Is the Independent Director Model Broken?

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I. INTRODUCTION

At common law, an interested director was barred from participating in corporate decisions in which he had an interest, and therefore "disinterested" directors became desirable. This concept of the disinterested director developed into the model of an "independent director" and was advocated by the Securities and Exchange Commission (SEC or Commission) and court decisions as a general ideal in a variety of situations. The SEC's policy preference for independent directors was embodied in the Investment Company Act of 1940[1] and highlighted in some early cases.[2] Although the term "independent director" is often used rather loosely, it should be understood to mean a director without any general conflict of interest with the corporation. An interested director, by contrast, is a director who has a conflicting interest in a particular transaction.

The SEC's view of the need for independent directors should be understood in the context of Adolph Berle's theory of the 1930s. It posits that shareholders had abdicated control of public corporations to corporate managers, and fiduciary duties needed to be imposed upon corporate boards to compensate for this loss of shareholder control.[3] Berle's writings laid the foundation for shareholder primacy as the theory of the

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1. Investment Company Act of 1940, 15 U.S.C. §§ 80a-1, 80a-2(19), 80a-10 (2012).

2. *See infra* text accompanying note 10.

3. A. A. Berle Jr., *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365 (1932); A. A. Berle Jr., *Corporate Powers As Powers in Trust*, 44 HARV. L. REV. 1049, 1049–50 (1931).

firm—a theory embraced by the SEC, which viewed itself as a surrogate for investors. Pursuant to this theory, a corporation is managed for the benefit of its shareholders.

The SEC has generally succeeded in imposing its corporate governance views in the wake of scandals. Following the sensitive payments enforcement program of the 1970s, the SEC embarked on an activist corporate governance reform program. During the merger and acquisition frenzy of the 1980s, the SEC used the Williams Act[4] to foster the view that the market for corporate control constrained incompetent managers. After the bursting of the technology bubble in 2000 and the financial reporting scandals that ensued, the SEC was able to incorporate its views on independent directors into the Sarbanes–Oxley Act of 2002 (Sarbanes–Oxley).[5] Following the financial crisis of 2008, the SEC further enforced its views on independent directors in the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank).[6]

The composition and behavior of securities markets and investors has changed drastically since the SEC was established in 1934. Yet, the SEC has persisted in its path-dependent view that independent directors, ever more stringently defined, should dominate the boards of public companies. What is the function and rationale for such directors? If it is to assure that corporations comply with laws and regulations imposed on public corporations, then they become just another (probably ineffectual) gatekeeper. If it is to weaken the power of the CEO, it should be noted that there is some doubt whether independent directors can or should do so. If it is to be responsive to the needs and views of shareholders, which shareholders of an increasingly diverse body should be served? In recent years, and particularly in the aftermath of the 2008 financial crisis, academics and others have been questioning both the shareholder primacy model of the firm and the independent director model of board governance.

The independent director ideal has not been embraced all over the world. Neither has shareholder primacy. In some countries, a director representing the controlling shareholder is considered to be not independent because one of the goals of corporate governance is the protection of minority shareholders. Also, where the government is a major

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4. Pub. L. No. 90-439, 82 Stat. 454 (1968) (modifying Securities Exchange Act of 1934, §§ 13, 14 and codified as 15 U.S.C. § 78m–n (2006)).

5. Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in scattered sections of 15 U.S.C. § 7201, 18 U.S.C. § 7201, and 28 U.S.C. § 7201).

6. Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered sections of 7, 12, 15, 42 U.S.C.).

shareholder, the independent director model is problematic. After the 2008 financial crisis, the conflicts between shareholders and creditors became more apparent. Should the independent director be independent of major shareholders as well as managers in order to preserve and increase the value of the firm?

I have never been entirely comfortable with the SEC's view that the best public company boards are those composed of directors whose only compensation for sitting on a board comes from directors' fees and who have no potentially conflicting business interests (past or present) with the company. The debates about independent directors were heated while I was a commissioner of the SEC from 1977 to 1980. Afterwards I served as an independent director of a large public company for twenty years, as a public director of the New York Stock Exchange from 1983 to 1989, and on the Advisory Committee for the American Law Institute Corporate Governance Project.[7] Many of my views are colored by these experiences. In particular, when I was a director, I found the insights of inside directors invaluable in decision making. Since 2008, my doubts about the independent director model have increased. This Article will explore those doubts and suggest that director expertise may be more important than director independence. Further, directors should have an obligation to the long-term viability of a corporation. Such an obligation would infringe upon the shareholder primacy theory of the firm, especially to the extent that this model encapsulates running the company for short-term economic gain. Furthermore, in an institutionalized marketplace, retail shareholders may need to be protected against institutional investors.[8]

Part II of this Article outlines the evolution of the independent director model as championed by the SEC. Part III discusses criticisms of the independent director model. Part IV discusses shareholder primacy and sets forth alternatives to the shareholder primacy theory of the firm. Part V discuses corporate governance models outside the United States. Part VI concludes.

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7. AMERICAN LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (1994).

8. *See* Roberta S. Karmel, *Should a Duty to the Corporation Be Imposed on Institutional Shareholders?*, 60 BUS. LAW. 1 (2004).

II. TWENTIETH-CENTURY SEC VIEWS ON INDEPENDENT DIRECTORS

A. Early SEC Views

In re Franchard Corp.[9] is generally cited as the first move by the SEC into the establishment of corporate governance standards. The Commission held that the "integrity of management—its willingness to place its duty to public shareholders over personal interests"—is a material disclosure item.[10] The SEC staff had argued in this administrative stop-order proceeding that "by identifying members of the board of directors, [the registrant] impliedly represented that they would provide oversight and direction to the registrant's officers."[11] The Commission rejected this theory on the ground that it would "stretch disclosure beyond the limitations contemplated by the statutory scheme."[12] The Commission believed it was not equipped to evaluate the entire conduct of a board in the context of the whole business operations of a company.

Over time, this limited view of the SEC's statutory authority and expertise gave way to a more activist approach to corporate governance. In its reports on the financial collapse of Penn Central, the SEC cited lapses by the railroad's board of directors: "They failed to perceive the complexities of the company's financial operations, problems, or the critical nature of the company's financial situation [and] permitted management to operate without any effective review or control" because they "were uninformed of important developments and activities."[13]

The SEC staff's view of the need for corporate governance reform has generally been aired in the context of corporate scandals. In the early 1970s, a number of influential voices cried out for federal corporate chartering in order to curtail the deleterious influence of giant corporations.[14] The SEC then embarked on an activist corporate governance reform program in the context of a general post-Watergate hysteria—an effort to blame business for a prevailing climate of corruption, a stagflation economy, and a long-bear market. The immediate spur to this program was the questionable foreign payments cases, where approximately 400 pub-

9. 42 S.E.C 163, Securities Act Release No. 33-4710, 1964 WL 67454 (July 31, 1964).

10. *Id*. at 5.

11. *Id.* at 8.

12. *Id.* at 9.

13. RALPH FERRARA & MARK GOLDFUS, EVERYTHING YOU EVER WANTED TO KNOW ABOUT THE FUTURE OF FEDERAL INFLUENCE IN CORPORATE GOVERNANCE 28 (1979).

14. *See, e.g.*, RALPH L. NADER ET AL., TAMING THE GIANT CORPORATION (1st ed. 1976); William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974); Donald E. Schwartz, *A Case for Federal Chartering of Corporations*, 31 BUS. LAW. 1125 (1976).

lic companies consented to injunctions to cease paying commercial bribes to foreign government agents in order to obtain business.[15] Some of these consents included the restructuring of a company's corporate board.

In response to the sensitive payments cases, Congress passed the Foreign Corrupt Practices Act,[16] which criminalized the payment of bribes to foreign officials.[17] It also required companies registered with the SEC to maintain accurate books and records, and to develop a system of internal accounting controls.[18] This was the first statute in which the SEC was given direct power to regulate the internal affairs of public corporations. Ironically, the statute was passed almost simultaneously with a Supreme Court decision prohibiting the use of Section 10(b) and Rule 10b-5 under the Securities Exchange Act of 1934 (Exchange Act) from being used to regulate directorial breaches of fiduciary duty.[19] According to the Court, such an extension of the securities laws would overlap and interfere with state corporation law: "Absent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities."[20] Therefore, the SEC obtained a new power to impact corporate governance with regard to internal controls at the same time the Court expressed the view that Congress did not intend to create a federal corporation law by passing the federal securities laws.

Nevertheless, in a general atmosphere of criticism of business leaders, the corporate governance debate turned to questions of board composition and director independence. The SEC embarked on a program to influence board structure with a new chairman who believed in independent board directors. In April 1977, the SEC announced that it would hold public hearings concerning shareholder communications, shareholder participation in the corporate electoral process, and corporate governance in general.[21] After these hearings, the SEC proposed rules to encourage boards to become independent of management by restructuring to include only persons not affiliated with the corporation.

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15. *See* SEC. & EXCH. COMM'N, 94TH CONG., REPORT ON QUESTIONABLE AND ILLEGAL CORPORATE PAYMENTS AND PRACTICES (Comm. Print 1976) [hereinafter SEC REPORT ON QUESTIONABLE PAYMENTS].

16. Pub. L. No. 95-213 (1977) (codified in scattered sections 15 U.S.C. 78).

17. 15 U.S.C. §§ 78dd-1 to -2 (2006).

18. 15 U.S.C. § 78m(b)(2).

19. *See* Santa Fe Indus. v. Green, 430 U.S. 462 (1977).

20. *Id.* at 478–79.

21. Reexamination of Rules Relating to Shareholder Communications, Shareholder Participation in the Corporate Electoral Process, and Corporate Governance Generally, 42 Fed. Reg. 23901-02 (May 11, 1977).

