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# The Demythification of the Board of Directors

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## Introduction

In the debate over corporate governance, the relationship between shareholders and directors rests at the epicenter. Management has a legal obligation to act in the best interests of shareholders but sometimes does not.[1] Shareholders have an interest in overseeing the actions of management but often cannot.[2]

Reforms designed to address these issues frequently take the form of structural changes to the board. In the aftermath of Enron, the stock exchanges mandated the use of audit, compensation, and nomination committees, and limited membership to independent directors,[3] thereby

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[1]Udi Hoitash, *Should Independent Board Members with Social Ties to Management Disqualify Themselves from Serving on the Board?*, 99 J. Bus. Ethics 399, 401 (2011) ("boards are responsible for overseeing and controlling company's management and, by doing so, reduce management's propensity to act in their own best interests").

[2]For a discussion of the problems associated with shareholder oversight, including those arising out of collective action concerns, see J. Robert Brown, Jr & Sandeep Gopalan, *Opting Only in: Contractarians, Waiver of Liability Provisions, and the Race to the Bottom*, 42 Ind. L. Rev. 285, 312–14 (2009).

[3]The stock exchanges define director independence. *See, e.g.,* NYSE Manual 303A.02, *available at* http://nysemanual.nyse.com/LCMTools/PlatformViewer.asp?searched=1&selectednode=chp%5F1%5F4%5F3%5F1&CiRestriction=303A&manual=%2Flcm%2Fsections%2Flcm%2Dsections%2F (last visited Oct. 31, 2014). State law also defines director independence. The definition is contextual and depends upon the identity of the interested party in the transaction. *See* J. Robert Brown, Jr., *Disloyalty Without Limits:*

excluding management.[4] Boards of listed companies were required to have a majority of independent directors.[5] Congress in the Sarbanes-Oxley Act[6] all but ordered the inclusion of financial expertise on the board[7] and imposed mandatory standards for audit committees of listed companies.[8] Dodd-Frank took a similar approach to compensation committees[9] and tightened the definition of independent director.[10]

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*"Independent" Directors and the Elimination of the Duty of Loyalty*, 95 KY. L.J. 53, 60 n.37 (2006–07).

[4]*See* Exchange Act Release No. 47672 (Apr. 11, 2003). The rules limit membership on these committees to independent directors. *See* NYSE MANUAL, *supra* note 3, at 303A. As a result, the chief executive officer (CEO) is excluded from the committee. The committees are not, however, prohibited from consulting with management in making their decisions.

[5]*See* NYSE MANUAL, *supra* note 3, at 303A.01 (requiring exchange traded companies to have a majority of independent directors). *See also* NASDAQ LISTING RULE 5605(b), *available at* http://nasdaq.cchwallstreet.com/NASDAQTools/PlatformViewer.asp?selectednode=chp%5F1%5F1%5F4%5F3&manual=%2Fnasdaq%2Fmain%2Fnasdaq%2Dequityrules%2F (last visited Oct. 31, 2014).

[6]Sarbanes-Oxley Act of 2002, Pub. L. No. 107–204, 116 Stat. 745 (2002) (codified at 15 U.S.C. §§ 7201–7266 (2012)) [hereinafter SOX].

[7]SOX requires the use of a financial expert or an explanation why one was not used. *See* SOX § 407. The Securities Exchange Commission (SEC) implemented the requirement in Item 407(d)(5) of Regulation S-K, 17 C.F.R. § 229.407(d)(5) (2014). For a discussion of the provision, see J. Robert Brown, Jr., *Corporate Governance, the Securities and Exchange Commission, and the Limits of Disclosure*, 57 CATH. U. L. REV. 45, 74–77 (2007). For a discussion of the importance of board expertise, particularly in the context of financial reporting, see Lawrence A. Cunningham, *The Dysfunctional Board: Causes and Cures: Rediscovering Board Expertise: Legal Implications of the Empirical Literature*, 77 U. CIN. L. REV. 465, 473–98 (2008).

[8]The requirements were implemented in Rule 10A-3, 17 C.F.R. § 240.10a-3 (2014). The requirements apply to listed companies. *Id.* SOX enhanced the monitoring function of the board. *See* Arthur R. Pinto, *An Overview of United States Corporate Governance in Publicly Traded Corporations*, 58 AM. J. COMP. L. 257, 281 (2010) ("In terms of corporate governance, Sarbanes-Oxley tries to increase the monitoring of the business and responsibilities of managers.").

[9]*See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203 § 952, 124 Stat. 1376, 1900–03 (2010) (codified at 15 U.S.C. § 78j-3) (Dodd-Frank)); *see also* Rule 10c-1, 17 C.F.R. § 240.10c-1 (2014).

[10]*See* Rule 10c-1, 17 C.F.R. § 240.10c-1 (2014) (setting out "factors" that board must consider in determine the independence of directors serving on the compensation committee).

These reforms have not always generated the anticipated results.[11] This may occur in part because of an emphasis on structural reform unaccompanied by necessary changes in process.[12] It may also occur, however, because of misconceptions about board behavior.

Two prevailing myths are used to explain board behavior at large public companies.[13] One is the myth that directors of these companies are chosen primarily on the basis of their substantive qualifications. They are not. Companies select directors because of their predisposition toward the policies of management.[14]

Directors have the inherent authority to intervene in corporate affairs, including the right to dismiss top officers. Moreover, in an era of independent directors and heightened shareholder organization, the potential for intervention in corporate affairs has grown.[15] Management, therefore, has a rational incentive to reduce this risk. Ensuring that the board consists of directors who favor the positions taken by the chief

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[11]For example, some thought that the requirement of a financial expert would increase the pool of eligible directors and improve diversity. *See infra* note 281. This has not, however, occurred. *See infra* note 282.

[12]For a criticism on what has been argued is an over emphasis on structural reform, see Nicola Faith Sharpe, *Informational Autonomy in the Boardroom*, 2013 U. Ill. L. Rev. 1089, 1096–111 (2013).

[13]The analysis in this article focuses on the largest public companies. Much of the data on board structure is taken from the S&P 500 or other similar indexes. *See* Robert Yates & Bimal Patel, *Board Practices: The Structure of Boards at S&P 1500 Companies U.S. 2013 Edition*, Institutional S'holder Servs., Inc. (Feb. 13, 2013) (on file with author) [hereinafter ISS Report] (study consisting of 1461 companies in the "Standard & Poor's 'Super 1500' companies—i.e. companies in the S&P 500, MidCap 400, and SmallCap 600 indices"). In analyzing the evolution of governance practices, setting out a universe of companies is critical. The trends among companies vary, particularly depending upon size. Thus, for example, boards of larger companies are more diverse, see *infra* note 187, are more likely to have adopted a majority vote provision, see *infra* note 47, and are less likely to separate the chair and CEO, see *infra* note 203. The trend toward excluding all insiders from the board except the CEO is most discernable among the largest companies. *See infra* note 201.

[14]*See infra* Part I.A. Concerns over social and personal connections can also arise in connection with directors designated by shareholders. *See In re* Trados Inc. S'holder Litig., 73 A.3d 17, 54 (Del. Ch. 2013) (noting that "[b]ecause of the web of interrelationships that characterizes the Silicon Valley startup community, scholars have argued that 'so-called' 'independent directors' on VC-backed startup boards 'are often not truly independent of the VCs' ").

[15]*See infra* notes 196–97.

executive officer (CEO) can advance the goal.[16] This does not render substantive qualifications irrelevant but does reduce them to a matter of secondary importance.

The other myth is that boards at large public companies perform a meaningful advisory function. Boards are commonly said to both monitor and advise management.[17] Advising, however, increases the risk of intervention in management functions. As a result, while the role may have existed at one time,[18] it is no longer a significant and systematic part of the board's responsibilities.[19] Without an advisory role, the relationship between directors and management loses much of its cooperative appearance and is mostly reduced to oversight and monitoring, activities that can be more accurately characterized as adversarial.[20]

Dispelling these myths explains certain board practices. First is the lack of diversity. The absence of women and minorities is usually attributed

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[16]*See infra* Part I.B.

[17]*See* Olubunmi Faleye et al., *Advisory Directors*, at 1 (Feb. 14, 2013), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1866166 ("Academics and practitioners have long recognized that the primary functions of the board of directors are two-fold: monitoring and advising top management.").

[18]Management may have been more willing to seek advice from the board in earlier eras when directors mostly consisted of officers and other persons with financial ties to the company. *See infra* Part II.A.

[19]*See* Lisa M. Fairfax, *Managing Expectations: Does the Directors' Duty to Monitor Promise More than It Can Deliver?*, 10 U. St. Thomas L.J. 416, 416–17 (2012) ("While it is true that directors can have both a managerial role and a monitoring role over corporate affairs, most directors of today's public corporations are not primarily responsible for managing the day-to-day affairs of the corporation.").

[20]In the corporate lexicon, the term "adversarial" is rarely used and mostly describes some type of actual breakdown in the relationship between directors and management. *See* Martin Lipton & Steven A. Rosenblum, *Election Contests in the Company's Proxy: An Idea Whose Time Has Not Yet Come*, 59 Bus. Law. 67, 81 (2003) ("It should also be noted that the board's monitoring function is hurt when an adversarial relationship develops among the directors or between the directors and management."). As used in this article, however, adversarial describes a structural relationship. *See* Roberta S. Karmel, *Should a Duty to the Corporation Be Imposed on Institutional Shareholders?*, 60 Bus. Law. 1, 9 (2004) (noting that, in the aftermath of SOX, "[a]udit committees and other committees are set up as potential adversaries of management"). *See also* Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. Corp. L. 1, 42 (2002) ("[M]andating complete independence of monitors risks creating an adversarial relationship between insiders and outsiders that may reduce both the efficiency of day-to-day management and the monitors' access to information.").

to an insufficient pool of qualified candidates.[21] Yet when considering the universe of substantively skilled individuals, this explanation has a hollow ring.[22] By focusing on the elevation of reliability over substantive qualifications, however, the lack of diversity is more readily explained. Directors are mostly selected from a pool of candidates notable for their willingness to support management.[23] These categories consist of executive officers and persons with personal and business connections to management. Both lack meaningful diversity.[24]

Demythification also explains the current shift taking place in board structure. Increasingly, the largest public companies have opted for boards that consist entirely of independent directors, with the CEO the only exception.[25] The CEO also typically serves as the chair of the board. Although appearing to benefit shareholders, the structure actually promotes the interests of the CEO by enhancing control over the information flow to independent directors and reducing the risk of board intervention.[26]

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[21]*See infra* note 171.

[22]Women, for example, "accounted for 51.5 percent of all workers in the high-paying management, professional, and related occupations." Women's Bureau, U.S. Dep't of Labor, *Women in the Labor Force: 2010*, http://www.dol.gov/wb/factsheets/Qf-laborforce-10.htm. These positions include 31.9% of all lawyers, 61.3% of all accountants and auditors, and 24.2% of all chief executives. Bureau of Labor Statistics, U.S. Dep't of Labor, *Women as a Percent of Total Employed in Selected Occupations, 2011*, http://www.bls.gov/opub/ted/2012/ted_20120501.htm. With professors, lawyers, and consultants commonly placed on boards, see *infra* note 173, not to mention executives from nonprofits, see *infra* note 199, there are a significant number of qualified minorities and women who could serve on boards. As the Chair of the SEC recently noted,

> Some defenders of the status quo still say that there are not enough qualified women to fill board vacancies at higher rates. I disagree. There is no shortage of highly qualified candidates. And if that is the view of any company, its nominating and governance committees should broaden their searches. The challenge is not a lack of suitable candidates.

Mary Jo White, Chair, Sec. & Exch. Comm'n, *Completing the Journey: Women as Directors of Public Companies* (Sept. 16, 2014), *available at* https://www.sec.gov/News/Speech/Detail/Speech/1370542961053#.VC6OwKzwv_U.

[23]*See infra* Part I.C.

[24]*See infra* notes 177–79 and accompanying text.

[25]*See infra* Part III.B.

[26]*See infra* notes 210–19 and accompanying text.

Concerns with board behavior have resulted in a number of proposed structural reforms. Some have suggested an increase in the number of insiders. Others have sought the transformation of the CEO into an *ex officio* member without voting rights. Reforms also have included proposals to divide directors into those assigned to monitor and those assigned to advise. When examined in the context of a demythicized board, however, these proposals are not likely to yield the anticipated results.[27]

Reliability as a primary criterion for board membership can be reduced. The board has the authority to determine the relevant qualifications for directors and can at any time demote the importance of reliability in selecting nominees. Such a shift, however, is unlikely to occur absent some sort of catalyst.

Two possible catalysts exist. Pressure for reform can come from shareholders. Shareholders have a variety of mechanisms that can be used to encourage boards to reduce the number of directors chosen on the basis of reliability.[28] Inadequate disclosure of personal and business relationships between management and directors, however, hampers these efforts.[29]

State courts and the Securities and Exchange Commission (SEC or Commission) represent a second catalyst. Both have increasingly required the disclosure of personal and business relationships between directors and managers.[30] The consequences of increased disclosure provide an incentive to reduce the number of directors with such relationships.

This article will do several things. As an initial matter, it examines the prevailing myths applicable to board behavior. The article will then discuss the impact of these myths on diversity and board structure. The next section will consider other reform proposals and assess them in the context of a demythicized board. The article will finish by examining the role of shareholders and regulators in reducing the prevalence of reliable directors on the boards of public companies.

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[27] *See infra* Part IV.

[28] *See infra* Part V.A.

[29] *See infra* note 297 and accompanying text.

[30] *See infra* Part V.B.

# I. Myth #1: Directors Are Selected on the Basis of Substantive Qualifications

The general assumption is that directors are selected on the basis of their substantive qualifications.[31] This, however, is a myth. While executive experience and other types of expertise are not irrelevant, directors are selected primarily because of their willingness to support the policies of incumbent management.

## *A. The Need for Reliability*

Although boards are legally responsible for managing the company,[32] the task is in reality assigned to the officers, particularly the CEO.[33] Boards, therefore, mostly play a monitoring role. Broadly speaking, they seek to mitigate CEO overconfidence, prevent shirking, address conflicts of interest,[34] and otherwise ensure that managers act in the best interests of

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[31] *See* Seletha R. Butler, *All on Board! Strategies for Constructing Diverse Boards of Directors*, 7 Va. L. & Bus. Rev. 61, 71 (2012) (describing "a three-prong model for evaluating the best directors in the boardroom: (1) skills and experience; (2) individual attributes; and (3) representative factors"); Michael E. Murphy, *The Nominating Process for Corporate Boards of Directors: A Decision-Making Analysis*, 5 Berkeley Bus. L.J. 131, 170 (2008) (noting that directors "are generally highly qualified individuals"). The SEC requires companies to disclose in the proxy statement the "specific experience, qualifications, attributes or skills" of each director. *See* Item 401(e) of Regulation S-K, 17 C.F.R. § 229.401(e) (2014). Likewise, the nominating committee is required to disclose "any specific minimum qualifications" and "any specific qualities or skills" believed necessary for the board. See Item 407(c)(v) of Regulation S-K, 17 C.F.R. § 229.407(c)(v) (2014). Moreover, the assumption is implicit in much of the analysis of board behavior.

[32] *See* Del. Code Ann. tit. 8, § 141(a) (2014) ("The business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors . . ."); *see also* Model Bus. Corp. Act Ann. § 8.01(b) (2008) ("All corporate powers shall be exercised by or under the authority of the board of directors of the corporation, and the business and affairs of the corporation shall be managed by or under the direction, and subject to the oversight, of its board of directors . . .").

[33] *See* Troy A. Paredes, *Too Much Pay, Too Much Deference: Behavioral Corporate Finance, CEOs, and Corporate Governance*, 32 Fla. St. U. L. Rev. 673, 730 (2005) ("[A]s a corporation's most senior executive, the CEO has far-reaching legal authority under corporate law and agency principles, and a CEO's authority extends further when he is also chairman of the board.").

[34] Jill E. Fisch, *The Overstated Promise of Corporate Governance*, 77 U. Chi. L. Rev. 923, 929 (2010) ("Rather, monitoring boards are likely to provide the most value in deterring managerial self-dealing and responding to crises.").

shareholders.[35] In fulfilling these responsibilities, they will sometimes need to intervene in corporate affairs and reverse or alter the decisions of management.[36] They may also be called upon to dismiss top officials.[37]

The possibility of intervention is both a matter of structure and a consequence of legal obligation. CEOs serve in a manner that must be consistent with the "express desires of the board of directors."[38] Directors in turn are obligated to act in the best interest of shareholders, something that may necessitate the dismissal of the CEO.[39] As a practical matter,

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[35]Marleen A. O'Connor, *The Enron Board: The Perils of Groupthink*, 71 U. Cin. L. Rev. 1233, 1242 (2003) ("[T]heir most important function is to monitor firm performance to prevent managerial self-dealing and shirking."). *See also* Robert Charles Clark, *Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act: A Morality Tale for Policymakers Too*, 22 Ga. St. U. L. Rev. 251, 278 (2005) ("Directors have ongoing fiduciary duties to look out for and to control management behavior that amounts to fraud, theft, excessive pay, extravagance, slack, poor performance, or avoidance of key issues."); James A. Fanto et al., *Justifying Board Diversity*, 89 N.C. L. Rev. 901, 912 (2011) ("A major complaint about public company boards is that . . . they are not active enough in detecting fraud or overreaching."); Lisa M. Fairfax, *The Uneasy Case for the Inside Director*, 96 Iowa L. Rev. 127, 138 (2010) ("The independent director's primary function is to monitor the corporation and its officers with an eye towards ensuring that managers do not abuse their authority by engaging in self-dealing or fraud, or otherwise shirking their responsibilities.").

[36]*See* Ben Worthen & Justin Scheck, *Inside H-P's Missed Chance to Avoid a Disastrous Deal*, Wall St. J. (Jan. 21, 2013), *available at* http://online.wsj.com/article/SB10001424127887323635504578211743521976174.html?mod=WSJ_hp_LEFTWhatsNewsCollection (CEO "proposed buying two midsize software companies. The board's finance committee scotched one, and negotiations to buy the other fell apart over price."). *See also* David Henry & Rick Rothacker, *JPMorgan slashes CEO Dimon's pay on "Whale" trade*, Reuters (Jan. 16, 2013), *available at* http://www.reuters.com/article/2013/01/16/us-jpmorgan-results-idUSBRE90F0PO20130116 ("Jamie Dimon, JPMorgan Chase's Chief Executive, had his 2012 bonus cut in half after the bank's board decided he should shoulder blame for $6.2 billion of 'London Whale' trading losses.").

[37]*See* Stephen J. Lubben, *Separation and Dependence: Explaining Modern Corporate Governance*, 43 Seton Hall L. Rev. 893, 899 (2013) ("Oversight responsibility means the board has the ability to fire managers who misbehave."). Unsurprisingly, management dislikes the function. *See* Faleye et al., *supra* note 17, at 1–2 (noting that "the CEO dislikes board monitoring"). *See also* Frank B. Cross & Robert A. Prentice, *The Economic Value of Securities Regulation*, 28 Cardozo L. Rev. 333, 343 (2006) ("CEOs do not like to be monitored and, generally speaking, they evade serious board scrutiny.").

[38]*In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 774 n. 570 (Del. Ch. 2005).

[39]*See In re* Walt Disney Co. Derivative Litig., 731 A.2d 342, 377 (Del. Ch. 1998), *rev'd on other grounds*, Brehm v. Eisner, 746 A.2d 244 (Del. 2000) (determining that board's decision to terminate president of company was "protected by the business judgment rule").

however, intervention is discretionary.[40] Boards determine when shareholders benefit from the veto of a decision or the replacement of the CEO.[41]

### *B. Reliability and Control over the Nomination Process*

Ensuring that the board includes directors who reliably support management reduces the risk of intervention.[42] These directors are less likely to second-guess or dismiss the CEO. Ensuring reliability begins with influence over the director nomination process.

With respect to the governance of public companies, directors, not shareholders, determine board composition.[43] Under the plurality system of voting,[44] nominees chosen by the board are guaranteed reelection

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[40]In addition, directors have a structural disincentive to intervene. *See* Paredes, *supra* note 33, at 730 ("[O]utside directors face only a slight risk of legal liability under state corporate law for failing to satisfy their responsibility to act with due care, even when they are relatively passive and essentially go along with management's recommendations for the business. Accordingly, there is little upside if directors oppose or even seriously challenge the CEO, and yet there are downside risks for doing so.").

[41]*See* Klaassen v. Allegro Dev. Corp., C.A. Case No. 8626–VCL (Del. Ch. 2013) ("Often it is said that a board's most important task is to hire, monitor, and fire the CEO.").

[42]*See* Kathy Fogel et al., *Powerful Independent Directors*, at 20 (European Corp. Governance Inst. Finance Working Paper No. 404, 2014), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2377106 (findings suggest that "reforms to the director nomination and selection processes and boards might be evaluated, in part at least, for their propensity to screen out 'yes men' while protecting legitimate CEO discretion"). Evidence indicates that directors more likely to intervene are less likely to be appointed to the board. *See* Anil Shivdasani & David Yermack, *CEO Involvement in the Selection of New Board Members: An Empirical Analysis*, 5 J. Fin. 1829, 1829 (1999) (evidence "consistent with the idea that independent directors, who are more likely to monitor the CEO, are appointed less frequently when the CEO is involved in director selection").

[43]Charles M. Elson, *The Duty of Care, Compensation, and Stock Ownership*, 63 U. Cin. L. Rev. 649, 656 (1995) ("The board of directors, theoretically composed of representatives of various shareholding groups, is instead peopled by individuals selected by management.").

[44]*See* Del. Code Ann. tit. 8 § 216(3) (2014) ("Directors shall be elected by a plurality of the votes of the shares present in person or represented by proxy at the meeting and entitled to vote on the election of directors."). In the plurality voting system, no votes are irrelevant. *See Spotlight on Proxy Matters—The Mechanics of Voting*, Sec. & Exch. Comm'n, *available at* http://www.sec.gov/spotlight/proxymatters/voting_mechanics.shtml (last modified May 23, 2012) ("A "plurality vote" means that the winning candidate only needs to get more votes than a competing candidate. If a director runs unopposed, he or she only needs one vote to be elected, so an "against" vote is meaningless. Because of this, shareholders have the option to

unless shareholders run a competing slate of directors, something that is rare,[45] particularly among the largest public companies.[46] The advent of majority vote provisions has not changed this dynamic.[47]

CEOs invariably serve on the board and are in a position to exert influence over the nomination process.[48] Indeed, some have encouraged their involvement in the process.[49] An example of the common nature of such influence occurred during the 2011 election of directors at Hewlett Packard. Five candidates for the board were "identified by an ad hoc

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express dissatisfaction with a candidate by indicating that they wish to "withhold" authority to vote their shares in favor of the candidate.").

