</sup> We will continue to use the term monitoring, while noting that monitoring and advising are far more intertwined and complementary than the distinction as articulated in the literature.

Besides these descriptive and normative shortcomings of understanding and conceptualizing independence as a lack of

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*Performance*, 57 J. ACCT. ECON. 110, 110–11 (2014). Some literature argues that good monitors need to be independent, but that independent directors may make bad advisers, given that they probably know less about the company (e.g., Faleye et al). Other literature argues that director tenure and expertise may compensate for the informational deficit (e.g., Kim et al).

<sup>183</sup> See Kim et al., *supra* note 182, at 111.

<sup>184</sup> For instance, see board functions related to risk management and compliance. AMER. L. INST., PRINCIPLES OF THE LAW, COMPLIANCE AND ENFORCEMENT (2021).

a certain sort of tie, there are other costs. The emphasis on independence conceptualized in this manner is pernicious, underscoring a particular aspect of manager performance that directors need to be monitoring for, and a correlative emphasis on directors not being disabled from that task on account of their own self-interest. There is another cost to giving pride of place to managerial agency costs. Boards monitor, but they also advise, tasks that are importantly intertwined. Monitoring focused on managerial agency costs not only summons up an adversarial relationship between managers and the board, but it is also counterproductive to effective advising, as it contradicts—really, undermines—directors’ actual responsibilities, which often encompass both monitoring and advising functions.<sup>185</sup> A narrower conception of monitoring discourages an important economy of scope.<sup>186</sup> Rather than searching for managerial advantage-taking, directors could be asking a far broader question, relevant for monitoring and advising: ‘what might go wrong?’ Courts, too, could in appropriate cases consider, as a few have done, whether the process the directors followed suggested true independence of thought.<sup>187</sup>

## B. Towards a New Conception of Independence

Coexisting with the focus on independence-as-lack-of-ties is a common sense and colloquial formulation of independence as lack of passivity and deference. Indeed, passive, rubber-

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<sup>185</sup> Some have argued that monitoring need not create an adversarial relationship. See, e.g., Jay W. Lorsch, *Empowering the Board*, HARV. BUS. REV. 107, Jan.–Feb. 1995, <https://hbr.org/1995/01/empowering-the-board>.

<sup>186</sup> It would seem inefficient to, for instance, ask if the manager is ‘helping himself’ given his compensation formula when promoting a particular acquisition but, only separately, consider whether the manager’s perhaps-genuine belief is fueled by an over-eagerness to transform the company into a major player without sufficient regard to the cost and to other reasons not to move forward.

<sup>187</sup> Consider in this regard the second step of the *Zapata* analysis, where the court uses its “own independent business judgement.” See *Zapata Corp. v. Maldonado*, 430 A. 2d. 779, 789 (Del. 1981).

stamp boards have been decried by corporate governance experts precisely for their lack of independence.<sup>188</sup> It seems that boards earning this appellation used to be more common than they are now, but there continue to be examples of majority independent boards (and independent directors) that were, at least as to some important matters, passive or deferential, probably excessively so. Consider in this regard WeWork and Theranos, both companies whose boards' monitoring of "visionary" CEOs were, by all accounts, allowed far too much leeway. WeWork's valuation plummeted as it was about to go public, and the CEO was forced out. WeWork's aggressive growth strategy, developed and driven by the CEO, yielded enormous losses, and the CEO had allegedly been self-dealing.<sup>189</sup> Theranos was built on a fraud—a technology that did not work. The CEO and COO nevertheless presented the technology as being successful, to investors, customers, and regulators. Notably, the Theranos board included prominent business, government, and academic figures, including Henry Kissinger, top executives of the Center for Disease Control and Wells Fargo, two people who had served as U.S. Secretaries of Defense, and others.<sup>190</sup>

As we discussed, law has mostly used the independence-as-lack-of-ties concept, and understandably so. The concept is tractable, allowing independence to be assessed *ex ante*. The narrower sense of independence is more congenial to standard economic theory, in which misaligned incentives are accorded pride of place as reasons why people's performance falls short. The managers help themselves (to the firm's assets) because they can; those not tied to them won't allow that. Indeed, even where courts have criticized boards or special committees for not acting independently, focusing on the conduct rather than the lack of ties, what's at issue is still misaligned incentives—of the managers or controllers. And that the special committee

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<sup>188</sup> See Claire A. Hill & Brett McDonnell, *Disney, Good Faith, and Structural Bias*, 2007 J. CORP. L. 833, 846 (2007).

<sup>189</sup> See generally BROWN & FARRELL, *supra* note 26.

<sup>190</sup> See JOHN CARREYOU, *BAD BLOOD: SECRETS AND LIES IN A SILICON VALLEY STARTUP* 181 (2018).

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or its members display “inertia” or are “supine” generally reflects, in these accounts, that they are dominated, controlled, or manipulated by those with misaligned incentives. There is some intimation that they were chosen because it was known that they would be supine—knowledge which might have been developed through some sort of tie.

Whether a board is “too passive” (or too deferential) is far harder to assess, even *ex post*, as to a decision that was already made; and certainly, *ex ante*, as to decisions it faces in the future. Courts are plausible venues to make such assessments. But doing so is costly and risks interfering in business affairs and compromising valued predictability. The duty of care would seem to address the concerns at issue, on its face being incompatible with rubber stamping and too-ready deference. But for some time, it has been “toothless” as a source of monetary liability given the exculpation available to outside directors for breaches,<sup>191</sup> although, importantly, it does have some force as a standard of conduct.

We hope here to explain why an understanding of independence should, and can, take both independence-as-ties, and passivity and deference, into account. The recent Boeing case, in which shareholders sought to sue the Boeing board for its conduct with respect to the MAX aircraft sets the stage. Importantly, the Boeing case was not about director independence. The case concerned whether demand was excused such that a shareholder could bring a claim against the board for not abiding by their *Caremark* duties.<sup>192</sup> The analysis as to whether demand was excused concerned interest, not independence: the directors were interested given their own potential for liability and hence not able to make an unbiased opinion as to whether the suit should be brought. But the case very much implicates independence, or more precisely, lack of independence in the form of passivity or deference.

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<sup>191</sup> DEL. CODE ANN. tit. 8, § 102(b)(7).

<sup>192</sup> *In re* Boeing Co. Derivative Litig., No. CV 2019-0907-MTZ, 2021 WL 4059934 at \*2 (Del. Ch. Sept. 7, 2021).

It was management's idea to pursue the strategy that resulted in the defective MAX's production and sale; the board, notwithstanding its *Caremark* duties,<sup>193</sup> signed off on the strategy without paying appropriate attention to safety concerns. From the perspective of liability under corporate law, the directors were independent, and the decision allowing the plaintiff to move forward with the case did not suggest otherwise. Indeed, a portion of the case that was not allowed to go forward concerned whether the directors were sufficiently independent of the officers that they could make a decision on the merits as to whether the corporation should sue the officers. The court noted that the plaintiffs had not argued "that any of the Director Defendants are beholden to or dominated by the Boeing officers such that they would be unable to assess" a lawsuit against the officers.<sup>194</sup> But from the perspective of how a board should have monitored, this one does seem to have fallen short—and in being as lax as it was, characterizations such as "passive" and "deferential" seem apt. The opinion is replete with details about what the board was told about and considered, and what it did not consider.

An objection to our argument might be that our "reconception" is just an articulation of *Caremark* rather than an account of independence. It is true that the directors' *Caremark* liability, what made demand potentially excused, did not relate to their independence. Stated differently, the directors' *Caremark* liability related to their own potential liability for not monitoring sufficiently well, not their relationship to the officers or the corporation. But surely, a common-sense understanding of the term independence—and what a monitor should do—is not compatible with passivity and deference of the sort the "independent" directors displayed, going along as they did with concerns about market share notwithstanding obvious safety implications. True independence might have alerted them to precisely what

<sup>193</sup> *Id.* at \*28; see *supra* note 145 and accompanying text.

<sup>194</sup> *In re Boeing Co. Derivative Litig.*, No. CV 2019-0907-MTZ, 2021 WL 4059934 at \*36 (Del. Ch. Sept. 7, 2021).

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seems to have occurred: managers terrified (for themselves and for their company) of losing market share and not thinking beyond the next bonus, where the next bonus was enormously dependent on market share retention. Such managers, perhaps planning to leave the company in the near term, might, to the extent they considered safety, view it as more of a moderate-term concern—one that would arise when they were long gone. Or, whatever their time horizons were, they might have managed to tune out any concerns about safety.

Consider, too, examples involving “going along” that don’t involve *Caremark* claims, such as expensive acquisitions and, by some accounts, some of the business models hedge fund activists critique.<sup>195</sup> The claim in those cases is that directors are going along with something the managers have done (or not done) that does not serve the corporation’s best interests—whether or not the managers believe it does.