In the view of then-SEC Chairman Harold Williams, a majority of board members should be independent, or at the very least a board's nominating, compensation, and audit committees should be composed of independent directors.[22] Williams also recommended that the CEO should not serve as chairman of the board. It is interesting that Chairman Williams was not a fan of shareholder primacy. He criticized shareholders who purchased stock to hold for a short period of time to sell at a profit, stating: "They do not perceive themselves as owners of the company, but rather as investors—or speculators—in its income stream and the stock market assessment of its securities."[23] Although he believed that a board of independent directors could be a countervailing force to CEO power—and thus necessary to make corporations more accountable—his concept of corporate accountability went far beyond that owed to shareholders:

> As a society, we depend on private enterprise to serve as the instrument through which to accomplish a wide variety of goals—full employment, equal economic opportunity, environmental protection, energy independence, and others. When viewed in light of these social implications, corporations must be seen, as to a degree, more than purely private institutions, and corporate profits as not entirely an end in themselves, but also as one of the resources which corporations require in order to discharge their responsibilities.[24]

The view that corporations are quasi-public institutions that should be held accountable to a number of constituencies has a long history, but the independent director movement did not usher in an era of corporate accountability to employees, customers, or the public. Rather, the model of the board of independent directors accompanied a shift from a manager-centric corporate governance system to a shareholder-centric system.[25]

Disclosure regulation was the only mechanism the SEC had for effecting boardroom reform during the SEC corporate governance program of the 1970s. Accordingly, the SEC proposed to require all corporations subject to the SEC's proxy rules to label their directors as "independent"

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22. Harold M. Williams, Chairman, Sec. and Exch. Comm'n, Address at the Sixth Annual Securities Regulation Institute, Corporate Accountability—One Year Later (Jan. 18, 1979), *available at* http://www.sec.gov/news/speech/1979/011879williams.pdf.

23. Harold M. Williams, Chairman, Sec. and Exch. Comm'n, Address at the Fifth Annual Securities Regulation Institute, Corporate Accountability 12 (Jan. 18, 1978), *available at* http://www.sec.gov/news/speech/1978/011878williams.pdf.

24. *Id.* at 8.

25. *See* Edward B. Rock, *Adapting to the New Shareholder-Centric Reality*, 161 U. PA. L. REV. 1907, 1910 (2013).

or "affiliated."[26] These rules aroused a storm of protest and the SEC's final rules required only a brief description of "significant economic and personal relationships . . . between the director and the issuer."[27] Although the SEC has generally managed to utilize disclosure requirements as a prophylactic device to achieve some modification of corporate conduct, the agency chafed at being unable to directly regulate corporate behavior. It viewed the absence of any SEC authority to regulate corporate board structure as a policy error to be corrected.

During the takeover battles of the 1980s, pressure for independent directors arose in court battles where incumbent boards attempted to maintain company independence or fight against corporate raiders by finding a white knight.[28] The active merger and acquisition market of this decade led to the demise of many established industrial companies. In administering the Williams Act, the SEC generally sided with bidders, or the interests of Wall Street, in opposition to target companies, or the interests of Main Street.[29] In retrospect, the takeovers of this period were part of the deindustrialization of the United States and may not have been entirely positive. Although the U.S. economy arguably became more efficient and competitive, the manufacturing of goods and many types of jobs were outsourced or exported. Finance overtook industry and income inequality markedly increased. Some of these issues were debated during the November 2012 elections with a hindsight view of the financial crisis of 2008. In my opinion, however, the asset bubble of the early years of this century, and its bursting in 2008, was the culmination of economic and financial regulation problems that should have been apparent in the 1980s. The SEC focused on defending the market for corporate control when perhaps it should have been focusing on the questionable behavior of financial investors who were dismantling public corporations for short-term shareholder gain.

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26. Shareholder Communications, Shareholder Participation in the Corporate Electoral Process and Corporate Governance Generally, Exchange Act Release No. 14,970, 43 Fed. Reg. 31945, 31947 (July 18, l978).

27. Shareholder Communications, Shareholder Participation in the Corporate Electoral Process and Corporate Governance Generally, Exchange Act Release No. 15,385385384, 43 Fed. Reg. 58522, 58523 (Dec. 6, 1978).

28. *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

29. The SEC did so by refusing to define the term "tender offer," *see* Hanson Trust PLC v. SCM Corp., 774 F.2d 47 (2d Cir. 1985); Wellman v. Dickinson, 475 F. Supp. 783 (S.D.N.Y. 1979), sometimes bringing cases, *see* SEC v. Carter Hawley Hale Stores, Inc., 760 F.2d 945 (9th Cir. 1985), refusing to close the 10-day window for Schedule 13D filings to allow bidders more time to accumulate stock, adopting Rule 14d-10, and participating in cases as amicus curiae.

The merger mania of the 1980s was financed to a significant extent with junk bonds emanating from Drexel Burnham Lambert (Drexel). The role of that firm in using leverage to take over major industrial companies continues to be controversial, even after Michael Milken, Drexel's maestro, went to jail for insider trading.[30] More recently, the spotlight has focused on Bain Capital, a Drexel client, which engaged in a number of highly leveraged private equity deals in the 1980s that resulted in the export of U.S. manufacturing and jobs.

The directors of target companies who attempted to fend off unwelcome hostile takeovers during this period were frequently criticized for their failure to act independently of management.[31] But with hindsight, it is possible to inquire whether the financial interests that fueled the takeover boom of the 1980s acted in the public interest or only in the interest of stock market speculators. The passage of state-other constituency or stakeholder statutes attempted to ameliorate the strong shareholder primacy underpinnings of the Williams Act,[32] but Delaware did not pass such a statute and continued to referee battles between bidders and target companies.

B. Investment Company Governance

For many years, the SEC enjoyed more success in promoting the idea of independent directors for investment companies than for other corporations because the securities laws gave the SEC more power to do so. Investment company corporations are organized under state law, often in the state of Maryland.[33] Under the Investment Company Act of 1940, at least 40% of the board must be composed of "independent" or "disinterested" directors.[34] The rationale for this provision was to eliminate conflicts of interest and abuses rampant in the investment trusts of the 1920s.[35] This principle may have originated at the New York Stock Exchange, Inc. (NYSE), which made independent representation on the boards of investment trusts a requirement for listing in 1931 on the theory that investor "protection could be most readily obtained by independ-

30. *See* CHARLES R. GEIST, WALL STREET: A HISTORY 335–42, 358 (1997).

31. *See, e.g.*, Smith v. Van Gorkam, 488 A.2d 858 (Del. 1985).

32. *E.g.*, 15 PA. CONSOL. STATS. ANN. §§ 1711, 1715, 1716, 1717, 2502.

33. *See* Burks v. Lasker, 441 U.S. 471 (1979).

34. Investment Company Act, 15 U.S.C. 80 §§ a-2(a)(19), a-10(a), 2(a)(19) (2006).

35. *See Investment Trusts and Investment Companies: Hearings on S.3580 Before a Subcommittee of the Committee on Banking and Currency Committee*, 76-768, Part 1, 76th Cong. 8–9, 32–47 (1940).

ent directors under whose scrutiny and friendly criticism [of] contemplated transactions would pass for review."[36]

Initially, the directors of an investment company could not be "affiliates" of the investment company, but in 1970 the statute was changed to the stricter standard that directors must be "disinterested."[37] However, the SEC did not remain satisfied with this amendment, so it advocated for further director independence. In 2001, the SEC determined that certain investment companies, those that rely on certain exemptions by rule, were required to have a majority of their boards be disinterested directors and have independent legal counsel for the independent directors.[38] This rule was never challenged.

In 2004, the SEC amended ten widely relied upon exemptive rules to enhance the effectiveness of independent directors.[39] Funds using these exemptions were required to have 75% disinterested directors and an independent chairman. Other provisions with regard to governance included the following: (1) fund directors must perform an evaluation, at least once annually, of the effectiveness of the board and its committees, and among other things, decide if they are serving on too many fund boards; (2) independent directors need to be authorized to hire their own employees; and (3) funds need to retain the written materials directors consider in approving an advisory contract. Two Commissioners dissented from the adoption of these rules and the case went to the D.C. Circuit Court, which held in *Chamber of Commerce v. SEC*[40] that the SEC had the authority to pass the rule mandating a 75% board of independent directors but did not appropriately consider costs and benefits with regard to the separation of the CEO and chairman. Therefore, the court vacated the independent chairman rule. Nevertheless, most funds now have at least a majority and usually 75% independent directors. Some have independent chairmen, but many have a lead director instead.[41]

The SEC is happy to experiment with its corporate governance ideas in the context of investment company regulation, but investment companies are merely a pool of assets without employees or products. The

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36. *Id.* at 36.

37. *See* Pub. L. No. 91-547, 84 Stat. 1416 (1970).

38. Role of Independent Directors of Investment Companies, Exchange Act Release No. 43786, 66 Fed. Reg. 3734 (Jan. 16, 2001).

39. Investment Company Governance, Inv. Co. Act Rel. No. 26520, 69 Fed. Reg. 46378 (Aug. 2, 2004).

40. Chamber of Commerce v. SEC, 412 F.3d 133 (D.C. Cir. 2005). The case was remanded to the SEC and a revised rule was also stricken. Chamber of Commerce v. SEC, 443 F.3d 890, 896 (D.C. Cir. 2006).

41. *Overview of Fund Governance Practices 1994–2012*, INVESTMENT COMPANY INST., www.ici.org/pdf/pub_13_fund_governance.pdf (last visited Nov. 22, 2013).

role of the board is to manage the relationships between the company and its service providers, particularly its advisers and underwriters. In many respects, the board serves a compliance function and is not involved with strategy or the development of new products or services. Despite the SEC's belief that the organization of an investment company board is a good model for all corporations, investment companies are highly regulated financial vehicles and their use as a model for other corporate boards is questionable.

C. Sarbanes–Oxley Reforms

After the bursting of the technology stock market bubble of the 1990s and the implosion of Enron and WorldCom,[42] Congress passed Sarbanes–Oxley in 2002[43] in an effort to reform the corporate governance of public companies under the direction and supervision of the SEC. In June 2002, immediately prior to the passage of Sarbanes–Oxley, a committee of the NYSE, at the urging of the SEC, issued a report recommending changes to the NYSE listing standards.[44] This report had a variety of recommendations for changes in NYSE listing standards that went beyond Sarbanes–Oxley, including: (i) requiring listed companies to have a majority of independent directors, with a stringent definition of the term "independent"; (ii) a provision for regularly scheduled executive sessions of boards chaired by a lead director or independent chairman; (iii) requiring listed companies to have nominating and compensation committees composed entirely of independent directors; and (iv) requiring shareholder votes on equity-compensation plans. These recommendations were then transmitted to the NYSE board of directors, and several of them were filed with the SEC as proposed new listing standards.

