

Lobbying, Pandering, and Information in the Firm

*Adam B. Badawi**

I. INTRODUCTION

In their classic and insightful article on team production in corporate law, Margaret Blair and Lynn Stout identify the minimization of rent-seeking as one of the chief benefits of vesting ultimate authority over a firm with the board of directors.¹ In their analysis, this problematic rent-seeking arises when parties need to divide the gains from production after the fact. The squabbling that is likely to ensue may threaten to eat away most, or all, of the gains that come from productive activity. If parties know that this sort of rent-seeking will occur, they may not engage in productive activity in the first place. Parties view the board's ability to act—or threaten to act—as a neutral arbiter to divide the gains from production as a mechanism that preserves the incentive to engage in productive activity.

While this is a creative and plausible account of the board's role and of its enduring success, the presence and prominence of the board introduces new opportunities for rent-seeking and other similarly distortive activity. In this Article, I identify the rent-seeking and related problems that the board *creates* rather than solves. Like Blair and Stout, I draw on insights from the theory of the firm literature to understand the incentives that firm managers may have to shade, contort, and otherwise manipulate the information that the board receives. These theories suggest why managers are likely to engage in this behavior and how boards are likely to respond.²

This exercise is not an indictment or criticism of the board. As an institution, the board has been remarkably successful, and it is important to understand the reasons for that success. Nevertheless, the presence of

* Associate Professor of Law, Washington University in St. Louis, Law School. I thank Scott Baker, Tony Casey, Jill Fisch, and Lynn Stout for their helpful comments and suggestions.

1. Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 249–51 (1999).

2. Throughout this contribution I use the terms rent-seeking and lobbying interchangeably.

an independent board encourages potentially problematic behavior that would probably not occur in the board's absence. To understand the board's role and its place in corporate law, it is important to comprehend how managers will respond and adapt to the behaviors the board's presence enables. Doing so, this contribution claims, will naturally lead to quite modest claims about what the board can do to limit squabbling and agency cost concerns.

The jumping-off point for this analysis is the observation that the CEO and other high-level managers are the information conduit for an independent board.³ As other scholars have noted, this ability to control information impacts how effective boards can be as monitors of managers and as providers of strategic advice.⁴ The specific pathways and behaviors that this control over information enables have received less attention, and it is those pathways and behaviors that I analyze in this piece. I focus on two specific behaviors that the informational dynamic between managers and the board engenders: lobbying and pandering.⁵

The institutional problem that underlies lobbying is that those who are affected by a decision may have stronger preferences than those with the authority to make that decision.⁶ If a superior has the right to make a choice that a subordinate deeply cares about, that subordinate may spend time trying to cajole the superior into making a decision that favors the subordinate. This danger may be particularly acute if the superior must rely on information from the subordinate in order to make that decision. This lobbying can pose costs to the firm because time spent lobbying could be devoted to more productive tasks.

These circumstances map quite neatly to the problems faced by a board of directors as it monitors firm management. As corporate scholars

3. There are some quite elegant formal models of this process. For example, Adams and Ferreira, *infra*, show that the strategic and monitoring roles of the board can lead a CEO to share less information with an independent board. This result arises from the CEO's fear that sharing too much with a tougher monitor (i.e., a more independent board) can adversely affect the CEO's well-being. See Renée B. Adams & Daniel Ferreira, *A Theory of Friendly Boards*, 62 J. FIN. 217, 217 (2007).

4. Arnoud W.A. Boot & Jonathan R. Macey, *Monitoring Corporate Performance: The Role of Objectivity, Proximity, and Adaptability in Corporate Governance*, 89 CORNELL L. REV. 356, 370 (2004) ("Management not only has the time and resources to cultivate the board, it also presents the board with the information necessary to make decisions. Over a wide range of issues, all management must do to sway the board's decision is present information in a manner likely to generate support or to achieve effective capture of the board. It is not surprising, therefore, that boards often lack objectivity.").

5. I use the term lobbying to refer to managerial efforts aimed at influencing the decision of supervisors. I use pandering to refer to the possibility that subordinates will strategically use private information to recommend projects that are not in the firm's interests.

6 See Adam B. Badawi, *Influence Costs and the Scope of Board Authority*, 39 J. CORP. L. 675 (2014).

have long recognized, senior management has most of its human capital bound up within the firm.⁷ These circumstances often lead managers to have intense preferences over firm decisions. Yet it is the board of directors that wields the ultimate authority within the corporation. Directors may have preferences over firm outcomes that are less strong than managers' preferences and, consequently, those managers may intensely lobby directors. These attempts to influence can take away from other productive tasks that managers might otherwise perform, and this lobbying may exert drag on firm performance. I argue that understanding these lobbying concerns can help to explain why boards tend to limit the amount of authority they exercise. Lobbying costs may also help contribute to an explanation of why the move toward more independent boards has been a muted success and why corporate law takes a hands-off approach in imposing liability for duty of care violations.

The second problem, pandering, arises when decisionmakers must rely on private information supplied by subordinates. Models show that, under certain conditions, subordinates will recommend projects that they know are objectively inferior for both the principal and the agent.⁸ Subordinates may do so even though the decisionmakers know they are pandering in this way. While the pandering models are relatively complex, the circumstances that trigger pandering share similarities with the interactions between noninsider directors and senior managers. These firm outsiders operate at an informational disadvantage when compared to insiders. That those insiders may make recommendations that put their own interests ahead of firm-wide interests is a concern that is at the heart of corporate law. The pandering models help to understand the depth of the pathologies that this informational disadvantage can create.

The difficulties directors face in obtaining truthful information from subordinates may help justify some important facets of corporate law. The possibility that management will recommend suboptimal projects and that directors can do little to wrest the truth from management lends credence to the insulation provided to directors by the business judgment rule. If directors struggle to get accurate information, it may not be desirable to make them liable for the decisions they make on the basis of that information.

The pandering phenomenon also provides some support for Delaware General Corporate Law § 141(e). This rule insulates directors from liability when they rely in "good faith" on the reports of managers and

7. See *infra* note 48.

8. See *infra* Part II.A for a more complete description of the model and its sources.

employees of the firm.⁹ Good faith may be understood as requiring directors to make reasonable efforts to ascertain the truth. If directors have done so, they should be able to avoid liability even though managers and other employees may not give accurate information.

The remainder of this Essay proceeds as follows. Part II describes the literature on influence costs and applies that literature to the problems faced by the board. Part III works through a recent model of pandering and analogizes that model to the interaction between the board and management. Part IV concludes by relating the problems of lobbying and pandering to the team production model of corporate law.

II. LOBBYING IN THE FIRM

Internal politics are a fact of organizational life.¹⁰ Subordinates may cajole, persuade, or otherwise influence their superiors into making decisions that benefit those subordinates. Control over information is a chief way to engage in this type of influence; limiting or manipulating information can affect decisions made by superiors.¹¹ People presumably engage in this sort of lobbying because it works, at least with respect to improving the lot of those who can effectively influence others.¹²

The literature on influence costs explores the potential downsides of this behavior.¹³ When managers spend time manipulating information, it takes away from time they could devote to more productive activities. Theorists argue that firms may adapt their institutional structures in a way that helps to minimize these influence activities.¹⁴ One way to do

9. DEL. CODE ANN. tit. 8, § 141(e) (2014).

10. As suggested earlier, this section draws substantially from the analysis in my earlier work on influence costs. See Badawi, *supra* note 6.

11. See Louis Kaplow, *Direct Versus Communications-Based Prohibitions on Price Fixing*, 3 J. LEGAL ANALYSIS 449, 471 (2011) (“Many [firm] decisions are based on soft information or are made despite seemingly contradictory information, perhaps because the information is seen to be unreliable, because there are overriding considerations, or because of incompetence. . . . Firm politics may . . . play a role, reflecting that employees are not perfect agents of the owners.”).

12. See, e.g., David B. Wilkins & G. Mitu Gulati, *Reconceiving the Tournament of Lawyers: Tracking, Seeding, and Information Control in the Internal Labor Markets of Elite Law Firms*, 84 VA. L. REV. 1581, 1618 (1998) (“[W]e should expect tournament winners to be selected as much on the basis of politics as on firm efficiency.”).

13. See generally Robert Gibbons, *Four Formal(izable) Theories of the Firm?*, 58 J. ECON. BEHAV. & ORG. 200, 200–01 (2005) (comparing and defining the four classical theories of the firm: a “rent-seeking” theory, a “property-rights” theory, an “incentive-system” theory, and an “adaptation” theory); Michael Powell, *An Influence-Cost Model of Firm Boundaries and Organizational Practices* (Nov. 1, 2012) (revised Ph.D. thesis, Massachusetts Institute of Technology), available at <http://static.squarespace.com/static/5097d207e4b06cb305096ef3/t/5097ee9be4b0c4855bdf00ee/1352134299819/InflCst%20Oct%2031%202012.pdf>.

14. See Powell, *supra* note 13, at 4 (explaining the choice between rigid and flexible institutional practices may depend on influence cost concerns).

this is to vest authority in parties that have intense preferences over a given set of decisions. If these parties get to make the decisions, they do not need to lobby anyone. Likewise, companies may institute policies like lockstep promotion that sharply diminish the gains from effective lobbying.¹⁵

This dynamic is likely to exist between the board of directors and the senior managers of a firm. The board has plenary authority over the firm, but it may also delegate that authority to managers. Because the board will typically rely on managers for information about the firm, managers will have an opportunity to shade that information in a way that suits their interests. It takes time and energy to engage in this sort of lobbying, and as managers do more of it, it can affect firm performance.

The drag on firm resources posed by lobbying suggests that there is a trade-off that comes with the board's ability to police agency costs.¹⁶ The advantage of a board is that concentrating authority with directors helps to avoid the free riding and conflict that comes with having a dispersed group of shareholders control the corporation.¹⁷ But boards must deal with managers who have most of their human capital tied to the firm.¹⁸ As a consequence, managers are likely to have intense preferences over firm decisions. When managers do not have authority over a choice that will affect their well-being, they are likely to lobby those that do have authority. Excessive amounts of this sort of lobbying could have a detrimental effect on firm performance.

The potential for lobbying may help to explain why boards take measures to insulate themselves from the firms they oversee.¹⁹ As boards

15. *Id.* (“[Lobbying] takes time that would be better spent on more productive tasks—the direct cost of influence activities is the opportunity cost of the influencer’s time. As such, these costs are convex—engaging in influence activities crowds out less productive tasks before more productive tasks.”).

16. See Jill E. Fisch, *Taking Boards Seriously*, 19 *CARDOZO L. REV.* 265, 268–69 (1997) (“The separation of ownership and control in the modern public corporation creates agency costs that interfere with efficient corporate decision making. In an effort to reduce these agency costs, corporate law has developed a number of mechanisms to align the interests of non-owner management with the interests of shareholders. Most recently, these efforts have focused upon the board of directors.”).

17. See Jonathan R. Macey & Jeffrey M. Netter, *Regulation 13D and the Regulatory Process*, 65 *WASH. U. L.Q.* 131, 155 (1987) (“Widely dispersed shareholders are ineffective monitors of the activities of the managers of the firms in which they own shares.”).

18. See Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 *VAND. L. REV.* 83, 113 (2004) (“Corporate managers typically have substantial firm-specific human capital. Unfortunately for such managers, however, the risks inherent in firm-specific capital investments cannot be reduced by diversification; managers obviously cannot diversify their human capital among a number of different firms. As a result, managers will be averse to risks shareholders are perfectly happy to tolerate.”).