[45]*See* Lucian A. Bebchuk, *Essay: The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 682–87 (2007) (discussing the infrequency of proxy contests). *See also 2013 Proxy Season Review: United States*, Institutional S'holder Servs., Inc., at 47 (Aug. 22, 2013), http://www.ecgi.org/tcgd/2013/documents/United%20States%20Postseason%202013.pdf (nineteen proxy contests in the first six months of 2012 and twenty-four in the first half of 2013). For a discussion of limitations imposed on the ability of shareholders to nominate directors, see Lawrence A. Hamermesh, *Director Nominations*, 39 DEL. J. CORP. L. 117, 136–48 (2014).

[46]Of the twenty-four proxy contests commended in the first half of 2013, eight were at companies with market capitalization above $1 billion. *See 2013 Proxy Season Review*, *supra* note 45, at 47. Only two of the companies—Hess Corp. and International Game Technology—were in the S&P 500. *See id*. at 48 (providing a table of all proxy contests).

[47]These provisions have become common among large public companies. *See* ISS Report, *supra* note 13, at 14 ("A significant majority (78 percent) of S&P 500 companies now have a majority vote standard for uncontested board elections."). In general, they require directors failing to receive a majority of votes cast to tender a letter of resignation. The board may and often does not accept the resignation. *See* J. Robert Brown, Jr., *The Myth of Majority Vote Provisions*, RACE TO THE BOTTOM (May 27, 2009, 6:00 AM), http://www.theracetothebottom.org/shareholder-rights/the-myth-of-majority-vote-provisions.html.

[48]Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 811 (2001) ("Boards self-select, often with strong input from the chief executive officer."). *See also* Fairfax, *supra* note 35, at 158 ("In fact, studies reveal that CEOs often dominate the director-nomination process, causing directors to feel beholden to CEOs."). CEO involvement in the director selection process is nothing new. Involvement apparently coincided with the separation of ownership and management. Tamar Frankel, *Corporate Boards of Directors: Advisors or Supervisors?*, 77 U. CIN. L. REV. 501, 505 (2008) ("With dispersed shareholder population, the CEOs began to choose the Board members rather than the reverse.").

[49]*See* John F. Olson & Michael T. Adams, *Composing a Balanced and Effective Board to Meet New Governance Mandates*, 59 BUS. LAW. 421, 449 (2004) (recommending that, in selecting directors, boards should "*involve* the CEO and other board members and, importantly, shareholders in the selection process."). *See also infra* note 51 and accompanying text.

committee of directors" that included the CEO.[50] In defending the involvement of the CEO, the board chair relied in part on the ubiquitous nature of the practice. According to a letter to shareholders, "most if not all, other companies, large and small, public and private, involve the CEO in the identification and vetting process for new director candidates."[51]

With the CEO often said to have "hand-pick[ed]" the board,[52] attempts have been made to reduce this influence. Stock exchanges require listed companies to employ nominating committees[53] that consist entirely of independent directors.[54] The CEO cannot, therefore, serve as a

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[50]Hewlett-Packard Co., Proxy Statement, at 20 (Feb. 1, 2011), *available at* http://www.sec.gov/Archives/edgar/data/47217/000104746911000421/a2201545zdef14a.htm.

[51]*See* Letter from Raymond J. Lane, Chairman of the Board, Hewlett-Packard Co., Mar. 10, 2011, *available at* http://www.sec.gov/Archives/edgar/data/47217/000110465911013713/a11-7793_1defa14a.htm. The directors recommended by the committee and approved by the nominating committee were elected. *See* Hewlett-Packard Co., Current Report (Form 8-K) (Mar. 23, 2011), *available at* http://www.sec.gov/Archives/edgar/data/47217/000004721711000007/form8-k_032811.htm. For additional analysis on this matter, see J. Robert Brown Jr., *The Myth of an Independent System for Nominating Directors*, Race to the Bottom (Mar. 17, 2011, 9:00 AM), http://www.theracetothebottom.org/shareholder-rights/the-myth-of-an-independent-system-for-nominating-directors-a-4.html (noting that the committee consisted of the CEO and three nonemployee directors and that their task was to assist in the identification of new director candidates and to facilitate the process of evaluating those candidates as potential directors).

[52]*See* Michael B. Dorff, *Softening Pharaoh's Heart: Harnessing Altruistic Theory and Behavioral Law and Economics to Rein in Executive Salaries*, 51 Buff. L. Rev. 811, 845 (2003) ("in many cases the CEO will effectively hand-pick the board of directors, and will almost always exercise a great deal of influence on the selection process").

[53]*See* NYSE Manual, *supra* note 3, at 303A.04. The committee is responsible for identifying "individuals qualified to become board members, consistent with criteria approved by the board, and to select, or to recommend that the board select, the director nominees for the next annual meeting of shareholders . . ." *Id.* at 303A.04(b)(i). The use of nominating committees had long been encouraged by the SEC. *See* J. Robert Brown, Jr., *The SEC, Corporate Governance and Shareholder Access to the Board Room*, 2008 Utah L. Rev. 1339, 1358–62 (2008).

[54]Only independent directors may serve on the committee. *See* NYSE Manual, *supra* note 3, at 303A.04. *See also* Exchange Act Release No. 48745, 81 SEC Docket 1586 (Nov. 4, 2003) ("The Commission believes that directors that are independent of management are more likely to support the nomination of qualified, independent directors . . ."). The requirement was not universally supported at the time of adoption. *See* Exchange Act Release No. 47672, *supra* note 4, at 23 ("Approximately one-fifth of the commenting companies thought that nominating committees should not have to consist solely of independent directors, some arguing that a majority of non-management directors would be sufficient, some requesting that at least one insider be allowed on the nominating committee.").

voting member.[55] As a mechanism for reducing influence, however, the approach has been unsuccessful.[56] Although not a member, the CEO retains the ability to consult with the committee,[57] submit nominees,[58] and veto objectionable candidates.[59]

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[55]Until the adoption of this requirement, CEOs could sit on the nominating committee. One study during this period noted that almost half of the Fortune 500 companies permitted the CEO to sit on the nominating committee or allowed the nomination function to be handled by the full board, including the CEO. *See* Shivdasani & Yermack, *supra* note 42, at 1833–834 (noting that CEO sat on the nominating committee at twenty-five percent of the companies studied or on the full board in the twenty-two percent of the companies that had no compensation committee). Moreover, the statistics likely did not fully capture CEO influence. *Id.* at 1835 ("We suspect our variable indicating CEO involvement in director selection is underinclusive, because many board nominating committees may solicit advice from or simply ratify choices suggested by a CEO who is not a committee member.").

[56]*See* O'Connor, *supra* note 35, at 1245 ("[D]espite nominating committees that consist entirely of independent directors, these committees are sympathetic to the CEO's views about the 'right type of person' to serve as a director."). *See also* Murphy, *supra* note 31, at 148 (2008) ("It is clear that CEO's may have the dominant voice in the nominating process even if not included in the membership of a nominating committees composed of independent directors."); Lucian Arye Bebchuk et al., *Executive Compensation & Takeovers: Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. Chi. L. Rev. 751, 767 (2002) ("And even when the CEO does not sit on the nominating committee, his influence on the nomination process is still generally thought to be considerable. The CEO can use his power and influence to encourage the appointment and reappointment of independent directors who are not likely to challenge his compensation.").

[57]Fairfax, *supra* note 35, at 159 ("notwithstanding the creation of independent nominating committees, evidence reveals that CEOs continue to influence the director-nomination process through informal consultations and recommendations of directorial candidates").

[58]Carl T. Bogus, *Excessive Executive Compensation and the Failure of Corporate Democracy*, 41 Buff. L. Rev. 1, 34 (1993) (survey from 1989 finding that "the CEO initially recommended 90–100% of all directorial nominees"). Recognizing this dynamic, the SEC supplemented the listing standards by requiring companies to disclose the source of any nominee, particularly those submitted by the CEO. *See* Item 407 of Regulation S-K, 17 C.F.R. § 229.407(c)(2)(vii) (2014). Some argued that this requirement would have a "chilling effect" on the nominating process. *See Disclosure Regarding Nominating Committee Functions and Communications Between Security Holders and Boards of Directors*, Exchange Act Release No. 48825, 81 SEC Docket 2135 (Nov. 24, 2003). These disclosure requirements do not, however, capture the entirety of the CEO's influence over the nomination process. Fairfax, *supra* note 35, at 159 (disclosure requirements did not apply to influence exercised "through informal consultations"). *See also* Langevoort, *supra* note 48, at 811 ("Boards self-select, often with strong input from the chief executive officer.").

[59]George W. Dent, Jr., *Corporate Governance: Still Broke, No Fix in Sight*, 31 J. Corp. L. 39, 43 (2005) ("CEOs influence if not dominate, the composition and operations of corporate boards. New directors are typically chosen on the CEO's recommendation. Most CEOs can at

Other efforts at limiting CEO influence have focused on the presence of nominees not selected by the board. In 2010, the SEC adopted a rule that would have allowed qualified shareholders to include their nominees in the company's proxy statement, defraying some of the costs associated with the election process.[60] The rule provided an avenue for the nominations that entirely circumvented management's influence. The rule predictably drew rigorous opposition from management[61] and was invalidated by the District of Columbia Circuit before it became effective.[62]

CEO influence over the nomination process is not identical in every company. Moreover, influence has a temporal component. A new CEO often needs time to exert control[63] and alter the composition of the board.[64] Influence over board membership also increases with trust (and

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least veto nominations to the board, and they exclude anyone who might 'rock the boat.'"); *See also* William A. Drennan, *Enron-Inspired Nonqualified Deferred Compensation Rules: If You Don't Know Where You're Going, You Might Not Get There*, 73 Tenn. L. Rev. 415, 499 (2006) ("At a minimum, CEOs have had considerable power to block nominations.").

[60]*See* Rule 14a-11, 17 C.F.R. § 240.14a-11 (2014). *See also Facilitating Shareholder Director Nominations*, Exchange Act Release No. 62764, 99 SEC Docket 694 (Nov. 15, 2010) (adopting release).

[61]*See* Jill Fisch, *The Destructive Ambiguity of Federal Proxy Access*, 61 Emory L.J. 435, 441 (2012) (noting that the SEC adopted rule "in the face of substantial opposition by corporate management").

[62]*See* Bus. Roundtable v. SEC, 647 F.3d 1144, 1148–49 (D.C. Cir. 2011). *See also* J. Robert Brown, Jr., *Shareholder Access and Uneconomic Economic Analysis: Business Roundtable v. SEC*, 88 Denv. U. L. Rev. Online (Sept. 30, 2011), http://www.denverlawreview.org/online-articles/2011/9/30/shareholder-access-and-uneconomic-economic-analysis-business.html (discussing case). Shareholders are nonetheless allowed to submit proposals to the company that would provide shareholders with this authority. *See* Catherine G. Dearlove & A. Jacob Werrett, *Proxy Access by Private Ordering: A Review of the 2012 and 2013 Proxy Seasons*, 69 Bus. Law. 155, 164 (2013). Shareholders adopted two such proposals in 2012 and three in 2013. *See 2013 Proxy Season Review*, *supra* note 45, at 31. In 2014, only a few were submitted to shareholders and none passed. *See* Proxy Monitor 2014 Score Card, Center for Legal Policy, Manhattan Institute, *available at* http://www.proxymonitor.org/ScoreCard2014.aspx (last visited Oct. 31, 2014).

[63]This also can be seen from the trend toward separating CEO and chair during the early years of a CEO's tenure. Once the trial period has ended and sufficient trust established, the two positions are recombined. *See infra* note 203.

[64]*See* Shivdasani & Yermack, *supra* note 42, at 1851 (noting study that argues "CEOs acquire power in director selection over time").

likewise decreases with a lack of trust).[65] Finally, influence is not always direct, with directors aware of the need for a reliable board even absent overt lobbying or pressure.[66]

### *C. Reliability and the Requirement of Independence*

Reliability has traditionally meant the selection of directors with close personal ties to, or subject to economic leverage of, management. Through the 1970s, reliability was established primarily through the nomination of family members and officers of the same company.[67] These individuals had an incentive to favor the policies of the CEO.[68] With the inexorable

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[65]Benjamin E. Hermalin & Michael S. Weisbach, *Boards of Directors as an Endogenously Determined Institution: A Survey of the Economic Literature*, FRBNY ECON. POL'Y REV., at 18 (Apr. 2003), *available at* http://faculty.haas.berkeley.edu/hermalin/601herma.pdf ("After a period of good performance, when a CEO's perceived value relative to a potential replacement is likely to be high, he is able to add more insiders to the board."). *See also* Byoung-Hyoun Hwang & Seoyoung Kim, *It Pays to Have Friends*, 93 J. FIN. ECON. 138, 139 (2009) ("Moreover, the incidence of socially linked directors increases as a new CEO's tenure at the firm progresses, suggesting that CEOs select directors along these social dimensions.").

[66]See Lucian A. Bebchuk & Jesse M. Fried, *Pay Without Performance: Overview of the Issues*, 30 J. CORP. L. 647, 655 (2005) ("Even if the CEO had no influence over nominations, members of the nominating committee would be unlikely to look favorably on an individual who has taken a tough position on the CEO's pay. They might wish to avoid the friction and unpleasantness accompanying disputes over the CEO's pay or might simply side with the CEO. . .").

[67]*See* Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1468 (2007) ("Circa 1950, . . . boards should consist of the firm's senior officers, some outsiders with deep connections with the firm (such as its banker or its senior outside lawyer), and a few directors who were nominally independent but handpicked by the CEO."). *See also* Ephraim P. Smith, *Interlocking Directorates Among the 'Fortune 500'*, 3 ANTITRUST L. & ECON. REV. 47, 47 (1970) (noting that in 1970, study of Fortune 500 companies showed that insiders held 4018 board seats out of a total of 6985 or almost fifty-eight percent of the total). The article described the prototypical board in the Fortune 500 as having fourteen directors, with eight insiders, and the others mostly coming from third parties with ties to the company, including a large bank, an investment bank, a local law firm that often consisted of the company's counsel, and a medium-sized business firm. *Id.* at 48. As boards shifted away from reliance on officers, they increasingly populated boards with "outside" directors. This category included "grey" directors, defined as outside directors with ties to the company. Ties included "family relationships with management." Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism*, 90 NW. U. L. REV. 898, 927 n.153 (1996).

[68]Lisa M. Fairfax, *Board Diversity Revisited: New Rationale, Same Old Story?*, 89 N.C. L. REV. 855, 881 (2011) ("boards or committees comprised of directors with previous managerial experience may have biases in favor of management that could undermine their ability to be

trend toward independent boards,[69] however, reliability increasingly had to coexist with director independence.[70] Traditional categories no longer qualified.[71] As a result, family members and officers of the same company were largely ousted from the board.[72]

The definition of director independence, however, remained sufficiently porous to accommodate the need for reliability.[73] Although family members were excluded, friends and social acquaintances of the CEO[74]

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independent and objective"). *See also* Randall S. Thomas, *Explaining the International CEO Pay Gap: Board Capture or Market Driven?*, 57 Vand. L. Rev. 1171, 1190 (2004) (noting that directors who are retired executives "are predisposed to award the company's executives attractive pay packages because of . . . their background"). The approach has been labeled "dysfunctional deference." Bernard S. Sharfman & Steven J. Toll, *Dysfunctional Deference and Board Composition: Lessons from Enron*, 103 Nw. U. L. Rev. Colloquy 153, 155 (2008) (defined as "extreme deference to management that leads to little or no board deliberation prior to a board decision").

[69]*See* Michael Klausner, *Fact and Fiction in Corporate Law and Governance*, 65 Stan. L. Rev. 1325, 1357–58 (2013) ("From 1950 to 2005, the percentage of independent directors on boards rose from approximately 35% to 70%.").

[70]The same phenomena occur whenever the definition of "independence" is tightened. Doing so reduces the pool of "reliable" and "independent" directors and requires a shift in board composition. *See* Byoung-Hyoun Hwang & Seoyoung Kim, *Social Ties and Earnings Management*, at 2 (Feb. 6, 2012), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1215962 ("The Sarbanes-Oxley Act of 2002 imposed stricter independence criteria on audit committees, resulting in a general decrease in audit committees' conventional affiliation to the CEO. However, of the firms whose audit committees lost conventionally affiliated members, 24% appointed socially affiliated replacements.").

[71]*In re* Walt Disney Co. Deriv. Litig., 731 A.2d 342, 357 (Del. Ch. 1998), *aff'd in part, rev'd in part*, Brehm v. Eisner, 746 A.2d 244 (Del. 2000) (shareholders successfully alleged facts raising "reasonable doubt" that directors who were also officers were independent).

[72]One consequence has been a significant decline in the number of insiders on the board of directors. *See* Gordon, *supra* note 67, at 1468 ("Inside directors are a dwindling fraction; the senior outside lawyer on the board is virtually an extinct species.").

[73]The definition also does not screen for length of service. Other countries view longevity on boards as impairing independence. *See* ISS Report, *supra* note 13, at 22 ("director tenure is considered a factor when determining independence in certain markets but is generally not considered in the United States").

[74]The terms also include relationships that arise out of structural bias, something state courts do not consider. *See* Beam v. Stewart, 845 A.2d 1040, 1047 (Del. 2004).

were not.[75] Moreover, while officers of the same company could not be counted as independent, retired officers[76] or officers of other companies[77] qualified.

Social connections with corporate insiders and employment as an executive can make directors more disposed toward the policies of management. Executive officers may be more reluctant to attribute poor performance or other negative outcomes to management.[78] To the extent favoring less interventionist boards at their own companies, they are more likely to apply this philosophy to their service as a director. Such officers may also benefit from a deferential attitude, particularly with respect to compensation matters.[79]

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[75]*See* Usha Rodrigues, *Let the Money Do the Governing: The Case for Reuniting Ownership and Control*, 9 STAN. J.L. BUS. & FIN. 254, 260 (2004) ("Independent directors are selected by inside directors: personal or professional relationships can create bias, even if not outright conflict of interest.").

[76]Retired executives of the same company are not considered independent until the completion of a three-year waiting period. *See* NYSE MANUAL, *supra* note 3, at 303A.02(b)(i) (director not independent if "[t]he director is, or has been within the last three years, an employee of the listed company").

[77]Except in narrow circumstances involving interlocking executive officers on compensation committees, the definition does not take the director's status as an officer at another company into account in determining independence. *See id.* ("The director or an immediate family member is, or has been within the last three years, employed as an executive officer of another company where any of the listed company's present executive officers at the same time serves or served on that company's compensation committee."). Studies show that boards with interlocks pay higher compensation to the CEO. *See* Hermalin & Weisbach, *supra* note 65, at 18 (according to one study, "CEOs with interlocking boards get paid more than otherwise similar CEOs"). The presence of interlocks cannot be explained through random behavior. *Id.* (discussing study of interlocking directors where "a firm's employee sits on another firm's board and that firm's employee sits on the first firm's board" and, despite the "potential for collusive or quid pro quo behavior" the prevalence of the practice "is too high to be explained by random chance"). *See also* Eliezer M. Fich & Lawrence J. White, *CEO Compensation and Turnover: The Effects of Mutually Interlocked Boards*, 38 WAKE FOREST L. REV. 935, 952 (2003) (describing "mutually interlocking directorships" as "prevalent").

[78]*See* Dennis J. Block et al., *The Role of the Business Judgment Rule in Shareholder Litigation at the Turn of the Decade*, 45 BUS. LAW. 469, 505 n.232 (1990) ("Most [outside directors] are themselves corporate executives, often with firms that do business with the corporation, and thus are unlikely to look favorably on shareholder interference with management generally, or on derivative suits seeking to foist liability on corporate directors.").

[79]Thomas, *supra* note 68, at 1190 ("Board capture leads to high executive pay since these directors, many of whom are current or retired executives themselves, are predisposed to award the company's executives attractive pay packages because of the manner in which they

Likewise personal and other social connections between directors and management can reduce the risk of intervention. Not always susceptible to public scrutiny,[80] these relationships typically have been analyzed through the use of imperfect proxies that likely understate their presence.[81] Data show, however, that the existence of social connections can "undermine active monitoring of the firm"[82] and is associated with negative performance,[83] reduced reliability of reported earnings,[84] greater risks

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are selected (or, once selected, kept on the board), the amount they are paid, and their background."). Current or former executive officers commonly serve on, and chair, the compensation committee. Lisa M. Fairfax, *Sue on Pay: Say on Pay's Impact on Directors' Fiduciary Duties*, 55 Ariz. L. Rev. 1, 43 (2013) ("Directors who are current or former executives are not only most likely to serve on the compensation committee, but are also most likely to chair that committee.").

[80]*See* Hoitash, *supra* note 1, at 419 ("[W]hile I can reveal social ties between board members through their joint work, I cannot observe social ties that are outside of the board room, such as sharing a golf club membership or attending the same social events.").

[81]Analysis in this area has relied upon objectively observable factors that suggest the possibility of social or professional connections. *See* Aiyesha Dey & Xiaohui Liu, *Social Connections, Stock-Based Compensation and Director Oversight*, at 2 (Apr. 3, 2011), *available at* http://muconf.missouri.edu/corporate_governance/abstracts/Session%207%20-%20Dey%20 Conference%20Paper.pdf (studying relationships through examination of "mutual alma mater, military service, employment overlaps, and memberships in social clubs, charities and other similar organizations"). Relationships that have less objective manifestations will not be includes in the analysis.

[82]Erica Beecher-Monas, *Marrying Diversity and Independence in the Boardroom: Just How Far Have You Come, Baby?*, 86 Or. L. Rev. 373, 383 (2007) ("the social connections between even financially independent board members and CEOs can undermine active monitoring of the firm").

[83]Hwang & Kim, *supra* note 70, at 20 ("We also provide suggestive evidence on an economic byproduct of recent regulatory changes requiring that all audit committee members have neither financial nor familial ties to the CEO: the heightened regulation is accompanied by a replacement of conventionally affiliated audit-committee members with socially affiliated ones."). *See also* Dey & Liu, *supra* note 81, at 4 ("[O]ur evidence suggests that increases in social and professional connections between independent directors on the board (and the audit committee) and his/her CEO are associated with decreases in operating performance, value relevance, and accruals quality, and increases in the frequency of restatements and meeting or beating of analysts' forecasts by a small amount.").

