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"The Promise of Corporate Governance"

by

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<u>Note</u>: It is expected that you will have reviewed the speaker's paper before the Seminar.

Abstract

Perhaps the most basic principle of corporate law in the U.S. is that corporations are controlled by boards of directors, rather than shareholders. The board of directors is at the epicenter of U.S. corporate governance. Specifically, under U.S. law, corporations are managed by or under the direction of boards of directors, making the directors literally the governors of the corporation. The intuition that directors add value is strong and deeply held. That intuition is not challenged here. What is challenged is that deeply held assumption that traditional directors add value by serving shareholders as independent monitors of managers. It is more likely that directors nominated and elected through traditional board processes serve managers by supporting them. Sometimes, particularly when managers have useful and constructive advice strategic advice for management, directors add value for shareholders. At other times, however, such as when managers need directors to approve managers' outrageous salary "requirements" or when managers need insulation from the market for corporate control or pesky institutional investors, so-called "independent" directors at best do not reduce shareholder value, and at worst they destroy it.

Dear Workshop Participant: this document consists of the title page, table of contents, edited introduction and fourth chapter of my forthcoming book,

"The Promise of Corporate Governance"

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--------------------------------- *Table of Contents* ---------------------------------

Chapter	Title	Pages
	Introduction	1-29
1.	The Goals of Corporate Governance: The Dominant Role of Equity	30-48
2.	Corporate Law and Corporate Governance	49-79
3.	Institutions and Mechanisms of Corporate Governance: A Taxonomy	80-86
4.	Boards of Directors	87-121
5.	Case Studies on Boards of Directors in Corporate Governance	122-157
6.	Dissident Directors	158-184
7.	Formal External Institutions of Corporate Governance: The Role of the Securities and Exchange Commission, the Stock Exchanges and the Credit Rating Agencies	185-211
8.	The Market for Corporate Control	212-231
9.	Initial Public Offerings and Private Placements	232-237
10.	Governance By Litigation: Derivative Lawsuits	238-282
11.	Accounting Rules and the Accounting Industry	283-304
12.	Quirky Governance; Insider Trading, Short Selling & Whistleblowing	305-472
13.	Shareholder Voting	373-418
14.	The Role of Banks and Other Lenders in Corporate Governance	419-457
15.	Hedge Funds and Private Equity	458-512
	Conclusion	473-478

Summary/Introduction/ Corporate Governance as Promise.

The purpose of corporate governance is to persuade, induce, compel, and otherwise motivate corporate managers to keep the promises they make to investors. Another way to say this is that corporate governance is about reducing deviance by corporations where deviance is defined as any actions by management or directors at odds with the legitimate, investment-backed expectations of investors. Good corporate governance, then, is simply about keeping promises.[1] Bad governance (corporate deviance) is defined as promise-breaking behavior.

The theory that underlies the way that this book treats corporate governance is that all investors have certain reasonable expectations about what corporate managers should and should not do with their power over the corporations. …

They come mostly from law and contract, but market forces and social norms also inform investors' expectations about how managers should perform in very important ways. For example, it is universally understood that managers cannot steal from the company's they work for. It also is well understood that managers and directors should avoid transactions that place them in conflict of interest between their obligations to the corporation and their own personal financial objectives. ….

A large and diverse array of mechanisms and institutions of corporate governance are credited with playing central roles in corporate governance. The list includes all sorts of gatekeepers, such as lawyers, investment bankers, and accountants, as well as

corporate boards of directors and financial institutions, which monitor companies to which they have loaned money. Shareholders rely on the institutions of corporate governance to solve the problems inherent in the separation of share ownership and management of large public corporations. The persistent willingness of investors to purchase residual equity interests in firms controlled by others is an astonishing and distinctive feature of U.S. capital markets, which are characterized by far more widely dispersed ownership than other capital markets throughout the world. The proclivity of investors to part with their investment dollars in far-flung ventures over which they have no practical control, and no legal rights either to the repayment of their principal or to receive periodic returns (dividends) on their capital requires a lot of trust on the part of investors. This trust, in turn, depends critically on the efficient operations of the institutions of corporate governance.

Everybody agrees that boards of directors, even ostensibly independent directors, are prone to capture. Nobody has even *suggested* a test for sorting out the directors who are truly independent of management from those who merely appear to be independent. Until such a test is devised, in my view, independent directors cannot be relied upon to solve the agency problem that lies at the heart of corporate governance.

What is worse, directors chosen for their independence alone often know little if anything about the actual operations or strategic challenges that face the companies on whose boards they serve. Shareholders may be better off abandoning the myth of independent directors, and moving back to boards of directors with several insiders on the

board. If senior managers are superior managers but not inferior monitors, then shareholders would be wise to bring more of them onto their companies' boards of directors. The costs to shareholders of having only one senior management on their companies' boards may be worse than the benefits.

Having identified corporate boards of directors as a rather ineffective corporate governance device in chapter 4, in other chapters I attempt to identify other corporate governance tools, some of which are effective and some of which are not.

Chapter Four

Boards of Directors

Perhaps the most basic principle of corporate law in the U.S. is that corporations are controlled by boards of directors, rather than shareholders. The board of directors is at the epicenter of U.S. corporate governance. Specifically, under U.S. law, corporations are managed by or under the direction of boards of directors, making the directors literally the governors of the corporation. The intuition that directors add value is strong and deeply held. That intuition is not challenged here. What is challenged is that deeply held assumption that traditional directors add value by serving shareholders as independent monitors of managers. It is more likely that directors nominated and elected through traditional board processes serve managers by supporting them. Sometimes, particularly when managers have useful and constructive advice strategic advice for management, directors add value for shareholders. At other times, however, such as when managers need directors to approve managers' outrageous salary "requirements" or when managers need insulation from the market for corporate control or pesky institutional investors, so-called "independent" directors at best do not reduce shareholder value, and at worst they destroy it.