One objection to our view might be that all “independence” should be about is monitoring for managers’ attempts to help themselves at the corporation’s expense, but not all managerial missteps. It is certainly true that other characteristics besides independence are important for monitoring, particularly expertise. But, as the Boeing example suggests, the issues that have arisen don’t principally reflect a technical expert matter that went undetected because of lack of expertise. Many of the issues could in fact reflect managerial self-interest, at least in part—a desire to head an empire, for instance, motivating an assessment that a big acquisition is a good idea for the company. Most importantly, perhaps, it seems odd to separate monitoring for canonical managerial agency costs from other components of monitoring that would involve the same or related inquiries and information.

A final objection might be that what we’ve argued for is a better *Caremark* regime, plus more power for hedge fund activists who are in the business of not deferring to

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<sup>195</sup> See Fairfax, *supra* note 156.

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management. But hedge fund activists present their own issues including, arguably, a short-term orientation. Moreover, hedge fund activists' interests would seem antithetical to a more vigorous *Caremark* regime. The monitoring inquiry "how might managers be helping themselves" seems more efficiently done as part of a broader inquiry of "how might managers' decisions be flawed and not properly serve the company's interests?"

### C. How Managers' Decisions Can be Flawed

With this as backdrop, we turn now to a taxonomy of how managers' decisions can be flawed. We then turn to the obstacles to better monitoring by directors. We show how these can exist consistent with independence-as-ties but could be better taken into account and potentially surmounted under our reconception of independence. Classic theory frames governance problems as being about incentives; the solution is thus to align the incentives. Managers can "help themselves" (that is, take advantage); directors should be able to stop that unless they have fealty to the managers. Or maybe directors aren't sufficiently incentivized to be as diligent as they should be. Some commentators have argued that the solution might be to increase their potential for liability.<sup>196</sup> We express no view as to the desirability of increasing liability in this context. But we think that this formulation of the issue gives undue pride of place to "interest misalignment" as the source of what is to be monitored for, and "interest alignment" (or at least lack of misalignment) as the solution. Our proposed taxonomy captures what the real-world cases make clear—that other factors less readily amenable to classic incentive alignment may be at play.

We start by dividing the possible cases into three categories. The first is indeed classic managerial agency costs. The officer is helping herself at the expense of the company, and probably doing so consciously. Classic examples include

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<sup>196</sup> See, e.g., *Board Compliance*, *supra* note 178, at 1267; see also, e.g., *Taking Compliance Seriously*, *supra* note 178, at 2.

causing the corporation to hire unqualified relatives, or having the corporation buy overvalued assets from her affiliate or merge with her affiliate on terms more favorable to the affiliate.<sup>197</sup> This last example also relates to controlling shareholders' potential for advantage-taking at the expense of the minority shareholders, and in breach of their fiduciary duties.<sup>198</sup> Lavish and unwarranted perquisites may fall into this category as well. Consider in this regard what Dan Loeb of the Third Point hedge fund had to say about the perquisite package of Sotheby's then-CEO:

A review of the Company's proxy statement reveals a perquisite package that invokes the long-gone era of imperial EOs: a car allowance, coverage of tax

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<sup>197</sup> See, for example, this description of Al Dunlap's misdeeds as CEO of Sunbeam: "The S.E.C. said that Mr. Dunlap and Russell A. Kersh, then Sunbeam's chief financial officer and a longtime close associate of Mr. Dunlap, used numerous improper tactics to inflate earnings. Millions of dollars in expenses in 1997 were wrongly charged to 1996, when the company had taken the write-off for Mr. Dunlap's reorganization. The S.E.C. said the reorganization created what it called "cookie jar" reserves, which could be used to create fake profits in 1997. It also said that Sunbeam unreasonably reduced the value of its inventory so that it could record large profits when the goods were sold. In 1997, the S.E.C. said, Sunbeam recorded some sales that were not real, through a variety of methods, and recorded other sales that came from 'channel stuffing,' putting inventory onto the books of distributors and retailers. In one case, the S.E.C. said, electric blankets that had been packaged for a certain retailer were sent to a distributor who agreed, in return for a guaranteed profit, to hold the blankets until the retailer was ready to accept them. Other sales were made by offering deep discounts to persuade customers to buy merchandise that they would not need for many months. The S.E.C. said that the company should have disclosed those discounts and that the sales should have been recorded in later quarters." Floyd Norris, *S.E.C. Accuses Former Sunbeam Official of Fraud*, N.Y. TIMES (May 16, 2001), <https://www.nytimes.com/2001/05/16/business/sec-accuses-former-sunbeam-official-of-fraud.html> [<https://perma.cc/5ARY-6QNN>].

<sup>198</sup> This is not technically an agency cost since they are entitled to act for themselves. It is, however, a breach of fiduciary duty. See, e.g., *Brookfield Asset Mgmt., Inc. v. Rosson*, 261 A.3d 1251, 1274 (Del. 2021) ("Controlling stockholders owe fiduciary duties to the minority stockholders, but they also owe fiduciary duties to the corporation.").



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planning costs, and reimbursement for membership fees and dues to elite country clubs . . . . Typical of the egregious examples was a story we heard of a recent offsite meeting consisting of an extravagant lunch and dinner at a famous “farm-to-table” New York area restaurant where Sotheby’s senior management feasted on organic delicacies and imbibed vintage wines at a cost to shareholders of multiple hundreds of thousands of dollars. We acknowledge that Sotheby’s is a luxury brand, but there appears to be some confusion—this does not entitle senior management to live a life of luxury at the expense of shareholders.<sup>199</sup>

That this example involves a hedge fund is no accident: their brand importantly involves addressing classic managerial agency costs.<sup>200</sup>

Another current example which probably involves managerial agency costs, as well as misaligned incentives of directors, is SPAC transactions. Sponsors (managers, for this purpose) raise money to use for a subsequent investment within a particular period of time. The investors have a right to veto the acquisition and redeem their shares. If they do so, the managers lose. If they agree to the acquisition, the managers do well. Of course, the managers do best if the transaction is profitable, but they still prefer an unprofitable transaction to a shareholder redemption. The managers thus have an incentive to find some deal, any deal, within the time period, and depict it as favorably as they can. This is a straightforward conflict and—while it is possible that problematic SPAC transactions may sometimes fall within the next category, where the managers convince themselves that

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<sup>199</sup> Letter from Daniel S. Loeb, CEO, Third Point LLC, to William F. Ruprecht, Chairman, President and CEO, Sotheby’s (October 2, 2013) <https://www.sec.gov/Archives/edgar/data/823094/000119312513388165/d605390dex993.htm> [<https://perma.cc/PG3W-46UV>].

<sup>200</sup> See *Captured Boards*, *supra* note 30, at 26 (discussing different models of shareholder activism); see also Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 UNIV. PA. L. REV. 1021, 1024 (2007).

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a bad transaction is really a good one—cases that have arisen thus far, especially those with disclosure that depicts the planned acquisition more favorably than is arguably warranted, suggest a straightforward example of managerial agency costs.<sup>201</sup>

The second category is what we term the “mixed motive” category. This is a murkier and more capacious category, involving managerial conduct that the managers believe, in some sense of that term, benefits the firm. They believe it would benefit them as well, since their compensation and prestige would presumably reflect the success of their idea. The belief that the idea would benefit the firm could be completely genuine; it could be self-serving and a product of motivated reasoning, which is reasoning that helps the reasoner reach a pre-ordained and desired conclusion.<sup>202</sup> After the course is set, “escalation of commitment,” an intuitive and well-known psychological mechanism (colloquially, “throwing good money after bad”) can continue the trajectory, limiting or preventing course-corrections.<sup>203</sup> Boeing’s MAX disaster provides an example, as does HP’s acquisition of Autonomy, in which HP vastly overpaid—by \$8 billion—in a \$11 billion acquisition (which was generally thought by “the Street” to be

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<sup>201</sup> See generally Michael D. Klausner & Michael Ohlrogge, *SPAC Governance: In Need of Judicial Review* (N.Y.U. Sch. L., Working Paper No. 22-07, 2021).

<sup>202</sup> Early seminal work on motivated reasoning was done by Ziva Kunda. See, e.g., Ziva Kunda, *The Case for Motivated Reasoning*, 108 PSYCH. BULLETIN No. 3, 480, 480 (1990). Motivated reasoning is closely related to confirmation bias, which will also be relevant in our account. See generally Raymond S. Nickerson, *Confirmation Bias: A Ubiquitous Phenomenon in Many Guises*, 2 REV. GEN. PSYCH. 175, 175 (1998) (discussing confirmation bias).