19. Some board features are mandated rather than chosen; for example, listing exchange requirements that the majority of a board be independent. See *infra* note 78 (describing NASDAQ and

try to do more, the opportunities for lobbying increase.²⁰ But if boards do too little, managers might exploit the agency costs that directors are supposed to minimize. As this Article suggests, deciding the proper scope of the authority that the board exercises poses a trade-off between minimizing agency costs and minimizing influence costs.

The remainder of this Part explores the lobbying phenomenon and its consequences for corporate law. The first section briefly reviews the formal models of influence costs. The next section suggests how those models might apply to the problems faced by the board of directors. The final section argues that understanding lobbying can contribute to our understanding of the increase in board independence and to corporate law's approach to the regulation of agency costs.

A. Models of Influence Costs

Understanding the internal structure of firms has long been a goal of firm theorists. This desire stems from the recognition that contracting happens within, as well as between, firms. As Klein, Crawford, and Alchian observe: "Vertical integration does not completely avoid contracting problems. The firm could usefully be thought of as a complex nonmarket contractual network where very similar forces are present."²¹ Robert Gibbons sums up the informal take on the topic by stating, "[P]oliticking within firms seems to be the inescapable internal-organization analog of haggling between firms."²²

Gibbons formalized rent-seeking within the firm by developing a model of decision rights and influence costs. To do this, he looked to older models of information asymmetry.²³ These models suggest that, in a situation where parties can influence a signal about an unobservable state of the world, parties will exert that influence even when the recipi-

NYSE rules). Nevertheless, the basic part-time approach of noninsider directors predates these requirements. See Edward S. Herman, *The Limits of the Market as a Discipline in Corporate Governance*, 9 DEL. J. CORP. L. 530, 533 (1985) ("Most modern analyses of the internal power structures of the large corporations have found the top insiders to be the power and decision-making center, with the outside directors usually serving in an advisory role. This is based on the factors just mentioned—command over resources, special skills, plus the tendency of the top insiders to build up a congenial board.").

20. See Benjamin E. Hermalin & Michael S. Weisbach, *Boards of Directors as an Endogenously Determined Institution: A Survey of the Economic Literature*, 9 FED. RES. BANK N.Y. ECON. POL'Y REV. 7, 8 (2003) ("[B]oards appear to evolve over time depending on the bargaining position of the CEO relative to that of the existing directors.").

21. Benjamin Klein et al., *Vertical Integration, Appropriable Rents and the Competitive Contracting Process*, 21 J.L. & ECON. 297, 299 n.4 (1978).

22. Gibbons, *supra* note 13, at 222.

23. *Id.*

ent knows they will do so.²⁴ The reason for this effect is that the recipient of the signal will expect the signal to be a product of influence. If the potential influencers choose to refrain from contributing noise to the signal, the recipient will, nevertheless, assume that influence has been exerted.

For example, the unobservable state of the world might be a firm's financial health and the signal may be quarterly earnings. Managers have the option of massaging those earnings to make them appear slightly better than they actually are. If the managers of a firm choose not to massage earnings, those that observe the earnings will, nevertheless, assume they have been massaged. This leads to a conclusion that the firm's health is worse than it actually is.²⁵ Likewise, if the observers of earnings did not believe that management had massaged the earnings, management would have that much more to gain by exerting this influence. In equilibrium, those who can influence will do so, and those that observe the signals will assume that the signals have been influenced.

Gibbons brings these influence activities into the firm by analyzing how a firm might allocate the right to make a decision between two parties (also known as a "decision right").²⁶ This right allows the party with control to make a decision that will have a large effect on the ultimate outcome. The decision is based on a signal that the decisionmaker cannot observe or verify. In the context of the board and management, a decision right might be whether to take on a new project. If the board will choose whether to initiate the project, it will have to rely on information from management about the likely success of the project. The board cannot, however, verify that information.

The party without control of the decision can expend effort to influence the signal. Gibbons shows, following the process outlined above, that the party without control will exert influence, and the party with control will adjust the interpretation of the signal to account for the lobbying that the other party has done.²⁷ The optimal allocation of the deci-

24. *Id.* at 224 ("In particular, in equilibrium, the party with control correctly anticipates the other party's attempts to influence [the signal], and so correctly accounts for those attempts in interpreting [the signal] as a signal about [the state of the world]. As we will see, however, the other party still has an incentive to influence [the signal].").

25. For the purpose of this discussion I assume that adjustments to the earnings signal fall within an interpretive range that would not trigger legal liability.

26. *Id.* at 222–26.

27. *Id.* at 224 ("[T]he party with control will try to extract from the signal whatever information [it] might contain about the state, prompting the other party to try to move the realization of [the signal] in a direction that is favorable to her. In equilibrium, both parties have correct beliefs. In particular, in equilibrium, the party with control correctly anticipates the other party's attempts to influence [the signal], and so correctly accounts for those attempts in interpreting [the signal] . . .").

sion right will go to the party who has the most intense preferences over the decision.²⁸ Allowing the party who cares the most to make the decision minimizes the loss from the decision, while also minimizing the cost of influence activities. To put this last point differently, those that have the most to lose will spend the most on wasteful lobbying if they do not have the decision right.

Powell extends Gibbons's analysis to demonstrate how a firm might allocate decision rights between two managers.²⁹ In his model, the firm can unify control of decision rights with one manager, or it can divide the decision rights between the two managers.³⁰ It can be expected that managers who do not control decisions will try to influence the signals that decisionmakers receive. Powell finds that, when lobbying costs are not a concern,³¹ it is best to allocate decisions to the manager that cares most about those choices.³² This approach should produce the best results from these decisions.

When managers care about decisions equally, lobbying makes all the difference. In this case, the optimal strategy is to divide control of the decisions. This is because as the costs of lobbying grow larger, the more a manager lobbies.³³ Or, to put it another way, the initial lobbying that one manager does is relatively inexpensive, but costs increase as the manager does more lobbying. The theory is that rent-seeking will initially crowd out the least valuable tasks that a manager would otherwise do. As the amount of lobbying increases, however, the theory suggests that these influencing activities are likely to take away from increasingly important tasks. If the firm divides control, both managers will lobby a little bit. This lobbying will be relatively cheap because it will not cut into a manager's most important tasks. Alternatively, if the firm unifies control of the decisions in one manager, the other manager will lobby both decisions.³⁴ This approach is more costly for the firm because the lobbying manager is taking away from other productive activities.

28. *Id.* at 225–26.

29. Powell, *supra* note 13, at 3.

30. *Id.* at 4.

31. With infinite lobbying costs, managers will not be willing to pay that cost.

32. Powell, *supra* note 13, at 12.

33. To put the assumption in economic terms, these models assume that lobbying costs are convex. See generally EDWIN K.P. CHONG & STANISLAW H. ZAK, AN INTRODUCTION TO OPTIMIZATION 370 (1996) (defining convexity).

34. Powell, *supra* note 13, at 4 (“Non-integration minimizes influence costs: divided control leads both managers to crowd out mundane activities, whereas unified control leads one manager to essentially specialize in influence activities, crowding out potentially important tasks. On the other hand, there may be benefits to unifying control: coordinating the two decisions could be important, or one manager might simply have more to lose from not having his ideal decision implemented.”).

Powell argues that influence costs may explain some seemingly unproductive practices that firms follow.³⁵ For example, he cites seniority-based promotion as one such rule because it can result in elevation for reasons unrelated to merit.³⁶ There is less to gain from schmoozing with a superior when a firm follows a strict seniority rule to govern promotion.

B. Influence Costs as Applied to the Board

This section applies the theory of influence costs discussed above to the specific context of the board of directors. First, it is helpful to provide an overview of how the boards of many public companies conduct their affairs. While these boards have substantial power to control a firm, they typically limit their involvement in the company's daily life. Most boards meet a handful of times a year, and the number of decisions they make are accordingly small.³⁷ Moreover, many outside directors have limits on their ability to be a full-time presence in the firm because they have other pressing demands on their time.

Boards tend to make a small number of intensely important decisions. These choices include whom to hire as top-level executives, whether to retain those executives, high-level compensation decisions, and choices about whether to merge with other companies.³⁸ But this structure reserves many important strategic and personnel decisions for management, even though these choices are very much within the permissible discretion of the board. Why has the allocation of decision rights between the board and management settled on this arrangement?

Boards could do things differently. Delaware law gives the board the authority to manage the "business and affairs of every corporation."³⁹ From this statutory grant of plenary authority, it follows that boards have complete freedom to decide which decision rights they will exercise. While firms vary in the scope of authority that their boards utilize, observation suggests that no board employs the full scope of authority that

35. *Id.* at 2 ("In order to [moderate influence activities], organizations [may] adopt rigid, seemingly inefficient, practices.").

36. *Id.*

37. See CORPORATE LAW COMM., ABA BUS. LAW SECTION, CORPORATE DIRECTORS GUIDEBOOK (6th ed. 2011), reprinted in 66 BUS. LAW. 975, 1008 (2011) ("Boards should hold regularly scheduled meetings at least quarterly, but many schedule six to eight regular meetings a year and hold additional special meetings as needed.").

38. Usha Rodrigues, *A Conflict Primacy Model of the Public Board*, 2013 U. ILL. L. REV. 1051, 1064 (2013) ("The board's monitoring responsibilities primarily involve appointing the CEO and evaluating the management team." (citing Fisch, *supra* note 16, at 269–71)).

39. DEL. CODE ANN. tit. 8, § 141(a) (2014).

corporate law permits. Instead, boards delegate much of the operation of the firm to management and their subordinates.

The lasting nature of this board model suggests that it may be adaptive.⁴⁰ While proving the efficiency of this arrangement is a difficult—if not impossible—task, the substantial market for corporate control provides some suggestive evidence.⁴¹ If the part-time board model does not work well, one should expect private equity or institutional investors to target boards that do not allocate their authority in an effective way.⁴² Nevertheless, the part-time approach persists despite a market that targets poorly governed companies.⁴³ The durable nature of the part-time board thus provides some evidence that this approach can contribute to the success of a firm.

The literature on lobbying within the firm may provide some insight to this behavior. That literature analyzes the costs and benefits associated with different allocations of decision rights within an organization.⁴⁴ This is a fair description of the board's charge. As discussed above, corporate law gives the board plenary power over firm decisions.⁴⁵ It may exercise or delegate any of these rights as it sees fit.

How much authority—or put another way, how many decision rights—will a board optimally exercise? Lessons from the influence cost literature suggest that this determination will depend, in part, on the trade-off outlined earlier. Asserting a decision right allows the board to control outcomes in a way that serves the board's interest in ensuring that management does not exploit agency costs. As the board exercises more authority on its own, it is presumably better able to further these inter-

40. See Hermlin & Weisbach, *supra* note 20, at 9 (“[B]oards are a market solution to an organizational design problem, an endogenously determined institution that helps to ameliorate the agency problems that plague any large organization. Whatever their virtues or problems, boards of directors are part of the market solution to the contracting problems inside most organizations. We believe that viewing boards of directors from this perspective is the most useful way to study how they are structured and function.”).

41. See Edward B. Rock, *Adapting to the New Shareholder-Centric Reality*, 161 U. PA. L. REV. 1907, 1923–25 (2013) (explaining how a vibrant market for corporate control has arisen despite the regulatory barriers to hostile takeovers).