Much is expected of boards of directors. The American Law Institute Principles of Corporate Governance provides that the directors of publicly traded corporations are responsible for overseeing and evaluating the business; selecting, compensating, and where necessary, replacing senior executives; and reviewing the firm's financial

objectives and its accounting.[2] The board has the authority to manage the business of the corporation, and can initiate strategic plans and cause the corporation to pursue, or to change its business plans. The board has plenary authority to act for the corporation in all matters not requiring shareholder approval.

Regulators, stock exchanges, corporate governance mavens, and plaintiff class action lawyers articulate very high standards for directors. And these groups point their fingers at board members when things go poorly. Strangely, however, while no one seriously thinks that boards of directors should be personally liable, or even morally responsible for everything that happens in the companies on whose boards they serve, there is stunningly little agreement regarding the contours of directors' responsibility.

In the U.S., directors' power to manage the business and affairs of the corporation is virtually absolute. This makes directors, along with managers, the natural focus of inquiry when companies fail or under-perform. And it is indisputable that even the best run companies can fail. Directors also are the natural focus of attention when a company is rocked, or ruined, by fraud. It is also understood that even with close monitoring by diligent and conscientious accountants and directors, fraud can occur. Thus, while there is an inexorable proclivity to blame directors, it has long been recognized that as long as directors act in good faith, directors will not be legally liable for bad outcomes. Instead, it is well-established that "redress for failures that arise from faithful management must come from the markets, through the action of shareholders, and the free flow of capital," rather than from the courts.[3] As courts have made plain, directors can comply with their

fiduciary duties, thereby avoiding personal liability for events that cause grave harm to the company, and still fail to satisfy what courts have described as "what is expected by the best practices of corporate governance."[4] These expectations constitute societal norms. Directors suffer when they fail to conform to these norms.

Since the mid-1980s, state legislatures have gone even further, authorizing corporations to add to their charters provisions exculpating directors (though not officers) from personal liability for breaches of fiduciary duties involving negligence and lack of due care, so long as there was no intention to harm the corporation.[5] These statutes permitting director exculpation were enacted in the wake of heightened concern about directors' personal liability. The concern about personal liability was generated by the Delaware Supreme Court's decision in *Smith v. Van Gorkom* (discussed below and in Chapter 1), which held the members of the board of directors of a large public company personally liable for failing to exercise due care in recommending the approval of a takeover bid for the company. The new statutes suggest that directors will avoid personal liability even when they fail to exercise due care, as long as they are not disloyal to the corporations.

While directors are, of course, intensely concerned about their personal liability for negligence or malfeasance, this is not their only concern. They also are concerned about their reputations as leaders and their standing in the community. In other words, the prevailing norms of director behavior are stricter and less forgiving than the liability rules by which directors are evaluated.

The prevailing theory among policy-makers in the U.S. is that increasing the quantity and improving the quality of board oversight is the key to improving corporate governance. Thus, the response of policy-makers to the public concern about the Enron-era wave of corporate scandals was simultaneously to blame the Enron board of directors, and to exhort future boards to perform more and better oversight of corporate managers.[6] Courts similarly have emphasized that board composition is an important factor in determining how much deference to give corporate decisions made with board approval. Reliance on the ability of future boards to out-perform the Enron board are at the heart of the post-Enron corporate governance environment, as reflected in the new rules promulgated for public companies by the National Association of Securities Dealers, the New York Stock Exchange, and by Congress in the Sarbanes-Oxley Act.

Sarbanes-Oxley and related rule-making initiatives at the New York Stock Exchange and the National Association of Securities Dealers represent responses to the Enron-era corporate scandals. The new rules do not add many legal responsibilities; rather, as we would predict, they simply import more norms from the legal culture into the business culture. The new rules reflect the preference of the legal culture for rules that specify structure and process rules over substantive rules. For example, the new rules stress that boards' committee structures must follow a particular organizational framework, featuring an audit committee, a compensation committee, and a nomination committee. The rules further stress that these committees, along with a majority of the

entire board, must be comprised of independent directors, a term the rules define with significantly more detail than clarity.

Monitoring and Managing

It is well understood that corporate boards of directors have a dual role in corporate governance. They are simultaneously supposed to serve as advisors to senior officers about management issues and as monitors of management. Simply put, directors are supposed to serve both a management function and monitoring function. However, the policy implications of the existence of this dual role are not well understood. In particular, the issue of whether it is possible for board members to serve in both of these roles has not been thoroughly explored.

It is unreasonable to expect directors to perform both of these functions because there is a fundamental and irreconcilable conflict between the monitoring function and the management function. To be sure, this problem has received some attention. For example, board members themselves have recognized that the dual role of monitoring and advising creates tension and conflict. According to one survey, "too much emphasis on monitoring tends to create a rift between non-executive and executive directors."[7]

The problem, however, goes beyond concerns about the personal dynamics between outside directors and senior management, though such concerns are entirely legitimate. The reason that the dual role of directors creates a fundamental, inescapable conflict for directors is because directors who are monitors inevitably are required to monitor themselves. When directors give advice in time period 1, they face a conflict in

time period 2 when they are called upon to evaluate decisions made by management in time period 1, which were made wholly or partially on the basis of the earlier advice the directors themselves provided.

This time-inconsistency problem was well understood by the framers and by constitutional theorists then and now. As Madison observed in Federalist 10, "[n]o man should be allowed to be a judge in his own cause, because his interest would certainly bias his judgment, and, not improbably, corrupt his integrity. With equal, nay with greater reason, a body of men is unfit to be both judges and parties at the same time." Unfortunately, the issue appears to be very poorly understood among academics and self-styled corporate governance experts.

