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The Political Economy of Board Independence

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THE POLITICAL ECONOMY OF BOARD INDEPENDENCE*

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Institutional investors, exchanges, and government regulators have pushed for increased board independence. The push has continued despite, at best, inconclusive evidence that independent boards improve corporate performance or reduce corporate malfeasance. This Article suggests that institutional investors value director independence because it displaces more meaningful reform.

Regulatory reform is inevitable after corporate scandals and crises. But, the content of that regulation is not inevitable. Institutional investors and managers have successfully convinced lawmakers to rely on corporate governance reforms in lieu of more stringent substantive regulation. Reforms involving independent boards have been popular with Congress and regulators because independence has connotations of objectivity, expertise, and fairness, because independence is familiar, and because Congress wants to minimize the cost of regulation and independence is inexpensive.

Independence may be inexpensive, but it is also ineffective. Managerial disloyalty to investors is only one type of misconduct. Since boards put the interests of investors first, the board may not stop misconduct that siphons resources from other groups to investors, from price fixing and bribes to excessive risk taking and fraud. Future corporate and financial reform should not aim to protect investors from management.

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Rather, it needs to control externalities that investors themselves impose on others. Board independence mandates should be retired because they are inefficient at best and damaging at worst.

INTRODUCTION

Since the turn of the millennium, boards of directors of public companies have become considerably more independent. In 2000, 78% of directors were independent, 22% of companies had only one nonindependent director, and 23% of companies had a nonexecutive chairman.[1] By 2013, 85% of directors were independent;[2] 60% of boards had only one nonindependent director—the CEO—and 45% had a nonexecutive chairman.[3] While the trend towards more independent boards is not new, boards approaching complete independence are of a recent vintage.[4]

Majority independent boards are traditionally associated with superior firm performance and better oversight of executives.[5] But

1. SPENCER STUART, 2010 SPENCER STUART BOARD INDEX 8 (2010) [hereinafter 2010 SSBI], *available at* https://content.spencerstuart.com/sswebsite/pdf/lib/SSBI2010.pdf.

2. SPENCER STUART, 2013 SPENCER STUART BOARD INDEX 6 (2013) [hereinafter 2013 SSBI], *available at* https://www.spencerstuart.com/~/media/PDF%20Files/Research%20and%20Insight%20PDFs/SSBI-2013_01Nov2013.pdf. The study relies on proxy statements issued by Fortune 500 companies, all of which are listed on the NYSE or NASDAQ. Both exchanges define "independence" similarly: a director will be deemed independent if she has no financial or familial ties to the firm or its management other than her directorship. *See* N.Y. STOCK EXCH., NEW YORK STOCK EXCHANGE LISTED COMPANY MANUAL § 303A.02 [hereinafter NYSE LISTED COMPANY MANUAL], *available at* http://nysemanual.nyse.com/LCMTools/PlatformViewer.asp?selectednode=chp_1_4&manual=%2Flcm%2Fsections%2Flcm-sections%2F; NASDAQ Listing Rules § 5605(a)(2), *available at* http://nasdaq.cchwallstreet.com/NASDAQTools/PlatformViewer.asp?selectednode=chp_1_1_4_3&manual=%2Fnasdaq%2Fmain%2Fnasdaq-equityrules%2F.

3. 2013 SSBI, *supra* note 2, at 6.

4. *See* 2010 SSBI, *supra* note 1, at 3 ("In 1986, only three boards (or only 3% of the 100 boards reviewed) had the chairman/CEO as the sole insider. Today, the CEO is the sole insider on more than half of the S&P 500 boards.").

5. *See generally* Jeffrey Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465 (2007) (arguing that the rise of independent boards correlates with the shift towards the primacy of shareholder value). Whether or not majority independent boards lead to better corporate performance has been debated for decades. While earlier studies found mixed evidence of whether majority independent boards improve accounting performance, they found support that majority independent boards tended to be more active in replacing failing CEOs, among other things. *See* Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921, 924, 933 (1999) (finding that "boards with at least 60% independent directors are more likely" to replace CEOs, and that independent directors may help control financial fraud). For recent studies showing similar results, see Olubunmi Faleye, Rani Hoitash & Udi Hoitash, *The Costs of Intense Board Monitoring*, 101 J. FIN. ECON. 160, 165–66 (2011) (showing that improved monitoring comes at the expense of corporate performance); Lixiong Guo

supermajority independent boards—those with only one nonindependent director—do not outperform their majority independent peers on any metric.[6] In fact, studies have suggested that "firms with supermajority-independent boards perform worse than other firms."[7] And yet, "the anti-insider movement rolls on unchecked."[8]

Critics of the Sarbanes-Oxley Act of 2002[9] and the subsequent board independence requirements that national exchanges imposed in its aftermath have blamed legal change for the inefficient governance structure.[10] Although legal mandates have not been irrelevant, they largely ratified existing practices at the time they were adopted.[11] Moreover, no law, regulation, or listing standard requires

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& Ronald Masulis, *Board Structure and Monitoring: New Evidence from CEO Turnovers* 5 (Eur. Corp. Governance Inst. Working Paper Series in Finance, Paper No. 351/2013), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2021468 (finding a positive relationship between an independent board and the likelihood that a poorly performing CEO is replaced).

6. *See* Shams Pathan & Robert Faff, *Does Board Structure in Banks Really Affect Their Performance?*, 37 J. BANKING & FIN. 1573, 1575–76, 1581 (2013).

7. Bhagat & Black, *supra* note 5, at 950; *see also* David Finegold, George S. Benson & David Hecht, *Corporate Boards and Company Performance: Review of Research in Light of Recent Reforms*, 15 CORP. GOVERNANCE: INT'L REV. 865, 867 (2007) (providing an overview of empirical studies that show no consistent positive correlation between percentage of board independence and firm performance).

8. Justin Fox, *Throwing Out Insiders Won't Fix Corporate Boards*, HBR BLOG NETWORK (Oct. 17, 2012, 1:29 PM), http://blogs.hbr.org/fox/2012/10/throwing-out-insiders-corporate-boards.html; *see also* Maxwell Murphy, *A "Waste of a Board Seat,"* WALL ST. J., Oct. 16, 2012, at B1 (reporting that CFOs "serving as directors at their own companies are a dying breed").

9. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 15 U.S.C.).

10. *See, e.g.*, Stephen M. Bainbridge, *A Critique of the NYSE's Director Independence Listing Standards*, 30 SEC. REG. L.J. 370, 393–96 (2002); Eric M. Fogel & Andrew M. Geier, *Strangers in the House: Rethinking Sarbanes-Oxley and the Independent Board of Directors*, 32 DEL. J. CORP. L. 33, 51–58 (2007); Usha Rodrigues, *A Conflict Primacy Model of the Public Board*, 2013 U. ILL. L. REV. 1051, 1052–55 (2013); Roberta Romano, *Regulating in the Dark*, *in* REGULATORY BREAKDOWN: THE CRISIS OF CONFIDENCE IN U.S. REGULATION 86, 89 (Cary Coglianese ed., 2012); Nicola Faith Sharpe, *Process Over Structure: An Organizational Behavior Approach to Improving Corporate Boards*, 85 S. CAL. L. REV. 261, 263–66 (2012). Even Sarbanes-Oxley agnostics have attributed the trend towards supermajority independence to legal mandates. *See* Afra Afsharipour, *A Shareholders' Put Option: Counteracting the Acquirer Overpayment Problem*, 96 MINN. L. REV. 1018, 1066 (2012).

