The New Managerialism and Diversity on Corporate Boards of Directors

Lynne L. Dallas*

Historically, U.S. corporation law has legitimized the interests of shareholders in controlling the corporation as owners of the corporation. Various formal legal rules and informal social, political, and economic factors have contributed, however, to a corporate governance system dominated by managers, called managerialism. This system has provided managers with professional opportunities and incentives that encouraged managers to assure the long-term stability and growth of their corporations. Nonshareholder stakeholders, such as employees and consumers, often benefited from these objectives, although these objectives were sometimes pursued at the expense of profits and dividends for shareholders. This Article explores how the tender offer phenomena of the 1980s disrupted this system of corporate governance. Formally, the law changed with many state legislatures passing constituency statutes and courts explicitly recognizing managerial discretion to consider the interests of nonshareholder stakeholders. To managers, the most salient legal change, however, was most likely those cases that in certain tender offer situations constrained rather than broadened managerial discretion and required managers to maximize shareholder value. To maximize stock price was the ultimate legal message to managers. Moreover, this message was reinforced by the felt economic and social power of institutional investors resulting from their increased share ownership and the enhanced mobility of capital in a global economy. This emphasis also resonated with other powerful actors, such as corporate raiders and financial service providers. The result was a cultural change in which the corporate governance system became more emphatically stock-value driven. In this setting, a "new" managerialism has arisen that consists of short-term decision making and window dressing to impress the stock market at the expense of improving underlying corporation values. The irrationality of stock markets has become the new playground for the new managerial economy. As current events have shown at Enron and other U.S. corporations, in this environment, managerial decisions often end up hurting shareholders and nonshareholder stakeholders alike.

The development of the new managerialism has not occurred without some countervailing social and economic pressures. This Article also explores the movement for diversity on corporate boards, which has the potential to counter a corporate environment focused exclusively on stock price. Diversity on corporate boards refers to having diverse perspectives on corporate boards, which popularly translates into having more women, minorities, and nonnationals on corporate boards of directors. Diversity is proposed to bring into the boardroom a focus on the interests of employees, consumers, and an international market place. This Article explores the extensive behavioral literature on decision making by heterogeneous and homogeneous groups and concludes that, on balance, the advantages outweigh the disadvantages in having diverse perspectives represented on corporate boards. Women, minorities, and nonnationals on corporate boards may provide needed diversity in perspectives and may increase attention in the boardroom to the interests of employees, consumers, and the international marketplace. The representation of these latter interests by

---

* Professor of Law, University of San Diego School of Law. J.D., Harvard Law School, 1975. I gratefully acknowledge the financial support of the University of San Diego School of Law. I also appreciate the comments of Professor Claire Moore Dickerson and Suzanne Schwartz, and the research assistance of Alison Durrant, Ash Hormozan, Sharon Larkin, Dylan L. Malagrino, Elisa Sue, and David Willensky.

actual stakeholder representatives (e.g., employee-elected directors), however, would most likely have the greater potential to reign in the stock-price environment that is fostering the new managerialism.

I. INTRODUCTION

Since the tender offer phenomena of the 1980s, the business environment in which managers operate has changed substantially. The change is reflected in an increased emphasis on the interests of shareholders, which translates in the current environment to concern with the corporation's stock price. This change is due to a number of factors. Shareholders have become more powerful as more shares are concentrated in the hands of institutional investors and as capital has become more mobile in a global economy. Powerful interests back the emphasis on shareholder value with the wealthy owning over eighty percent of the stock in the United States,[1] and with financial intermediaries reaping substantial prestige and compensation from the financial transactions they recommend to influence stock price. In this environment, business norms support and legitimize an exclusive focus on stock price. A consequence of this new environment is what I call the "new managerialism," in which managers exercise their discretion to further their self-interest by second-guessing stock market

1. LAWRENCE MISHEL ET AL., The STATE OF WORKING AMERICA 2000/01, at 265, 269 (2001).

reactions to their actions and by justifying their actions on the basis of a shareholder-value rhetoric. Unlike the old managerialism, in which managers furthered their self-interest by assuring the stability and growth of the enterprise, sometimes at the expense of shareholders, the new managerialism involves greater attention to short-term shareholder value, which also does not serve the interests of shareholders.

The new managerialism is identified by a number of features. It is identified by the ever-increasing compensation packages for executives that are justified by using stock price as the normative reference point for executive compensation. It is known by the increasing disparity in compensation between executives and lower-level employees. Such disparities are justified in an environment of corporate downsizing to maximize stock price where legitimate and admired business behaviors are characterized by the marginalization of lower-level employees and the social and psychological distancing of executive officers from the persons they employ. Additional manifestations of this new managerialism are "earnings management," in which accounting numbers are manipulated to influence artificially stock prices, unbridled short-lived growth, and short-term corporate cost-cutting, which leaves the corporation ill-prepared for the future. At the end of the day this new managerialism, as with the old managerialism, has consequences that neither serve the interests of shareholders nor nonshareholder stakeholders, such as employees and consumers.

This Article is about the new managerialism, its evolution, and its manifestations. In addition, it is about a substantial grass roots movement for diversity in terms of gender, race, and ethnicity on corporate boards of directors of public corporations. This "new" corporate social responsibility movement arguably has the potential to counter the negative consequences of a corporate governance system myopically oriented to stock price. According to its proponents, diversity on corporate boards will serve to keep boards focused on the importance of the interests of nonshareholder stakeholders to the corporation's success. This Article takes a socio-economic approach by examining socio-psychological literature on the advantages and disadvantages of heterogeneous/homogeneous groups. It concludes that, on balance, diverse perspectives on corporate boards of directors are likely to improve the quality of board decision making. Moreover, the presence of women, minorities, and nonnationals on boards may increase the diversity of perspectives on corporate boards and may serve to direct attention away from an exclusive focus on stock price to consideration of the interests of employees, consumers, and an ethnically diverse marketplace. The shareholder-centered structure of the U.S. corporation, the shareholder stock-price rhetoric that heavily surrounds the discussion of the diversity movement, and various board socialization factors, however, may ultimately defeat the purposes of the board diversity movement. In the end, the direct representation of stakeholder interests on corporate boards (e.g., employee-elected directors) may provide the only way to counter effectively the consequences of a corporate environment so heavily focused on stock price.

This Article begins in Part II with a brief description of the U.S. corporate governance system prior to the 1980s. As the Article explains, contrary to the views of some legal scholars, the U.S. corporate governance system from a doctrinal standpoint has always been shareholder-centered. However, formal legal and informal economic and social factors supported a form of managerialism (old) that placed less of an emphasis than now placed on stock price. Part III explains how the business environment and corporate governance system evolved to focus more heavily on stock price. The consequences of this evolved system is the new managerialism and its various manifestations discussed in Part IV. Arguably countering the new managerialism to some degree is the movement for diversity on corporate boards that is explored in Part V. This Part is entitled the "Hidden Story of Corporate Boards" because it involves the important relational functions performed by corporate boards. Part VI examines the behavioral literature and its application to homogeneous and heterogeneous boards. In Part VII, conclusions of this Article are found.

II. SHAREHOLDER CENTEREDNESS AND THE OLD MANAGERIALISM

Immutably underpinning public corporations since the time of their formation in the United States is the formal selection of directors by shareholders and the exercise of considerable discretion by managers.[2] From a formal legal perspective, the power of shareholders derives fundamentally from their voting rights to elect directors and

2. For the history of the legal rights of shareholders and managers, see generally Lynne L. Dallas, *The Control and Conflict of Interest Voting Systems*, 71 N.C. L. REV. 1, 5-11 (1992).

approve certain fundamental changes in the business enterprise.[3] The power of directors is present in their ability to manage the business enterprise without the direct interference of shareholders.[4] Arguably, the discretion of directors is circumscribed by a fiduciary duty owed to shareholders. This duty may flow from the shareholders' right to elect the directors. Indeed, some early cases expressly state that directors owe a fiduciary duty to shareholders.[5]

Some recent writers have argued that the directors' duty is really owed to the corporation, not the shareholders, and therefore the interests of nonshareholder stakeholders have always been protected by U.S. corporation law.[6] Corporation law, then, is not shareholder-

3. For a description of the voting rights of shareholders under state law, see Dallas, *supra* note 2, at 12-13, 21. The federal proxy rules affect the exercise of voting rights by shareholders of public corporations. These rules, adopted in the 1940s, provide for the inclusion of shareholder proposals in the annual proxy statements of public corporations. *Securities and Exchange Commission Proxy Rules: Hearings on H.R. 1493, H.R. 1821 & H.R. 2019 Before the House Comm. on Interstate and Foreign Commerce*, 78th Cong., 1st Sess., 169-70 (1943); *see also* 17 C.F.R. 240.14a-7 (2001); Letter of the Director of the Corporation Finance Division Relating to Section 20 and to Rule X-14A-7 under the Securities Exchange Act of 1934, Exchange Act Release No. 34-3638, Fed. Sec. L. Rep. (CCH) ¶ 24,102, at 17,616 (Jan. 3, 1945) (discussing what types of proposals could lawfully be included in proxy statements). The rights of shareholders are limited under these rules. Dallas, *supra* note 2, at 13-19. For example, these rules have never permitted shareholders to use the corporation's proxy statement to nominate directors. *E.g.*, 17 C.F.R. 240.14a-8(i)(8) (2001). Moreover, the rules require most shareholder proposals to be in the form of recommendations to the corporation's board of directors. Adoption of Amendments Relating to Proposals by Security Holders, Exchange Act Release No. 12,999 [1976-77 Transfer Binder] Fed. Sec. L. Rep. (CCH) 80,812 (Nov. 22, 1976) (providing that proposals involving subjects not expressly covered by state statutory provisions must be in the form of recommendations to the board).

4. By the early twentieth century managers were not considered the agents of the shareholders. *See* Dallas, *supra* note 2, at 9-10.

5. In 1912, the New York Court of Appeals stated that "[e]quity, at least, recognizes the truth that the stockholders are the proprietors of the corporate interests, and are ultimately the only beneficiaries thereof, and the remedies given the corporation are really, though indirectly, for the protection of their rights." Pollitz v. Wabash R.R. Co., 100 N.E. 721, 725 (N.Y. 1912); *see also* Dunnett v. Arn, 71 F.2d 912, 918 (10th Cir. 1934) (noting that directors have a fiduciary duty toward stockholders regarding transactions); Farmers' Loan & Trust Co. v. Pierson, 222 N.Y.S. 532, 545-46 (Sup. Ct. 1927) (holding that directors must disclose relevant information to shareholders and abide by shareholder limitations on their powers in the corporation's articles or bylaws because according to the court "the right of the stockholders to know about their own business—for they are the real owners—can hardly be questioned, [because] [t]he directors occupy a very real and broad fiduciary relation to the stockholders," and "[t]he powers of the directors are conferred to enable the business to be transacted in the interest and for the profit of the stockholders" (citations omitted)); Bailey v. Jacobs, 189 A. 320, 324 (Pa. 1937) (stating that "[d]irectors and officers occupy toward stockholders what is commonly characterized as a fiduciary relationship").

6. Professors Blair and Stout challenge the belief that U.S. corporation law prior to the 1980s was shareholder-centered. *See* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 288-89 (1999). They argue that

centered. There is some authority in early cases that the directors' fiduciary duty is owed to the "corporation," which arguably may encompass the interests of nonshareholder stakeholders. For example, some cases referred to the duty of directors to the corporation as an entity.[7] This is consistent with the changing view of the powers of directors at the turn of the twentieth century from powers being delegated by shareholders to directors' powers being in some sense "original and undelegated."[8] Some early cases also refer to the directors' fiduciary duty to the "corporation and shareholders."[9] This latter phraseology concerning the obligations of directors may imply that the corporation's and the shareholders' interests are (1) the same or (2) are distinct but must coincide to justify corporate action. The cases do not resolve the meaning of this language, however, because most cases involve the self-dealing of directors in which the interests of the

---

corporation law "encourages directors [as 'mediating hierarchs'] to serve the joint interests of *all* stakeholders who comprise the corporate 'team'" by granting managers considerable discretion. *Id.* The cases they rely on for the period prior to the 1980s, however, do not seem to support their position. *See* David Millon, *New Game Plan or Business As Usual? A Critique of the Team Production Model of Corporate Law*, 86 VA. L. REV. 1001, 1015 n.40 (2000). As for the 1980s and thereafter, the law is more ambiguous, although the case law and constituency statutes cited by Blair and Stout are also consistent with managerialism. Moreover, the tender offer cases that require directors to maximize shareholder value in change-of-control situations present special problems for their theory. Rather than viewing these cases as reflecting the limits of the court's willingness to endorse managerialism, however, Blair and Stout describe these cases as involving going private transactions to which they claim their theory does not apply because directors are only mediating hierarchs for public (not private) corporations. *See* Blair & Stout, *supra*, at 309. However, the decisions scrutinized by the courts are made by directors who at the time of their decisions are directors of public corporations. As such, these directors have obligations to the public shareholders. They have no obligation to potential future private owners.

7. McQuade v. Stoneham, 189 N.E. 234, 238 (N.Y. 1934) (Lehman, J., concurring); Jackson v. Hooper, 75 A. 568, 571 (N.J. Ct. Err. & App. 1910) (stating that "the corporation itself is an entity wholly separate and distinct from the individuals who compose and control it"); *see* Thomas A. Smith, *The Efficient Norm for Corporate Law: A Neotraditional Interpretation of Fiduciary Duty*, 98 MICH. L. REV. 214, 243 n.70 (1999); *see also* Blair & Stout, *supra* note 6, at 287-315 (analyzing fiduciary duties owed to the corporation as an entity).

8. People *ex rel.* Manice v. Powell, 94 N.E. 634 (N.Y. 1911); *see* Whitfield v. Kern, 184 A. 333, 341, *rev'd*, 192 A. 48 (N.J. 1937); Dayton & Cincinnati R.R. Co. v. Hatch, 3 Ohio Dec. Reprint 501, 505-06 (Super. Ct. 1855). *See generally* Dallas, *supra* note 2, at 9-10 (discussing the rejection of the view that directors are the agents of shareholders).

