

The Cosmetic Independence of Corporate Boards

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INTRODUCTION

This Essay tackles a pervasive misperception on the part of regulators that director independence significantly increases the efficacy of corporate boards. In this Essay, I assert that such “cosmetic independence” is not enough to remedy the corporate failures of recent years. Cosmetic independence is independence that takes into account only a corporate director’s relationship with the corporation and not the tools a director needs to achieve substantive independence. These tools include time, information, and knowledge, all of which have been recognized as critical to effective decision-making processes in organizational behavior literature.

This Essay is critical of regulatory reforms intended to improve board monitoring. Regulators have consistently responded to each new wave of corporate failure by requiring greater board independence without much regard to the organizational process necessary for boards to function effectively. These regulations are designed to enhance board performance by changing the composition and structure of the board through increasing the number of directors that meet a superficial definition of independence and creating a more detailed and independent committee structure.¹ The changes assume that stricter definitions of di-

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1. Implicit in the critique of *who* should be on the board of directors is a criticism about *how* boards can be better monitors. The solutions that increase cosmetic board independence operate by changing the composition and the structure of the board. See discussion *infra* notes 36–53 and accompanying text. For a more in-depth discussion of why compositional and structural changes are

rector independence necessarily lead to boards more effectively monitoring corporate management. There are numerous, well-known examples of this shift toward increasing director independence, which started in the 1970s² and has continued through major legislative overhauls such as the Sarbanes-Oxley Act.³ Examples include changes in stock-exchange listing standards post-Enron, the federal government's involvement in corporate boards following the 2008 financial crisis,⁴ and most recently, several of the corporate governance provisions in the Dodd-Frank Act.⁵

These reforms have implemented little more than a cosmetic independence, which is both static and decontextualized. Cosmetic independence does not provide the board with the substantive components that are necessary for successful, informed decision-making and form the foundation of the board's monitoring role.⁶ I therefore challenge the conventional wisdom that increasing director independence, by itself, can meaningfully reduce agency costs or the likelihood of repeated corporate failure when a substantive approach to selecting directors is needed. I submit that we should be skeptical of cosmetic independence as the principal criteria for board membership. In order to reduce managerial influence in the boardroom, the basis on which directors are selected must be broadened to include time, information, and knowledge.

inadequate, see Nicola Faith Sharpe, *Improving Corporate Board Process Through Organizational Behavior*, 85 S. CALIF. L. REV. (forthcoming 2011).

2. See discussion *infra* notes 36–53 and accompanying text.

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

4. See, e.g., Nicola Faith Sharpe, *Rethinking Board Function in the Wake of the 2008 Financial Crisis*, 5 J. BUS. & TECH. L. 99 (2010) (examining the government's response to the 2008 financial crisis in the context of the corporate board of directors and its potential impact on corporate governance reforms).

5. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010). For a discussion of § 10C that prohibits listing securities of issuers that do not have an independent compensation committee, see discussion *infra* notes 49–50 and accompanying text. In addition to § 10C, at least two parts of the Act emphasize the importance of independence. One provision increases shareholder access to the proxy ballot. Pursuant to the Act, the SEC adopted New Exchange Act Rule 14a-11, which mandates that shareholders who own at least three percent of a company's stock for three years are entitled to nominate a candidate for a directorship and have her nomination included in the company's proxy materials. See generally U.S. SEC. & EXCHANGE COMM'N, S7-10-09, FACILITATING SHAREHOLDER DIRECTOR NOMINATIONS (Aug. 25, 2010), available at <http://sec.gov/rules/final/2010/33-9136.pdf>. The Act also specifies that in accordance with SEC rulemaking, a corporation will have to disclose why it either combines or separates the offices of board chairperson and CEO in its annual proxy statement. Dodd-Frank Act, § 972, 124 Stat. at 1915 (to be codified at 15 U.S.C. § 78n-2).

6. *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996). Many scholars interpret *Caremark* as setting forth an affirmative monitoring obligation for directors and consider *Caremark* as the modern foundation for the board's good-faith obligation to monitor the corporation. Melvin A. Eisenberg, *The Duty of Good Faith In Corporate Law*, 31 DEL. J. CORP. L. 1, 62-63 (2006); Hillary A. Sale, *Monitoring Caremark's Good Faith*, 32 DEL. J. CORP. L. 719, 720 (2007).

A more useful method of identifying the characteristics of a successful board can be found in organizational behavior literature.⁷ This literature examines the attributes of successful teams, many of which have attributes that are applicable to the board of directors. Adopting its insights about high-performing teams leads to the conclusion that it is the critical components of good decision-making, which include knowledge, time, and information, that lead to effective team performance. These attributes go beyond cosmetic independence and help fill in the gaps left by the conventional regulatory approach. In this regard, an organizational behavior approach is consistent with the tenets of agency theory but, as compared to conventional prescriptions for board reform, it takes a deeper look at the factors that enable corporate boards to make sound decisions. Using these factors to identify strong candidates for board membership does not require that we eliminate independence as a criterion for board membership; it means that we must recognize that independence without the underlying attributes of time, information, and knowledge is not enough.

In addition to identifying independent directors as the ideal and the largely exclusive *who* to fulfill the monitoring responsibilities of the board,⁸ regulatory reforms have invested tremendous effort in refining the definition of independence as *how* to improve board function.⁹ This cosmetic definition of independence actually reduces the likelihood that

7. Organizational behavior theory studies how individuals and groups function within organizations. Models based on this contextualized organizational behavior approach attempt to examine the organization as a whole, rather than reducing it to smaller, isolated parts. GREGORY B. NORTHCRAFT & MARGARET ANN NEALE, ORGANIZATIONAL BEHAVIOR: A MANAGEMENT CHALLENGE 26 (1990) “[Organizational behavior] is the confluence of individual, group, and organizational studies flowing from industrial—organizational psychology and organization and management theory with headwaters in psychology (social, psychometrics), sociology (organizational, work, occupational), and management (scientific, human relations).” *Id.*; Benjamin Schneider, *Organizational Behavior*, 36 ANN. REV. PSYCHOL. 573, 574 (1985). See Chip Heath & Sim B. Sitkin, *Big-B Versus Big-O: What Is Organizational About Organizational Behavior?*, 22 J. ORG. BEHAV. 43, 44, 51 (2001) (“Organizational behavior differs from related fields [psychology, sociology, political science, anthropology] in its focus not just on individual or group behavior, but specifically on individual and group behavior in organizations.”).

8. Irwin Borowski, *Corporate Accountability: The Role of the Independent Director*, 9 J. CORP. L. 455, 459, 469 n.15 (1984); see Lisa M. Fairfax, *The Uneasy Case for the Inside Director*, 96 IOWA L. REV. 127, 137–38 (2010); James D. Westphal, *Collaboration in the Board Room: Behavioral and Performance Consequences of CEO-Board Social Ties*, 42 ACAD. MGMT. J. 7, 8 (1999).

9. Barry D. Baysinger & Henry N. Butler, *Corporate Governance and the Board of Directors: Performance Effects of Changes in Board Composition*, 1 J.L. ECON. & ORG. 101, 102 (1985) (“Proposals for corporate board reform devote special attention to the issues of board composition and director independence.”); Fairfax, *supra* note 8, at 138 (“The principle corporate-governance response to the agency problem has been the independent director.”); Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 11 (2002) (“One of the favorite projects of corporate reformers has been the creation of the so-called ‘monitoring’ board.”).

independent directors will be able to act independently of the Chief Executive Officer (CEO). The primary reasons for this reduction are that independent directors are outsiders unaffiliated with the company and hence they frequently lack the time, information, and knowledge to properly monitor the CEO and other top-level management.¹⁰ Provisions must be made to consistently account for these elements before we can reasonably expect corporate boards to succeed because regulatory reforms influence the characteristics of the board, which in turn directly impact *how* the board operates.