11. By 2002, when the Sarbanes-Oxley Act required public companies to have a fully independent audit committee, 97% of the S&P 500 companies already complied. SPENCER STUART, 2007 SPENCER STUART BOARD INDEX 9 (2007) [hereinafter 2007 SSBI], *available at* http://content.spencerstuart.com/sswebsite/pdf/lib/SSBI_FINAL.pdf. By 2004, when listing standards mandated a majority independent board, 80% of companies already complied. SPENCER STUART, 2009 SPENCER STUART BOARD INDEX 8 (2009),

that public company boards appoint only independent directors or separate the roles of the chairman and the CEO.[12] Change has continued in unregulated space.[13]

That the trend towards more independent boards has continued in the absence of evidence that it improves corporate performance or reduces wrongdoing presents a puzzle that academic commentators have struggled to explain. Two competing theories have been advanced. Professors Sanjai Bhagat and Bernard Black attributed the trend to the conventional wisdom that the proportion of independent directors on the corporate board and firm performance are positively correlated.[14] They shepherded considerable evidence to demonstrate that increased independence in fact reduced firm performance and proposed that firms nominate fewer independent directors.[15] Writing nearly a decade later, Professor Jeffrey Gordon proposed a competing theory.[16] He argued that the independence trend is a positive development made possible by better securities disclosure and the rise of shareholder primacy as the goal of corporate governance.[17] Independent boards "enhance the fidelity of managers to shareholder objectives."[18] As all companies become better managed, empirical studies comparing performance between companies cannot identify differences with sufficient confidence.[19] According to Gordon, increasingly independent boards are an efficient adjustment to the change in circumstances.[20]

Fifteen years have passed since Bhagat and Black published their study, enough time for hard evidence to overcome, or at least

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[hereinafter 2009 SSBI], *available at* http://content.spencerstuart.com/sswebsite/pdf/lib/SSBI2009.pdf. By 2012, when independent compensation committees became legally required, all S&P 500 companies already complied. SPENCER STUART, 2012 SPENCER STUART BOARD INDEX 11 (2013) [hereinafter 2012 SSBI], *available at* http://content.spencerstuart.com/sswebsite/pdf/lib/Spencer-Stuart-US-Board-Index-2012_06Nov2012.pdf.

12. *See infra* Part II.B.

13. *See* Lisa M. Fairfax, *Board Diversity Revisited: New Rationale, Same Old Story?*, 89 N.C. L. REV. 855, 878 & n.114 (2011) (observing that despite mixed evidence on the value of independence, corporations have been willing to embrace board reforms before legal reforms mandated them).

14. *See* Bhagat & Black, *supra* note 5, at 942.

15. *See id.*

16. *See* Gordon, *supra* note 5, at 1465–66.

17. *See id.* at 1563.

18. *Id.* at 1469.

19. A rising tide of better disclosure and oversight of managers lifted all "boats" (i.e., reduced shirking and misconduct in all firms, not just those that have more independent boards).

20. *See* Gordon, *supra* note 5, at 1465–66, 1509–10.

undermine conventional wisdom, particularly when investors' money is on the line.[21] Yet boards have become considerably more, not less, independent since 1999.[22] And while Gordon's theory appears accurate to a point, it "does not by itself justify the move to *supermajority* independent boards."[23] The marginal benefit of adding another independent director to a board that already has nine appears tiny, while the marginal cost is not negligible.

This Article advances a third explanation for the ongoing independence trend which does not supplant either theory, but suggests that both are incomplete. Institutional investors and corporate managers value director independence because it displaces more meaningful reform.[24] A legal response is inevitable after corporate scandals and crises.[25] But, the content of that regulation is not inevitable. Investors and managers, by and large, want to prevent regulation that would reduce stock prices, even where such regulation would increase overall welfare.[26]

Shareholders (and managers whose compensation is linked to the stock price) benefit when firms develop successful products. But shareholders can also benefit from misconduct. Price fixing and bribes, for example, boost stockholder returns at the expense of

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21. Conventional wisdom promoted by the corporate governance industry is certainly powerful and influential. This Article merely suggests that other factors contribute to the entrenched independence trend.

22. *See infra* Table 1. In 1999, 78% of all S&P 500 board members were independent, compared with 84% in 2012. *Id.* In 1999, 21% of firms had a board with only one inside director, the CEO. *Id.* In 2012, 59% of firms did. *Id.*

23. Usha Rodrigues, *The Fetishization of Independence*, 33 J. CORP. L. 447, 462–63 (2008); *see also infra* Part III.A (arguing that the supermajority independence trend is a result of institutional investor preference).

24. *See* Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 652–54 (1982) (explaining that the early proponents of independent directors believed that they would be better than the government at addressing negative externalities and promoting social values). Brudney concluded that it would be unrealistic to expect independent directors to foster "social responsibility well enough to justify eliminating or diluting regulatory controls on corporate behavior." *Id.* at 597.

25. *See, e.g.*, Hillary A. Sale, *Public Governance*, 81 GEO. WASH. L. REV. 1012, 1022 (2013) (explaining that the Sarbanes-Oxley reforms replaced corporate self-regulation with federal regulation in the aftermath of accounting scandals). *See generally* STUART BANNER, ANGLO-AMERICAN SECURITIES REGULATION: CULTURAL AND POLITICAL ROOTS, 1690–1860 (1998) (tracing the cyclical nature of financial regulation through the eighteenth and nineteenth centuries).

26. *See, e.g.*, John C. Coffee, Jr., *The Political Economy of Dodd-Frank: Why Financial Reform Tends to Be Frustrated and Systemic Risk Perpetuated*, 97 CORNELL L. REV. 1019, 1030 (2012) (explaining that after enactment of legislation industry attempts to diminish the impact of reforms).

consumers and competitors.[27] Similarly, excessively risky strategies transfer wealth to shareholders at the expense of creditors and employees; shareholders receive all of the upside if the strategy succeeds, but do not bear the full cost of the downside if it does not.[28] Finally, even though shareholders do not benefit from fraud, they are unwilling to spend enough to prevent or discover fraud.[29]

Director independence thus serves an important political goal by deflecting substantive regulation that might limit rent-seeking or force firms to internalize fully the costs of their activities, whether legal or illegal. It is a rational political strategy for institutional investors and managers to trade marginal decreases in corporate performance for the reduced risk of costlier substantive regulation.[30]

Part I introduces the puzzle. It presents evidence of the ongoing trend towards increasingly independent corporate boards, followed by a literature review reflecting increasingly negative scholarly thought and empirical evidence on supermajority independent boards.

The apparent contradiction begets two questions that Parts II and III discuss in turn: whether the trend is the result of investors' preferences, and if so, why would investors want increasingly independent boards in the absence of empirical support that they improve corporate performance? Part II first reviews institutional

27. Recent studies estimate that 14.5% of public firms are manipulating their earnings at any point in time, and 22.9% of firms pay significant bribes. *See* Alexander Dyck, Adair Morse & Luigi Zingales, How Pervasive is Corporate Fraud? 1 (Apr. 2013) (unpublished manuscript), *available at* http://www.usc.edu/schools/business/FBE/seminars/papers/F_4-12-13_MORSE.pdf; Jonathan M. Karpoff, D. Scott Lee & Gerald S. Martin, The Economics of Foreign Bribery: Evidence from FCPA Enforcement Actions 28 (July 29, 2013) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1573222. Most are never caught and sanctioned, yielding investors considerable returns in the process. *See* Karpoff et al., *supra*, at 28 (estimating that the probability of getting caught paying a bribe is 6.4%).