42. Increases in shareholder concentration are likely to incentivize increased monitoring. Cf. Jens Dammann, *Corporate Ostracism: Freezing Out Controlling Shareholders*, 33 J. CORP. L. 681, 687–88 (2008) (suggesting that controlling shareholders are likely to scrutinize managers more closely).

43. The argument is not that this structure is efficient. Rather, the claim is that there are some forces that can eliminate less-than-optimal approaches to governance. See Mark Roe, *Chaos and Evolution in Law and Economics*, 109 HARV. L. REV. 641, 641 (1996) (“Although institutions that have survived cannot be too inefficient, evolution-toward-efficiency constrains but does not fully determine the institutions we observe.”).

44. See, e.g., Gibbons, *supra* note 13; Powell, *supra* note 13.

45. See DEL. CODE ANN. tit. 8, § 141(a) (2014).

ests. But recall that a chief lesson from this literature is that those who do not make decisions will try and influence decisions made by others if those decisions affect their welfare.⁴⁶ The resulting lobbying costs are one potential downside of exercising any given decision right.⁴⁷

This sort of rent-seeking will almost certainly pose a problem for a board that must oversee firm management. As corporate law literature has long appreciated, executives have a strong interest in many of the firm's decisions.⁴⁸ Unlike diversified, passive shareholders (who are unlikely to care intensely about any single decision that a corporation makes), management has much of its human capital tied to the firm. This situation creates strong incentives to manipulate information and otherwise engage in rent-seeking. Rent-seeking can be costly because it takes away time from more productive tasks that management could be doing.

The high cost of lobbying provides one reason for boards to limit the scope of the authority they actually exercise. For example, imagine that a firm is considering whether to launch a new product. Suppose that the new product is expected to have a modest effect on profitability and does not represent a substantial shift in strategy. The board may not care much about this type of decision insofar as it is a marginal choice with regard to revenue and strategy. Some managers may, however, care dearly about this decision because their careers and pay depend on it in important ways. If the board chooses to make these types of decision rights by itself, management can be expected to spend a significant amount of time and energy attempting to influence these decisions.⁴⁹

This aspect of lobbying may give a board pause about exercising a wide scope of authority. The benefits to the board of exercising authority over a decision that will contribute only marginally to firm success are likely small. The lobbying costs, however, could be substantial. Moreo-

46. Gibbons, *supra* note 13, at 224.

47. I do not mean to suggest that lobbying costs are the only costs associated with the exercise of a given decision right. Making any decision will require time and energy—both of which are costly. My claim about lobbying costs is that the unique structure of the corporation creates an incentive structure that can lead to a significant amount of management lobbying. This concern has not been recognized in the literature and understanding the nature of these costs may provide a partial account of why and how the board limits its authority.

48. See Bainbridge, *supra* note 18, at 113; George W. Dent, Jr., *Toward Unifying Ownership and Control in the Public Corporation*, 1989 WIS. L. REV. 881, 889 (1989) (“Managers fear risk more than shareholders do because managers cannot diversify their investment of human capital as shareholders can diversify their investments of money.”).

49. Note that delegating these sorts of decisions to management will not eliminate lobbying within the firm. Managers have subordinates, thus if managers have authority over the launch of a new product, their subordinates can be expected to lobby the managers. But if the board delegates the decision to managers, the lobbying costs shift down the organizational ladder and are presumably not as costly to the overall health of the firm.

ver, recall that the theoretical literature on intrafirm lobbying suggests that incremental costs of rent-seeking grow at an increasing rate.⁵⁰ If this assumption is correct, the influence costs may be apt to climb quickly as management does more and more lobbying.

This organizational problem may help to explain some of the board's durable features. If lobbying can quickly grow beyond what is desirable, the board may seek to limit the number of decision rights that it has. Indeed, as discussed earlier, it appears that nearly every board exercises authority in an amount that falls far short of the full extent of the powers that a board can exercise by law.⁵¹ By limiting the number of decision rights that they make, boards reduce the amount of time that managers spend trying to shade information and otherwise trying to get things to go their way.⁵² These managers can, instead, spend that time accomplishing tasks that provide more benefits to the firm as a whole.

The degree of board dependence on management, emphasized by corporate scholars, suggests that management has ample opportunities to spin the information and otherwise engage in lobbying. Management is typically responsible for setting board agendas⁵³ and produces many of the reports that directors receive regarding firm performance.⁵⁴ This structure may make it possible for a manager to massage information in a way that favors that manager's interests.⁵⁵ If the board were to increase

50. See CHONG & ZAK, *supra* note 33.

51. See *supra* notes 37, 38 and accompanying text.

52. It is worth pointing out that lobbying may not necessarily lead to waste. It is conceivable that some attempts to influence might benefit outside directors because it gives them greater access to firm information. For the purposes of this discussion, however, I refer only to lobbying activities that displace more productive activities.

53. Note that the board may be able to implement some structural features that inhibit the ability of managers to set the board agenda. One oft-discussed mechanism for doing so is to separate the role of CEO and board chair. See, e.g., Sydney Finkelstein & Richard A. D'Aveni, *CEO Duality as a Double-Edged Sword: How Boards of Directors Balance Entrenchment Avoidance and Unity of Command*, 37 ACAD. MGMT. J. 1079, 1081–83 (1994). There is mixed empirical evidence on the consequences. Compare B. Ram Baliga et al., *CEO Duality and Firm Performance: What's the Fuss?*, 17 STRATEGIC MGMT. J. 41 (1996) (finding little support for the hypothesis that split roles improves results), with Paula L. Rechner & Dan R. Dalton, *CEO Duality and Organizational Performance: A Longitudinal Analysis*, 12 STRATEGIC MGMT. J. 155 (1991) (showing some evidence that firms with split roles perform better).

54. See Rodrigues, *supra* note 38, at 1060–61 (“Typically, senior management plays a significant part in the selection of directors, in proposing the compensation for directors, in selecting their committee assignments, in setting agendas for their meetings, and in evaluating their performance.” (quoting James H. Cheek, III et al., *Preliminary Report of the American Bar Association Task Force on Corporate Responsibility*, 54 MERCER L. REV. 789, 799 (2003))).

55. See Nicola Faith Sharpe, *Informational Autonomy in the Boardroom*, 2013 U. ILL. L. REV. 1089, 1118 (2013) (“Boards’ almost complete dependence on management for the information required to successfully oversee the same managers means that boards are unlikely to play a proactive role in monitoring.”).

the number of decisions that it makes, doing so might deepen dependence on management and hence expand lobbying opportunities.

A fear of excessive influence costs may also help to account for the manner in which boards tend to exercise their authority. Directors are not a constant presence in the firm's daily life. Studies indicate that, on average, directors spend less than 20 hours a month carrying out board work.⁵⁶ Boards usually meet infrequently and, while they tend to keep communication channels open with management, directors appear to structure their work in a way that minimizes direct contact with managers.⁵⁷ Taking into account the prospect of lobbying identifies an unappreciated benefit from this limited interaction: by making themselves relatively inaccessible, directors limit managers' ability to engage in arm twisting and cajoling. These barriers allow managers to devote more of their time to tasks that contribute to firm productivity.

But if the board is to be a useful monitor of agency costs it must, of course, make some decisions. The theories of the firm discussed in Part II.A above suggest that decisionmaking authority should lie with the party who has the most intense preference about the outcome of that decision. This is an obvious problem in the relationship between the board and management. The board typically represents a group of passive investors. Even if an investor is more active—say in the mold of Carl Icahn—that investor will often have a portfolio of somewhat diversified assets. Management, as discussed above, has a heavy investment of its human capital bound up with the firm.⁵⁸ It is likely that, for any given decision, management will have a more intense interest in the decision than either the stockholders or the board.⁵⁹

This potential mismatch of preference intensity means that a board can expect any decision that it allocates to itself to be lobbied with fervor. In making a decision, the board must presumably balance the benefit of taking the decision against the organization-wide costs associated with

56. MARTIN LIPTON ET AL., WACHTELL, LIPTON, ROSEN & KATZ, *SOME THOUGHTS FOR BOARDS OF DIRECTORS IN 2012*, at 5 (2011), available at <http://www.wlrk.com/files/2012/SomeThoughtsforBoardsOfDirectorsin2012.pdf> (“The 2011 Public Company Governance Survey of the National Association of Corporate Directors (NACD) suggests that public company directors spent an average of over 227 hours performing board-related activities in 2011.”).

57. *Cf.* Rodrigues, *supra* note 38, at 1082 (“The team production model envisions directors who are actively and constantly mediating between the various interests of labor, shareholder, management, and perhaps the larger community. The modern part-time board simply cannot take such an active role in management.”).

58. Dent, *supra* note 48, at 889.

59. See Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231, 265 (2002) (discussing the likely mismatch in preference intensities between directors and managers).

signal jamming and influence efforts. Insights from the influence cost theory literature suggest that boards will take a small number of decisions that convey the largest benefits associated with the exercise of their authority. This phenomenon may help to explain why most boards largely limit the scope of their decisionmaking authority to the right to hire and fire senior management and other highly consequential decisions.

The control that the board has over the hiring and firing of C-level executives will naturally lead to significant lobbying.⁶⁰ Management has an intense interest in these decisions and can be expected to shade information and attempt to influence these choices actively. But by exercising this decision right, the board wields a powerful weapon for reducing agency costs. The amount of these benefits presumably declines as the decisions take on less and less importance. Making a small number of decisions has many benefits in an influence cost-based framework. The board will reserve for itself those decisions that produce the biggest benefits for policing agency costs. Executive lobbying with regard to those decisions is inevitable, but because the board limits its authority, this lobbying only displaces the least valuable tasks that executives perform.

An influence cost approach may also help explain how the board acquires information. As noted earlier, corporate law scholars have voiced concerns about how management can set board agendas and otherwise manipulate the signals that directors receive.⁶¹ As the signal jamming literature shows, the board should be aware that this activity is going on and should discount the information it receives from management accordingly.⁶² But this discounting does not eliminate the problems associated with lobbying; these attempts to exert influence affect the amount of noise in the signals that the board receives and make it more difficult for directors to understand what is happening within the firm.

The ability and opportunity that management has to manipulate information may push the board to use independent sources for information. Michael Powell suggests that the hiring of external consultants

60. See Stephen M. Bainbridge, *Independent Directors and the ALI Corporate Governance Project*, 61 GEO. WASH. L. REV. 1034, 1061 (1993) ("If an active director does step forward [to challenge management] . . . he must not only overcome the forces of inertia and bias, he probably will face active opposition from the threatened managers, who will try to cut off the flow of information to the board, co-opt key board members, and otherwise undermine the disciplinary process.").

61. Rodrigues, *supra* note 38, at 1068–69 ("Further, because '[the CEO] has a monopoly over the information delivered to the [board],' such information 'can easily be manipulated or suppressed by the CEO because of his position as the sole source of information.'" (quoting Lawrence E. Mitchell, *Structural Holes, CEOs, and Informational Monopolies: The Missing Link in Corporate Governance*, 70 BROOK. L. REV. 1313, 1348–50 (2005))).

62. Gibbons, *supra* note 13 and accompanying text.

by a firm may be motivated by a desire to avoid the dangers of signal jamming that come with the internal supply of information.⁶³ Directors may think along similar lines. If directors can get information from independent sources, such as consultants and outside auditors, this may be an attractive way to reduce the impact of lobbying.⁶⁴ While these independent sources may have to obtain some information from internal employees—who are likely to influence this information—an independent source’s diminished interest in the outcome of a board decision may improve the quality of the information directors receive.⁶⁵

Different types of decisions may be more or less amenable to reliance on independent sources of information. Take a potential acquisition for example. If the board relied on management to evaluate the proposed target, management could attempt to influence that information in a way that serves the management’s interests. But if the board makes use of independent investment bankers and consultants, the signals they receive might reflect more accurate information. In most situations, it is probably safe to assume that management has no great advantage in evaluating the acquisition of another company when compared to bankers and consultants that specialize in these sorts of tasks. One would, accordingly, expect that boards would be willing to make these sorts of decisions with less input from management.