9. Holcomb v. Forsyth, 113 S. 516, 519 (Ala. 1927); Horner v. New S. Oilmill, 197 S.W. 1163, 1164 (Ark. 1917); *see* Kennerson v. Burbank Amusement Co., 260 P.2d 823, 831 (Cal. App. 1953); Minn. Loan & Trust Co. v. Peteler Car Co., 156 N.W. 255, 258 (Minn. 1916). Some cases also indicate that a fiduciary duty is owed by directors to creditors, particularly during the insolvency of the corporation. *Minn. Loan & Trust Co.*, 156 N.W. at 258; Pender v. Speight, 75 S.E. 851, 852 (N.C. 1912).

corporation and shareholders are the same.[10] Moreover, the considerable discretion granted to directors under the business judgment rule, for reasons having nothing to do with protecting nonshareholder stakeholders, obscures from judicial scrutiny the distinction between the interests of the shareholders and the corporation.[11] For example, under the business judgment rule, directors are justified in taking an action to benefit the "corporation and shareholders" that may primarily benefit, in the short-term, nonshareholder stakeholders as long as there is a rational or theoretical connection to a long-term shareholder interest.[12] Therefore, to whom the directors owe a duty becomes muddied in the face of the considerable discretion placed by the business judgment rule on the directors. Of course, in the context of dissolving a corporation, it is clear that the financial interests of shareholders may prevail over the "corporation's" interest in its own survival, which serves to reinforce the interpretation that the interests of the "corporation and shareholders" comes down to the interests of the shareholders.[13]

Rather than determining whether the interests of the "corporation" are distinct from the interests of the "shareholders," however, the issue as to whether the corporation is shareholder-centered is probably more squarely faced in cases where managerial decision making is depicted as expressly placing the interests of nonshareholder stakeholders, such as employees or consumers, over and above the interests of shareholders. An early case seemed to resolve this issue in favor of a shareholder-centered interpretation of

---

10. *Holcombe*, 113 S. at 519; *Horner*, 197 S.W. at 1164; *Minn. Loan & Trust Co.*, 156 N.W. at 258.

11. The discretion granted to managers is not intended to bear on the issue of to whom the corporation is designed to serve, but primarily on perceptions about the prerequisites of smooth corporate functioning, the obligation of the corporation to all shareholders, the competency of courts to oversee managerial decision making, and the incentives necessary to encourage managerial tenure and appropriate risk taking.

12. For a history of the business judgment rule, see 1 DENNIS J. BLOCK ET AL., THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS 9-11 (5th ed. 1998); *see also* Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971), *aff'd*, 332 A.2d 139 (Del. 1975) (stating that a "board of directors enjoys a presumption of sound business judgment, and its decisions will not be disturbed if they can be attributed to a rational business purpose"); AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 2.01, at 57 (1994) (describing the economic objective of enhancing long-term shareholder gain).

13. Even today, shareholders in some states can dissolve the corporation without the approval of the board of directors. *E.g.*, CAL. CORP. CODE § 1900 (Deering 1977 & Supp. 2002) (requiring the consent of one-half of stockholders); DEL. CODE ANN. tit. 8, § 275(c) (2001) (requiring unanimous consent from stockholders); N.Y. BUS. CORP. LAW, § 1001 (McKinney 1986 & Supp. 2001-2002) (requiring two-thirds consent).

U.S. corporation law. In *Dodge v. Ford Motor Co.*, the court decided that Henry Ford could not use corporate assets to further the interests of employees and consumers when no interest of shareholders was offered to justify his actions.[14] Although this decision involved a closely held corporation, this case came to represent the rule on corporate purpose, even in the context of the public corporation, until the tender offer jurisprudence of the 1980s.

In conclusion, the formal legal model of corporate governance in the United States was shareholder-centered, but with considerable discretion granted to management over corporate decision making. This discretion was provided by the power granted to boards of directors to manage the corporation, the limited voting rights of shareholders, and the deferential judicial standard for reviewing director decision making.[15]

The informal story of corporate governance in the United States, at least prior to the 1980s, reflects to some degree this formal story. The main difference is that shareholders were less involved in corporate governance than their limited rights warranted. Thus, the dominance of the corporate governance system by managers, the "old" managerialism, was supported by informal political, economic, and social factors that contributed to the passivity of shareholders.[16] Adolph Berle and Gardiner Means in their seminal book, *The Modern Corporation and Private Property*, first published in the 1930s, described the phenomenon of dispersed share ownership in U.S. corporations.[17] Political reasons for dispersed ownership in the early public corporations are attributed by Professor Roe to populist legal regulations that discouraged large shareholdings by financial institutions.[18] Economic reasons for dispersed shareholding are supplied by modern finance theory, which explains that the risk of

14. 170 N.W. 668, 684-85 (Mich. 1919).

15. *See* Dallas, *supra* note 2, at 5-22. Even a labor representative on the board of a U.S. corporation is obligated to place shareholder interests first. *See* Larry W. Hunter, *Can Strategic Participation Be Institutionalized? Union Representation on American Corporate Boards*, 51 INDUS. & LAB. REL. REV. 557, 570 (1998).

16. "Managerialism" refers to a corporate governance system dominated by managers as a result of their position in the corporation's hierarchy rather than from their ownership of shares. *See* ALFRED D. CHANDLER, JR., THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS 484-500 (1977); Alfred F. Conard, *Beyond Managerialism: Investor Capitalism?*, 22 U. MICH. J.L. REF. 117, 118 (1988).

17. *See* ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (rev. ed. 1968) (1932).

18. MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE 28-32 (1994).

investing in corporations is minimized by shareholders investing small amounts in different corporations.[19] This diversification strategy decreases the cost of capital to corporations by lowering the shareholders' risk of investing in corporations. Dispersed shareholding contributes to shareholder apathy, because shareholders who own small interests in individual corporations do not have the incentive to incur the substantial costs necessary to participate actively in the governance of the corporations in which they hold shares. These shareholders may "free ride" on the efforts of more active shareholders.[20] In this way, dispersed shareholding contributed to the considerable control that managers and inside directors exercised over their corporations' boards of directors. Inside directors dominated boards and board member nomination processes.[21] Social group dynamics on boards further enhanced the managers' control.[22] Thus, informal political, economic, and social factors contributed to the power of managers over the corporations.

The power of managers was circumscribed, however, by the social and economic milieu in which they operated. Managers had to attend to some extent to shareholder interests. Structural and social factors that contributed to this result included the status of shareholders in the formal corporate governance structure, the belief that shareholders were the legitimate owners of the corporation, the effect of stock price on the corporation's ability to attract financing (although the major source of financing was retained earnings), and the possible sale of control by shareholders that could result in a loss of control by incumbent directors, although hostile takeovers were not

---

19. EUGENE F. BRIGHAM, FUNDAMENTALS OF FINANCIAL MANAGEMENT 119-26 (1989).

20. *See* ROBERT CHARLES CLARK, CORPORATE LAW 389-94 (1986); Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 821-22 (1992); Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 402-03 (1983). The collective action problem was partially addressed by federal proxy rules adopted in the 1940s that required corporations to include certain shareholder proposals in their proxy statements. *See* 17 C.F.R. § 240.14a-7 (2001).

21. *See* MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION 144-48 (1976); JAY W. LORSCH & ELIZABETH MACIVER, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS 20-23 (1989); CONFERENCE BOARD RESEARCH REPORT, BOARD DIVERSITY IN U.S. CORPORATIONS: BEST PRACTICES FOR BROADENING THE PROFILE OF CORPORATE BOARDS 20 (1999) ("In the United States, the CEO has traditionally been the chairman of the board and the main driver of the recruitment process for new board members.").

22. James D. Cox & Harry C. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 1985 L. & CONTEMP. LEGAL PROB. 83; Lynne L. Dallas, *Proposals for Reform of Corporate Boards of Directors: The Dual Board and Board Ombudsperson*, 54 WASH. & LEE L. REV. 91, 104-11 (1997).

then popular. The corporate governance system, however, operating in the public corporation provided considerable leeway for managers to attend to their own interests, which often, but not necessarily, coincided with those of nonshareholder stakeholders. Managers benefited from the survival and growth of the business enterprise and these goals were consistent with the business values of the time.[23] Historically, the power of managers was expanded to permit industrialists to engage in acquisitions and mergers.[24] In addition, managers were rewarded by compensation packages that often took account of growth or the amount of assets under their control.[25] The larger corporations also provided considerable professional opportunities for managers within the corporations.[26] Managerialism also gave managers the general incentive to attend to the growth of the corporation without slavish attention to shareholder interests.[27] Corporation historian Alfred Chandler explains the growth of managerialism capitalism in the United States:

> [C]areer managers preferred policies that favored the long-term stability and growth of their enterprises to those that maximized current profits.
>
> For salaried managers the continuing existence of their enterprises was essential to their lifetime careers. Their primary goal was to assure continuing use of and therefore continuing flow of material to their facilities. They were far more willing than were the owners (the stockholders) to reduce or even forego current dividends in order to maintain the long-term viability of their organizations. They sought to protect their sources of supplies and their outlets. They took on new products and services in order to make more complete use of existing facilities and personnel. Such expansion, in turn, led to the addition of still more workers and equipment. If profits were high, they preferred to reinvest them in the enterprise rather than pay them out in dividends.

---

23. *See* GORDON A. DONALDSON, JR., MANAGING CORPORATE WEALTH 21-22 (1984); GORDON DONALDSON & JAY W. LORSCH, DECISION MAKING AT THE TOP 7 (1983).

24. Dallas, *supra* note 2, at 10; Morton J. Horwitz, Santa Clara *Revisited: The Development of Corporate Theory*, 88 W. VA. L. REV. 173, 215-16 (1985); David Millon, *Theories of the Corporation*, 1990 DUKE L.J. 201, 214-16.

25. DONALDSON, *supra* note 23, at 133; John M. Abowd & David S. Kaplan, *Executive Compensation: Six Questions That Need Answering*, 13 J. ECON. PERSP. 145, 148-52 (1999); David H. Ciscel, *Determinants of Executive Compensation*, 40 S. ECON. J. 613, 617 (1974) (noting collinearity problems with studies on the hypothetical relationship between executive compensation and company assets and sales).

26. DONALDSON, *supra* note 23, at 23. When compared to other industrialized nations, U.S. corporations were known for their many managerial levels.

27. *See* GORDON DONALDSON, CORPORATE RESTRUCTURING: MANAGING THE CHANGE PROCESS FROM WITHIN 189-91 (1994).

> In this way the desire of the managers to keep the organization fully employed became a continuing force for its further growth.[28]

These observations are consistent with the observations of organizational behavior researchers.[29]

As briefly outlined, then, prior to the 1980s, formal legal and informal economic, social, and political factors supported a system of corporate governance that, while extolling the legitimacy of shareholder primacy, provided managers substantial discretion. In the business environment of the time, managers exercised that discretion to insure the stability and growth of their corporation. These objectives often benefited employees and consumers, but did not always benefit shareholders. The next Part explores the changes in the business environment represented and propelled by the tender offer phenomena of the 1980s and the effect of changes in the business environment on the manner in which managers exercised their discretion.

III. TENDER OFFERS OF THE 1980S AND SHAREHOLDER PRIMACY

The tender offer phenomena of the 1980s represented, precipitated, and accelerated changes in the corporate landscape.[30] The

---

28. Alfred D. Chandler, Jr., *Introduction to* The Visible Hand, *in* THE ESSENTIAL ALFRED CHANDLER: ESSAYS TOWARD A HISTORICAL THEORY OF BIG BUSINESS 387, 396 (Thomas K. McCraw ed., 1988).

29. For example, Professor Mintzberg observed that corporations tended to pursue a hierarchy of goals consistent with the corporation's state of development: "[F]irst, survival; second, a certain level of efficiency to ensure survival; third, control of the organization's environment to ensure an adequate degree of independence . . . and fourth, . . . growth." HENRY MINTZBERG, POWER IN AND AROUND ORGANIZATIONS 247 (1983); *see also* DONALDSON, *supra* note 23, at 21-22 (1983). Mintzberg states that "most often, survival, efficiency, and control seem to be treated as constraints, goals subordinate to growth, the most common primary goal." MINTZBERG, *supra*, at 278 (emphasis omitted).

30. During the 1980s almost one-half of United States major corporations received takeover offers. Mark L. Mitchell & J. Harold Mulherin, *The Impact of Industry Shocks on Takeover and Restructuring Activity*, 41 J. FIN. ECON. 193, 199 (1996).

Contrary to popular belief, the elimination of excess capacity and deconglomeration are probably not the primary reasons for the tender offers of the 1980s. Professors Holmstrom and Kaplan explain:

> Specifically, if firms involved in takeovers and buyouts were spending too much money on capital expenditures, then after the corporate control transaction, these companies should spend less. The evidence for this is mixed. Kaplan (1989) and Kaplan and Stein (1993) find that management buyout firms do make large cuts in capital expenditures. However, Servaes (1994) finds no evidence that targets of all takeovers, of hostile takeovers, and of going-private transactions were overinvesting in capital expenditures before the takeover. Furthermore, there do not appear to be significant changes in the ratio of capital expenditures to sales for firms that went

roadblocks against hostile tender offers put in place by directors of target companies in the 1980s frustrated corporate raiders and shareholders.[31] In responding to tender offers, managers of target corporations seemed indifferent to at least the short-term interests of shareholders who could obtain substantial premiums by tendering their stock.[32] The theoretical rationale for granting managers substantial discretion in terms of furthering shareholder interests began to crumble. Institutional investors, who had become substantial economic players in the stock markets, felt betrayed by corporate managers. Institutional investor ownership in the United States had substantially increased from 15.8% in 1970 to 38% in 1981.[33] With the

---

> through takeovers in the 1980s. (Healy, Palepu and Ruback, 1992; Bhagat, Shleifer and Vishny, 1990).

Bengt Holmstrom & Steven N. Kaplan, *Corporate Governance and Merger Activity in the United States: Making Sense of the 1980s and 1990s*, J. ECON. PERSP., Spring 2001, at 121, 130. Concerning deconglomeration Professors Holmstrom and Kaplan write: "If mergers were about deconglomeration, then it should be true that corporate diversification decreased values and deconglomeration increased values in the 1980s, and that U.S. business became substantially less diversified in the 1980s after the wave of deconglomeration. The evidence on these implications is mixed." *Id.*

These findings challenge Professor Coffee's deconglomeration argument for the tender offer phenomenon of the 1980s, although they support his emphasis on some role for institutional investors in explaining why it occurred. *See* John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1291-93 (1991). Of course, a number of factors contributed to tender offers, including deregulation, lax antitrust law enforcement, trade liberalization, and financial innovation. *See, e.g.*, Mitchell & Mulherin, *supra*, at 213-14.

31. The defensive tactics used by target corporation management were numerous, including the issuance of "poison pills," sales of corporate "crown jewels" and defensive mergers with "white knights." *See, e.g.*, LEWIS D. SOLOMON ET AL., CORPORATIONS: LAW AND POLICY 1143-44 (4th ed. 1998) (discussing defensive tactics used by target corporation management). State legislatures also placed limitations on corporate takeovers. *E.g.*, DEL. CODE ANN. tit. 8, § 203 (1991) (business combination statute); ILL. COMP. ANN. STAT. ch. 32, para. 7.85 (West 2001) (fair price statute); MINN. STAT. ANN. § 302A.671(2)(d) (1985 & Supp. 2002) (control share acquisition statute).