I have argue elsewhere that board characteristics, like structure and composition, directly impact and constrain process, which is *how* boards engage in monitoring management.¹¹ The process of *how* boards monitor should be more of a focus of corporate reforms than simply *who* sits on the boards.¹² This Essay argues that adopting cosmetic independence as the ideal *who* of directorships is misguided. There are more substantive characteristics that would lead to better decision-making and reduced

10. The term “independent director” does not have a uniform meaning or consistent legal definition in corporate and securities law. See Fairfax, *supra* note 8, at 133 (noting that although there is no “uniform definition” of an independent director, the definitions uniformly exclude “‘inside directors’—directors who are currently employed by the corporation on whose board they serve.”). For some of the meanings used in the securities context, see Sarbanes-Oxley Act of 2002, 15 U.S.C. § 78j-1(m)(3)(B) (2006) (excluding from the definition of “independent director” anyone who receives compensation from the corporation). Similarly, both the NYSE and NASDAQ exclude from the definition of “independent” any director who receives compensation from the corporation other than her director fees. Specifically, the NYSE rules exclude from the independence definition anyone who received, “during any twelve-month period within the last three years, more than \$120,000 in direct compensation from the listed company” (other than compensation related to director service). NYSE, LISTED COMPANY MANUAL § 303A.02(b)(ii) (2010) [hereinafter NYSE LISTED COMPANY MANUAL], available at <http://nysemanual.nyse.com/lcm>. NASDAQ listing rules also exclude directors who receive any non-fee-related or retirement related compensation “in excess of \$120,000 during any period of twelve consecutive months within the three years preceding the determination of independence.” NASDAQ, THE QUALIFICATION, LISTING AND DELISTING OF COMPANIES, RULE IM-5605(a)(B) (2010) [hereinafter NASDAQ QUALIFICATION], available at <http://nasdaq.cchwallstreet.com>. The NYSE rules also exclude any director that is employed with “a company that has made payments to, or received payments from, the listed company . . . in any of the last three fiscal years [that] exceeds the greater of \$1 million or 2% of such company’s consolidated gross revenues.” NYSE LISTED COMPANY MANUAL, *supra*, § 303A.02(b)(v). NASDAQ has a similar rule. Generally, a director is not considered independent if she is currently a partner, controlling shareholder, or executive officer of a company that receives or has received payments from the corporation on whose board the director sits in “the current or any of the past three fiscal years” in excess of the greater of 5% of the receiving company’s gross revenues or \$200,000. NASDAQ QUALIFICATION, *supra*, 5605(a)(D). In contrast to the securities laws and listing standards, Delaware courts offer a contextual definition of independence. Fairfax, *supra* note 8, at 134 (discussing the Delaware courts’ definition of independence, which distinguishes “between a ‘disinterested director’ and an ‘independent director’”). As a result, outsider status is a necessary but insufficient characteristic of independence. *Id.*

11. See Sharpe, *supra* note 1.

12. *Id.*

managerial influence over directors: time, information, and knowledge. Moreover, cosmetic independence negatively impacts how boards are able to monitor managers because directors who are not employed with the company face a significant time, information, and knowledge deficit, which reduces the efficacy of their decision-making and monitoring.

The aim of the Essay is two-fold. First, like other critics of independent directors, it highlights the inadequacies inherent in the current definition of independence in corporate governance reforms. By identifying better criteria for board membership and better processes for board decision-making, the Essay suggests that these attributes are more accurate indicators of an effective board than cosmetic independence. Second, the Essay goes beyond the frequently discussed flaws of independence and suggests that the attention paid to the independent director/inside director distinction is misplaced.¹³ Instead, the Essay encourages scholars to turn to the organizational behavior literature on group decision-making to identify the attributes of effective teams, which include time, information, and knowledge. The Essay argues that these three attributes should be the driving force behind director selection, not cosmetic independence. While understanding and reforming the corporate board of directors is a complex undertaking, this Essay concludes that scholars should nevertheless fully engage with that complexity by questioning the assumptions underlying cosmetic independence.

This Essay proceeds as follows: Part I argues that agency justifications provide the foundation for most modern corporate governance reform, specifically, the assumptions that boards exist to monitor management and that independent directors are best-suited to do so. Part II asserts that regulations designed to improve board efficacy have adopted cosmetically independent directorships as the “magic bullet” of corporate governance reform; however, this move toward cosmetic independence is at best an incomplete response to corporate malfeasance and failure. By applying the insights of organizational behavior, Part III identifies three attributes: time, information, and knowledge, that are more important to effective board monitoring than the cosmetic independence discussed in Part II, and argues that these three attributes, which contribute to substantive independence, should play a dominant role in determining board membership. A brief conclusion follows.

13. Avoiding managerial capture is important for boards to be able to engage in effective monitoring. Yet cosmetic independence does not alleviate the problem of a captured board. It is likely that the potential for managerial capture still exists because of CEO and management's influence over the director selection process. In the event that such capture is reduced or eliminated, there is a high likelihood that directors will be biased in favor of the interests of their fellow board members. Fairfax, *supra* note 8, at 157–59. For a discussion of in-group biases, see discussion *infra* at notes 61–72 and accompanying text.

I. CORPORATE GOVERNANCE AND ITS AGENCY THEORY FOUNDATIONS

The fundamental assumptions underlying the conception of the corporate board and the numerous attempts to reform it can be traced to the seminal insights of Adolf Berle and Gardiner Means in *The Modern Corporation and Private Property*.¹⁴ Berle and Means describe a sea change in how private property is owned and controlled.¹⁵ They detail the rise of the modern corporation, and their assumptions have informed much of the scholarly work on corporations in the decades that have followed.¹⁶ The challenges created by the separation of ownership and control, which Berle and Means identify as the central concern of corporate governance, result in a divergence of the interests of shareholders and managers. This divergence means that since managers are no longer owners, they will not be motivated by a property owner's "quest for profits."¹⁷ In other words, managers will no longer have a strong ownership interest to incentivize them to run the corporation profitably.¹⁸ Although there have been important changes to the ownership structure of the firm since *The Modern Corporation and Private Property* was first published, including less dispersed shareholders, the rise of the institutional investor, and an increase in management's ownership interest due to equity-based compensation, the concerns identified by Berle and Means continue to dominate corporate governance discourse.¹⁹ In particular, this discourse has largely framed the role of shareholders, managers, and directors in terms of agency theory.

Under agency theory, shareholders are the firm's owners and principals, and corporate managers are the shareholders' agents who control

14. See ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (Transaction Publishers 2010) (1932).

15. *Id.* at 8, 219.

16. William W. Bratton, *Berle and Means Reconsidered at the Century's Turn*, 26 J. CORP. L. 737, 738 & n.5 (2001) ("Westlaw's 'JLR' index shows citations of *The Modern Corporation and Private Property* in 677 articles as of March 2001.") Bratton notes that the database maintains its presence "somewhat crudely" *Id.* (citations omitted). Ten years later, the number of citations to Berle and Means has more than doubled. As of May 4, 2011, the database shows 1,561 citations when searching with Bratton's search terms "berle /10 'modern corporation and private.'"