Sarbanes–Oxley gave the SEC the authority it had long wanted to restructure aspects of corporate governance, but it did so primarily by authorizing the SEC to direct self-regulatory organizations (SROs) to change their listing rules to meet certain standards.[45] The law mandated that the SEC put into place requirements pertaining to the independence and functioning of public company boards—audit committee members, in particular—by ordering the NYSE and other SROs to make such re-

42. *See* Kathleen Brickey, *From Enron to WorldCom and Beyond: Life and Crime After Sarbanes–Oxley*, 81 WASH. U. L.Q. 357 (2003).

43. *See* sources cited *supra* note 5.

44. N.Y. STOCK EXCH., REPORT OF THE NEW YORK STOCK EXCHANGE CORPORATE ACCOUNTABILITY AND LISTING STANDARDS COMMITTEE (2002) [hereinafter NYSE CORPORATE ACCOUNTABILITY REPORT], *available at* http://www.nyse.com/pdfs/corp_govreport.pdf. This project was requested by the Chairman of the SEC.

45. Sarbanes–Oxley Act § 301, 15 U.S.C. § 78j-l (2002).

quirements part of their listing standards. In addition to regulating the manner in which audit committees are structured and function in a way that was not previously done, Sarbanes–Oxley made these regulations a matter of federal, rather than state, law.

Because Sarbanes–Oxley greatly enlarged the scope of the Exchange Act as to specific matters of corporate governance, the SEC acquired greater freedom to utilize SRO listing standards to accomplish corporate governance reform. In implementing Sarbanes–Oxley, the SEC has made ample use of this new authority, raising the interesting question of where the line between federal and state law should be drawn with respect to a corporation's internal affairs.

In addition to proposals that relate to audit committees, the NYSE proposed that non-management directors must meet at regularly scheduled executive sessions, and that nominating and compensation committees be composed entirely of independent directors.[46] Nasdaq filed similar listing proposals with the SEC.[47] The final SRO listing rules, as approved by the SEC for implementing Sarbanes–Oxley, include provisions for independent board members for key committees; mandate executive sessions of non-management directors; define committee independence for audit and nominating committee members; define audit committee financial experts; set forth specific size requirements and obligations of the audit committee; and require companies to have codes of business conduct and ethics.[48] Continuing education for directors is also suggested.[49]

46. *See* Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by the New York Stock Exchange, Inc. Relating to Corporate Governance, Exchange Act Release No. 47672, 68 Fed. Reg. 19051 (Apr. 11, 2003).

47. Self-Regulatory Organizations; New York Stock Exchange, Inc. and National Association of Securities Dealers, Inc., Exchange Act Release No. 48745, 81 SEC Docket 1586 (Nov. 4, 2003).

48. Self-Regulatory Organizations; New York Stock Exchange, Inc. and National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Changes (SR-NYSE-2002-33 and SR-NASD-2002-141) and Amendments No. 1 Thereto; Order Approving Proposed Rule Changes (SR-NASD-2002-77, SR-NASD-2002-80, SR-NASD-2002-138 and SR-NASD-2002-139) and Amendments No. 1 to SR-NASD-2002-80 and SR-NASD-2002-139; and Notice of Filing and Order Granting Accelerated Approval of Amendment Nos. 2 and 3 to SR-NYSE-2002-33, Amendment Nos. 2, 3, 4 and 5 to SR-NASD-2002-141, Amendment Nos. 2 and 3 to SR-NASD-2002-80, Amendment Nos. 1, 2, and 3 to SR-NASD-2002-138, and Amendment No. 2 to SR-NASD-2002-139, Relating to Corporate Governance, Exchange Act Release No. 48,745, 68 Fed. Reg. 64154 (Nov. 12, 2003).

49. Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Am. No. 1 thereto by the New York Stock Exchange, Inc. Relating to Corporate Governance, File No. SR-NYSE-2002-33, Exchange Act Release No. 47672, at *12 (Apr. 11, 2003) (director orientation and continuing education must be described in corporate governance guidelines); Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by the American Stock Exchange LLC Relating to Enhanced Corporate Governance Requirements Applicable to Listed Companies, File No. SR-Amex-2003-65, Exchange Act Release No. 48706, at *10 (Oct. 27,

D. Dodd–Frank Reforms

The restructured public company board, as mandated by Sarbanes–Oxley, did little to prevent the financial meltdown of 2008. It has been argued that, leading up to the crisis, independent directors did not sufficiently focus on or understand risk and risk management.[50] However, rather than questioning the soundness of the independent director model in the wake of widespread corporate failures, the SEC pushed forward with its ideological preference for independent directors and so added provisions to this effect into Dodd–Frank.[51]

Dodd–Frank further tightened the independence requirements for compensation committees, requiring that each member of compensation committees be independent and clarifying the standards by which committee members are determined to be independent.[52] Additionally, Dodd–Frank requires compensation committees to consider certain enumerated factors in selecting compensation consultants, legal counsel, or other advisors to the committee, such as "the policies and procedures of the person that employs the compensation consultant, legal counsel, or other adviser that are designed to prevent conflicts of interest."[53]

Some Dodd–Frank reforms reached beyond independent director requirements and fingered executive compensation as a cause of the financial crisis. Dodd–Frank attempted to empower shareholders to curb risky behavior by managers by giving shareholders an advisory vote on executive compensation and golden parachutes.[54] A claw-back provision for executive compensation based on erroneous financial statements was also inserted for public companies.[55] With regard to financial institutions, Dodd–Frank required appropriate financial regulators to impose regulations on such institutions to disclose the structures of all incentive-based compensation arrangements that could lead to material financial loss or

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2003) (listed companies urged to develop and implement continuing education programs for all directors).

50. Michael E. Murphy, *Assuring Responsible Risk Management in Banking: The Corporate Governance Dimension*, 36 DEL. J. CORP. L. 121, 128–34 (2011); Andrew Ellul & Vijay Yerramilli, *Stronger Risk Controls, Lower Risk: Evidence from U.S. Bank Holding Companies* (AXA Working Paper Series, Paper No. 1, Discussion Paper No. 646, 2010); Bernadette A. Minton, Jérôme P.A. Taillard & Rohan Williamson, *Do Independence and Financial Expertise of the Board Matter for Risk Taking and Performance?* (Fisher Coll. of Bus. Working Paper Series, Paper No. 2010-03-014, 2011).

51. *See supra* note 6 and accompanying text.

52. 15 U.S.C. § 78j-3 (2010).

53. *Id.* § 78j-3(b)(2)(C).

54. *Id.* § 78n-1.

55. *Id.* § 78j-4.

would be excessive for executive officers, employees, directors, or principle shareholders.[56]

Dodd–Frank also directed the Board of Governors of the Federal Reserve Board to issue regulations requiring each bank holding company with consolidated assets of greater than $10 billion, as well as each nonbank financial company supervised by the Board of Governors, to establish a risk committee.[57] The risk committee is responsible for the oversight of enterprise-wide risk management practices of the supervised company or bank holding company, and it is to include such a number of independent directors as the Board of Governors determines appropriate.[58] Additionally, the risk committees are to include at least one risk management expert having experience in identifying, assessing, and managing risk exposures of large, complex firms.[59] This reform thus emphasizes expertise rather than independence.

Misguided ratings for structured products were widely blamed for the 2008 financial crisis. In response, Dodd–Frank put into place new requirements for Nationally Recognized Statistical Rating Organizations (NRSROs).[60] At least half of the board of an NRSRO must be comprised of independent directors.[61] Further, a portion of the independent directors must include users of NRSRO ratings.[62]

In order to be considered independent, a member of the board of an NRSRO may not, other than as a board member, accept any consulting, advisory, or other compensatory fee from the NRSRO or be associated with any affiliated company of the NRSRO.[63] Additionally, a board member must be disqualified from any deliberation involving a specific rating in which the independent board member has a financial interest in the outcome of the rating.[64] Finally, the compensation of these independent board members may not be linked to the business performance of the NRSRO, and the term of office of such a director is limited to five years.[65]

Despite affirming the independent director model for compensation committees, Dodd–Frank sought to address capital market failures that

56. 12 U.S.C. § 5641(a)(1) (2010).
57. *Id.* § 5362.
58. *Id.* § 5365(h)(3)(A)–(B).
59. *Id.* § 5365(h)(3)(C).
60. 15 U.S.C. § 78o-7 (2010).
61. *Id*. § 78o-7(t)(2)(A).
62. *Id.*
63. *Id.* § 78o-7(t)(2)(B).
64. *Id.*
65. *Id.* § 78o-7(t)(2)(C).

led to the 2008 financial crisis in ways that go beyond, or even contradict, the usual SEC solution of mandating more independence for corporate board members. First, the statute and the financial regulators focus on the ability of directors to assess risk. Although firm stability and the interests of creditors are not synonymous, this focus on risk may lead creditor interests to trump shareholder interests in certain situations. Second, in the case of NRSROs, the concept of independence is geared to directorial responsibility for the quality of a company's products. Also, Dodd–Frank suggests a distinction in the shareholder primacy model between Main Street business corporations and financial institutions. Although Dodd–Frank inserted the idea of directors with expertise on boards of financial institutions, it is uncertain whether the expert director model will migrate to boards of other kinds of companies.

This Article focuses more on flaws in the independent director model for financial institutions than for industrial companies primarily because financial corporations failed so spectacularly in 2008. However, the failures of Enron and Worldcom, which were not financial institutions, raise the question of whether the independent director model needs reexamination more generally.

III. PROBLEMS WITH THE INDEPENDENT DIRECTOR MODEL

The installation of independent directors on the boards of public corporations is "grounded in the belief that outside directors are more effective than inside directors in monitoring management conduct"[66] because independent directors' incentives are more closely aligned with the goals of shareholders. Therefore, independent directors should maximize shareholder value by keeping a closer watch on executive management.[67] Independent directors are elected by shareholders so they are, in theory, "not beholden to the CEO."[68] The conventional wisdom is that independent directors will "reduce executive mismanagement, and decrease the likelihood of future corporate failure."[69]

The primary function of the independent director is to monitor the CEO and other executive officers to ensure that managers do not abuse their authority by engaging in self-dealing or fraud, or shirk their respon-

66. Thuy-Nga T. Vo, *To Be or Not to Be Both CEO and Board Chair*, 76 BROOK. L. REV. 65, 70 (2010).

67. Nicola Faith Sharpe, *Process over Structure: An Organizational Behavior Approach to Improving Corporate Boards*, 85 S. CAL. L. REV. 261, 276 (2012).