32. The premiums offered by raiders were substantial. *See* Greg A. Jarrell et al., *The Market for Corporate Control: The Empirical Evidence Since 1980*, J. ECON. PERSP., Winter 1988, at 49, 51 (stating that premiums were thirty percent above average returns); Louis Lowenstein, *Hostile Takeovers: A Remedy of First Resort or Last Resort*, *in* 15TH ANN. SEC. REGULATION INST. 9 (1988) (explaining that the "average premium over market for a large number of transactions in the late 1970s and early 1980s was 80 percent"). As for the long-term interests of shareholders, some commentators claimed that takeovers led to overindebtedness and improvident liquidations and were led by managers seeking to enlarge their empires and perks. Conard, *supra* note 16, at 124.

33. James P. Hawley, *Political Voice, Fiduciary Activism, and the Institutional Ownership of U.S. Corporations: The Role of Public and Noncorporate Pension Funds*, 38 SOC. PERSP. 415, 417 (1995) (noting that institutional ownership increased further "by 1986, to 44.8%; and by 1990, to 53.3%"). Large institutional investors doubled their share of the common share market from 1980 to 1996 and controlled over one-half of the market in 1996.

economic clout represented by institutional share ownership, the alleged political interests of public pension fund managers,[34] and the encouragement of the Department of Labor,[35] institutional investors fueled what I call the shareholder primacy or stock price movement in the United States. This movement has since extended beyond the borders of the United States.[36] Institutional investor associations were formed.[37] These organizations collected relevant information for institutional investors and developed strategies for monitoring managers to enhance stock price.[38] Initially, these institutional investor associations targeted defensive tactics used by managers of target corporations to thwart hostile takeovers.[39] Later, these organizations took on additional issues, such as board reform.[40]

This stock price movement resonated with powerful actors, such as corporate raiders, financial service providers, and institutional investors, and was supported by the neo-classical shareholder-centered theory of the firm popular since the late 1970s.[41] Today, it continues to mesh with the increased power of capital due to its mobility in a global

---

Paul A. Gompers & Andrew Metrick, *Institutional Investors and Equity Prices*, 116 Q.J. ECON. 229 (2001). The substantial power of institutional investors contributed to the takeover phenomenon itself. DONALDSON, *supra* note 27, at 4-5.

34. Hawley, *supra* note 33, at 420-24.

35. PWBA Prohibits Proxy Voting by Trustees or Named Fiduciaries Where Investment Manager Has Such Authority, 6 Pens. Plan Guide (CCH) ¶ 23,747W (Feb. 23, 1988).

36. *See* Mary E. Kissane, Note, *Global Gadflies: Applications and Implications of U.S.-Style Corporate Governance Abroad*, 17 N.Y.L. SCH. J. INT'L & COMP. L. 621, 636-37 (1997).

37. Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 570-75 (1990); *see* Conard, *supra* note 16, 143-44; Patrick J. Ryan, *Rule 14a-8, Institutional Shareholder Proposals, and Corporate Democracy*, 23 GA. L. REV. 97, 157-63 (1988).

38. Ryan, *supra* note 37, at 157-63.

39. Black, *supra* note 37, at 571-72; Kissane, *supra* note 36, at 635.

40. Tod Perry & Marc Zenner, *CEO Compensation in the 1990s: Shareholder Alignment or Shareholder Expropriation?*, 35 WAKE FOREST L. REV. 123, 127-28 (2000).

41. Modern agency cost theory depicts managers as "agents" for the stockholders. *E.g.*, Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1263-65 (1982). This use of the term "agent" is inaccurate because the shareholders do not have the power of a principal over managers. *See* Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403, 1428 (1985); Robert Clark, *Agency Costs Versus Fiduciary Duties*, *in* PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 55, 56-59 (John W. Pratt & Richard J. Zeckhauser eds., 1991); Lynne L. Dallas, *Two Models of Corporate Governance: Beyond Berle and Means*, 22 MICH. J.L. REFORM 19, 34-36 (1988). Professor Klein finds the use of agency terminology inappropriate because it does not recognize management's legitimate interest in control. William A. Klein, *The Modern Business Organization: Bargaining Under Constraints*, 91 YALE L.J. 1521, 1542-43 (1982).

marketplace.[42] Although this movement has encouraged corporations to adopt good principles of corporate governance, it has also encouraged corporate decision making that is more shareholder-centered and, consequently, more focused on stock price than ever before.[43] A 1999 survey of over 1000 directors in major U.S. corporations confirmed a "cultural" change on corporate boards of directors.[44] The report stated that the "change corresponded to a growing awareness by board members of their duty to properly represent the shareholders who elected them as directors."[45]

Courts and state legislatures were less inclined to embrace a stock price perspective in their decisions and enactments in reacting to the tender offer phenomena of the 1980s. Although the United States Supreme Court initially viewed the economics of hostile takeovers positively,[46] it was later less sanguine about the economic consequences of hostile takeovers.[47] Moreover, Delaware courts continued to give management substantial discretion to defend against tender offers under the business judgment rule.[48] Contrary to the stock price perspective, over one-half of the states passed constituency statutes, which provided that directors may take into account in their decision making the interests of nonshareholder stakeholders.[49] The court decisions during this period, which actually limited the discretion of directors, however, were likely more salient to managers.[50] These decisions applied a new rule in sale of control situations that explicitly

42. *E.g.*, Gunseli Berik, *Globalization*, *in* THE ELGAR COMPANION TO FEMINIST ECONOMICS 402-05 (Janice Peterson & Margaret Lewis eds., 1999); Robert C. Feenstra, *Integration of Trade and Disintegration of Production in the Global Economy*, J. ECON. PERSP., Fall 1998, at 31, 46; *see* Robert A. Spence, *Economic Globalization*, *available at* http://www.yorku.ca/faculty/academic/raspence/eglob.htm (last visited Feb. 28, 2002); Mark Weisbrot, *Globalization for Whom?*, 31 CORNELL INT'L L.J. 631, 645-46 (1998).

43. *E.g.*, CalPERS, *U.S. Corporate Governance Principles*, *available at* http://www.calpers-governance.org/principles/domestic/us/page01.asp (last visited Feb. 24, 2002).

44. KORN/FERRY INT'L, 26TH ANNUAL BOARD OF DIRECTORS STUDY 5 (1999); *see* DONALDSON, *supra* note 27, at 190-91; John A. Byrne, *The Best & Worst Boards: Our Report Card on Corporate Governance*, BUS. WK., Nov. 25, 1996, at 82, 94.

45. KORN/FERRY INT'L, *supra* note 44, at 5.

46. Edgar v. MITE Corp., 457 U.S. 624, 633 (1982).

47. CTS Corp. v. Dynamics Corp., 481 U.S. 69, 81-86 (1987).

48. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 185 (Del. 1986); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 959 (Del. 1985).

49. *See generally* James J. Hanks, Jr., *Playing With Fire: Nonshareholder Constituency Statutes in the 1990s*, 21 STETSON L. REV. 97 (1991) (discussing nonshareholder constituency statutes).

50. *See* Paramount Comm. Inc. v. QVC Network Inc., 637 A.2d 34, 48-49 (Del. 1994); *Revlon*, 506 A.2d at 182.

required managers to maximize shareholder value.[51] In addition, the power of shareholders was evident to management in the success of many hostile takeovers and in the economic power and increasing activism of institutional investors.[52] Note that the newly adopted constituency statutes and court decisions recognizing the concerns of nonshareholder stakeholders did not provide these stakeholders with new rights that could be enforced in lawsuits (based on a breach of fiduciary duty owed to them) and did not grant them access to the corporate governance structure.[53] I surmise that changes in law that are less salient to corporate actors and that depart from prior long-standing beliefs as to whom the corporation is designed to serve are likely to have a limited effect on corporate governance. This is particularly true when these changes are inconsistent with other more traditional messages from the legal system that support the philosophy of shareholder centeredness and are not accompanied by adequate enforcement tools.[54] Thus, the system that emerged from the tender offer phenomena of the 1980s placed greater emphasis on shareholder interests.

IV. THE "NEW" MANAGERIALISM

From the perspective of managers, the new corporate landscape requires greater attention to shareholder interests, which often translates into attention to stock market price. This new era provides its own unique opportunities for managerial self-dealing. The new managerialism is characterized by rhetoric supporting shareholder value and corporate decision making that involves second guessing stock market reactions. This environment often encourages a short-term focus that ignores the underlying economic health of the

51. *Paramount Comm. Inc.*, 637 A.2d at 44; *Revlon*, 506 A.2d at 182.

52. Black, *supra* note 37, at 570-75; Ryan, *supra* note 37, at 157-63.

53. These court decisions and state statutes may reflect a desire (1) to preserve managerialism in a shareholder primacy culture by permitting managers to justify their decisions by reference to the benefits obtained by nonshareholder stakeholders, and/or (2) to balance shareholder primacy with stakeholder concerns. If the desire is to balance shareholder primacy with a stakeholder orientation, the message has been too ambiguous to make much of an impact either on Wall Street or Main Street. The tension between managerialism and shareholder primacy was also exhibited in the controversy over whether shareholders could limit the discretion of directors through bylaw amendments. *See* JEFFREY D. BAUMAN ET AL., 2001 SUPPLEMENT TO SOLOMON, SCHWARTZ, BAUMAN & WEISS, CORPORATIONS: LAW AND POLICY 57-59 (2001).

54. Professors Jolls, Sunstein, and Thaler explain the importance of salience to the adoption of laws. *See* Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1520-22 (1998). Salience is equally important to gauge the effect of laws that are not enforced.

corporation to the detriment of the long-term interests of shareholders and other stakeholders.

Shareholder primacy legitimates the psychological distancing of managers from the human relationships that constitute the corporation and the formation of new compensation norms.[55] This distancing allows executive officers to justify greater disparities in compensation between themselves and the lowest-paid employees of the corporation and larger compensation packages that are a small fraction of overall shareholder value.[56] The greater disparity in compensation between executives and lower-level employees also feeds into biases that produce further income disparities and that may lead to dysfunctional decision making and competition within the corporation for top executive positions.[57] Excessive compensation packages also produce endgame problems as executives do not need future employment to support themselves and their families. It is probably not surprising that the dramatic rise in executive compensation came during a period when shareholder primacy had become the mantra.[58] As one study reports: In 1965, U.S. CEOs in major companies earned 20.3 times more than an average worker; this ratio grew to 28.5 in 1978, to 55.9 in 1989, and then to 106.9 in 1999.[59]

The rise in executive compensation is in part attributed to the issuance of stock options to executives. Salaries and bonuses to CEOs rose by 97% between 1980 and 1994, and stock options rose by 683%.[60] The mean stock option grant to individual CEOs rose from $155,000 to $1.2 million during this period.[61] Given these numbers, it

---

55. *E.g.*, RICHARD H. THALER, THE WINNER'S CURSE 36-49 (1992) (challenging the efficiency wage model in the context of inter-industry wage rates).

56. *See* MISHEL ET AL., *supra* note 1, at 211 (displaying information on disparity in compensation).

57. People tend to view their own expertise as more relevant to solving problems than the expertise of others. *See* JEFFREY PFEFFER & GERALD R. SALANCIK, THE EXTERNAL CONTROL OF ORGANIZATIONS: A RESOURCE DEPENDENCE PERSPECTIVE 71-83 (1978); JEFFREY PFEFFER, ORGANIZATIONS AND ORGANIZATION THEORY 119-20 (1982). Administrators perceive their contributions to the resolution of problems to be more significant than that of others, even though the input of others is necessary to resolve the problem. PFEFFER, *supra*, at 119-20.

58. In 1998, CEOs of Fortune 500 corporations, on average, earned $7.9 million. Matthias Benz et al., *Are Stock Options the Managers' Blessing? Stock Option Compensation and Institutional Controls*, U. of Zurich, Institute for Empirical Research in Economics Working Paper No. 61, at 2, *available at* http://papers.ssrn.com/so13/papers.cfm?abstract_id=251009 (Oct. 13, 2000); *see also infra* notes 60-61 and accompanying text.

59. MISHEL ET AL., *supra* note 1, at 211.

60. Brian J. Hall & Jeffrey B. Liebman, *Are CEOs Really Paid Like Bureaucrats?*, 113 Q.J. ECON. 653, 661-62 (1998) (using mean values).

61. *Id.* at 662.

is not surprising that foreign executives are showing considerable interest in the U.S. shareholder value rhetoric and are seeking to have their corporations listed on U.S. stock exchanges to make the issuance of stock options as part of their compensation packages more feasible.[62]

The new managerialism is reflected in the increasing use of stock options as a form of managerial compensation.[63] Stock options permit managers to participate on the upside of their stock market gambles, but not the downside. Their issuance may mislead shareholders because stock options are not reflected in the expenses of the corporation when they are issued.[64] As one study notes, stock options are a convenient way for top managers "to raise their total income with a relatively low risk of losses, and with a relatively low risk of attracting the attention of shareholders."[65] The distortion of earnings-based valuations of the corporation, such as the price-earnings ratios of the corporation, is assisted by the issuance of stock options and their accounting treatment. A surprising conclusion was reached by one study that "if options had been properly accounted for at the time when they were granted, the profits of large listed companies in 1998 would have been two-thirds lower."[66] The following are dramatic numbers for

---

62. *See* John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641, 706-07 (1999).

63. There was an "explosion" of stock option issuances during the 1980s and 1990s. *See supra* note 60 and accompanying text.

64. Benz et al., *supra* note 58, at 6. This study purports to demonstrate that stock options are often not explained by agency theory, which claims that stock options align the interests of shareholders and managers, but rather by rent-seeking behavior on the part of managers. The study found that the absolute value of options granted to managers was greater (not less) the fewer the institutional constraints on the corporation and its management. The institutional constraints used in the study were board composition (whether the stock option recipient was on the board), concentration of share ownership (measured by average share ownership), and product market concentration ratios. *Id.* at 6-14. An agency theorist could argue, however, that stock options play a more important role when institutional constraints are few. The study does not appear to prove either position because it is subject to different interpretations.

65. *Id.* at 3.