28. *See, e.g.*, Frederick Tung, *Pay for Banker Performance: Structuring Executive Compensation for Risk Regulation*, 105 NW. U. L. REV. 1205, 1206 (2011).

29. Ultimately, however, cost-cutting on compliance and providing incentives to employees to produce growth result in illegality. As I showed in previous work, fraud harms employees, suppliers, rivals, and government. *See* Urska Velikonja, *The Cost of Securities Fraud*, 54 WM. & MARY L. REV. 1887, 1887–88 (2013).

30. The Volcker Rule is an example of substantive regulation that managers and investors want to avoid at all cost. If given the choice, financial firms would prefer an independent risk committee to the Volcker Rule. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 619, 124 Stat. 1376, 1620–31 (2010) (codified at 12 U.S.C. § 1851 (2012)). *See generally* COMM. OF SPONSORING ORGS. OF THE TREADWAY COMM'N, BOARD RISK OVERSIGHT: A PROGRESS REPORT (2010), *available at* http://www.coso.org/documents/Board-Risk-Oversight-Survey-COSO-Protiviti_001.pdf (discussing improvements to risk oversight by corporate boards).

investors' stated positions on preferred board composition and their voting and nomination practices, and concludes that both are consistent with the proposition that investors favor supermajority independent boards. Part II then considers alternative causes of the independence trend—changes in the legal regime, pressure by proxy advisory firms, managerial capture, director influence, and exit by noncompliant firms—and concludes that they, alone, cannot explain the trend.

Part III answers the question of why rational investors might prefer a supermajority independent board chaired by a nonexecutive chairman. Investors want high stock prices, which result from both increased productivity and from value transfers from noninvestors, some efficient, others not.[31] Delaware law is at best a weak constraint on shareholder rent-seeking, while Congress moves faster than Delaware and is willing to restrict such opportunities in the aftermath of corporate scandals or financial crises.[32] Investors and their self-regulatory organizations either offer independent boards as a voluntary solution or, when a legislative intervention is inevitable, propose that Congress require increased independence in lieu of substantive regulation. Corporate directors overwhelmingly believe that they are accountable to shareholders and are obligated to increase shareholder returns.[33] Part III also considers why the strategy has successfully appeased nonshareholder interests. Finally, the Part uses three examples—bribery scandals in the 1970s, accounting frauds in the 2000s, and the financial crisis in 2008—to illustrate how institutional investors have used independence as both a sword and a shield against alternative laws that were considered in the aftermath of corporate crises.

The Article concludes that independent boards are, at best, a weak constraint on the ability of managers to impose negative externalities on nonshareholders and a poor substitute for substantive regulation. It argues that corporate governance mandates should be retired, not because they are costly for shareholders, but because they are considerably less effective than the government at resolving negative externalities and reinforcing social values. Future financial reform should not try to protect shareholders from management,

31. *See, e.g.*, Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, 31 J. CORP. L. 637, 659 (2006) (explaining that while "shareholders can benefit from increasing productivity, they can also benefit by transferring value from fixed claimants to themselves").

32. *See* Mark J. Roe, *Delaware's Politics*, 118 HARV. L. REV. 2491, 2495 (2005).

33. *See* Gordon, *supra* note 5, at 1529 & n.259.

from each other, and from themselves. Rather, it needs to control externalities that investors themselves impose on others.

I. THE INDEPENDENCE PUZZLE

A majority independent board of directors is one where more than half of the directors are independent—they have no financial or familial ties to the firm or its management other than their directorship.[34] Most public companies have maintained a majority independent board since at least the late 1980s.[35]

In contrast, a supermajority independent board—one with *all* independent directors except for the chief executive officer—is a recent innovation.[36] Twenty-five years ago, such boards were unheard of, and as recently as 2000, a mere fifth of public companies had a board with only one insider.[37] By 2013, 60% of public company boards had only one nonindependent director.[38]

Surprisingly, a growing body of economic research has failed to find any statistical correlation between supermajority independent boards and corporate profitability or the likelihood of misconduct, leading academics and policy makers to question their value. This Part sets out the two basic elements of the puzzle: the observed trend towards increasingly independent boards and the growing academic consensus that supermajority independent boards do result in greater corporate profitability.

A. The Trend Towards Increasingly Independent Boards

Corporate boards during the first half of the twentieth century were made up of company employees and outside directors, who were also affiliated with the firm, usually as the firm's bankers, lawyers, and suppliers.[39] As late as 1950, insiders made up half of board members, but independent (as opposed to affiliated) directors

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34. *See* NYSE LISTED COMPANY MANUAL, *supra* note 2, § 303A.02. Significant stock ownership is usually not a bar, since independence *from management* is the primary concern. The NYSE listing standards provide one good example of independence standards.

35. *See* Gordon, *supra* note 5, at 1474.

36. *See* Bhagat & Black, *supra* note 5, at 923. Bhagat and Black consider boards with one *or two* inside directors as supermajority independent. Since their seminal 1999 article, the number of boards with a single inside director has nearly tripled, hence the redefinition of the term "supermajority independent board" in this Article.

37. *See* 2010 SSBI, *supra* note 1, at 8.

38. *See* 2013 SSBI, *supra* note 2, at 4.

39. *See* Gordon, *supra* note 5, at 1513.

were still relatively rare.[40] The number of insiders sitting on corporate boards declined steadily from the mid-1970s and fell precipitously towards the end of the century.[41] A typical public board today has ten or eleven members, and only one of them is an insider: the chief executive officer.[42] Moreover, in a growing minority of firms, the CEO no longer chairs the board, sets the agenda, or leads the discussion.[43]

Supermajority independent boards are a relatively recent phenomenon. In 1986, the CEO was the only nonindependent director in 3% of S&P 500 firms.[44] By 1997, that number increased to 23%, while another 33% of firms had boards with two inside directors.[45] The trend accelerated after the turn of the millennium. By 2013, the CEO was the only nonindependent director in 60% of S&P 500 firms.[46] The trend is not limited to S&P 500 companies, however. Medium-sized and small public firms are reporting similar trends.[47]

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40. *See id.* at 1474–75. Between 1950 and 1970, about 20% of directors were independent. *See id.*

41. *See id.*

42. *See* 2013 SSBI, *supra* note 2, at 6 (showing that the CEO is the only nonindependent director in 60% of firms, that the average board has 10.7 members, and that 84% of boards have twelve or fewer members).

43. *See* 2012 SSBI, *supra* note 11, at 23, 27.

44. *See* 2010 SSBI, *supra* note 1, at 3.

45. *See* Bhagat & Black, *supra* note 5, at 921–22.

46. *See* 2013 SSBI, *supra* note 2, at 4. If the trend were to continue at the pace set since 1997, all corporate boards would be fully independent save for the CEO by 2028 (the calculation is made based on the linear regression of data points for each year: $y = 2.6132x + 15.6$ ($R^2 = 0.9641$)). Extrapolating from known data to predict the future is a dangerous game. It is plausible that the number will plateau or reverse. Or, we might begin to see the next frontier: completely independent boards. *See* Rodrigues, *supra* note 10, at 1071.