There are two important potential counterarguments to the influence cost theory developed here. The first concerns the meaning of delegation and authority. One might argue that, by wielding the right to hire and fire executive officers, the board effectively exercises all the decision rights that management purports to make. As George Baker, Robert Gibbons, and Kevin Murphy relate: “Authority is the defining feature of hierarchy. . . . [A] boss can restrict the subordinate’s actions, overturn his decisions, and even fire him. . . . Tracing this chain of authority up the hierarchy, we eventually reach . . . [a group that] can be thought of as

63. Powell, *supra* note 13, at 16 (“Hiring outside consultants to acquire independent information about the state of the world might increase [the quality of the information], thereby reducing [the signal-to-noise ratio].”).

64. Donald G. Kempf, Jr., “*Can They Take My House? : Defending Directors and Officers*,” 81 ILL. B.J. 244, 247 (1993) (“In determining whether directors made an ‘informed decision,’ Delaware law allows good faith reliance on a corporation’s own records and employees, as well as an [sic] outside professionals such as lawyers, accountants, appraisers, investment bankers, and the like.”).

65. To be sure, the improvement in the quality of the information may be slight due to potential interest conflict on the part of the advisors. For example, if an advisor has an existing relationship with firm management, there may be little difference between the quality of the information that comes from management versus the information that comes from an investment banker. *See also* Jonathan R. Macey, *Efficient Capital Markets, Corporate Disclosure, and Enron*, 89 CORNELL L. REV. 394, 403–11 (discussing how advisors may have contributed to the Enron scandal).

owning all the decision rights in an organization.”⁶⁶ Baker et al. argue that this sort of authority is not contractible; the boss always has the power to retract decisionmaking authority or overrule a specific decision.⁶⁷ As they put it, “we see all subordinates’ decision rights as loaned, not owned.”⁶⁸

In the context of the board and management, one could argue that because the board wields ultimate authority it retains all the decision rights in the corporation. While this may be a legally correct description of the board’s authority, several leading contract theorists have shown that those who have been delegated authority can wield real power.⁶⁹ Philippe Aghion and Nobel Laureate Jean Tirole have an influential model of authority suggesting that a superior may defer to a subordinate when the subordinate has better information about a decision.⁷⁰ Under these circumstances, the boss may exercise “formal” authority, but the actual decisionmaking power rests with the subordinate.⁷¹ Baker et al. take a different approach by showing that superiors and subordinates may be able to enter into a relational contract that supports a credible promise for the subordinate to exercise decisionmaking authority.⁷² The long-run interaction between the superior and the subordinate supports this promise: if the boss “breaches” this agreement, any future delegations of authority will not be credible.

For the purposes of the theory developed here, these models of authority show that meaningful delegation is possible even when it is not possible to draft an enforceable contract between superior and subordinate. If subordinates can exercise authority without fear of being overruled by a superior, the influence cost theory developed still has some application in the corporate context. One key to this theory is the prediction that those given authority over a decision right will not invest resources in an attempt to influence those decisions. In the context of the board and management, this means that decision rights given to management will not result in management trying to influence those deci-

66. George Baker et al., *Informal Authority in Organizations*, 15 J.L. ECON. & ORG. 56, 56 (1999).

67. *Id.*

68. *Id.*

69. Philippe Aghion & Jean Tirole, *Formal and Real Authority in Organizations*, 105 J. POL. ECON. 1, 2 (1997).

70. *Id.*

71. *Id.*

72. Baker et al., *supra* note 66, at 63–69 (discussing two studies: first with an informal delegation and an informed boss, and second with informal authority with an uninformed boss).

sions. For this to be true, the delegation must be meaningful in the sense that the board will not overrule the management's decisions.

While there is little empirical evidence on how much actual authority management exercises, most accounts support the view that management's authority is meaningful.⁷³ To put it another way, directors tend to observe outcomes rather than micromanage decisions. The choice whether to fire senior management tends to turn on outcomes resulting from the exercise of management's relatively unfettered discretion. If the board exercises its authority in this way—rather than by overruling management decisions—a delegation to management should provide the benefits predicted by the influence cost theory. Namely, management will not spend time trying to lobby the board. As a result, the firm is likely to enjoy the benefits of reduced influence costs when it allocates decision rights to management.

The second counterargument addresses another trade-off that might account more broadly for how the board exercises its authority. A straightforward reason why the board may limit its monitoring is because directors do not view intense monitoring as a productive use of their time. This is almost assuredly correct; expending effort is costly and directors engage in that effort only when doing so is likely to provide a benefit. But opportunity costs are not inconsistent with the presence of influence costs. My claim is not that influence costs are the sole cost-side factor that a board considers when it determines how widely it will exercise its authority. Rather, my argument is that the structure of the corporation creates a situation where influence cost dynamics may contribute to director decisionmaking, and that those dynamics have not been fully appreciated in the literature.

Teasing out the degree to which opportunity costs and influence costs each contribute to board decisionmaking is, of course, a daunting empirical task. There are some indications, however, that influence costs play a role in determining the scope of board authority. Consider a world where opportunity costs are the sole costs that directors consider when determining whether to exercise their authority. In this example, direc-

73. See Kelli A. Alces, *Beyond the Board of Directors*, 46 WAKE FOREST L. REV. 783, 783 (2011) (“[I]t is the senior corporate officers who are responsible for the day-to-day operation of the company and who are most involved in its business decisions.”); Nicola Faith Sharpe, *Questioning Authority: The Critical Link Between Board Power and Process*, 38 J. CORP. L. 1, 24 (2012) (“Boards are passive recipients of the information that managers identify. They are also passive recipients of management’s analysis and their subsequent recommendations. Managers are closer to the resources the firm needs to continue operations and the information from and about those resources. Managers thus engage in more direct analysis of the information and how it either supports or undermines particular firm strategies.”).

tors would simply ask whether the agency cost reduction benefits of taking a decision right are worth their time. If all else is equal, it follows from this assumption that directors with higher opportunity costs will do less monitoring.⁷⁴ Of course, all else is not equal; some directors are better monitors than others.⁷⁵ Nevertheless, if opportunity costs were the sole cost-side concern, it would be odd to select people with extremely high opportunity costs—such as the CEOs of Fortune 500 companies—to serve as directors. Doing so would virtually ensure that these directors would devote less time to monitoring than directors who have lower opportunity costs. One could easily imagine that preferred directors would have expertise in monitoring but would not have outside commitments that place intense demands on their time.⁷⁶

Yet, noninsider directors on public company boards tend to be the types that have very high opportunity costs. Choosing this type of director consequently places limits on how much monitoring the director can do. The theory of influence costs developed here suggests one potential reason for this approach: installing high quality monitors with significant outside demands on their time tends to circumscribe the degree of authority that the board can effectively exercise. One benefit of this limitation is that management will likely confine its lobbying activities to those areas where the board actively wields its authority. Insofar as lobbying can be wasteful, there is a possibility that diminished attempts to influence will give management more time to improve firm performance.

74. It is, of course, true that one role of corporate law is to shift the opportunity cost associated with the failure to monitor. See Lynn A. Stout, *In Praise of Procedure: An Economic and Behavioral Defense of Smith v. Van Gorkom and the Business Judgment Rule*, 96 NW. U. L. REV. 675, 692 n.61 (2002) (noting that “case law on the duty of care may influence director behavior[] by threatening legal sanctions, which change directors’ opportunity costs . . .”). While this threat of liability may help to level the opportunity costs across directors, it does not change the reality that monitoring is more costly for some directors than it is for others.

75. For some empirical support for the notion that director quality matters, see Laura Field, Michelle Lowry & Anahit Mkrtychyan, *Are Busy Boards Detrimental?*, 109 J. FIN. ECON. 63 (2013) (hypothesizing that busy directors tend to be of higher quality and developing evidence to support that hypothesis). *But see* Eliezer M. Fich & Anil Shivdasani, *Are Busy Boards Effective Monitors?*, 61 J. FIN. 689 (2006) (discussing evidence that firms in which a majority of outside directors hold three or more board seats are associated with weak corporate governance and lower measures of financial performance).

76. Some corporate scholars have suggested that there may be a role for this sort of professional director. See Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 885–86 (1991) (outlining a proposal for full-time directors who would serve on up to six corporate boards).

C. Influence Costs and Independence

This section argues that the theory of influence costs articulated above can add to our understanding of two core issues in corporate law. The first is the less-than-complete success of the movement to make boards more independent. The second is corporate law's hands-off approach to liability for unconflicted decisions made by directors.

1. Influence Costs and Independence

The rise of the monitoring board model spurred many corporate theorists to emphasize the importance of independent directors.⁷⁷ The idea is that independent directors—who, at the very least, are not employed at the firm, do not have relatives at the firm, and who do not have significant business interests tied up in the firm⁷⁸—are likely to be more effective monitors of management than insiders.⁷⁹ Promoting independ-

77. STEPHEN M. BAINBRIDGE, *CORPORATE GOVERNANCE AFTER THE FINANCIAL CRISIS* 77 (Oxford Univ. Press 2012) (“As the monitoring model came to dominate thinking about the board’s role, the board’s composition inevitably came to the fore. A board comprised of insiders is poorly positioned to monitor the CEO.”); Usha Rodrigues, *The Fetishization of Independence*, 33 J. CORP. L. 447, 449 (2008) (“Nevertheless, a student of corporate governance discourse over the past 40 years could easily conclude that independent boards are an essential—indeed, a natural—part of good corporate governance. It is now conventional wisdom that independent boards must run companies, so obvious that it does not even warrant discussion.” (internal citations omitted)).

78. Recent governance initiatives have moved away from bright line rules for independence and toward more open-ended standards. For example, SEC Rule 10C-1 directed securities exchanges to require the independence of compensation committee members. See Todd B. Pfister & Aubrey Refuerzo, *New NYSE Listing Rules Raise the Accountability of Company Boards and Compensation Committees Through Flexible Standards*, 69 BUS. LAW. 135, 136 (2013) (citing 17 C.F.R. § 240.10C-1 (2013)). In response to that directive, the updated NYSE listing standards added a requirement that the board consider “all factors specifically relevant” to the judgment that a compensation committee is independent. NYSE, LISTED CO. MANUAL § 303A.02(a)(ii) (2013) [hereinafter NYSE LISTED CO. MANUAL], available at <http://nysemanual.nyse.com/LCM/sections/> (follow “section 3” hyperlink; then scroll down to § 202A.02(a)(ii)). NASDAQ listing standards now include the requirement that the board make the affirmative determination that an independent director does not have any relationship that “would interfere with the exercise of independent judgment in carrying out the responsibilities of a director.” NASDAQ STOCK MKT., NASDAQ LISTING RULES § 5605(a)(2) (2013) [hereinafter NASDAQ EQUITY RULE], available at <http://nasdaq.cchwallstreet.com/> (follow “Rule 5000A” hyperlink). These approaches look more like the searching standard that Delaware case law requires for independence. That standard asks whether “a director is, for any substantial reason, incapable of making a decision with only the best interests of the corporation in mind.” *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, 920 (Del. Ch. 2003) (quoting *Parfi Holding AB v. Mirror Image Internet, Inc.*, 794 A.2d 1211, 1232 (Del. Ch. 2001)).