66. *Called to Account*, THE ECONOMIST, Jan. 27, 2001, at 15, 16; Daniel Murray, *Employee Stock Options: The Fed Joins In*, Rep. No. 142, at 1, 13, *available at* http://www.smithers.co.uk/aboutreports.shtml (Jan. 20, 2000). The two-thirds number (actually sixty-three percent) is based on "full cost accounting," which "takes into consideration the net increase, over the course of the year, of the value of options outstanding, together with the estimated costs of options exercised during the year." *Id.* at 4. Earnings are overstated by 18% to 27% if the "recurring cost" approach is used that "estimates the value of options issued, as they are issued, plus the cost of financing the immunisation [hedging] of any options that are already outstanding." Murray, *supra*, at 1, 13; *see also* Daniel Murray, *Employee Stock Options: Revisited*, Rep. No. 131, *available at*

Microsoft alone: "[H]ad Microsoft accounted for its options properly [as expenses], in 1998 it would have made not a profit of $4.5 billion, as its accounts showed, but a loss of $17.8 billion."[67] Stock options may also have an adverse impact on investment. A recent study concluded:

> [F]irms experiencing significant [employee stock option] exercises shift resources *away* from real investments [research and development and capital expenditures] *towards* the repurchase of their own stock. We further document a persistent decline in subsequent firm performance (as measured by return on assets) following the cut in discretionary investments as a result of stock option exercises. Collectively, our findings indicate that [employee stock option] exercises impose a real cost on the firm in terms of foregone real investment opportunities.[68]

Corporations with outstanding stock options substantially benefited from the September 11th terrorism when the New York Stock Exchange suspended trading except for corporations buying their own shares.

The new managerialism is also reflected in a phenomena known as "earnings management," whereby accounting numbers are manipulated to meet stock market expectations regarding corporate quarterly earnings.[69] Former chairman of the Securities and Exchange

---

http://www.smithers.co.uk/aboutreports.shtml (Mar. 5, 1999) (discussing the effects of employee stock options and accounting on the economy).

67. *Called to Account*, *supra* note 66, at 16.

68. Daniel A. Bens et al., *Real Investment Implications of Employee Stock Option Exercises* 27 (Dec. 2000), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=254708 (last visited Aug. 26, 2002); *see* David Leonhardt, *Will Today's Huge Rewards Devour Tomorrow's Earnings?*, N.Y. TIMES, Apr. 2, 2000, at MB1 (noting that from 1991 to 1994, Standard and Poor's 500 companies more than tripled the amount paid on stock repurchases). Corporate debt rose forty-five percent in the 1995 to 2000 period, much of which was caused by stock repurchases. Bens et al., *supra*, at 14. Managers of TIAA-CREF are beginning to vote against stock option plans. *Id.* A New York Stock Exchange task force has recommended shareholder approval for such plans. *Id.* For information on the relationship between executive compensation and corporate performance, see Abowd & Kaplan, *supra* note 25; Hall & Liebman, *supra* note 60; *see also* Kevin J. Murphy, *Executive Compensation*, *in* 3 HANDBOOK OF LABOR ECONOMICS 2555-56 (Orley Ashenfelter & David Card eds., 1999) (surveying of executive compensation and concluding that "[a]lthough there is ample evidence that CEOs (and other employees) respond predictably to dysfunctional compensation arrangements, it is more difficult to document that the increase in stock-based incentives has led CEOs to work harder, smarter, and more in the interest of shareholders").

69. There is some dispute as to where the blame lies for the misstatement of earnings. Some place the blame on market analysts for giving undue weight to whether companies meet quarterly earnings expectations. A recent study, however, finds that "firms meeting expectations are not 'rewarded' by analysts with higher earnings forecasts than are warranted," although the market rewards firms that meet expectations. *See* Ron Kasznik & Maureen F. McNichols, *Does Meeting Expectations Matter? Evidence from Analyst Forecast*

Commission Arthur Levitt in his famous "Numbers Game" speech directed attention to this practice.[70] He and others have detailed the sophisticated methods used by management to enhance the market's perception of positive quarterly performance, including improper revenue recognition, "big bath" over-inclusive restructuring charges, creative acquisition accounting by allocating an ever-growing portion of the acquisition price to "in-process" research and development, the creation of "cookie jar" reserves by overinflating estimates of such items as sales returns, loan losses, or warranty costs, and misusing the concept of materiality.[71] Accounting disasters have occurred at such companies as Sunbeam Corp., Waste Management Inc., Cendant Corp., Micro-Strategy, Inc., and California Micro Devices.[72]

Revisions and Share Prices 8 (Aug. 1999), *available at* http://papers.ssrn.com/sol3/papers.clm?abstract_id=18975 (last visited Aug. 26, 2002). Others put the blame on an antiquated accounting system that fails to keep up with investors' demand for information. *See* Stephen Barr, CFO Magazine, *Misreporting Results, available at* http://www.cfo.com/printarticle/0,5317,1555,00.html (Dec. 1, 1998) (recommending a "real-time" reporting system for companies rather than quarterly and annual reports). The blame, of course, rests in the first instance on the managers who actually misstate the earnings of their companies. Managerial self-dealing is implicated as most commentators point to the stock options of managers as partially motivating earnings management. Stephen Barr, CFO Magazine, *Guilty as Charged, available at* http://www.cfo.com/printarticle/0,5317,1358,00.html (Apr. 1, 1999); Remarks by Chairman Arthur Levitt, Securities and Exchange Commission, *The "Numbers Game"*, *at* http://www.sec.gov/gov/news/speech/speecharchive/1998/spch220.txt (Sept. 28, 1998). Analysts seek more information from management and, in a survey, eighty-seven percent of them viewed corporate boards of directors as representing the interests of managers rather than investors. Joseph McCafferty, CFO Magazine, *Speaking of Earnings. . ., available at* http://www.cfo.com/printarticle/0,5317,1643,00.html (Oct 1, 1997). Ultimately, shareholders and the markets are hurt by the managers' misstatement of earnings.

70. Remarks by Levitt, *supra* note 69.

71. *See id.*; *see also* Remarks by Lynn E. Turner, Chief Accountant, Securities and Exchange Commission, *Opportunities for Improving Quality* (Dec. 15, 2000), *at* http://www.sec.gov/news/speech/spch451.htm (last visited Feb. 24, 2002) (discussing responsibility for a quality financial reporting process); Louis Lavelle, *'Corporate Liposuction' Can Have Nasty Side Effects,* BUS. WK., July 17, 2000, at 74, 74-76 (listing ways to book earnings "that have nothing to do with selling goods or services").

72. An example of a company that used improper revenue recognition is the business software developer, MicroStrategy Inc. MicroStrategy's restatement of its revenues resulted in the lowering of revenue for 1999 from $205.3 to $151.3 million and a reduction of profits from fifteen cents per share to a loss of forty-four cents per share. The company's stock price plunged by sixty-two percent on the day it announced it would restate its earnings consistent with new rules drafted by the American Institute of Certified Public Accountants. *See* Andrew Osterland, CFO Mazazine, *Hard Lessons: In Its Ongoing War on Earnings Management, The SEC May Have Outdone Itself With New Rule on Revenue Recognition available at* http://www.cfo.com/printarticle/0,5317,901,00.html (Sept. 28, 2000). Similar accounting disasters occurred at Cendant Corp., Sunbeam Corp., Waste Management Inc., and California Micro Devices. Stephen Taub, CFO Magazine *Andersen Settles with SEC, available at* http://www.cfo.com/printarticle/0,5317,3749,00.html (June 19, 2001) (discussing how Waste Management overstated pretax income by more than $1 billion); *The Sunbeam*

Spokespersons for the U.S. Securities and Exchange Commission have sought no less than a "cultural change" concerning misstatements of financial information.[73] One survey found that forty-five percent of chief financial officers surveyed had been asked to misrepresent financial results and a full thirty-eight percent of that group did so.[74] In addition, seventy-eight percent had been asked to use accounting rules to put financial results in a more favorable light and one half of that group complied.[75] Levitt notes the negative consequences to the corporation and its stakeholders of using these accounting gimmicks. Levitt comments that these gimmicks may "increase the value of [managerial] stock options" and may assist corporations in attaining short-term competitive advantage, but in the long run they will undermine confidence in the U.S. capital markets.[76] Considerable regulatory attention has recently been directed to curtailing these practices.[77] Fraudulent financial reporting is increasingly resulting in the ending of chief financial officers' careers and resulting in prison terms.[78] Further developments are likely in the wake of Enron Corporation's accounting irregularities.[79]

Managerial self-dealing may also occur by cost-cutting measures that raise reported profits and positively impact executive compensation, but that negatively affect corporate performance in the long run.[80] An egregious example of this cost-cutting mentality is Petrobas Corp. A Petrobas executive declared:

Case Casts a Long Shadow, BUS. WK., *available at* http://www.businessweek.com/bwdaily/dnflash/may2001/nf2001518_436.htm (May 18, 2001); Lisa Yoon, *Standing by "Chainsaw Al*," *available at* http://www.cfo.com/printarticle/0,5317,1365,00.html (Nov. 30, 2000) (reporting that allegedly Sunbeam overstated sales by $50 million); Ronald Fink, *Hear No Fraud, See No Fraud, Speak No Fraud*, *available at* http://www.cfo.com/printarticle/0,5317,1498,00.html (Oct. 1, 1998) (discussing how Cendant Corp., as a result of merger with CUC International, overstated earnings by $700 million); John A. Byrne, *Chainsaw Al*, BUS. WK., *available at* http://www.businessweek.com/1999/99_42/b3651099.htm (Oct. 18, 1999); Barr, *supra* note 69.

73. *See* Remarks by Levitt, *supra* note 69; Remarks by Turner, *supra* note 71.

74. Barr, *supra* note 69.

75. *Id.*

76. Remarks by Levitt, *supra* note 69.

77. *E.g.*, Audit Committee Disclosure, Release No. 34-42266, 71 SEC. Docket 787 (Oct. 12, 2000); REPORT AND RECOMMENDATIONS OF THE BLUE RIBBON COMMITTEE ON IMPROVING THE EFFECTIVENESS OF CORPORATE AUDIT COMMITTEES (1999), *available at* http://www.nyse.com/pdfs/blueribb.pdf (last visited Aug. 17, 2002).

78. Remarks by Turner, *supra* note 71.

79. Howard Fineman & Michael Isikoff, *Lights Out: Enron's Failed Power Play*, NEWSWEEK, Jan. 21, 2002, at 14, 15.

80. A short-term earnings focus places too much emphasis on reducing costs. FREDERICK F. REICHHELD & THOMAS TEAL, THE LOYALTY EFFECT: THE HIDDEN FORCE BEHIND GROWTH, PROFIT, AND LASTING VALUE 155-56 (1996). Although cost cutting is often

> Petrobas has established new global benchmarks for the generation of exceptional shareholder wealth through an aggressive and innovative program of cost cutting on its P36 production facility.
>
> . . .Through an integrated network of facilitated workshops, the project successfully rejected the established constricting and negative influences of prescriptive engineering, onerous quality requirements and outdated concepts of inspection and client control.
>
> Elimination of these unnecessary straight jackets has empowered the project's suppliers and contractors to propose highly economical solutions with the win-win bonus of enhanced profitability margins for themselves.
>
> The P36 [offshore drilling] platform shows the shape of things to come in [the] unregulated global market economy of the 21[st] century.[81]

Shortly thereafter, the P36 offshore drilling platform—the biggest in the world—"collapsed and sank into the Atlantic Ocean off the coast of Brazil, killing ten workers and spilling oil."[82] Another example of the dangers of the cost-cutting mentality, expressly to please Wall Street, is the downfall of Sunbeam Corp. under the leadership of the Wall Street heralded downsizer Al Dunlap.[83] Thus, the business environment has changed to focus more emphatically on stock price with negative consequences to both shareholders and nonshareholder stakeholders.

V. THE HIDDEN STORY OF CORPORATE BOARDS

Organizational behavior research demonstrates that board memberships often serve as "bridging strategies"[84] or "boundary

---

necessary, for example, to meet the demands of global competition and deregulation, it has become an expedient methodology that is losing its ability to produce value. DWIGHT L. GERTZ & JOAO P.A. BAPTISTA, GROW TO BE GREAT: BREAKING THE DOWNSIZING CYCLE 8-14 (1995). One study found that eighty percent of downsized companies experienced a decline in morale and that only one-third of these companies resulted in increased employee productivity. *Id.* at 19. The compound annual revenue growth rate for the Fortune 500 industrial companies during the period of substantial downsizing between 1983 and 1993, adjusted for inflation, was -0.33%. *Id.* at 22; *see also* Lavelle, *supra* note 71, at 76.

81. Robert Browning, *Is Corporate Cost Cutting Proving Deadly*, *available at* http://www.skynet.com.au/~rwb/esso.htm (last visited Mar. 3, 2002).

82. *Id.*

83. *See* Byrne, *supra* note 72.

84. *See* Dallas, *supra* note 41, at 91-94; *see also* Shaker A. Zahra & John A. Pearce II, *Boards of Directors and Corporate Financial Performance: A Review and Integrative Model*, 15 J. MGMT. 291, 297-99 (1989).

spanning'"[85] devices that enable the corporation to mediate its relationships with various stakeholders. With the increasing focus on shareholder stock value, it is not surprising that attention has turned to using the board as a means to impress on the corporation the importance of nonshareholder stakeholder concerns.

Shareholders have made a number of proposals to corporations to urge them to increase board diversity. The shareholders making these proposals consist of mainly individuals and church groups and a few unions and institutional investors.[86] These proposals vary in their content.[87] Some proposals seek to have corporations adopt formal policies declaring the corporation's commitment to board diversity. In addition, these proposals often request that corporations issue reports that disclose their progress toward board diversity, their criteria for board memberships, and their selection process for board committee members. Other proposals request that corporations take direct actions to increase board diversity by placing a woman or minority on their boards, enlarging their search for qualified board members, and/or making greater efforts to identify women and minority board candidates.

These board diversity proposals have received substantial shareholder support.[88] In 1998, 1999, and 2000, they received an average favorable shareholder vote of 14.3% (7 proposals), 15.2% (7 proposals), and 19.9% (5 proposals), respectively.[89] In 2000, diversity board proposals to American Power Conversion and Bed, Bath & Beyond received favorable shareholder votes of 30.1% and 20%, respectively.[90] Record votes were obtained for board diversity proposals at Cypress Semiconductor with supporting votes of 43.8% in 1999 and 35.1% in 1998.[91] Diversity proposals have been withdrawn from many other companies on the basis of favorable discussions with management.[92]

The movement to have diversity on corporate boards is intended to sensitize the corporation to the interests of employees and

---

85. Catherine M. Daily et al., *A Decade of Corporate Women: Some Progress in the Boardroom,* None *in the Executive Suite,* 20 STRATEGIC MGMT. J. 93, 95 (1999); Zahra & Pearce, *supra* note 84, at 297, 304.

86. IRRC Database (1974-2000) (made available to author).

87. *See* Susan Williams, 2001 Background Report E, Board Diversity (Feb. 16, 2001) (unpublished manuscript, on file with author); IRRC Database, *supra* note 86.