<sup>203</sup> Important early articles on the subject of escalation of commitment include Joel Brockner, *The Escalation of Commitment to a Failing Course of Action: Toward Theoretical Progress*, 17 ACAD. MGMT. REV. 39, 40 (1992) and Max H. Bazerman, Toni Giuliano & Alan Appelman, *Escalation of Commitment in Individual and Group Decision Making*, 33 ORG. BEHAV. & HUM. PERFORMANCE 141, 141–42 (1984).

overpriced).<sup>204</sup> Part of the story there is apparently that the management persuaded themselves that their stodgy software business needed a racy software business run by a Cambridge PhD. To be fair, Autonomy does seem to have misrepresented its business significantly—but not, it seems, by enough to warrant what HP paid for it.<sup>205</sup> And it seems fair

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<sup>204</sup> James B. Stewart, *From H.P., a Blunder That Seems to Beat All*, N.Y. TIMES (Nov. 30, 2012), <https://www.nytimes.com/2012/12/01/business/hps-autonomy-blunder-might-be-one-for-the-record-books.html> [on file with the Columbia Business Law Review].

<sup>205</sup> How much misrepresentation there was remains a question. The settlement of the derivative suit against HP's board was approved in 2017. The settlement terms included corporate governance reforms; they do not include any payment on account of director or officer conduct or omissions. See *In re Hewlett-Packard Company S'holder Derivative Litig.*, 716 Fed. App'x 603, 605 (9th Cir. 2017) (affirming the settlement). A federal securities claim was settled as well, for \$100 million. See generally *In re HP Securities Litig.*, No. 3:12-cv-05980-CRB, 2015 WL 12990170, at \*2 (N.D. Cal. Nov. 16, 2015).

Another question is how much HP knew, or had some notice and awareness of, as to the fact that Autonomy was not worth nearly what they were paying, and that top executives at Autonomy might have been engaging in misrepresentation and fraud. Mike Lynch, Autonomy's co-founder and former CEO, currently faces seventeen charges over HP's acquisition of Autonomy. These include charges of securities fraud and wire fraud. *Michael Richard Lynch, Former CEO Of Autonomy Corporation, Makes Appearance In Federal Court To Face Conspiracy, Fraud Charges*, DEP'T OF JUST. (May 12, 2023), <https://www.justice.gov/usao-ndca/pr/michael-richard-lynch-former-ceo-autonomy-corporation-makes-appearance-federal-court> [<https://perma.cc/L46D-DQQS>].

The actions against Lynch follow a six-year civil fraud case in the UK by HP against Lynch and Sushuvan Hussain, Autonomy's former CFO, where the British judge found that Lynch and Hussain had dishonestly inflated revenues. Rob Davies, *Hewlett-Packard wins civil fraud case against Mike Lynch over Autonomy sale*, THE GUARDIAN (Jan. 28, 2022), <https://www.theguardian.com/business/2022/jan/28/hewlett-packard-wins-civil-case-against-mike-lynch-over-autonomy-sale> [<https://perma.cc/TMS2-3ASP>]; *Mike Lynch has lost Britain's biggest fraud case*, THE ECONOMIST (Feb. 5, 2022), <https://www.economist.com/britain/2022/02/05/mike-lynch-has-lost-britains-biggest-fraud-case> [on file with the Columbia Business Law Review].

to consider whether HP's eagerness to buy Autonomy limited a more critical inquiry in which red flags might have emerged. The picture that emerges is one in which some top managers were gung-ho on the acquisition, there were some red flags (including as to Autonomy's misrepresentations and possible fraud) and some dissent within the board and senior ranks, but HP went ahead.<sup>206</sup> More generally, and as is well recognized, managers can have quite uncritical perspectives as to what should and should not be done. The types of people who become top executives tend to have character traits consistent with considerable (and perhaps excessive) self-confidence,<sup>207</sup> and in many cases, dominance. There are of course ways for contrary voices to be heard: hedge fund activism, hostile takeovers, shareholder proposals, proxy fights, and other types of pressures. But these are dramatic, and it's not as though in prospect (or even in retrospect) the correct course of action is clear. Moreover, as the reports detailing compliance and other like failures tell us, a big cause is often a well-embedded corporate culture that, for instance, encourages the pursuit of profit at all costs (including by envelope-pushing) and discourages whistleblowing.<sup>208</sup> Problematic corporate cultures aren't just problematic with regard to compliance. The cultures are problematic for business results as well, when, for instance, short-term attempts to increase profits through cost-cutting lead to greater expenditures later on.

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<sup>206</sup> See generally Afra Afsharipour & J. Travis Laster, *Enhanced Scrutiny on the Buy-Side*, 53 GA. L. REV. 443, 449–50 (2018). As to the commonly-held view that HP was paying too much, see *id.* at 450 n.22. As to board dissent, see *id.* at 450 n.23. As to HP's view that it needed a software business, see *id.* at 450 n.24. On these points, see also the allegations made in the Consolidated Complaint for Violation of the Federal Securities Laws at 3–4, *In re HP Sec. Litig.*, 2015 WL 12990170 (N.D. Cal. 2013) (No. 3:12-cv-05980-CRB).

<sup>207</sup> Afsharipour & Laster, *supra* note 206, at 454–56.

<sup>208</sup> AMER. L. INST., PRINCIPLES OF THE LAW, COMPLIANCE, RISK MANAGEMENT AND ENFORCEMENT, §§ 4.01 Reporters' Note f, 4.06 Reporters' Notes e–f (A.L.I. 2022).

The third category, for failure of the imagination, is the inquiry “What might we be missing?” The first category was about how managers might consciously be helping themselves at the expense of their firms. The second was about how managers who believed they were helping their firms might have been incorrect in that belief. The third is about things that might be missed and could perhaps be sought more systematically. GM’s ignition switch issues<sup>209</sup> did not come to the attention of top management or the board in ways that indicated their importance.<sup>210</sup> Why not, and how do we understand what happened? Notwithstanding a culture in which many of the right things were said, there was a competing culture, in which profits and cost-cutting were given pride of place and “messengers” were, if not shot, certainly not rewarded.<sup>211</sup> And again, even though this example is about compliance, examples more in the business realm, such as buying into bubbles, could be given.<sup>212</sup>

Importantly, the current paradigm of director independence falls short in addressing each of these three categories. Below we highlight the reasons why mere lack of formal ties misses the mark.

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<sup>209</sup> Tanya Basu, *Timeline: A History of GM’s Ignition Switch Defect*, NPR (Mar. 31, 2014, 4:33 PM ET), <https://www.npr.org/2014/03/31/297158876/timeline-a-history-of-gms-ignition-switch-defect> [<https://perma.cc/2X3K-UGZM>].

<sup>210</sup> ANTON R. VALUKAS, JENNER & BLOCK, REPORT TO BOARD OF DIRECTORS OF GENERAL MOTORS COMPANY REGARDING IGNITION SWITCH RECALLS 4 (2014), <https://s3.documentcloud.org/documents/1183508/g-m-internal-investigation-report.pdf> [<https://perma.cc/JE5V-XMS6>] (“While the issue of the ignition switch passed through numerous hands at GM, from engineers to investigators to lawyers, nobody raised the problem to the highest levels of the company.”).

<sup>211</sup> *Id.* at 250 (“[A]n engineer stated that an emphasis on cost control at GM ‘permeates the fabric of the whole culture.’”).

<sup>212</sup> See generally James D. Gwartney & Joseph Connors, *The Crash of 2008: Causes and Lessons to Be Learned*, 72 SOC. EDUC. 63 (2009).

#### D. The Obstacles to Better Monitoring

Director deference is a key obstacle to effective monitoring. But why would purportedly independent board members be deferential? There are many reasons for deference. Some reflect a director's own agency costs: wanting to be picked for boards by getting a reputation for deference with managers generally; or relatedly, wanting to please the managers who put them on this board; or benefiting, in their own capacity as managers of other corporations, from a norm of board deference (something one of us has called the "pernicious golden rule").<sup>213</sup> Directors thus motivated have an ally in "motivated reasoning."<sup>214</sup>

Other reasons are more neutral: they might reflect "trust" or belief in management's superior information, or simply general passivity. In this regard, consider what Warren Buffet said in Berkshire Hathaway's 2002 Annual Report as to his behavior as a public company director: "Too often I was silent when management made proposals that I judged to be counter to the interests of shareholders. In those cases, collegiality trumped independence."<sup>215</sup> Consider too, in this regard, the passivity of the CBS special committee, charged with ensuring fairness to CBS and its minority shareholders as against controller and CEO Shari Redstone's attempts to merge CBS and Viacom.<sup>216</sup>

There are many other reasons why directors might defer or otherwise fail to be sufficiently independent. Directors have traditionally come from the same "community" as managers and might hence have similar perspectives. Initially independent directors may have drifted toward an insider's perspective on account of their long board service. There are

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<sup>213</sup> See Claire Hill & Brett McDonnell, *Executive Compensation and the Optimal Penumbra of Delaware Corporate Law*, 4 VA. L. & BUS. REV. 333, 335, 348, 371 (2009).

<sup>214</sup> Kunda, *supra* note 202, at 493.

<sup>215</sup> BERKSHIRE HATHAWAY INC., 2002 ANNUAL REPORT 17 (2002).