79. See Rodrigues, *supra* note 77, at 455 (“Behind all of these rules lurks the belief that, by closing off connections to management, rulemakers can create the ideal board.”); John H. Matheson & Peter D. Favorite, *Multidisciplinary Practice and the Future of the Legal Profession: Considering a Role for Independent Directors*, 32 LOY. U. CHI. L.J. 577, 609 (2001) (“Today, it is generally accepted by all concerned that independent directors may provide effective oversight of management and promote accountability.”); Ira M. Millstein & Paul W. MacAvoy, *The Active Board of Directors*

ence has been a success, at least with regard to policy. NYSE and NASDAQ require that listed companies have a majority of independent directors.⁸⁰ Similarly, the Sarbanes–Oxley Act requires that audit committees of U.S. public company boards include only independent directors.⁸¹ NYSE and NASDAQ regulations also require compensation and nominating committees to be comprised entirely of independent directors.⁸²

Whether the move toward independence has produced the desired results is less clear. The impact of this shift is difficult to discern empirically and even the correlations do not provide clear answers. Studies, however, appear to show that increasing the number of independent directors has not led to broad increases in firm value.⁸³ There are some

and Performance of the Large Publicly Traded Corporation, 98 COLUM. L. REV. 1283, 1291 (1998) (“An active and independent board of directors working for shareholders clearly would seem to benefit the corporation by reducing the losses from misdirected ‘agency’ inherent in the separation of ownership from control that is fundamental to the modern corporation.”).

80. Eric M. Fogel & Andrew M. Geier, *Strangers in the House: Rethinking Sarbanes–Oxley and the Independent Board of Directors*, 32 DEL. J. CORP. L. 33, 35 (2007) (“Each of the Stock Exchanges has required that the majority of a listed company’s board of directors consist of independent directors.”); Robert B. Thompson, *Corporate Governance After Enron*, 40 HOUS. L. REV. 99, 106–07 (2003) (detailing the independence requirements implemented by the NYSE and NASDAQ in 2002).

81. Jody K. Upham, *Audit Committees: The Policemen of Corporate Responsibility*, 39 TEX. J. BUS. L. 537, 544 (2004) (“The key provisions of the Act are the requirements of the independence of all the audit committee members and the disclosure of whether at least one member of the committee is a financial expert.”).

82. See NYSE LISTED CO. MANUAL, *supra* note 78, § 303A.05(a) (requiring all compensation committee members to be independent); NASDAQ EQUITY RULE, *supra* note 78, § 5605(d)(2)(A) (requiring any committee that determines CEO and CFO compensation or that recommends that CEO and CFO compensation to the board to be comprised of all independent directors); NYSE LISTED CO. MANUAL, *supra* note 78, § 303A.04(a) (requiring nominating committee members to be independent); NASDAQ EQUITY RULE, *supra* note 78, § 5605(e) (same).

83. See Bhagat & Black, *supra* note 59, at 263 (“We find a reasonably strong inverse correlation between firm performance in the recent past and board independence. However, there is no evidence that greater board independence leads to improved firm performance. If anything, there are hints that greater board independence may impair firm 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, 1500 (2007) (“Evidence that connects the increased presence of independent directors to shareholder benefit is weak at best.”). While the contribution of more independent boards to an overall increase or decrease in firm value is uncertain, there is some evidence that an increase in independence can lead to outcomes that may benefit shareholders. See Vidhi Chhaochharia & Yaniv Grinstein, *CEO Compensation and Board Structure*, 64 J. FIN. 231, 232 (2009) (showing a decrease in CEO compensation took place in firms that had to implement listing requirement exchange oversight requirements, including increasing the presence of independent directors); James F. Cotter, Anil Shivdasani & Marc Zenner, *Do Independent Directors Enhance Target Shareholder Wealth During Tender Offers?*, 43 J. FIN. ECON. 195, 214 (1997) (developing evidence that independent boards can increase target shareholder gains as a result of mergers and acquisitions).

theories that account for this alleged failure, but they do not address how director independence interacts with lobbying within the firm.⁸⁴ This section considers the existing theories and discusses how lobbying considerations can add further depth to these approaches.

Inside directors, almost by definition, have a larger investment of firm-specific human capital than outside directors do.⁸⁵ This will, of course, be the case for inside directors who are employees of the firm, but this is also likely the case for inside directors who have significant business relationships with the firm. Examples of these business relationships include attorneys, investment bankers, and suppliers who rely on the firm for a significant amount of business. The careers and livelihoods of these inside directors depends on the fate of the firm far more than the typical outside director, who will usually have another job and may serve on other boards. These differences mean that inside directors will likely have intense preferences—albeit ones that do not necessarily align with those of shareholders—while outside directors are more likely to have preferences similar to those of shareholders, although the intensity of these preferences may be diminished relative to those of inside directors.

Some explanations for the mixed evidence on director independence focus on the difference in preference intensities. Bhagat and Black argue that “[t]here is . . . a trade-off between independence and incentives. Many independent directors own small amounts of their company’s shares, and hence have limited incentives to monitor carefully.”⁸⁶ Bhagat and Black also highlight the potential informational advantages that inside directors may have over outsiders.⁸⁷ By virtue of their positions within firms, inside directors are likely to know more about what is occurring at the firm and how best to address any potential problems.

The different lobbying incentives of inside and outside directors may counteract some of the benefits that come with replacing inside directors with outside directors. Insiders may have intense preferences over firm outcomes, but if they serve on the board, that intensity is unlikely to lead to lobbying. Insiders’ positions on the board give them significant

84. See Bhagat & Black, *supra* note 59, at 264–65 (linking the lack of evidence about independence being effective to modest financial incentives for directors).

85. *Id.* at 264 (“Inside directors lack independence, but have their human capital, and often most of their financial capital, committed to their company.”).

86. *Id.* Bhagat and Black provide evidence for the link between the financial incentives of directors and the performance of the firm. See *id.* at 264–65 (citing Sanjai Bhagat et al., *Director Ownership, Corporate Performance, and Management Turnover*, 54 BUS. LAW. 885 (1999) (arguing that there is a trade-off between independence and incentives); Brian J. Hall & Jeffrey B. Liebman, *Are CEOs Really Paid Like Bureaucrats?*, 113 Q. J. ECON. 653 (1998)).

87. Bhagat & Black, *supra* note 59, at 264.

latitude to implement the decisions they prefer.⁸⁸ A board full of insiders, however, creates the familiar danger that the board will exploit agency costs in a way that harms firm performance. Substituting outside directors for inside directors may improve the policing of agency costs—which, after all, is a predominant reason for the move towards more independent boards. Yet, influence cost theory suggests a potential downside associated with the move to independent directors: insiders who would otherwise be on the board will be pushed down the organizational ladder. These insiders have an interest in the board's decisions and may spend time cajoling directors and skewing information in order to influence decisions. This lobbying could diminish firm performance and may offset some of the gains associated with decreased agency costs.

This trade-off suggests another reason why the movement towards independent boards has not had the clear success that some expected. The lobbying costs that come with independent directors may eat away at the reduced agency costs. The net effect may be that the gains or losses from this shift will be minimal. This dynamic can help to explain the mixed evidence on independence and firm value. This explanation is, of course, compatible with other theories about why the shift towards independence has not produced unambiguous evidence of an increase in firm value. The lack of increase in firm value may be partly due to the diminished financial incentives of outside directors, but it may also be due to an increase in lobbying. Teasing apart how these different theories affect the value of firm performance is a topic ripe for further empirical investigation.

2. Intrafirm Lobbying and the Regulation of Agency Costs

This subsection looks at how the influence cost theory, as developed in this Article, can help contribute to a more complete understanding of the ways in which corporate law copes with agency costs in public corporations. The primary legal mechanism for this regulation of agency costs is the imposition of fiduciary duties. Directors owe these duties to shareholders and, as has been exhaustively analyzed, the degree of scrutiny directors receive depends on whether their activity implicates the duty of care or the duty of loyalty.⁸⁹ The application of the duty of care,

88. See Bainbridge, *supra* note 18, at 103 (“[D]irectors are vested with wide powers to exercise their discretion by fiat . . .”). See also Stephen M. Bainbridge, *Director Primacy: The Means and Ends Of Corporate Governance*, 97 NW. U. L. REV. 547, 579 (“Given the substantial discretion vested in the board, directors could theoretically pursue their own personal self-interests.”).

89. See generally Thomas A. Uebler, *Shareholder Police Power: Shareholders’ Ability to Hold Directors Accountable for Intentional Violations of Law*, 33 DEL. J. CORP. L. 199 (2008) (arguing

which covers decisionmaking in the ordinary course of business, results in a very hands-off approach toward directors. The duty of loyalty, which applies when directors fail to act in an impartial way, generally requires much closer scrutiny than when directors make unconflicted decisions.⁹⁰

The more exacting analysis for conflicts of interest is relatively straightforward to justify. The duty of loyalty implicates the agency cost concern that is at the heart of corporate law and, accordingly, receives a close look from courts.⁹¹ There has been more hand-wringing by academics and judges over the deferential approach that comes with the duty of care. This subsection examines how influence costs may help explain why there has been such a strong preference for deference in this area.

The traditional doctrinal vehicle for exercising this light scrutiny has been the business judgment rule. In its most deferential form, courts refuse to examine a board's decision unless the board's behavior implicates fraud, illegality, or self-dealing.⁹² When applied in its most stringent form, this relaxed standard allows directors to escape liability even when they exercise poor judgment.⁹³ A variety of reasons have been put forward to justify this extreme deference. Perhaps the most famous is the Michigan Supreme Court's declaration—in a case that did not exercise much deference—that “judges are not business experts.”⁹⁴ This rationale is straightforward enough: judges do not have specialized knowledge in the operation of a business and are not well suited to second-guess the complex decisions that are sometimes involved. But as others have pointed out, there are plenty of fields where judges do not have expertise and they are perfectly comfortable second-guessing decisions.⁹⁵

directors, under a profit-maximizing view, are likely to violate the law and their fiduciary duties unless this creates a presumption of bad faith); Julian Velasco, *How Many Fiduciary Duties Are There in Corporate Law?*, 83 S. CAL. L. REV. 1231 (2010) (suggesting that there are really five separate duties to which directors should be held accountable).

90. Uebler, *supra* note 89, at 203 (“[T]he duty of loyalty mandates that the best interest of the corporation and its shareholders takes precedence over any interest possessed by a director, officer or controlling shareholder and not shared by the stockholders generally.” (quoting *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993))).

91. Bainbridge, *supra* note 18, at 122–23 (“Where the directors’ decision is motivated by considerations other than shareholder wealth, as where the directors engage in self-dealing or seek to defraud the shareholders, however, the question is no longer one of honest error but of intentional misconduct. Despite the limitations of judicial review, rational shareholders would prefer judicial intervention with respect to board decisions so tainted.” (internal citation omitted)).

92. *See Shlensky v. Wrigley*, 237 N.E.2d 776, 780 (Ill. App. Ct. 1968).

93. *See, e.g., Kamin v. Am. Express Co.*, 383 N.Y.S.2d 807 (Sup. Ct. 1976) (invoking the business judgment rule to protect a decision that substantially increased the tax bill of the corporation with little or no discernable benefit).

94. *Dodge v. Ford Motor Co.*, 170 N.W. 668, 684 (Mich. 1919).