17. BERLE & MEANS, *supra* note 14, at 9.

18. *Id.*

19. See Roberta S. Karmel, *Should a Duty to the Corporation Be Imposed on Institutional Shareholders?*, 60 BUS. LAW. 1, 10 (2004) ("At the end of the third quarter of 2002, U.S. institutions held 49.8 percent of all U.S. equities . . ."); Robert A.G. Monks, *What Will Be the Impact of Active Shareholders? A Practical Recipe for Constructive Change*, 32 LONG RANGE PLANNING 20, 20-21 (1999) (Describing the "New Owners" of corporate securities as "the modern institutional investor who hold[s] more than 60% of the outstanding stock in the largest U.S. and U.K. companies."). Equity-based compensation is a substantial portion of most senior executives' compensation packages, which reduces the space between shareholder and manager observed by Berle and Means almost eighty years ago.

its day-to-day operations.²⁰ Shareholders want the highest return on their investment—hence the common notion that a public corporation’s primary purpose is to maximize shareholder wealth.²¹ In order to maximize their wealth, shareholders must, among other things, keep agency costs to a minimum.²² But as the economic and legal literature exploring principal–agent concerns illustrates, reducing agency costs is as important as it is challenging.²³

The agency problem, namely the misalignment of an agent and principal’s incentives, has received sustained academic attention.²⁴ When the principal and agent’s interests are not aligned, the agent, like all economically rational actors, will maximize her own interests at the expense

20. Joan MacLeod Heminway, *Enron’s Tangled Web: Complex Relationships; Unanswered Questions*, 71 U. CIN. L. REV. 1167, 1173 (2003) (stating that corporate officers act as agents of the corporation or its board of directors in the traditional principal–agent model).

21. *Dodge v. Ford Motor Co.*, 170 N.W. 668, 684 (Mich. 1919) (“A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the nondistribution of profits among stockholders in order to devote them to other purposes.”); Stephen Bainbridge, *Director Primacy, the Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 563 (2003) (“[M]ost corporate law scholars some variant of shareholder primacy.”); Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES MAG., Sept. 13, 1970, at 32, available at <http://www.umich.edu/~thecore/doc/Friedman.pdf> (“[Corporate executives’] responsibility is to conduct the business in accordance with [shareholders’] desires, which will generally be to make as much money as possible while conforming to their basic rules of society, both those embodied in law and those embodied in ethical custom.”). There is a closely related corporate governance debate about who benefits from the board’s monitoring. The traditional view, consistent with the shareholder wealth maximization norm, is that the board monitors managers to ensure that they are maximizing shareholder value. Another commonly accepted view is that the board is there to work toward stakeholder interests. The corporate social responsibility debate can be traced back to Adolf Berle and E. Merrick Dodd, who are often credited with being the original advocates of shareholder wealth maximization and stakeholder theory, respectively. See Adolf A. Berle, *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049, 1049 (1931); E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1147 (1932).

22. Agency costs are the costs incurred when managers (agents) pursue interests that diverge from those of the principal. These costs can be expressed as the sum of monitoring and bonding costs plus the residual loss borne by principals to curb their agent’s shirking. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308–09; see also BERLE & MEANS, *supra* note 14.

23. Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 248–49 (1999) (“This principal-agent model, in turn, has given rise to two recurring themes in the literature: First, that the central economic problem . . . is reducing agency costs . . . and second, that the primary goal of the public corporation is—or ought to be—maximizing shareholder’s wealth.”); Park McGinty, *The Twilight of Fiduciary Duties: On the Need for Shareholder Self-Help in an Age of Formalistic Proceduralism*, 46 EMORY L.J. 163, 188 (1997) (stating that reducing agency costs is the “most important and difficult challenge” of corporate law).

24. Jensen & Meckling, *supra* note 22, at 308 (“If both parties to the relationship are utility maximizers there is good reason to believe that the agent will not always act in the best interests of the principal.”).

of her principal. This results in the problem of managerial opportunism,²⁵ leading managers to be disloyal, to engage in rent-seeking behavior, and to shirk. Certain monitoring mechanisms are therefore necessary to reduce agency costs by ensuring that agents are truly working in the best interest of the principal. In the context of the corporation, these monitoring mechanisms help to guarantee that the corporation's officers are maximizing shareholder wealth. Accordingly, the corporation's board of directors functions as an important monitoring mechanism in a publicly traded corporation,²⁶ thereby giving the corporation a corporeal form through which it can affect its intentions.²⁷

In accordance with agency theory, many scholars assert that an effective board is critical to reducing managerial shirking and opportunism, thereby decreasing agency costs, increasing shareholder wealth, and preventing corporate failure.²⁸ Specifically, under agency theory, the corporate board of directors reduces these adverse effects through monitoring managers, which is considered its central function.²⁹ The board performs this function by hiring, firing, and setting the compensation of the CEO

25. Amir N. Licht, *Genie in a Bottle? Assessing Managerial Opportunism in International Securities Transactions*, 2000 COLUM. BUS. L. REV. 51, 52 (describing managerial opportunism as the opportunity of agents in corporate organizations "to take advantage of their position and derive private benefits from 'other people's money'").

26. See AM. L. INST. PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 3.02 cmt. d (1992) (discussing the board of director's "oversight function"). Donald C. Langevoort, *Agency Law Inside the Corporation: Problems of Candor and Knowledge*, 71 U. CIN. L. REV. 1187, 1191 (2003) (recognizing that when the principal's rights and responsibilities "are divided between the board of directors and the shareholders," there is "a strong bias" toward the board "as it relates to the running of the corporation's affairs") (footnotes omitted); see also Jill E. Fisch, *Taking Boards Seriously*, 19 CARDOZO L. REV. 265, 268-69 (1997); Paul E. Juras & Yvonne L. Hinson, *Examining the Effect of Board Characteristics on Agency Costs and Selected Performance Measures in Banks*, 7 ACAD. BANKING STUD. J. 87, 87 (2008).

27. Langevoort, *supra* note 26, at 1191 ("To animate and give the corporation a voice, corporate law recognizes the board of directors.").

28. Blair & Stout, *supra* note 23; Donald C. Clarke, *Three Concepts of the Independent Director*, 32 DEL. J. CORP. L. 73, 81 (2007); Fairfax, *supra* note 8, at 137; Jensen & Meckling, *supra* note 22, at 308-09; Juras & Hinson, *supra* note 26, at 89; Usha Rodrigues, *The Fetishization of Independence*, 33 J. CORP. L. 447, 457 (2008); James D. Westphal, *supra* note 8, at 8 (noting that the "function of boards is to reduce agency costs") (1999).

29. Bainbridge, *supra* note 21, at 599; Lynne L. Dallas, *Multiple Roles of Corporate Boards of Directors*, 40 SAN DIEGO L. REV. 781, 801 (2003); Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1278 (1999) ("The managerial model of the board has now been supplanted by a monitoring model."); Eugene F. Fama & Michael Jensen, *The Separation of Ownership and Control*, 26 J.L. & ECON. 301, 306 (1983) (asserting that the separation of decision management and decision control, the latter being controlled by the board, is necessary to protect residual claimants from opportunistic behavior on the part of decision agents (managers)); Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 802 (2001).

and other senior managerial executives.³⁰ It also monitors managers by cleansing conflicts of interest between the corporation and top-level management.³¹ Finally, boards review management's most important decisions, such as certain types of mergers or acquisitions.³²

II. INDEPENDENT DIRECTORS: A POPULAR RESPONSE TO THE CORPORATION'S WOES

Regulators have heavily focused on the monitoring function of boards, which is often thought of as the "minimal duty of every board."³³ Reforms have assumed that an independent board is best-suited to perform the board's monitoring tasks.³⁴ Accordingly, increasing board independence has been the standard regulatory response to the widely publicized corporate scandals and failures of the recent past.³⁵ Policymakers direct the bulk of their criticisms at the board of directors, and their solutions are based on the perceived connection between proper board monitoring and better firm performance. This Part illustrates that reforms have

30. Fama & Jensen, *supra* note 29, at 311 (noting that "boards always have the power to hire, fire, and compensate the top-level decision managers and to ratify and monitor important decisions."); Daniel P. Forbes & Frances J. Milliken, *Cognition and Corporate Governance: Understanding Boards of Directors as Strategic Decision-Making Groups*, 24 ACAD. MGMT. REV. 489, 492 (1999).