88. Williams, *supra* note 87, at 2-3.

89. *Id.*

90. *Id.*

91. *Id.*

92. *Id.* at 3-4; IRRC Database, *supra* note 86.

consumers in an increasingly diverse, global society. The interest in diversity to some extent represents a recognition of the necessity of stakeholder capitalism, although the discussion proceeds emphatically in the context of enhancing shareholder value. A recent study of best board practices that examined the perceptions of groups of corporate executives, investors, and directors found that these groups considered diversity "a key part of good governance."[93] Diversity included diversity of gender, race, and cultural diversity as corporations become international. The study reported considerable consensus on the statement that substantial economic arguments exist for broadening the diversity of corporate boards. "This is especially true as companies broaden the scope of what they consider relevant to creating shareholder value to include things like *workplace practices and customer satisfaction*."[94]

A. *Minority Directors*

A study of board best practices reports that a substantial number of directors, particularly of the largest corporations, consider it important to have minority representation on their boards. The reason is "to better reflect the changing marketplace and the growth in minority market segments."[95] In 1998, sixty percent of public corporations had ethnic minorities on their boards,[96] although ethnic minorities account for only six percent of the directors of Fortune 500 corporations.[97] Based on a recent survey of directors, twenty-nine

93. CONFERENCE BOARD RESEARCH REPORT, *supra* note 21, at 7 (stating that the diversity focus does not change the boards obligations as fiduciaries to represent all shareholders, but rather helps a board "fulfill its principal mission-enhancing shareholder value").

94. *Id.* (emphasis added) (reporting that shareholder value is strengthened when intangibles such as diversity, workplace practices, and customer satisfaction permeate a company).

95. KORN/FERRY INT'L, *supra* note 44, at 13. Service industries such as motels, restaurants, telephone companies, and airlines that have substantial minority employees are found to have more minority representation on boards, indicating a labor stakeholder orientation. *See* Gerald E. Fryxell & Linda D. Lerner, *Contrasting Corporate Profiles: Women and Minority Representation in Top Management Positions*, 8 J. BUS. ETHICS 341, 345-46 (1989).

96. KORN/FERRY INT'L, *supra* note 44, at 11. Thirty-nine percent of the companies have African-Americans on their boards, twelve percent Hispanic directors, and nine percent Asian directors. *Id.*; *cf.* SPENCER STUART, 1999 SPENCER STUART BOARD INDEX 6 (detailing statistics for 1999).

97. KORN/FERRY INT'L, *supra* note 44, at 11. Minorities are underrepresented in the executive suite. Dan R. Dalton & Catharine M. Dailey, *The Other Ceiling*, ACROSS THE BOARD, Nov./Dec. 1998, at 19, 19. Women of color, in particular, are underrepresented in the managerial labor force when compared with their participation in the total labor force.

percent of the corporations plan to increase the numbers of African-American directors, fourteen percent to increase the number of Latino directors, and ten percent to increase the number of Asian directors.[98]

B. Women Directors

Another recent trend is the increase in the number of women directors.[99] James Preston, retired CEO of Avon Products, Inc., states that because "60% of all purchases in this country are made by women, having women on the board just makes good business sense."[100] Another reason given for ensuring female membership on boards is that it permits the corporation to send important signals to its employees, particularly its current female managers and potential recruits.[101] Women directors also serve as role models for more junior women employees. Moreover, considering women for board memberships permits corporations to take advantage of the full range of intellectual capital available to them.[102] Actual changes in board composition are occurring. Unlike the glass ceiling observed in the executive suite,[103] women have made steady progress in the corporate boardroom, although this progress is slow.[104] Fortune 500 companies with one or more women on their boards increased from sixty-nine percent in 1993 to eighty-six percent in 1998.[105] This change

---

Margaret Blackburn White & Joseph Potts, *Just the Facts: Women of Color in U.S. Corporations*, DIVERSITY FACTOR, Spring 1999, at 12.

98. White & Potts, *supra* note 97, at 12-13.

99. *See infra* notes 105-108 and accompanying text.

100. Daily et al., *supra* note 85, at 94.

101. *Id.* at 94, 98.

102. *Id.* at 96-97. As one CEO of a Fortune 1000 company said "When you open positions to both sexes, you double the number of people in the top 10, or in the top 1% of ability in the marketplace." Donna Dillon Manning, *Women Directors: A CEO Priority*, DIRECTORS & BOARDS, Spring 1995, at 19, 20.

103. There is not much change since the "Glass Ceiling Commission at the Department of Labor.... Women still make up about 5 percent of senior management ... and minorities about 3 percent." CONFERENCE BOARD RESEARCH REPORT, *supra* note 21, at 26 (quoting attorney Cari Dominguez). Many argue that because of barriers in corporate America, women have sought careers in service industries, the law, accounting, and human resources or have left the corporate sector to start their own businesses. *Id.* (citing Catalyst data). When capable women and minorities leave corporations to start their own business, they are less likely to be recruited for board membership. *Id.* at 13.

104. Williams, *supra* note 87, at 4.

105. CONFERENCE BOARD RESEARCH REPORT, *supra* note 21, at 16-17; Diana Bilimoria, *Women Directors: The Quiet Discrimination*, THE CORP. BD., July/Aug. 1995, at 10 n.93 (stating that "[a]lthough 85 percent of CEOs considered it important to have female directors, 48 percent found female candidates 'difficult to identify' and cited this as a reason for current low levels of female directorships"). A study based on 1998 proxy statements found that seventy-three percent of all company boards have at least one woman and that

represents an increase in the percent of total board seats held by women from 8.3% in 1993 to 11.1% in 1998,[106] with larger companies tending to have more women on their boards.[107] The percentage of Fortune 500 companies with more than one woman director increased from 29.2% in 1993, to 37.6% in 1998, with 6.8% of such companies in 1998 having three or more women directors.[108]

C. Nonnational Directors

In a survey of corporate directors, twenty percent of directors expressed the desire to add to the board a non-U.S. director "to enhance their global perspective."[109] A study of global companies

---

twenty-five percent have two women, constituting ten percent of the overall director population. KORN/FERRY INT'L, *supra* note 44, at 11. Boards of public corporations have an average of twelve members.

106. CONFERENCE BOARD RESEARCH REPORT, *supra* note 21, at 17-18; *see also* KORN/FERRY INT'L, *supra* note 44, at 11; SPENCER STUART, *supra* note 96, at 6.

107. CONFERENCE BOARD RESEARCH REPORT, *supra* note 21, at 18 (finding also that corporations located in the Northeast tended to have more women on their boards).

108. *Id.* at 17. A 1995 study of female directors found no consensus on whether qualified women are available to increase the number of women on corporate boards. *See* Manning, *supra* note 102, at 96. It is clear, however, that the women now serving on corporate boards are not "token" directors; they are on corporate boards because of their business expertise and their ability to access the information and resources that the corporation requires. The percentage of female outside directors with corporate backgrounds rose from 13.3% in 1987 to 37.6% in 1996, only ten years later. Daily et al., *supra* note 85, at 96. Moreover, the percentage of women serving as affiliated directors (outside directors who represent organizations that provide services to the corporation) rose from 13.3% in 1987 to 32.6% in 1996. *Id.*

Some studies have examined whether there are gender-based biases in the appointment of women directors to board committees. A recent study, based on 1983 data, found gender-based biases in committee assignments, even after controlling for experience-based characteristics. Diana Bilimoria & Sandy Kristin Piderit, *Board Committee Membership: Effects of Sex-Based Bias*, 37 ACAD. MGMT. J. 1453, 1465 (1994). *But see* Idalene F. Kesner, *Directors' Characteristics and Committee Membership: An Investigation of Type, Occupation, Tenure, and Gender*, 31 ACAD. OF MGMT. J. 66, 73 (1988). Bilimoria's study observed that female directors were as qualified as, if not better qualified than, their male counterparts on most characteristics examined. Women were favored for public affairs committee membership over men, and men were favored for the more powerful compensation and executive committees. Bilimoria & Piderit, *supra*, at 1464-65. Women are most likely to be on audit and social/corporate responsibility committees (fourteen and fifteen percent respectively) and least likely to be on executive committees (six percent). They are most likely to chair social/corporate responsibility committees (twenty-one percent). CONFERENCE BOARD RESEARCH REPORT, *supra* note 21, at 30. This data is dated, however, and the small number of female directors on boards and, therefore, surveyed make reliance on this study, as well as studies attempting to link the presence of female or minority directors to corporate performance, problematic.

109. SPENCER STUART, *supra* note 96, at 5. Although time and distance barriers exist to having non-U.S. directors on corporate boards, these barriers are being overcome by fewer (but possibly longer) board meetings and video teleconferencing. *Id.* at 7.

found that these companies added nonnational directors to acquire an in-depth understanding of new markets, comprehend a new customer base, deal with the demands of international investors, and gain credibility in certain capital markets or political environments.[110]

There is little support for having constituency or special interest directors on U.S. corporate boards.[111] It is significant, however, that the issues focused on for improving returns to shareholders by a diverse board include important stakeholder concerns such as workplace practices and/or customer satisfaction.[112] Corporations with diverse boards are expected to have greater sensitivity to stakeholder issues. For example, one report observes that issues like family life and flexible work arrangements are given greater prominence in companies that attract both female executives and female board members.[113] As previously mentioned, with the emphasis currently placed on shareholder primacy, it is probably not surprising that countervailing pressures are felt by corporations also to attend to the interests of its employees and consumers through the recruitment of diverse directors.

VI. HETEROGENEOUS/ HOMOGENEOUS BOARDS OF DIRECTORS

There is some psychological research that attempts to explore the effects of group-member characteristics and heterogeneity on group decision making. This research has been extensively applied to top management teams and, to a lesser extent, to corporate boards of directors. In the first portion of this Part, I discuss the top echelon theory, which considers the importance of group-member characteristics and heterogeneity among group members for the performance of top management teams. In the second portion of this Part, I consider research on corporate boards of directors and discuss

110. *See* CONFERENCE BOARD RESEARCH REPORT, GLOBALIZING THE BOARD OF DIRECTORS: TRENDS AND STRATEGIES 15 (1999).

111. *E.g. id.* at 9-10.

112. *See* CONFERENCE BOARD RESEARCH REPORT, *supra* note 21, at 9; *see also* Manning, *supra* note 102, at 21 (detailing a survey showing that, of over one-third of the CEOs of Fortune 1000 companies, the following percentages of CEOs sought to have women directors to exemplify commitment to diversity to shareholders (60%), exemplify commitment to advancing women (59%), enhance the ability to recruit and retain women (46%), initiate discussions about issues that affect female employees (29%), reflect female consumers' perspectives (26%), and contribute a perspective different from those of male directors (38%)).

113. CONFERENCE BOARD RESEARCH REPORT, *supra* note 21, at 8, 27 (discussing also the Executive Leadership Council's proposals that companies conduct a self-audit that would include making "key stakeholder evaluations").

the relevance of the top echelon theory and other behavioral research to corporate boards of directors. Important to this latter discussion is the recognition of the differing roles of the top management team and corporate boards of directors.

A. *The Upper-Echelon Theory*

The upper-echelon theory focuses on the demographics of the corporation's dominant coalition (or top management team). This theory suggests that corporate strategy and performance reflects the values and cognitive base of the top management team or the dominant coalition within the corporation.[114] Consistent with its origin in the Carnegie School,[115] the upper-echelon theory recognizes the importance of social-psychological factors in making corporate decisions.[116] This theory predicts that a person's cognitive base and values will affect his recognition of problems and opportunities, interpretation of them, consideration of alternatives, and ultimate decisions.[117] Persons are restricted in their field of vision in scanning the environment by their different professional orientations, cognitive styles, business and life experiences, and social networks.[118] A person's cognitive base and values are viewed as important to a person confronted with myriad stimuli from within and outside the corporation.[119] The upper-echelon theory utilizes observable background characteristics, such as age, gender, length of tenure in the corporation, functional background, education, socioeconomic roots, minority status, and financial position as proxies for a person's

---

114. *See* Donald C. Hambrick, *Top Management Groups: A Conceptual Integration and Reconsideration of the "Team" Label*, 16 RES. IN ORGAN. BEHAV. 171, 172-74 (Barry M. Staw & L.L. Cummings eds., 1994); Donald C. Hambrick et al., *The Influence of Top Management Team Heterogeneity on Firms' Competitive Moves*, 41 ADMIN. SCI. Q. 659, 660-82 (1996). *See generally* Donald C. Hambrick & Phyllis A. Mason, *Upper Echelons: The Organization as a Reflection of Its Top Managers*, 9 ACAD. MGMT. REV. 193, 193-204 (1984) (discussing the upper-echelon theory).

115. The Carnegie School rejected the rational actor analysis in favor of considering behavioral factors, such as bounded rationality, multiple and conflicting goals, and varying aspirational levels. *E.g.*, RICHARD M. CYERT & JAMES G. MARCH, A BEHAVIORAL THEORY OF THE FIRM 28, 34-36 (1963).

116. *See* Sydney Finkelstein & Donald C. Hambrick, *Top-Management Team Tenure and Organizational Outcomes: The Moderating Role of Managerial Discretion*, 35 ADMIN. SCI. Q. 484, 485 (1990); Hambrick & Mason, *supra* note 114, at 194.

117. A person's cognitive base is defined as (1) "knowledge or assumptions about future events," (2) "knowledge of alternatives, and" (3) "knowledge of consequences attached to alternatives." Hambrick & Mason, *supra* note 114, at 195. Values refer to the "principles for ordering consequences or alternatives according to preference." *Id.*

118. *See* SUSAN T. FISKE & SHELLEY E. TAYLOR, SOCIAL COGNITION 98-99 (1984).

119. Hambrick, *supra* note 114, at 175; Hambrick & Mason, *supra* note 114, at 195.

perspectives, belief systems, networks, and affiliations.[120] "[A]t the heart of the [upper-echelon] theory is the portrayal of upper echelon characteristics as determinants of strategic choice and, through these choices, of organizational performance."[121]

The upper-echelon theory makes a number of predictions based on background characteristics. For example, a team with a long tenure with the corporation is expected to become more homogeneous because of the development of close working relationships.[122] Moreover, processes of socialization and filtering are expected to reduce the variance in candidates considered for inclusion in the team.[123] Such teams are expected to have problems in effectively scanning, interpreting, and responding to a tumultuous environment, when, for example, the corporation is confronted with deregulation, intense foreign competition, or major technological changes. On the positive side, however, teams with longer tenures have in-depth industry knowledge and settled working relationships that may be advantageous in more stable industries.[124]

Studies have supported some of the predictions of the upper-echelon school. For example, with respect to firm tenure, top management teams with long tenure have been associated with strategic persistence or absence of change, whereas young, highly educated teams with short tenures are associated with more

120. *E.g.*, Hambrick, *supra* note 114, at 177; Hambrick et al., *supra* note 114, at 663; Finkelstein & Hambrick, *supra* note 116, at 486. The upper-echelon theory is similar to resource dependence theory when it recognizes that top management characteristics "are in part a reflection of the situation that the organization faces." Hambrick & Mason, *supra* note 114, at 197. For example, resource dependence theory predicts that the composition of the board of directors will reflect areas of environmental uncertainly for the corporation. The top echelon approach focuses more on the exercise of managerial discretion while recognizing that environmental and inertial forces affect corporate performance. Thus, these two theories together suggest that situational factors and upper-echelon characteristics are relevant to corporate strategy, and situational factors, upper-echelon characteristics, and corporate strategy to corporate performance.