95. Bainbridge, *supra* note 18, at 87–88 (“On the other hand, the business judgment rule mandates that courts defer to the board of directors’ judgment absent highly unusual exceptions. Com-

A number of theories have been put forward to justify this different treatment, but they are not entirely satisfying. Some argue, for example, that businesses are subject to the discipline of the market.⁹⁶ If directors make poor decisions, competitive forces will provide enough punishment. But the same explanation could be offered for doctors who make consistently bad decisions: hospitals may refuse such doctors admitting privileges and word may travel to potential patients about their faults. Given the potential for market discipline in fields where courts are quite willing to impose liability, it is difficult to see how this justification makes sense of this differential treatment.

In order for the business judgment rule to have a persuasive rationale, there must be something unique about the relationship between directors and shareholders that distinguishes it from other situations in which the law imposes liability for poor judgment. One means for distinguishing corporate governance from other areas of decisionmaking has been the encouragement of risk taking.⁹⁷ This theory argues that there may be a mismatch in the preference for risk between shareholders and management.⁹⁸ Consequently, an ordinary negligence standard may not be appropriate for directors because it may encourage directors to give management more room to take on high levels of risk.

pare the liability of physicians, who are also held to a duty of care, but whose medical judgment gets no such deference. Why are directors of an incorporated business entitled to deference that physicians are denied?" (internal citation omitted)).

96. *See id.* at 122 ("Corporate directors operate within a pervasive web of accountability mechanisms. A very important set of constraints are provided by competition in a number of markets. The capital and product markets, the internal and external employment markets, and the market for corporate control all constrain shirking by directors and managers. . . . As such, rational shareholders will prefer the risk of director error to that of judicial error. Hence, shareholders will want judges to abstain from reviewing board decisions." (internal citation omitted)).

97. Lyman Johnson, *Rethinking Judicial Review of Director Care*, 24 DEL. J. CORP. L. 787, 819–20 (1999) ("Chancellor Allen describes the judicial deference accorded director decision making through the business judgment rule—where no self-dealing or improper motive exists—as 'protection against a threat of suboptimal risk acceptance.' By this, Chancellor Allen relates that shareholders in public corporations, because they can manage risk by diversifying their portfolio of investments, do not want directors of any particular corporation to be unduly risk averse. . . . To more closely align director attitudes toward risk with shareholder preferences, the business judgment rule is designed to accord directors substantial latitude in their business decision making." (quoting *Gagliardi v. Trifoods Int'l, Inc.*, 683 A.2d 1049, 1052–53 (Del. Ch. 1996))).

98. There are different accounts of this phenomenon. Some argue that shareholders want managers to take excessive risk because they are the residual claimants and because managers know they will get paid even if they play things safe. Alternative approaches contend that management is willing to swing for the fences while shareholders are concerned about preservation of capital. *But see* WILLIAM A. KLEIN & JOHN C. COFFEE, JR., *BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES* 246 (9th ed. 2002) ("A critical axiom of modern investment analysis is that in their major investment decisions the overwhelming majority of people are risk averse.").

While this approach depends on a unique aspect of the corporate structure, it does not necessarily justify the business judgment rule. Corporate law could provide for a heightened negligence standard—such as recklessness—to govern the behavior of directors. Doing so would allow directors to delegate tasks to managers, which would allow firms to take on more risk. The business judgment rule—which significantly diminishes the prospect of director liability as long as decisions are informed and unconflicted⁹⁹—is likely to increase the amount of risk that a firm will take. But these arguments generally do not provide a rationale for why the absence of liability is likely to incentivize an optimal amount of risk taking.

An influence cost approach to director liability may help provide a more complete account of why corporate law shields directors to an extent. If courts apply a lower threshold for liability, directors will presumably monitor management more intensely in order to avoid liability. The influence cost theory, as articulated here, suggests that this increased monitoring—including an increase in the number of decision rights the board exercises—can produce an increase in the feedback effects associated with influence costs. This feedback comes in the form of degraded information received from management due to signal jamming and a reduction of productive activities due to management lobbying.¹⁰⁰

As the standard for liability increases, the feedback effects associated with influence activities can increase at a steep rate. Recall from earlier discussion that the theory of firm literature predicts that lobbying costs increase at a convex rate (i.e., each additional unit of lobbying effort costs more than the last).¹⁰¹ As corporate law increases the amount of monitoring that directors must do, the convexity assumption suggests that the influence costs associated with increased monitoring may escalate very quickly. Moreover, these costs may increase in a way that is quite difficult for a court to observe. A court may be aware that influence costs increase as the threshold for liability lowers, but knowing how much—or trying to gauge the influence costs present in a given case—may be very difficult. All these reasons may contribute to corporate law's inclination to avoid making liability determinations when decisions are impartial and informed.

99. Bainbridge, *supra* note 18, at 88 (“[I]f the business judgment rule does anything, it insulates directors from liability for negligence.”).

100. See Powell, *supra* note 13, at 4 (stating lobbying uses up management time that would be better spent on productive tasks).

101. *Id.* (discussing how the opportunity costs of influencer's time are convex).

These aspects of influence costs provide a rationale for why corporate law solves the problem of liability for risky decisionmaking in a way that differs from other areas. As previously discussed, in the medical context, the dynamics of influence costs and lobbying may not be present. Decision rights in this context tend to be vested with the medical decisionmaker. When it is the doctors themselves who have the decision rights and are subject to liability, there is no one for those doctors to lobby. A liability threshold that is too low—in the sense that it makes doctors take excessive precaution—may impose social costs. But those social costs will not replicate the influence cost dynamic where a group (management) takes away from its more productive activities by engaging in lobbying.

III. PANDERING AND THE OPACITY OF INFORMATION

The problems caused by information asymmetry are a staple of principal–agent analysis. When parties hold information that is unobservable or that cannot be verified, markets can break down. One motivation for the theory of firm literature has been to understand the degree to which some of these problems are intractable. A recent contribution to this literature by Yeon-Koo Che, Wouter Dessein, and Navin Kartik (CDK) shows just how difficult it can be to obtain accurate information from an agent.¹⁰²

CDK examine what they call pandering. Pandering occurs when an agent recommends a project that is objectively inferior from the perspective of *both* the principal and the agent.¹⁰³ Subordinates' ability to put their superiors in this position may have consequences for corporate law. The possibility that directors will not be able to consistently obtain truthful reports about the best course of action from subordinates creates questions about imposing liability on those directors. Answering those questions requires knowledge regarding how prevalent pandering is likely to be in the corporate context.

A. The Pandering Model

CDK emphasize that pandering is not a *fait accompli*.¹⁰⁴ To arise, pandering requires a situation where an agent can recommend more than

102. Yeon-Koo Che, Wouter Dessein & Navin Kartik, *Pandering to Persuade*, 103 AM. ECON. REV. 47 (2013) [hereinafter CDK], available at <https://economics.wustl.edu/files/economics/imce/cdk-pandering.pdf>.

103. *See id.* at 52–53.

104. *Id.*

one project to a decisionmaker.¹⁰⁵ This decisionmaker must be able to choose between those projects or to maintain the status quo.¹⁰⁶ The decisionmaker knows the expected value of the projects, but the actual value of the projects is the private, nonverifiable information of the agent.¹⁰⁷ The agent can recommend a project to the decisionmaker, but the nonverifiable nature of the information means that the recommendation is “cheap talk.”¹⁰⁸ The decisionmaker then chooses to either pursue a project or to maintain the status quo (i.e., do nothing). This model assumes that the decisionmaker and the agent receive the same benefit when the decisionmaker elects to pursue a project. But when the decisionmaker opts to maintain the status quo, the decisionmaker gets a positive benefit while the agent does not.

Pandering can occur when a project with a lower expected value takes on values that are higher than the highest possible values of other projects. To borrow from CDK’s example, one project can confer a benefit of 1 or 7 with equal probability while another has an equal chance of being worth 4 or 6.¹⁰⁹ The first project has a lower expected benefit than the second (4 vs. 5),¹¹⁰ but it also has a chance to take on the largest realized benefit of the projects (7 vs. 6).

The agent observes the realized value and then makes the nonverifiable recommendation to the decisionmaker. The incentive conflict in the model arises from the fact that the decisionmaker benefits from maintaining the status quo while the agent does not. For that reason, the agent will always favor pursuing a project—all of which confer positive values—while the decisionmaker wants only to choose a project that will provide a higher benefit than the status quo.

CDK show that, despite the shared benefit between the principal and agent, the agent will sometimes recommend the inferior project.¹¹¹ The decisionmaker will sometimes accept this recommendation even

105. *Id.*

106. *Id.*

107. *Id.*

108. Cheap talk refers to communication that is costless and unverifiable. As a consequence of these conditions, these communications may not be believable. For an introduction to the analysis of cheap talk see ROBERT GIBBONS, *GAME THEORY FOR APPLIED ECONOMISTS* 210–18 (Princeton Univ. Press 1992). The extent to which communication and commitments are credible has been examined in a variety of legal contexts. *See, e.g.*, Philip Keefer & Razvan Vlaicu, *Democracy, Credibility, and Clientelism*, 24 *J.L. ECON & ORG.* 371 (2008) (examining how difficulty in communicating credibly with the electorate can delay the development of political institutions).

109. *See* CDK, *supra* note 102, at 52.

110. The expected benefit of the first project is 4 because $(.5)(7) + (.5)(1) = 4$. Similarly, the expected benefit of the second project is 5 because $(.5)(4) + (.5)(6) = 5$.

111. *See* CDK, *supra* note 102, at 52–53.

though she knows that the agent is pandering. For this equilibrium to be stable, the value of the status quo to the principal must be greater than 5. In this circumstance, it is not feasible for the agent to recommend the objectively better project in all cases. If the agent did so, the decisionmaker would only accept a recommendation of the first project. The decisionmaker would only accept a recommendation of the first project because she knows that the value is 7. But when she receives a recommendation for the second project, she will not know whether the value is 6 or 4. She will only know that it has an expected value of 5—so she will reject the recommendation in favor of the status quo.

Notice, however, that it is also not a stable strategy for the decisionmaker to limit acceptance to recommendations of the second project. In that case, the agent would always recommend the first project, even when it has a value of 1. Nevertheless, CDK show that a partially informative equilibrium can be stable.¹¹² Equilibrium occurs when the agent always recommends the first project when it is superior—equal to 7—and sometimes recommends the first project when it is inferior. More specifically, the agent recommends the better project when the first and second projects take on the values of [7,6], [7,4], and [1,6], but sometimes recommends the first project when the values are [1,4]. In this equilibrium, the decisionmaker will always accept a recommendation of the first project, but will only sometimes accept recommendations of the second project.

Pandering works because recommendations of the second project appear better. To put this another way, by sometimes recommending the first project when it is worse—specifically when the values are [1,4]—the agent increases the decisionmaker's estimate of the value of a recommendation for the second project. As long as the decisionmaker's estimate of the value of the second project is at least equivalent to the value of the status quo, the decisionmaker will tolerate the agent's pandering of the first project. The ranges of values that will support pandering are, however, limited. In this example, pandering only occurs when the value of the status quo lies between 5 and 5.5; beyond that point, the decisionmaker will opt for the status quo every time because it provides a higher value.