68. *Id.*

69. *Id.* at 277.

sibilities.[70] Through oversight of management, independent directors are supposed to "detect and prevent fraud . . . and managerial shirking of responsibilities."[71] This in turn should "enhance corporate performance because they can proactively examine corporate affairs, not only to ensure that managers are productive, but also to ensure that managers make the most efficient and effective decisions."[72]

Nevertheless, "companies have continued to fail despite the ubiquity of the majority independent board and related committee structures."[73] Some studies have shown that independent directors actually negatively affect corporations because they "are more likely to support management prerogatives than shareholder interests, [because] increasing outsider representation reduces research and development spending, and [because] an outsider-dominated board is more likely to award 'golden parachutes'[74] to the company's executives."[75] A 2009 study by David Erkens et al. points to "the inadequacy of measures to make boards more accountable to shareholders and to increase the independence of boards."[76] The study examined 296 financial institutions in thirty different countries that were at the heart of the 2008 financial crisis. The results showed that firms with more independent directors on their boards and a higher level of institutional ownership "experienced worse stock returns during the crisis period."[77] Professor Edward Rock has suggested that today's directors may be too closely aligned with shareholder interests and insufficiently attuned to creditors' interests.[78]

Independent directors are part-time participants in a corporation's affairs. By definition, they are outsiders. However intelligent, hardworking, or strong minded they may be, they do not have the time or the mandate to challenge management's judgments except as to a discrete number of issues. If they spend all of their time trying to audit the auditors

70. Lisa M. Fairfax, *The Uneasy Case for the Inside Director*, 96 IOWA L. REV. 127, 138 (2010).

71. *Id*.

72. *Id*.

73. *See* Sharpe, *supra* note 67, at 280.

74. "Golden parachutes" are compensation arrangements "that allow covered managers to voluntarily resign and collect substantial remuneration—in some cases several million dollars—after a triggering event, usually a hostile takeover." Philip L. Cochran, Robert A. Wood & Thomas B. Jones, *The Composition of Boards of Directors and Incidence of Golden Parachutes*, 28 ACAD. MGMT. J. 664, 664–65 (1985).

75. Vo, *supra* note 66, at 70.

76. Allan C. Hutchinson, *Hurly-Berle-Corporate Governance, Commercial Profits, and Democratic Deficits*, 34 SEATTLE U. L. REV. 1219, 1223 (2011).

77. *Id*.

78. *See* Rock, *supra* note 25.

and assure that executive compensation is reasonable, they will have no time for focusing on important business and strategy matters. And if they become essentially full-time directors, they will no longer be independent.

Independent directors are completely beholden to management for information. This dependence on insiders may give a CEO more power than was the case when a board included insiders. Moreover, the most informed outsiders may not be able to sit on a board due to antitrust or competitive constraints.

If independent directors repeatedly challenge the judgments of a CEO, the CEO will lose his authority and be forced to resign. Corporations are essentially hierarchical and need a strong leader. The SEC has not necessarily respected the celebrity CEO, and activist shareholders today are doing their best to diminish the CEO's authority.[79] Indeed, in the struggle between management and shareholders, it appears that CEO power is being diminished.[80] But some of the most highly regarded U.S. corporations have had authoritarian CEOs who have rewarded shareholders over a long period of time.[81] This does not mean that independent directors are a bad idea, but corporations should have greater freedom to experiment with board structures than they now have in the United States under federal law. Also, although the board of independent directors has been advocated in jurisdictions around the world, it might not be appropriate everywhere. Further, because the independent director board simply cannot carry the freight the SEC has placed upon it, it is bound to disappoint, causing investor and public dissatisfaction and loss of confidence.

The collegial board has its flaws and there are times when management deserves to be challenged and even thrown out of office, but the model of mixed independent and non-independent directors actually served the U.S. economy well over a long period of time. The consequences of changing this model to one where investors control the public corporation and a federal government agency controls board structure is problematic and did not prevent the 2008 financial meltdown.

The tweaking of the independent director model for NRSROs is an interesting development. In the case of rating agencies, the purpose of

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79. *See, e.g.*, Michael J. De La Merced, *Dell Buys Time to Seek Support for Sale to its Founder*, N.Y. TIMES, July 19, 2013, at B2 (detailing the battle between CEO Michael Dell and activist shareholder Carl Icahn for control of Dell, Inc.).

80. Marcel Kahan & Edward Rock, *Embatttled CEOs*, 88 TEX. L. REV. 987, 989 (2010).

81. The corporations run by Warren Buffet (Bershire Hathaway), Jack Welch (General Electric), and Bill Gates (Microsoft) come to mind as examples. *See* Helen Stock, *Buffet Admonishes Fund Directors*, WASH. POST, Mar. 7, 2004, at A15.

the independent director no longer seems to be acting on behalf of the shareholders as a check on management, but rather, is acting to insure the quality of the corporation's product ratings. The NRSRO independent director would appear to be a director who can put a brake on the quest for corporate profits if necessary to improve ratings quality. This confuses the independent director model and makes one wonder whether the entire independent director concept needs rethinking.

The SEC does not have general authority to regulate internal corporate affairs.[82] Yet, state law does not require particular board structures, including whether or not any independent directors are required on boards or particular committees, such as the audit committee. Rather, state legislators have been silent on this issue so that corporations could deal with it flexibly and good corporate practices could develop over time.[83] Courts have dealt with issues of board structure and independent directors in cases enforcing fiduciary duties[84] or in other specific contexts, such as whether demand needs to be made in a derivative case.[85] Courts have generally encouraged boards to have independent directors by more carefully scrutinizing the actions of non-independent directors.[86] In some cases, state law has been more flexible than stock exchange definitions of independence, but in other situations state law has held relationships that would not fit within those definitions to demonstrate a lack of independence.[87] If the SEC prevents the development of state law with regard to independent directors, state law is likely to atrophy.

IV. SHAREHOLDER PRIMACY AND OTHER MODELS

Shareholder primacy has been the dominant corporate governance theory since Berle and Dodd first debated it in the 1930s. However, the theory has recently begun to fall out of favor for several reasons. First, the theory is premised on the idea of shareholder homogeneity—the ex-

82. Santa Fe Indus. v. Green, 430 U.S. 462, 479 (1977).

83. *See generally* STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS § 5.5 (2002); FRANK EASTERBROOK & DANIEL FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (Harvard Univ. Press 1991).

84. *See* McMullin v. Beran, 765 A.2d 910 (Del. 2000); Kahn v. Tremont, 694 A.2d 422 (Del. 1997); Paramount Commc'ns v. QVC Network, 637 A.2d 34 (Del. 1994); Cooke v. Oolie, 2000 WL 710199 (Del. Ch. May 24, 2000); Chesapeake v. Shore, 771 A.2d 293 (Del. Ch. 2000).

85. *See, e.g.*, Marx v. Akers, 666 N.E.2d 1034 (N.Y. 1996); Grobow v. Perot, 539 A.2d 180 (Del. 1988); Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984); Zapata v. Maldonado, 430 A.2d 779 (Del. 1981)

86. *See, e.g.*, Kahn v. Lynch Commc'ns Sys., 638 A.2d 1110 (Del. 1994); Weinberger v. UOP, 457 A.2d 701 (Del. 1983); Globe Woolen Co. v. Utica Gas & Elec., 224 N.Y. 483 (N.Y. 1918).

87. *E.g.*, *In re* Oracle Corp. Derivative Litig., 824 A.2d 917 (Del. Ch. 2003).

istence of which is becoming increasingly rare. Second, the theory gives managers a short-term focus, rather than a focus on the long-term development of the corporation, with its emphasis on shareholder value. In addition, shareholder primacy is thought to have resulted in increased risk taking by financial corporations, which led to the 2008 financial crisis. Scholars continue to debate whether other theories of corporate governance are better models than the dominant shareholder primacy approach.

A. Shareholder Primacy

The independent director model is intertwined with the shareholder primacy model. The shareholder primacy theory "derives from the concept that the shareholders are the owners of the corporation and, as such, are entitled to control it, determine its fundamental policies, and decide whether to make fundamental shifts in corporate policy and practice."[88] Under this theory, officers and directors are considered agents of the shareholders.[89] They have a duty to maximize the financial value of the corporation in order to increase the value of the shareholders' interest.[90] Essentially, shareholder primacy means that corporations exist to serve the economic interests of shareholders.[91]

In addition to the ownership rationale that supports the shareholder primacy theory, proponents also point out that shareholders are the sole residual claimants of the corporation and, as such, "are in the best position to exercise control for the good of all corporate constituents."[92] Because shareholders are not paid until after all other stakeholders receive their entitlements, shareholders must "exercise discretion in a way that maximizes value for the entire corporation."[93]

At one time, directors' fiduciary duties were to the corporation and the body of shareholders as a whole. Because the SEC views its mandate as the protection of investors, it has changed this duty (for public compa-

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88. Robert Sprague, *Beyond Shareholder Value: Normative Standards for Sustainable Corporate Governance*, 1 WM. & MARY BUS. L. REV. 47, 59 (2010) (quoting John H. Matheson & Brent A. Olson, *Corporate Law and the Longterm Shareholder Model of Corporate Governance*, 76 MINN. L. REV. 1313, 1327 (1992)).

89. Andrew S. Gold, *Dynamic Fiduciary Duties*, 34 CARDOZO L. REV. 491, 501 (2012).

90. Marshall M. Magaro, *Two Birds, One Stone: Achieving Corporate Social Responsibility Through the Shareholder-Primacy Norm*, 85 IND. L.J. 1149, 1153–54 (2010).

91. Grant M. Hayden & Matthew T. Bodie, *The Bizarre Law and Economics of Business Roundtable v. SEC*, 38 J. CORP. L. 101, 116 (2012) [hereinafter *Bizarre Law and Economics*].

92. Grant M. Hayden & Matthew T. Bodie, *Shareholder Democracy and the Curious Turn Toward Board Primacy*, 51 WM. & MARY L. REV. 2071, 2076 (2013) [hereinafter *Shareholder Democracy*].