The irreconcilable nature of the monitoring function and the management function is so profound that it affects the structural organization of the firm and requires important strategic choices by those organizing the corporation. Whether they know it or not, when lawmakers, stock exchanges, and other policy-makers develop rules about board structure and composition, they are deciding whether they are creating a board structure that facilitates monitoring or managing by board members. For example, a board structure that emphasizes independent directors reflects a corporate governance policy of favoring monitoring over managing because the independent directors inevitably will have less information and therefore will be less able to contribute to managerial decision-making than inside directors. On the other hand, a board structure designed to maximize the efficacy of board participation in strategic planning and other managerial functions will

have relatively few outside independent directors. Instead, such boards will feature relatively more insiders who have sufficient information about the company to enable them to participate meaningfully in managerial decision-making.

Transnational differences in corporate governance structures can be explained on the basis of whether such structures are intended primarily to promote better governance in the form of better monitoring, or better governance in the form of higher quality advice for management. For example, the U.S. board structure, which has a unitary board of directors comprised of a very small number of insiders (often only one) and a large number of outsiders, reflects an implicit policy choice promoting a monitoring corporate governance paradigm rather than an advising corporate governance paradigm. In contrast, in the United Kingdom, the board structure features a much higher number of insiders on the board. This structure reflects a corporate governance paradigm focused on forming and refining strategy and otherwise advising management, since clearly, the large number of insiders on the boards of U.K. companies undermines the capacity of the board to conduct credible outside monitoring.

The separation of the board into two separate governance structures is common in civil law companies. This board structure, which consists of a supervisory (monitoring) board and a management (managerial) board, represents a clear attempt to eliminate the problems associated with vesting the board's managerial and monitoring functions in a single group of people.[8] This explains why shareholders sometimes prefer a dual board system to a single board system.[9]

Utilization of the committee structure has been suggested as a way of reducing conflict on single-tier boards of directors. Specifically, board committees are said to permit the separation of the monitoring function from the advisory function.[10] The assertion that board members somehow can function as independent monitors when serving on committees, but then magically rejoin the management team when they are meeting as part of the full board rather than on the committee seems highly doubtful. It seems more likely that some board members, regardless of their committee affiliation, will view their distance from management, and resulting ability to contribute to the value of the corporation through monitoring, as the source of their value to the enterprise. Other board members will view their experience in, and ability to work with management as the source of their value-added to the business.

Financial economists have argued that management's view of whether the board is serving more as friendly internal advisor or as detached outside monitor will influence the quantity of information provided to the board. On this view, the corporation benefits if management reveals more information to the board because the increased disclosure enables the board to provide better advice to management. The CEO, however, has private incentives to refrain from revealing information to the board, to the extent that such disclosure allows the board to monitor management more effectively and more intensively.[11] In other words, managers who disclose more to their boards receive better advice but are scrutinized more closely. Renee Adams and Daniel Ferreira develop a

model that shows that management-friendly boards can be optimal because they increase the quality of the advice that directors provide to managers.[12]

These results, however, critically depend on the assumption that the benefit to shareholders of the increase in firm value from the better advice are greater than the costs to shareholders of the decrease in firm value from the lower-quality monitoring performed by management-friendly but information-rich directors.

Sarbanes-Oxley attempts to deal with the problem of auditor capture by corporate management by making it clear that outside auditors should be selected, compensated by and report to the audit committee of the board of directors, rather than to management, as was previously done. Ironically, Sarbanes-Oxley, in focusing on the problem of capture, evinces a clear recognition that the capture phenomenon is a problem in corporate governance that must be reckoned with. Unfortunately, the statutes addresses only the problem of auditor capture (and rather ineffectively, as discussed in Chapter 11), ignoring the more profound problem of board capture, which is the focus of this chapter.

Ironically, these responses to the collapse of Enron ignore what may be the most important lesson for corporate governance offered by the Enron debacle, which is that putting more reliance on any particular corporate governance mechanism increases investors' vulnerability to any failure in that mechanism. To the extent the U.S. system of corporate governance relies more heavily on board monitoring than other corporate governance systems, it is concomitantly more vulnerable when such monitors fail, as they did with Enron.

A crucial, but wholly unexamined, assumption underlying this foundational theory of corporate governance is that boards of directors can reasonably be expected to do what is required of them. This assumption cannot withstand scrutiny. If it is not possible to design a corporate governance system capable of identifying and selecting board members competent to perform the monitoring and oversight functions expected during the course of their tenure in office, then our reliance should shift from boards of directors to other mechanisms of corporate governance.

The basic point of this chapter is that the reliance on boards of directors by U.S. policy-makers is wholly misplaced. Public choice, social psychology, and historical observation all suggest that boards can be counted on to be only as honest and effective as the managers they are supposed to supervise. The problem with boards is their unique susceptibility to capture by the managers they are supposed to monitor. The problem of capture is so pervasive and acute that no board, not even those that appear highly qualified, independent, and professional, should not be relied upon entirely. Other, more objective corporate governance devices such as trading (Chapter 7) and the market for corporate control (Chapter 8) are required to supplement the monitoring and discipline ostensibly done by boards of directors.

The problem of board capture is so acute that it simply is not reasonable to construct a system of corporate governance that relies in any meaningful way on boards of directors to improve corporate performance or prevent corporate deviance. The analysis here draws on early work that I have done jointly with Arnoud Boot about the

trade-off between objectivity and proximity in corporate governance.[13] In this work, we analyze corporate governance systems as providing mechanisms and institutions by which outside investors monitor managers. Some mechanisms and institutions of corporate governance, such as the market for corporate control, operate objectively through markets, while others, notably boards of directors, operate at close proximity through direct, personal, intra-firm interaction.