31. DEL. CODE ANN. tit. 8, § 144 (2010).

32. Board approval in this context has been categorized as part of what some call the board's control function, which is subsumed by the monitoring function. There is a significant amount of scholarship discussing whether the board actually exerts control over management's decisions. The general consensus is that boards do not exercise this control well. Richard Saliterman, has stated:

The corporation, for the most part, has been and presently is governed by a highly theoretical and, arguably, a non-reality oriented framework of perceptions: 1) that shareholders—the principal corporate investors—control the corporations and reflect their shareholder sovereignty by electing boards of directors; and 2) that these boards of directors select or otherwise carefully govern the activities of corporate executives who are subservient to both the board and the shareholders.

Richard Saliterman, *Perceptions Bearing on the Public Policy Dynamics of Corporation Law*, 20 HAMLINE L. REV. 261, 261 (1996).

33. COLIN B. CARTER & JAY W. LORSCH, BACK TO THE DRAWING BOARD 50–51, 67–68 (2003); James D. Cox, *Managing and Monitoring Conflicts of Interest: Empowering the Outside Directors with Independent Counsel*, 48 VILL. L. REV. 1077, 1082 (2003) (noting that the "central task" of outside directors "is to monitor the performance of senior management, most particularly the chief executive officer (CEO)"). For an in-depth analysis of the monitoring model of the board, see Lynn A. Stout, *The Shareholder as Ulysses: Some Empirical Evidence on Why Investors in Public Corporations Tolerate Board Governance*, 152 U. PA. L. REV. 667, 673–77 (2004).

34. Ribstein, *supra* note 9, at 11.

35. Improving independence is not the only response to corporate failure. For a discussion of the response to and problems with the regulatory approach to corporate fraud, see Ribstein, *supra* note 9, at 11–18 (describing regulatory responses to corporate fraud including those found in the Sarbanes-Oxley Act such as director independence, whistleblower protection, audit committee reforms, and executive compensation).

responded to corporate failure with measures designed to strengthen the board's independence.

A. Independence as a Cure-All

The prevailing wisdom is that the boards that are best-suited to monitor management are those that are independent from management.³⁶ Current best practices of corporate governance articulate several criteria for the ideal corporate board of directors. This list includes many concepts familiar to corporate governance scholars: individual directors should be independent; the core committees (audit, compensation, and nomination) should be made up of independent directors;³⁷ boards should hold an executive session during which the independent directors meet without any inside directors, including the CEO; boards should be as small as practicable; and director compensation should have an equity-based component to better align directors' interests with shareholders' interests.³⁸ Underlying each solution is the assumption that independent directors, meaning those that do not have material ties to the company on

36. William W. Bratton & Michael L. Wachter, *Tracking Berle's Footsteps: The Trail of the Modern Corporation's Last Chapter*, 33 SEATTLE U. L. REV. 849, 866 (2010) (describing the modern model of the corporation, which includes an independent board that should be "an effective monitor of management performance"); Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1540 (2007) (The board's added responsibilities for "the monitoring of financial controls and disclosure" has led "to more rigorous standards of director independence."); Note, *Beyond "Independent" Directors: A Functional Approach to Board Independence*, 119 HARV. L. REV. 1553, 1560–61 (2006) (arguing "that effective corporate governance" depends "on the independent behavior of the board as a unit"). This Essay criticizes cosmetic independence or independence in name only. It agrees that a board needs to have substantive independence from managerial influence in order to engage in effective monitoring. See *supra* note 13 and accompanying text.

37. See 15 U.S.C. § 78j-1(m)(3)(A) (2006) (stating that, in general, each member of the audit committee of the issuer must be a member of the board of directors of the issuer, and must otherwise be independent). NASDAQ requires that independent directors provide oversight of execution compensation. See NASDAQ QUALIFICATION, *supra* note 10, at IM-5605-6. "Director nominees must either be selected or recommended for the Board's selection, either by: (A) Independent Directors constituting a majority of the Board's Independent Directors in a vote in which only Independent Directors participate, or (B) a nominations committee comprised solely of Independent Directors." *Id.* at IM-5605(e)(1) (2009). Audit committee responsibilities and authority are described *id.* at IM-5605(c) (2009). NYSE rules require that "listed companies have a nominating/corporate governance committee composed entirely of independent directors." NYSE LISTED COMPANY MANUAL *supra* note 10, § 303A.04. Furthermore, "listed companies must have a compensation committee composed entirely of independent directors." *Id.* § 303A.05.

38. CARTER & LORSCH, *supra* note 33, at 42; Bainbridge, *supra* note 21, at 562 (noting that in the 1980s and 1990s, a trend emerged that sought to align the interests of directors and shareholders by paying directors with company stock); R. William Ide, *Post-Enron Corporate Governance Opportunities: Creating a Culture of Greater Board Collaboration and Oversight*, 54 MERCER L. REV. 829, 841 (2003); see Charles M. Elson, *Director Compensation and the Management-Captured Board—The History of a Symptom and a Cure*, 50 SMU L. REV. 127 (1996) (noting that making equity a part of director compensation aligns their interests more closely with those of shareholders).

whose board they sit, through an employment, familial, or investment relationship, will not be captured by management and will effectively safeguard the company's assets, so that the assets are used to maximize shareholder wealth. This basic assumption has been the foundation of many of the corporate governance reforms that have shaped the modern corporate landscape.

As with the reforms that followed the Penn Central Railroad collapse³⁹ and the savings and loan crisis,⁴⁰ reforms after scandals such as Enron, Tyco, and WorldCom⁴¹ were meant to restore investor confidence in the financial integrity of the stock market. The Sarbanes-Oxley Act of 2002 (SOX) directed the Securities and Exchange Commission (SEC) to "undertake rulemaking in a number of areas, including mandatory listing standards to be adopted by self-regulatory organizations (SROs)."⁴² Many of the SEC's and SROs' reforms formalized the assumption that board independence would reduce executive mismanagement, and that proper oversight from an independent board would decrease the likelih-

39. For a description of the Penn Central Railroad collapse and the rise of the monitoring board, see Gordon, *supra* note 36, at 1515–19. Gordon describes the directors of Penn Central Railroad as unaware of the financial trouble that resulted in the company's collapse. *Id.* at 1515. For instance, "in the two years before the collapse, the board [approved over \$100 million in dividends. . . .] [The directors] had been neither advisors nor monitors, but figureheads." *Id.* at 1516. The failure of the "advisory board model" led to a "reconceptualization of the board," which is the monitoring model. *Id.* at 1518.

40. See Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (codified as amended at 29 U.S.C. §§ 1001–1461 (2006)) (regulating employee benefit plans, including pension plans); Financial Institutions Reform, Recovery Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183 (codified in scattered sections of 12 U.S.C. (2006)).