93. *Id.* at 2083.

nies) to a direct duty by directors to shareholders. But the SEC's mantra that it is the investors' advocate is too narrow. Since 1996, an amendment to the securities laws requires the SEC to consider efficiency, competition, and capital formation in addition to the protection of investors.[94]

One problem with the shareholder primacy theory is that it assumes the existence of "shareholder preference homogeneity"—that all shareholders "have a single-minded interest in wealth maximization."[95] However, in recent years, it has become evident that not all shareholders share this common goal. Rather, "their interests diverge along a number of dimensions."[96] For example, some shareholders are in the control group while others are not. Non-employee shareholders often have different interests than employee and pension-holding shareholders. In addition, "time horizons" for wealth maximization vary among shareholders.[97] "Short-term and long-term shareholders often have strongly divergent goals, which is particularly relevant given the increasing role of activist short-term investors such as hedge funds."[98] And in instances where shareholder interests are aligned and they can agree on the definition of wealth maximization, they may still differ as to the best way to achieve that goal.[99]

One response to the lack of shareholder homogeneity is to move away from the shareholder primacy theory and move towards one of the board primacy theories. Because shareholder preferences are as diverse as those of the corporation's other constituents, it is arguable that "corporate boards should be less responsive to shareholder interests[,] and more power and discretion should be accorded to these boards."[100] However, while shareholder heterogeneity may provide some support for a board primacy approach, "it is relevant to almost any feature of corporate gov-

94. 15 U.S.C. § 77b(b) (2010); *see also id.* § 78b(j).

95. Hayden & Bodie, *Shareholder Democracy*, *supra* note 92, at 2085.

96. Hayden & Bodie, *Bizarre Law and Economics*, *supra* note 91, at 181.

97. Because of computerized trading, investors today can hold stock for only seconds or nanoseconds. While other investors may hold for the long term, at the end of World War II, the average holding period for stockholders was four years; by 2008 it was two months and by 2011, it was only twenty-two seconds. Tom C.W. Lin, *The New Investor*, 60 UCLA L. REV. 678, 700 (2013). While many pension funds and other investors hold for longer periods of time, the SEC should be considering the impact of today's trading techniques on its corporate governance theories.

98. Martin Gelter, *Taming or Protecting the Modern Corporation? Shareholder–Stakeholder Debates in a Comparative Light*, 7 N.Y.U. J. L. & BUS. 641, 659 (2011).

99. Grant M. Hayden & Matthew T. Bodie, *Arrow's Theorem and the Exclusive Shareholder Franchise*, 62 VAND. L. REV. 1217, 1230–32 (2009).

100. Hayden & Bodie, *Shareholder Democracy*, *supra* note 92, at 2096.

ernance that makes the system more or less responsive to the shareholders."[101]

Another criticism of the shareholder primacy theory is that it causes management to focus too much on short-term goals, like stock price, and pay less attention to the long-term development of the corporation.[102] The 2008 financial crisis "added more fuel to the debate about shareholder empowerment."[103] Although recent legislation and rulemaking by the SEC has pushed "the trend toward more shareholder influence, we cannot rule out that the increased shareholder orientation of the past two decades is partly to blame for the [2008] events, given that pressure to produce more shareholder value may have led to more risk-taking, particularly in financial institutions."[104]

In *Hurly-Berle-Corporate Governance, Commercial Profits, and Democratic Deficits,* Allan C. Hutchison argues that there was "a failure on the part of regulators to appreciate that it was the single-minded focus on maximizing shareholder value that was at the heart of the [financial crisis]."[105] According to Hutchison, "the corporation's demise was fueled by the single-minded and irresponsible efforts by the management and board to inflate and maintain share prices and stock values."[106] Thus, it was the "continuing attachment to shareholder primacy [that] was as much the problem as the solution."[107] While Hutchison does not propose that any particular theory of corporate governance replace the shareholder primacy norm, he does recommend the creation of a more democratic corporate governance approach through "limits on limited liability; a broadening of directors' fiduciary duties; the increased representativeness of the board; and the enactment of substantive regulatory standards."[108]

The impact that financial institutions have on the real economy and the great recession that followed the 2008 Wall Street collapse should not be ignored in assessing shareholder primacy. Neither should other examples of corporate focus on shareholder gain resulting in anti-social conduct by large corporations. Shareholder primacy often drives public corporations to act in ways that are contrary to the interests of other constituencies and the public generally. In the United States, the problems

101. *Id.* at 2097.
102. Gelter, *supra* note 98, at 659.
103. *Id.* at 660.
104. *Id.*
105. *See* Hutchinson, *supra* note 76, at 1238.
106. *Id.*
107. *Id.*
108. *Id.* at 1250.

created by operating corporations exclusively for shareholder gain have been ameliorated by broad regulatory statutes to protect such interests, e.g., food and drug safety, as well as environmental and employee safety. But the burden on business of such regulation is great, and it might be better if director focus on constituencies beyond shareholders could substitute for ever-increasing statutory and agency regulation.

B. Board Primacy and Other Theories

Proponents of the board primacy theory focus on advocating for greater board independence, rather than "advocating for greater shareholder involvement."[109] According to Grant Hayden and Matthew Bodie, there are four primary board theories: the director primacy theory, the team production theory, the self-perpetuating board theory, and the quinquennial election model.[110]

Under the first theory, director primacy theory of corporate law, directors must manage "the corporation according to their best judgment."[111] According to one proponent of this theory, Stephen M. Bainbridge, "The chief economic virtue of the public corporation is . . . that it provides a hierarchical decision-making structure well-suited to the problem of operating a large business enterprise with numerous employees, managers, shareholders, creditors, and other constituencies."[112] Bainbridge and other director primacy advocates believe that this view of director conduct actually supports a "shareholder wealth maximization norm."[113] This view of director conduct supports a view of directors as "neutral mediating hierarchs."[114] Under this theory, directors "make sure that each corporate constituent receives adequate returns in light of their participation in the corporate endeavor."[115] Thus, "shareholder wealth maximization is no longer a mandate."[116]

According to Margaret Blair and Lynn Stout, under the second theory, the team production theory, the corporation is comprised of "a series of relationships"[117] that "result in the joint production of goods or ser-

109. Hayden & Bodie, *Shareholder Democracy*, *supra* note 93, at 2076.

110. *Id.* at 2089.

111. *See* Gold, *supra* note 89, at 501.

112. Hayden & Bodie, *Shareholder Democracy*, *supra* note 93, at 2090 (citing Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1754–57 (2006)).

113. *See* Gold, *supra* note 89, at 501.

114. *Id.*

115. *Id.*

116. *Id.*

117. Hayden & Bodie, *Shareholder Democracy*, *supra* note 93, at 2091.

vices that in turn create wealth."[118] In the context of these relationships, directors must be insulated and independent because they "serve as the ultimate authority when it comes to assigning responsibilities, mediating disputes, and divvying up the profits."[119] If the board were to favor one group over another, those in the unfavored group "would be less willing to make the proper investments of capital and labor to make the firm function."[120] Unlike proponents of the director primacy theory, Blair and Stout do not argue for shareholder wealth maximization. Instead, they argue that directors "owe a duty to the corporation and that the corporation consists of all of the stakeholders who are responsible for the business of the enterprise."[121]

The third theory is the self-perpetuating board theory. This approach, which is chiefly supported by Lawrence Mitchell, argues that boards of public corporations should be self-perpetual and that the directors themselves should "fill the periodic vacancies resulting from death, resignation, and increases in board size by selecting the people to fill those vacancies."[122] Mitchell argues that this admittedly radical approach "would best free managers to manage the firm."[123] Mitchell advocates against any control by shareholders because such control causes directors to only focus on share price.[124] By contrast, granting directors "complete freedom from shareholder oversight would 'enable them to manage responsibly and for the long term.'"[125]

Proponents of the fourth theory, the quinquennial election model of the corporation, "deplore the short-term focus that shareholder primacy brings to the corporation," and instead establish a new framework that revolves around lengthening the terms of directors to five years.[126] During their five-year terms, directors could only be fired for illegal conduct or "willful malfeasance."[127] Although directors would have the authority to approve mergers, acquisitions, and the like, these changes could only occur "at the time of the directors' election."[128] In addition, directors would be required to present a detailed five-year corporate plan that

118. *Id.*

119. *Id.*

120. *Id.*

121. *Id.*

122. *Id.* at 2093.

123. *Id.*

124. *Id.*

125. *Id.* (quoting LAWRENCE E. MITCHELL, CORPORATE IRRESPONSIBILITY: AMERICA'S NEWEST EXPORT 101 (2001)).

126. *Id.*

127. *Id.*

128. *Id.*

would be critiqued by independent advisors prior to the election. The director's compensation would also be directly tied to the success or failure of the plan.[129]

In *Questioning Authority: The Critical Link Between Board Power and Process*, Professor Nicola Faith Sharpe discusses an additional theory of corporate control—managerialism.[130] Under this theory lies the assumption that managers "run the firm free from any significant influence of the boards."[131] Advocates of this theory place the ultimate right of corporate control in the hands of managers, not directors or shareholders."[132] While discussions about this approach have diminished in modern corporate governance scholarship, there is practical evidence that the theory is in use. For example, CEOs have control over the selection of directors, over the board meeting agendas, and because of information asymmetry, the CEOs also have control over the amount and nature of the directors' knowledge and information about the corporation.[133]

C. Stakeholder Theory

Under the stakeholder theory, which is similar to the team-production theory, officers and directors' fiduciary obligations flow not only to the shareholders of the corporation, but also to "nonshareholder constituents whose interests are affected by corporate action."[134] "The heart of stakeholder theory is that corporations affect a variety of individuals and groups who have a 'stake' in the firm."[135] Because the corporation "benefits from the fruits of those individuals and groups," management has a "reciprocal duty to them."[136] Thus, managers have "broader obligations to balance the interests of shareholders with the interests and concerns of [stakeholders]."[137] Stakeholders, unlike shareholders, are those people with whom corporate "[m]anagers regularly deal with: employees, regarding work performance and working conditions; suppliers, concerning the quality of the goods delivered and non-delivery of goods; customers, who complain about the goods that the corporation markets;

129. *Id.* at 2093–94.

130. Nicola Faith Sharpe, *Questioning Authority: The Critical Link Between Board Power and Process*, 38 J. CORP. L. 1, 12 (2012).

131. *Id.*

132. *Id.*

133. *Id.*

134. Marshall M. Magaro, *Two Birds, One Stone: Achieving Corporate Social Responsibility Through the Shareholder-Primacy Norm*, 85 IND. L.J. 1149, 1156 (2010).