47. *See* Marcel Kahan & Edward Rock, *Embattled CEOs*, 88 TEX. L. REV. 987, 1024 (2010).

Table 1: Board Independence 1997–2013[48]

	% CEO Only Insider	Board Size	% Indep. on Board	% Separate CEO/Board Chair	% Indep. Board Chair
1997	23	n/a	n/a	n/a	n/a
1998	23	12	78	16	n/a
1999	21	11.8	78	20	n/a
2000	22	11.5	78	23	n/a
2001	27	11.1	77	26	n/a
2002	31	10.9	79	25	n/a
2003	35	10.9	79	23	n/a
2004	39	10.8	80	26	9
2005	39	10.7	80	29	9
2006	39	10.7	81	33	10
2007	43	10.8	81	35	13
2008	44	10.8	82	39	16
2009	50	10.8	82	37	16
2010	53	10.7	84	40	19
2011	57	10.7	84	41	21
2012	59	10.7	84	43	23
2013	60	10.7	85	45	25

As the share of firms with only one nonindependent director on its board has tripled, the size of the average board itself has declined over the last twenty years, from fourteen directors to fewer than eleven.[49] The decline in average board size suggests that firms are both replacing inside directors with independent directors and letting inside directors retire without replacement.[50]

Independent directors dominate oversight committees. In 2006, the compensation and audit committees in all surveyed S&P 500 firms were fully independent, and the nominating committees of those

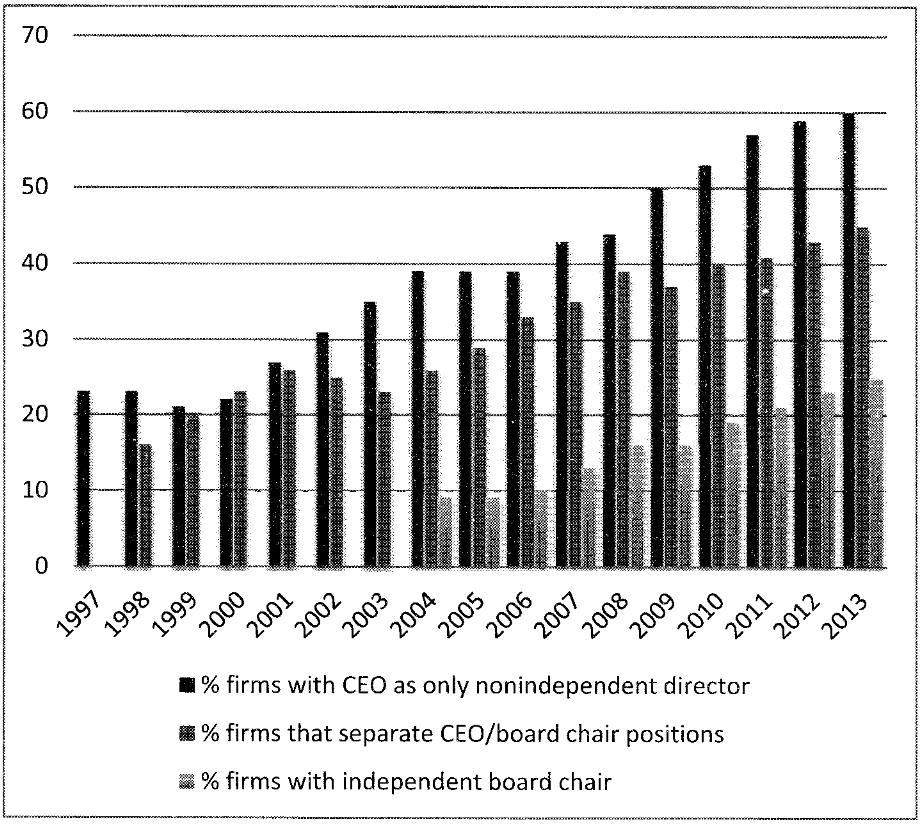
48. Data is derived from a survey of company proxy statements as compiled by the Spencer Stuart Board Index from 2007 until 2013. *See, e.g.*, 2012 SSBI, *supra* note 11, at 8 ("As always, this year's *Spencer Stuart Board Index* is based on our analysis of the most recent proxy reports from the S&P 500, plus an extensive supplemental survey."). Figure 1, For 1997 figures, see Bhagat & Black, *supra* note 5, at 922 tbl.1A.

49. *See* 2012 SSBI, *supra* note 11, at 10; SPENCER STUART, 2003 SPENCER STUART BOARD INDEX 6 (2003) [hereinafter 2003 SSBI] (on file with the North Carolina Law Review). *See infra* Table 1.

50. While retirements could explain the rising share of boards with one insider between 1997 and 2004, they do not explain the trend from 2004 onwards; board size has remained stable, while the share of firms with a supermajority independent board of directors increased by half—from 39% in 2004 to 59% in 2012. *See infra* Table 1.

same firms were 99% independent.[51] To be sure, perfect committee independence today is a function of the exchange listing standards, but the trend predates the mandate.[52] Table 1 provides additional detail.

Figure 1: Board Independence 1997–2013



51. *See* SPENCER STUART, 2011 SPENCER STUART BOARD INDEX 9 (2011) [hereinafter 2011 SSBI], *available at* http://content.spencerstuart.com/sswebsite/pdf/lib/SSBI_2011_final.pdf.

52. Since 2004, the NYSE has required listed companies to maintain fully independent nominating, compensation, and audit committees. *See* NYSE LISTED COMPANY MANUAL, *supra* note 2, §§ 303A.4–7; Order Approving NASD and NYSE Proposed Rule Changes Relating to Corporate Governance, 68 Fed. Reg. 64,154, 64,176–78 (Nov. 12, 2003) (noting that while the NYSE required committees, NASDAQ allowed companies to forego nominating and compensation committees and instead defer decisions to the full board that had to be majority independent).

Splitting the role of the board chair and the CEO has been on the agenda of shareholder activists for some time, but progress was initially slow: between 1998 and 2003 the percentage of boards with separate roles for chairman and CEO only rose 7%, from 16% to 23%.[53] It is difficult to unseat an active CEO, so most companies wait until transition.[54] By 2013, however, 45% of boards had separated the two positions.[55]

The independence trend shows no signs of slowing down. The following Section canvasses academic literature which to date has failed to find evidence that supermajority independent boards increase corporate performance.

B. *If Majority Independent Boards Are Good, Are Supermajority Independent Ones Better?*

Academic commentators generally agree that majority independent boards are a good thing, certainly better than their insider-dominated peers.[56] Majority independent boards appear to be more responsive to shareholder concerns than ones staffed mostly with insiders, and more willing to fire underperforming executives, control their pay, and reduce self-dealing.[57]

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53. 2003 SSBI, *supra* note 49, at 8.

54. *See* 2010 SSBI, *supra* note 1, at 23 (reporting that 82% of boards split the roles as a result of CEO transition, and 12% did so because of pressure from shareholders).

55. *See* 2013 SSBI, *supra* note 2, at 5. A little over half of nonexecutive chairmen are independent (23% of all firms). *See id.* Commentators have recognized the information gap as the biggest downside to increased independence. But, it appears that outside directors are bridging the gap, at least to some extent. In 20% of large public firms, the lead independent director has the primary responsibility to develop the agenda for board meetings. In 20% of firms, an independent director is principally responsible for determining whether information received from management is timely, accurate, and sufficient. *Id.* at 27.