41. See Alexi Barrionuevo, *Two Enron Chiefs Are Convicted in Fraud and Conspiracy Trial*, N.Y. TIMES, May 26, 2006, <http://www.nytimes.com/2006/05/26/business/businessspecial3/26enron.html> (a jury found that former Enron chief executives Ken Lay and Jeffrey Skilling lied to "investors, employees, and regulators" in an attempt to hide the troubled financial situation of the corporation); Ken Belson, *Adelphia Proposes to Settle Federal Cases*, N.Y. TIMES, Dec. 29, 2004, <http://query.nytimes.com/gst/fullpage.html?res=9A07E5D81639F93AA15751C1A9629C8B63> (Adelphia Communications Corp., some employees, and members of the family that founded Adelphia were "accused of securities fraud and improper accounting"; the company declared bankruptcy in 2002); Simon Romero & Alex Berenson, *WorldCom Says It Hid Expenses Inflating Cash Flow \$3.8 Billion*, N.Y. TIMES, June 26, 2002, <http://www.nytimes.com/2002/06/26/business/worldcom-says-it-hid-expenses-inflating-cash-flow-3.8-billion.html> (stating that at its peak in June 1999, WorldCom had a value of \$115.3 billion, but by June 2002 it was worth less than \$1 billion after an internal audit revealed its cash flow was inflated by over \$3.8 billion); Andrew Ross Sorkin & Alex Berenson, *Corporate Conduct: The Overview: Tyco Admits Using Accounting Tactics to Inflate Earnings*, N.Y. TIMES, Dec. 31, 2002, <http://www.nytimes.com/2002/12/31/business/corporate-conduct-overview-tyco-admits-using-accounting-tricks-inflate-earnings.html> (after admitting that it had employed "financial gimmickry" to inflate its earnings, Tyco agreed to "erase \$382 million in profits it had previously claimed.")

42. See Order Approving Proposed Rule Changes Relating to Corporate Governance, Exchange Act Release No. 4875, 68 Fed. Reg. 64,154, 64,175 (Nov. 12, 2003).

ood of future corporate failure.⁴³ Subsequently, the New York Stock Exchange (NYSE) and National Association of Securities Dealers Automated Quotations (NASDAQ) enacted rules that were, in significant part, “aimed to ensure the independence of directors of listed companies.”⁴⁴ Specifically, the new requirements stated that all listing companies must have boards made up of a majority of independent directors, with a stricter standard of what constituted “independence.”⁴⁵ Moreover, the exchanges also required that the non-management directors of listed companies regularly hold executive sessions during which directors would meet without management.⁴⁶ The listing agencies also adopted rules targeting the structure of the board of directors by requiring that the nominating or corporate governance, compensation, and audit committees be staffed only by independent directors.⁴⁷

Like the reforms of years past, the most recent round of corporate governance reforms, enacted as part of the Dodd-Frank Act, seemingly embrace independence as a solution to the agency cost problems in the publicly traded corporation.⁴⁸ For instance, section 10C emphasizes the

43. See SEC, Standards Relating to Listed Company Audit Committees, S7-02-03 (Apr. 10, 2003), available at <http://www.sec.gov/rules/final/33-8220.htm>:

As directed by the Sarbanes-Oxley Act of 2002, we are adopting a new rule to direct the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with the audit committee requirements mandated by the Sarbanes-Oxley Act of 2002. These requirements relate to: the independence of audit committee members; the audit committee’s responsibility to select and oversee the issuer’s independent accountant; procedures for handling complaints regarding the issuer’s accounting practices; the authority of the audit committee to engage advisors; and funding for the independent auditor and any outside advisors engaged by the audit committee.

Id. at 1.

44. See Order Approving Proposed Rule Changes Relating to Corporate Governance, 68 Fed. Reg. 64,154, 64,176–78 (referring to the NYSE changes—the NASDAQ changes described mirror those of the NYSE); see also NASDAQ QUALIFICATION, *supra* note 10, at IM-5605; NYSE LISTED COMPANY MANUAL, *supra* note 10, §§ 303A.01 & 303A.02 (2011).

45. See Order Approving Proposed Rule Changes Relating to Corporate Governance, 68 Fed. Reg. at 64,157.

46. Order Approving Proposed Rule Changes Relating to Corporate Governance, 68 Fed. Reg. at 64,158 (requiring that the independent directors hold an executive session and that certain decisions be made by only independent directors or by a majority of independent directors); see also NASDAQ QUALIFICATION, *supra* note 10, at 4350(c)(4)(A); NYSE LISTED COMPANY MANUAL, *supra* note 10, § 303A.0.4.

47. Order Approving Proposed Rule Changes Relating to Corporate Governance, 68 Fed. Reg. at 64,158–59.

48. This Essay does not provide an exhaustive account or treatment of the corporate governance reforms in the Dodd-Frank Act. See Dodd-Frank Wall Street Reform and Consumer Protection Act, § 111(a), Pub. L. No. 111-203, 124 Stat. 1376, 1392–94 (2010) (to be codified at 12 U.S.C. § 5321) (establishing the Financial Stability Oversight Council); § 152(a), 124 Stat. at 1413 (to be codified at 12 U.S.C. § 5342) (establishing the Office of Financial Research); § 204, 124 Stat. at

value of an independent board. It provides that within 360 days after the bill is enacted,⁴⁹ “the SEC must issue rules directing the national securities exchanges to prohibit the listing of any security of an issuer that does not have an independent compensation committee.”⁵⁰ The reforms reflect the assumption that the directors who are best-suited to monitor managers are those that do not have strong economic or familial ties to the company. In the year immediately preceding the 2008 financial crisis, the average board of the Fortune 1000 had two inside directors and eight outside directors.⁵¹ This is a dramatic difference from 1950, when approximately fifty percent of the board was made up of outsiders.⁵² The more significant change extends beyond merely shifting the ratio of insiders to outsiders to the increase in unaffiliated, independent directors. This shift is even more dramatic, with a change from around twenty percent in 1950 to approximately seventy-five percent fifty-five years later.⁵³ But these changes, like those that have come before, are incomplete. Despite the fact that independent boards are ubiquitous, there are still recurring instances of widespread corporate failure.

B. Limitations on Independence

While altering board composition has been a popular regulatory response to many corporate scandals and financial failures,⁵⁴ recent research has raised doubts about its efficacy.⁵⁵ Empirical studies have

1454–56 (to be codified at 12 U.S.C. § 5384); § 1011, 124 Stat. at 1964–65 (to be codified at 12 U.S.C. § 5491) (establishing the Bureau of Consumer Financial Protection).

49. Dodd-Frank Wall Street Reform and Consumer Protection Act, § 10C(f)(1), Pub. L. No. 111-203, 124 (2010) (to be codified at 15 U.S.C. § 78j-3).

50. *Id.* § 10C, 124 Stat. at 1900–03.

51. KORN/FERRY INST., 34TH ANNUAL BOARD OF DIRECTORS STUDY, app. A (2008); see also Sydney Finkelstein & Ann C. Mooney, *Not the Usual Suspects: How to Use Board Process to Make Boards Better*, 17 ACAD. MGMT. 101, 101 (2003) (finding that “outsiders now account for seventy-five percent of directors on the average board” of the S&P 500).

52. Gordon, *supra* note 36, at 1473.

53. *Id.* at 1475.

54. See, e.g., Charles M. Elson & Christopher J. Gyves, *The Enron Failure and Corporate Governance Reform*, 38 WAKE FOREST L. REV. 855, 855–56 (2003) (observing that the collapse of Enron and other corporate scandals was “a watershed moment in U.S. corporate governance.” The perceived monitoring failure by Enron’s board resulted in a “dramatic change in approach to corporate board composition, conduct, and responsibility . . . at the legal and regulatory levels”). See *supra* note 9.