In addition to this numerical example, CDK develop a more complete model that establishes the necessary conditions for the partially informative equilibrium to exist.¹¹³ In addition, CDK explore the extent to

112. *Id.*

113. *See id.* at 54–65.

which the parties might be able to develop mechanisms to minimize pandering.¹¹⁴ In the absence of transfers between the parties, the behavior is difficult to eliminate.¹¹⁵ CDK show that it may, however, be optimal for the decisionmaker to examine all verifiable information and, on that basis, either pick the outside option or delegate the choice to the agent.¹¹⁶

B. Pandering in the Firm

The interaction described in the last section bears more than a passing resemblance to the relationship between a board and management. Indeed, CDK point to the board as a potential example of a decisionmaker in their model.¹¹⁷ But to what extent do the necessary conditions for pandering actually exist in the firm? This section explores this question.

The basic setup of the model—an agent recommending projects to a decisionmaker—maps relatively well to the corporate form. An important role for the board is to make strategy calls after receiving advice from management.¹¹⁸ Directors can either accept that advice or opt to remain with the status quo. When directors make decisions, they are often operating at an informational disadvantage. Management works on a full-time basis and knows the business intimately. Noninsider directors, alternatively, work on a part-time basis and may not have industry expertise.¹¹⁹ This element of the board dynamic maps well to the model; pandering is partially driven by the fact that the agent knows more about the outcome of the project than the principal.

One of the key components in the CDK model is that the decisionmaker values the status quo more highly than the agent's recommendation.¹²⁰ This, too, seems plausible in the corporate context.¹²¹

114. *See id.* at 66–71.

115. *Id.*

116. *Id.*

117. *See id.* at 47.

118. *See* Mason A. Carpenter & James D. Westphal, *The Strategic Context of External Network Ties: Examining the Impact of Director Appointments on Board Involvement in Strategic Decision Making*, 44 *ACAD. MGMT. J.* 639 (2001), available at http://webuser.bus.umich.edu/westjd/Articles/Strategic_Context_of_External_Network_Ties.pdf; *see also* Hillary A. Sale, *Independent Directors as Securities Monitors*, 61 *BUS. L.* 1375, 1411 (2006), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=900458## (detailing that independence and monitoring can facilitate information transmission about strategic options).

119. *See supra* notes 56, 57 and accompanying text.

120. *See* CDK, *supra* note 102.

121. *See* Nicola F. Sharpe, *Questioning Authority: The Critical Link Between Board Power and Process*, 38 *J. CORP. L.* 1, 24 (2012), available at <http://law.bepress.com/uiuclwps/art110/> (arguing that directors may have a preference for the status quo).

By taking on new projects, managers may increase revenue, profits, and the number of employees they oversee. These increases may result in higher pay for those managers. It is less clear how firm directors benefit from engaging in new projects. The board is likely aware of management's preference for doing something rather than nothing. To the degree the board is trying to police agency costs, management's desire to empire build is likely to be a central target of the board's attention.

The nature of the projects also appears to resemble choices that directors must make. For pandering to occur, a project with a lower expected value must have the possibility of taking on a higher realized value than the realized values of the projects with a larger expected value. The CDK example in the last section demonstrated these conditions.¹²² It is conceivable that these circumstances could arise in a real-world situation. For instance, a firm might consider two projects: a risky project that has significant upsides and a safe project with less potential for variance. If the safe project has a higher expected value than the risky project, the conditions resemble those in the CDK model. It is possible that the board could face a choice between these two such projects at the same time, but that fact alone is not sufficient to trigger pandering behavior.

Recall from the example that the value of the status quo must be within a relatively narrow band to support the pandering effect.¹²³ This condition is probably least likely to find a real-world analogue. The status quo must provide a benefit to the decisionmaker that is low enough to make the projects desirable, but the benefit cannot be too high; otherwise, the decisionmaker will always opt for the status quo. While extrapolating these values to the real world is difficult, the delicate nature of the pandering equilibrium suggests that it may be uncommon. Further, even if the pandering equilibrium did arise, one may doubt that a manager would actually recommend an objectively worse project given all the negative collateral consequences that could arise from doing so.

But even if pandering is not an everyday occurrence, the phenomenon still carries two lessons for corporate law. First, the pandering model shows the steps that a decisionmaker can take to prevent pandering. Specifically, the CDK model suggests that the decisionmaker will typically be better off by (1) absorbing all "hard," or verifiable, information; and, on that basis, (2) deciding whether to delegate project authority to the agent.¹²⁴ One can imagine a corporate board doing the same. Rather than risk that managers will be less than forthcoming, the board can take an

122. See discussion *supra* Part III.A.

123. See *supra* notes 110–16 and accompanying text.

124. See CDK, *supra* note 102, at 56–57.

all-or-nothing approach. Doing so, however, requires delegation of complete authority in some cases.

These additional delegation benefits may provide another explanation of why boards delegate so much of their authority. While the pandering model may be an extreme consequence of informational opacity, it presents an unpleasant choice to directors. Rather than making a decision on the basis of pandered information, a board may prefer to either veto projects or give authority over projects entirely to managers.

This choice poses a problem for those who worry about agency costs. Complete delegation allows managers to exploit any disparity between their interests and the interests of directors and shareholders. Thus, corporate law's regulation of these costs must accommodate both the difficulty of oversight—which gives rise to behaviors such as pandering—and the desire to limit agency costs arising from the separation of ownership and control.

A second, related lesson comes from exposing the depth of the pathologies in principal-agent relationships. The existence of private information enables behavior, such as pandering, which then poses serious concerns for the regulation of principal and agent relationships. It is an understandable impulse to impose liability on the principal for the wrongs of the agent. Doing so would likely encourage better monitoring, but pandering by agents presents a serious challenge to the principal's ability to exercise this oversight.

In the corporate context, imposing liability on directors should incentivize them to keep closer tabs on managers. But if it is difficult to obtain accurate information from management, monitoring may not have the intended effect. The potentially limited effectiveness of monitoring may account for some of the ways that corporate law regulates directors. Two immediate examples of insulating directors are the business judgment rule and the right of directors to rely on the good faith reports of firm employees and advisors.

As detailed in the discussion on lobbying, the business judgment rule and related statutory exculpation clauses pose a stark contrast to other areas of law where negligence can cause harm.¹²⁵ Corporate law takes a relatively hands-off approach when it comes to potential duty of care violations by directors.¹²⁶ Previously, I argued that one way to justify this approach—if it is to be justified—is to emphasize the unique principal-agent dynamics that the corporate context presents.¹²⁷ This dynamic cre-

125. See discussion *supra* Part II.C.2.

126. See *id.*

127. *Id.*

ates the potential for lobbying, but it also creates the potential for pandering.

Insulating directors can be squared, to some extent, with the problems posed by pandering. If the opacity of information is a fact of corporate life, there is a limit on the directors' ability to know as much as managers about the value of potential decisions. Limiting the likelihood of liability, be it through the business judgment rule or through statutory exculpation clauses, may be a concession to that reality. This approach may also reflect a judgment to respect how a board chooses to deal with this opacity. The board could—as CDK suggest—choose to either veto projects or delegate them completely to management.¹²⁸ The imposition of liability might inhibit the ability of management to delegate so much authority to management because doing so could be considered an insufficient exercise of care and, thus, trigger liability.

One could also understand the threat of pandering as a rationale for Delaware General Corporation Law § 141(e). This provision accords directors protection for “relying in good faith” on “information, opinions, reports or statements presented to the corporation by any of the corporation's officers or employees.”¹²⁹ The definition of good faith is not precise and is the subject of some debate. At a bare minimum, however, intentional wrongdoing violates Delaware's requirement that directors act in good faith.¹³⁰ Moreover, the case law on § 141(e) suggests that a director's reliance on a statement must reflect the exercise of reasonable care to receive protection.¹³¹

Recall from the pandering model that a key assumption is that the agent has private information that the principal cannot verify.¹³² Consequently, whether § 141(e) would protect pandering should turn, to some degree, on the ability to learn the agent's private information through the exercise of due care. In the corporate context, this is not always a simple matter. A board can set up reporting processes and monitor them, which may limit the incidence of fraud and other wrongs based on misrepresentation of verifiable facts. But when it comes to knowing how much value

128. See CDK, *supra* note 102, at 67–68.

129. DEL. CODE ANN. tit. 8, § 141(e) (2014).

130. As a Delaware court explains, “[T]o establish liability for misstatements when the board is not seeking shareholder action, shareholder plaintiffs must show that the misstatement was made knowingly or in bad faith.” *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 135 (Del. Ch. 2009).

131. See *In re Primedia, Inc. S'holders Litig.*, 67 A.3d 455, 489 (Del. Ch. 2013) (stating that directors may rely on statements made by persons who have “been selected with reasonable care” (quoting DEL. CODE ANN. tit. 8, § 141(e) (2014))).

132. See *supra* notes 107–108 and accompanying text.

a certain project is likely to have, it may be difficult to verify the private information of managers and other employees.¹³³

Directors can exercise some degree of diligence by hiring outside consultants. These experts, however, may have to rely on management's reports, which will do little to resolve information asymmetry. To the degree the problem is intractable, the potential for pandering may be unavoidable even when directors exercise extensive amounts of care. If that is the case, it makes sense to limit liability for directors once directors have made reasonable efforts to learn what they can about potential projects. Additional efforts may yield little or no additional information, but are likely to be costly to the director.

Of course, one function of corporate law is to change the incentive structure for corporate actors. It is worth asking whether the lessons from the pandering model provide guidance for those who favor stronger regulation of director behavior. The dynamics of the pandering model suggest that some avenues of regulation are likely to be better than others.

For example, the importance of director reliance on hard, verifiable information supports the idea that directors should be incentivized to obtain that information where possible. The line of *Smith v. Van Gorkom* jurisprudence encourages directors to obtain fairness opinions and similar reports from outside consultants and provides one example of this type of litigation.¹³⁴ Similarly, the use and refinement of standardized accounting rules helps directors—as well as public investors—get a clearer picture of the firm's financial state. One could view these approaches as an attempt to narrow the degree of information asymmetry that can arise between directors and managers.

But adjusting director incentives may pose difficult challenges. Take, for example, an attempt to alter the value associated with the status

133. There is robust empirical evidence that managers know more than the market does about a firm's prospects. The strongest suggestion comes from studies of the results of managers' trading in the stock of their own firms. That research shows that managers enjoy positive abnormal returns from that trading. See MALCOLM BAKER ET AL., HANDBOOK OF CORPORATE FINANCE, VOLUME 1: EMPIRICAL CORPORATE FINANCE 149 (B. Espen Eckbo ed., 2007) (stating that "corporate managers have superior information about their own firm," which "is underscored by the evidence that managers earn abnormally high returns on their own trades . . ."). Directors should, presumably, know more about the firm than public equity investors. But if they are outside directors there is presumably some limitation on their ability to know exactly as much as firm managers.

134. *Smith v. Van Gorkom*, 488 A.2d 858, 881 (Del. 1985) (highlighting the role that fairness opinions prepared by investment bankers can play); see also Christian C. Day, *Corporate Governance, Conrail, and the Market: Getting on the Right Track!*, 26 J. CORP. L. 1, 19 (2000) ("Now, to protect themselves, shrewd boards that know the value of their companies routinely obtain 'fairness opinions' from very expensive investment bankers. In effect, they are told what they already should know (and this too comes out of some shareholders' pockets).").

quo. Corporate law could do this by penalizing directors for taking on risky projects. The prospect of this liability should incline directors to veto such projects more often. It is unclear, however, whether doing so would increase or decrease the amount of pandering that occurs. Recall from the pandering model that if the status quo exceeds a certain value, decisionmakers will cease to rely on the reports of agents and will veto projects.¹³⁵ But when the value of the status quo is sufficiently low, pandering does not occur because the potential projects are all superior to the status quo. In that case, the agent will report truthfully and the decisionmaker will follow that guidance. When the value of the status quo falls within this range, an increase in its value might create conditions for pandering that would not have otherwise existed.