56. *See, e.g.*, I AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 3A.01 (1994) (recommending that "[t]he board of every large publicly held corporation . . . should have a majority of directors who are free of any significant relationship . . . with the corporation's senior executives"); MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS 170 (1976); Ira M. Millstein, *The Evolution of the Certifying Board*, 48 BUS. LAW. 1485, 1488 (1993). *But see* Bainbridge, *supra* note 10, at 393 (mentioning the mixed results that accompany independent boards).

57. *See* Ira M. Millstein & Paul W. MacAvoy, *The Active Board of Directors and Performance of the Large Publicly Traded Corporation*, 98 COLUM. L. REV. 1283, 1292–94 (1998). Responsiveness is a relative term that obscures a fair amount of slack and opportunity for the board to shirk or be bribed. *See* Steve Stecklow, *Outside Directors' Options Role Is Cited in Backdating Study*, WALL ST. J., Dec. 18, 2006, at B3 ("The study is notable because it suggests that outside, or independent, directors—who are supposed to play a special role safeguarding against cozy board relationships with management—

In contrast, virtually all academic commentators view supermajority independent boards as too much of a good thing.[58] Although, at least in theory, wholly independent boards might be marginally more willing than only majority independent boards to fire a failing chief executive or stop fraud, they are less able to do so because their independence renders them unaware of the problem.[59] Many believe the share of independent directors on the board and the amount of relevant information that the board possesses are inversely correlated.[60] As the board reaches the majority independence mark, the marginal cost of the diminishing quality of information exceeds the marginal benefit of increased independence.[61] Adding one more independent director to a board that already has nine such directors (and two insiders) adds very little, but halving the number of insiders on the board (from two to one) reduces the quality of information in the board's hands.[62]

Empirical studies seem to support the theoretical intuition that majority independent boards are a good development, but supermajority independent ones are not. In a literature review, Professors Sanjai Bhagat and Bernard Black reported that supermajority independent boards performed no better than merely majority independent boards, and, by some measures, worse.[63] In

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may have been co-opted in options backdating by receiving manipulated grants themselves.").

58. This development is of relatively recent vintage. One of the first articles to question the desirability of supermajority independent boards is Jill E. Fisch, *Taking Boards Seriously*, 19 CARDOZO L. REV. 265 (1997). More recent treatments include Bainbridge, *supra* note 10; Lisa M. Fairfax, *The Uneasy Case for the Inside Director*, 96 IOWA L. REV. 127 (2010); Donald Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797 (2001); Rodrigues, *supra* note 23. But for empirical studies that indicate boards wholly independent of management perform better at large, see generally Bill Francis, Iftekhar Hasan & Qiang Wu, *Do Corporate Boards Affect Firm Performance? New Evidence from the Financial Crisis* (Bank of Fin. Research Discussion Paper No. 11.2012), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2041194 (finding that when independence is re-defined as outside directors who are less connected with current CEOs, there is a positive relationship between independence and firm performance); Millstein & MacAvoy, *supra* note 57, at 1318 (finding that an independent board tends to produce "superior corporate performance").

59. *See* Bhagat & Black, *supra* note 5, at 950.

60. *See id.*; Gordon, *supra* note 5, at 1541; *see also* Sharpe, *supra* note 10, at 266 (noting that independent directors "face informational disadvantages that may make it difficult for them to evaluate management's decisions").

61. *See* Bhagat & Black, *supra* note 5, at 949.

62. The CEO is the only insider on the board who can more easily control the information given to the board.

63. *See* Bhagat & Black, *supra* note 5, at 949.

comparing boards with two or fewer insiders to those with three or more, they found that those boards with more independent directors performed worse.[64] The effect was quite modest, a 3.4% reduction in return on assets, but nonetheless statistically significant.[65] In light of their findings, Bhagat and Black proposed that firms experiment with more insiders on boards.[66] Recent empirical studies confirm Bhagat and Black's results.[67]

In addition to being correlated with worse financial performance, supermajority independent boards are less able to perform specific tasks compared to their majority independent peers. Professors Richard Geddes and Hrishikesh Vinod reported a curvilinear relationship between the share of outside directors and the likelihood of CEO termination.[68] Majority independent boards were more likely to fire an underperforming chief executive than their insider-dominated peers, but boards with only one or two insiders were less likely to do so.[69]

Several studies published in the 1990s suggested that supermajority independent boards were positively correlated with top executive compensation (i.e., the more independent directors, the higher the CEO's pay) as well as with compensation of other executives at the firm, whereas the firm's subsequent performance was negatively correlated with independence.[70] In addition, the more independent the board, the more likely the firm was to adopt a golden parachute plan for its executives for acquisition-related

64. *See id.* at 947.

65. *See id.*

66. *See id.* at 951.

67. *See* Faleye et al., *supra* note 5, at 165–66 (showing that improved monitoring comes at the expense of corporate performance); Guo & Masulis, *supra* note 5, at 5 (finding a positive relationship between an independent board and the likelihood that a poorly performing CEO is replaced).

68. *See* R. Richard Geddes & Hrishikesh D. Vinod, *CEO Age and Outside Directors: A Hazard Analysis*, 12 REV. INDUS. ORG. 767, 769 (1997).

69. *Id. Cf.* Guo & Masulis, *supra* note 5, at 3–4 (finding a positive relationship between an independent board and the likelihood that a poorly performing CEO is replaced). However, directors who terminate a CEO suffer adverse labor market consequences. Professors McDonnell and King found that they are less likely to be appointed to another board, and that if they do find new board positions, the subsequent boards on which they serve are "smaller and less reputable" than those that recruit their peers who did not terminate a CEO. Mary-Hunter McDonnell & Brayden G. King, The Market Hates a Monitor: The Adverse Selection of Independent Directors Who Oust a CEO 6 (July 23, 2011) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1893713.

70. *See* Bhagat & Black, *supra* note 5, at 931 & nn.35–38.

terminations.[71] Golden parachutes reduce the likelihood that management will oppose an unsolicited takeover bid, so they may be shareholder value-enhancing, if the payment is relatively small.[72] But this may not always be the case.[73]

Increasing board independence by splitting the role of the CEO and the board chairman has likewise produced mixed results.[74] Professors Reena Aggarwal, Isil Erel, René Stulz, and Rohan Williamson found no correlation between shareholder value and separating the two positions,[75] while Professors Ronald Masulis, Cong Wang, and Fei Xie found that firms where the two positions are separated experienced higher abnormal returns on announcement of an acquisition.[76]

The Bhagat and Black survey of empirical work resonated loudly among academic commentators.[77] On one side of the debate, Professors Roberta Romano and Larry Ribstein (in separate articles) have relied squarely on Bhagat and Black's research to argue against the independence movement and laws requiring majority independent boards.[78] Professors Bhagat, Brian Bolton, and Romano, along with Professor Stephen Bainbridge, have argued that legal independence mandates forced all firms into the same mold.[79]

71. *See id.* at 932 & n.42.

72. *See id.* at 932.

73. *See* Richard A. Lambert & David F. Larcker, *Golden Parachutes, Executive Decision-Making, and Shareholder Wealth*, 7 J. ACCT. & ECON. 179, 200–01 (1985).