55. M. Bednar & James D. Westphal, *Pluralistic Ignorance in Corporate Boards and Firms’ Strategic Persistence in Response to Low Firm Performance*, 50 ADMIN. SCI. Q. 262, 263 (2005) (“Yet there is considerable qualitative and anecdotal evidence that boards often fail to check executives’ tendencies to persist with failing strategies, regardless of the number of outside directors on the board.”); see, e.g., Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231 (2002) (finding that firms with more independent boards do not perform better than other firms); see also Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS.

yielded contradictory conclusions demonstrating the lack of consensus on the efficacy of such changes. Some scholars have asserted that directors lack the time, information, and knowledge to properly perform their monitoring task.⁵⁶ In his 1971 book *Directors: Myth and Reality*, Myles Mace, a vocal critic of outside directors, found that outside directors were not appointed for the substantive contributions they could make to the company, but for the prestige value they added.⁵⁷ Mace was skeptical as to whether outside directors, who were mostly nominated by the president and CEO, would meaningfully challenge management.⁵⁸ Directors were seen as the servants of managers, not shareholders. Additionally, directors lacked the time and motivation to properly understand the company, being occupied in demanding full-time jobs elsewhere.⁵⁹ Mace's criticism, similar to those of Lorsch and MacIver, who thought independent directors were more accurately labeled pawns rather than potentates, have found support with many scholars in decades since his book was first published.⁶⁰

Whether a director can ever truly be independent has also been called into question. Studies have found that outside, unaffiliated directors often lack independence from the CEO for various reasons. As a

LAW. 921, 922 (1999) (presenting evidence that overall firm performance was not correlated to the composition of the board and that "[i]ndependent directors often turn out to be lapdogs rather than watchdogs"); Dan R. Dalton et al., *Meta-Analytic Reviews of Board Composition, Leadership Structure, and Financial Performance*, 19 STRATEGIC MGMT. J. 269, 278 (1998) (finding "little support for a systematic relationship" between "board composition and financial performance"); Finkelstein & Mooney, *supra* note 51, at 102 (studying the relationship of several indicia of board independence to shareholder returns and finding that there was "no significant difference in the number of outsiders, director shareholdings, board size, and CEO duality" between the firms that performed in the upper quartile of the S&P 500 and those that performed in the lower quartile). See generally John A. Wagner III, J. L. Stimpert & Edward I. Fubara, *Board Composition and Organizational Performance: Two Studies of Insider/Outsider Effects*, 35 J. MGMT. STUDIES 655, 655 (1998) ("[The results] suggest the existence of a curvilinear homogeneity effect in which performance is enhanced by the greater relative presence of either inside or outside directors.").

56. JAY W. LORSCH WITH ELIZABETH MACIVER, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS 84-88 (1989); Fairfax, *supra* note 8, at 161-67 (discussing the information asymmetries and knowledge deficit that confront outside directors and consequently limit their efficacy).

57. MYLES MACE, *DIRECTORS: MYTH AND REALITY* 107 (1971).

58. *Id.* at 108.

59. *Id.* at 107, 109.

60. LORSCH WITH MACIVER, *supra* note 56; Stephen M. Bainbridge, *Independent Directors and the ALI Corporate Governance Project*, 61 GEO. WASH. L. REV. 1034, 1058-59 (1993); Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 611-21 (1982); Fairfax, *supra* note 8 (questioning the trend toward independent directors, arguing that their value has been overstated because their ability to perform their monitoring function is constrained, whereas inside directors may offer valuable contributions to the board); Ribstein, *supra* note 9, at 26; Rodrigues, *supra* note 28 (criticizing current regulations' overemphasis on independence).

general matter, criticism of board independence can be divided into two categories: psychological limitations on independence and practical limitations on independence.

Director independence is subject to *psychological* limitations as a result of the group dynamics in the boardroom, including norms, structural bias, and “groupthink.” The social dynamic of board meetings and boardroom norms often mean that board members are unwilling to contradict the CEO.⁶¹ In addition to the norms, directors have self-interested reasons for not voicing their disapproval. CEOs frequently nominate candidates for an outside directorship, which means that many directors fear they will not be reappointed if they contradict or alienate the CEO.⁶² It also means that many board members feel obligated to support the CEOs who supported their appointment.⁶³ Additionally, structural bias and groupthink may constrain director’s independent judgment.⁶⁴ Studies of structural bias indicate that independent directors cannot be seen as a panacea to the problems facing corporate boards because no director remains independent for long.⁶⁵ Chief among the reasons for structural bias is that board members form close relationships that make it unlikely that a director will voice an opinion that runs contrary to the position taken by the majority of other board members.⁶⁶ Directors value their close relationships and will work to maintain them even at the expense of optimal decision-making. Therefore, structural bias limits a director’s critical assessment of the CEO or her proposals.⁶⁷

61. LORSCH WITH MACIVER, *supra* note 56, at 92–93.

62. Fairfax, *supra* note 8, at 158 (noting that not only do “studies reveal that CEOs often dominate the director-nomination process, causing directors to feel beholden to the CEOs” but they also reveal that directors feel “beholden to their fellow directors because those directors nominated them”); Paul Hempel & Charles Fey, *Outside Director Compensation and Firm Performance*, 33 HUMAN RESOURCES MANAGEMENT 111, 113 (1994).

63. Westphal, *supra* note 8, at 8.

64. For a more detailed discussion of structural bias, see James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 L. CONTEMP. PROBS. 83 (1985); Claire A. Hill & Brett H. McDonnell, *Disney, Good Faith, and Structural Bias*, 32 J. CORP. L. 833 (2006); Julian Velasco, *Structural Bias and the Need for Substantive Review*, 82 WASH. U. L. Q. 821 (2004).

65. Kenneth B. Davis, Jr., *Structural Bias, Special Litigation Committees, and the Vagaries of Director Independence*, 90 IOWA L. REV. 1305, 1308 (2005); Anthony Page, *Unconscious Bias and the Limits of Director Independence*, 2009 U. ILL. L. REV. 237, 239–40.

66. Hill & McDonnell, *supra* note 64, at 852–53; Velasco, *supra* note 64, at 824.

67. *Beam v. Stewart*, 845 A.2d 1040, 1050–51 (Del. 2004) (“[Structural bias] presupposes that the professional and social relationships that naturally develop among members of a board impede independent decisionmaking.”); *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, 938 (Del. Ch. 2003) (while the opinion does not use the term “structural bias,” it does discuss bias-creating relationships and identifies “motives like love, friendship, and collegiality” as influential in decision-making).

Whereas structural bias has been most often discussed in the context of special litigation committees, which are used to terminate derivative suits,⁶⁸ another form of in-group bias, groupthink, can be even more pervasive on boards. Groupthink further reduces the likelihood that even an independent director will be willing to express dissenting opinions. Groupthink occurs when a board's decision-making is subconsciously influenced by boardroom norms, especially in situations where directors form a cohesive group that is working toward consensus decision-making.⁶⁹ While scholars disagree on the effects of groupthink on the decision-making capabilities of corporate boards, the downside of groupthink is that boards are less likely to individually analyze the decisions they are asked to make. In other words, groups engaged in groupthink make poor judgments because they allow their desire for unanimity to reduce the quality of their decision-making.⁷⁰ Although there are significant negatives to groupthink, a few authors have concluded that strong group cohesion can be positive or negative depending on other circumstances.⁷¹ Nevertheless, there is some consensus that groupthink limits the board's independence for purposes of monitoring.⁷²

Independent directors are *practically* limited in their ability to effectively monitor boards because they are at a time, information, and knowledge disadvantage relative to the managers they monitor. The remainder of this Essay explores the practical limitations that must be remedied for boards to engage in effective monitoring. It is important to note, however, that the practical limitations discussed below and psychological limitations mentioned above are not binary categories. Increased time, information, and knowledge can help directors to think individually, thereby reducing the impact of structural bias and their propensity to

68. Bainbridge, *supra* note 60, at 1059.

69. For a more detailed discussion of groupthink, see Marleen A. O'Connor, *The Enron Board: The Perils of Groupthink*, 71 U. CIN. L. REV. 1233 (2003); see also IRVING L. JANIS, *VICTIMS OF GROUPTHINK: A PSYCHOLOGICAL STUDY OF FOREIGN-POLICY DECISIONS AND FIASCOES* (Houghton Mifflin Co. 1972); Stephen M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1, 32 (2002).

70. See Bainbridge, *supra* note 69, at 32; see also O'Connor, *supra* note 69, at 1238–39 (noting that the quest for unanimity affects decision-making by impeding “critical reflection and reality testing”).