The utilization of both proximate and objective mechanisms of corporate governance has costs as well as benefits. The benefit of objective corporate governance mechanisms is that they are not subject to capture or other biases that can affect their ability to analyze and evaluate the performance of management. The cost of objective corporate governance mechanisms is that these mechanisms lack the high quality real time information about corporate decisions and corporate performance that is available to proximate monitors. Thus, participants in the market for corporate control are objective, but the information they use to evaluate corporate performance is the publicly available information available to all market participants when and if the company chooses to disclose it.

In contrast, the benefit of proximate corporate governance mechanisms, of which boards of directors are the archetypal example, is that they have access to the highest quality information about what is occurring within the corporation whenever they want to have it. Unlike objective monitors, proximate monitors do not learn about corporate plans and strategies when those plans and strategies are executed. Rather, proximate

monitors learn about plans and strategies as they are being formulated and developed. The cost of proximate monitoring is that such monitoring is far more susceptible to capture than are objective monitors. As shown below, because proximate monitors, like directors, participate in corporate decision-making, they take ownership of the strategies and plans that the corporation pursues. In doing so, these proximate monitors are rendered incapable of objectively evaluating these strategies and plans later on.

In particular, boards of directors have long been responsible for selecting and evaluating the performance of top management. After top managers have been selected, retained, and promoted, boards become committed to and responsible for these managers. For this reason, as board tenure lengthens, it becomes increasingly less likely that boards will remain independent of the managers they are charged with monitoring.

Research in public choice and psychology strongly supports the claim that the potential for capture is inextricably associated with proximate monitoring such as that performed by boards of directors. Boards inevitably have close proximity to management, and this makes it highly likely that they will become captured by management. For example, the "theory of escalating commitments" predicts that board members identify strongly with management when they begin to agree with management's decisions.[14] Earlier decisions, once made and defended, affect future decisions such that later decisions comport with earlier decisions.[15] As such, studies of the decision-making process during the Vietnam War era reveal that this country's leaders paid more attention to new information compatible with their earlier decisions.

They tended to ignore information that contradicted those earlier assumptions.[16] These studies suggest that once ideas and beliefs become ingrained in the minds of a board of directors, the possibility of altering those beliefs decreases substantially. Gilovich argues that "beliefs are like possessions" and "[w]hen someone challenges our beliefs, it is as if someone criticized our possessions."[17]

Furthermore, social psychologists show that people tend to internalize their vocational roles. Occupational choices, such as the choice to accept employment as a corporate director, strongly influence our attitudes and values.[18] In the context of boards of directors, this influence means that board members tend to internalize management's perspective. This tendency causes board members to lose their objectivity. This problem does not arise with shareholders in public markets who have little or no contact with management, and thus does not generally affect the objectivity in participants in the market for corporate control. [19]

The cognitive bias that afflicts boards of directors and other proximate monitors involves the cognitive bias that Kahneman and Lovallo have described as the "inside view."[20] Like parents unable to view their children objectively or in a detached manner, proximate monitors tend to reject statistical reality and view their firms as above average. Objective monitors, by contrast, evaluate management decisions and compare incumbent management and rival management teams dispassionately, albeit on the basis of less information than is available to proximate monitors.

Similarly, proximate monitors may be afflicted with what is known as an "anchoring bias" which leads them to establish or "anchor" their initial views and opinions of management. This generally occurs during the time that a firm retains a monitor or recruits an outside director. Once a proximate monitor develops a positive view of management, that opinion is "anchored" and does not change.

In addition, proximate boards lack objectivity from an economic perspective. Board supervision tends to make the board jointly responsible with management for the state of the firm. The degree of joint responsibility depends on the level of the board's involvement with the firm. The board may abstain from corrective action because of "cognitive biases," but also for related reputational reasons. The board then abstains, because corrective action may reveal the board's failure to take the proper course of action.[21] Boards may resist action for other reasons, as well. They invest considerably in the information specific to the existing management. Changing management would then potentially dilute the value of this investment. Moreover, to a large extent, boards of directors resemble legislatures with essentially one interest group constituency: management. Management not only has the time and resources to cultivate directors it is also the group that presents the board with the information necessary to make decisions. Over a wide range of issues, all management must do is present information in a way likely to generate support or to achieve effective capture of the board. It is not surprising, therefore, that boards often lack objectivity.[22]

The idea of board capture, of course, is not new. Oddly, however, analysis of the problem that the independence of ostensibly independent outside directors might be compromised by board capture has been confined to the relatively narrow issue of executive compensation. Consistent with the idea of board capture, in their work on executive compensation, Lucian Bebchuk, Jesse Fried and David Walker have argued that "outside directors are connected to the executives by bonds of interest, collegiality, or affinity."[23] As a consequence of the "substantial influence" of the CEO and the CEO's management team over even nominally independent directors, bargaining over executive compensation does not, according to these commentators, even "approach the arm's length ideal. Rather, executives use their power to set a high level of compensation, and outside directors cooperate with management at least to some extent."[24]

This approach to executive compensation seems accurate. There is no reason, however, why this approach should be limited to the context of executive compensation. Management's self-interest in their compensation is obvious and palpable. If directors are "strongly inclined to defer to and support the CEO's judgment" about managers' compensation, they will be even more strongly inclined to defer to them on issues that do not involve such a direct conflict of interest.