135. *Id.*

136. *Id.*

137. *Id.*

and local communities, concerning what the corporation is doing or not doing as a corporate citizen."[138] By taking into account all stakeholders' interests, "managers gain respect and trust in the eyes of stakeholders; and, importantly for the corporation, they can do their job better and more efficiently."[139]

The stakeholder theory competes with shareholder primacy because shareholder primacy "pushes managers to exploit non-shareholders in pursuit of shareholder gains."[140] For example, "directors can put downward pressure on wages and benefits for corporate employees"[141] in order to increase shareholder wealth. In addition, "unlike shareholder primacy, no grouping has prima facie priority over another, and no group warrants priority over any other groups."[142]

Some commentators have argued that "for a corporation to be truly sustainable, it will have to adopt a stakeholder, rather than a shareholder, value approach."[143] Robert Sprague argues that shareholder wealth maximization occurs in the long run when "managers act in the best interests of those who also have a stake in the success of the corporation—such as employees, suppliers, customers, and society. If corporate activities promote a healthy society, that society, in return, can support an environment conducive to business growth."[144]

The anti-takeover statutes passed by many states in response to the takeover mania of the 1980s were based on a stakeholder theory. Some of these statutes allow directors to consider constituencies other than shareholders when confronted with a hostile takeover.[145] Other statutes allow such considerations for any and all directorial decisions.[146] These statutes have been upheld as not preempted by the federal securities laws, which expressed a principle of neutrality as between bidders and target companies. Although these other constituency statutes were passed at the behest of labor interests because of the large-scale firings that generally

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138. Andrew Keay, *Stakeholder Theory in Corporate Law: Has It Got What It Takes?*, 9 RICH. J. GLOBAL L. & BUS. 249, 267 (2010).

139. *Id.*

140. David G. Yosifon, *The Public Choice Problem in Corporate Law: Corporate Social Responsibility After* Citizens United, 89 N.C. L. REV. 1197, 1200 (2011).

141. *Id.*

142. *See* Keay, *supra* note 138, at 268.

143. Robert Sprague, *Beyond Shareholder Value: Normative Standards for Sustainable Corporate Governance*, 1 WM. & MARY BUS. L. REV. 47, 78 (2010).

144. *Id.* at 80–81.

145. *See* Michal Barzuza, *The State of State Antitakeover Law*, 95 VA. L. REV. 1973, 2040 tbl.6 (2009) (listing other constituency statutes and effective dates by state).

146. *E.g.*, 15 PENN. CONS. STATS. ANN. §§ 1711, 1715, 1716, 1717, 2502 (West 1990).

followed takeovers,[147] they could be utilized more generally to protect employee and other interests against shareholder interests.[148]

The Stewardship Code[149] adopted in the United Kingdom after the financial crisis may change the shareholder-centric perspective of U.K. law to a stakeholder perspective, at least for financial institutions. Further, because of the existence of depositor insurance or bailouts by the state, the government is recognized as a key stakeholder who may be more concerned about the public interest than shareholder interests.[150]

Recently, many states have made provisions for the incorporation of benefit and flexible purpose corporations, which straddle a space between for-profit and non-profit corporations. The benefit corporation commits its owners to pursue social or philanthropic objectives, although shareholder profits may also be pursued. However, there is no obligation to give shareholders priority.[151] Flexible purpose corporations similarly would allow customers, the community, or society to trump shareholder interests.[152] These statutes are an updated version of the other constituency statues, and their use is an indication that at least some entrepreneurs eschew the model of managing a corporation exclusively for shareholder gain.

D. Bank Boards

After the 2008 financial crisis, regulators in the United States and Europe gave greater attention to the corporate governance of banks. Dodd–Frank required large bank holding companies to establish a risk committee. Similarly, the EU draft Capital Requirements Directive mandates that banks establish a risk committee composed of members of the management body who do not perform any executive functions at the bank.[153] The management body is defined as the governing body of a

147. Barzuza, *supra* note 145, at 1989.

148. Roberta S. Karmel, *Implications of the Stakeholder Model*, 61 GEO. WASH. L. REV. 1156 (1993).

149. FIN. REPORTING COUNCIL, THE UK STEWARDSHIP CODE (2012), *available at* http://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Stewardship-Code-September-2012.aspx.

150. *See* Iris H-Y Chin, *Institutional Shareholders as Stewards: Toward a New Conception of Corporate Governance*, 6 BROOK. J. CORP. FIN. & COM. L. 387, 418 (2012).

151. *See, e.g.*, CAL. CORP. CODE § 14620(d) (West 2011); N.Y. BUS. CORP. LAW § 1707(1)–(3) (McKinney 2011).

152. *See* CAL. CORP. CODE § 2602 (West 2011).

153. Jaap W. Winter, *The Financial Crisis: Does Good Corporate Governance Matter and How to Achieve It?*, 9 (DSF Policy Paper, No. 14, 2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1972057 .

corporation, comprising of the supervisory and the managerial functions with ultimate decision-making authority.[154]

Under the corporate law of the United States, directors do not generally owe a duty to creditors, with the possible exception of when the corporation is on the verge of insolvency.[155] This proposition was tested during the takeover battles of the 1980s and was maintained in several cases.[156] Yet, at one time, bank directors were held to have duties to depositors of the bank, and bank deposits in the United States are insured by the FDIC.[157] Similarly, directors of failed banks were even subject to some personal liability.[158] The concern after the 2008 financial crisis is, rightly, to prevent future bank insolvencies. Although risk committees are one response, explicitly charging directors with a duty to depositors would be another appropriate response.

As discussed above, Dodd–Frank did effect some changes in the corporate governance of financial institutions, particularly with regard to executive compensation.[159] European thinking has progressed further in this regard to focus on the short-term thinking and behavior of investors and attempt to impose stewardship duties on investors in financial institutions in order to curb risky managerial behavior.[160] Improved monitoring of corporate governance codes in the public interest is suggested. In addition, shareholders, as stewards, should be looking at the long-term viability of the corporation with the interests of the state as a lender of last resort in mind.[161]

Most of the corporate governance reforms for bank and public company boards have focused on director independence, although executive compensation and the establishment of risk committees have received some attention. Nevertheless, the populist response to the 2008 financial crisis has failed to address the role of equity market pressures in

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154. *Id.*

155. *See* N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92 (Del. 2007); Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns, Corp., No. 12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991).

156. *See, e.g.*, Metro. Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504 (S.D.N.Y. 1989); Katz v. Oak Indus., Inc., 508 A.2d 873 (Del. Ch. 1986).

157. Christopher M. Bruner, *Conceptions of Corporate Purpose in Post-Crisis Financial Firms*, 36 SEATTLE U. L. REV. 527, 536–41 (2013).

158. *Id.*

159. *See supra* Part II.D.

160. *Internal Market & Services, Report of the Reflection Group on the Future of EU Company Law*, at 46 (Apr. 5, 2011), *available at* http://ec.europa.eu/internal_market/company/docs/modern/reflectiongroup_report_en.pdf.

161. *See* Chin, *supra* note 150, at 423, 431–32.

risk-taking by financial institutions.[162] Indeed, there is some evidence that shareholders supported higher leverage and risky conduct by banks in order to generate higher returns.[163] Therefore, giving shareholders more power over bank management does not seem to be a valid solution to the problems of bank failure. Further, relying on independent directors to monitor managers with regard to their remuneration is futile if shareholders appoint the members of the compensation committee.[164] Therefore, conferring the power to appoint members of the compensation committee upon debt holders might be a better solution.[165]

F. Further Problems When the Government Is a Shareholder or Stakeholder

In emerging economies, especially the BRIC (Brazil, Russia, India, and China) countries, former state owned enterprises (SOEs) that have been fully or partially privatized have been listed on national or foreign stock exchanges and have become subject to independent director requirements. Nevertheless, where the government remains a major stockholder, questions remain as to what independence means and how independent a director can be.

A similar issue has arisen with regard to public companies in which the U.S. government and European governments took a major stake as a stockholder, a bondholder, or otherwise during the 2008 financial crisis. From 2008 to 2009, the U.S. government's portfolio of securities in private sector companies increased 282% from $340.4 billion to $959.9 billion.[166] As of June 1, 2010, the U.S. government held equity positions of either preferred or common shares in five major corporations (AIG, Chrysler, Citigroup, GM, and GMAC) and in Fannie Mae and Freddie Mac.[167] Similarly, the U.K. government became a major shareholder of Royal Bank of Scotland (RBS) and Lloyds Banking Group, amongst oth-

162. Bruner, *supra* note 157, at 529.

163. *Id.* at 557.

164. Edyta M. Dorenbos & Alessio M. Pacces, *Corporate Governance of Banks: Is More Board Independence the Solution?*, DOVENSCHMIDT Q., May 3, 2013, at 4, *available at* http://ssrn.com/abstract=2260341.

165. *Id.* at 32.

166. Benjamin A. Templin, *The Government Shareholder: Regulating Public Ownership of Private Enterprise*, 62 ADMIN. L. REV. 1127, 1152 (2010).

167. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-10-719, REPORT TO CONGRESSIONAL COMMITTEES, FINANCIAL ASSISTANCE, ONGOING CHALLENGES AND GUIDING PRINCIPLES RELATED TO GOVERNMENT ASSISTANCE FOR PRIVATE SECTOR COMPANIES, 13 (2010) [hereinafter GAO REPORT]. *See* Steven M. Davidoff, *Uncomfortable Embrace: Federal Corporate Ownership in the Midst of the Financial Crisis*, 95 MINN. L. REV. 1733, 1737–56 (2011).

er banks.[168] These holdings were considered antithetical to Anglo-Saxon capitalism;[169] therefore, it was thought that the government should not act like an ordinary commercial shareholder, but rather, a reluctant one. The preference of both the U.S. and U.K. governments was for a short holding period during which the government should not control day-to-day management decision making.[170]

Nevertheless, certain inherent conflicts between the government as a stockholder, committed to protecting taxpayer interests, and other governmental roles, such as the government as regulator of financial institutions, became apparent.[171] Additionally, there was a conflict between the goal of stabilizing the financial and housing markets and early divestment. Therefore, gaining concessions from management, labor, and creditors became a priority and exerting control over management also occurred.[172] The U.S. government limited executive compensation and dividend payments.[173] The government also mandated the appointment of new board members and executive officers more directly and more successfully than is generally accomplished by an institutional investor or private equity fund.[174] So, even limited government ownership raises the question as to what director independence means when the government is a major investor in a company.