121. Hambrick & Mason, *supra* note 114, at 197.

122. *See id.*

123. Finkelstein & Hambrick, *supra* note 116, at 487; *see* Stefan Schulz-Hardt et al., *Biased Information Search in Group Decision Making*, 78 J. PERSONALITY & SOC. PSYCHOL. 655, 667 (2000) (stating that "socialization in an organization leads to management teams in which members hold similar opinions"); Edgar H. Schein, *Organizational Socialization and the Profession of Management*, INDUS. MGMT. REV., Winter 1968, at 1, 6-7.

124. Consequently, the upper-echelon theory makes the following hypotheses concerning a management team's average tenure: Years of inside service by top managers will be negatively related to strategic choices involving new terrain, for example, product innovation and unrelated diversification. "For an organization in a stable environment, years of inside service will be positively associated with profitability and growth." *See* Hambrick & Mason, *supra* note 114, at 200.

innovation.[125] Another study found that managerial tenure had a positive influence on strategic persistence (unchanging firm strategy) and strategic conformity (conformance to a central strategic tendency in the industry), but that this effect was more pronounced in industries where executives had more discretion, such as the computer industry, as distinct from lower managerial discretion industries, such as chemicals and natural gas.[126] Other studies have found no relationship between firm tenure and organizational strategy or performance.[127]

The upper-echelon literature also considers the amount of diversity in background characteristics of top management teams or the degree of heterogeneity within the team. The literature has partially based its predictions about heterogeneous and homogeneous groups on psychological studies of group behavior in experimental settings. These group studies find that heterogeneous groups tend to make higher quality decisions in matters involving creative and judgmental decision making.[128] Thus, in complex decision making requiring creativity and judgment, heterogeneous groups seem to improve the quality of thinking. "Cognitive conflict" is said to explain this finding: heterogeneous groups share conflicting opinions, knowledge, and perspectives that result in a more thorough consideration of a wide range of interpretations, alternatives, and consequences.[129] However, heterogeneous groups do not necessarily have an advantage over homogeneous groups when the task is solving problems that have verifiably, correct answers, unless the heterogeneous group "increases the probability of the group containing

---

125. Hambrick, *supra* note 114, at 185; Hambrick et al., *supra* note 114, at 662.

126. Finkelstein & Hambrick, *supra* note 116, at 499-501.

127. Ken G. Smith et al., *Top Management Team Demography and Process: The Role of Social Integration and Communication*, 39 ADMIN. SCI. Q., 412, 415-16, 434 (1994).

128. *See generally* Susan E. Jackson, *Consequences of Group Composition for the Interpersonal Dynamics of Strategic Issue Processing*, 8 ADVANCES IN STRATEGIC MGMT. 345, 354-56 (1992) (evaluating studies that assess the decisions made by groups by surveying group members and/or obtaining the judgment of an external panel of experts concerning the quality of the group's decision). Some recent studies have confirmed these findings. One study found that homogeneous groups arrive at more inaccurate judgments than heterogeneous groups. *See* Janet A. Sniezek & Rebecca A. Henry, *Accuracy and Confidence in Group Judgment*, 43 ORGAN. BEHAV. & HUMAN DECISION PROCESSES 1, 20 (1989) (finding that "[t]he more disagreements that group members reported, the more accurate were their group judgments"). A recent study involving mixed-ethnicity groups found superior problem-solving skills in groups with more diversity. *See* Taylor H. Cox et al., *Effects of Ethnic Group Cultural Differences on Cooperative and Competitive Behavior on a Group Task*, 34 ACAD. MGMT. J. 827, 839 (1991).

129. *E.g.*, Daniel P. Forbes & Frances J. Milliken, *Cognition and Corporate Governance: Understanding Boards of Directors as Strategic Decision-Making Groups*, 24 ACAD. MGMT. REV. 489, 494-95 (1999).

some members who are capable of determining the correct answer to the problems being solved."[130] Importance is placed on issue-relevant expertise in solving such problems. As one writer explains:

> For example, an issue processing group dealing with race relations may be more likely to base their decisions on accurate conclusions about how minority members would react to a proposal if that group had relevant minorities represented on it. Similarly, groups dealing with problems that require them to accurately assess reactions from various religious, political or consumer groups may have some advantage if those constituencies are represented.[131]

Thus, based on psychological studies of heterogeneous/homogeneous groups, the upper-echelon theory makes the following kinds of predictions:

> (1) Heterogeneous groups processing strategic issues that involve high degrees of creative thinking and judgmental decision making will, as a consequence of their external contacts, import to the issue processing group a broader range of information and possible solutions for consideration, in comparison to more homogeneous groups.[132]
> (2) For strategic issue processing groups working on issues that involve large amounts of fact finding and logical reasoning, performance will usually be unrelated to personal attribute composition. However, in situations where personal attributes are related to issue-relevant expertise, heterogeneity on the relevant attribute should enhance performance.[133]

---

130. *See* Jackson, *supra* note 128, at 359. However, a recent study found that a moderate amount of solution diversity that members brought to group discussions enhanced decision quality even in a problem with verifiably correct answers. John P. Wanous & Margaret A. Youtz, *Solution Diversity and the Quality of Group Decisions*, 29 ACAD. MGMT J. 149, 155-56 (1986). Wanous and Youtz suggest that "diversity may increase decision quality by increasing the amount of attention and discussion paid to each group member's individual solution." *Id.* at 157. In addition, another study involving problems with verifiably correct answers found some support, although weak, that mixed-gender groups outperformed same-gender groups. Wendy Wood, *Meta-Analytic Review of Sex Differences in Group Performance*, 102 PSYCHOL. BULL. 53, 67-68 (1987). Another relevant division of group tasks is whether the task is disjunctive, conjunctive, additive, or discretionary. *See* ROBERT S. BARON ET AL., GROUP PROCESS, GROUP DECISION, GROUP ACTION 36-37 (1992).

131. Jackson, *supra* note 128, at 359. Having true diversity in a group tends to counter the "false consensus" effect, in which people view their "own knowledge, beliefs, attitudes, and actions as more representative of those of others than they really are." Raymond S. Nickerson, *How We Know—And Sometimes Misjudge—What Others Know: Imputing One's Own Knowledge to Others*, 125 PSYCHOL. BULL. 737, 749-50 (1999). For an extended discussion of the tendency to overestimate that one's own perspective and knowledge is shared by others, see *id.* at 738-39, 747.

132. Jackson, *supra* note 128, at 355.

133. *Id.* at 359.

The psychological literature, however, also indicates the importance of additional socio-psychological factors that may impact on the relative performance of heterogeneous/homogeneous groups. Cognitive conflict (heterogeneity) can decrease a group's cohesiveness.[134] Cohesiveness refers to the personal attraction among group members, that is, the positive feelings that group members have for other members of the group.[135] Psychological research indicates that people are attracted to other individuals who share similar attitudes.[136] Attraction among group members is diminished by cognitive conflict.[137] When members are more attracted to the other members of the group, they express greater satisfaction with the group, are willing to give more attention to group tasks (that is, are less likely to engage in "social loafing" or withdrawal), and are less likely to leave the group.[138] Thus, group cohesion is important to the amount of effort a group member will expend on group issues, to his/her remaining in the group, and to the member's actual use of his/her knowledge and skill to assist the group in its tasks.[139] However, greater effort by group members may result in cognitive conflict, thus diminishing group cohesion.[140] Moreover, group cohesion will not always result in a group member giving greater attention to group tasks and using his/her knowledge and skill. Too much cohesion may result in the reduction of critical thinking and self-censorship. Cohesive groups can engage in "groupthink" in which group decision making fully replaces the exercise of individual judgment.[141] Thus, some compromise between cognitive conflict and cohesion appears necessary for effective group decision making.[142] Also, offsetting the need for cohesion to motivate groups are group tasks that are "involving, attractive or intrinsically interesting" and that involve

---

134. Forbes & Milliken, *supra* note 129, at 496; Smith et al., *supra* note 127, at 420.

135. Jackson, *supra* note 128, at 361.

136. *Id.* at 362.

137. *Id.* at 363.

138. Forbes & Milliken, *supra* note 129, at 494-95. Process losses in groups may be due to "coordination losses" or "motivational losses." *See* BARON ET AL., *supra* note 130, at 33-34. Group size, for example, may have an impact on process losses. *Id.* at 42-43, 47.

139. *See also* Wanous & Youtz, *supra* note 130, at 156-57. Other factors are also relevant, such as communication processes that provide "equal participation and respect." *See* John G. Oetzel, *Self-Construals, Communication Processes, and Group Outcomes in Homogeneous and Heterogeneous Groups*, 32 SMALL GROUP RES. 19, 42, 44 (2001).

140. Forbes & Milliken, *supra* note 129, at 493.

141. *Id.* at 494; Hambrick, *supra* note 114, at 188. For a discussion of factors that may lead to conformity in the board context, see Dallas, *supra* note 22, at 108-11.

142. Trade-offs may depend on the importance of high-quality decisions and the level of acceptance required for the decision. *See* Wanous & Youtz, *supra* note 130, at 157.

performance goals.[143] Norms also provide important motivational influences on individual boards. Boards have different effort norms, for example, that refer to "the group's shared beliefs regarding the level of effort each individual is expected to put toward a task."[144] Norms regarding cooperation and effort are particularly important for groups, such as corporate boards, whose work is interdependent.[145]

In addition, although issue-relevant expertise is important for solving problems that have verifiably correct answers, social-psychological factors may inhibit or encourage the use of expertise by individual group members. The leadership style of the group's leader[146] and the status of the member[147] may affect the member's use of his/her expertise. In addition, research on social influence indicates that a group member will often not express a solution even when it is verifiably correct, unless at least one other person agrees with his/her solution.[148] This finding suggests that a critical mass of at least two like-minded group members may encourage the use of expertise. Moreover, studies show that members of less powerful social groups (such as minorities) exhibit more passive behavior, defined as lower levels of participation and assertive leadership behaviors, when they are a numerical minority in groups,[149] although passive behavior is less likely when they are viewed as possessing greater relative experience on the group's tasks.[150] In addition, the cultural composition of a heterogeneous group may affect communication patterns in the group,

---

143. BARON ET AL., *supra* note 130, at 48.

144. Forbes & Milliken, *supra* note 129, at 493.

145. Ruth Wageman, *Interdependence and Group Effectiveness*, 40 ADMIN. SCI. Q. 145, 150 (1995).

146. Jackson, *supra* note 128, at 370-71; *see also* Hambrick, *supra* note 114, at 180 (discussing how management team members tend over time to "cater to the informational and behavioral preferences of the CEO"). Strategies are proposed for leaders of homogeneous groups to create cognitive conflict and to counter confirmation biases, such as encouraging open discussions, not championing his/her view early in the discussion, considering worst-case scenarios, and having group ideas reviewed by outside experts or devil's advocates. BARON ET AL., *supra* note 130, at 73; *see also* Wanous & Youtz, *supra* note 130, at 156 (recommending future study on the possibility of leaders generating solution diversity that did not naturally occur through such practices as encouraging groups to develop second solutions, appointing devil's advocates, and inviting outsiders to meetings).

147. Jackson, *supra* note 128, at 357.

148. *Id.*

149. Ji Li et al., *The Effects of Proportional Representation on Intragroup Behavior in Mixed-Race Decision-Making Groups*, 30 SMALL GROUP RES. 259, 274-77 (1999). These behaviors are offset by a person's sense of "self-efficacy," defined as "the personal judgment of one's own capability to successfully perform a behavior." *Id.* at 264.

150. Leonard Karakowsky & J.P. Siegel, *The Effects of Proportional Representation and Gender Orientation of the Task on Emergent Leadership Behavior and Mixed-Gender Work Groups*, 84 J. APPLIED PSYCHOL. 620, 627-29 (1999).

which can influence the group's decision making. Effective Decision Making Theory, for example, predicts that group decision making is affected by whether members are from individualistic or collectivist cultures, that is, whether members construe themselves as distinct and unique from other group members or connected to other members of the group.[151] One study found that in heterogeneous groups European Americans took more turns to speak, initiated more conflicts, and used more competitive tactics than Japanese members.[152] The use of expertise is also affected by whether novices are in the group. Psychological studies show that groups benefit from a mixture of

---

151. Individualism is defined as "a social pattern consisting of loosely connected individuals who view themselves as unique" and collectivism is defined as "a social pattern consisting of loosely connected individuals who view themselves as members of one or more in-groups." John G. Oetzel, *Explaining Individual Communication Processes in Homogeneous and Heterogeneous Groups Through Individualism-Collectivism and Self-Construal*, 25 HUMAN COMM. RES. 202 (1998).

152. *Id.* at 208-09. Oetzel also found that both European Americans and Japanese used fewer competitive conflict tactics in heterogeneous groups. He comments that the "salience of cultural identity may increase the awareness of misunderstandings and difficulties in intercultural situations and, as a result, the participants attempt to work through the difficulties in a supportive manner." *Id.* at 221; *see also* Lois Recascino Wise & Mary Tschirhart, *Examining Empirical Evidence on Diversity Effects: How Useful Is Diversity Research for Public Sector Managers*, 60 PUBLIC ADMIN. REV. 386 (2000)("[S]ome researchers speculate that the introduction of Asian American, Black American, and Hispanic American workers, who are typically more collectivist, might enhance group performance since majority-group Americans are characteristically more competitive and individualistic")(citing Taylor Cox et al., *Effects of Ethnic and Group Cultural Differences on Cooperative and Competitive Behavior on a Group Task*, 34 ACAD. MGMT. J. 827, 827-47 (1991)). According to Professor Blackeney:

> By the early 1990s, researchers looked at the impact on complex problem solving of greater degrees of cultural diversity in groups. They used a combination of extensive USA intracultural diversity with some international intercultural diversity. The result was that these culturally more diverse teams did more poorly than culturally homogeneous teams because of disruption caused by the degree of culture heterogeneity. However, with feedback to both culturally similar and culturally diverse groups on their group process and their group performance, both types of groups improved over time. But, the culturally diverse groups catch up with culturally similar groups in overall performance, plus they exceeded them in the range of perspectives used in their analysis and in the number of alternative solutions generated").

Roger N. Blackeney, A Micro History of Group Decision Making Research (2000) (unpublished manuscript, on file with author).