[84]Dey & Liu, *supra* note 81, at 29–30 (Social and professional connections "are associated with lower usefulness and reliability of reported earnings numbers (as measured by the value relevance of earnings, accruals quality, earnings restatements and the meeting or beating of analysts' forecasts) as well as lower operating performance."). At least one study has taken the opposite view, concluding that friends on the board can result in improved value for shareholders. Hoitash, *supra* note 1, at 419 ("These findings suggest that ethically, socially tied

of fraud,[85] and higher levels of CEO compensation.[86] Such boards are less likely to dismiss the CEO.[87]

Management, therefore, has an incentive to, and regularly does, place directors from reliable categories on to the boards of public companies.[88] Executive officers are among the most "sought after" category of independent directors,[89] making up about half of those appointed each

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directors can still serve on the board and add value to shareholders."). This article, which is discussed in the Dey & Liu paper, uses a more narrow definition of social ties, looking only at directors and managers who serve together on the same boards.

[85]N.K. Chidambaran et al., *CEO-Director Connections and Corporate Fraud, Not Just Whether You Are Connected but How*, at 31 (Mar. 2012), http://www.sec.gov/divisions/riskfin/seminar/prabhala051712.pdf ("Connections of non-business origins such as those from common alma mater and non-business activities elevate fraud probability.").

[86]Hwang & Kim, *supra* note 70, at 3 ("[W]hen a conventionally and socially independent board is present, the CEO's total compensation decreases, on average, by $3.3 million."). *See also* Hoitash, *supra* note 1, at 419 ("This study finds that, everything else equal, CEO compensation is higher when social ties between management and independent directors exist.").

[87]Hwang & Kim, *supra* note 70, at 3–4 ("We find that, within the subsample of firms with conventionally independent boards, those CEOs whose boards are not conventionally and socially independent exhibit a lower sensitivity of turnover and compensation to performance."). *See also* Breno Schmidt, *Costs and Benefits of "Friendly" Boards During Mergers and Acquisitions*, at 1, 3 (Oct. 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1219102 ("For instance, friendship ties between CEOs and outside board members can impair board members' willingness to discipline the CEO, reducing their true independence."). Some have recommended that these directors be required to disqualify themselves where personal relationships with management can interfere with neutral decision making. *See* Hoitash, *supra* note 1, at 401 ("directors who are socially tied to managers should disqualify themselves from making decisions that pertain to executive compensation, where a clear conflict of interest exists. However, these directors can still serve on the general board or the audit committee without violating the ethical code embedded in their duty.").

[88]In many cases, these categories will overlap and reinforce each other. Executive officers appointed to the board may also be someone from the CEO's social network. As a result, their predisposition comes from more than one source.

[89]Murphy, *supra* note 31, at 175. The trend, however, has been to favor retired executives. *See Spencer Stuart Board Index 2013*, at 3, https://www.spencerstuart.com/~/media/PDF%20Files/Research%20and%20Insight%20PDFs/SSBI13%20revised%2023DEC2013.pdf (last visited Oct. 31, 2014) [hereinafter *Stuart Spencer 2013 Index*]. *Id.* at 9 ("In 2013, 23% of new directors were retired CEOs, COOs, chairmen, presidents and vice chairmen, compared with just 16% in 2012. For the first time, fewer active CEOs than retired CEOs joined S&P 500 boards, 77 versus 79.").

year to the board.[90] Likewise, boards commonly draw from the CEO's social and professional network,[91] something that has been encouraged.[92] When these relationships are taken into account, board independence drops significantly.[93]

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[90]*See Stuart Spencer 2013 Index*, *supra* note 89, at 10 (placing percentage of new independent directors in 2003, 2008, and 2013 who were current or former CEOs or other top officers at fourty-four percent, forty-seven percent, and forty-six percent, respectively). *See also* Jayne W. Barnard, *Narcissism, Over-Optimism, Fear, Anger, and Depression: The Interior Lives of Corporate Leaders*, 77 U. Cin. L. Rev. 405, 406 (2008) ("[A] significant proportion of corporate directors are still current or former CEOs.").

[91]*See* Z. Jill Barclift, *Corporate Governance and CEO Dominance*, 50 Washburn L.J. 611, 617 (2011) ("CEOs often select directors who are not only social and economic peers but also most likely to be generally supportive of them as CEOs."). *See also* Block et al., *supra* note 78, at 505 n.232 ("Outside directors are often friends of high executives in the corporation before becoming directors, and even if not, friendships among directors naturally grow during their tenures on the board."). The same phenomenon has been observed with respect to mutual funds. *See* Alan R. Palmiter, *Mutual Fund Voting of Portfolio Shares: Why Not Disclose?*, 23 Cardozo L. Rev. 1419, 1473 (2002) (quoting ex-CEO of Vanguard Group as saying that "Everybody knows . . . that people come on fund boards because they're friends of the CEO. So they go along with whatever he wants.").

[92]*See* J. Robert Brown, Jr., *Directors and FOCs (Friends of CEO)*, Race to the Bottom (Mar. 19, 2011, 6:00 AM), http://www.theracetothebottom.org/independent-directors/directors-and-focs-friends-of-ceo.html. *See also* E. Norman Veasey, *The Defining Tension in Corporate Governance in America*, 52 Bus. Law. 393, 405–06 (1997) ("Friendship, golf companionship, and social relationships are not factors that necessarily negate independence. . . . [T]here is nothing to suggest that, on an issue of questioning the loyalty of the CEO, the bridge partner of the CEO cannot act independently as a director."). Some companies expressly seek directors from these categories. Sonoco Prods. Co., Proxy Statement, at 14 (Mar. 14, 2014), *available at* http://www.sec.gov/Archives/edgar/data/91767/000119312514098973/d679429ddef14a.htm ("Our Corporate Governance and Nominating Committee recommends to our Board of Directors nominees to fill vacancies on the Board of Directors as they occur, and recommends candidates for election as directors at Annual Meetings of Shareholders. Such candidates are routinely identified through personal and business relationships and contacts of the directors and executive officers."); Synalloy Corp., Proxy Statement, at 9 (Mar. 11, 2014), *available at* http://www.sec.gov/Archives/edgar/data/95953/000009595314000016/synlproxy-2014.htm ("The Nominating/Corporate Governance Committee does not have any specific process for identifying director candidates. Such candidates are routinely identified through personal and business relationships and contacts of the directors and executive officers."). *See also* Heartland Fin. USA, Proxy Statement, at 12 (Apr. 4, 2014), *available at* http://www.sec.gov/Archives/edgar/data/920112/000092011214000016/htlf2014proxyformdef14a.htm (according to compensation/nominating committee, directors should have, among other things, "a significant business and personal relationship with Heartland or its subsidiary banks and share the Company's philosophy, including the same sense of mission, vision and values.").

[93]Hwang & Kim, *supra* note 65, at 139 ("Overall, our results suggest that social ties affect how directors monitor and discipline the CEO and that, consequently, a considerable percentage

The selection of directors primarily from these "reliable" categories has resulted in significant homogeneity on the board.[94] Directors typically have similar backgrounds[95] and overlapping political affiliations.[96] They often attend the same schools[97] and adhere to the same faith.[98] Nor are boards particularly youthful affairs, with the average age of directors[99] and

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of the boards currently classified as independent are substantively not."). *See* Fairfax, *supra* note 35, at 145–52. *See also* Hatice Uzun et al., *Board Composition and Corporate Fraud*, 60 Fin. Analysts J. 33, 42 (2004) ("the presence of outside directors who were not independent because they had business or personal ties to the company significantly increased the likelihood of fraud in the sample").

[94]This gives rise to concern over "groupthink." *See* O'Connor, *supra* note 35, at 1309 ("Empirical studies evaluating the gender composition of small groups found that mixed-gender groups have a higher tendency to avoid group-think, whereas groups composed of one gender have a higher probability of succumbing to this phenomenon."). Studies have increasingly shown that the inclusion of women in the decision-making process alters the way matters are resolved. *See* Pat K. Chew, *Judges' Gender and Employment Discrimination Cases: Emerging Evidence-based Empirical Conclusions*, 14 J. Gender Race & Just. 359, 367 (2011). *See also Women on Top: Does Having More Females in the Boardroom Make a Difference*, Mindful Money (July 14, 2011), http://www.mindfulmoney.co.uk/5529/investing-strategy/women-on-top-does-having-more-females-in-the-boardroom-make-a-difference.html (quoting president of Confederation of Business Industry as saying "Boards are intellectually and socially enriched by the presence of women and consistently more effective through balanced judgment [sic] and opinion in decision-making").

[95]*See* Bryan Ford, *In Whose Interest: An Examination of the Duties of Directors and Officers in Control Contests*, 26 Ariz. St. L.J. 91, 124 (1994) ("Independent directors tend to be drawn from the same social milieu as corporate chief executives. The directors often attend similar schools, belong to the same clubs and charitable organizations, and have similar backgrounds."). *See also* O'Connor, *supra* note 35, at 1263 (noting that Enron directors had common backgrounds that were "conducive to producing a clubby atmosphere in the Enron Boardroom").

[96]*See* O'Connor, *supra* note 35, at 1245 ("[C]orporate boards are quite homogeneous, consisting mostly of white males, in their mid-fifties, who are predominately Protestant and Republican.").

[97]David B. Fischer, *Comment: Bank Director Liability under FIRREA: A New Defense for Directors and Officers of Insolvent Depository Institutions—Or a Tighter Noose?*, 39 UCLA L. Rev. 1703, 1732 (1992) ("these directors attended a comparatively small circle of higher educational institutions").

[98]*Id.* at 1732 ("Whereas Protestants comprise 58% of the American population and Catholics 30%, nevertheless 73% of the nation's major corporate directors are Protestant, and only 18% are Catholic.").

[99]Directors in the S&P 500 are getting older, *see Spencer Stuart 2013 Index*, *supra* note 90, at 3 ("The average age of all directors now reaches nearly 63, versus 60 in 2003."), and extending the retirement age. *Id.* ("boards also are raising their mandatory retirement ages to allow

CEOs[100] roughly the same. As one commentator put it, "[t]hese corporate directors tend to be CEO's themselves . . ."[101]

The emphasis on reliability as a preeminent qualification also explains the seemingly inexplicable gap in the competency and skill set sometimes apparent on boards. The importance of the audit committee's role in oversight of the independent accountant notwithstanding, boards were sufficiently lacking in financial expertise to require congressional intervention.[102] Nor is this necessarily the only substantive gap on boards.[103] And while companies prioritize executive experience, despite its unproven value,[104] evidence suggests that it is often the wrong executive

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experienced directors to serve longer; 88% of boards that have established a mandatory retirement age set it at 72 or older, versus 46% a decade ago").

[100]The average age of CEOs departing from public companies in 2009–10 was sixty-one. Gary Larkin, *The Conference Board CEO Succession Report Now Available*, Conf. Bd. (July 12, 2011, 2:37 PM), http://tcbblogs.org/governance/2011/07/12/the-conference-board-ceo-succession-report-now-available/, but compare ISS Report, *supra* note 13, at 49 ("The average age of study company directors [those in the S&P 500] is 62.1 years for 2012, up slightly from 61.8 years in 2011.").

[101]Fischer, *supra* note 97, at 1732.

[102]*See supra* note 8 and *infra* notes 281–82.

[103]There is no reason to believe that this was the only gap in substantive expertise. *See* Joann S. Lublin, *Wanted: More Directors with Digital Savvy* Wall St. J. (May 14, 2013, 10:27 PM), http://online.wsj.com/article/SB10001424127887324031404578483043683328314.html?mod=WSJ_hps_MIDDLE_Video_Top ("Boards worried about their scant digital expertise are scrambling to recruit newcomers who can advise management on strategies for mobile devices, social media and data analytics. . . . Thirty-seven of the 100 biggest U.S. companies lack directors with digital expertise, and only 16 have at least three such members comprising 20% of the board."). *See also* Lawrence J. Trautman & Kara Altenbaumer-Price, *The Board's Responsibility for Information Technology Governance*, 28 J. Marshall J. Computer & Info. L. 313, 327 (2011) (suggesting the need for IT expertise on the board of directors). Similarly, one study has asserted that lawyers add value to boards but are not always present. *See* Lubomir P. Litov et al., *Lawyers and Fools: Lawyer-Directors in Public Corporations*, 102 Geo. L.J. 413, 415 (2014).

[104]Fairfax, *supra* note 68, at 881 ("there are no studies indicating that enhanced board or corporate performance is linked to ensuring that a majority or a supermajority of board members have executive-level expertise"). *See also* Rüdiger Fahlenbrach et al., *Why Do Firms Appoint CEOs as Outside Directors?*, at 35 (Fisher College of Business Working Paper No. 2008-03-009, 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1160276 ("Though the literature finds a positive stock-price reaction to the appointment of CEO directors, we find no evidence that CEO directors have an impact on the firm after their appointment, positive or negative, except for CEO interlocked boards, in which case there is evidence of a negative impact for some but not all outcome measures.").

experience.[105] The preeminence of reliability over substantive qualifications offers an explanation.

*D. Summary*

Management has a rational incentive to reduce the risk that the board will interfere in corporate affairs. This is accomplished through influence over board membership and the appointment of directors predisposed toward the policies of management.[106] In an era of independent directors, the categories of reliable directors are limited. They include certain categories of executive officers and persons drawn from the CEO's social and professional network.[107] The need for predisposition takes precedent over substantive qualifications.

This is not to say that reliable directors are entirely lacking in benefits.[108] Executive officers of the same company offer operational

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[105] One study suggests that directors from related industries improve performance. *See* Omesh Kini et al., *Board Expertise: Do Directors from Related Industries Help Bridge the Information Gap?*, at 36 (23rd Australasian Finance & Banking Conference 2010 Paper, 2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1663584 ("Overall, our results suggest that the documented positive relation between firm performance and *DRI*s [directors from related industries] is likely to be causal."). In wondering why "every firm" does not select these directors, they note, among other things, "CEOs may shun these directors due to their better monitoring ability." *Id.*

[106] The approach can result in a culture designed to limit dissent and opposition to the CEO. *See* Fogel, *supra* note 42, at 19 ("Post mortems of corporate governance shipwrecks suggest this has not changed greatly in many boards, often describing corporate cultures that equated dissent with disloyalty. For example, an Enron executive describes an 'atmosphere of intimidation' in which many could see problems looming, but none dared confront the CEO.").

Where directors engage in behavior that raises doubts about reliability, they may not be renominated or may opt to leave the board. *See* David Enrich & Dana Cimilluca, *Barclays Director Is Latest to Leave*, WALL ST. J. (July 25, 2012, 7:18 PM), http://online.wsj.com/article/SB10000872396390443477104577548653797504604.html?mod=WSJ_hp_LEFTWhatsNewsCollection (independent director that "clashed" with management over pay packages resigned).

[107] *See* Derek Higgs, *Review of the Role and Effectiveness of Non-executive Directors*, at 39 (Jan. 2003), http://www.ecgi.org/codes/documents/higgsreport.pdf ("Almost half of the non-executive [independent] directors surveyed . . . were recruited to their role through personal contacts or friendships. Only 4% had had a formal interview, and 1% had obtained their job through answering an advertisement. This situation . . . can lead to an overly familiar atmosphere in the boardroom.").

[108] Some data suggests that companies with directors with certain types of personal or business relationships have a lower risk of fraud. Chidambaran et al., *supra* note 85, at 31 ("fraud

insight and expertise.[109] Personal connections can contribute to board cohesion and enhance communications.[110] Such directors may be in a better position to convey criticism to the CEO[111] or deliver bad news.[112] Whatever the benefits, however, they are often of secondary importance to the goal of reducing intervention into the activities of the corporation.

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probability is reliably lower when CEOs and directors have professional connections originating in shared employment experiences, especially when the connected individuals serve as employees rather than as directors or director and employee").

[109] *See* Marc Goldstein, *Mitigating Dysfunctional Deference through Improvements in Board Composition and Board Effectiveness*, 103 Nw. U. L. Rev. Colloquy 490, 496–98 (2009) ("Corporate executives, particularly those who have served successfully as CEOs, have the ability to draw on their own management experience not only in advising management of the company on whose board they sit, but also to rally support from other outside directors when it becomes necessary to break with management's plans.").

[110] O'Connor, *supra* note 35, at 1310 ("Although homogeneity on the board can lead to too much cohesiveness, some level of collegiality is desirable because it promotes a well-functioning board."). *See also Corporate Governance and American Competitiveness*: *Statement of the Business Roundtable*, 46 Bus. Law. 241, 247 (1990) ("Providing advice and counsel to the CEO is a very important function of boards of directors. It is fulfilled both in formal board meetings through the collective deliberations of the board and also in informal, individual director contacts with the CEO."); Hoitash, *supra* note 1, at 403 ("the board collaboration model . . . suggests that when the board performs certain duties, the existence of personal ties is associated with better performance").

[111] *See* O'Connor, *supra* note 35, at 1284 ("Viewed in a similar light, we can see why intelligent, experienced directors who monitor firms on a part-time basis may be unwilling to challenge management's business acumen. Most people, but particularly professionals, do not want to risk embarrassment by displaying their ignorance in public."). *See also* Stephen M. Bainbridge, *Independent Directors and the ALI Corporate Governance Project*, 61 Geo. Wash. L. Rev. 1034, 1064 (1993) ("Individual directors pass on concerns to the CEO, who in turn bounces ideas off board members. Rather than struggling to overcome the collective action problems that impede the dismissal of a CEO, an individual director may try to obtain better performance through a private reprimand.").

[112] Sometimes this may fall to the lead director. *See* Committee on Corporate Laws, ABA Section of Business Law, *Corporate Director's Guidebook, Fifth Edition*, 62 Bus. Law. 1479, 1508 (2007) ("The presiding or lead director may also be called upon by the board or by senior management to meet with shareholders or shareholder groups that wish to convey concerns to the board of directors.").

# II. Myth #2: The Advisory Function of the Board

The myth that directors are selected primarily on the basis of substantive qualifications is related to the second myth about board behavior. Contrary to conventional belief, boards of public companies do not perform a significant advisory role.

## *A. Conventional Wisdom*

The second myth concerning board behavior is that directors at large public companies perform a meaningful advisory or management function.[113] In this cooperative and interactive vision,[114] directors are viewed as providing useful advice[115] and historical context.[116] They may help to hone corporate strategies,[117] anticipate

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[113]*See* Jonathan R. Macey, Corporate Governance, Promises Kept, Promises Broken 53 (2008) (Directors "are simultaneously supposed to serve as advisors to senior officers about management issues and as monitors of management."); *see also* Faleye et al., *supra* note 17, at 1 ("Academics and practitioners have long recognized that the primary functions of the board of directors are two-fold: monitoring and advising top management."); Jill E. Fisch, *Corporate Governance: Taking Boards Seriously*, 19 Cardozo L. Rev. 265, 272 (1997) ("Although no bright line separates the board's managing and monitoring functions, the obligations of the modern board continue to contain a management component."). Some view this as the most important function of the board. *See* Lipton & Rosenblum, *supra* note 20, at 80 ("Clearly the board has to be ready to perform its monitoring function when and if required, but the bulk of a board's activity is typically devoted to its advising function.").

[114]*See* Clark, *supra* note 35, at 281 ("[I]t is not impossible to imagine that a board can act in a friendly and collegial way when discussing most business decisions but shift to the stance of an impartial judge when confronted with a situation involving a potentially serious conflict of interest between the officers and the shareholders.")

[115]Advice from the entire board results from a collective process, something that can improve the quality of any feedback. *See* Stephen Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 Vand. L. Rev. 1, 19 (2002) ("In sum, groups appear to outperform their average member consistently, even at relatively complex tasks requiring exercise of evaluative judgment."). *See also* O'Connor, *supra* note 35, at 1243 ("[G]roups provide more reliable decisions, generate fewer errors, and uncover more mistakes than individuals.").

[116]The average tenure of directors in the S&P 1500 is around ten years. *See* ISS Report, *supra* note 13, at 53 ("The average tenure of directors at S&P 1500 companies is 10.3 years.").

[117]*See* Kelli A. Alces, *Beyond the Board of Directors*, 46 Wake Forest L. Rev. 783, 798 (2011) ("[T]he board performs an advisory function, offering advice and opinions to management

problems,[118] and encourage CEO flexibility.[119] Moreover, at the apex of the corporation,[120] the board is uniquely positioned to deliver advice that management cannot easily disregard.[121] Some have even suggested that the function has grown in importance.[122]

The vision is attractive but not a useful description of board behavior,[123] at least with respect to the largest public

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about general business concerns."). Ultimate responsibility for the final decision would still rest with management. *See* Frankel, *supra* note 48, at 502 ("When the Board advises—the CEO and management ultimately decide.").

[118]*See* O'Connor, *supra* note 35, at 1243 ("To explain these results, social psychologists theorize that groups curb individual weaknesses by offering different perspectives, arousing greater attention to the issues, and correcting random errors among members.").

[119]*See* Bainbridge, *supra* note 115, at 29–30 ("Although individuals may well be better at devising a brilliant plan, individuals often become wedded to their plans and fail to see flaws that others might identify. As with all decisionmakers, corporate managers likewise become heavily invested in their beliefs, which makes them unable to recognize that those beliefs may be biased."); *see also* O'Connor, *supra* note 35, at 1253 ("In extreme cases where the superstar is engaged in serial decision making, this overconfidence may lead to serious problems.").

[120]Lower-level officers have an incentive to avoid dissenting when dealing with the CEO. *See* Paredes, *supra* note 33, at 722 ("Perhaps the most obvious deferential group is subordinate officers. Although there are always exceptions, such as an influential chief operating officer, managers who report to the CEO can be expected to quiet their dissent, or at least not to push hard in second-guessing the chief executive.").

[121]The CEO can seek advice from other employees or consultants. *See* Donald C. Langevoort, *Board Diversity and Corporate Performance: Filling in the Gaps: Commentary: Puzzles About Corporate Boards and Board Diversity*, 89 N.C. L. Rev. 841, 844 (2011) (noting that advisory function of board can "be played by professional management consultants without encumbering the board with the responsibility"). The advice, however, may be easier to ignore than advice from the board.

[122]*See* Marcel Kahan & Edward Rock, *Embattled CEOs*, 88 Tex. L. Rev. 987, 1039 (2010) ("By the same token, we believe that CEOs involve board members more in major strategic decisions and that board members have become more willing to share any concerns over operations with their CEOs outside the boardroom.").