71. Daniel P. Forbes & Frances J. Milliken, *Cognition and Corporate Governance: Understanding Boards of Directors as Strategic Decision-Making Groups*, 24 ACAD. MGMT. REV. 489, 496–97 (1999) (finding that group cohesiveness can have positive effects on group decision-making unless the group also experiences self-censure and pressure).

72. Empirical research has emphasized that close social ties can provide greater board involvement in their advisor/counselor roles, though it may not have as positive an effect on their monitoring role. Westphal, *supra* note 8, at 9.

engage in groupthink.⁷³ Focusing on process-oriented approaches as discussed below can reduce the harmful cohesion that engenders in-group biases through fostering an atmosphere that promotes multiple viewpoints while maintaining collegiality.⁷⁴

III. BEYOND COSMETIC INDEPENDENCE—AN ORGANIZATIONAL BEHAVIOR APPROACH

The organizational behavior literature that studies effective decision-making teams identifies attributes that exert greater influence on the board's decision-making ability than "independence,"⁷⁵ and thereby the board's ability to effectively monitor managers. Companies continue to fail despite the ubiquity of the majority-independent board, in large part because the board lacks three critical components for successful monitoring: time, information, and knowledge.⁷⁶ For instance, the boards of *Fortune's* 2001 list of the most-admired and least-admired companies had similar governance practices and characteristics.⁷⁷ In other words, both corporate failures and successes have independent directors and committee structures. Many factors contribute to corporate failure.⁷⁸ But revisiting the *who* of the board from an organizational behavior perspective offers valuable insights that may be able to help slow or deter some of

73. According to Janis, faulty structure is an antecedent condition to groupthink. Each of the three attributes discussed in this Essay are improvements to the current structural flaws present in most boards, hence they make it less likely that a board will be susceptible to groupthink. See JANIS, *supra* note 69, at 243–45; O'Connor, *supra* note 69, at 1265–66 (applying Janis's work to the Enron board and discussing inadequate decision-making procedures).

74. See discussion *infra* Part III.D.

75. G. Tyge Payne, George S. Benson & David L. Finegold, *Corporate Board Attributes, Team Effectiveness and Financial Performance*, 46 J. MGMT. STUDIES 704, 708 (2009).

76. In addition to the three attributes of time, knowledge, and information discussed in this Essay, the literature often identifies the power of the group to reach independent decisions and incentives to align the interests of the board with those of the shareholders. See Payne et al., *supra* note 75, at 708. The balance of power between the CEO and management is beyond the scope of this Essay. Aligning directors' incentives with the shareholders has inspired another popular category of reforms, namely those that advocate equity-based compensation for directors. See discussion *supra* note 38 and accompanying text.

77. Jeffrey A. Sonnenfeld, *What Makes Great Boards Great: It's Not Rules and Regulations. It's the Way People Work Together*, 80 HARV. BUS. REV. 106, 107 (2002).

78. John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301 (2004) (rejecting arguments that a lack of independence caused the corporate scandals that occurred in 2001–2002; arguing that boards were more independent during 2001–2002 than they were in previous periods, and such independence did not prevent several high profile scandals; and arguing that an alternative explanation is "that the gatekeepers failed"); John C. Coffee, Jr., *What Caused Enron? A Capsule Social and Economic History of the 1990s*, 89 CORNELL L. REV. 269, 304–305 (2004) (suggesting the post-Enron NYSE and NASDAQ reforms regarding independence standards would not have affected the boards of Enron or WorldCom; arguing that SOX failed to address key drivers of corporate malfeasance such as perverse incentives, structural conflicts, and gatekeeper failure).

the problems plaguing many modern corporations. More importantly, identifying and using inputs that create effective teams is an antecedent condition to boards implementing better decision-making processes, and thus contributing to higher-performing corporations.⁷⁹

Organizational behavior scholars have noted that boards are similar to other decision-making teams within organizations.⁸⁰ Like most teams, there is a connection between a board's attributes, its effectiveness, and ultimately the outcomes it produces.⁸¹ Perhaps most importantly, contrasting these team-oriented attributes supported by an organizational behavior approach with the conventional focus on cosmetic independence indicates that the conventional approach does not provide an adequate solution to corporate failure. The contemporary model of corporate governance reform has assumed that if the definition of independence is changed to include more observable traits of independence, firms will perform better. The empirical evidence described in the preceding Part indicates otherwise.⁸²

While studying board characteristics and their connection to firm performance is a difficult task, it is clear that there is something missing between the regulatory inputs and their desired outcomes. Through focusing on the components necessary for individuals and groups to make sound decisions and perform their roles well, organizational behavior argues that directors need time, information, and knowledge in order to properly evaluate the recommendations and decisions of management. Similarly, processes that strengthen these three attributes are critical to the success of corporate boards and the firms that they serve. Each of these three components can simultaneously be a limiting and enabling factor for board success.⁸³ Stated differently, improve one of the three components and a board is likely to perform better. Diminish one and the board will perform worse. A board that possesses these characteristics is likely to be more proactive, and less reactive, in performing its duties. Cosmetic independence can reduce the board's ability to effectively monitor managers because it limits time, information, and knowledge.

79. Payne et al., *supra* note 75, at 719 (finding that "knowledge, information, power, and opportunity/time[] were significantly related to board effectiveness," which is a strong predictor of a corporation's financial performance); Sharpe, *supra* note 1.

80. Payne et al., *supra* note 75, at 707 ("Corporate boards are defined groups of individuals who each bring unique skills and backgrounds along with their own personal interests and agendas, but must work together interdependently to achieve common goals."); Forbes & Milliken, *supra* note 71, at 491-92 (noting that although boards differ from other work groups, group decision-making literature is still instructive; writing that "boards of directors can be characterized as large, elite, and episodic decisionmaking groups that face complex tasks pertaining to strategic-issue processing").

81. Payne et al., *supra* note 75, at 707.

82. See discussion *supra* at note 55.

83. Payne et al., *supra* note 75, at 708.

A. Time

Many boards lack the time necessary to fulfill their monitoring obligations and oversee management.⁸⁴ The lack of time that boards face is a problem because a board cannot perform its oversight function if it does not have complete information in a timely manner, and the time to review and understand it.⁸⁵ Currently directors hold an average of eight meetings per year in addition to any other committee meetings they may have.⁸⁶ The realities of independent-director life mean that in increasing any of the attributes of effective decision-making, we must consider how much time a part-time director can actually devote to increasing her knowledge or obtaining the best types of information to do her job. Directors are usually officers of other companies, and acting as a director occupies only a small fraction of any given director's time.⁸⁷ On average, directors spend less than sixteen hours a month on board-related work, including the time it takes to travel to and from board meetings.⁸⁸ In these meetings, the directors are responsible for monitoring management through reviewing the corporation's financial statements, approving committee reports, and possibly approving major strategic decisions. Recent regulations, such as SOX, impose added requirements for regulatory compliance, which increase the responsibilities of the board members and put even greater pressure on their time.⁸⁹

B. Information

In order to perform their monitoring task well, boards need information about how the company is operating and being managed.⁹⁰ Additionally, boards need information about the competitive environment in which the company operates, such as intelligence on competitors and the business environment.⁹¹ Yet the information board members are provided

84. CARTER & LORSCH, *supra* note 33, at 73.

85. Sonnenfeld, *supra* note 77, at 109.

86. KORN/FERRY INST., *supra* note 51, at 10. The boards of American companies meet an average of eight times per year not including telephonic meetings. *Id.* Two decades ago the Korn/Ferry survey showed twenty-five percent of American companies held monthly board meetings. *Id.* That number dropped to nine percent of surveyed American companies in 2003, and by 2007, only seven percent met monthly. *Id.*

87. *Id.* at 4–5.