An interesting study found that members' self-construals are better indicators of communication than other factors such as cultural or gender heterogeneity. John G. Oetzel, *Self Construals, Communication Processes, and Group Outcomes in Homogeneous and Heterogeneous Groups*, 32 SMALL GROUP RES. 19, 42-3 (2001) (finding that "one cannot make an assumption that because a group is composed of diverse members that they will have difficulty interacting").

experts and novices.[153] One writer speculates that this finding concerning expert/novice groups may be due to the role of teacher assumed by experts in such groups, which causes experts to sharpen their thinking, and the requirement that experts in the face of novice questions "unbundle the assumptions and rules they automatically use when dealing with issues and problems in which they are expert."[154] Thus, a number of socio-psychological factors related to group composition affect whether expertise is used by group members.

The information relied on by the group and information-seeking processes are also affected by group heterogeneity. Groups tend to focus on information that the members share in common (shared information), which can adversely affect the group's performance by limiting the information considered by the group.[155] However, the "greater the diversity of individual preferences present in the group [heterogeneity], the more the reliance on shared information is reduced."[156] Moreover, information-seeking processes that attempt to find information that confirms the majority's viewpoint are more likely in groups where the minority is small relative to the majority.[157] Thus, corporate performance may benefit from greater group heterogeneity because of its affect on expanding information-seeking processes.

Finally, time considerations may affect the performance of heterogeneous/homogeneous groups. Heterogeneous groups often invest more time resolving issues that require creativity and consensus building because of their members' diverse vocabularies, paradigms, and possible objectives.[158] With clear time pressures, heterogeneous groups are less likely to reach consensus and more likely to resolve issues by negotiation and compromise or majority voting. This resolution of matters may result in less group acceptance of the solution adopted. Lower confidence in the group's decision by its members has advantages though, in terms of assuring the group's monitoring of its decisions. Such groups are characterized by the "development and use of more elaborate mechanisms for obtaining feedback, greater attention to signals suggesting failure, and greater

153. *See* Jackson, *supra* note 128, at 358.

154. *Id.*

155. Nickerson, *supra* note 131, at 739-40.

156. Schulz-Hardt et al., *supra* note 123, at 656 (citing F.C. Brodbeck et al., *The Dissemination of Critical Unshared Information in Decision-Making Groups: The Effect of* Prediscussion Dissent, 32 EUROPEAN J. SOC. PSYCHOL. 35 (2002).

157. Schulz-Hardt et al., *supra* note 123, at 666.

158. *See* Hambrick et al., *supra* note 114, at 668; Jackson, *supra* note 128, at 356.

willingness to change the group's decision in the face of negative feedback."[159]

The top-echelon research on heterogeneous/homogeneous groups has not reached the stage where there are consistent findings and agreement among researchers on general principles.[160] Findings are inconsistent in terms of the effect of heterogeneity/homogeneity of the top management team on various measures of corporate performance.[161] Findings are also inconsistent on the effects of

---

159. *Id.* The mixed effects of heterogeneity in terms of cognitive conflict and time demands is illustrated by a study of competitive decision making by management and behavior in the domestic airline industry during the 1980s, a time when the industry was exceedingly turbulent. Hambrick et al., *supra* note 114, at 659-82. The study was based on competitive moves by thirty-two major airlines (1445 moves) over an eight-year period found in Aviation Daily, a publication containing complete and detailed information on airline competition. The study found that heterogeneity in top management teams was positively related to an airline's tendency to undertake creative initiatives. *Id.* at 680-81. This study explained that heterogeneous teams have "broader cognitive resources, encompassing a wider field of vision and more extensive external contacts." *Id.* at 665. Heterogeneous teams also observe "more opportunities, threats, and overall stimuli on multiple fronts" and thus having "a broader potential repertoire for generating actions." *Id.* Heterogeneous management teams were also found to make bolder competitive initiatives in term of strategic significance, noteworthiness, and scope of action, but were slower in execution speed than homogeneous teams. *Id.* at 679. Thus, "broad gathering of information, decision creativity and boldness" were offset to some extent by "friction and slowness in decision making and action." *Id.* A negative association was found, however, between the competitive responses of an airline to the moves of another airline (as distinct from action initiatives) in terms of propensity to respond, and response generation and execution speeds. *Id.* These results suggest that heterogeneous teams may engage in "more interpretation, negotiation, and creative formulation of responses, which lessens their likelihood of responding at all, compared with the more straightforward, reflexive response behaviors of homogeneous teams." *Id.* at 679-80. In terms of the contribution of team composition to overall corporate performance, the study found that the three types of heterogeneity studied (functional, educational, and tenure) were positively related to the airline's profitability and market share. *Id.* at 680. Thus, the benefits of team heterogeneity compensated for low response propensity and the slowness of the heterogeneous team. The mixed effects of heterogeneity in terms of cognitive conflict and time demands worked to the benefit of the airlines in a period that was "exceedingly turbulent and lacked clear competition role models." *Id.* The authors of this study warned, however, that heterogeneity could be less successful in "a more stable industry, with more widely accepted models or recipes for behavior and less intense rivalry." *Id.* (citation omitted). It might also be less successful in an industry where time demands were more pressing and where competitive responses (as opposed to action initiatives) were more important.

160. For various criticisms of workplace diversity studies that may be applicable to some studies referred to in this Article as well, see Wise & Tschirhart, *supra* note 152, at 386-88.

161. Catherine M. Daily & Charles Schwenk, *Chief Executive Officers, Top Management Teams, and Boards of Directors: Congruent or Countervailing Forces?*, 22 J. MGMT. 185, 189 (1996). Heterogeneity has been positively associated with innovativeness in a large sample of banks and in growth rates in semiconductor companies and negatively associated with innovation in a wide cross section of corporations and adaptive change in a sample of electronic firms. *See* Hambrick et al., *supra* note 114, at 662-63.

different demographic characteristics, that is, whether the study involves heterogeneity in terms of company tenure, functional background, or some other characteristic of the top management team.[162]

A number of reasons may explain the lack of consistent findings. While decision making by a heterogeneous group may benefit from cognitive conflict useful for complex decision making, a homogeneous group may benefit from cohesion (in a moderate amount) and a quicker response time. Moreover, competitive situations confronting corporations are different and may change from time to time, resulting in a different assessment of the benefits of heterogeneity/homogeneity. In addition, leadership styles may intervene to enhance the benefits of heterogeneity or to suppress them. For example,

> [i]nept leaders may squander the potential benefits of group diversity by not allowing adequate time for a full discussion to occur or by supporting norms that stifle the expression of disagreement in general, or the expression of dissent by a minority faction in particular.... Alternatively, they may be insensitive to the importance of moving from disagreement to consensus through the construction of new and genuinely shared understandings and instead encourage compromises to which no one feels committed.[163]

The studies may imperfectly measure diversity of perspective because many top management groups may lack appreciation for the significant benefits of cognitive diversity and thus give insufficient attention to counteracting the powerful forces of conformity in their groups.[164] Certainly, experimental studies have demonstrated the

---

162. For example, in the airline industry study, see *supra* note 159, education and tenure heterogeneity were significantly positively related to strategic action propensity, but functional heterogeneity was not. Functional and educational heterogeneity were negatively related to firm response execution speed, but tenure heterogeneity was not. Hambrick et al., *supra* note 114, at 679-80.

163. Jackson, *supra* note 128, at 370-71; *see also supra* note 146 and accompanying text.

164. Recent studies have also raised some questions about the process assumptions underlying the upper-echelon theory. A recent study attempted to measure cognitive diversity directly by having top executives complete a survey on corporate goals and corporate strategies. C. Chet Miller et al., *Cognitive Diversity Among Upper-Echelon Executives: Implications for Strategic Decision Processes*, 19 STRATEGIC MGMT. J. 39, 43-44 (1998). The study found that diversity concerning the corporation's goals (but not diversity concerning corporate strategies) negatively impacted the amount of investigation undertaken by such executives, such as the extent of brainstorming sessions and the preparation of lists of alternative solutions. *Id.* at 52. The authors concluded that communication problems and lack of cohesion were overwhelming the positive effects of cognitive diversity. *Id.* at 51. However, the survey failed to recognize the negative aspects of brainstorming, left out informal communications, and did not relate the kind of investigation outlined in the survey

advantages of cognitive diversity in judgmental decision making, which is the most important kind of managerial decision making. The studies discussed in this Part on the advantages of cognitive diversity to avoid reliance on shared information and to broaden information-seeking processes are also relevant and important to managerial decision making, as are the studies on group polarization, egocentrism, and the confirmation bias discussed in the next Part in the context of board decision making. Because of conformity pressures, however, it is likely that future research will show that various process dimensions are more important to managerial decision making than the heterogeneity/homogeneity of the management team. Moreover, as studies become more sophisticated in taking into account more potentially relevant variables, generally accepted findings may emerge concerning the heterogeneity/homogeneity of management teams.

B. *Heterogeneous/Homogeneous Boards of Directors*

Care must be taken in applying the upper-echelon research concerning management to corporate boards of directors, because of the different functions of corporate boards of directors. Whereas management must implement corporate policy, the board's role is to monitor management and to provide a bridge between the corporation

---

with corporate performance. A recent study actually found a negative relationship between communication frequency among top executives and return on investment. Smith et al., *supra* note 127, at 428. This study found that more cohesive groups relied on informal communications. *Id.* at 432. The study used a social integration measurement based on such questions as whether group members get along well together and are ready to cooperate and help each other. Therefore, this study's measurement is more inclusive than cohesiveness. *Id.* at 425. The authors of this study opined that the "only communication necessary in [cohesive] groups, apparently, is a fairly unstructured and sparse exchange of information, without the need to formalize communication . . . for the record." *Id.* at 432. Moreover, research to date is inconsistent concerning the relationship between consensus on goals/means among top executives and corporate performance. Clifford T. West, Jr. & Charles R. Schwenk, *Top Management Team Strategic Consensus, Demographic Homogeneity and Firm Performance: Report of Resounding Nonfindings*, 17 STRATEGIC MGMT. J. 571, 571-72 (1996). An important study of top executives of corporations in the competitive paints and allied products industry found no support for the hypothesis that consensus on both corporate objectives and competitive methods is necessary to explain corporate performance differences. The study concluded that consensus on goals or competitive methods is equally important. Gregory G. Dess, *Consensus on Strategy Formulation and Organizational Performance: Competitors in a Fragmented Industry*, 8 STRATEGIC MGMT J. 259, 273 (1987); *see also* West & Schwenk, *supra*, at 574 (finding no positive relationship between strategic consensus among the top management team and performance). The results of this study suggest that "additional efforts on the part of management to achieve a consensus among members of the [top management team] on both objectives and methods may not enhance the organization's performance beyond that obtained by achieving a consensus on only one." Dess, *supra*, at 273.

and its environment. These functions constitute the (1) manager-monitoring and (2) relational roles of corporate boards of directors. Cognitive diversity is important to both of these functions. In terms of manager-monitoring, diversity "may promote the airing of different perspectives and reduce the probability of complacency and narrow-mindedness in a board's evaluation of executive proposals."[165] Such a board can produce a wider range of solutions for problems and decision criteria for evaluating corporate strategies. In addition, both the manager-monitoring and relational roles of the board are furthered by having outside directors on boards to share their diverse perspectives and experiences. One writer explains that outside directors "ensure the continued operation of the firm through access to valued information and resources, facilitation of interfirm commitments, and establishing and maintaining the firm's legitimacy."[166] These outside directors represent "important external constituencies provid[ing] the firm with resources otherwise unavailable from firm management"[167] and as "[l]inkages with critical external constituents [outside directors] serve as a buffer between the organization and its operating environment."[168]

The advantages of diversity to some extent outweigh the advantages of group cohesion when the group's function is to monitor some of its own members as required by the manager-monitoring function of the board and when the purpose of manager-monitoring and relational monitoring is to have members on the board who will expose the corporation to differing perspectives. Moreover, the selection and socialization of board members assures cohesion on

---

165. Jerry Goodstein et al., *The Effects of Board Size and Diversity on Strategic Change*, 15 STRATEGIC MGMT J. 241, 243 (1994).

166. Daily & Schwenk, *supra* note 161, at 191.

167. *Id.* at 194.

168. *Id.* This conceptual study surmises that board composition is explained by reliance on resource dependence requirements and the concentration of share ownership. *See id.* at 199. This study also proposes that, irrespective of board composition, more successful corporations facing more complex operating environments, such as corporations more extensively diversified or more highly globalized, are more likely to have heterogeneous management teams. *Id.* at 196. By contrast, homogeneous management teams are more congruent with a relatively narrow strategic focus, low globalization, and low informational requirements. *Id.* It seems that more highly diversified and highly globalized corporations would have more resource dependence requirements, requiring more outside directors. *Id.* Thus, outsider/insider board composition may similarly relate to the complexity of the corporation's environment. *Id.* at 196-97. Moreover, the study's additional proposition that an insider board is more effective, for the short term, when the corporation is in crisis or dealing with substantial organizational change and transition is consistent with the upper-echelon literature's concern with the effect of time pressures on the relative benefits of heterogeneity/homogeneity. *See id.* at 199.

corporate boards, often to a degree that interferes with the effective performance of the relational and manager-monitoring functions of boards. Conformity on boards has been well documented.[169] Time pressures on the board, of course, increase the importance of cohesion, although boards generally operate with fewer time constraints than management. Moreover, the possible need to resolve such time-constrained issues by negotiation and compromise, rather than by consensus, is offset by the advantage of having diverse perspectives aired on issues and the subsequent enhanced oversight that the compromise is likely to receive from diverse board members.[170]

Other socio-psychological factors observed in groups, such as *polarization*, *egocentrism*, and the *confirmation bias*, may also point toward the advisability of heterogeneity on corporate boards of directors. Group polarization is "the tendency for groups to take more extreme positions following group discussion than the positions originally held by individual members."[171] Thus, group discussions can lead to more risk averse or more risky decisions. The degree of initial consensus, however, affects the polarization dynamic. That is, "group polarization represents intensification of preexisting initial group preferences."[172] Heterogeneity in groups decreases polarization or depolarizes attitudes and opinions of the group.[173] For example, one study found that groups composed of members who initially unanimously agreed were more extreme than groups in which only a majority of the group initially agreed.[174] The normative and informational influences operating in groups result in a reduction of

---

169. *E.g.*, Dallas, *supra* note 22, at 108-11.

170. *See supra* note 159 and accompanying text.