[123]*See* Stephen J. Lubben, *Separation and Dependence: Explaining Modern Corporate Governance*, 43 Seton Hall L. Rev. 893, 899 (2013) ("This is a change from the past, when the board was largely an advisor to senior management. But since Sarbanes-Oxley, that role has changed and should be acknowledged. Further, Dodd-Frank suggests that there will be no return to the 'good old days.' ").

companies.[124] The need for less interventionist directors has all but eliminated a meaningful advisory role. To provide advice or participate in management, the board must be informed. Likewise, an advisory role works best with a board that contains a wide range of experiences and substantive skills,[125] thereby allowing directors to provide management with a broader set of outcomes.[126] The emphasis on reliability as the

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[124]The analysis may be different for smaller companies. *See* Fisch, *supra* note 113, at 285 ("Immature or rapidly growing firms that face extensive strategic planning decisions waste a valuable resource if they do not utilize the business expertise of their board members in management decisions."). Perhaps unable to afford outside expertise, these companies may be more willing to rely on the skills of board members, even if carrying a greater risk of intervention. Moreover, the conclusion that boards do not play an advisory role does not rule out the possibility that individual directors may do so, see Kini et al., *supra* note 105, at 1 ("directors are valued more for advice when . . . they provide contacts, financial expertise, and political influence"), or provide useful business or political contacts that can help the business. *See* Eitan Goldman et al., *Politically Connected Boards of Directors and the Allocation of Procurement Contracts*, 17 REV.FINANCE 1617 (2013) ("The above discussion suggests that if former politicians who sit on the board of a company are able to help their company meet and advise these government officials and thus help shape the RFP, then they can increase the chances that their company would win the contract."); *see also* Jeffrey L. Coles et al., *Boards: Does One Size Fit All?*, 87 J. FIN. ECON. 329, 332 (2008) (noting one board that included Henry Kissinger, Donald Rumsfeld, and Colin Powell as directors and indicating that, "[m]ost likely these directors were selected not for monitoring, but for their ability to provide advice in obtaining defense contracts").

[125]*See* Lisa L. Broome et al., *Dangerous Categories: Narratives of Corporate Board Diversity*, 89 N.C. L. REV. 759, 765 (2011) ("[D]iverse groups may possess more information, consider more varied alternatives to any given course of action, and generate higher quality decisions.").

[126]Janis Sarra, *Class Act: Considering Race and Gender in the Corporate Boardroom*, 79 ST. JOHN'S L. REV. 1121, 1128 (2005) ("The homogeneity of existing directors creates a barrier to boards being able to fully engage in strategic planning and risk assessment, given that the lack of diversity in perspectives means that directors are less likely to be able to foresee the full range of both upside and downside risks to corporate decisions."). *See also* Fanto et al., *supra* note 35, at 913 ("Groups in the thrall of groupthink can make disastrous decisions, often because they ignore conflicting viewpoints and evidence."); Ronald C. Anderson et al., *The Economics of Director Heterogeneity*, at 28 (May 6, 2009), http://astro.temple.edu/~dreeb/The%20Economics%20of%20Director%20Heterogneity.pdf ("[O]ur analysis indicates that board heterogeneity bears a positive relation to firm performance; providing evidence consistent with the notion that a diverse director pool enhances firm value.").

preeminent qualification for board service, however, conflicts with the goal of an informed[127] and diverse board.[128]

To the extent some suggest that an advisory or "management" function continues to exist, they often point to the board's obligation to approve certain types of transactions such as dividends and mergers.[129] Board consideration of these transactions does provide a theoretical opportunity to advise and suggest alternatives. In reality, however, the proposals typically arrive at the board level after successful negotiation by management and a thorough vetting by outside experts.[130] The board's

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[127]State law does not provide strong incentives for boards to be informed. Directors are not liable for harm caused by matters for which they were unaware. The only real exception is the failure to put in place a system designed to report information to the board. *See In re* Caremark Int'l Inc. Deriv. Litig., 698 A.2d 959, 971 (Del. Ch. 1996) ("Generally where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation, . . . only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exits—will establish the lack of good faith that is a necessary condition to liability."). This, however, has been characterized as perhaps the "most difficult" case to bring against the board. *Id.* at 967. In Delaware, therefore, ignorance is a defense to claims for liability.

[128]For a discussion of the phenomena of boards without adequate substantive expertise, see *infra* note 279 and accompanying text. Management may also have an incentive to appoint directors with substantive skills but not the skills needed to effectively monitor. There is some evidence of this. *See* Kini et al., *supra* note 105, at 33–34 (concluding that directors from related industries can improve performance but noting that not all companies use these directors and hypothesizing that one reason may be CEO concern over the potential for improved monitoring that results from their appointment).

[129]*See* Fisch, *supra* note 113, at 272–73 ("The board's statutory obligations have typically emphasized the board's management responsibilities over its monitoring role. Corporation law statutes require board approval before a company issues stock or pays dividends, even when these transactions involve no element of management self-dealing."). *See also* Usha Rodrigues, *A Conflict Primacy Model of the Public Board*, 2013 U. Ill. L. Rev. 1051, 1064 (2013) ("The board's management responsibilities essentially involve having the final say-so on major corporate issues, such as bringing suit on the corporation's behalf, pursuing mergers and acquisitions, issuing of dividends, and the like.").

[130]Paredes, *supra* note 33, at 728 ("It is very difficult as a practical matter for a board to stop a transaction that has considerable momentum, such as when senior management, the lawyers, the accountants, and the investment bankers have all signed off.").

role is legal sufficiency,[131] with management seeking ratification[132] not input.[133]

### *B. The Case of Strategic Planning*

Perhaps the closest a board comes to a formal advisory role is through participation in the strategic planning process. Strategic planning can be both advisory and cooperative,[134] providing directors an opportunity to help determine the mission of the company.[135] Indeed, some have argued for a strengthening of the board's role in this process.[136]

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[131]*See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993) (entire fairness requires board to show "that the transaction was the product of both fair dealing and fair price").

[132]These functions require board examination of transactions typically initiated and negotiated by management and for the most part reviewed by market professionals. Paredes, *supra* note 33, at 728. In these circumstances, boards are mostly ratifying rather than advising. Macey, *supra* note 113, at 53 ("As a result, the act is not management but ratification. In that case, the board is essentially making certain that, within its fiduciary obligations, management's proposal is appropriate.").

[133]Langevoort, *supra* note 121, at 848 ("Absent some unusual sort of external pressure, board meetings are largely exercises in impression management by the senior management team, in which board members are expected to acquiesce by polite, intelligent, but not particularly challenging discussion.").

[134]Lynne L. Dallas, *The Relational Board: Three Theories of Corporate Boards of Directors*, 22 J. Corp. L. 1, 22 (1996) ("The substantial presence of a knowledgeable and expert CEO is clearly desirable when business transactions or strategic planning issues not involving acute conflicts for managers are the subjects of deliberation at board meetings."); *see also* Nadelle Grossman, *Turning a Short-term Fling into a Long-Term Commitment: Board Duties in a New Era*, 43 U. Mich. J.L. Reform 905, 932 (2010) ("Boards also rely heavily on officers in forming strategy."); Ira M. Millstein, *The Professional Board*, 50 Bus. Law. 1427, 1434 (1995) ("Typically, strategic plans are developed by senior management in the divisions, further developed by the CEO's staff and then the CEO, approved by the board, and carried out by senior management at the CEO's direction.").

[135]Millstein, *supra* note 134, at 1433 (strategic planning entails the development of a corporate goal or mission).

[136]*See* Millstein, *supra* note 134, at 1433–35 (describing more active participation by board in strategic planning process); *see also* Martin Lipton & Theodore N. Mirvis, *Enhanced Scrutiny and Corporate Performance: The New Frontier for Corporate Directors*, 20 Del. J. Corp. L. 123, 126–27 (1995). Surveys generally indicate that directors view some sort of advisory role as the most satisfying aspect of their position; *see Engaging with Strategy, After the Financial Crisis*, 11 Lead Director Network Viewpoints, at 3 (Aug. 4, 2011), *available at* http://www.kslaw.com/

Strategic planning is a somewhat "fuzzy" concept.[137] Boards assign to strategic planning committees a myriad of diverse functions. This can include the obligation to determine "long-term business strategies"[138] or, as one board put it, to ensure "that the Corporation's strategies, priorities and policies are consistent with the Corporation's overriding goals of creating and building long-term sustainable value for its stockholders."[139] The committees may alert management about alternative technologies[140] or industry trends.[141]

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imageserver/KSPublic/library/publication/2011articles/8-11LDNViewPoints.pdf [hereinafter *Engaging with Strategy*]. *See also* Langevoort, *supra* note 48, at 802–03 ("Boards do help to formulate corporate strategy, acting as a sounding board for the chief executive and senior management team and providing external input into the strategic process. This role is the one often cited by board members as their most valuable and satisfying one.").

[137] Millstein, *supra* note 134, at 1434 n.15 ("While strategic planning seems to be more of a developed science, it is suspected that the elements of board involvement in mission development are similarly fuzzy.").

[138] Susanna M. Kim, *Dual Identities and Dueling Obligations: Preserving Independence in Corporate Representation*, 68 Tenn. L. Rev. 179, 212 (2002) ("The board can consider the elements that are required for a sound strategic plan and then help the CEO and management team refine their long-term business strategies for the corporation."). *See also* Lifetime Brands, Inc., Proxy Statement, at 13 (Apr. 30, 2014), *available at* http://www.sec.gov/Archives/edgar/data/874396/000119312514172586/d720788ddef14a.htm (strategic planning committee assigned to review and recommend to the board "long-term business objectives and plans developed by management").

[139] Microfinancial, Proxy Statement, at 6 (Apr. 11, 2014), *available at* http://www.sec.gov/Archives/edgar/data/827230/000119312514139626/d704566ddef14a.htm.

[140] Tetra Tech Inc., Proxy Statement, at 15 (Jan. 10, 2014), *available at* http://www.sec.gov/Archives/edgar/data/831641/000104746914000122/a2217903zdef14a.htm (committee responsible for, among other things, "assessing how technology influences our business strategy and resource allocation").

[141] National Research Corp., Proxy Statement, at 6 (Apr. 11, 2014), *available at* http://www.sec.gov/Archives/edgar/data/70487/000143774914006423/nrci20140409_def14a.htm ("The Strategic Planning Committee assists the Board in reviewing . . . industry trends and their effects, if any, on the Company and assessing the Company's products, services and offerings"); *see also* ACNB Corp., Proxy Statement, at 6 (Mar. 15, 2014), *available at* http://www.sec.gov/Archives/edgar/data/715579/000104746914002921/a2219164zdef14a.htm ("The principal duties of the Strategic Planning Committee include . . . keeping the Board of Directors informed of developments, trends and opportunities in the industry that might help improve the Corporation's profitability, growth and/or customer service").

Directors can suggest new products,[142] identify acquisition candidates,[143] or propose business opportunities.[144]

These functions notwithstanding, strategic planning does not result in boards playing a consistent and meaningful advisory role within the company. First, not all public companies engage in the practice.[145] Few

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[142]Digital Ally, Inc., Proxy Statement, at 12 (Apr. 24, 2014), *available at* http://www.sec.gov/Archives/edgar/data/1342958/000149315214001231/form14a.htm ("Our Strategic Planning Committee assists our Board of Directors by providing guidance in the formulation of both short and long-term business development plans, including identifying and recommending new strategic initiatives and alternatives, technologies and products for the Company.").

[143]Independent Bank Grouping, Inc., Proxy Statement, at 19 (Apr. 18, 2014), *available at* http://www.sec.gov/Archives/edgar/data/1564618/000119312514148224/d709098ddef14a.htm ("The Company's Strategic Planning Committee has responsibility for, among other things . . . identifying acquisition targets and developing plans to pursue acquisitions of such identified targets"); Craft Brew Alliance, Proxy Statement, at 11 (Apr. 16, 2014), *available at* http://www.sec.gov/Archives/edgar/data/892222/000114036114016883/formdef14a.htm (strategic planning committee responsible for "reviewing and recommending to the Board management proposals related to expansion, capital investment, acquisitions, partnerships, joint ventures or alliances, dispositions of capital assets, adequacy of the existing capital structure and similar issues").

[144]Baldwin & Lyons, Inc., Proxy Statement, at 6 (Apr. 3, 2014), *available at* http://www.sec.gov/Archives/edgar/data/9346/000000934614000007/proxy.htm ("The Strategic Planning Committee is responsible for working closely with management to identify new opportunities available to the Corporation as well as strategies for profitably expanding existing businesses.").

[145]The percentage of boards engaging in strategic planning has, apparently, been flat in recent years. *See Engaging with Strategy, supra* note 136, at 3 ("A recent survey conducted by McKinsey found that directors spend almost exactly the same amount of time on strategy today as they did in 2008: it takes up 23% of board time now and took 24% then."). Among larger public companies, the practice may also be in decline. *See also* Lawrence J. Trautman, *The Matrix: The Board's Responsibilities for Director Selection and Recruitment*, 11 FLA. ST. U. BUS. REV. 75, 118 (2012) (although at one some companies sometimes had standing strategic planning committees, "[t]hirty years later, few standing board strategic planning committees are to be found, perhaps a testament of how hard this function is to institutionalize at the board level"). Yahoo at one time had a Transaction and Strategic Planning Committee. *See* Yahoo!, Inc., Proxy Statement, at 19 ( June 4,2012), *available at* http://www.sec.gov/Archives/edgar/data/1011006/000119312512258870/d319086ddef14a.htm (describing the duties of the committee). The following year, the strategic planning function was dropped from the committee. *See* Proxy Statement, Yahoo!, Inc., Proxy Statement, at 19 (Apr. 30, 2013), *available at* http://www.sec.gov/Archives/edgar/data/1011006/000119312513187918/d501548ddef14a.htm (describing the duties of the Transactions Committee). The Transactions Committee was dissolved the following year. Yahoo!, Inc., Proxy Statement, at 28 (Apr. 30, 2014), *available at* http://www.sec.gov/Archives/edgar/data/1011006/

companies have in place standing committees responsible for strategic planning[146] with the number apparently declining in recent years, particularly among the largest public companies.[147] Nor, when they exist, do they necessarily meet on a frequent basis.[148]

Second, the actual planning function is typically episodic and therefore occurs infrequently. Once developed, long-term goals presumably remain in place for an extended period of time.[149]

Third, as a practical matter, strategic planning is likely influenced and guided by management.[150] Boards are often presented with a preexisting

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000119312514172132/d710905ddef14a.htm (noting the "dissolution of the Transactions Committee in September 2013").

[146]A search of the Edgar data base (proxy statements) for 2014 turned up only a small number of public companies that disclosed the existence of "strategic planning committees" of the board of directors. The search did not reveal any such committee among the largest public companies.

[147]Trautman, *supra* note 145, at 118 (noting that at one time Texas Instruments relied on a standing strategic planning committee).

[148]Level 3 Comm., Inc., Proxy Statement, at 19 (Apr. 11, 2014), *available at* http://www.sec.gov/Archives/edgar/data/794323/000104746914003724/a2219420zdef14a.htm ("The Strategic Planning Committee met one time during 2013 in a separate meeting and one time in connection with a full Board meeting."); Tetra Tech, *supra* note 140, at 15 ("This committee held two meetings during fiscal 2013."); Digital Ally, *supra* note 142, at 12 ("The Strategic Planning Committee held one meeting during the year ended December 31, 2012."); Landstar System, Inc., Proxy Statement, at 3 (Apr. 11, 2014), *available at* http://www.sec.gov/Archives/edgar/data/853816/000119312513150747/d519785ddef14a.htm ("During the Company's 2013 fiscal year, the Strategic Planning Committee held one meeting, no telephonic meetings and did not act by written consent."); First United Corp., Proxy Statement, at 10 (Mar. 28, 2014), *available at* http://www.sec.gov/Archives/edgar/data/763907/000114420414018475/v372618_def14a.htm ("This committee met two times in 2013."); Famous Dave's of America, Proxy Statement, at 40 (Mar. 19, 2014), *available at* http://www.sec.gov/Archives/edgar/data/1021270/000119312514105911/d694079ddef14a.htm ("The Strategic Planning Committee did not hold any meetings during fiscal 2013.").

[149]*See* Pool Corp., Proxy Statement, at 12 (Mar. 27, 2014), *available at* http://www.sec.gov/Archives/edgar/data/945841/000094584114000040/a2014proxy.htm ("Our strategic plan incorporates specific goals for growth and business development over the next three to five years, which we update and review with the Board periodically.").

[150]Fanto et al., *supra* note 35, at 909 ("Board members serve as advisors to the CEO and other major executives on significant, often strategic, issues related to the firm."); Fisch, *supra* note 113, at 274 ("Strategic planning is clearly a managing function.").

plan.[151] In that context, they are not devising a strategic direction but merely commenting on, or validating, management's existing vision.[152]

Finally, the board may lack the structure needed to adequately and effectively perform a strategic planning function. Given the emphasis on reliability,[153] boards often are devoid of the diversity of views required for a robust and meaningful discussion.[154] Similarly, strategic planning requires informed directors.[155] Corporate officials, however, have an incentive to withhold information in order to reduce the board's "ability to monitor management's performance."[156]

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[151]*See* Granite Construction, Inc., Proxy Statement, at 10 (Apr. 25, 2014), *available at* http://www.sec.gov/Archives/edgar/data/861459/000114036114017499/formdef14a.htm ("The Strategic Planning Committee reviews and recommends for approval the Strategic Plan developed by management and provides overall strategic planning direction.").

[152]James D. Cox, *The ALI, Institutionalization, and Disclosure: The Quest for the Outside Director's Spine*, 61 Geo. Wash. L. Rev. 1233, 1237 (1993) (citing studies and arguing that "outside directors spend most of their time reacting to management's strategic planning and reviewing other corporate policies and practices, to an extent that allows only infrequent explicit and formal review of management's performance") (citations omitted).

[153]Thus, it took an act of Congress to force public companies to ensure that they had financial expertise on the board despite the important of the board's role in the disclosure process. *See supra* note 7 and *infra* note 279.

[154]*See Engaging with Strategy*, *supra* note 136, at 2 ("Strategic oversight is improved when corporate boards are composed of knowledgeable, engaged, and diverse directors."). *See also* Anderson et al., *supra* note 127, at 8 ("Directors coming from different business, socioeconomic, technical, and professional backgrounds potentially provide managers with a broader and deeper knowledge base than board members from more uniform backgrounds.").

[155]*See* Dallas, *supra* note 134, at 25 (noting that strategic planning committee provides a forum for outside directors to meet with management).

[156]Sharpe, *supra* note 12, at 1129 (strategic plan can help improve the ability of directors to monitor management's performance). *See also* The First of Long Island Corp., Proxy Statement, at 9 (Mar. 17, 2014), *available at* http://www.sec.gov/Archives/edgar/data/740663/000114036114012901/formdef14a.htm ("The Strategic Planning Committee is responsible for providing oversight with respect to the preparation and revision of the Corporation's strategic plan and monitoring the Corporation's ongoing performance with respect to the plan.").

### *C. Summary*

The boards of the largest public companies do not perform an advisory role, at least in any systematic or meaningful fashion.[157] Nor does the board "manage" the corporation. Instead, directors mostly ensure legal sufficiency and establish outer boundaries for management. They do not devise the policies or practices implemented by the company but have the authority and, sometimes, the obligation, to intervene when necessary to protect the interests of shareholders.

## III. The Myths and Their Consequences

Exposing these myths brings a degree of clarity to a number of board practices. First, they explain in a cogent manner the absence of racial and gender diversity. Second, they explain the current evolution in board structure among large public companies, particularly the exclusion of all corporate officers except the CEO.

### *A. Demythification and Board Diversity*

The boards of public companies are not diverse. Women represent only about fourteen percent of directors of the 1500 largest public companies;[158] minorities around ten percent.[159] Women serve as chair in these companies only three percent of the time.[160]

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[157]CEOs may be willing to seek advice from directors who are not independent and therefore viewed as reliable. *See* Langevoort, *supra* note 121, at 844–45 (noting research that "suggests that the advisory function is most effective when the CEO feels relatively strong social connections to board members").

[158]*See* ISS Report, *supra* note 13, at 42 ("The overall proportion of female directorships has increased to 14 percent, a 2-percentage point increase over the levels seen between 2006 and 2009, and about a 1-percentage point increase from 2011."). The percentages are slightly higher for larger companies. Catalyst, *2013 Catalyst Census: Fortune 500 Women Board Directors*, at 1 (2013), available at http://www.catalyst.org/system/files/2013_catalyst_census_fortune_500_women_board_director.pdf (placing percentage of women on boards of Fortune 500 at 16.6% in 2012 and 16.9% in 2013) (*Catalyst Census*).

[159]*See* ISS Report, *supra* note 13, at 45 ("In 2012, the proportion of identifiable minority directorships was 10 percent.").

[160]*See Catalyst Census*, *supra* note 158, at 1 (noting that in Fortune 500 companies, 3.1% of chairs are held by women). For a discussion of the history of gender board diversity, see David

The absence of diversity is a significant concern. Diversity has recognized benefits.[161] It can enhance the decision-making process,[162] provide a role model for employees,[163] send positive signals to consumers,[164] and improve the overall reputation of the company.[165] Diversity results in improved attendance at board meetings[166] and can serve as a catalyst for other shifts in board composition.[167]

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F. Larcker & Brian Tayan, *Pioneering Women on Boards: Pathways of the First Female Directors*, at 2–3 (Stanford Closer Look Series, 2013), available at http://www.gsb.stanford.edu/sites/default/files/35_Women.pdf.

[161]*See* David A. Carter et al., *Corporate Governance, Board Diversity and Firm Value*, 38 Fin. Rev. 33, 37 (2003) (discussing the link between diversity and firm value); David Carter et al., *The Gender and Ethnic Diversity of US Boards and Board Committees and Firm Financial Performance*, 18 Corp. Gov.: An Int'l Rev. 396, 398–400 (2010).

[162]Racial and gender diversity may also bring benefits associated with diverse viewpoints. *See* Douglas M. Branson, *Initiatives to Place Women on Corporate Boards of Directors—A Global Snapshot*, 37 J. Corp. L. 793, 795–96 (2012) ("The presence of women aids proliferation of the array of perspectives and viewpoints on corporate boards, leading to better assessments of risk and less rubberstamping of CEOs' decisions."); Fanto et al., *supra* note 35, at 934 ("The hope is that a diverse board (with suitable numbers of diverse members who would express perspectives other than that of shareholder value) could help alter the dominant, finance-based social identity that now characterizes public company boards."). This may be particularly true in firms with "complex operating environments." Anderson et al., *supra* note 126, at 4 ("Specifically, the analysis indicates that in firms with complex operating environments, performance improves as boards become increasingly heterogeneous.").