IV. LOBBYING, PANDERING, AND TEAM PRODUCTION

This Part concludes by reflecting on what lobbying and pandering may mean for the team production model. The goal is not to refute or undermine that model. Rather, this discussion aims to understand the aspects of the board that the team production model can and cannot explain. Augmenting this theory with the concerns of lobbying and pandering helps to provide a more complete theory of the interests that motivate the board. Doing so also clarifies that the information transmission problems that underlie lobbying and pandering may place limits on what corporate law can do to incentivize more effective director monitoring.

Blair and Stout's team production theory envisions the board as a solution to the contracting problems that can arise when multiple inputs produce a single output.¹³⁶ If work takes this form, it can be problematic to draw up a contract that will properly incentivize the people who will be providing the inputs.¹³⁷ For example, take the development and sale of a complex piece of software. The decisions that go into this task include financing, coding, testing, and marketing. It can be difficult to describe what would be a satisfactory performance and an appropriate reward for each of these tasks—indeed, these are some of the contracting difficulties highlighted by theorists of the firm. In the language of modern contract

135. *See supra* notes 110–16 and accompanying text.

136. Blair & Stout, *supra* note 1, at 249–50 (explaining the team production approach which focuses on non-shareholder groups “that may provide specialized inputs into corporate production”).

137. *Id.* at 266 (“Team production of this sort poses a difficult problem when it comes to designing efficient incentives. If the team members agree in advance to allocate any profits according to some fixed sharing rule, obvious free-rider problems arise: Each team member will have an incentive to shirk, since he will get the same share of the total whether or not he works hard.”).

theory: parties can often observe performance, but verifying it in court can be uncertain and expensive.¹³⁸

One option to provide appropriate incentives for these team production problems is to have a party observe the inputs and divvy up the project's gains. But parties in that position will have an incentive to favor themselves when it comes to doling out the rewards. In a firm, if managers play that role, they may give themselves an excessive share of the surplus from the project. Knowing this, other members of the team that provide inputs will potentially underinvest effort because they know they will not be rewarded for it. Blair and Stout see a role here for the board.¹³⁹ A board that is separate from management may be able to more credibly reward team production according to the effort expended. Blair and Stout see this mechanism as the chief benefit of moving from a close corporation with a board dominated by insiders to a public corporation with a majority of outsiders.¹⁴⁰ The credibility that comes with a more independent board improves incentives in a way that justifies managers ceding some control.¹⁴¹

In the team production model, the board has a comparative advantage relative to other organizational forms.¹⁴² That advantage lies in being a credible party when dividing the gains from joint endeavors. Un-

138. 1 BENJAMIN E. HERMALIN, AVERY W. KATZ & RICHARD CRASWELL, HANDBOOK OF LAW AND ECONOMICS 68–69 (A. Mitchell Polinsky & Steven Shavell eds., 2006) (“From a theoretical perspective, it is useful to model a contract as a mapping from *verifiable events* to outcomes. For instance, an insurance contract could contain a provision that related damage to one’s car (a verifiable event) to a payment to the insured (an outcome). In this context, ‘verifiable’ means an event is observable not only by the parties to the contract, but also by any third party (e.g., a judge) who might be called upon to adjudicate a dispute. The focus on verifiable events is motivated as follows. Were an outcome contingent on an unverifiable event (i.e., one not observable to the third party), then there would be no way for the third party to judge the extent of breach of contract (if any) or even who breached (if anyone did). Hence, a contractual obligation that is contingent on an unverifiable event cannot be effectively enforced by a third party.”).

139. See Blair & Stout, *supra* note 1, at 249–50, 266.

140. *Id.* at 319.

141. See *id.* at 282 (“Thus an independent board of directors may be able to encourage shareholders, executives, and employees to invest in corporate production not because these team members expect the board to determine which group gets what portion of the resulting economic surplus, but because the possibility that the board could make that allocation discourages the more egregious forms of shirking and rent-seeking among team members.”); see also *id.* at 319 (“[A]n independent board of directors that serves as a mediating hierarch may well offer substantial economic advantages over other possible forms, such as partnerships or close corporations, which allow some subset of the participants in the productive coalition to be ‘owners’ who exercise greater control over the firm and are entitled to receive its residual profits.”).

142. *Id.* at 265–66 (“Yet because the outcome of their efforts—a successful product—is nonseparable, it may be impossible to determine who is ‘responsible’ for what portion of the final output. Who is to say which team member’s contribution was more valuable, when all were essential to the venture?”).

like shareholder and director primacy models, the team production theory predicts how much authority a board is likely to exercise. If a firm must make use of a large number of team processes, the board's potential authority should be commensurately broad. When firms do not face substantial team production problems, the need for an independent body with wide ranging authority to split up the spoils may not be as pressing. If boards solve team production problems, their involvement should depend on the extent to which team production problems arise in a given firm.

But Blair and Stout's theory does not provide a counterweight that would limit the scope of authority at some point.¹⁴³ As team production problems increase, so should the amount of work that the board performs. Accordingly, in a large firm that involves thousands of teams, a board would face a larger scope of team production problems. Delegating this sort of authority to management would undermine the appeal of the team production approach because management does not have the same credibility as the board.¹⁴⁴ To be fair, Blair and Stout emphasize that the board need only be a credible threat to resolve team production matters; the board does not have to referee these issues constantly.¹⁴⁵ Nevertheless, to be a credible threat as a mediating hierarchy, the board would likely need to monitor management at a rate that roughly scales with the scope of the team production problems in a firm.

It is not difficult to believe that there is a wide variation in the scale of team production problems across public firms. A small company that uses a large amount of automated manufacturing should need less refereeing than a large firm where many of the inputs are human capital. The degree of monitoring should vary with respect to the team production problems if solving these problems is the board's primary role. But ob-

143. Scholars have made other critiques of Blair and Stout's claims. See, e.g., Alan J. Meese, *The Team Production Theory of Corporate Law: A Critical Assessment*, 43 WM. & MARY L. REV. 1629, 1634–35 (2002) (arguing that participants in public firms are less susceptible to opportunism than those in smaller enterprises); David Millon, *New Game Plan or Business as Usual? A Critique of the Team Production Model of Corporate Law*, 86 VA. L. REV. 1001, 1030–32 (2000) (suggesting that the team production model may exacerbate rather than diminish the degree of rent seeking within the firm).

144. A possible response is that the board may be able to monitor management's ability to act as an effective referee of team production processes. But in order to do this, the board must be aware of the actual team inputs that the board is rewarding. Doing so would likely require intensive monitoring that goes beyond what we observe in public company boards.

145. Blair & Stout, *supra* note 1, at 282 (“[T]he mediating hierarchy model does not imply that directors actually manage the corporation on a day-to-day basis. . . . Only rarely is it necessary for directors to fire an executive officer for paying herself an immense salary while corporate profits are declining. In most cases such blatant opportunism will be discouraged by the executive's knowledge that the board could fire her.”).

servation suggests that the boards of public companies do not vary their involvement in a way related to team production problems.¹⁴⁶ The board of a massive company, like Apple, appears to take the same approach as a small public firm.¹⁴⁷ The directors are part-time players regardless of size.¹⁴⁸

This seeming mismatch between theory and reality suggests that boards are responding to concerns that go beyond team production. The lobbying account developed above may be able to explain the theoretical gap.¹⁴⁹ The effect of influence costs may mean that when the board takes on more authority or monitors managers more intensely, it risks increased information shading and arm-twisting by those managers. This sort of rent-seeking behavior can harm firm performance. Every firm will face this constraint, which can help account for the relatively uniform approach directors take to monitoring. This is not to say that the board does not act as a mediating hierarch; rather, my claim here is that lobbying concerns are likely to limit the ability of the board to act as a mediating hierarch. This claim also suggests an informational limit on the ability to resolve disputes. As boards do more to resolve team production problems, they are likely to need more information to do so. That need for information may increase the ability of managers to manipulate that information, which will exert drag on the firm. As a consequence, boards may shy away from resolving those disputes, which limits their ability to act as mediating hierarchs.

The pandering phenomenon also suggests some limits on the predictions of team production theory. To act as a mediating hierarch—or to pose a credible threat to act as a mediating hierarch—the board must rely, at least to some extent, on information from different firm constituencies. It is, after all, difficult to referee disputes unless one has reliable information about the dispute. The pandering theory shows a particularly

146. One reason why board authority does not scale with team production problems is that influence costs may become difficult to manage as those problems increase.

147. According to one survey of Fortune 1000 companies, the difference between companies of the smallest size (under \$3 billion) and the largest size (over \$20 billion) is that the largest companies have, on average, three more directors (nine versus twelve) and meet one time per year more than the smallest companies (eight meetings per year versus nine). See KORN/FERRY INST., 34TH ANNUAL BOARD OF DIRECTORS STUDY 10 (2007). These are modest differences given that the larger companies are more than six times the size of the smaller companies. Unless monitoring problems scale at a very slow rate or there are vast differences in the monitoring abilities of directors, it would be difficult to argue that the boards of large companies can monitor with the same intensity as the boards of smaller companies.

148. *Id.*

149. See *supra* Part II.

extreme example of the lengths to which agents will go to manipulate the information that they report to principals.¹⁵⁰

The specific context of the pandering problem was the selection of a project. One can easily imagine a board having to help resolve a dispute between different teams within the firm regarding which projects the firm should pursue. The pandering model demonstrates that directors should be cautious about believing what executives or other team leaders say about these projects. Managers may recommend lower-value projects because it helps ensure that directors will recommend a project—any project—over the status quo option of doing nothing. And, as the pandering model shows, managers may do so even when directors know that this behavior may happen.

One way to avoid or minimize this problem is for the board to delegate the task to managers. Doing so, however, may call into question the value that the board is providing. When the board delegates authority to managers in this way, there is little difference between a board made up of insiders and one made up of independent outsiders. In both cases, it is ultimately the insider-managers who are calling the shots. When that happens, the benefits of team production have, to some extent, been lost.

As with lobbying, this effect of pandering suggests that the difficulty of receiving accurate, nonmanipulated information from subordinates poses concrete problems for boards. To resolve a dispute fairly, or to credibly threaten to resolve a dispute fairly, requires reasonably correct information. When the source of that information has an incentive to pander and to otherwise skew what directors learn, the ability to resolve disputes may suffer. Boards can avoid these problems through delegation, but when they do so, they are not acting as effective monitors or—most importantly for this piece—as mediating hierarchs.

* * *

The ultimate claim in this contribution is a plea for modesty about the abilities of the board. As nearly everywhere in this life, trade-offs abound. The existence of the board helps to solve the serious agency cost and team production problems that come with the public corporation. But the board's presence creates problems that would not exist in its absence. This piece highlights two of the largest potential problems. Stripping authority from those who care most about firm outcomes creates the incentive to lobby. To counter this problem, the board may cede much of that authority back to managers. In addition, the board's presence requires information to monitor and make decisions. As pandering models show,

150. See *supra* Part III.

there is no guarantee that the board will receive accurate information. Both of these limitations place substantial constraints on the board's ability to solve the problems that, for many corporate scholars, justify the board's existence. We should thus be wary of overstating the board's abilities.