88. *Id.*

89. Jay W. Lorsch & Robert C. Clark, *Leading from the Boardroom*, 86 HARV. BUS. REV. 104, 107 (2008) (writing that “since the introduction of Sarbanes-Oxley, in 2002, for instance, the time required for audit committee meetings has at least doubled.” As a result, “The directors’ committee work usually cannot be completed in the allotted time, and their discussions often end up being truncated or spilling over into hastily arranged teleconferences.”).

90. Payne et al., *supra* note 75, at 710.

91. *Id.*

is insufficient and does not prepare them to properly perform their monitoring role. Directors typically receive their information packets shortly before board meetings, and those packets are often voluminous and poorly organized.⁹² Most of the data is backward looking and constitutes nothing more than lagging indicators of firm performance.⁹³ Frequently the information is limited in scope to financial data, as opposed to the competitive, strategic, product, employee, or customer information the board needs to properly evaluate management and their strategies.⁹⁴ Moreover, directors receive information packets prepared by the CEO or by the executives who work for her; directors rarely have channels outside of the CEO for information gathering.⁹⁵ If executive management's vision of the company is flawed, the board's information will share the same flaws.⁹⁶ Not surprisingly, many directors believe that they do not have the right information to assess the costs and benefits of particular courses of action before they must vote to approve that action.⁹⁷ Thus, critics of the information-dissemination system that exists at most corporations rightly argue that directors have neither the correct information nor the time to assimilate the information they are given. As a result, directors often must review and approve complex issues without a sufficient understanding of the context in which the issues occur, which in-

92. CARTER & LORSCH, *supra* note 33, at 27; *see also* David A. Nadler, *Building Better Boards*, 82 HARV. BUS. REV. 102, 109 (2004); *see also* Sonnenfeld, *supra* note 77, at 109 (describing how late-arriving information can undermine the trust and respect a board has for the CEO). Sonnenfeld writes, "What kind of CEO waits until the night before the board meeting to dump on the directors a phone-book-size report that includes, buried in a thicket of subclauses and footnotes, the news that earnings are off for the second consecutive quarter? Surely not a CEO who trusts his or her board. Yet this destructive, dangerous pattern happens all the time." *Id.*

93. Nadler, *supra* note 92, at 110.

94. CARTER & LORSCH, *supra* note 33, at 27.

95. It is important to note that, according to the Delaware courts, in order for boards to avoid breaching their duty of care, directors "have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them. Having become so informed, they must *then* act with requisite care in the discharge of their duties." *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345 (Del. 1993) (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)). Similarly, in *In re Caremark International Inc. Derivative Litigation*, the Delaware Court of Chancery noted that "relevant and timely information is an essential predicate for satisfaction of the board's supervisory and monitoring role under Section 141 of the Delaware General Corporation Law." 698 A.2d 959, 970 (Del. Ch. 1996). Additionally, boards of directors have a right to rely on the information of third-party gatekeepers, such as attorneys and outside consultants. These third parties do not reduce the reliance on the CEO; because they obtain their information from corporate insiders, they often have their own conflicts of interest that increase the likelihood that they will go along with management's recommendations, and they may suffer from some of the same in-group biases as the board itself. Fairfax, *supra* note 8, at 162. Thus, the prevailing wisdom is that directors are generally limited to information provided by the CEO and her team. *See* Nadler, *supra* note 92, at 110.

96. CARTER & LORSCH, *supra* note 33, at 46.

97. Nadler, *supra* note 92, at 110.

cludes the underlying assumptions that affect the outcome of the board's decision.⁹⁸

C. Knowledge

Even if directors had the appropriate information, being able to comprehend the information is a more difficult task that requires in-depth knowledge about the firm. A director's relevant knowledge can be classified in two ways: knowledge about functional business areas, such as marketing or accounting, or knowledge that is firm-specific.⁹⁹ Most directors are knowledgeable business people; however, they lack knowledge about the company on whose board they sit and the industry within which that company operates.¹⁰⁰ A lack of knowledge about the particular company means that independent directors cannot properly evaluate or meaningfully challenge the decisions they are asked to approve.¹⁰¹ The very definition of independence usually means that directors do not have a current or recent relationship with the company or any of its competitors.¹⁰² Consequently, directors develop their company-specific knowledge as part of their work on the board, which can take years given the limited time they spend on board service.¹⁰³ One recent survey found that directors who had long tenures on particular corporate boards still felt as though they did not "really understand how their companies make money."¹⁰⁴ A Boston Consulting Group/Harvard Business School survey of 132 CEOs in 2001 found that only half of North American CEOs believed their boards were well-prepared at meetings.¹⁰⁵ The same survey showed that CEOs question whether directors are knowledgeable enough about the business to approve strategic decisions or evaluate their company's performance.¹⁰⁶

The pervasive lack of knowledge most directors face reduces their efficacy in many ways. Directors recognize their ignorance and are often reluctant to voice their opinions in board meetings.¹⁰⁷ One reason for this reluctance is that directors care about their image and do not want to ap-

98. LORSCH WITH MACIVER, *supra* note 60, at 58.

99. Forbes & Milliken, *supra* note 71, at 495.

100. CARTER & LORSCH, *supra* note 33, at 45; Fairfax, *supra* note 8, at 165.

101. LORSCH WITH MACIVER, *supra* note 60, at 57.

102. CARTER & LORSCH, *supra* note 33, at 45.

103. *Id.*

104. Nadler, *supra* note 92, at 110.

105. CARTER & LORSCH, *supra* note 33, at 25. Preparedness is related to each attribute: time, information, and knowledge.

106. *Id.* at 24 (citing a Boston Consulting Group/Harvard Business School Global Survey of 132 CEOs in 2001 finding that only forty-six percent agree that boards "understand the factors that drive performance in each of the [firm's] main businesses").

107. LORSCH WITH MACIVER, *supra* note 60, at 84-85.

pear uniformed in front of their peers.¹⁰⁸ Consequently, the type of open and honest discourse necessary to properly evaluate management's decisions is limited. As a result, the board's ability to monitor is constrained.

D. Beyond Cosmetic Independence

The aforementioned problems intrinsic to cosmetic independence are an indication that corporate governance reform needs a new approach. The conventional model operates on an assumption that if a particular input is added (i.e., more independent directors), a specific output will follow (i.e., firms that are less likely to fail and have better market performance). In light of the attributes of effective teams, adding more independent directors and committees composed of independent directors is not likely to improve firm performance. At best, cosmetic independence is an inadequate criterion for board membership. At worst, it impedes the board's ability to perform the actual work of monitoring.

CONCLUSION

This Essay has identified problems with selection criteria for corporate directors. To address the problems, I have looked to the group decision-making literature within organizational behavior. This literature identifies three of the essential attributes of effective teams: time, information, and knowledge. These attributes are necessary for boards to move beyond cosmetic independence to where directors, and the boards on which they serve, are free from significant managerial influence. Improving corporate boards is a complex problem, but it is critical that we reexamine conventional assumptions in order to engage that complexity and, ultimately, improve board efficacy. The study of organizational behavior, with its focus on effective team decision-making, would greatly assist us in achieving this goal.

Although this Essay focuses on the qualifications of board membership and asserts that it influences how boards function, I am not arguing that it is the only factor that does so. In a separate and more detailed exploration of the issues raised in this Essay, I have asserted that the processes by which corporate boards gather information and make decisions are equally if not more important than who sits on them.¹⁰⁹ Nevertheless, to the extent that regulation continues to emphasize changes to the characteristics of the board, policymakers should adopt better selection criteria for directors. In my view, they should emphasize substantive characteristics over merely cosmetic ones.

108. *Id.*

109. See Sharpe, *supra* note 1.