<sup>216</sup> See *In re Viacom Inc. S'holders Litig.*, No. 2019-0948-JRS, 2020 Del. Ch. LEXIS 373, at \*5 (Del. Ch. Dec. 29, 2020).

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also potentially problematic group dynamics, especially with a board containing directors with similar perspectives as the managers, those with long tenure, and particularly those with long joint tenure.<sup>217</sup> Compounding those factors, a board might also contain some directors with an aversion to conflict, with a dominant personality carrying the others along.

Consider in this regard the complaints against “rubber stamp boards,” with the Disney Corporation being a paradigmatic example. “[Disney CEO and COB] Eisner ruled both Disney and its tame board with iron-fisted control for two decades.” What did the board rubber-stamp? Basically, everything. Gold wrote:

It is clear to me [, a departing director,] that this board is unwilling to tackle the difficult issues I believe this company continues to face—management failures and accountability for those failures, operational deficiencies, imprudent capital allocations, the cannibalization of certain company icons for short-term gain, the enormous loss of creative talent over the last years, the absence of succession planning and the lack of strategic focus[.]<sup>218</sup>

What was being critiqued was lack of independence that resulted in broad deference to managers, including for bad business ideas.

Insofar as there was a theory as to why boards would rubber-stamp management decisions, it has generally been structural bias or “beholdenness,” as in the case of Revata Bowers, a Disney director who was the principal of Michael

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<sup>217</sup> See generally *New Insiders*, *supra* note 17.

<sup>218</sup> Associated Press, *Disney Corporate’s Mouse Droppings*, CBS NEWS (Dec. 1, 2003, 8:32 AM), [https://www.cbsnews.com/news/disney-corporates-mouse-droppings/\[https://perma.cc/5XFN-4URN\]](https://www.cbsnews.com/news/disney-corporates-mouse-droppings/[https://perma.cc/5XFN-4URN]); see Richard Verrier, *Ovitz Case Haunts Disney Board*, L.A. TIMES (Sept. 20, 2004, 12 AM PT), [https://www.latimes.com/archives/la-xpm-2004-sep-20-fi-disney20-story.html \[https://perma.cc/JPJ6-DJSZ\]](https://www.latimes.com/archives/la-xpm-2004-sep-20-fi-disney20-story.html [https://perma.cc/JPJ6-DJSZ]).

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Eisner's children's elementary school<sup>219</sup> and who clearly owed her directorship to Eisner and her continuing deference to him. Attempts to question her independence, as well as those of a majority of the (rubber-stamping) Disney board, were rejected by the Delaware Chancery Court.<sup>220</sup> As to Bowers, the court noted that it was particularly reluctant to question the independence of "regular folk" who had "less than extraordinary means."<sup>221</sup>

#### E. When and Why "Independence" Doesn't Serve its Intended Purpose

With this as backdrop, let us now consider what directors are to be monitoring for, and how the current conception of independence fell short on each account. We start with the first category: straightforward managerial agency costs. These should present the fewest difficulties for directors without ties to management, unless the manager is able to conceal what she is doing. After all, the canonical story is that directors without ties are not impeded from calling out the behavior at issue.

Certainly, directors put on a special committee precisely to address the potential for self-dealing would have sufficient incentive, in the form of visibility, to push back against the self-dealing. But as noted above, in several contexts involving controlling shareholder conflict transactions—notably *Southern Peru* and *CBS*—largely unimpeachably independent

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<sup>219</sup> *In re Walt Disney Co. Deriv. Litig.*, 731 A.2d 342, 359 (Del. Ch. 1998), *aff'd in part, 'ev'd in part sub nom.* Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

<sup>220</sup> Claire Hill and Brett McDonnell, *Sanitizing Interested Transactions*, 36 DEL. J. CORP. L. 903, 928 n.154 (2011) ("[The court was reluctant to] discourage the membership on corporate boards of people of less-than extraordinary means. Such 'regular folks' would face allegations of being dominated by other board members, merely because of the relatively substantial compensation provided by the board membership compared to their outside salaries.") (quoting *In re Walt Disney Co. Deriv. Litig.*, 731 A.2d at 360).

<sup>221</sup> *Id.*



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directors, lacking in problematic ties, did not, or appear to have not, push(ed) back, but instead deferred, acquiescing in furthering precisely the conflicted behavior they had been appointed to curtail.<sup>222</sup> Then-Vice-Chancellor Strine used the term “controlled mindset.”<sup>223</sup> The “independent” directors deferred (*Southern Peru*), or allegedly did (*CBS*), when their duties commanded them to do otherwise.

Why would they defer? These two cases suggest that the directors were controlled or dominated, even though most did not have “ties.”<sup>224</sup> Of course, “control” and “domination” are often part of the analysis of why particular ties compromise independence. What is particularly notable about these cases is the extent to which the ties are attenuated, or that one might expect countervailing forces, such as reputation, to push in the opposite direction.

There are other reasons why directors might generally be deferential. As discussed above, they might trust the management, especially given the management’s superior information; or they might simply be passive, not wanting to “rock the boat;” or be inclined to accept what they are told at face value. Finally, they might have a self-serving reason for their deference. They might hope to be on other boards and think, as per the earlier quote about the “agreer,” that deference to management would be a useful reputation to that end; they might be concerned that if they stand up to

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<sup>222</sup> See *In re S. Peru Copper Corp. S’holder Derivative Litig.*, 52 A.3d 761, 784 (Del. Ch. 2011); *In re CBS Corp. S’holder Class & Deriv. Litig.*, C.A. No. 2020-0111-JRS, 2021 WL 268779, at \*1 (Del. Ch. Jan. 27, 2021).

<sup>223</sup> *In re S. Peru Copper Corp. S’holder Derivative Litig.*, 52 A.3d at 798.

<sup>224</sup> Interestingly, in *Southern Peru*, Strine offered another explanation as to one of the independent directors: that the director had an incentive, that was to some extent misaligned with that of shareholders generally, to do a deal quickly to gain liquidity for shares of a large shareholder he represented, as well as an incentive to get the highest price, an incentive he did share with the other shareholders. Characterizing “[h]uman relations and motivations” as “complex,” Strine did not question the director’s independence, but said that he was “less than ideally situated to press hard.” *In re S. Peru Copper Corp. S’holder Derivative Litig.*, 52 A.3d at 778, 780.

management, they will lose their board seat; or, still self-servingly but more attenuated, directors themselves who are managers of other corporations might value a norm of deference in hopes that it would somehow carry through to their own board.<sup>225</sup> Self-serving possibilities of this sort have been considered in the literature and in court decisions.<sup>226</sup>

Courts have to some extent noted and bemoaned the lack of independence displayed by “independent and disinterested” directors, suggesting that to some extent the perspective we are arguing for has been recognized by courts. This is mostly in the context of special committees established for controlling shareholder transactions. Thus, not surprisingly, courts already know that a “controlling” (in the colloquial sense) controller’s influence is strong; not surprisingly, the analyses already take a very broad view into account, often but not always ties-based, of what might compromise independence. Usually it is ties, but sometimes the committees are criticized more for “passivity” and “inertia”<sup>227</sup> and being “supine.”<sup>228</sup>

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<sup>225</sup> See Hill & McDonnell, *supra* note 213, at 335.

<sup>226</sup> See, e.g., Goldstein v. Denner, C.A. No. 2020-1061-JTL, 2022 WL 1671006, at \*47–52 nn.31–35 (Del. Ch. May 26, 2022) and accompanying text, as to the benefits of being a director favored by an entity that has the power to choose directors frequently, such as a private equity or venture capital fund or a law firm that routinely works with funds that are involved with distressed firms.

<sup>227</sup> See *In re Loral Space and Commc’ns Inc.*, No. 2808-VCS, 3022-VCS, 2008 WL 4293781, at \*22 (Del. Ch. Sept. 19, 2008). See also *In re Viacom Inc. S’holders Litig.*, No. 2019-0948-JRS, 2020 Del. Ch. LEXIS 373, at \*61 (Del. Ch. Dec. 29, 2020). Viacom, the other company involved in the CBS/Viacom merger, whose shareholders didn’t like the deal either, sued, among others, the committee members for breach of fiduciary duty; the shareholders’ suit is also moving forward. The court in that case characterized as reasonably conceivable that the committee did not act independently: “[e]ven an independent, disinterested director can be dominated in his decision-making by a controlling stockholder,” resulting in directors who are “more independent in appearance than in substance.” *Id.* at 68.

<sup>228</sup> See *In re Mindbody Inc. S’holders Litig.*, No. 2019-0442-KSJM, 2020 WL 5870084, at \*1 (Del. Ch. Oct. 2, 2020) (quoting *In re Toys “R” Us, Inc.*

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(That being said, ultimately, the discussions in the cases suggest that often, even if the ties seem quite attenuated, the committee members may have been chosen to act passively or deferentially by people who knew that they would.) Thus, it might seem, independence here is already being reconceived. But not sufficiently for our purposes.