In the context of government ownership, independence should mean not only independence from the management of the company but also independence from the majority stockholder. Yet, when the government appoints, or at least approves, the directors, the directors are not realistically independent of government control.[175] As a political actor, the government is in a position to pick the winners and losers among various corporate and other constituencies. The government may well not

168. *Privatising British Banks: Cutting Losses*, ECONOMIST, May 11, 2013, at 61. The U.K. government took an 82% stake in RBS; *see also*, George Parker, *Prospect of Early Sale Looks Less Likely*, FIN. TIMES, June 13, 2013, at 19.

169. *See* The Government Corporation Control Act of 1945, which requires congressional authorization before the U.S. government can own private sector companies. 31 U.S.C. § 9102 (1982).

170. *See* GAO Report, *supra* note 167, at 10.

171. *Id.* at 55.

172. *Id.* at 51.

173. *Id.* at 26.

174. *Id* at 20–25. Similar government control of management appointment has occurred in the United Kingdom. *See* Jonathan Ford, *Osborne Shouldn't Treat RBS Like His Family Business*, FIN. TIMES, June 14, 2013, at 9; Patrick Jenkins, *RBS Marriage Counsellor Turns Executioner*, FIN. TIMES, June 14, 2013, at 15.

175. *See generally* Mariana Pargendler, *The Unintended Consequences of State Ownership: The Brazilian Experience*, 80 FORDHAM L. REV. 2917 (2012), *available at* http://ir.lawnet.fordham.edu/flr/vol80/iss6/19/.

operate private sector companies with a view to maximize wealth, but rather may be seeking to achieve other goals. These problems and the doubts they raise about the viability of independent directors are readily apparent, even in a situation such as the temporary taking of equity positions in banks and other companies during the 2008 financial crisis. The issue of how independent directors can be independent becomes even more interesting in the case of long-term government holdings in partially privatized companies in other countries.

V. CORPORATE GOVERNANCE OUTSIDE THE UNITED STATES

A. Europe

Europe has employed different corporate governance models. For example, Germany has two-tier boards, with employee representation on the second tier. Conversely, the United Kingdom has boards of directors and directorial fiduciary duties similar to the United States. The U.K. Cadbury Code of 1992, however, led to a split between the executive and non-executive directors. Since the non-executive directors, in theory, supervise the executive directors, the requirements for non-executive directors serve to harmonize the one-tier and two-tier board structures.[176] Independence of directors at the board level became a paradigm in Europe at the beginning of the twenty-first century and was included as a recommendation in the Action Plan of the European Commission in 2003.[177] In particular, the codes recommended a majority of independent directors for the audit, nominating, and compensation committees.[178]

In the United Kingdom, independence standards are contained in the Corporate Governance Code of 2010 and prior codes. Independence is not affirmatively defined and is determined by the board.[179] The use of codes to encourage independent board members was endorsed by the European Commission in 2005.[180] Accordingly, the issue of having a substantial number, and often a majority, of independent directors is gen-

176. Patrick C. Leyens, *Corporate Governance in Europe: Foundations, Developments and Perspectives*, *in* RESEARCH HANDBOOK ON THE ECONOMICS OF EUROPEAN UNION LAW 183–98 (2012), *available at* http://ssrn.com/abstract=2176987.

177. *Id.* at 6.

178. *Id.*

179. *Id.*

180. Comm'n of Eur. Communities, *Recommendation on the Role of Non-Executive or Supervisory Directors of Listed Companies and on the Committees of the (Supervisory) Board*, 2005 O.J. (L 52) 51, *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2005:052:0051:0063:EN:PDF.

erally covered by "comply or explain" corporate governance codes.[181] There are few mandatory requirements, although under an EU directive, at least one member of the audit committee must be independent.[182]

In Germany, supervisory board members are non-executive by definition, but they are not necessarily independent.[183] An important issue is the definition of independence. An EU Green Paper defines independent as "free of any business, family or other relationship, with the company, its controlling shareholder or the management of either, that creates a conflict of interest such as to impair his judgment."[184] The question of whether a representative of a controlling shareholder is independent is important in Europe and other countries, but it has not been a focus in the United States. In several European countries a representative of a 10% shareholder is not considered independent.[185]

In Europe, the financial crisis has led to a skeptical view of the value of director independence as opposed to other qualities a director should have. This view is more pervasive than it has been in the United States and is especially pronounced in regard to the boards of financial institutions. According to an EU Green Paper, the non-executive directors of financial institutions did not devote sufficient resources or time to their duties; did not come from sufficiently diverse backgrounds; did not carry out a serious appraisal of their performance; and were unable or unwilling to ensure that the risk management of their companies was appropriate.[186]

Because shortcomings in corporate governance led to some of the problems at financial institutions during the crisis, debates in Europe have moved away from independent directors and have turned to other criteria for boards. One problem with the independent director model is a downplaying of competence. Recent debates in Europe about board composition focus on expertise and diversity as much as independ-

181. Eur. Comm'n, *Report of the Reflection Group on the Future of EU Company Law*, at 41 (Apr. 5, 2011), *available at* http://ec.europa.eu/internal_market/company/docs/modern/reflection group_report_ en.pdf.

182. Directive 2006/43/EC of 17 May 2006, (EC) No. 157/87, art. 41.1.

183. Paul L. Davies & Klaus J. Hopt, *Boards in Europe—Accountability and Convergence* 16 (ECGI Law Working Paper, No. 205, 2013), *available at* http://ssrn.com/abstract=2212272. In the Italian two-tier model, if the management board has more than four members, at least one should be independent.

184. Comm'n of Eur. Communities, *supra* note 181, at 13.1.1(d).

185. Davies & Hopt, *supra* note 183, at 17–18.

186. Eur. Comm'n, *Corporate Governance in Financial Institutions and Remuneration Policies*, at 6, COM (2010) 285 final (June 2, 2010).

ence.[187] Especially for financial firms, there is a need for expertise so the board can effectively discharge its responsibilities.[188]

The most recent European Commission Action Plan on corporate governance of listed companies has recommended enhanced transparency, shareholder engagement, and company growth and competitiveness.[189] Director independence is ignored or, at best, subsumed under a concern about conflict-of-interest transactions. Improved implementation of the "comply or explain" policy of the corporate governance codes is recommended, which could strengthen the independence of directors.[190] Yet, the first item discussed in the Action Plan with regard to transparency is disclosure of board diversity policy and management of non-financial risks.[191] Although diversity is advocated in order to limit groupthink and challenge management, it is also related to the Commission proposal on improving gender balance on boards.[192] The debates about diversity are a push for more women on corporate boards in Europe. In some countries, such diversity has been mandated, but other countries have rejected required diversity.[193]

The financial crisis of 2008, the subsequent sovereign debt crisis in Europe, and the LIBOR scandal may serve to orient boards and regulators in the direction of demanding more director competence, especially with regard to risk identification and management. These new desired attributes for board members in Europe—expertise and diversity—are likely to reduce independence as a priority. Furthermore, independence may actually contribute to the lack of meaningful involvement by non-executive directors. Accordingly, insider knowledge and experience may be required for effective board participation in the decision making of firms, especially financial firms.[194]

B. China

In China, the opening of the capital markets to foreign investment has not led to a full implementation of corporate governance principles, nor has it led to shareholder primacy. Nevertheless, securities regulators in China and Hong Kong have implemented formal requirements for di-

187. Davies & Hopt, *supra* note 183, at 22.

188. *See id.* at 23.

189. Eur. Comm'n, *Action Plan: European Company Law and Corporate Governance*, COM (2012) 740 final (Dec. 12, 2012).

190. *Id*. at 7.

191. *Id.* at 4–5.

192. *Id.* at 6.

193. Davies & Hopt, *supra* note 183, at 23–25.

194. *See* Winter, *supra* note 153, at 7.

rector independence. As will be discussed below, two elements intrinsic to the formation of capital within China have prevented shareholder primacy from taking root: extensive government involvement and relation-based governance. Both elements are interrelated and work together to trump shareholder primacy as a focus of Chinese corporate directors.

The Company Law of China was passed in the 1990s and adopted a two-tiered board structure, similar to the German corporate governance model, with a board of directors and a board of supervisors. Employee representatives may sit on both boards.[195] As the capital markets grew, the regulatory framework expanded to encourage capital formation and the privatization of traditional state-owned enterprises into joint stock companies.[196] The Code of Corporate Governance for Listed Companies in China and the Securities Law of the People's Republic of China were passed to regulate the corporate governance of the newly minted corporate entities. The Code of Corporate Governance for Listed Companies maintains multiple provisions regarding directors and their independence, including rules for related party transactions and independent directors.[197] In addition, various financial regulators, including the China Securities Regulatory Commission (CSRC), and the exchanges regulate these public companies.[198]

The Code of Corporate Governance for Listed Companies in China requires listed companies to be operated "in an independent manner" with directors "independent from the listed company that employs them and the company's major shareholders."[199] Further, the Code of Corporate Governance for Listed Companies encourages directors to "diligently perform their duties for the best interests of the company and all the shareholders."[200] The exchanges, in an attempt to promote international investment, have adopted even more stringent requirements for inde-

195. Companies Law of the PRC (中华人民共和国公司法, 2005) (promulgated by the Standing Comm. People's Cong. Nat'l People's Cong., Oct. 27, 2005, effective Jan. 1, 2006), arts. 45, 52, 109, 118 (China), *available at* http://www.csrc.gov.cn/pub/csrc_en/laws/rfdm/statelaws/200904/t20090428_102712.htm.

196. *See* Donald Clarke, *The Independent Director in Chinese Corporate Governance*, 31 DEL. J. CORP. L. 125, 131 (2006) (noting the high percentage of listed companies being former state owned enterprises).

197. Code of Corporate Governance for Listed Companies in China (issued by the Chinese Securities Regulatory Commission, effective Jan. 7, 2007), *available at* http://www.csrc.gov.cn/pub/csrc_en/newsfacts/release/200708/t20070810_69223.htm.

198. *See, e.g.*, *GEM Listing Rules*, HONG KONG EXH., at 5.05, http://www.hkex.com.hk/eng/rulesreg/listrules/gemrules/documents/chapter_5.pdf [hereinafter HKEX, *GEM Listing Rules*].