171. Steve Williams & Robert J. Taormina, *Unanimous Versus Majority Influences on Group Polarization in Business Decision Making*, 133 J. SOC. PSYCHOL. 199 (1993); *see also* BARON ET AL., *supra* note 130, at 73-75 (exploring the intensification of group opinion in discussion). Another decision-making bias that is referred to as the compromise effect or extremism aversion may dictate against heterogeneous groups when diverse members are expected to suggest irrelevant alternatives. This bias could also contribute to depolarization when all alternatives are relevant. The compromise effect refers to the observed tendency of persons to avoid extremes and to find a compromise position among given alternatives. The context for decision making is important. That is, how choices are framed. Thus, an element of strategy is added to group decision making where members, by suggesting irrelevant alternatives, can manipulate the group to reach their desired outcomes. *See* Mark Kelman et al., *Context-Dependence in Legal Decision Making*, *in* BEHAVIORAL LAW AND ECONOMICS 62-64 (Cass R. Sunstein ed., 2000); Cass R. Sunstein, *Behavioral Law and Economics: A Progress Report*, 1 AM. L. & ECON. REV. 115, 135-36 (1999).

172. BARON ET AL., *supra* note 130, at 73.

173. *See* Schulz-Hardt et al., *supra* note 123, at 656; Williams & Taormina, *supra* note 171, at 203.

174. Williams & Taormina, *supra* note 171, at 203.

polarization when initial opinions differ and are voiced because disagreements create "ambiguity as to the correctness and social desirability" of group members' initial inclinations.[175] Thus, the polarization effect is less likely in heterogeneous groups.

An individual decision-making bias that may affect group decision making is egocentrism. Egocentrism is a form of bounded rationality and refers to the tendency of individuals to assume that others are more like them than is actually the case.[176] This bias creates difficulties when decision makers decide issues in which they must assess the preferences and perspectives of others, such as decisions involving employees and consumers. Thus, having heterogeneous groups that include members who actually have the diverse perspectives and sets of values that the group is trying to assess can improve the quality of the group's decision making.

Another decision-making bias is the confirmation bias. The confirmation bias refers to the observed tendency of group members to seek information that confirms their initial opinions.[177] Members are unlikely to agree initially in heterogeneous groups and, thus, such groups are less likely to engage in biased search processes. The confirmation bias is less apparent in heterogeneous groups in which divergent views are held at least until the search process begins.[178]

---

175. *Id.*

176. For an extended discussion of the tendency to overestimate that one's own perspectives and knowledge is shared by others, see Nickerson, *supra* note 131, at 738-41, 747. Nickerson also discusses studies on the related "false consensus effect" in which people view their "own knowledge, beliefs, attitudes, and actions as more representative of those of others than they really are." *Id.* at 749-50.

177. *See generally* J. Edward Russo et al., *The Distortion of Information During Decisions*, 66 ORG. BEHAV. & HUM. DECISION PROCESSES 102 (1996) (developing preference for one alternative led to distortion of information favoring that alternative); Schulz-Hardt et al., *supra* note 123, at 666; Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CAL. L. REV. 1051, 1093 (2000) ("[W]hen experimental subjects were given factual evidence about the effects of the death penalty, subjects identified as proponents of capital punishment said the evidence reinforced their prior beliefs, while subjects identified as opponents of capital punishment said that the [same] information reinforced their prior beliefs." (citing Charles G. Lord et al., *Biased Assimilation and Attitude Polarization: The Effects of Prior Theories on Subsequently Considered Evidence*, 37 J. PERSONALITY & SOC. PSYCHOL. 2098, 2102 (1979)). *But see* Helmut W. Crott et al., *The Process of Inductive Inference in Groups: The Use of Positive and Negative Hypothesis and Target Testing in Sequential Rule-Discovery Tasks*, 75 J. PERSONALITY & SOC. PSYCHOL. 938 (1998) (exploring the value and limits in the use of the positivity heuristic or the confirmation bias).

178. Schulz-Hardt et al., *supra* note 123, at 655, 666. Schulz-Hardt notes that the confirmation bias may, however, not appear when the group perceives its task as judgmental rather than problem-solving. *Id.* at 667.

Heterogeneous groups are also less prone to overconfidence.[179] Heterogeneity in groups can, therefore, contribute to the quality of decision making through improving the informational search process.[180]

C. Diverse Boards and the New Managerialism

Diverse boards of directors have the potential to counter the new managerialism by focusing the enterprise not only on stock price, but also on the perspectives of lower-level employees and consumers. While institutional investors have incentives to support diverse boards as evidenced by their sponsorship of some shareholder board-diversity proposals, they are more susceptible than diverse directors to the stock-price rhetoric of managers. As previously explained, diverse directors have the potential to improve the monitoring capacity of the board and the quality of its decision making.

Moreover, as previously noted, various socio-psychological factors may discourage the use of expertise. A critical mass of women or minority directors, which does not exist on current corporate boards of directors, may be necessary to assure the actual expression of their diverse perspectives.[181] In addition, selection processes, socialization

---

179. The overconfidence bias refers to an unrealistic optimism in understanding risk-related facts. *See* Sunstein, *supra* note 171, at 136-37. Sniezek finds that her information processing theory "predicts a decrease in confidence but an improvement in decision quality if there is variance in the information held by group members [heterogeneity] and all information is shared and processed." Janet A. Sniezek, *Groups Under Uncertainty: An Examination of Confidence in Group Decision Making*, 52 ORG. BEHAV. & HUM. DECISION PROCESSES 124, 149 (1992).

180. An evaluation of the effect of the confirmation bias depends on normative views as to decision-making processes. For example, some scholars claim that "preventing indecisiveness by immediately bolstering confidence and focusing on the opportunities of the preferred alternative often far outweigh the risk of overlooking serious disadvantages of the preferred alternative." Schulz-Hardt et al., *supra* note 123, at 667. A functional perspective would hold that decision making involves divergence and convergence phases with heterogeneous groups providing advantages during the divergence phase when alternatives need to be explored and homogeneous groups supplying advantages during the convergence phase when commitment and confidence in the alternative chosen is most desirable. *Id.* at 666-67.

181. Studies of corporate boards of directors that seek to correlate gender and ethnicity to corporate performance are not very useful because most corporate boards, which contain twelve members on average, usually have only one female or minority member who is unlikely to be able to influence significantly board decision making. One study of 240 nonprofit YMCA boards found that gender diversity was positively associated with an organization's ability to fulfill its social agency mission and had no relationship with the organization's operating efficiency. Julie I. Siciliano, *The Relationship of Board Member Diversity to Organizational Performance*, 15 J. BUS. ETHICS 1313, 1317 (1996). The study found a negative association between higher percentages of female directors and fundraising

factors, and situational factors may tend to produce like-mindedness and similar behaviors among board members.[182] Women and

by the YMCA, which suggests, according to the researcher, that "women may not have access to needed economic, social and political resources, which may have influenced their success in the fundraising arena." *Id.* at 1319.

182. Schulz-Hardt refers to the "principle of similarity" whereby group formation is guided by the similarity among members. *See* Schulz-Hardt et al., *supra* note 123, at 667. Studies find in-group biases in minimal groups formed by arbitrary assignments of members to them. *See* Dallas, *supra* note 22, at 128-29. Concerning situational factors, there has been considerable research in the area of managerial leadership styles of males and females. Some studies support psychological theories that emphasize "the different outlook, attitudes and values inculcated in men and women during their development and socialization." MARY C. GENTILE, MANAGERIAL EXCELLENCE THROUGH DIVERSITY 30 (1996). Other studies support situational theories that argue "gender differences are few, and largely an artifact of differences in opportunity, power, and lack of representation in business and organizational settings." *Id.*; *see also* JEAN LIPMAN-BLUMEN ET AL., WOMEN IN CORPORATE LEADERSHIP: REVIEWING A DECADE'S RESEARCH 39 (1996). One writer summarizes the research as follows:

> A review of studies conducted in the 1980s concluded that there was little "hard" evidence for the "male" task-orientation or for the "female" relationship-orientation. These studies also failed to produce evidence of gender differences in motivational factors. There was evidence, however, that men and women tended to differ in their choice of influence strategies: Men appeared more likely than women to exercise influence based on the power of their position and tended to rely on promises and threats significantly more than women; women, by contrast, seem to be more likely to use sources of influence based on personal relationships and to rely on internal indirect influence strategies."

GENTILE, *supra*, at 33 (citing G.N. Powell, *One More Time: Do Female and Male Managers Differ?*, 4 ACAD. MGMT. EXEC. 68 (1990)). In terms of leadership styles, see also LIPMAN-BLUMEN ET AL., *supra*, which explains:

> In a 1990 comprehensive meta-analysis of 162 studies, Eagly and Johnson analyzed two commonly-tested, paired dimensions of leadership: autocratic versus democratic style and task-oriented versus interpersonally-oriented style . . . . Eagly and Johnson found that although female leaders were, indeed, slightly more interpersonally-oriented, they were also somewhat more task-oriented than their male counterparts. In accordance with gender stereotypes, however, men were more autocratic, while women displayed more democratic leadership behavior.

LIPMAN-BLUMEN ET AL., *supra*, at 40-41 (discussing Alice H. Eagly & Blair T. Johnson, *Gender and Leadership Style: A Meta-Analysis*, 108 PSYCHOL. BULL. 233 (1990)).

Eagly and Johnson found that leadership styles in experimental settings were more gender stereotypic than in organizational settings where, however, they found women's leadership styles were more democratic than men's. Eagly & Johnson, *supra*, at 249. According to Eagly and Johnson, these differences may reflect "differences in female and male personality or skills (e.g., women's superior social skills) or subtle differences in the status of women and men who occupy the same organizational role." *Id.* For motivations of female and male managers, see LIPMAN-BLUMEN ET AL., *supra*, at 41-42; Leonard H. Chusmir, *Gender Differences in Variables Affecting Job Commitment Among Working Men and Women*, 126 J. SOC. PSYCHOL. 87, 91 (1985); Leonard H. Chusmir, & C.S. Koberg, *Creativity Differences Among Managers*, 29 J. VOCATIONAL BEHAV. 240 (1986).

Chusmir and Koberg explain:

minorities are not immune to these influences. Sex and minority status may also provide a poor proxy for representation of employee and consumer interests on corporate boards.[183] It is important to note, however, that there is evidence that women on corporate boards are not tokens solely to serve public relations purposes.[184] Although even if women and minorities are sometimes on corporate boards for public relations or co-optation reasons, their presence nevertheless has the potential for providing more diverse perspectives on corporate boards of directors. More importantly, the evolving importance placed on diverse boards may indicate that it is time for U.S. corporations to consider stakeholder representation (e.g., employee-elected directors) on U.S. corporate boards.

VII. CONCLUSION

Historically, U.S. corporation law has legitimized the interests of shareholders in controlling the corporation as owners of the corporation. Various formal legal and informal social, political, and economic factors have contributed, however, to a corporate governance system dominated by managers. The system has provided managers with professional opportunities and incentives that encouraged managers to assure the long-term stability and growth of their corporations. Nonshareholder stakeholders often benefited from these objectives, although these objectives were sometimes pursued at the expense of profits and dividends for shareholders.

The tender offer phenomena of the 1980s, to some degree, disrupted this formal and informal system. Legally, state legislatures passed constituency statutes and tender offer cases that permitted managers to exercise their discretion to benefit nonshareholder stakeholders. However, probably more salient to corporate managers

---

> Chusmir's research revealed that managerial women had higher achievement needs than male managers, similar affiliation needs, and higher power needs. . . . Here, too, however, these findings are not consistent with other studies. Chusmir and Koberg, while testing for creativity differences between 96 male and 69 female managers, found different motivations. . . . [M]ale managers had higher power and achievement needs. Men's affiliation needs, however, were equivalent to their female counterparts'. Interestingly, the women's need for affiliation predicted their level of creativity, while men's creativity was predicted by their need for achievement.

LIPMAN-BLUMEN ET AL., *supra*, at 41-42.

183. A labor orientation, however, may explain the presence of more minority representatives on the corporate boards of service industries such as motels, restaurants, telephone, and airlines. Fryxell & Lerner, *supra* note 95, at 345-46.

184. *See supra* note 108 and accompanying text.

in terms of legal developments were court decisions that in sale of control situations constrained, rather than broadened, the discretion of managers and required them to maximize shareholder value. To maximize stock price was the ultimate legal message. Moreover, this message was brought home by the felt power of institutional investors. The tender offer phenomena was applauded and made possible by the consent of increasingly powerful institutional investors whose power was enhanced by the increasing mobility of capital in a global marketplace, and by corporate raiders and financial intermediaries. The result was a cultural change in which the corporate governance system became more emphatically stock-value driven.

The corporate landscape for managers today includes the potent political and economic presence of institutional investors. A "new" managerialism has arisen that consists of short-term decision making and financial manipulations to impress the stock market at the expense of improving underlying corporation values. That is, there is a dark side to shareholder primacy. Managerial decisions are made that are neither in the interests of shareholders nor other corporate constituencies.

Diversity on corporate boards is responsive to the increasing focus on shareholder value and the demands of globalization. The presence of women, minorities, and nonnationals on corporate boards of directors is sought as providing a means for corporations to relate to employees, consumers, and other cultures. There is mixed support for heterogeneity in groups. Heterogeneous groups tend to make higher quality decisions in matters involving creative and judgmental decision making. For problems that have verifiably correct answers, heterogeneity is an advantage to the extent that it increases the likelihood that a member will have the necessary expertise or experience. There is also the issue as to whether certain background characteristics, such as sex and ethnicity, are valid proxies for differing perspectives. Time demands facing the group may also affect the assessment of the benefits of heterogeneity. Also, a variety of socio-psychological factors affect actual decision making in the group. The use of expertise is often contingent on such factors as whether others in the group shares the member's perspectives, the status of the member within the group, and the leadership style of the group's leader. A mixture of experts and novices in the group may also affect the use of expertise. Moreover, the degree of attraction or cohesion among group members may affect the effort members expend and their tenure with the group. Group effort norms may also play a role in the quality of decision making by the group.

The manager-monitoring and relational roles of corporate boards of directors point to the importance of diverse perspectives on corporate boards of directors. Cognitive conflict is clearly useful to effective manager-monitoring. Moreover, diverse perspectives counter decision-making biases such as group polarization, egocentrism, and the confirmation bias. They also decrease reliance on only "shared" information and encourage broader information search processes. In addition, the relational role of the board takes on particular importance as decision making becomes more complex and as the marketplace becomes more global. The presence of diverse directors who are able to present the perspectives of nonshareholder stakeholders has the potential to reign in the new managerialism. However, a number of factors interfere with this potential, such as the selection of directors by shareholders, rather than nonshareholder stakeholders; the socialization process on corporate boards of directors that may encourage conformity to the majority view; the strength of the shareholder primacy norm; the few women, minorities, and nonnationals on corporate boards of directors; and the issue as to whether the "diverse" directors selected by existing director selection processes represent diverse perspectives, such as those of employees and consumers.

***