First, the fact that people who might seem irreproachably independent, such as the CBS special committee, were nevertheless passive suggests that the ethos that independence is antithetical to passivity and deference in many contexts—and particularly one in which the charge was to counter the effects of a controlling shareholder—is not as strong as it should be. Second, cases at issue are about someone's—the CEO, controlling shareholder, or directors'—canonical self-interest that is antithetical to the interests of the corporations or its minority shareholders. But this suggests that but for passivity (or even complicity) in the face of a controller who pursued her own interests, these people would have been independent in other respects. Certainly, a person may be passive or even apt to facilitate someone else's behavior in some contexts but not in others. But the idea that, in the absence of a controller or dominating person's self-interest, passivity is not a problem is mistaken. Passivity is antithetical to independence. The issue is a complicated one: some types of deference, which may seem like passivity, may be perfectly sensible and appropriate, such as deference to an expert in a technical area, or one with much more experience and information. But surely, if board monitoring means anything, it means that there should not be blanket deference to the probably-better-informed managers. Motivated reasoning could lead a director to justify such deference, but again, the charge is to monitor, not to defer.

An important context in which to consider director independence is compensation. Directors might favor high compensation for a CEO to encourage high compensation for CEOs and executives generally, notably including themselves

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*S*'holder Litig., 877 A.2d 975, 1002 (Del. Ch. 2005) (internal quotation marks omitted).

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at their own corporations (where they, as is common, are CEOs or other executives). This account of course refers to management-selected directors; as more directors come through other channels, such as hedge funds and other shareholder activists who have gotten more involved in selecting directors, this should be far less of a factor (a point to which we will return). The same is true of the familiar rationale that, because directors are generally chosen from the same cohort as the management, they may have similar perspectives—again, something that should change as fewer directors are management-chosen. Other relevant factors are the tenure of individual directors, whether some or many of the directors have, together, had a long tenure, and relatedly, other group dynamics, such as acquiescence to a powerful personality or a desire to go along, as relates to the other directors rather than the managers.<sup>229</sup>

Common psychological biases are also at issue in many of these cases. Even where the director is being self-serving in some fairly obvious way (quick and near-reflexive deference, for instance), and certainly when she is not (having the same perspective as the managers by reason of being in the same community, for instance) she presumably has some narrative in which her interests happen to coincide with those of the corporation. The psychological mechanisms include confirmation bias, motivated reasoning, and willful blindness, mechanisms that, together, enable a person to come to a desired conclusion. Confirmation bias refers to how the person takes in new “inputs” (data/information) so as to confirm pre-existing views. Motivated reasoning refers to what a person does with the inputs—the reasoning steps a person takes in order to reach her desired conclusion. Willful blindness is the way a person manages not to take in the inputs, so as to be able to maintain a desired pre-existing view.<sup>230</sup> These

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<sup>229</sup> Many of these dynamics fall into the general category of “structural bias.” See generally Hill & McDonnell, *supra* note 213.

<sup>230</sup> On confirmation bias and motivated reasoning, see Kunda, *supra* note 202. On willful blindness, see MARGARET HEFFERNAN, WILLFUL

dynamics play a role when a decision is being considered and made, and may continue if the matter continues to command attention (“escalation of commitment”).<sup>231</sup> Consider in this regard the Congressional Report’s description of the Boeing board’s conduct as to the MAX aircraft as the plane was being developed, and continuing after the plane crashed.

Group dynamics are of considerable interest as well, notably groupthink, the tendency to go along with a group consensus, often really the view of a dominant person.<sup>232</sup> Dominant people, and others, may be overconfident, overestimating their performance, their relative aptitudes, or their ability to predict or understand issues.<sup>233</sup> Note that these biases apply to managers as well; a director should, for instance, take into consideration that the manager’s thought process is influenced by one or more of these biases.<sup>234</sup>

How do these obstacles relate to director independence from management? Certainly, some complement lack of independence. For instance, a director who was beholden to a manager might be able to conclude, without sufficient critical examination, through confirmation bias, motivated reasoning, willful blindness, or some combination of those mechanisms, that going along with the manager’s self-interested idea was best for the company. As importantly, they silence a critical perspective and voice as to what’s being proposed. True independence as we conceive it—independence in perspective—should be free of these obstacles.

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BLINDNESS: WHY WE IGNORE THE OBVIOUS AT OUR PERIL (Doubleday Canada 2011).

<sup>231</sup> See Joel Brockner, *The Escalation of Commitment to a Failing Course of Action: Toward Theoretical Progress*, 17 ACAD. MGMT. REV. 39, 39–40 (1992).

<sup>232</sup> See generally REID HASTIE & CASS SUNSTEIN, *WISER: GETTING BEYOND GROUPTHINK TO MAKE GROUPS SMARTER* (2015).

<sup>233</sup> Two books discussing overconfidence are DANIEL KAHNEMAN, *THINKING, FAST AND SLOW* (2011) and SCOTT PLOUS, *THE PSYCHOLOGY OF JUDGMENT AND DECISION MAKING* (1993).

<sup>234</sup> See Afsharipour & Laster, *supra* note 206; Laster, *supra* note 174.

## F. Compliance as a Case Study

Compliance serves as an excellent case study of the shortcomings of independence-as-ties, and the importance of independence of perspective. The law has assigned directors a significant role in ensuring their corporations do not violate the law; there may, too, be an important penumbra beyond law violation that compliance is supposed to capture. The *Caremark* doctrine<sup>235</sup> has become increasingly influential, placing liability with boards who have failed to act on red flags or that have acted in total dereliction of their duty to monitor.

This influence has extended far beyond the original and paradigmatic *Caremark* facts, which involve a corporation's violation of a law or regulation. Whether or not *Caremark* itself will ever impose liability on directors in circumstances that do not involve the violation of law, it is clear that compliance duties, as directors have come to understand them, have a considerable penumbra. A compliance program that does not discourage getting "close to the line" is likely to be far less effective, and far less favored by regulators, than one that does. Moreover, various federal regulatory regimes encourage or require director involvement in risk management.<sup>236</sup>

Compliance monitoring is a somewhat uneasy fit with the canonical story of monitoring as concerning managerial agency costs. There is an idealized world in which appropriate compliance expenditures are value-adding for a firm. Assume perfect law and perfect markets (including perfect information). In such a world, markets reward appropriate compliance and punish insufficient compliance, and, if independent directors are in fact good at compliance

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<sup>235</sup> *In re Caremark Int'l Derivative Litig.*, 698 A.2d 959, 971 (Del. Ch. 1996).

<sup>236</sup> See *Corporate Compliance*, BD. OF GOVERNORS OF THE FED. RESRV. SYS., <https://www.federalreserve.gov/supervisionreg/topics/compliance.htm> [<https://perma.cc/BCY2-BR4R>] (last updated June 30, 2022); see also 17 C.F.R. § 229.407(h) (2010) ("disclose the extent of the board's role in the risk oversight of the registrant, such as how the board administers its oversight function, and the effect that this has on the board's leadership structure.").

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monitoring, the result is reflected in the firm's share price. Good agents, whether directors or officers, cause optimal monitoring for compliance; bad agents may not. A manager may, for instance, seek to benefit himself by shirking on monitoring in order to game insufficiently well-designed compensation formulas. In such a world, independent directors' lack of ties to managers should situate them well to monitor for compliance in ways that are value-adding.

But real-world compliance issues show the limits of this worldview.<sup>237</sup> For instance, according to the House Transportation & Infrastructure Committee's Report on the 737 MAX<sup>238</sup> ("Congressional Report"), Boeing, facing enormous competitive pressure from Airbus, produced, got approval for, and sold MAX planes, cutting costs and corners, pressuring regulators, and minimizing the training needed to fly the new planes in respects that ultimately proved disastrous and cost hundreds of lives. And this is not a case where low-level people were motivated to, and did, conceal the situation from higher management and the board. The management and board were well aware of the broader story—the rush to deliver an approved plane, and that dramatic steps were being taken to that end. Boeing's potential loss of market share to Airbus seems, according to the Congressional Report, to have been a significant

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<sup>237</sup> See also *Taking Compliance Seriously*, *supra* note 178, at 5. This article argues that managers' short term time horizons will give them an incentive to shirk on compliance and that markets aren't well situated to detect that given firms' general lack of disclosure as to compliance activities and expenditures. It further argues that directors share managers' motives to underinvest in compliance because they also have "skin in the game" (stock ownership in the firm), the result of which is that they also benefit the same way managers do, albeit not to the same extent, from lesser expenditures on compliance. We think this may be part of the story, but we also think the role of incentives for directors and even managers in this account is overstated, and that other forces make for less effective monitoring that would be optimal, certainly for society and even for the firm.