The core problem is that, over time, with regard to both executive compensation and to other issues of corporate governance, all directors, including outside directors, eventually become reputationally linked to management. When management performs well, the directors who have selected, recruited, and compensated these managers are

viewed as able. When management performs poorly, its performance casts a long and negative shadow on the directors. In other words, in a very real sense, directors assume "virtual ownership" of the managers they ostensibly monitor. Nowhere is this problem more acute than when the chairman of the board of a company serves concurrently as the company's CEO. In such cases, the person in charge of overseeing the CEO is, literally, the CEO himself. It is difficult to rationalize this organizational structure on shareholder welfare grounds in light of the fact that the dual CEO/chairman roles exacerbate the problem of capture and undermine the efficacy of the position of board chairman.

The fact that directors are literally responsible for selecting competent management makes it exceedingly difficult for directors to evaluate managers with any distance or objectivity. Unlike outside observers of the company, directors are being asked to evaluate their own decisions when they evaluate the decisions of managers. This may be literally true, as when directors are required to evaluate the results of strategic plans that they themselves have participated in formulating and developing. It may also be indirectly true, as when directors are required to evaluate the performance of managers whose competence they have already repeatedly endorsed over the years, through their retention and promotion decisions related to those managers.

The problem of board capture is exacerbated by the fact that managers are, of course, fully aware that they are being evaluated by the directors. As such, managers have extremely high-powered incentives to present themselves, and their work, to directors in the most favorable possible light. This, in turn, strongly suggests that the

flow of information from management to the board will be biased in ways that put management in the most favorable possible light, and undermine the effectiveness of dissident or uncooperative directors.

For example, boards of directors frequently must make decisions under tight time constraints. Directors who challenge management's recommendations or who simply demand more information risk being branded as ineffective or accused of impeding the company's ability to respond to new opportunities efficiently. Professor Donald Langevoort summarized the situation as being one involving a trade-off between collegiality and commitment, claiming that "the more dissension there is in a group, the less committed members become to it."[25] At the same time, Professor Langevoort claims that research studies support the finding that "[t]he most productive boards are ones that have enough diversity to encourage the sharing of information and active consideration of alternatives, but enough collegiality to sustain mutual commitment and make consensus-reaching practicable within the tight time frames in which boards must operate."

Another way of putting all of this is that a trade-off exists between true board independence and board productivity. Truly independent boards are willing to sacrifice the goal of consensus-building so that they can roundly criticize management when necessary or appropriate. The sustained mutual commitment necessary to create a truly collegial board will be highly productive, but will not be a hospitable environment for board members who want to dissent or even to challenge the group consensus.

Similarly, managers also have strong incentives to develop close personal ties with directors, "wining and dining" them and urging upon them the idea that collegiality is an important part of a director's work. While directors are, of course, encouraged to ask tough questions, to meet among themselves independent of management, and to avail themselves of outside, independent sources of information about corporate performance and director competence, many directors face conflicting social norms that may make it difficult for them to perform the tough oversight function that they are theoretically supposed to perform. In particular, directors are supposed to be "team players" who "get along" with senior executives, and their fellow directors, and perform their duties in an atmosphere of comfortable collegiality.

As Renee Jones has observed, "the prototypical director conduct is attributable to the social phenomenon of conformity: a willingness to comply with the wishes and opinions of others to avoid embarrassment or discomfort. This tendency toward conformity perpetuates many undesirable director traits which stand impervious to outside influence without external feedback and intervention."[26] The dilemma faced by directors appears to be intractable because any board that is too collegial is likely to be ineffective in monitoring managers, and any board that is insufficiently collegial is likely to be unproductive because it will be unable to reach needed consensus within the tight time-constraints in which boards are required to operate.

In other words, certain widely embraced social norms that are generally highly important and constructive in most social and business contexts can be quite inefficient in

the context of corporate boards of directors. These norms include not only that of collegiality discussed in the preceding paragraph, but also other fundamental norms such as loyalty, civility, transparency, and deference to authority.

The conflict between the operation of these norms in the boardroom and the aspirational view of directors as independent, objective monitors of senior management has gone almost wholly unrecognized. Challenging senior management can easily be construed as disloyal. Engaging in adversarial dialogue and suggesting that the performance of senior management be discussed in closed sessions may appear to be uncivil and non-transparent. Moreover, in the U.S., where the board chairmen of seventy percent of public companies serve concurrently as CEO of the company, challenging senior management may be viewed as insubordinate.

Because boards of directors are group enterprises, board members also face collective action problems in decision-making that make it even more difficult for individual board members to challenge management or otherwise to act independently. Where a CEO makes a proposal to a group of board members, the first board member to raise questions or to disagree with management bears the greatest risk of being branded uncooperative or non-collegial. With this in mind, even when a board member disagrees with management, he has an incentive to remain quiet, hoping that another board member will speak first, thereby relieving the pressure on the remaining board members. Famed corporate gadfly Warren Buffett captured the problem well in a 2002 letter to shareholders of his company, Berkeshire Hathway. Note that Mr. Buffett uses the term

“boardroom atmosphere” when he refers to the social norms that permeate the boardroom. Consistent with the analysis here, Mr. Buffett suggests that breaching these norms simply is not done be well-mannered people:

> Why have intelligent and decent directors failed so miserably? The answer lies not in inadequate laws -- it's always been clear that directors are obligated to represent the interests of shareholders -- but rather in what I'd call "boardroom atmosphere." It's almost impossible, for example, in a boardroom populated by well-mannered people, to raise the question of whether the CEO should be replaced. It's equally awkward to question a proposed acquisition that has been endorsed by the CEO, particularly when his inside staff and outside advisors are present and unanimously support his decision. (They wouldn't be in the room if they didn't.) Finally, when the compensation committee -- armed, as always, with support from a high-paid consultant -- reports on a megagrant of options to the CEO, it would be like belching at the dinner table for a director to suggest that the committee reconsider.[27]

Of course, it is widely understood that a lack of objectivity undermines the efficacy of directors as corporate governance mechanisms. Even special interest groups representing business, such as the Business Roundtable, have joined the SEC, the stock exchanges, and institutional investors in championing the idea of the ideal director as an independent director. Typical approaches to boards of directors advise that board members should

“have a substantial degree of independence from management.”[28] At precisely the same time that companies are being exhorted to become more independent, they also are being required to do more actual work with management, and to take on more responsibility for decision-making within the company. Thus, boards of directors in the U.S. are being asked to be more independent at precisely the same time that they are being asked to interact more with management.