199. Kan Zhang, *Corporate Governance in China: How Does the State Influence Its Own Enterprises?*, 9 B.Y.U. INT'L L. & MGMT. REV. 111, 115 (2013); *see also* Code of Corporate Governance, *supra* note 197, at ch. 2(3), ch. 3(5).

200. *See* Code of Corporate Governance, *supra* note 197, at ch. 3(2).

pendent directors. For example, the Hong Kong exchange (HKEx) requires that an issuer have at least three independent directors, which must comprise one-third of the board members.[201] Independence is further defined as owning less than 1% of the shares, although exchange approval can occur for those owning less than 5%; not having worked as a principal or partner for an advisor to the issuer or controlling shareholder within one year of becoming a director; not having a material interest in the activities of the corporation; and not being a direct relative (child, sibling, or parent) of a chief executive or substantial shareholder.[202] These requirements, while better than none, are insufficient to prevent the exploitation of minority shareholders by the countervailing forces of government prerogatives and related party transactions.

Chinese companies maintain an obligation to consider the general welfare of the PRC[203] and not only the welfare of minority or public shareholders; therefore, independence does not have the same meaning as in the United States.[204] Independence of directors in Chinese companies does not equate to independence from government interference of corporate governance. Chinese corporations have a general mandate to take state priorities into account for their operations. Moreover, the state is a controlling shareholder in a large majority of listed Chinese companies.[205] As a result, Chinese companies and state owned enterprises have similar social responsibilities and are viewed as vehicles for state control over certain industries, rather than drivers of capital markets deriving profits for their shareholders.

While advocating for increased shareholder returns in a 2012 interview, former CSRC Commissioner Guo Shuqing acknowledged Chinese corporate directors' low priority for investor returns among other competing interests.[206] Despite pressure for independence from the govern-

201. HKEx, *GEM Listing Rules*, *supra* note 198, at 5.05A

202. HKEx, *GEM Listing Rules*, *supra* note 198, at 5.09.

203. Companies Law, *supra* note 195, at Art. 14 ("A company must . . . strengthen the construction of socialist culture and ideology and accept supervision of the government and the public.").

204. *See generally*, Li-Wen Lin & Curtis J. Milhaupt, *We Are the (National) Champions: Understanding the Mechanisms of State Capitalism in China* (Columbia Law & Econ. Working Paper, No. 409, 2011), *available at* http://ssrn.com/abstract=1952623; *see also*, Companies Law, *supra* note 195, at art. 57 (restricting those deemed "without capacity or with restricted capacity for civil acts" from acting as directors).

205. *See* Clarke, *supra* note 196, at 139; Andrei Molchynsky, *'Seize and Hold With Both Hands': The Political Implications of Corporate and Securities Law Reforms Under Hu Jintao* 139 (Nov. 2012), *available at:* http://ssrn.com/abstract=2257263.

206. Interview by Gong Wen and Xu Zhifeng with Guo Shuqing, Chairman, China Sec. Regulatory Comm'n (Mar. 1, 2012), *available at* http://www.csrc.gov.cn/pub/csrc_en/Informations/phgall/201208/t20120809_213655.htm.

ment in the capital markets, directors are unlikely to promote shareholder gain over state prerogatives. The continued divergence from the traditional Western corporate objective of shareholder gain stems from the directors of Chinese corporations frequently being bureaucrats and politicians that view their fiduciary duty as being towards the state instead of the company's shareholders.[207] With that viewpoint, directors have limited incentive to maximize profit potential, as there is limited political payout for modestly increasing a company's profits.[208] Instead, the directors represent the state's interests in a variety of ways, including maintaining depressed prices for essential products, enforcing state birth control policies among employees, and pursuing an urban full-employment policy.[209] Furthermore, where politically connected chief executives are concerned, the board of directors face increased challenges in monitoring and disciplining the management of the company.[210]

In addition to state owned or dominated enterprises, non-state owned companies exist in China and Hong Kong. Many are controlled by family members or small groups that in turn control large segments of the Chinese economy.[211] The controlling family members and their representatives on boards of directors negatively impact the minority shareholders through increased agency costs.[212] Majority stakeholders are rarely encumbered by corporate governance structures and are able to place directors on the board of the company.[213] In order to get around the independence requirements, such as those of the HKEx, family conglomerates use non-relative family representatives, entrusted to represent the family's interests, to promote their interests on the board of directors

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207. *See* Clarke, *supra* note 196, at 198; *see also* Nancy Huyghebaert & Lihong Wang, *Expropriation of Minority Investors in Chinese Listed Firms: The Role of Internal and External Corporate Governance Mechanisms*, 20 CORP. GOVERNANCE: INT'L REV. 328, 329 (2012).

208. *See* Wei Shen & Chen Lin, *Firm Profitability, State Ownership, and Top Management Turnover at the Listed Firms in China: A Behavioral Perspective*, 17 CORP. GOVERNANCE: INT'L REV. 443, 444 (2009).

209. *See* Clarke, *supra* note 196, at 140–41.

210. *See* Jiaxing You & Guqian Du, *Are Political Connections a Blessing or a Curse? Evidence from CEO Turnover in China*, 20 CORP. GOVERNANCE: INT'L REV. 179, 180 (2012).

211. *See* Shaomin Li, *China's (Painful) Transition from Relation-Based to Rule-Based Governance: When and How, Not If and Why*, 21 CORP. GOVERNANCE: INT'L REV 567, 575 (2013) (discussing the "princelings" of China). Relation-based governance is common in emerging economies particularly from Confucian-based culture where family is of particular importance. As the economies grow, the model becomes untenable as globalization trends persist, and Li posits that China will soon forego the model in favor of a more efficient rule-based system.

212. *See* En-Te Chin, Stephen Gray & John Nowland, *Family Representatives in Family Firms*, 21 CORP. GOVERNANCE: INT'L REV. 243, 260 (2013).

213. *See* Clarke, *supra* note 196, at 170–71.

above those of minority shareholders.[214] The control of these shareholders is exacerbated by the low presence of institutional shareholders with sufficient shares to place members on the boards of directors to challenge self-dealing transactions.[215] Even with an increased size of board of directors, an increase in the number of independent directors, or both, no impact is made on the occurrence of related party transactions.[216] Only the increase in control rights held by the second to tenth largest investors acts as an offset to related party transactions.[217]

The primacy of the state over shareholders and the low presence of institutional investors allow continued related party transactions to divert funds from the companies' shareholders. Independent directors are deemed ineffective in preventing either problem because directors maintain a loyalty to the state above the shareholder. Further, if the state is not the majority shareholder, the director is in place due to another large stakeholder. Either way, the independent directors are ineffective at representing any interests but those of the largest stakeholders.

Despite the weakness of Chinese corporate law in protecting minority shareholders, the CSRC has made significant strides in altering corporate governance for listed companies with regard to the independence of directors and other shareholder protection devices. The CSRC had injected corporate fiduciary duties into Chinese law for controlling shareholders, which may be a state or party organ.[218] Further, the provisions with regard to independent directors came from the CSRC.[219] How the Chinese independent director will develop remains to be seen, but independence does not have the same meaning as it does in the United States or Europe.

VI. CONCLUSION

The independent director model advocated by the SEC has been accepted in many jurisdictions, either as a mandatory requirement for public companies or a recommended structure. Yet, boards of independent

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214. *See* Chin, Gray & Nowland, *supra* note 212, at 243.

215. *See* Interview of Guo Shuqing, *supra* note 206 (noting China's low institutional ownership accounting for 15.6% of market capitalization in comparison with the average developed capital market having institutional ownership representing 70% of market capitalization).

216. *See* Huyghebaert & Wang, *supra* note 207, at 329.

217. *Id.*

218. Nicholas Calcina Howson, *"Quack Corporate Governance" As Traditional Chinese Medicine—The Securities Regulation Cannibalization of China's Corporate Law and a State Regulator's Battle Against State Political Economic Power*, 37 SEATTLE U. L. REV. 667, 679–680 (2014).

219. *Id.* at 683.

directors did not prevent the scandals of Enron, WorldCom, and other companies in the United States and in Europe after the bursting of the technology bubble of the 1990s. Such boards also failed to prevent the financial institution meltdowns of 2008. Thus, a rethinking of this model is necessary.

Although inside or executive directors may have conflicts of interest, they are more knowledgeable than outsiders and more involved in making business decisions for the corporation, both short-term and long-term. Their most serious conflicts-of-interest decisions relate to compensation, but where directors and officers are both compensated, in whole or in part, on the basis of contingent stock awards, insiders and outsiders have similar conflicts. Further, such compensation has resulted in shareholder primacy run amuck. It also encouraged the risk taking that resulted in the 2008 financial crisis. Accordingly, shareholder primacy also needs to be reexamined.

Since 2008, director diligence and expertise have been areas of focus, but a board of independent directors remains dependent on a corporation's management for information. Regulation cannot compel those personal qualities that make a director excellent—intelligence, integrity, experience, competence, and a willingness to question herd decision making. Also, a public corporation should not be a battleground where executives, directors, and shareholders are adversaries. Neither should the board of directors become a super-compliance committee, more concerned about government regulations than a corporation's operations and strategy.

Public corporations should have a mix of independent and non-independent directors with directors having a duty to the corporation as a whole. The interests of employees, customers, and creditors should be balanced against a duty to shareholders, especially when those shareholder interests are short-term. Although such complicated duties may prove more difficult to enforce than a simple duty to obtain economic gain for shareholders, shareholder primacy has brought business to a sorry pass, especially in the United States where our industrial base has been seriously impaired and speculation in the financial markets has wreaked havoc on the real economy. Only an experienced, competent, and fully informed board can possibly help to steer a forward course for public corporations in our complex global economy. The board needs to be informed by expert and responsible insiders (including service providers to the firm such as commercial bankers, lawyers, and retired company officers) with a stake in the future of the corporation, as well as independent outsiders who have the expertise and ability to both question, challenge, and advise management.

In the United States and elsewhere, "independence" now carries a statutory or stock exchange definition that has frequently led to the selection of former government officials, other famous personalities, educators, and CEOs from other companies who meet the definition of independence but who are not sufficiently expert or diverse to assist in the creation of overall firm value. The qualities that make a director truly independent do not come from a statutory definition but rather come from intelligence, experience, and a strong sense of ethical responsibility. The ability to challenge the conventional wisdom, to tell truth to power, is rare, and even rarer is the director who can do so but not destroy the collegiality of the boardroom. Yet, seeking such individuals should be the object of director selection.