<sup>238</sup> See generally THE HOUSE COMMITTEE ON TRANSPORTATION & INFRASTRUCTURE, FINAL COMMITTEE REPORT: BOEING 737 MAX (2020).

motivating factor.<sup>239</sup> Beating, or at least not being beaten by, Airbus presumably benefited the managers personally, but the firm as well. And the compliance fiasco has been very costly to the firm.<sup>240</sup> Even correcting for hindsight bias, what led up to the fiasco seems predictable, as does the fact that it would be exceedingly costly, both financially and reputationally.

Yet, there are possible ex ante computations in which Boeing's strategy had a positive expected value. Their aim was to produce and obtain approval for a plane quickly, to compete with Airbus. It was realistic to compute that the cost of not succeeding was very large: their sales would be reduced, both at the time and prospectively. How could they assess the likelihood that their planes would crash, and the associated costs? Could a plausible assessment have suggested that the costs were acceptable under the circumstances? An instinctive answer might be 'why not?' But the reputational costs of making such a quantification, and the consequent pressure for regulatory action, would seem to argue otherwise—it is just not a good “look.” Nor would any ex post attempt to point to the only way such an assessment could have been made—by assigning an exceedingly low probability to an event that has in fact happened, where the probability assignment could scarcely have been made with much precision or confidence.

Indeed, it seems hard to imagine that such a computation was in fact made. What happened seems better explained by well-known psychological factors such as motivated reasoning and confirmation bias. Even if a defensible computation,

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<sup>239</sup> *Id.* at 12.

<sup>240</sup> The derivative litigation was settled on November 5, 2021, with D&O insurers paying Boeing \$237.5 million, and Boeing agreeing to make certain corporate governance changes. Stipulation and Agreement of Compromise, Settlement, and Release, *In re Boeing Derivative Litigation* at 27–28, 2021 Del. Ch. Lexis 197 (Del. Ch. Sep. 7, 2021) (Consol. C.A. No. 2019-0907-MTZ). The settlement with the U.S. government cost Boeing \$2.5 billion. *Boeing Charged with 737 Max Fraud Conspiracy and Agrees to Pay over \$2.5 Billion*, DEP'T OF JUST. (Jan. 7, 2021), <https://www.justice.gov/opa/pr/boeing-charged-737-max-fraud-conspiracy-and-agrees-pay-over-25-billion>. [<https://perma.cc/3KGC-MMHK>].



taking into account only shareholder value, was that the risk was worthwhile, it seems implausible that the directors would have actually decided to take it given what was at stake. A pure shareholder maximization perspective might argue that they should in fact take such risks, and that they are actually bad agents if they do not do so and take their own interests in peace of mind and their reputations risk into account. Certainly, we can, and do, put a dollar value on human life every day: business cannot avoid risk, even serious risk. But it does seem that even in prospect, this particular risk should have been weighted more heavily than it was. How to weigh remote but catastrophic risks is an important topic in risk management, and it's clear, especially given the grave limitations in quantifying the appropriate weighing in this context, that multiplying the huge number (catastrophic risk) by the very small number (remoteness) is not akin to a computation of a more likely but more manageable risk.<sup>241</sup> Treating the remote catastrophic risk differently is probably justifiable even on shareholder wealth maximization grounds, but it is certainly justified on broader societal welfare grounds. Indeed, as we argue below, compliance opens the door to consideration of interests other than that of shareholders.

The Boeing directors did not anticipate what would happen when they went along with the quick-production and quick-approval strategy. Yes, hindsight does make their failure clearer. But aircraft safety is, in parlance used by the Delaware courts in recent cases which have gone forward with *Caremark* claims against the directors and related claims against the officers, "mission critical." Something directors were charged with doing a better job of monitoring than plaintiffs allege they did. It is hard to imagine that managers

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<sup>241</sup> AMER. L. INST., *supra* note 184, at § 4.07 Reporter's note c. (2021); Nicholas Barberis, *The Psychology of Tail Events: Progress and Challenges*, 103 AMER. ECON. REV. PAPERS AND PROCEEDINGS 611, 611–16, (2013); David Leonhardt, *Spilloomics, Underestimating Risks*, N.Y. TIMES (June 1, 2010), <https://www.nytimes.com/2010/06/06/magazine/06fob-wwlnt.html> [<https://perma.cc/R2SE-Z4AL>].

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made an appropriate cost/benefit computation for the firm, and they had no obvious way to obtain significant private benefits. Certainly, failure would have yielded a significant personal cost, but their perception of their interests and those of the firm were probably closely linked. The firm's failure would be theirs, and their failure would be the firm's. It is unlikely that directors' "skin in the game" made them do less to monitor than they otherwise would have.

Rather, this seems like a situation in which the firm got caught up in a fierce competitive ethos and proceeded, tuning out disconfirming evidence and a more holistic consideration of the trajectory and its likely (or perhaps one should say not-unlikely) result. Arguably consistent with this view of the world is Boeing's board's (non-)reaction after the first crash in 2018. The Board was willing to go along with the pilot error scenario being advanced by the management, a scenario that treated the problem as more one of public relations than anything else. This is, of course, a familiar dynamic, although thankfully it does not often result in the loss of hundreds of lives. Just because hundreds of lives were lost, it does not necessarily follow that anyone did anything wrong. But the claim here is that it should have been clear to the directors and the management that safety was critical and that what was being done had a reasonable chance of seriously compromising safety. In *Caremark* cases, the state-law independence analysis is often not at issue. In such cases, demand is commonly sought to be excused on grounds that the board's potential liability for not abiding by its *Caremark* duties disables it from fairly considering demand. This is, as noted above, a case of director interest, not director independence. When director independence is at issue in the case analyses, it is typically because there are allegations that directors did not call out managers for behavior that breaches the managers' fiduciary duties.<sup>242</sup>

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<sup>242</sup> There are some indications that officers can be liable under *Caremark*, although there are also statements to the contrary. But for our purposes, this does not matter, since the managerial conduct or omission at

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But independence is nevertheless important in this context. As noted above, federal requirements as to independence were inspired by notable compliance scandals; independence was thought to be helpful in preventing such scandals. A lack of independence could make a director reluctant to agree to bring any suit, meritorious or not, against other directors or managers. It might, too, have yielded some level of deference or even going along with self-serving managerial behavior that compromised compliance. But, as we noted above, the situations at issue will not infrequently involve mixed motives. Surely Boeing's did: it is simply easier to go along, and that is so whether a director is beholden to an officer or not. Indeed, the other obstacles we have identified—the deference, for self-serving or other reasons, the psychological biases such as confirmation bias, motivated reasoning, and willful blindness, the groupthink—could yield reluctance to bring a suit, or, as importantly, less effective monitoring in the first instance and on an ongoing basis, as the stage was being set for the events ultimately triggering the lawsuit.<sup>243</sup>

The foregoing leads to a critical point in our analysis. We started with the classic construction of director independence: it is needed so that directors can monitor for managerial agency costs (including causing the corporation to bring lawsuits against the managers as appropriate). But the picture we have painted is of monitoring that is not just for agency costs, and of obstacles to monitoring that may not

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issue would presumably be a violation of the managers' fiduciary duties even if not a violation of *Caremark*. *Marchand v. Barnhill*, 212 A.3d 805, 809 (Del. 2019).

Consider in this regard that managers remain liable for breaches of the duty of care, since DGCL 102(b)(7) exculpation does not apply to them. *In re KSL Media, Inc.*, 732 Fed. App'x. 535, 537 (9th Cir. 2018).

<sup>243</sup> In this regard, one of us served as associate reporter for the ALI's Principles of Compliance and Enforcement project. The definition of compliance risk went beyond illegality, and the description of good and best practices for compliance risk management very much involved obstacles such as the ones discussed here. AMER. L. INST., *supra* note 184, §§ 4.07–4.13.

relate to lack of independence. Attempts to salvage the classic construction might characterize what directors do when they are not monitoring for managerial self-interest as “advising.” But this is unpersuasive. Surely looking for ways the management might be knowingly enriching itself by, for instance, causing the corporation to engage in a particular action, is best done in tandem with looking for ways the management might genuinely believe or convince itself that the same course of action was actually good for the corporation but be mistaken.

Going further, as was argued earlier, good compliance may very well not be reflected in stock price. While *Caremark* nominally and formally is about harm to shareholders, *Caremark* duties as they are taken on, and adjacent federal regimes, are about harms to third parties. So long as law and markets are not perfect—if they were, harms to third parties would be harms to shareholders—the door opens to consideration of the interests of those third parties as part of the board’s charge.

Where does this leave us? We began with the classic rationale for director independence, relating to managerial agency costs, and argued that it had serious shortcomings. While independence can’t suffice as a qualification for board membership, having it serve only to ferret out managerial agency costs limits and distorts what independence can and should do for a company. Moreover, this more limited conception of independence discourages an important economy of scope: considering whether a course of action might constitute managerial advantage-taking seems sensibly done in the course of a broader inquiry as to how well-advised the course of action is.

## V. HOW CAN RECONCEPTION BE ACHIEVED?

A reconception of independence should stress the need for independence in *thought and perspective*. What, specifically, do we propose, and how would we achieve our aim?