74. *See* Stephen M. Bainbridge, *Dodd-Frank: Quack Federal Corporate Governance Round II*, 95 MINN. L. REV. 1779, 1798–1800 (2011).

75. *See* Reena Aggarwal et al., *Do U.S. Firms Have the Best Corporate Governance? A Cross-Country Examination of the Relation Between Corporate Governance and Shareholder Wealth* 19 (European Corporate Governance Inst., Fin. Working Paper No. 145/2007), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=954169 (finding no correlation between CEO/chair duality and shareholder wealth).

76. *See* Ronald W. Masulis, Cong Wang & Fei Xie, *Corporate Governance and Acquirer Returns*, 62 J. FIN. 1851, 1873–75 (2007).

77. *See* Bhagat & Black, *supra* note 5. As of February 2014, law review articles listed as "Citing References" on Westlaw totaled 135.

78. *See* Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 26–28 (2002); Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1530 (2005). I should note that Bhagat and Black's work actually supports a legal requirement that firms maintain a majority independent board of directors. What it does not support is requiring supermajority independence, something that no law to date has done. *See* discussion *infra* Part II.A.

79. *See* Stephen M. Bainbridge, *Independent Directors and the ALI Corporate Governance Project*, 61 GEO. WASH. L. REV. 1034, 1064–66 (1993); Bainbridge, *supra* note 74, at 1804–05; Sanjai Bhagat, Brian Bolton & Roberta Romano, *The Promise and Peril of Corporate Governance Indices*, 108 COLUM. L. REV. 1803, 1862–63 (2008).

Because firms are diverse and subject to a variety of accountability mechanisms, including product markets, managerial labor markets, external audits, and the market for corporate control, firms ought to be allowed to adjust the board to fit their particular needs.[80]

Delaware Chancellors William Chandler and Leo Strine have also cautioned against boards where the CEO is the only inside director.[81] In addition to doubting the ability of the independent board to control managers, they noted that it might be difficult to hold non-director officers liable in a Delaware court for breaches of fiduciary duties.[82]

Supermajority independent boards have fared no better among scholars receptive to regulatory interventions in corporate governance. Professor Donald Langevoort has cautioned that outsiders on the board are likely to focus excessively on monitoring management.[83] Since management also sits on the board, the monitoring focus causes friction among board members.[84] This is problematic because boards are also tasked with setting strategy and advising management on acquisitions. Boards where insiders and outsiders can work cooperatively on those tasks add value to the company, while supermajority independent boards increase unproductive discord on the board.[85] Similarly, Professor Jill Fisch has argued that managing is an important board function and that too many outsiders on the board detract from that function.[86] Finally, Professor Hillary Sale has observed that independent boards of directors have failed to prevent corporate crises and scandals.[87] The failure of corporate self-regulation hurt shareholders and

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80. *See* Bainbridge, *supra* note 79, at 1065–66; *see also* Adam J. Epstein, *The Broken Small-Cap Market Undermines the Recovery*, BLOOMBERG BUSINESSWEEK (Mar. 11, 2013), http://www.businessweek.com/articles/2013-03-11/the-broken-small-cap-market-undermines-the-recovery ("One-size-fits-all corporate governance doesn't work because small public companies have a fraction of the resources of their larger counterparts.").

81. *See* William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953, 1002 & n.119 (2003).

82. *See id.* at 1003–04. The reason is that, absent some act in Delaware, its courts might not have personal jurisdiction over remote officers. The Chancellors propose an amendment to the Delaware Code presuming the consent of top officers to service of process in Delaware. *See id.*

83. *See* Langevoort, *supra* note 58, at 801.

84. *See id.* at 799–80.

85. *See id.* at 799; *see also* Faleye et al., *supra* note 5, at 160–61 (suggesting that intense independent monitoring negatively affects corporate productivity).

86. *See* Fisch, *supra* note 58, at 267–68.

87. *See* Hillary A. Sale, *The New "Public" Corporation*, 74 LAW & CONTEMP. PROBS. 137, 147–48 (2011).

nonshareholders.[88] This resulted in public scrutiny and increased demand for federal regulation of public companies.

Scholars have proposed a variety of remedies to fix the perceived problem. In light of their findings, Professors Bhagat and Black suggested that rational investors should resist conventional wisdom and opt for mixed boards.[89] In a similar vein, Professor Lisa Fairfax recently argued in favor of increasing the number of inside directors on the board.[90] She observed that independent directors suffer from a "knowledge deficit" that they cannot overcome easily.[91] In addition, independent directors' incentives to monitor are dampened by their limited exposure to liability and their financial, social, and structural ties to the chief executive that they are expected to oversee and discipline.[92] Inside directors, while more likely to authorize self-dealing by insiders or allow financial fraud to continue, could help the entire board overcome the knowledge deficit that renders supermajority independent boards less effective.[93]

Animated by concerns about the information gap facing supermajority independent boards, Professors Kelli Alces and Nicola Sharpe have made two radically different proposals. Convinced that the "board of directors has outlived its purpose," Alces has advocated abolishing the board of directors and replacing it with contractual governance by shareholder and creditor governance agreements.[94] Sharpe, on the other hand, proposed creating independent information channels for the independent board to bridge the knowledge gap.[95]

Finally, Professor Usha Rodrigues, who is not a proponent of supermajority independent boards,[96] has suggested that corporate

88. *See id.*

89. Bhagat & Black, *supra* note 5, at 950.

90. *See* Fairfax, *supra* note 58, at 127.

91. *Id.* at 164–67. In addition to being outsiders, independent directors who live more than 100 kilometers from the headquarters know less about the company and rely more heavily on the stock price as the indicator of value. *See* Zinat S. Alam et al., *Does the Location of Directors Matter? Information Acquisition and Board Decisions*, J. FIN. & QUANTITATIVE ANALYSIS (forthcoming) (manuscript at 21, 23, 33), *available at* http://ssrn.com/abstract=1571862.

92. *See* Fairfax, *supra* note 58, at 177–78.

93. *See id.* at 179–80.

94. *See* Kelli A. Alces, *Beyond the Board of Directors*, 46 WAKE FOREST L. REV. 783, 783, 785–86 (2011).

95. Nicola Faith Sharpe, *Questioning Authority: The Critical Link Between Board Power and Process*, 38 J. CORP. L. 1, 34–36 (2012).

96. *See* Rodrigues, *supra* note 23, at 447.

boards be repurposed as managers of conflicts.[97] Rodrigues proposed that boards should focus on one thing: approving (or rejecting) transactions where managers have a conflict of interest, including compensation packages, related party transactions, takeovers, derivative litigation, and CEO removal and succession.[98]

The trend towards greater board independence has continued despite a substantial academic backlash against increasingly independent boards. The contradiction raises two important questions. First, are boards becoming more independent as a result of investors' preferences or are other forces at work? Part II of this Article offers evidence that institutional investors are pushing for increased independence. Second, why would rational investors want supermajority independent boards in the absence of empirical evidence that it improves performance or eliminates corporate wrongdoing? Part III argues that the increase in board independence can be explained as a rational response by institutional investors and corporate managers in the face of threatened regulation.