[163]Branson, *supra* note 162, at 795 (noting that an increase in women directors provides "a positive role model for other women in the middle and lower ranks of corporate organizations").

[164]*Id.* at 796.

[165]The pressure from investors and the public suggests that diverse boards would be perceived as more progressive and/or more in tune with current social values. *See id.* at 796 ("[C]orporations will increasingly function in a diverse world. Their governance and the makeup of their boards should reflect this, including more women and persons of color as directors.").

[166]Butler, *supra* note 31, at 77.

[167]In Norway, for example, the increase in gender diversity mandated by law also resulted in the appointment of younger directors. J. Robert Brown, Jr., *Board Diversity and the Norwegian Experience*, Race to the Bottom ( July 8, 2009, 6:00 AM), http://www.theracetothebottom.org/independent-directors/board-diversity-and-the-norwegian-experience.html.

At the same time, empirical evidence has not established a definitive causal link between diversity and performance.[168] The failure to show such a causal connection does not, however, justify the lack of women and minorities on boards.[169] Nor does the supposed dearth of qualified candidates explain the phenomena.[170] The universe of qualified directors can include lawyers, professors, politicians, consultants, and officers at nonprofits.[171] Women and minorities are well represented in these categories[172] and are sufficient in number to provide adequate diversity among

[168]*See* Fanto et al., *supra* note 35, at 902–03 ("[P]roponents of board diversity may not want to pin all of their hopes on empirical results, for it has been notoriously difficult to show that the design or composition of a corporate board improves or harms the firm's performance."). *See also* Barbara Black, *Stalled: Gender Diversity on Corporate Boards*, 37 U. Dayton L. Rev. 7, 20 (2011) (noting the empirical support for the proposition that increased board diversity improves corporate performance is mixed). A report by Credit Suisse noted a number of metrics that improved with increased gender representation but ultimately concluded that "[n]one of our analysis proves causality; we are simply observing the facts." Credit Suisse Research Institute, *Gender Diversity and Corporate Performance* 15 (2012), available at https://www.credit-suisse.com/newsletter/doc/gender_diversity.pdf.

[169]Academics continue to try to show links between performance and specific categories of directors, all with mixed success. With respect to diversity, the absence of a link may arise from the lack of an advisory function by the board. *See* Fisch, *supra* note 34, at 929 ("Concededly, monitoring boards do not offer corporations strategic advice, operational analysis, or other types of managerial support. As a result, large-scale empirical studies are unlikely to find a link between board monitoring and firm performance."). Without the function, the benefits that arise from multiple views and perspectives may be greatly reduced.

[170]Kimberly D. Krawiec et al., *The Danger of Difference: Tension in Directors' Views of Corporate Board Diversity*, 2013 U. Ill. L. Rev. 919, 948 ("When we asked why boards were not more diverse, the response almost always related to the talent pool. Many thought it was just a matter of time before more women and minorities gained sufficient experience at the appropriate corporate level to be qualified for and considered for board service."). Some also contend that a lack of training plays a role in the lack of diversity. *See* Regina F. Burch, *Worldview Diversity in the Boardroom: A Law and Social Equity Rationale*, 42 Loy. U. Chi. L.J. 585, 600 (2011) ("[T]wo reasons are often given for the predominance of white males on corporate boards: lack of qualified senior executives in the pipeline, and lack of corporate governance training of potential diversity candidates who are female or people of color.").

[171]*See* ISS Report, *supra* note 13, at 37 (noting that attorneys and academics account for about six percent of the directors in the S&P 500; consultants and those from the financial services industry make up twenty-one percent).

[172]*See supra* note 22. Women make up over fifty percent of the population; minorities more than thirty percent. *Census State and County Quick Facts*, *available at* http://quickfacts.census.gov/qfd/states/00000.html (placing the percentage of women at 50.8% and the percentage of white, non-Hispanic or Latino, at sixty-three percent in 2012).

the 13,716 directors who sat on the boards of the S&P 1500 in 2013.[173] A sufficient pool of qualified candidates[174] and the benefits arising from diversity,[175] therefore, eliminate the traditional justifications for the low numbers of women and minorities on corporate boards.

The need for "reliable" and "independent" directors does, however, explain the absence of diversity. "Reliable" categories of directors are notoriously lacking in diversity. With respect to executive officers, few women have risen to the position of CEO of large public companies.[176] Likewise, the pool drawn from the CEO's social and professional circle is not diverse.[177] To the extent, therefore, that nominees are chosen from these categories, rather than the broader pool of substantively qualified candidates, diversity does, and will continue to, suffer.[178]

The impact of reliability in the director selection process can be gleaned from the pattern of diversity on the boards of large public companies. For the most part, shareholder pressure[179] and public

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[173]*See* ISS Report, *supra* note 13, at 5.

[174]*See supra* notes 22 & 172–73.

[175]*See supra* notes 170–76.

[176]In the S&P 500, 23 companies have a woman as CEO (as of January 2014), representing slightly more than four percent. *See* J. Robert Brown, Jr., *Appendix*, (U. of Denver Legal Research Paper Series Working Paper No. 14–57, 2014), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2505109. The statistics are not much better for executive officers as a group. *See Women Make Little Progress Atop Fortune 500 in 2012*, US NEWS & WORLD REP. (Dec. 12, 2012), *available at* http://www.usnews.com/news/articles/2012/12/19/women-make-little-progress-atop-fortune-500-in-2012 (noting that women consist of about fourteen percent of the executive officers within the Fortune 500).

[177]Those within the CEOs social and professional circuit are not particularly diverse. *See* Gloria Sandrino-Glasser, *Latcrit Theory, Critical Legal Education, and Board Diversity: Reflections of an Afro-Cuban Law Professor*, 8 RUTGERS RACE & L. REV. 199, 252–53 (2007).

[178]*See* Burch, *supra* note 170, at 601 (noting that according to some, "the issue is not a dearth of board-ready diversity candidates, but that board candidates are often within the nominating committee's or CEO's 'circle of acquaintance'; those committees and acquaintanceships just do not include many qualified women or people of color.").

[179]*See* Ernst & Young, *From the Boardroom to the C-suite*, at 5 (2013), *available at* http://www.ey.com/Publication/vwLUAssets/EY-Diversity-drives-diversity/$FILE/EY-Diversity-drives-diversity.pdf ("Long-standing investor campaigns have played a significant role in driving increased gender diversity on boards from 11% in 2006 to 15% in 2013."). Given the number of boards that lack any representation of women and minorities, shareholder pressure typically focuses on them. Thus, in 2013, three proposals were submitted to shareholders

criticism[180] has successfully ensured a degree of diversity. At the same time, however, diversity will often force companies to seek nominees from outside the traditional pool of reliable candidates.[181]

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calling for increased diversity on the board. All three were submitted to companies with no women on the board. One passed. *See Proposal 6: Stockholder Proposal Regarding Diversity*, CF Industries, Proxy Statement, at 53–55 (Apr. 3, 2013), *available at* http://www.sec.gov/Archives/edgar/data/1324404/000104746913003875/a2213922zdef14a.htm#dq77401_proposal_6__stockholde__dq702404; *see also* CF Industries, Current Report on Form 8-K (May 16, 2013), *available at* http://www.sec.gov/Archives/edgar/data/1324404/000110465913042420/a13-12240_18k.htm (noting that proposal received slightly more than fifty percent of the votes cast). The other two proposals were submitted to Freeport-McMoRan, see Freeport-McMoRan Copper & Gold Inc., Proxy Statement, at 70 ( July 16, 2013), *available at* http://www.sec.gov/Archives/edgar/data/831259/000119312513246406/d468089ddef14a.htm ("Currently, Freeport-McMoRan has no women or minorities on its board.") and Urban Outfitters, see Urban Outfitters, Inc., Proxy Statement, at 22 (Apr. 1, 2013), *available at* http://www.sec.gov/Archives/edgar/data/912615/000119312513136991/d509777ddef14a.htm. Neither passed but both received significant support. *See* Urban Outfitters, Current Report on Form 8-K (May 31, 2013), *available at* http://www.sec.gov/Archives/edgar/data/912615/000119312513243348/d547735d8k.htm; Freeport-MacMoRan, Form 8-K ( July 7, 2013), *available at* http://www.sec.gov/Archives/edgar/data/831259/000083125913000053/fcxform8-k07162013.htm.

Likewise investor groups that target companies with inadequate diversity tend to focus on the boards that have no women or minorities.*See* 30 Percent Coalition, *Coalition Contacts 127 Russell 1000 Companies* (2013), *available at* http://www.30percentcoalition.org/news/94-coalition-contacts-127-russell-1000-companies (describing letter writing campaign to the 127 companies in the Russell 1000 that have no women on the board).

[180]*See* Vauhini Vara, *Why One Female Board Member Isn't Enough*, New Yorker (Dec. 6, 2013), *available at* http://www.newyorker.com/online/blogs/currency/2013/12/why-one-female-board-member-isnt-enough.html.

[181]In one study, twenty-nine percent of women directors serving on the boards of the Fortune 500 came from "academia, nonprofits, and former government service." Lissa Lamkin Broome, *The Corporate Boardroom: Still a Male Club*, 33 Iowa J. Corp. L. 665, 678 (2008) (examining data developed by Douglas Branson and discussed in No Seat at the Table: How Corporate Governance and Law Keep Women Out of the Boardroom (2007)). In other cases, diversity occurs through the appointment of "reliable" directors from categories that do not fall within the definition of independent. Thus, Facebook provided gender diversity by elevating an officer to the board, see J. Robert Brown, Jr., Facebook, *Board Diversity and the Dearth of Women on the Board of Directors*, Race to the Bottom ( June 27, 2012, 6:00 AM), http://www.theracetothebottom.org/home/board-diversity-facebook-and-the-dearth-of-women-in-the-boar.html, while Urban Outfitters elevated the spouse of the CEO, see Sheryl Nance-Nash, *Urban Outfitters Names CEOs Wife to Board to Quiet Diversity Demands*, Corp. Sec'y (May 30, 2013), *available at* http://www.corporatesecretary.com/articles/boardrooms/12451/urban-outfitters-names-ceos-wife-board-quiet-diversity-demands/ ("In a move to quell the furor over the lack of diversity on the board of Urban Outfitters, management said this week it would add a woman to its board. The only problem is that their appointee is Margaret Hayne, the wife of CEO, co-founder and chairman of the board

Boards typically reconcile these conflicting approaches by ensuring diversity but only to the minimum necessary to alleviate criticism.[182] As a result, more than ninety percent of the largest public companies include women,[183] and more than seventy percent include minorities.[184] Nonetheless, they do so mostly by observing an unofficial quota[185] of one or two.[186]

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Richard Hayne, who would certainly fail a litmus test for independence."). Elevating insiders is not uncommon. *See* ISS Report, *supra* note 13, at 45 ("Within the S&P 1500, approximately 0.7 percent of directorships overall and 5.3 percent of all female directorships are held by company insiders.").

[182]An example of the enforcement of this requirement occurred in connection with the public offerings of Facebook and Twitter. Both went public with boards that included no women. *See* Facebook, Inc., Form S-1, at 109–11 (May 16, 2012), *available at* http://www.sec.gov/Archives/edgar/data/1326801/000119312512235588/d287954ds1a.htm. *See also* Twitter, Inc., Form S-1, at 126 (Nov. 4, 2013), *available at* http://www.sec.gov/Archives/edgar/data/1418091/000119312513424260/d564001ds1a.htm. The absence drew negative attention from shareholders, see Letter from Anne Sheehan to Facebook, CALSTRS *available at* http://www.calstrs.com/CorporateGovernance/letter_facebook.pdf, and the public, see Twitter, Inc., Current Report on Form 8-K (Dec. 5, 2013), *available at* http://www.sec.gov/Archives/edgar/data/1418091/000119312513462921/d638295d8k.htm. Both Facebook and Twitter quickly appointed women to the board shortly after the IPO. *See* Facebook, Inc., Form 8-K, *available at* http://www.sec.gov/Archives/edgar/data/1326801/000119312512282349/d371533d8k.htm.

[183]ISS Report, *supra* note 13, at 10 ("On balance, large companies have higher levels of racial or ethnic and gender diversity than smaller ones: 91 percent of S&P 500 boards include at least one woman, up from 90 percent in 2011"). The statistics, however, vary considerably by industry. *See* Ernst & Young, *supra* note 179, at 6 ("Gender diversity among industries varies greatly. Companies in the media and entertainment, retail and wholesale, and telecommunications industries have the highest levels of gender diversity in the boardroom and C-suite. Nearly 40% of oil and gas companies do not have any women on their boards. Other industries most likely to have all-male boards include diversified industrial products, real estate, and technology industries.").

[184]ISS Report, *supra* note 13, at 41 ("75 percent of S&P 500 boards have at least one minority director, the same as last year, but up significantly from 63 percent in 2010").

[185]Continental Europe has confronted the problem, mostly through the use of quotas. *See Opinion of the European Economic and Social Committee on the "Proposal for a directive of the European Parliament and of the Council on improving the gender balance among non-executive directors of companies listed on stock exchanges and related measures"*, COM(2012) 614 final—2012/0299 (COD) (2013/C 133/13), *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2013:133:0068:0076:EN:PDF ("By the end of 2011, 11 Member States had adopted laws establishing quotas or targets for gender representation on company boards.").

[186]Of the almost 1500 companies examined by ISS in 2012, the average number of women and minorities was one. ISS Report, *supra* note 13, at 41 ("the majority of study companies

The impact of the CEO's social/professional network and the impact on diversity can also be seen from a useful, if unscientific, empirical analysis. Only a small number of women serve as the CEO of large public companies. Their social networks presumably include more women than their male counterparts. As a result, they are in a better position to select nominees who are both reliable and will increase gender diversity on the board. One would therefore expect that, once these CEOs are in office long enough to exert influence over board membership, gender diversity will increase.

In fact, this hypothesis is supported by practice. At the beginning of 2014, twenty-three women served as the CEO of a Fortune 500 company, a meager 4.6%.[187] Of that number, five CEOs were appointed in 2013 or 2014, providing inadequate time to influence board composition. The websites for the remaining eighteen companies listed 209 directors including sixty-three women (or thirty percent), almost double the average.[188] Stated simply, when women are CEOs, boards are more gender inclusive.

## *B. Demythification and Board Structure*

A demythicized board that recognizes the need to minimize intervention also explains the current evolution taking place in board structure among the largest public companies. Intervention by the board in corporate affairs is in part a matter of structure. State law places the board at the pinnacle of the managerial hierarchy.[189] In reality, however, intervention is

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where such traits are identifiable have no more than one female and/or one minority board member"). For companies in the S&P 500, the average was two women. *Id.* at 41 ("the average S&P 500 board includes two female directors"). It should be noted, however, that in 2013, thirty companies in the S&P 500 had at least four women on the board. *Id.* at 45.

[187]*See* Catalyst, *Women CEOs of the Fortune 1000*, at 1 (2014), *available at* http://www.catalyst.org/knowledge/women-ceos-fortune-1000. The percentage also applies to the Fortune 1000. *Id.*

[188]*See* Brown, *supra* note 176, at 1. These statistics are consistent with a similar study conducted in 2013. *See Stuart Spencer 2013 Index*, *supra* note 89, at 18 (twenty-two CEOs in the S&P 500; women made up thirty percent of the total directors at these companies).

[189]*See supra* note 32.

a matter of discretion. As a result, the catalyst for, and frequency of, intervention can vary considerably.[190]

In the new millennium, pressure on boards to intervene in managerial affairs has increased. Institutional investors predominate and have become better organized.[191] An increasing array of devices facilitates the collective expression of shareholder views on managerial practices.[192] Pressure to remove the CEO has become routine.[193] In addition, shifts in the fiduciary obligations of directors have clarified the circumstances when intervention at least sometimes is legally required.[194]

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[190]Periods of poor performance raise the risk of intervention. *See* Charles K. Whitehead, *Public Servants and Private Fiduciaries: Why Not a CEO Term Limit?*, 91 B.U. L. Rev. 1263, 1268 (2011) ("CEOs, instead, often are fired only after an extended period of poor performance."). *See also CEO Succession Practices, 2012 Edition*, Conf. Bd., http://www.conference-board.org/press/pressdetail.cfm?pressid=4453 ("The probability of CEO succession is higher following poor performance.").

[191]For a discussion of this phenomenon, see Brown, *supra* note 53, at 1358–62.

[192]These include an advisory vote on executive compensation, see Rule 14a-21, 17 C.F.R. § 240.14a-21 (2014), and changes to Rule 14a-8 that permit bylaw proposals that would require the inclusion of shareholder nominees in the company's proxy statement. *See* Catherine Dearlove & A. Jacob Werrett, *Proxy Access by Private Ordering: A Review of the 2012 and 2013 Proxy Seasons*, 69 Bus. Law. 155, 161 (2013). Similarly, the increasing prevalence of majority vote provisions has not added to the substantive authority of shareholders but has provided a mechanism for an expression of collective dissatisfaction with management. *See supra* note 47.

[193]*See* Joann Lublin & David Benoit, *Hertz CEO Mark Frissora Steps Down*, Wall St. J. (Sept. 8, 2014), *available at* http://online.wsj.com/articles/hertz-ceo-mark-frissora-steps-down-1410179061 (CEO "stepped down over the weekend amid disappointing results and accounting problems that had drawn outcries from activist investor Carl Icahn and other shareholders."); David Benoit & Julie Jargon, *Darden Restaurants CEO, Chairman to Step Down*, Wall St. J. (July 28, 2014), *available at* http://online.wsj.com/articles/darden-chairman-ceo-to-step-down-1406581334 (The company "shook up its leadership Monday, announcing the departure of its longtime chairman and chief executive and opening the door for activist investors to gain some board seats.").

[194]Acting with "conscious disregard" in the face of a known problem can constitute bad faith. Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006) ("Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith."). As a result, directors have an incentive to respond to red flags. *See In re* Caremark Int'l Inc. Deriv. Litig., 698 A.2d 959 (Del. Ch. 1996). The courts in Delaware have defined "red flag" in a very narrow fashion. *See In re* Citigroup, Inc. S'holders Litig., 2003 Del. Ch. LEXIS 61, at *8 (Del. Ch. June 5, 2003) (" 'Red flags' are only useful when they are either waived in one's face or displayed so that they are visible to the careful observer.").

Changes in structure also may render boards more susceptiable to pressure from shareholders.[195] With boards of the largest public companies required to include a majority of independent directors,[196] companies can no longer resort to the most reliable categories of directors such as family members and officers of the same company.[197] Boards have instead turned to other categories, such as members of the CEO's social circle and retired CEOs,[198] that, while reliable, are likely to be less supportive of management than those chosen in earlier eras.[199]

To address the increased risks of intervention, public companies are altering their board structure. Although only required to include a majority of independent directors, listed companies have increasingly opted for a supermajority[200] that eliminates all insiders except

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[195]*See* Edward Rock, *Adapting to the New Shareholder-Centric Reality*, 161 U. Pa. L. Rev. 1907, 1923 (2013) ("Through changes in listing requirements and much greater attention to the board's monitoring functions, boards have become much more independent of CEOs than they were in the past.").

[196]*See supra* note 5. State law also provided companies with incentives to include a majority of independent directors on the board. In particular, matters traditionally subject to the duty of loyalty because of a conflict of interest inside the board room were reviewed under the duty of care when approved by an informed board with a majority of independent directors. *See* J. Robert Brown, Jr., *Returning Fairness to Executive Compensation*, 84 N.D. L. Rev. 1141, 1150 (2008).

[197]*See supra* note 68.

[198]Other categories of directors may qualify as "reliable" and "independent." Officials from nonprofits may be an example. Particularly where the nonprofit has financial ties to the company, an executive director would have significant incentive to maintain a positive relationship with the CEO. Despite the obvious connections, such individuals are generally treated as "independent." *See In re* Goldman Sachs S'holder Litig., 2011 Del. Ch. LEXIS 151, at *31 (Del. Ch. Oct. 25, 2011) (The plaintiffs failed to allege facts that rebut presumption of independence where plaintiffs "do not state how [the director's] decision-making was altered by the donations."). The desire to remain on the board and protect the income stream to the organization may qualify these directors as "reliable." This category may, however, be more diverse than the others. *See* James J. Fishman, *Stealth Preemption: The IRS's Nonprofit Corporate Governance Initiative*, 29 Va. Tax Rev. 545, 577 (2009) ("The nonprofit sector is far more structurally diverse than the for-profit organizations to whom SOX applies.").

[199]The dismissal rate of CEOs has increased in recent years. *See* Lee Harris, *CEO Retention*, 65 Fla. L. Rev. 1753, 1784–85 (2013). This reduced degree of reliability may be an explanation.

[200]Most large public companies, however, have opted for a supermajority of independent directors. *See* Shearman & Sterling LLP, *Corporate Governance of the Largest US Public Companies, General Governance Practices 2011*, at 7, *available at* https://reaction.shearman.com/reaction/corpgov2011/CorpGov_GeneralGov_0825.pdf ("Independent directors constituted

the CEO.[201] On these boards, the CEO also commonly serves as chair.[202]

At first blush, the approach seems shareholder friendly. Investors would appear to benefit from the increased independence of the board.[203] Reducing the influence of the CEO has the potential to strengthen the monitoring function of the board.[204]

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75% or more of the directors on the boards of 95 of the Top 100 Companies surveyed this year.") [hereinafter Shearman & Sterling Study]. *See also* ISS Report, *supra* note 13, at 23 (placing the percentage of companies in the S&P 500 with seventy-five percent or more directors who meet ISS standards for independence at eighty-one percent).

[201]*See Spencer Stuart 2013 Index, supra* note 90, at 4 ("On 60% of boards today [in the S&P 500], the CEO is the only non-independent director, compared with just 35% of boards in 2003."). The phenomenon is recent. *See* Fairfax, *supra* note 35, at 135 ("as recently as 1989, it was rare for a board to have fewer than three inside directors").

[202]Whether the two positions are separate in large part depends upon the size of the company. Small companies are more likely to separate. In the case of large public companies (S&P 500), sixty-one percent of the companies combine the position. Moreover, only twenty-one percent have an independent chair. ISS Report, *supra* note 13, at 8. In the case of smaller companies, separation was more common. *See id*. (noting that fifty-two percent of the S&P 1500 combine the positions; thirty-one pecent of the mid-cap companies and twenty-nine percnet of the small-cap companies have independent chairs). Moreover, for the S&P 500, the trend since 2004 has largely plateaued. While twenty-seven percent of the companies separated the two positions in 2004, the percentage increased to thirty-eight percent in 2008, where it has more or less remained. *Id*. at 9. Moreover, in some cases, the separation may be temporary. *See Spencer Stuart 2013 Index*, *supra* note 90, at 5 ("[O]ur analysis [for 2012] has found that 25% of S&P 500 boards have a truly independent chair, an increase from 23% in 2012. In most of the remaining cases, the former CEO serves as the chair as part of the initial leadership transition. Many times, boards will separate the chair and CEO roles when a new CEO is first appointed and, after a certain period of time, the CEO will assume the chair duties.").