The second question—how we can achieve such independence—turns out to be easier to answer than the first;

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indeed, we are hard-pressed to answer how such independent should be defined. Whatever else can be said about independence-of-ties, it is at least tractable and intuitively appealing as a proxy. Worse than pornography, one may not even ‘know [independence of perspective] when one sees it.’ But many aspects of law function in this way. Standards such as “reasonableness” or “due care” or “materiality” are examples of concepts both law and norms make use of but are hard pressed to define in the abstract.

Therefore, the second question may be the more meaningful one. How can we achieve more diversity and independence of perspective? Below we outline several key channels through which independence of perspectives could be strengthened. We argue that (a) underscoring the importance of critical perspective as part of directors’ duty of care, (b) independently nominated directors (directors that are nominated by shareholders and not management), (c) structural changes to the way boards receive and discuss information and (d) emphasis on diversity, can improve the board’s independence of thought. Several of these channels have already been gaining momentum, while some, we hope, will gain momentum in years to come.

#### A. The Duty to Critically Examine

First, directors clearly believe themselves to have a duty of care, and their advisors tell them how to comply with it. A critical perspective should be viewed as a core part of directors’ fiduciary duties in general, and the duty of care in particular. Certainly, the duty of care requires directors to proceed “with a critical eye[.]”<sup>244</sup> This amplification is, we think, increasingly happening in court decisions such as *CBS*, which criticizes not the ties between the directors and the officer/controller/shareholders, but the deference when more active oversight was called for.<sup>245</sup> Courts need not, and indeed,

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<sup>244</sup> *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985).

<sup>245</sup> *In re CBS Corp. S’holder Class & Deriv. Litig.*, C.A. No. 2020-0111-JRS, 2021 WL 268779, at \*41 (Del. Ch. Jan. 27, 2021).

given current jurisprudence, probably should not, find that there is liability for deference, even in some of the more extreme cases we have seen, where there was a strong public interest (*Boeing*)<sup>246</sup> or an indication that non-deference was particularly called for (*Southern Peru; CBS*— ‘you had one job!’).<sup>247</sup> But, consistent with classic articulations of what the duty of care and good faith require, a standard of conduct could, and should, be articulated in opinions where the standard of liability was not met.<sup>248</sup>

Delaware judges are notorious for their “sermons” and exhortations. In their opinions, they make clear that some conduct that is not actionable as a breach of fiduciary duty nevertheless falls below the standard of conduct.<sup>249</sup> Law firms can be expected to take notice of these portions of the opinions and advise their clients accordingly. Might there be a way for courts to consider whether directors were too deferential more routinely in corporate law contexts? Courts are notoriously reluctant to interfere with business judgment. But maybe there are other stylized contexts where directors’ non-deference is particularly important. And a discussion in dicta as to concerns about excessive directorial deference would certainly provide an actionable roadmap for directors and their advisors.

In this regard, as we discussed, there are decisions bemoaning non-independent behavior by directors. Consider in this regard the criticisms of the Southern Peru and CBS directors’ “controlled mindsets.” There are some other references as well to excess deference by “supine” boards,<sup>250</sup> or

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<sup>246</sup> See *supra* notes 192 and 194 and accompanying text.

<sup>247</sup> See *supra* notes 222-24, 215-16 and accompanying text, respectively.

<sup>248</sup> The ‘standard of conduct’ terminology originated with Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 *FORDHAM L. REV.* 437 (1993); see also *Basho Tech. Holdco B, LLC v. Georgetown Basho Inv., LLC*, C.A. No. 11802-VC, 2018 WL 3326693, at \*55–56 (Del. Ch. July 6, 2018).

<sup>249</sup> See *Basho Tech*, 2018 WL 3326693 at \*55–56.

<sup>250</sup> See *In re Toys “R” Us, Inc. S’holder Litig.*, 877 A.2d 975, 1002 (Del. Ch. 2005); *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1280 (Del. 1989).

boards whose members are “at rest” when they should be “in motion.”<sup>251</sup> Hopefully, if the facts so warrant, these criticisms, whether as part of the holdings or as dicta, will continue, and increase.<sup>252</sup>

Shareholders, too, can amplify such expectation. Through shareholder proposals or direct questions in annual meetings—nowadays often done virtually and allowing more to participate—shareholders can press the issue of critical board discussion.

## B. Independently Nominated Directors

Hedge fund activism, and a more general push towards non-management-selected directors is helpful as well, although, as to hedge-fund promoted directors, with an important caveat. Non-management-selected directors can be expected to be non-deferential—after all, the rationale for them getting on a board is precisely that the board needed different voices that would potentially lead the company in different directions. And the specter of such directors is helpful as well, insofar as even a self-interested board member wanting to keep his seat may conclude that the safest course is no longer deference given the possibility of activism. But the caveat, as noted above, is as to hedge fund activists: a strong push towards improving performance as activists do might make balancing competitive and other business-oriented considerations with safety and other like concerns less likely.

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<sup>251</sup> *In re Loral Space and Commc'ns Inc.*, C.A. Nos. 2808-VCS, 3022-VCS, 2008 WL 4293781, at \*22 (Del. Ch. Sept. 19, 2008) (“And Harkey’s fellow member, Simon, brought the scientific concept of inertia to the Special Committee by generally remaining at rest until set into motion by the Committee’s advisors.”).

<sup>252</sup> That being said, one reading of the cases characterizing independent-but-passive directors as having a “controlled mindset” might lead to a recommendation that this mindset, which might not suffice to yield liability, might be appropriately viewed as a cognitive bias for which, perhaps, de-biasing, would be a solution. This would, in our view, be unfortunate, cabining as it would a broader norm, ethos, and temperament into a narrow “mistake” box, squandering the opportunity to address the issue of independence more holistically.

Hedge fund activist emphasis on quick financial results may “economize” more on compliance than society, and perhaps even more than the firm in the moderate to long term, would want.<sup>253</sup>

In this regard, we should note the effect that “proxy access” has had. Shareholders increasingly have “proxy access,” the right to nominate directors at U.S. companies on their corporations’ ballots.<sup>254</sup> Proxy access is now a mainstream bylaw provision at S&P 500 companies.<sup>255</sup> The growing availability of proxy access could be harnessed to incorporate new, less deferential, directors into the boardroom, without the traditional dependency on management nomination. Thus far, while proxy access is now permitted at most major public companies, it has almost never been used.<sup>256</sup> It has nevertheless arguably been influential. Governance scholars have explained that “the primary benefits of proxy access would result not so much from its use, but from its general effect on directors’ incentives, making them more accountable to shareholders.”<sup>257</sup> This effect can include the company’s selection of directors that they think shareholders might have nominated. For example, empirical evidence suggests that

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<sup>253</sup> See Houman B. Shadab, *Hedge Fund Governance*, 19 STAN. J.L. BUS. & FIN. 141 (2013) (arguing that “[t]he hedge fund governance regime is also notable for what it lacks. Not only do hedge funds lack permanent or long-term capital but hedge fund managers are also not subject to stringent board oversight, removal by investors, or any market for corporate control.”)

<sup>254</sup> Michal Barzuza, *Proxy Access for Board Diversity*, 99 B.U. L. REV. 1279, 1284 (2019); see also Danielle Vukovich, *Proxy Access Voting: Evaluating Proxy Access and the Recent Phenomenon of Corporations Adopting Shareholder Protective Policies*, 19 SAN DIEGO INT’L L.J. 437, 444 (2018).

<sup>255</sup> See Danielle M. Kinchen, *Look to Your Left, Look to Your Right: Why the SEC Should Reserve Seats at the Boardroom Table for Shareholder Nominees*, 20 U.C. DAVIS BUS. L.J. 1, 10 (2019).

<sup>256</sup> Bernard S. Sharfman, *Now Is the Time to Designate Proxy Advisors as Fiduciaries under ERISA*, 25 STAN. J.L. BUS. & FIN. 1, 22 (2020).

<sup>257</sup> Kobi Kastiel and Yaron Nili, *The Corporate Governance Gap*, 131 YALE L.J. 782, 831–32 (2022) (quoting Lucian A. Bebchuk & Scott Hirst, *Private Ordering and the Proxy Access Debate*, 65 BUS. L. 329, 335–36 (2010)).



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proxy access still functions as a bargaining tool to improve board diversity, even if it has not been used to directly nominate directors.<sup>258</sup> Having shareholders directly nominate directors can insert new voices into the boardroom in a way that could reduce groupthink and other social biases.

### C. Equipping the Board

Third, there could be more emphasis on how boards can better fulfill their monitoring role. Currently management has control over the type, volume, and framing of information that is presented to the board, and directors are often lacking the time and resources to review what is provided to them or collect alternative data and viewpoints. This “Board Capture”<sup>259</sup> can be mitigated by the creation of a Board Suite: an office with dedicated resources that would allow boards to better digest and collect data independently from management.<sup>260</sup> Private equity and hedge fund-nominated directors can also help better inform the board with competing information and data to be considered.