II. DO INVESTORS FAVOR INCREASED BOARD INDEPENDENCE?

Over the long term, firms tend to develop board structures that are optimal for their circumstances.[99] Within constraints, firms tend to choose boards that maximize shareholder value.[100] Because supermajority independent boards do not obviously increase stock prices or improve corporate performance,[101] the observed trend towards supermajority independent boards presents a puzzle, but only if it is in fact emerging in response to investor pressure.

This Part offers evidence that supermajority independent public boards are primarily the product of institutional investor preferences. Other factors, including legal change, pressure by proxy advisory firms, managerial influence, directors' own influence, and exit of

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97. *See* Rodrigues, *supra* note 10, at 1051–52.

98. *See id.* at 1052, 1070–81. Rodrigues includes the audit function among the matters for the board. I consciously excluded it, largely because it is unclear whether and how exactly the involvement of the *independent board* improves corporate disclosure (separate from having an expert audit committee and prohibiting the provision of nonaudit services).

99. *See* Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 302, 313–15 (1983).

100. *See, e.g.*, Kenneth R. Ahern & Amy K. Dittmar, *The Changing of the Boards: The Impact on Firm Valuation of Mandated Female Board Representation*, 127 Q.J. ECON. 137, 182 (2012) (suggesting that legal rules on board composition may reduce stock prices overall, but that firms will nevertheless adapt to limit the stock price decline).

101. *See supra* note 6–7 and accompanying text.

noncompliant firms have also contributed to the already strong underlying trend.

A. *Boards Have Changed Because That Is What Investors Want*

Market forces appear to be the main drivers of change in board composition. Regulatory independence mandates implemented since the Sarbanes-Oxley Act merely ratified preexisting corporate norms.[102] Institutional investors, including pension funds, mutual funds, and hedge funds, have demonstrated a healthy and sustained appetite for governance changes.[103] This Section surveys institutional investors' written corporate governance policies and their voting practices to conclude that the ongoing independence trend is one that institutional investors have favored.

1. Institutional Investors' Written Policies

The largest of American public firms have been majority owned by institutional investors for decades. By the early 1990s, institutional investors held 55% of stock in the one hundred largest public firms.[104] Households (a term that includes hedge funds)[105] currently own directly 38% of corporate equities, federal and state governments own less than 0.6%, while institutional investors—mutual funds, private and public pension funds, life insurance companies, and exchange-traded funds—own the balance: about one-half of all outstanding corporate stock.[106] Thus, a survey of the largest institutional investors' corporate governance policies is a useful starting point to investigate whether institutional investors favor supermajority independent boards in publicly traded companies.

The Investment Company Institute ("ICI") is a trade group representing mutual funds, closed-end investment companies, and

102. *See* Jill E. Fisch, *The Overstated Promise of Corporate Governance*, 77 U. CHI. L. REV. 923, 930 (2010) (book review); Gordon, *supra* note 5, at 1471; Kahan & Rock, *supra* note 47, at 1022–23.

103. *See* Kahan & Rock, *supra* note 47, at 995–1007.

104. *See* CAROLYN K. BRANCATO & PATRICK A. GAUGHAN, INSTITUTIONAL INVESTORS AND CAPITAL MARKETS: 1991 UPDATE tbl.19 (Columbia Univ. Sch. of Law, Ctr. for Law & Econ. Studies, 1991) (reporting that institutions held 54.8% of 100 largest U.S. companies).

105. *See* Kahan & Rock, *supra* note 47, at 997 (explaining that hedge funds do not have to disclose their positions and thus are counted in the residual category of "households").

106. BD. OF GOVERNORS OF THE FED. RESERVE SYS., FINANCIAL ACCOUNTS OF THE UNITED STATES: FLOW OF FUNDS, BALANCE SHEETS, AND INTEGRATED MACROECONOMIC ACCOUNTS THIRD QUARTER 2013, at 100 (2013), *available at* http://www.federalreserve.gov/releases/z1/current/z1.pdf.

exchange-traded funds that together manage more than $16 trillion and serve more than ninety million investors.[107] The ICI has endorsed board independence as the preferred governance strategy, but its corporate governance policies do not advocate supermajority independence.[108]

The Council of Institutional Investors ("CII"), a non-profit association of 125 pension funds—including United Auto Workers and the California State Teachers' Retirement System ("CalSTRS")[109]—employee benefit funds, foundations, and endowments, representing more than $3 trillion in assets, has promoted strong corporate governance since its establishment in 1985.[110] In its Corporate Governance Policies, it recommends that public company boards be at least two-thirds independent.[111] The CII recommends that an independent director chair the board.[112] Furthermore, if the roles of the CEO and chairman are combined, CII recommends that the board should appoint a lead independent director.[113]

The California Public Employees' Retirement System ("CalPERS") is the nation's largest pension fund and one that is very active on governance matters.[114] For a period, CalPERS advocated that "the only company executive on the board should be the chief

107. *See About ICI*, INV. CO. INST., http://www.ici.org/about_ici (last visited Feb. 4, 2014).

108. *See* INV. CO. INST., 2012 ANNUAL REPORT TO MEMBERS 2 (2012), *available at* http://www.ici.org/pdf/12_ici_annual.pdf; Letter from Dorothy Donahue, Deputy Gen. Counsel of Sec. Regulation, to Elizabeth Murphy, Sec'y of the SEC (Nov. 1, 2012), *available at* http://www.ici.org/pdf/26634.pdf (endorsing a proposed NASDAQ rule requiring independent compensation committees).

109. CalSTRS, the largest teachers' retirement fund in the United States, independently endorses board independence. In its corporate governance principles, it threatens to withhold votes from directors who sit on boards that are not "[a]t least two-thirds" independent. CALSTRS, CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM CORPORATE GOVERNANCE PRINCIPLES 3 (2011), http://www.calstrs.com/sites/main/files/file-attachments/corporate_governance_principles_1.pdf.

110. *About Us*, COUNCIL OF INSTITUTIONAL INVESTORS, http://www.cii.org/about_us (last visited Feb. 18, 2014).

111. *See* COUNCIL OF INSTITUTIONAL INVESTORS, CORPORATE GOVERNANCE POLICIES 3 (2012), *available at* http://www.cii.org/files/ciicorporategovernancepolicies/09_27_13%20CII%20Corp%20Gov%20Policies%20Full%20and%20Current%20%20FINAL.pdf.

112. *See id.*

113. *See id.*

114. *See CalPERS Investments*, CALPERS, http://www.calpers.ca.gov/index.jsp?bc=/investments/home.xml (last visited Nov. 15, 2013).

executive,"[115] but has since abandoned this position. In its current corporate governance principles, CalPERS recommends that a "substantial majority" of board members be independent, but does not define the term.[116] It also advocates the appointment of an independent chairman.[117]

Similarly, Teachers Insurance and Annuity Association-College Retirement Equities Fund ("TIAA-CREF"), which manages almost $600 billion in assets,[118] recommends that boards of its portfolio companies "be composed of a substantial majority of independent directors."[119] Its chief investment counsel explained in 2005 that board independence was one of the issues that mattered most to the fund.[120]

Vanguard, a family of investment funds, and the Business Roundtable, an association of chief executives, recommend that a "substantial majority" of directors be independent.[121] Fidelity and T. Rowe Price, two major families of investment and mutual funds, merely require that the board of its portfolio companies be majority independent.[122]

Corporate governance policies of high-volume institutional investors suggest that they favor substantially independent boards,

115. *The Fading Appeal of the Boardroom*, THE ECONOMIST, Mar. 31, 2001, *available at* http://www.economist.com/node/559111; Adam Bryant, *Calpers Draws a Blueprint for its Concept of an Ideal Board*, N.Y. TIMES, June 17, 1997, at D1.