The problem of capture suggests that it may be very difficult for a board of directors to attain this goal because the risk of capture increases as the board becomes more closely linked – and aligned – with the managers they ostensibly are monitoring. While the core functions of the board of directors remains that of overseeing and providing guidance to management, the job descriptions of directors have expanded significantly. Directors are now required to provide far more than the broad and rather vague oversight and guidance services they traditionally provided. In the post Sarbanes-Oxley regulatory environment, directors must review the key risks in the company's businesses, supervise the company's management of those risks, and ensure the adequacy of the company's risk management programs. Traditional tasks, like reviewing and approving major transactions, have become significantly more time-consuming and involved as directors are required to establish that these reviews have followed adequate procedures.

As the hands-on management responsibilities of boards has increased, so too has the frequency of board interaction with management. In other words, boards of directors

are being asked to become a much more integral part of the decision-making and financial reporting processes within firms at the same time that they are being asked to provide more objective evaluations of the quality of these decisions and processes. These expectations are unrealistic. Boards cannot be expected to be more objective in their evaluations of senior management at the same time that they are being required to become increasingly involved with senior management in the decisions about strategy and financial reporting.

In sum, the cognitive biases leading directors to identify with management are exacerbated by the increased expectations to manage the company that modern corporate governance regulation places on directors. All directors of modern public companies are supposed to be highly diligent and closely involved with the management of the firm. Directors who are properly doing their jobs are expected to have regular, if not almost daily contact with management. Thus, board members are increasingly being asked literally to police themselves to the extent that they are being required to police management because directors are deeply involved with management in formulating strategy and in making important decisions about the direction of the company.

In addition to these problems of cognitive bias that lead to board capture, a second problem with constructing a corporate governance system that relies primarily on boards of directors to monitor managers is that it is virtually impossible to identify, much less to monitor and control, the myriad ways that board independence can be compromised. Personal relationships, which are far more difficult to monitor and evaluate, are as likely

to compromise a director's independence as a professional relationship. In other words, it often is impossible to determine whether a board is independent. This means that often it is extremely difficult, if not impossible, to distinguish a company with an independent board from one in which subtle relationships between board members and managers and among board members causes the board to lack independence from management. This point was made quite powerfully by former SEC Commissioner Cynthia Glassman, who observed that "personal relationships with the CEO - living in the same community, kids at the same school, moving in the same social circle - are just as likely to undercut independence" as the financial relationships that a director may have with the company.[29]

The highly subjective nature of the concept of an independent board member is a result of the fact that there are myriad ways that board members can be captured by management. This problem is concretely manifested in efforts by regulators to make boards more independent. For example, the New York Stock Exchange recognizes that it is impossible as a practical matter to draft standards that provide guidance for when a board member is independent and when he is not. The problem is that "[i]t 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."[30] Consequently, the NYSE rule provides that the issue of whether a director is independent must be determined not by any objective standard, but by the business judgment of the directors' colleagues on the board. Thus, according to the NYSE, a director qualifies as independent when the board of directors

“affirmatively determines that the director has no material relationship with the listed company (either directly or as a partner, shareholder, or officer of an organization that has a relationship with the company).”[31] The rule promulgated for directors in public companies traded over-the-counter is virtually identical to the NYSE’s rule. The NASD rule, which applies to the corporate governance of companies whose shares trade over-the-counter, provides that the board must determine whether a particular board member is independent based on whether he has a relationship that, “in the opinion of the company’s board, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director.”[32]

In practice, however, courts clearly do not evince much faith in the ability of boards of directors to identify the subtle conflicts of interest that face directors. In the context of corporate decision-making, this suggests we will observe two types of errors in evaluating board independence. In addition to the obvious problem that a conflicted or a captured board will appear to be independent, there is the problem that an independent board will be wrongly construed as captured.

Recent shareholder litigation involving Oracle Corporation provides a vivid illustration of the difficulty of regulating director independence. The Oracle litigation began with a shareholder lawsuit against Larry Ellison, Oracle's CEO, Jeffrey Henley, its CFO, and Donald Lucas and Michael Boskin, two of its board members, claiming these officers and directors had harmed the company by engaging in improper insider trading.

The lawsuit was filed in Delaware, where Oracle is incorporated. Delaware, like every other state, treats lawsuits of this kind (known as derivative law suits) as the property of the corporation who allegedly was harmed, rather than as the property of the shareholder bringing the suit. The corporation, which, of course really means the board of directors of the corporation, has the right to make its own determination about whether proceeding with the lawsuit is in the best interests of the corporations or not.

Derivative lawsuits typically name some or all of the existing board members as defendants, alleging that their malfeasance or negligence somehow has harmed the corporation (the effectiveness of these sorts of lawsuits as a corporate governance device is discussed below in Chapter 10). To deal with this obvious conflict of interest involved in having directors determine whether the corporation would benefit from proceeding with a lawsuit in which they themselves are named as defendants, judges have developed an elaborate procedure that enables the corporation to respond to derivative lawsuits. The procedure calls for the board to appoint a special litigation committee (SLC) of independent directors to conduct a good faith investigation of the merits of the case being brought on the corporation's behalf, and to make a recommendation to the court that the lawsuit be dismissed.