[203]Shareholders favor independent boards. *See infra* note 208. It would seem logical that they would benefit from greater board independence. At least where increased independence is demonstrated through a supermajority of independent directors, however, this has not been empirically demonstrated. *See infra* note 209. Of course, this assumes that "independent" directors are in fact independent, something that may not be the case. Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. Corp. L. 231, 266 (2002) (noting that "some directors who are classified as independent are not truly independent of management because they are beholden to the company or its current CEO in ways too subtle to be captured in customary definitions of independence").

[204]*See* Fairfax, *supra* note 35, at 130 ("This virtual elimination of inside directors' role on corporate boards is inextricably linked to the overwhelming consensus that boards should be dominated by 'independent' directors. Such consensus stems from a belief that independent

Examined through the lens of a demythicized board, that is, a board that consists of directors primarily selected for their willingness to reliably support management, the benefits to shareholders fade away. The shift cannot be attributed to pressure from shareholders. Although lobbying for a supermajority, shareholders have generally been satisfied when two-thirds of the board consists of independent directors.[205] The decision to exceed this percentage, therefore, is a choice made by management.[206] Shareholders also have not pressed for the removal of all other officers and generally have opposed the unification of chair and CEO.[207] Finally, the empirical data does not demonstrate that shareholders benefit from this structure.[208]

If not for shareholders, then what explains the ongoing shift?[209] In a demythicized board, the structure advances the goal of reliability.

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directors are better equipped to monitor the corporation, detect fraud, and protect shareholders' interests.").

[205]The Council for Institutional Investors, for example, recommends that at least two-thirds of the board consist of independent directors. *See Policies on Corporate Governance*, Counsel for Institutional Investors, at 2.3 (May 9, 2014), *available at* http://www.cii.org/content.asp?contentid=76. *See also* ISS Report, at 21 ("Some governance activists believe that company boards should be at least two-thirds independent in order to represent shareholders' interests.").

[206]ISS Report, *supra* note 13, at 23 (noting that eighty-one percent of the companies in the S&P 500 have boards that are at least seventy-five percent independent).

[207]The Council of Institutional Investors favors a separation. *See Independent Board Chair*, Council of Institutional Investors, *available at* http://www.cii.org/independent_boardchair. The issue has generated a significant number of shareholder proposals. *See* ISS Report, *supra* note 13, at 7 (forty-four shareholder proposals seeking a separation of chair and CEO in 2012, with the proposals 34.7% among companies in the S&P 500).

[208]Bhagat & Black, *supra* note 203, at 233 ("firms with more independent boards . . . do not achieve improved profitability, and there are hints in our data that they perform worse than other firms").

[209]At least one commentator has suggested that the increase in the number of independent directors (and the exclusion of insiders) is explained by the joint desire of management and shareholders to avoid additional regulatory reform. *See* Urska Velikonja, *The Political Economy of Board Independence*, 92 N.C. L. Rev. 855, 860 (2014) (concluding that "[i]nstitutional investors and corporate managers value director independence because it displaces more meaningful reform"). The article bases the conclusion on what it perceives to be the inexplicable increase in the number of independent directors given the absence of benefit to shareholders. *Id.* at 868 ("virtually all academic commentators view supermajority independent boards as too much of a good thing"), and the opposition of "top executives." *Id.* at 889 ("Top executives

Independent directors have one thing in common: they lack any significant relationship with the company.[210] As a result, they have no independent source of information about the internal operations of the company.[211] Awareness comes mostly, if not entirely, through their participation on the board,[212] making the directors particularly dependent upon information provided by management.[213]

Incentivized to limit the information flow to directors,[214] the CEO can do so in two ways. First, he or she can control the formal system of

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appear unhappy with the shift towards a more director-controlled process."). The article does not address the possibility that the structure is explained by the benefits that inure to the CEO.

[210]See NYSE MANUAL, *supra* note 3, at *303A.02 (directors not independent if they have a "material" relationship with the company)*. See also Fairfax, supra note *35*, *at 133* ("[A]ll definitions [of director independence] are uniform in their exclusion of 'inside directors'–directors who are currently employed by the corporation on whose board they serve.").

[211]Directors often acknowledge significant limits on what they know about the business of the company. *See* Paredes, *supra* note 33, at 725 (discussing study reporting that "approximately 56% of the directors polled said that they only 'moderately' know what is going on at the companies where they serve, while 14% of the directors polled responded 'partially' when asked to what degree they really know what is going on at their companies"); *see also Engaging with Strategy*, *supra* note 136, at 5 ("Only 21% of the directors McKinsey surveyed felt they had a thorough understanding of their company's current strategy, which leaves plenty of room for the lead director to help.").

[212]*See* Sung Hui Kim, *The Banality of Fraud: Re-Situating the Inside Counsel as Gatekeeper*, 74 FORDHAM L. REV. 983, 1059 (2005) (noting "outside directors' almost exclusive reliance on senior managers for company-related information"). *See also* Corporate Governance Committee, *Report of the Task Force of the ABA Section of Business Law Corporate Governance Committee on Delineation of Governance Roles and Responsibilities*, 65 BUS. LAW. 107, 128 (2009) ("As a general matter, independent directors do not have their own sources of information about the company's performance, its strategic opportunities, and the risks associated with those opportunities.").

[213]Hoitash, *supra* note 1, at 402 ("board members often depend on information received from management"). *See also* Langevoort, *supra* note 48, at 812–13 ("[T]he CEO's incentive to distort information and engage in other influence activities makes the task of monitoring far more difficult, costly, and unpleasant."). Directors themselves acknowledge that most of what they know comes from management. *See* Paredes, *supra* note 33, at 725 ("Of the directors McKinsey & Company surveyed, 76% said that the CEO 'largely' 'controls and shapes what directors learn about the company.'"); *see also Engaging with Strategy*, *supra* note 136, at 6 ("Many members said that their primary source of information regarding global corporate strategy comes from management.").

[214]Evidence suggests that informed independent directors are more likely to take an active role in monitoring. *See* Ran Duchin et al., *When Are Outside Directors Effective?*, 96 J. FIN. ECON.

dissemination.[215] Meetings are held infrequently.[216] The CEO, as chair, sets the agenda[217] and decides on the supporting materials to be distributed.[218]

Second, the CEO can control the informal flow of information to directors. As the sole officer with guaranteed access to the boardroom (and any accompanying social events), the CEO is in a position to answer any questions or assuage any concerns expressed by directors.[219] Moreover, the monopoly reduces the ability of directors to form relationships with other officers, eliminating another possible channel for conveying information.

Efforts to reduce the CEO's control over the flow of information have occasionally surfaced. Some have sought to provide the lead director with a role in setting the agenda. Others have called for a separation of chair and CEO.[220] Neither proposal, however, eliminates board dependency on the CEO. The monopoly over information and knowledge of internal issues effectively provides the CEO with significant influence over the agenda, irrespective of the official role in the process.[221]

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195, 212 (2010) ("Consistent with recent theoretical research, we find that outside directors are associated with significantly better performance when their cost of acquiring information is low, and are associated with significantly worse performance when their cost of acquiring information is high.").

[215]Nicola Faith Sharpe, *The Cosmetic Independence of Corporate Boards*, 34 Seattle U. L. Rev. 1435, 1454 (2011) ("[D]irectors receive information packets prepared by the CEO or by the executives who work for her; directors rarely have channels outside of the CEO for information gathering.")

[216]ISS Report, *supra* note 13, at 25 ("Companies included in this study reported that they held an average of eight meetings in 2012, a number that has remained steady for several years."). *See also* Shearman & Sterling Study, *supra* note 200, at 26 (noting that among top one hunded companies, boards averaged nine meetings, with twenty-two holding six or fewer meetings).

[217]*See* Paredes *supra* note 33, at 725 ("Further, CEOs have control over the board's agenda and, therefore, can set what the board considers at its meetings.").

[218]The selection of material for distribution to the board may not reflect deliberate obfuscation but may arise out of CEO bias. *See* Sharpe, *supra* note 12, at 1116 (discussing "commitment bias" and "self-interested bias" by the CEO when disclosing information to the board).

[219]*See Id*. at 1092 ("directors often accept the CEO's interpretations of that information because they do not have the time or knowledge necessary to understand and digest it themselves").

[220]Council of Institutional Investors, *supra* note 207, at 1.

[221]Separating the two positions has not been shown to improve performance. Sharpe, *supra* note 12, at 1092 (noting that "[m]ultiple empirical studies have found that there is

Congress sought to reduce this control by imposing affirmative reporting obligations that eliminate the discretion of the CEO over the information flow to independent directors. Sarbanes-Oxley effectively required outside accountants to report any disputes with management to the audit committee of listed companies.[222] The statute also mandated that lawyers at least sometimes report suspected legal violations directly to directors.[223] Finally, the Commission has occasionally sanctioned officers for failing to keep directors informed about developments that can interfere with their gatekeeper role.[224]

In those circumstances, reporting is not discretionary.[225] The CEO has no ability to withhold the information. Nonetheless, these obligations are limited in timing and scope and have not significantly altered the

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little to no connection between a separate and independent chairperson and firm performance"). The data may demonstrate that companies do not benefit from a transfer of the agenda setting authority to someone other than the CEO. More likely, however, the absence of any benefit reflects the reality that the separation does not fundamentally alter the CEO's control over the agenda. *See id.* ("Ending CEO/Chairperson duality without additional processual change is suboptimal because this simple structural change does not address the larger informational and knowledge asymmetries that exist.").

[222]*See* Rule 10A-3, 17 C.F.R. § 240.10A-3 (2014). *See also* Exchange Act Release No. 47654 (Apr. 20, 2003) (adopting release).

[223]*See* Section 307 of SOX; *see also* 17 C.F.R. § 205.01 et seq. (2014). In connection with disclosure practices, the SEC encouraged companies to create qualified legal compliance committees that included members of the board. Management, however, has not favored the structure because of the increased potential for monitoring by the board. *See* Robert Eli Rosen, *Ethics in Corporate Representation: Resistances to Reforming Corporate Governance: The Diffusion of QLCCs*, 74 Fordham L. Rev. 1251, 1282 (2005) ("Resistance to the QLCC may be understood as resistance to a monitoring board.").

[224]*See In re* Isselmann, Exchange Act Release No. 50428 (admin. proc. Sept. 23, 2004) (officer "failed to provide important information to ESI's Audit Committee, Board of Directors, and auditors regarding a significant accounting transaction . . . [thereby failing] to fulfill his gatekeeper role was a cause of the Company reporting materially false financial results for ESI's first quarter").

[225]State law requires as a matter of fiduciary duty the implementation of a system for reporting information to the board of directors. Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006). Delaware courts, however, have not provided meaningful content to this requirement. *See* Fairfax, *supra* note 19, at 434 ("almost any monitoring effort, however minimal or formulaic, appears to prevent a showing of bad faith").

basic dynamic.[226] Moreover, the impact of required disclosure can be minimized.[227]

Whatever the merits, the reforms only seek to alter the CEO's role in the formal disclosure process. They do not purport to alter the ability of the CEO to monopolize less structured channels that arise from unique access to the boardroom. So long as he or she is the only insider serving as director, the CEO remains the sole source of day-to-day information about the company inside the boardroom and is in a position to influence the decisions of the board.

## IV. Reform Proposals and a Demythicized Board

Proposed reforms designed to address concerns about the board have proliferated. Some seek to increase the consultative role of the body by reducing the risk to the CEO of "informed" directors. Suggestions range from the creation of "advisory" directors to the inclusion of more insiders on the board.

Another proposal seeks to increase director independence through limits on the function of the board and reductions in the role of the CEO. One suggestion has been to restrict the board to a monitoring role and changing the CEO's status to a nonvoting, ad hoc director. The proposal recognizes the importance of the CEO on the board but seeks to limit his or her involvement in the decision-making process.

Recognizing the myths that surround board behavior will provide a more complete and accurate context in which to assess these proposals. Whatever the intended effect, the suggested changes do not displace the goal of reliability. Management, therefore, retains the incentive to ensure that any reforms are implemented in a manner that minimizes the impact

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[226]The instances of required disclosure are limited. *See supra* notes 223–25. They do not, therefore, substantially reduce the discretion of the CEO with respect to the information provided to the board. *See supra* notes 216–21.

[227]Rodrigues, *supra* note 129, at 1061 ("The ways in which board members receive information are also problematic. Directors typically obtain information shortly before board meetings and this material is often voluminous and poorly organized.").

on reliability. As a result, alterations in the structure or composition of the board may not generate the desired shifts in board behavior.

### *A. Advisory Directors*

One proposal has been to strengthen the board through bifurcation of the advisory and monitoring functions.[228] Directors that advise should not monitor.[229] This could be accomplished by excluding directors from committees with monitoring responsibilities, including audit, compensation, and nominating, while allowing the directors to serve on the board as a whole or on committees considered advisory, including finance, investment, strategy, acquisitions, science and technology, and executive.[230] By removing directors from the oversight process, they will be less likely to intervene and more likely to be viewed as management "friendly."[231] In these circumstances, management will be more willing to seek counsel and share with them the information necessary to provide the requested advice.[232]

The approach, however, raises a number of concerns. First, the activities of directors are not always so easily divided. Most "advisory" committees also monitor, and, similarly, "monitoring" committees sometimes advise. Thus, while the compensation committee of a listed company plays a monitoring role by "determin[ing] and approv[ing] the CEO's compensation level," the same committee is also expected to provide

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[228]*See* Faleye et al., *supra* note 17, at 1. For a discussion of the advisory function, see *supra* Part II and accompanying text.

[229]Faleye et al., *supra* note 17, at 2 ("[W]e define an advisory director as an independent director who does not serve on any of the principal monitoring committees but serves on at least one advisory committee if the company has any.").

[230]*Id.* at 8.

[231]*Id.* at 2 ("[T]he CEO is more likely to perceive independent directors not involved in monitoring as friendly and be more likely to share information with and receive advice from them.").

[232]*Id.* at 23 (advisory directors "enjoy better information advantage with the CEO, are more likely to perceive themselves as strategic advisors, and their strategic inputs are valued more by the CEO."). *See also* Emeka Duruigbo, *Stimulating Long-Term Shareholding*, 33 Cardozo L. Rev. 1733, 1751 (2012) ("The adopting company may also create an advisory director position . . . The advisory director will assume limited or no monitoring role, making it easier for CEOs to be less antagonistic and share relevant strategic information with her.").

"recommendations to the board with respect to non-CEO executive officer compensation, and incentive-compensation and equity-based plans," an advisory function.[233] Similarly, an acquisition committee may be advisory to the extent recommending merger candidates,[234] but monitoring to the extent reviewing and approving deals originated by management.[235]

Nor does the avoidance of a "monitoring" committee necessarily eliminate participation in the oversight function. Committees often make recommendations to the full board.[236] In these instances, advisory directors must participate in matters that arise out of the monitoring function. While abstaining is a possibility,[237] directors have a fiduciary obligation to monitor.[238] As a result, abstentions raise concerns[239] about

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[233]*See* NYSE Manual, supra note 3, at 303A.05(b)(i).

[234]*See supra* note 144.

[235]*See* Charter, Acquisition Committee, Board of Directors, Cisco Corp. (Mar. 12, 2009), *available at* http://files.shareholder.com/downloads/CSCO/3169312185x0x280259/ebff4faa-f6f7-441e-9947-2e3c5f602e28/Acquisition_Committee_Charter_-_March_12_2009.pdf. ("The Acquisition Committee shall have the authority to review and approve merger and acquisition transactions and investment transactions proposed by the Company's management.").

[236]*See* Kahn v. M & F Worldwide Corp., 88 A.3d 635, 650 (Del. 2014) (special committee had authority "report to the Board its recommendations and conclusions with respect to the" merger); *see also* Versata Enter., Inc. v. Selectica, Inc., 5 A.3d 586, 598 (Del. 2010) (Independent Director Evaluation Committee of the Board was assigned the authority to "make recommendations regarding the implementation of the NOL Poison Pill.").

[237]*In re* Tri-Star Pictures, Inc. Litig., 1995 WL 106520, at *2, 1995 Del.Ch. LEXIS 27 (Del. Ch. Mar. 9, 1995) ("Delaware law clearly prescribes that a director who plays no role in the process of deciding whether to approve a challenged transaction cannot be held liable on a claim that the board's decision to approve that transaction was wrongful.").

[238]*See* TVI Corp. v. Gallagher, C.A. No. 7798–VCP, 2013 Del.Ch. LEXIS 260, at *39 (Del. Ch. Oct. 28, 2013) ("Corporate directors have several other fiduciary obligations that are derivative of the duties of care and loyalty. These include obligations to exercise proper oversight and monitoring over the corporate entity they serve."); *see also* Beam v. Stewart, 833 A.2d. 961, 971 n.16 (Del. Ch. 2003), *aff'd*, 845 A.2d 1040 (Del. 2004) ("The 'duty to monitor' is not a separate fiduciary duty, but rather stems from the core fiduciary duties of care and loyalty.").

[239]*See In re* Dairy Mart Convenience Stores, Inc., No. C.A. 14713, 1999 Del.Ch. LEXIS 94, at *3 n.2 (Del. Ch. May 24, 1999) (noting that the "office of director is one that comes with affirmative fiduciary duties" and the "mere abstinence from a vote does not, in the ordinary course, shield or absolve directors from liability").

fulfilling these obligations.[240] This is particularly true where the director participated in, or has unique knowledge about, the transaction at issue.[241]

Most importantly, however, in the context of a demythicized board, the approach does not adequately take into account the goal of management to control the flow of information to directors. Once advisory directors learn about an issue or development, the CEO cannot prevent further dissemination of the information to the other members of the board, including those engaged in a monitoring function. The expectation of other directors[242] or the mandates of the law[243] at least sometimes will result in disclosure.

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[240]*Id.* ("While there may be perfectly appropriate reasons why directors choose to abstain from a particular vote, where there is evidence which shows that the directors could have formed an opinion based on reasonably available information, and where there are no duty of loyalty issues present, abstaining from taking a position on a matter will not provide directors with a safe harbor from liability.") (citation omitted); *see also In re* Tri-Star Pictures, Inc. Litig., 1995 WL 106520, at *2 ("I agree that no per se rule unqualifiedly and categorically relieves a director from liability *solely* because that director refrains from voting on the challenged transaction.").

[241]*See* Gesoff v. IIC Indus., Inc. 902 A.2d 1130, 1166 n. 202 (Del. Ch. 2006) (absence from meeting where challenged matter approved not a defense; director was "closely involved with the challenged merger from the very beginning"); Valeant Pharmaceuticals Int'l v. Jerney, 921 A.2d 732, 753 (Del. Ch. 2007) (noting the general rule that directors who did not attend or participate in board deliberations or approval will not be held liable "is not an invariable rule and the result may differ where the absent director plays a role in the negotiation, structuring, or approval of the proposal"); *see also In re* Tri-Star Pictures, Inc. Litig., 1995 WL 106520, at *2 ("One might, for example, imagine a scenario in which certain members of the board of directors conspire with others to formulate a transaction that is later claimed to be wrongful. As part of the conspiracy, those directors then deliberately absent themselves from the directors' meeting at which the proposal is to be voted upon, specifically to shield themselves from any exposure to liability. In such circumstances it is highly unlikely that those directors' 'nonvote' would be accorded exculpatory significance.").

[242]Miguel Bustillo, *Best Buy Chairman to Resign After Probe*, Wall St. J. (May 15, 2012), *available at* http://online.wsj.com/article/SB10001424052702304192704577403922338506912.html (founder of company stepped down as chair after failing to "alert other directors that his handpicked successor as chief executive. . . .was allegedly having an inappropriate relationship with a female employee").

[243]Director removed from the monitoring function in order to provide advice would still have legal obligations to monitor. Red flags received during the advising or monitoring function create the same legal obligation to act. Macey, *supra* note 113, at 55 ("The assertion that board members somehow can function as independent monitors when serving on committees but then magically rejoin the management team when they are meeting as part of the full board rather than on the committee seems highly doubtful.").

Similarly, recognition of a demythicized board would take into account the preeminence of reliability in the director selection process. As a result, boards may lack the range of skills and experiences needed to provide useful advice.[244] Merely separating the two functions[245] does not, therefore, address the quality of the advice.[246]

### B. *Inside Directors*

Another approach has been to suggest an increase in the number of inside directors on the board. Professor Fairfax rightfully notes the porous nature of the definition of independence[247] and hypothesizes that the replacement of outside directors with insiders will not necessarily impair board independence.[248] Her analysis seeks to convince shareholders and their supporters that boards may benefit from greater reliance on inside directors, both because they are "better equipped than outside directors to bridge the information and knowledge divide" and because they may result in increased diversity.[249]

The analysis astutely recognizes that boards can benefit from a membership that includes more than a single officer. The approach would provide independent directors with additional informal sources of insight that could help make decisions more informed. Nor would the presence of

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[244]Another possible solution might be the creation of a "devil's advocate" and assign the task to someone on the board. *See* Paredes, *supra* note 33, at 740–47 (proposing the institution of a "chief naysayer" and suggesting that the position could be filled by, among others, term limited independent directors or shareholder nominees).

[245]There will be at least some instances when the entire board must undertake the monitoring function. The board, for example, must approve mergers. As a result, dividing directors by function may not be possible.

[246]Thus, there is no guarantee that the advice will be taken. *See* Faleye et al., *supra* note 17, at 26 (effectiveness of advisory directors depends upon "the CEO's willingness to accept strategic advice from directors").

[247]Fairfax, *supra* note 35, at 146 ("[T]he current conception of director independence continues to fall short of capturing all of the ties that compromise a director's ability to be objective.").

[248]*Id.* at 177 ("[T]he fact that independent directors and inside directors are subject to ties that compromise them in similar ways indicates that inside directors may perform no worse than independent directors with respect to monitoring the corporation.").

[249]*Id.* at 185.

these directors harm the interests of shareholders.[250] From the perspective of a demythicized board, however, the proposed reform will be difficult to implement.