Complementing such an approach, boards might be required or encouraged (perhaps via a comply or explain regime) to assign a “contrarian” role to one of its members, on a time-limited and rotating basis. Having an in-house contrarian has been suggested in various other contexts.<sup>261</sup> The assigned contrarian could be charged with bringing to the board reasons to not go along with a managerial decision, for instance.

Indeed, the rise of the Lead Independent Director role and the push for Independent Chair of the board, similarly presents an opportunity to further enhance the board’s inquisitorial role.<sup>262</sup> Recognizing the power imbalance

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<sup>258</sup> Barzuza, *supra* note 254, at 1299.

<sup>259</sup> *Captured Boards*, *supra* note 30, at 26.

<sup>260</sup> *Id.*

<sup>261</sup> Brett McDonnell & Daniel Schwarcz, *Regulatory Contrarians*, 89 N.C.L. REV. 1629, 1633 (2011).

<sup>262</sup> *See Board Gatekeepers*, *supra* note 97.

between the management representative on the board and the independent directors, investors have begun asking boards to introduce two key independent leadership roles within the boardroom—an Independent Chair of the board and LID. The LID and the Independent Chair are meant to serve as the “independent counter-balance to the CEO,”<sup>263</sup> signaling, and ensuring, the existence of proper monitoring of management by the board. Today, most companies have either an Independent Chair or LID (or both) on their boards.<sup>264</sup> Endowing these independent directors with effective, enumerated powers, could provide tangible results, as some directors directly indicated.<sup>265</sup> Finally, the growing push towards director expertise in areas of ESG, Cyber and other areas can potentially improve the board’s ability to critically examine the management’s information deck or presentations.<sup>266</sup>

#### D. Diversity

The increasing push for diversity on boards can also play a role in our proposed reconception. Incorporating more diverse backgrounds and lived experiences could help foster a more inquisitorial boardroom that is less deferential to management. What diversity means, what ‘kind’ of diversity is most desirable, and who counts as diverse are all highly contested (as is the rationale for diversity). But, while we may not know what diversity should look like, we know quite a bit about what non-diversity looks like and what’s pernicious about it: again, conformism, the pernicious golden rule, the ‘same perspectives,’ and so on.

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<sup>263</sup> *Role of LID*, *supra* note 103.

<sup>264</sup> *See supra* Section II.A.

<sup>265</sup> *Id.*

<sup>266</sup> Yaron Nili & Roy Shapira, *Expert Directors*, YALE J. ON REG. (forthcoming) [on file with the Columbia Business Law Review].

Societal benefits of diversity are, at least in theory, straightforward.<sup>267</sup> Benefits to the corporation are harder to measure and assess. Does ‘benefit’ mean profitability? Less volatility in times of crisis? Better reputation? Some combination of these things? One interesting potential benefit is suggested by research indicating that diverse teams may be better at creative tasks, especially when those tasks are cooperative.<sup>268</sup>

Consider the following finding:

We investigate whether diversity in points of view within corporate boards, as captured by the diversity in political ideology of board members, can affect a firm’s performance. We employ personal political contributions’ data to measure political ideology distance among groups of inside, outside directors and the CEO. Our empirical evidence strongly supports the notion that outside directors’ monitoring effectiveness is more likely to be enhanced when their viewpoints are distinct from those of management. We find that ideologically diverse boards are associated with better firm performance, lower agency costs and less insiders’ discretionary power over the firm’s Political Action Committee (PAC) spending. Taken together, our results lead us to conclude that multiplicity of standpoints in corporate boardrooms is imperative for board effectiveness.<sup>269</sup>

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<sup>267</sup> Jared Landlaw, Barington Cap. Grp., *Maximizing the Benefits of Board Diversity: Lessons Learned From Activist Investing*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (July 14, 2020), <https://corpgov.law.harvard.edu/2020/07/14/maximizing-the-benefits-of-board-diversity-lessons-learned-from-activist-investing/> [https://perma.cc/X4W9-RTGP].

<sup>268</sup> John M. Levine, Kira M. Alexander, Aidan G.C. Wright, & E. Tory Higgins, *Group Brainstorming: When Regulatory Nonfit Enhances Performance*, 19 GROUP PROCESSES & INTERGROUP REL. 257, 268–69 (2016).

<sup>269</sup> Incheol Kim, Christos Pantzalis & Jung Chul Park, *Corporate Boards’ Political Ideology Diversity and Firm Performance*, 21 J. EMPIRICAL FIN. 223, 223 (2013).

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This suggestion is somewhat, but not completely, orthogonal to ours. We are arguing that boards should be comprised of people who take as their charge to offer an independent perspective. But the suggestion complements ours, and even if independence in perspective is not so easy to achieve, limiting pernicious group dynamics through diversity of various sorts should make deference more difficult, thus achieving an important aim of independence.

Another point to note in this regard is the following. Let us assume that less deferential and more critically minded directors would be better at compliance. Is that just ‘good for society’ or is actually just good for the corporation? If law were perfect, the answer would be both. But, as one of us has argued, neither law nor markets are perfect in this regard—companies may find it worthwhile to externalize some costs.<sup>270</sup> Given increasing attention to ESG/CSR, it seems likely that there will be more pressure, either legal, regulatory, market, or reputational, to internalize more costs. The trajectory towards taking at least some other stakeholders’ interests into account seems inexorable. This line of reasoning can potentially unify profit maximization, as it is understood, and as it might, more expansively, be understood with a fuller appreciation of the various forces CSR/ESG may unleash.

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A few final points are in order. We do not take on the broader critiques of the importance of independent directors—that given what is gained (not much) from independent directors and what is lost from having fewer insiders (information), there should be fewer independent directors and more insiders. This argument is of course very sensitive to the definition of independence. Our argument suggests that independence as we propose to reconceive it would offer considerably more value than independence as presently defined. It may also reduce the push currently in place to have boards that are completely deprived of insiders or those with

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<sup>270</sup> Claire A. Hill, *The Rhetoric of Negative Externalities*, 39 SEATTLE U.L. REV. 517, 517 (2016).

ties to the corporation—even if they can promote less deference.

We also do not fully consider other possible solutions to particular problems that independence is supposed to help address, such as continuing compliance issues and acquiror overpayment—for example, in the *Caremark* context, more liability for directors (Gordon et al); in the context of acquisitions, shareholder voting rights (Afsharipour/Laster). Our focus is a board that would best manage the corporation, whatever else is put in place. That being said, our arguments suggest that increased liability may have less force than might be thought, insofar as what's lacking in some instances is not the 'will' but rather, the 'way.'

## VI. CONCLUSION

Until the middle of the last century, corporate boards were largely comprised of insiders, managers of the company. Starting around then, board composition changed, and boards began to have people who were neither insiders nor those who had familial, professional, or financial ties to the managers or the company—that is, they were “independent directors.” Boards have become increasingly independent, and nowadays, all listed company boards are at least majority-independent. Why was independence thought to be needed? As companies in the early twentieth century became larger, so did their shareholder bases. Small, dispersed shareholders lacked the ability and incentive to monitor managers. Managers were thus more able to take advantage—to help themselves at the expense of their companies. Thus, management needed to be monitored by independent directors.

But, as we have argued, there are many situations that potentially implicate a manager's less-than-critical perspective as to his own aptitudes and judgments. There is no reason why “independent” directors would be particularly well-situated to push back if doing so was appropriate. Nor does the definition of independence do a good enough job picking out the directors who are well situated to ferret out

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and respond appropriately where managerial self-interest is at issue.

What is needed is a new conception of independence. Our reconception starts with an analysis of what, beyond managerial agency costs, might yield managerial decisions that are not good for the company, and what obstacles directors might face, in addition to a willingness to let their relatives or business partners help themselves, in appraising a proposed course of action. Lacking problematic ties to management is generally a good starting point, but independent directors also need to be independent-minded, providing a needed critical perspective, and check, on management's decisions. When managers are advancing a particular course of action, independent directors should not just consider how a manager might be helping herself at the expense of the company. Rather, the inquiry should be broader: how might the manager's proposed course of action be harmful to the company? What might the managers be missing in promoting the course of action? The need for independence in perspective is sometimes discussed in the literature, and in commentary bemoaning "rubber stamp" boards, but the law has not sufficiently kept up, focusing more on expanding the types of ties that compromise independence, while not doing enough to address the perspective issue.

Maybe most importantly, reconceiving director independence also bears importance in some of the most vivid debates in contemporary corporate governance. How and why should board be diverse? How should stakeholders be accounted for in the corporation's actions and structure? Should we encourage or limit shareholder activism? Our proposed framework provides initial answers to all of these questions but also opens the door for further exploration, research, and debate. One thing is clear: keeping with a single notion of director independence is no longer viable. This Article is an explicit invitation to engage with the vision of what it should mean.