In theory, of course, the SLC does not have to recommend that the plaintiff's lawsuit be dismissed. An SLC could recommend the plaintiff be allowed to continue the lawsuit. As a practical matter, however, this is virtually never done. SLCs uniformly recommend that derivative lawsuits brought by outside shareholders be dismissed. When

the SLC recommends dismissal of the suit in Delaware, the Court of Chancery, sitting without a jury, reviews the SLC's recommendation.

The critical determination regarding how much deference to give the recommendation of the SLC to dismiss the lawsuit will depend on the Chancery Court's evaluation of the independence of the SLC members. If the Court determines the SLC is not sufficiently independent of the officers and directors whose conduct it investigated, it will decline to accept the SLC's recommendation of dismissal. In a decision that stunned the corporate world, a Delaware Chancery Court judge determined that the SLC appointed to investigate the Oracle officers and directors involved in trading Oracle shares was not sufficiently independent.

Oracle chose two Stanford professors, Joseph Grundfest and Hector Garcia-Molina, to the SLC investigating the claims against Ellison, Henley, Lucas and Boskin. These professors were not implicated in the alleged trading improprieties. In fact, they were not even on the board when the trading occurred. By objective measures, the directors were clearly independent. As the court noted, they were "distinguished tenured (Stanford) faculty members whose current jobs would not be threatened by whatever good faith decision they made as SLC members." The members of the SLC had no "economically consequential" relationships with the defendants, and could, therefore reach a decision independent of pressure from the defendants. At least this is what the SLC and its lawyers thought.

However, the SLC members were linked to some of the defendants by significant ties to Stanford. The two Stanford professors on the committee were investigating another Stanford professor (Boskin), a major Stanford donor (Lucas) and a potentially major Stanford donor (Ellison). The web of Stanford connections proved too much for the judge, who indicated a willingness to evaluate independence much more strenuously than other courts:

> [T]he SLC focuses on the language of previous opinions . . . that indicates that a director is not independent only if he is dominated and controlled by an interested party . . . . [M]uch of our jurisprudence on independence focuses on economically consequential relationships between the allegedly interested party and the directors who allegedly cannot act independently of that director. Put another way, much of our law focuses the bias inquiry on whether there are economically material ties between the interested party and the director whose impartiality is questioned, treating the possible effect on one's personal wealth as the key to the independence inquiry.

The Chancellor took the position that the traditional focus on the economic interests and conflicts of SLC members:

> would serve only to fetishize much-parroted language, at the cost of denuding the independence inquiry of its intellectual integrity….

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 sapien 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.

In other words, the court found that the social norms of the directors on the SLC, coupled with the web of connections between the SLC members and the defendants, rendered the SLC incapable of evaluating the conduct of the defendant directors:

> [A] person in Grundfest's position would find it difficult to assess Boskin's conduct without pondering his own association with Boskin and their mutual affiliations. Although these connections might produce bias in either a tougher or laxer direction, the key inference is that these connections would be on the mind of a person in Grundfest's position, putting him in the position of either causing serious legal action to be brought against a person with whom he shares several connections (an awkward thing) or not doing so (and risking being seen as having engaged in favoritism toward his old professor and . . . colleague).

Interestingly, the court acknowledges that it is unable to tell whether the existence of the relationships it was evaluating would lead the members of the SLC to be tougher or laxer than they might be otherwise.

Still more problematic is that there is no indication of the limits of the court's analysis. The societal norms and the "there but for the grace of God go I" issues that plagued the Oracle SLC will plague directors any time they are called upon to evaluate senior officers or director colleagues in any context. As one commentator trenchantly observed,

> if it is difficult for two Stanford professors to investigate another Stanford professor, when there are over 1,700 Stanford professors, how much more difficult must it be for two directors to investigate three directors on a ten-person board? Social and institutional bonds, as well as economic bonds, can be much stronger between directors than between professors at a large university.[33]

To date, the entire infrastructure of board conduct is based on the idea that the board is a collegial decision-making body. It would be possible, of course, to imagine replacing the current highly collegial norms of board behavior with an adversarial model. Human nature being what it is, it is not plausible to imagine directors simultaneously being collegial and adversarial, or shifting seamlessly between these two patterns of interaction with management. To do so would require unrealistic assumptions about human behavior.

Although boards of directors are rarely adversarial, other corporate governance mechanisms and devices employ an adversarial model. Sometimes adversarial corporate governance works, and sometimes it doesn't.

It is not for nothing that outside bidders in hostile takeovers are called "hostile" bidders. And few corporate governance mechanisms are as effective as the market for corporate control.

Another adversarial corporate governance mechanism is the litigation system, which, of course is built on the adversarial idea that sharply opposing interests interacting before an impartial fact finder generates a truthful outcome. In the context of corporate governance, however, there is no independent and impartial judge to decide contentious issues, rendering the applicability of the adversarial model somewhat dubious, unless one is comfortable putting directors in the singular position of serving both as advocates for and against, as well as judges of managerial behavior.

Notes to Chapter 4

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[1] The term "corporate governance" is surely the most over-used and poorly defined in the lexicon of business.

Widely used definitions of the term corporate governance– with my commentary on each–include the following:

- **"Corporate governance refers to corporate decision-making and control, particularly the structure of the board and its working procedures. However, the term corporate governance is sometimes used very widely embracing a company's relations with a wide range of stakeholders or very narrowly referring to a company's compliance with the provisions of best practices codes."** [1] This definition is both too broad and too narrow. It is too narrow, because it wrongly limits the focus of corporate governance to internal institutions like boards of directors. Moreover, to the extent that corporate governance is thought to include toothless devices such as codes of best practices that do not actually constrain deviant corporate behavior, the definition is too broad because it suggests that the purpose of corporate governance is to serve some vague general purpose, rather than govern deviant corporate behavior.
- According to the OECD, "**Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and**

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responsibilities among different participants in the company, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives and strategy are set, and the means of attaining those objectives and monitoring performance".[1] The OECD's definition is consistent with the one presented by Cadbury[1]. This is a pretty good definition. The definition is a little confusing, because it is not clear whether the term "corporate governance" is being used to discuss a set of internal rules within firms, or more broadly to include legal rules and societal norms, as I think it should.