Insiders were entirely removed not as a consequence of shareholder pressure but at the behest of the CEO.[251] As a result, the benefits to shareholders that come from an increase in the number of insiders on the board are in fact the very reasons they were excluded in the first instance. So long as boards are selected primarily as part of a strategy to reduce the risk of intervention, insiders are unlikely to be returned in any significant numbers.

### *C. Ad Hoc Director*

Other proposals have sought to increase director independence by restricting the functions of the board and reducing the influence of the CEO. Professor Rodrigues acknowledges the adversarial nature of some functions performed by directors and, rather than reduce or minimize the dynamic, believes it should be a defining quality of board responsibility.[252]

She argues that boards should essentially be confined to oversight of conflicts of interest.[253] To ensure that this task is properly administered, the board should remove most insiders. Doing so would help "solidify the separate and distinct identity of the board as the place to go when conflict with management arises."[254] The CEO could remain but would be reduced to a nonvoting, *ex officio* member of the board.[255] The position would "strip [CEOs] of much of their power, while retaining the benefits of having them

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[250]*See supra note* 216.

[251]*See supra* Part I and accompanying text.

[252]Rodrigues, *supra* note 129, at 1055 ("Liberated from the foolish notion that it can effectively manage corporate strategy, the board could focus on those areas in which independence is an asset rather than a liability."). For a discussion of the adversarial nature, see *supra* note 20.

[253]Rodrigues, *supra* note 129, at 1068 ("The conflict primacy view of the board makes a virtue out of a vice by limiting the independent board's responsibilities to those areas where independence matters: problems of conflict of interest.").

[254]*Id.* at 1070.

[255]*Id.* at 1068 ("In confining the board to these areas I suggest one further change to boards: the elimination of any inside directors from the board, excepting only the CEO in an ex officio role.").

on the board, and send a clear signal that the board should not—within its limited jurisdiction—serve as a mere validation of the executive team's decision."[256]

Viewed from the perspective of a demythicized board, the proposal is not likely to generate a reduction in CEO influence. The approach recognizes the absence of a meaningful advisory role on the part of the board.[257] By formalizing the monitoring role, however, the approach increases management's incentive to ensure reliability.[258]

The proposal seeks to reduce this possibility by removing most insiders from the board and eliminating voting rights for the CEO. In the context of a demythicized board, however, neither will alter the fundamental influence of management. As Professor Rodrigues rightfully notes, minimizing the presence of all insiders except the CEO will not be particularly "disruptive" because the process is already under way.[259] The observation, however, does not take into account that the impetus for the ongoing transformation is augmentation of, rather than the reduction in, CEO influence.[260]

As for the demotion of the CEO to a nonvoting, *ex officio* director, the change will not, standing alone, provide the anticipated reduction of influence. Voting rights are not synonymous with influence. With boards typically operating by consensus, the significance of any individual director's vote is limited.[261] By remaining inside the boardroom and a participant in the deliberative process, the CEO retains the ability to persuade.

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[256]*Id.* at 1069–70.

[257]*See supra* Part II and accompanying text.

[258]For a discussion of the reasons why management favors a reliable board, see *supra* notes 33–42 and accompanying text.

[259]Rodrigues, *supra* note 129, at 1069–70 ("Demoting CEOs to nonvoting member status and meeting in executive session to vote would strip them of much of their power, while retaining the benefits of having them on the board, and send a clear signal that the board should not–within its limited jurisdiction–serve as a mere validation of the executive team's decision.").

[260]For a discussion of the control exercised by the CEO over boards devoid of other insiders, see *supra* note 221 and accompanying text.

[261]*See* Nicola Faith Sharpe, *Questioning Authority: The Critical Link Between Board Power and Process*, 38 J. Corp. L. 1, 39 (2012) (describing boards as "cohesive groups working toward consensus decision making.").

Moreover, the approach does not affect the influence that arises out of the control over information.[262]

The relative unimportance of voting rights is not a subjective observation. The approach has, in a limited fashion, already been tried. The stock exchanges prohibited the CEO from serving as a voting member of the nomination committees.[263] Nonetheless, the influence has remained.[264] With the ability to ensure the selection of reliable directors, the CEO can retain significant control with or without voting rights.

## V. Demythification and the Paths Forward

The emphasis on reliability reduces diversity. Diversity, however, will improve as the categories of reliable directors become more diverse. To some degree, this will occur naturally. As more women and minorities populate the C-suite, they will expand the diversity of the pool of executive officers.[265] The pool also will also expand to the extent that CEOs develop a more diverse social circle.

Nonetheless, such shifts will be slow and in some cases may take a generation or more to occur.[266] Moreover, greater diversity within the reliable categories will not necessarily result in a proportionate increase in board diversity. To the extent that women and minorities are not as

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[262]*See supra* notes 215–20.

[263]*See supra* notes 54–55.

[264]*See supra* notes 56–59 and accompanying text.

[265]Thus, the number of women CEOs in the S&P 500 increased from twenty-one in 2013, see ISS Report, *supra* note 13, at 12, to twenty-three in early 2014, see Brown, *supra* note 176. Moreover, there will be a compounding effect. As more women serve as CEOs, their social circle will result in more gender balance to the board. *See supra* notes 188–89 and accompanying text. Some have suggested that the problem of diversity will decline as more "qualified" women and minorities join the pool of eligible candidates. *See supra* note 171.

[266]Gender attitudes may require generations to change. *See* Morley Winograd & Michael D. Hais, *As Millennials Reject Gender Roles, but Embrace Marriage, They're Changing Society*, Christian Sci. Monitor (May 24, 2012), *available at* http://www.csmonitor.com/Commentary/Opinion/2012/0524/As-Millennials-reject-gender-roles-but-embrace-marriage-they-re-changing-society.

supportive of management as other directors, even when members of reliable categories, they will likely not receive appointments proportionate to their percentage of the relevant pool.[267]

More immediate improvement in diversity can come about from a reduction in the use of reliability as a primary criterion for board membership. In theory, this can occur at anytime. The board has the authority to determine and modify the applicable qualifications for nominees.[268] A change in board qualifications designed to reduce reliance on reliability is, however, unlikely. Reliability and diversity have something akin to an inverse relationship. More diversity can result in reduced reliability and visa versa.[269] Such a shift in approach, therefore, would have to overcome opposition both from the CEO[270] and directors selected on the basis of their reliability.[271]

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[267]Women, for example, may be tougher monitors and more likely to intervene in corporate affairs. *See* Renée B. Adams & Daniel Ferreira, *Women in the Boardroom and Their Impact on Governance and Performance*, 94 J. Fin. Econ. 291, 301 (2009) (concluding that women may engage in "tougher monitoring of the CEO"). Whether such a predilection remains true of women selected only from "reliable categories" of directors remains untested.

[268]The board also has the inherent authority to impose an advisory function. Management could resist or attempt to undermine the function. Doing so could increase the possibility of dismissal. *See* Bainbridge, *supra* note 111, at 1064 ("RJR Nabisco's management spent millions of dollars to develop a smokeless cigarette. When the board was finally informed, many directors were reportedly angered by management's failure to consult with them beforehand. Their anger was wholly justified, for the smokeless cigarette flopped. The responsible CEO resigned to avoid dismissal."). Effective implementation could not occur simply from imposition. Without management buy-in, the effectiveness of the function and the willingness of the CEO to accept any advice proffered would be in doubt. This is particularly true given the CEO's informational advantage with respect to day-to-day activities of the company. *See* Frankel, *supra* note 48, at 503 ("The CEOs are often as knowledgeable as their advisory Board members are, and perhaps even more knowledgeable than some of them. CEOs are more informed about the affairs of the corporation than their Board is. Therefore, the CEO's degree of reliance and dependence on the Board is not necessarily very high, especially when the CEOs can take Board advice or leave it.").

[269]The categories of reliable directors for the most part lack diversity. *See supra* notes 177–78. As a result, an increase in diversity sometimes requires companies to select candidates from other, less "reliable" categories. *See supra* notes 180–87 and accompanying text.

[270]Efforts have been made to reduce the influence of the CEO in the nomination process. *See supra* notes 53–55. They have largely been unsuccessful. *See supra* notes 56–58.

[271]Even framing the debate would have its difficulties. Boards are unlikely to acknowledge that directors are selected primarily on the basis of reliability. This can be seen from existing disclosure requirements. Companies already must reveal the qualifications of each individual director. *See infra* note 291 and accompanying text. Reliability does not appear to be an often-mentioned attribute.

Nonetheless, reform is still possible. Shareholders can pressure boards to select nominees from outside the traditionally reliable categories.[272] In addition, regulators, whether the SEC or the Delaware courts, can induce companies to make more complete disclosure of personal and business relationships, reducing the attractiveness of the nominees with these connections. The two approaches are related. Shareholders more easily will influence the selection process to the extent that regulators require meaningful disclosure.

### *A. Shareholders as a Catalyst*

Shareholders can act as a catalyst for the reduction in the use of reliability as a primary criterion for board membership. Bylaws represent a possible avenue of influence. Under state law, bylaws may "prescribe" qualifications for directors.[273] Shareholders can adopt bylaws that seek to limit the number of reliable directors.

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[272]The approach likely would improve diversity beyond increased representation of women and minorities. The SEC has emphasized a broad approach to diversity in formulating disclosure requirements. *See* Exchange Act Release No. 61175 (Dec. 16, 2009), http://www.sec.gov/rules/final/2009/33-9089.pdf ("some companies may conceptualize diversity expansively to include differences of viewpoint, professional experience, education, skill and other individual qualities and attributes that contribute to board heterogeneity, while others may focus on diversity concepts such as race, gender and national origin. We believe that for purposes of this disclosure requirement, companies should be allowed to define diversity in ways that they consider appropriate.").

[273]State law permits the inclusion of director qualifications in the bylaws. *See* DEL. CODE ANN. tit. 8, § 141(b) (2014) ("Directors need not be stockholders unless so required by the Certificate of Incorporation or the bylaws. The Certificate of Incorporation or bylaws may prescribe other qualifications for directors."). *See also* Bragger v. Budacz, 1994 WL 698609, at *10 (Del. Ch. Dec. 7, 1994) ("Any qualifications for the office of corporate director must be set forth either in the certificate of incorporation or the bylaws."). Shareholders have the authority to adopt bylaws. *See* DEL. CODE ANN. tit. 8, § 109 (2014). *See also* CA, Inc. v. AFSCME Employees Pension Plan, 953 A.2d 227, 227 (Del. 2008) (permitting shareholders to adopt "procedural, process oriented" bylaws). Qualifications in the bylaws cannot, however, be used to shorten the term of an incumbent director. *See* Kurz v. Holbrook, 989 A.2d 140, 157 (Del. Ch.), *rev'd on other grounds, aff'd in part sub nom*, Crown EMAK Partners, LLC v. Kurz, 992 A.2d 377 (Del. 2010) (bylaws cannot "impose a requirement that would disqualify a director and terminate his service"). Federal law allows these types of proposals to be included in the company's proxy statement, facilitating consideration by shareholders. *See* Rule 14a-8, 17 C.F.R. § 240.14a-8 (2014). The authority is not, however, without limits. A proposal could be excluded where not permitted under state law. *See* Monsanto Corp. (Nov. 7, 2008), *available at* http://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2008/harringtoninvestments110708-14a8.pdf (permitting the omission of a proposal that would

Efforts to directly confront the issue through bylaws almost certainly will fail. Provisions that limit the number of reliable directors are difficult to draft and easy to circumvent.[274] Implementation will confront the usual array of collective action problems, making adoption infrequent.[275] Finally, restrictions in the pool of available directors have the potential to conflict with the board's fiduciary obligations, providing a basis for ignoring or repealing the bylaw.[276]

Alternatively, shareholders can seek to reduce the number of reliable directors by prescribing substantive qualifications. Doing so potentially forces the board to select nominees from less reliable categories. The approach is, however, also unlikely to succeed. Collective action problems and drafting difficulties will make the efforts difficult. Moreover, Congress essentially tried this approach in Sarbanes-Oxley when it "encouraged" companies in Sarbanes-Oxley to include financial experts on the board.[277]

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adopt bylaw to "establish a requirement that all directors take an oath of allegiance to the Constitution of the United States of America" where company argued that state law required that director qualifications be reasonable and related to the objects and purpose of the business of the corporation).

[274]Directors often have some type of connection. *See In re* Dow Chem. Co. Deriv. Litig., No. 4349–CC, 2010 Del. Ch. LEXIS 2, at *33 (Del. Ch. Jan. 11, 2010) ("It is a business reality that current directors often nominate new directors, and some former relationship usually factors in to the nomination."). Isolating the specific type of personal and business relationships that result in "reliability" will be difficult. *See* Zimmerman v. Crothall, 2012 WL 707238, at *13 (Del. Ch. Mar. 27, 2012); *see also* Beam v. Stewart, 845 A.2d 1040, 1050 (Del.2004) ("Allegations of mere personal friendship or a mere outside business relationship, standing alone, are insufficient to raise a reasonable doubt about a director's independence"). Moreover, such relationships have a temporal component. Thus, for example, directors may have had, but no longer have, a business relationship with management.

[275]*See* Brown & Gopalan, *supra* note 2, at 312–314.

[276]Bylaws that conflict with the board's fiduciary obligations have been deemed invalid. *See* CA, Inc. v. AFSCME Employees Pension Plan, 953 A.2d 227, 227 (Del. 2008). Directors also typically have the authority to adopt and amend bylaws. *See* Del. Code Ann. tit. 8, § 109 (2014) (authority permitted if included in certificate of incorporation). As a result, they could conceivably repeal or amend a shareholder bylaw. To the extent the board viewed a qualification bylaw as interfering with the fiduciary obligation to select directors deemed in the best interests of shareholders, the board could have the authority to repeal the requirement.

[277]Congress stopped short of actually requiring financial expertise. Nonetheless, companies routinely included experts on the board. *See* Ernst & Young, *Audit Committee Reporting to*

The need for substantive expertise expanded the pool of eligible candidates and held the promise of greater board diversity.[278] Nonetheless, hoped-for effects never materialized.[279]

In the context of a demythicized board, the outcome was predictable. The barrier to diversity is not the dearth of qualified candidates but the need for reliability.[280] The substantive imposition under Sarbanes-Oxley did not eliminate this motive. As a result, even when required to locate nominees with certain specified qualifications, boards retain the incentive to select them from existing categories of reliable directors.[281] Bylaws that

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*Shareholders: 2013 Proxy Season Update*, at 3, *available at* http://www.ey.com/Publication/vwLUAssets/Audit_committee_reporting_2013_proxy_season_update/$FILE/Audit_committee_reporting_shareholder_2013_proxy_season_update.pdf (all Fortune 100 companies studied had at least one financial expert; companies in study averaged 2.7 directors with financial expertise). While only obligated to comply or explain, most large companies complied, avoiding the need to explain why they did not need financial expertise on the board. *See* Eric Alden, *Blocking the Ax: Shielding Corporate Counsel from Retaliation as an Alternative to White Collar Hypercriminalization*, 36 U. Haw. L. Rev. 95, 151 n.178 (2014) ("Desirous of avoiding such embarrassing disclosure, public companies generally strive to find audit committee financial experts whenever possible."). The lack of expertise occurred in an environment where directors were often aware that this was the case. L. Murphy Smith, *Audit Committee Effectiveness: Did the Blue Ribbon Committee Recommendations Make a Difference?*, 3 Int'l. J. Accounting, Auditing & Performance Eval., 240, 245 (2006) (noting one student finding that "many audit committee members believe that they do not have the requisite skills and expertise to effectively carry out their duties" and that public accounting firms "ranked their perception of audit committee member knowledge even lower than the audit committees ranked themselves").

[278]*See* Broome, *supra* note 181, at 678 ("Financial experts' are in demand post-Sarbanes-Oxley, and women CFOs or even CPAs should be increasingly attractive candidates when board searches are focused on financial expertise.")

[279]*See* Lisa M. Fairfax, *Clogs in the Pipeline: The Mixed Data on Women Directors and Continued Barriers to Their Advancement*, 65 Md. L. Rev. 579, 606 (2006) ("Unfortunately, the strong representation of women in financial fields has not translated into greater board representation. . . . only one woman Fortune 100 director serves as a financial expert. Hence, the emphasis on financial experience does not appear to have translated into increased board seats for women.").

[280]*See supra* notes 22 & 172–73.

[281]Burch, *supra* note 170, at 600 ("The Sarbanes-Oxley requirements seem to have created more opportunities to serve on corporate boards. As senior executives have resigned from board positions because of the increased time commitment commensurate with increased monitoring obligations due to Sarbanes-Oxley, board positions open up. However, this benefits qualified women and people of color who seek to become directors only if they are considered as directors.").

impose substantive qualifications can be expected to have the same effect.[282]

Shareholders have the authority to vote against directors with excessive indicia of reliability.[283] They can organize "just say no" campaigns targeting these individuals[284] and, where companies have majority vote provisions, force directors to submit letters of resignation.[285] For this type of private ordering to work, however, shareholders must receive adequate disclosure, including insight into the personal and business connections between directors and management that were considered by the board. Sufficiently fulsome disclosure of these relationships has not, however, always occurred.[286]

### *B. Regulators as a Catalyst*

Regulators can also provide a catalyst for a reduction in the number of "reliable" directors. Under recent pronouncements by the SEC, listed companies have been subjected to a clear obligation to disclose personal and business relationships between directors and management. Similarly,

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[282]Shareholders could also seek to achieve the result in a more direct fashion by directly pressuring boards to nominate candidates from outside the traditional categories of reliable directors. This has essentially occurred with respect to the efforts to increase board diversity. Because the traditional categories of reliable directors are not diverse, see *supra* notes 176–78, boards seeking increased representation of women and minorities at least sometimes must examine a broader pool of eligible candidates. Although successful to a point, the approach has limits. *See supra* notes 182–87. The relatively low level of diversity suggests that boards will limit the number of directors who do not possess sufficient indicia of reliability.

[283]*See infra* note 295–296. Other sources of shareholder pressure exist. *See* Level 3 Comm., Inc., *supra* note 148, at 19 ("In connection with the execution of the STT Stockholder Rights Agreement, we agreed to form a new committee of the Board to be called the Strategic Planning Committee.").

[284]Plurality voting, however, renders a no vote for directors largely irrelevant. *See supra* note 44. Negative votes are, therefore, mostly a mechanism for sending a message of dissatisfaction without requiring the director to actually leave the board.

[285]The board, however, has the authority to, and with some frequency does, reject the tendered resignation. *See supra* note 47. The term "zombie director" has been used to describe nominees who do not receive a majority of the votes cast but remain on the board. *See* J. Robert Brown, Jr., *The Problem of Zombie Directors (Part 1)*, Race to the Bottom (Apr. 25, 2013 6:00 AM), http://www.theracetothebottom.org/independent-directors/2013/4/25/the-problem-of-zombie-directors-part-1.html.

[286]*See infra* notes 295–96.

recent decisions by the Delaware courts have potentially expanded the instances when ties to management must be revealed.

### 1. The SEC and the Proxy Process

The proxy rules require the disclosure of background information on directors,[287] including their names and ages, positions or offices with the company, length of service, and any understandings or arrangement connected to the nomination process.[288] The proxy statement also must reveal any family relationships between directors and executive officers;[289] a nominee's business experience, including the "specific experience, qualifications, attributes or skills that led to the conclusion that the person should serve as a director"; directorships held at other public companies; and involvement in certain types of legal proceedings.[290]

The disclosure requirements also specifically address director independence. The proxy statement must identify those directors determined by the board to be independent under the listing standards of the relevant

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[287]*See* Item 7, Schedule 14A; *see also* Item 401 of Regulation S-K, 17 C.F.R. § 229.401 (2014).

[288]Item 401(a). The requirement to disclose arrangements and understandings has been around since the 1940s. *See* Exchange Act Release No. 2376 (Jan. 12, 1940). The requirement may have arisen from the practice of requiring nominees to submit undated letters of resignation. *See In re* Sweets Steel Co., Exchange Act Release No. 1899 (Feb. 24, 1939) (finding the statement "registrant does not contemplate any change in its present management" false and misleading where an undated resignation letter was in the possession of a controlling shareholder); *see also Staff Report on Proxy Solicitations in Connection with Compass Investment Group*, Exchange Act Release No. 16343 (Nov. 15, 1979) (Section 21(a) Report) (finding that decision to designate one nominee as chairman and pay a specified amount of compensation constituted an "arrangement or understanding" under the proxy rules); *In re* Occidental Petroleum Corp., 47 SEC Docket 330 (July 2, 1980) ("certain persons standing for election as directors of Oxy signed undated letters of resignation as directors of Oxy . . . Shareholders expect that the directors they elect will serve and function for the full elected term. Accordingly, any understandings or arrangements, whether oral or written, under which a director may not be able to do so, or pursuant to which the director's functions or term may be limited, should be fully disclosed."); *In re* Massie, 25 SEC Docket 492 (Apr. 11, 1947) (asserting that proxy rules violated as a result of the failure to disclose an undated letter of resignation submitted by a director nominee).

[289]Item 401(d) of Regulation S-K, 17 C.F.R. § 229.401(d) (2014). As the instructions note: The term "family relationship" means any relationship by blood, marriage, or adoption, not more remote than first cousin.

[290]*See* Item 401 of Regulation S-K, 17 C.F.R. § 229.401 (2014).

stock exchange.[291] The New York Stock Exchange (NYSE) defines independence in the negative, excluding any director who has a "material relationship" with the "listed company."[292] The proxy statement also must reveal any "transactions, relationships, or arrangement" considered but rejected by the board in determining director independence.[293]

To the extent that the board considers personal and business relationships, they must be disclosed, at least with respect to directors found to be independent. Whether boards traditionally considered these types of relationships, however, was unclear. The NYSE listing standard for director independence focused on "material relationships" with the *listed company* rather than management.[294] The Commission has clarified that relationships with management must be considered. As the Commission has stated,

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[291]Item 407(a), 17 C.F.R. § 229.407(a) (2014). Companies must use the definition of the exchange where they are traded, assuming the exchange requires that at least a majority of the board be independent. If they are not traded on such an exchange, the companies must pick a definition from one that does. *See* Item 407(a)(1). Companies have the right to augment these definitions but must either post the policies on their website or attach them to the proxy statement as an appendix at least once every three years. *See* Item 407(a)(2), 17 C.F.R. § 229.407(a)(2) (2014).

[292]NYSE Manual, *supra* note 3, at 303A.02. The NYSE takes the position that this also applies to material relationships with the senior management. *See* Joann S. Lublin, *Big Board Questions Black & Decker*, Wall St. J., Mar. 11, 2010.

[293]Item 407(a)(3), 17 C.F.R. § 229.407(a)(3) (2014). *See also* Exchange Act Release No. 54302A (Aug. 29, 2006) ("the amended rule requires that the disclosure be made on a director by director basis, with separate disclosure of categories or types of transactions, relationships or arrangements for each director and director nominee"). Disclosure was to be made by "specific category or type," see Item 407(a), 17 C.F.R. § 229.407(a), with enough detail "to fully describe the nature of the transactions, relationships or arrangements." Note 3, Item 407(a), 17 C.F.R. § 229.407(a) (2014).

[294]NYSE Manual, *supra* note 3, at 301A.02. The Commentary somewhat obliquely suggested otherwise. *See id.* at 303A.02 ("as the concern is independence from management, the Exchange does not view ownership of even a significant amount of stock, by itself, as a bar to an independence finding"). At least one company indicated that the NYSE requirement did not apply to business and personal relationships. *See* J. Robert Brown, Jr., *The NYSE and the Problems of Director Independence: The Plain Meaning of NYSE 303A.02 (Part 2)*, Race to the Bottom (June 1, 2010 9:00 AM), http://www.theracetothebottom.org/independent-directors/2010/6/1/the-nyse-and-the-problems-of-director-independence-the-plain.html. The NYSE, however, disagreed with the position. *See* J. Robert Brown, Jr., *The NYSE and the Problems of Director Independence: The Plain Meaning of NYSE 303A.02 (Part 3)*, Race to the Bottom (June 2, 2010 6:00 AM), http://www.theracetothebottom.org/independent-directors/the-nyse-and-the-problems-of-director-independence-the-non-t.html.

> Although personal and business relationships, related party transactions, and other matters suggested by commenters are not specified either as bright-line disqualifications or explicit factors that must be considered in evaluating a director's independence, the Commission believes that compliance with NYSE Arca's rules and the provision noted above would demand consideration of such factors with respect to compensation committee members, as well as to all Independent Directors on the board.[295]

The SEC's clarification likely will result in increased consideration by boards of personal and business relationships and increased disclosure of those considered but rejected when determining director independence.[296]

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[295]Exchange Act Release No. 68639 (Jan. 11, 2013). The same statement appears in the release amendments to the NASDAQ listing standards. See Exchange Act Release No. 68640 (Jan. 11, 2013). The NYSE does affirmatively require that the board "consider all factors specifically relevant to the determination whether a director has a relationship to the listed company which is material to the director's ability to be independent from management in connection with the duties of a compensation committee member." NYSE MANUAL, *supra* note 3, 303A.02(a)(ii). The requirement, however, applies only to those serving on the compensation committee and not to all directors on the board.

[296]Some companies note explicitly that they consider these relationships. *See* Endurance Specialty Holdings, Ltd., Proxy Statement (Apr. 9, 2014), at 19, *available at* http://www.sec.gov/Archives/edgar/data/1179755/000119312514136309/d707101ddef14a.htm (Shareholder submitting a nominee must include: "a description of all material personal and business relationships between the shareholder and any such nominee during the preceding ten (10) years."); Bridge Capital Holdings, Proxy Statement, at 11 (Apr. 15, 2014), *available at* http://www.sec.gov/Archives/edgar/data/1304740/000104746914003809/a2219357zdef14a.htm ("No significant business or personal relationships exist between any director and the Company or its management."); Proofpoint, Inc., Proxy Statement, at 5 (May 1, 2014), *available at* http://www.sec.gov/Archives/edgar/data/1212458/000104746914004460/a2219939zdef14a.htm ("They also specify various relationships that preclude a determination of director independence. Material relationships may include commercial, industrial, consulting, legal, accounting, charitable, family and other business, professional and personal relationships."); Otelco, Inc., Proxy Statement, at 7 (Apr. 11, 2014), *available at* http://www.sec.gov/Archives/edgar/data/1288359/000157104914001145/t1400371-proxy.htm ("For prospective non-employee directors, independence under Securities and Exchange Commission and applicable stock exchange rules, and the absence of any conflict of interest (whether due to a business or personal relationship) or legal impediment to, or restriction on, the nominees serving as a director."); Silver Spring Networks, Inc., Proxy Statement, at 6 (Apr. 21, 2014), *available at* http://www.sec.gov/Archives/edgar/data/1180079/000119312514150753/d711466ddef14a.htm ("These provide that a director is independent only if our Board of Directors affirmatively determines that the director has no direct or indirect material relationship with our company. They also specify various relationships that preclude a determination of director independence. Material relationships may include commercial, industrial, consulting, legal, accounting, charitable, family and other business, professional and personal relationships.").

Shareholders should therefore be more often made aware of any close connections between directors and management.[297]

## 2. The Role of the Delaware Courts

Fiduciary obligations apply to all aspects of board behavior, including director nominations.[298] Judicial interpretation of a board's fiduciary obligations represents another possible catalyst for reducing the number of reliable directors. Selecting directors in order to benefit management rather than shareholders is inconsistent with this duty. A direct challenge to the use of reliability in the nomination process will, however, confront significant barriers.

Bringing a claim based upon a violation of the duty of good faith necessitates a showing that the board acted "with a purpose other than advancing the best interests of the corporation."[299] At least one court entertained this type of claim where a director submitted a nominee over the objections of the board.[300] Nonetheless, in an era of independent

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[297]In at least one case in 2014, a company disclosed business and personal relationships with a controlling shareholder that resulted in a decision not to characterize the directors as independent. Las Vegas Sands Corp., Proxy Statement, at 11 (Apr. 25, 2014), *available at* http://www.sec.gov/Archives/edgar/data/1300514/000119312514160074/d707917ddef14a.htm (noting that two directors have "business and personal relationships" with the controlling shareholder including one director who acted as a trustee of several trusts that benefited the controlling shareholder's family and noting that the directors "may have their financial interests aligned" with the controlling shareholder). In another, the company disclosed the existence of business and personal relationships but viewed them as insufficient to impair independence. WR Berkley Corp., Proxy Statement, at 15 (Apr. 7, 2014), *available at* http://www.sec.gov/Archives/edgar/data/11544/000119312514133484/d704105ddef14a.htm (concluding that director with "business and personal relationships" with CEO was independent in part because of the director's "reputation and professional background evidencing his independent nature, and particularly [the director's] history of acting independently of Company management").

[298]Indeed, one court has suggested that directors have a fiduciary obligation to resist shareholder nominees. Business Roundtable v. SEC, 647 F.3d 1144, 1150 (2d Cir. 2011) (noting that boards have a fiduciary obligation to oppose candidates nominated by shareholders).

[299]*In re* Walt Disney Co. Deriv. Litig., 906 A.2d 27, 67 (Del. 2006) ("A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation.").

[300]*See* Indep. Bank Corp. v. Spence, 15 Mass. L. Rptr. 609, 2003 Mass. Super. LEXIS 8, at *15 (Mass. Super. Jan. 29, 2003) (allowing case to go forward where "the complaint alleges that

nominating committees,[301] shareholders rarely will succeed in marshaling the evidence needed to successfully bring such an action.[302]

Shareholders can potentially challenge the use of reliability in a more indirect fashion. To the extent directors are chosen for their willingness to support management and not for their substantive abilities, they may lack the skill set needed for service on the board. Shareholders, could, therefore, allege that boards violated their fiduciary obligations by nominating unqualified candidates. State law, however, imposes no meaningful standards for director nominees.[303] Moreover, reliable directors often, as a secondary matter, have a skill set that arguably benefits the board.[304]

As a result, these claims are unlikely to succeed.[305] In *Bragger v. Budacz*,[306] shareholders asserted that the board violated its fiduciary obligations by nominating two candidates who also served as executive officers at a company "alleged to be a competitor."[307] The court dismissed the case, finding that there was "no *per se* rule prohibiting a corporate officer from one corporation from sitting on the board of a company with whom his

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Spence, purportedly acting as a shareholder, nominated his daughter to serve as an IBC director and refused to withdraw the nomination even after it was unanimously opposed by the IBC board, causing the board to retain outside corporate counsel to provide advice on this issue").

[301]*See supra* notes 53–55.

[302]Delaware courts impose high barriers to these types of action. *See* Chen v. Howard-Anderson, 87 A.3d 648, 685 (Del. Ch. 2014) ("Although they made decisions which, for purposes of summary judgment, can be regarded as falling outside the range of reasonableness, the factual record will not support a reasonable inference that any of the outside directors were motivated by a non-stockholder-related influence.").

[303]*See* Del. Code Ann. tit. 8, § 141(b) (2014).

[304]Indeed, public companies are already required to describe qualifications and skills possessed by nominees that are necessary for service on the board. *See supra* note 31.

[305]*See* Ross Systems Corp. v. Ross, Del. Ch., Civ.A. No. 10378, 1993 WL 49778, at *1145 (Del. Ch. Feb. 19, 1993) (director's fraud upon the corporation does not disqualify him from serving on that board of directors); Kirkland v. Int'l Cmty. Corp., Del. Ch., C.A. No. 7577, slip op. at 9, Berger V.C. (July 13, 1984) (director who has personal or business interests conflicting with those of the corporation is not disqualified from serving on the board of directors).

[306]1994 WL 698609 (Del.Ch. Dec. 7, 1994).

[307]*Id.*

employer may compete in one or more markets."[308] Instead, the matter was more appropriately left to the consideration of shareholders when electing directors.[309]

Shareholders have been more effective addressing concerns over reliability through challenges to director independence. While not requiring the use of independent directors, the Delaware courts provide legal benefits for doing so. A board with a majority of independent directors can more easily obtain the dismissal of derivative suits.[310] The decisions of committees consisting of independent directors are typically entitled to additional deference when challenged.[311]

Personal and business relationships between directors and management can result in the loss of independence.[312] Moreover, to the extent characterizing a candidate as "independent,"[313] companies may have an obligation to reveal potentially inconsistent information,[314] including

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[308]*Id.*

[309]*See In re* Gulla, 115 A. 317, 318 (Del. Ch. 1921) ("the fitness or unfitness of individuals to become directors [is] a matter for the stockholders to pass upon").

[310]*See* Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984) (shareholders may establish demand futility by establishing that directors were not independent and disinterested).

[311]*See* Brown, *supra* note 53, at 1353. *See also* Kahn v. M & F Worldwide Corp., 88 A.3d 635, 650 (Del. 2014) (discussing shift in standard of review following approval of going private transaction by special committee consisting of independent directors).

[312]*See* Beam v. Stewart, 845 A.2d 1040, 1040 (Del. 2004).

[313]Directors have a fiduciary duty to make complete disclosure to shareholders. Not an independent duty, the disclosure obligation is a subset of the duty of care or loyalty. Pfeffer v. Redstone, 965 A.2d 676, 684 (Del. 2009) ("duty of disclosure is not an independent duty, but derives from the duties of care and loyalty"); *see also* Stroud v. Grace, 606 A.2d 75, 84 (Del. 1992) ("[D]irectors of Delaware corporations are under a fiduciary duty to disclose fully and fairly all material information within the board's control when it seeks shareholder action."). An obligation to disclose that a director qualifies as "independent" may not be material. Kahn v. Caporella, Del. Ch., C.A. No. 13248, mem. op. at 15, 1994 WL 89016, at *7 (Del. Ch. Mar. 10, 1994) (rejecting plaintiff's claim that failure to disclose directors' lack of independence was a material omission when the court found no basis to question those directors' independence).

[314]*In re* Freeport-McMoran Sulphur, Inc. S'holder Litig., Civ.A. No. 16729, 2005 WL 1653923, at *14 (Del. Ch. June 30, 2005) ("Since the evidence raises genuine issues of material fact about the directors' and the Special Committee's independence, it also raises issues about the disclosure of those same facts. Without proper disclosure of all material information, the Sulphur board cannot rely on stockholder ratification in its attempt to

personal connections to management.[315] Although not all personal and business relationships are material,[316] the Delaware courts have found that at least some may cross that threshold.[317]

The issue arose in *In re Orchard Enterprises, Inc. Stockholder Litigation*.[318] In that case, Joseph Samberg exercised "sole voting and sole dispositive power" over Dimensional Associates, a private equity fund.[319] Dimensional, in turn, owned 53.3% of the outstanding voting power of Orchard and

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invoke the protection of the business judgment rule. Therefore, both the fiduciary duty claims and disclosure claims must be tried together.").

[315]*See* Millenco LP v. meVC Draper Fisher Jurvetson Fund I, Inc., 824 A.2d 11, 15 (Del. Ch. 2002) ("[W]here, as here, the omitted information goes to the independence or disinterest of directors who are identified as the company's 'independent' or 'not interested' directors, the 'relevant inquiry is not whether an actual conflict of interest exists, but rather whether full disclosure of potential conflicts of interest has been made.'"). The omitted information does not necessarily have to negate the independent status of the director. *See In re* Netsmart Techs., Inc. S'holders Litig., 924 A.2d 171, 206 (Del. Ch. 2007) ("[T]here are facts that, although not in themselves sufficient to render a committee member non-independent, might be material. Otherwise, there would be no need to disclose anything about independent directors, on the grounds that only the disclosure of facts that were fatal to their independence was required.").

[316]*See* Beam v. Stewart, 845 A.2d 1040, 1051–52 (Del. 2004) ("[A]llegations of mere personal friendship or a mere outside business relationship, standing alone, are insufficient to raise a reasonable doubt about a director's independence."). Nor have the Delaware courts taken an expansive interpretation on these obligations. *See In re* Netsmart Techs., 924 A.2d at 206 ("In view of the tightened definitions of independence that now prevail, I am chary about adding a judicially-imposed disclosure requirement that past interlocking board service involving a target's CEO and another independent director must always be disclosed."). *See also* Loudon v. Archer-Daniels-Midland Co., Civ.A. No. 14638,1996 WL 74730, at *7 (Del. Ch. Feb. 20, 1996) ("The plaintiff provides no legal authority or reasoned argument to support his apparent position that nominees must also issue a manifesto of their personal views or otherwise indicate their intentions as to how they will exercise their independent business judgment in the future once elected.").

[317]T. Rowe Price Recovery Fund, L.P. v. Rubin, 770 A.2d 536, 536 (Del. Ch. 2000) (alleged undisclosed past business relationships by director raised possible issues of fairness).

[318]88 A.3d 1 (Del. Ch. 2014). As the court noted, "The facts are drawn from the materials presented in support of the cross-motions for summary judgment." *Id.* at 8.

[319]As the Proxy Statement for Orchard described, "Joseph D. Samberg has a direct minority membership interest in Dimensional Associates and is managing member of JDS Capital Management, LLC. As the managing member of JDS Capital Management, LLC, the ultimate parent of Dimensional Associates, Joseph D. Samberg may be deemed to have sole voting and sole dispositive power with respect to all of our equity securities that are owned of record by Dimensional Associates." The Orchard Enterprises, Inc., Proxy Statement, at 104 (June 18, 2010), *available at* http://www.sec.gov/Archives/edgar/data/1339729/000114420410034176/v188479_defm14a.htm.

possessed the right to designate four of the seven directors.[320] Dimensional ultimately sought to acquire the remaining shares of Orchard.

The Orchard board appointed a special committee of "independent" directors, with Donahue designated as the chair. The court described the chair as "the point man for Orchard in negotiating with" Dimensional.[321] The special committee ultimately accepted an offer from Dimensional at $2.05 a share conditioned upon the approval of the majority-of-the-minority vote. In a subsequent appraisal action, the Chancery Court valued the shares at $4.67.[322]

Shareholders challenged the acquisition. Among other claims, they alleged that the company had not adequately disclosed the relationship between Samberg and Donahue. They further asserted that, as a result of the relationship, Donahue lacked independence, thereby depriving the decision of the special committee of judicial deference.

In resolving a motion for summary judgment, the Chancery Court found that the plaintiffs had presented sufficient facts to raise an issue as to Donahue's independence. Shareholders presented at least some evidence that Donahue had "long-standing ties to members of the Samberg family."[323] As the opinion described,

> Discovery revealed that Donahue and Jeff Samberg, who is Joseph's brother, have been business associates and personal friends for approximately twenty years. They attended the NCAA Final Four together every year from 1999 to 2008, and they have invested together in fifteen different companies, either directly or through Greylock Partners, a venture capital fund. Donahue and Arthur Samberg, Joseph and Jeff's father, are also long-time friends.[324]

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[320]As of the 2010 squeeze-out, Dimensional and its affiliates held approximately forty-two of Orchard's common stock (2,738,327 shares) and ninety-nine percent of its Series A convertible preferred stock (446,918 shares). *In re Orchard Enters.*, 88 A.3d at 8.

[321]Donahue was alleged to have negotiated with Stein, another Orchard director, who was in turn described by the court as "the point man for Dimensional in the events giving rise to the merger." *Id.* at 8. Stein resigned as the interim CEO at the outset of the negotiations but remained on the board of Orchard. *Id.* at 10.

[322]*In re* Appraisal of the Orchard Enters., Inc., C.A. No. 5713–CS, 2012 WL 2923305, at *23 (Del. Ch. July 18, 2012), *aff'd without opinion*, 2013 WL 1282001 (Del. Mar. 28, 2013).

[323]*Id.* at *9.

[324]*Id.*

The court indicated that "some financial ties or personal relationships" were not, standing alone, adequate to impair independence.[325] Nonetheless, "[a] sufficiently close relationship between Donahue and the Samberg family could render him unfit to have served as a member of the Special Committee, much less as its Chair."[326] Moreover, the information also had to be considered in the context of "the leading role that Donahue played in the process" and his alleged efforts to seek postclosing consulting work with Dimensional.[327] As a result, the court concluded that the issue could withstand a motion for summary judgment.[328]

*Orchard* provides insight into the types of relationships that may result in the loss of independence,[329] including those arising from family connections.[330] The possibility provides directors with an incentive to investigate, and be aware of, personal and business relationships between

[325]*Id.* at *25.

[326]*Id.* at *25–26 ("The plaintiffs have pointed to past business and social connections between Donahue and the Samberg family which, if viewed in isolation, would not be sufficient to raise a triable issue about his independence.").

[327]*Id.* at *26 ("The factual record could support a finding at trial that Donahue was the committee's most influential figure, making his independence and disinterestedness all the more important.").

[328]*Id.* at *23 ("At this stage of the case, in the context of a controller squeeze-out, it is not possible to rule as a matter of law on the materiality or completeness of the disclosures about Donahue. The plaintiffs have cited evidence which, if credited, could lead to findings of fact that would render the disclosures about Donahue incorrect or, alternatively, cause them to be viewed as misleading partial disclosures. The defendants have pointed to evidence which, if construed in their favor, could result in findings of fact that would lead to the disclosures being accurate. These matters create issues of fact that only can be resolved through a trial.").

[329]*See also In re* MFW S'holders Litig., 67 A.3d 496, 509 n.37 (Del. Ch. 2014), *aff'd*, Kahn v. M & F Worldwide Corp., 88 A.3d635 (Del. 2014) ("If the friendship was one where the parties had served as each other's maids of honor, had been each other's college roommates, shared a beach house with their families each summer for a decade, and are as thick as blood relations, that context would be different from parties who occasionally had dinner over the years, go to some of the same parties and gatherings annually, and call themselves 'friends.' ").

[330]*See also In re* Trados Inc. S'holder Litig., 73 A.3d 17, 55 (Del.Ch. 2013) (director had "a long history" with venture capital fund and that "current and past relationships" with fund and partner of fund "resulted in a sense of 'owingness' that compromised his independence for purposes of determining the applicable standard of review").

management and a nominee.[331] Failure to consider these relationships may result in in reduced deference to board decisions and a heightened risk of liability.

## Conclusion

Demythification explains a number of important dynamics in board behavior, including the lack of diversity and the growing exclusion of executive officers other than the CEO.[332] Moreover, the analysis indicates that degree of reliability is not static but evolves, particularly with shifts in the definition of director independence.

Although reliability is not invariably harmful, shareholders have an incentive in at least some circumstances to seek the reduction in the use of this attribute as the primary criterion for board membership.[333] They have a number of available avenues for doing so, including electoral campaigns against candidates with excessive ties to management and judicial challenges to those appointed to "independent" committees of the board.

The case law in Delaware and the guidance issued by the SEC suggest an increased emphasis on the need for the disclosure of these relationships. Failure to do so may give rise to a breach of a board's fiduciary obligations or a violation of the federal securities laws. Moreover, cases

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[331] Loudon v. Archer-Daniels-Midland Co., 1996 WL 74730, at *7 (Del. Ch. Feb. 20, 1996) ("Persons nominated to serve on a corporate board are normally required to present a summary of their qualifications to serve on a board, as well as facts relating to any actual or potential conflict of interest.").

[332] The approach would likely improve diversity beyond increased representation of women and minorities. The SEC has emphasized a broad approach to diversity in formulating disclosure requirements. *See* Exchange Act Release No. 61175 (Dec. 16, 2009), http://www.sec.gov/rules/final/2009/33-9089.pdf ("some companies may conceptualize diversity expansively to include differences of viewpoint, professional experience, education, skill and other individual qualities and attributes that contribute to board heterogeneity, while others may focus on diversity concepts such as race, gender and national origin. We believe that for purposes of this disclosure requirement, companies should be allowed to define diversity in ways that they consider appropriate.").

[333] As noted, "reliable" directors can bring value to the board. *See supra* notes 109–13. Moreover, opposition to reliability could result in a board taking an over-inclusive approach to the types of relationships that will be excluded. *See supra* note 92 (noting the interconnections among directors in Silicon Valley). This could harm shareholders by excluding directors that have both important skills and disqualifying personal relationships.

such as *Orchard* provide insight into the types of personal and business relationships that may trigger disclosure obligations or result in the loss of independence.[334]

These possibilities provide directors with an incentive to investigate, and be aware of, such relationships.[335] Knowledge of connections between directors and management in turn may reduce their prevalence. To the extent close personal and business ties will generate shareholder opposition or increased liability, directors have an incentive to forgo nominating such candidates to the board.[336]

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[334] *See also In re Trados Inc.*, 73 A.3d 17, 55 (A director had "a long history" with venture capital fund and that "current and past relationships" with fund and partner of fund "resulted in a sense of 'owingness' that compromised his independence for purposes of determining the applicable standard of review.").

[335] Loudon v. Archer-Daniels-Midland Co., 1996 WL 74730, at *7 (Del. Ch. Feb. 20, 1996) ("Persons nominated to serve on a corporate board are normally required to present a summary of their qualifications to serve on a board, as well as facts relating to any actual or potential conflict of interest.").

[336] Indeed, the SEC has often adopted disclosure requirements that are designed to effect substantive behavior. *See* Brown, *supra* note 3, at 78–86.