- "**Corporate governance is about promoting corporate fairness, transparency and accountability**" J. Wolfensohn, former president of the World Bank, as quoted by an article in Financial Times, June 21, 1999. Corporate governance is about governance. It is really not about "promoting" anything. However, to the extent the corporations are well governed, they are likely to exhibit characteristics like fairness, transparency and accountability.
- "**Some commentators take too narrow a view, and say it (corporate governance) is the fancy term for the way in which directors and**

auditors handle their responsibilities towards shareholders. Others use the expression as if it were synonymous with shareholder democracy. Corporate governance is a topic recently conceived, as yet ill-defined, and consequently blurred at the edges…corporate governance as a subject, as an objective, or as a regime to be followed for the good of shareholders, employees, customers, bankers and indeed for the reputation and standing of our nation and its economy".[1] This last definition is at least frank about the lack of a generally recognized definition of the term "corporate governance". As broad as it is, however, this definition, like many of the others, provides no concrete sense of whether corporate governance is a descriptive term that tells us what directors actually do, or a normative term that describes what directors ought to be doing.

[2] A.L.I. Principles of Corporate Governance Section 3.02.

[3] *In re The Walt Disney Company Derivative Litigation*, 825 A.2d 275 (Del. Ch. 2005).

[4] Ibid.

[5] See, for example, Delaware General Corporate Law, sec. 102(b)(7) or Model Business Corporation Act, sec. 2.02(b)(4), both of which shield directors from personal liability for breach of the fiduciary duty of care.

[6] Report of the Permanent Subcommittee on Investigations of the U.S. Senate Committee on Governmental Affairs, *The Role of the Board of Directors in Enron's Collapse*, July 8, 2002.

[7] *The Economist*, February 10, 2001, 68 (reporting on a survey of corporate boards performed by PriceWaterhouse Coopers).

[8] Renee Adams and Daniel Ferreira, "A Theory of Friendly Boards," (2005 working paper).

[9] Ibid.

[10] Ibid.

[11] Ibid.

[12] Ibid.

[13] Jonathan Macey and Arnoud Boot, *Monitoring Corporate Performance: The Role Of Objectivity, Proximity And Adaptability In Corporate Governance*, 89 Cornell Law Rev 356 (2004).

[14] See David G. Myers, *Social Psychology* 46–47 (New York: McGraw Hill, 1983).

[15] See id.

[16] See Ralph K. White, *Selective Inattention*, Psychology Today, Nov. 1971, 82 (observing that "there was a tendency, when actions were out of line with ideas, for decision-makers to align their actions.").

[17] Thomas Gilovich, *How We Know What Isn't So: The Fallibility of Human Reason in Everyday Life* 86 (New York: The Free Press, 1991); Robert P. Abelson, "Beliefs are like Possessions," 16 Journal Theory of Social Behavior 222 (1989).

[18] Jerald G. Bachman & Patrick O'Malley, "Self-Esteem in Young Men: A Longitudinal Analysis of the Impact of Educational and Occupational Attainment," 85 Journal of Political Economy 365, 370–76 (1977).

[19] Of course in the case of leveraged buyouts by management, where the participants in the market for corporate control are managers, cognitive bias may be an issue.

[20] See Daniel Kahnman & Dan Lovallo, "Timid Choices and Bold Forecasts: Perspectives on Risk Taking," 39 Management Science 17, 24–27 (1993).

[21] In this interpretation, the board monitors management. In a two-tier system (e.g., the Netherlands and Germany), this is clearly the supervisory board's task. Under a one-tier system (e.g., the United States and United Kingdom), non-executive directors act as monitors.

[22] Bainbridge argues for group decision-making. He emphasizes, however, not the effectiveness of monitoring the CEO, but rather the potential benefits of team decision-making versus individual decision-making. See Stephen M. Bainbridge, *Why a Board? Group Decision Making in Corporate Governance*, 55 Vanderbuilt Law Rev 1, 19–38 (2002). Holström defends the opposite view, however, and argues that group decision-making may undermine each individual's incentive to engage in monitoring. See Bengt

Holmström, Moral Hazard in Teams, 13 Bell Journal Economics 324, 326–28, 334–40 (1982).

[23] Managerial Power and Rent Extraction in the Design of Executive Compensation, (2002)

[24] Ibid.

[25] Donald Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 Georgetown Law Journal 810-811 (2001).

[26] Renee Jones, "Policing Corporate Boards: Behavior Analysis Suggests Enforcement Mechanisms Needed," available at http://www.bc.edu/schools/law/alumni/magazine/2005/winter/currents/

[27] http://www.berkshirehathaway.com/letters/2002pdf.pdf.

[28] Business Roundtable, "Principles of Corporate Governance," May, 2002, available at www.brt.org.

[29] Cynthia A. Glassman, U.S. Securities and Exchange Commission, Remarks on Governance Reforms and the Role of Directors before the National Association of Corporate Directors, 20 October, 2003

[30] www.nyse.com/pdfs/finalcorpgovrules.pdf

[31] Ibid.

[32] NASD Rule 4200(a)(15).

[33] Mike O'Sullivan, posted at http://www.corplawblog.com/archives/000161.html (30 June, 2003).