116. *See* CAL. PUB. EMPL. RET. SYS., GLOBAL PRINCIPLES OF ACCOUNTABLE CORPORATE GOVERNANCE 8 (2011), *available at* https://www.calpers.ca.gov/eip-docs/about/board-cal-agenda/agendas/invest/201111/item03b.pdf.

117. *See id.*

118. As of June 30, 2013, TIAA-CREF managed $542 billion for 4.8 billion people. *About TIAA-CREF*, TIAA-CREF, https://www.tiaa-cref.org/public/about-us/who-we-are-at-tiaa-cref (last visited Feb. 23, 2014).

119. TIAA-CREF, TIAA-CREF POLICY STATEMENT ON CORPORATE GOVERNANCE 15 (6th ed.), *available at* https://www.tiaa-cref.org/public/pdf/pdf/governance_policy1.pdf.

120. *See* SPENCER STUART, 2005 SPENCER STUART BOARD INDEX 23 (2005) [hereinafter 2005 SSBI], *available at* http://content.spencerstuart.com/sswebsite/pdf/lib/SSBI-2005.pdf. The counsel noted that TIAA-CREF frequently communicates directly with the board of directors, circumventing management. *See id.*

121. *See Our Views on Corporate Governance at the Companies in Which We Invest*, VANGUARD, https://about.vanguard.com/vanguard-proxy-voting/corporate-governance/ (last visited Feb. 23, 2014); BUS. ROUNDTABLE, PRINCIPLES OF CORPORATE GOVERNANCE 2012, at 14 (2012), *available at* http://www.alcoa.com/global/en/about_alcoa/corp_gov/PDFs/BRT_2012_Principles_of_Corp_Governance.pdf.

122. *See Proxy Voting Policies*, T. ROWE PRICE, http://corporate.troweprice.com/ccw/home/responsibility/conductingBusinessResponsibly/proxyVotingPolicies.do (last visited Feb. 23, 2014); *Fidelity Funds' Proxy Voting Guidelines*, FIDELITY, http://personal.fidelity.com/myfidelity/InsideFidelity/InvestExpertise/governance.shtml#summary (last visited Feb. 23, 2014).

though not necessarily boards with only one inside director and chaired by an independent director.

2. Voting Patterns and Nomination Practices

Institutional investors' corporate governance policies are only the beginning of the investigation into their actual preferences. Shareholders express their preferences in two other ways: by casting votes in director elections and by influencing nominating committees that select board nominees.

a. Director Elections

Many factors influence outcomes in director elections: the nomination process, whether the board elections are staggered, the presence of majority voting for directors, and the distribution of voting power, to name a few. In most companies, directors are subject to re-election annually, but in companies with staggered boards, generally only one-third of directorships turn over each year.[123] Plurality voting used to be the norm.[124] Most directors run unopposed, so a director could be elected if she received a single vote in her favor. Between 2003 and 2009, however, majority voting replaced plurality voting in virtually all public firms.[125] It is now standard for company bylaws to require that director nominees receive a majority shareholder vote in favor to be elected or re-elected.[126] Directors who fail to receive majority support must offer their resignation to the board.[127] In 2011, 2% of directors who left the board did so for failing to secure a majority vote.[128]

Although the word "election" suggests democratic contest, individuals that firms nominate for directorships rarely face competition. Between 1996 and 2005, there were only 118 contested elections (out of several thousand public companies), and of those,

123. *See* DEL. CODE ANN. tit. 8, § 141(d) (2011) (allowing corporations to stagger board elections every two or three years). To this author's knowledge, the norm for staggered boards is a three-year election cycle.

124. *See* Kahan & Rock, *supra* note 47, at 1010. If there are as many nominees as there are open seats, theoretically a candidate can be elected with a single vote in favor and one hundred million against or abstaining. *See id.* at 1010 & n.149.

125. *See id.* at 1011 (reporting that 10% of companies had a majority vote in place in 2003, but 90% did in 2009).

126. *See* 2012 SSBI, *supra* note 11, at 15. In 2012, 83% of S&P 500 companies had a destaggered board, 40% more than in 2002, while 84% had majority vote policies. *See id.*

127. *Id.*

128. 2011 SSBI, *supra* note 51, at 12.

the rivals succeeded only one-third of the time.[129] More recent data suggests that proxy contests have been more common and marginally more successful in the wake of the financial crisis, but remain rare in the aggregate.[130]

The average election thus features as many nominees as there are open seats, and the median nominee receives 97% of the vote.[131] Professors Stephen Choi, Jill Fisch, and Marcel Kahan found that 89% of directors received more than 90% of the vote.[132] The remaining 10% were directors in poorly governed firms, those who missed more than a quarter of board meetings, and those disfavored by proxy advisory firms.[133]

The evidence suggests that shareholders appear to support directors that the firms nominate by large margins. It is worth repeating, however, that firms ordinarily nominate only as many directors as there are open seats and that proxy fights are rare. As a result, shareholders are not choosing independent directors over insiders at the election stage. Instead, decisions about board composition are made at the nomination stage.

129. *See* Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 677, 686 (2007).

130. The 2011 Georgeson corporate governance report includes thirteen contests for director nominees, and the 2010 and 2009 reports feature between 20 and 30 contests. GEORGESON, 2011 ANNUAL CORPORATE GOVERNANCE REVIEW 50–51, *available at* http://www.shareholderforum.com/e-mtg/Library/20111129_Georgeson.pdf.

131. Jie Cai, Jaqueline L. Garner & Ralph A. Walkling, *Electing Directors*, 64 J. FIN. 2389, 2397 (2009). The lopsided election results are the product of several confounding factors. The absence of alternatives is one. The second factor is the presence of brokers' discretionary voting. Under NYSE Rule 452, brokers could vote shares in their customer accounts in routine matters, unless beneficial owners directed them otherwise. The NYSE deemed uncontested director elections to be routine, and brokers tended to vote shares in favor of the slate of directors that the firm proposed. *See* Kahan & Rock, *supra* note 47, at 1015. On average, brokers voted between 13% and 19% of outstanding shares. *See id.* at 1017 & n.194 (attributing the figure to Broadridge Financial, offered during SEC testimony on broker votes); Cai et al., *supra*, at 2415. Since most directors are elected with wide margins, the broker vote was rarely outcome determinative: excluding uninstructed shares voted by brokers, the median nominee still received 93.8% of votes in favor. *Id.* at 2416. The practice ended in 2010 when amendments to NYSE Rule 452 deeming all director elections "nonroutine" went into effect. *See* Kahan & Rock, *supra* note 47, at 1016–17.

132. Stephen Choi, Jill Fisch & Marcel Kahan, *The Power of Proxy Advisors: Myth or Reality?*, 59 EMORY L.J. 869, 888 (2010).

133. *See* Cai et al., *supra* note 131, at 2416–17.

b. Nomination Practices

Managers used to control the nomination process: chief executives "hand-picked" directors.[134] If directors rocked the boat, they were certain to be asked to leave.[135] A lot has changed.

A corporate governance expert and activist, Nell Minow, observed in 2004 that investors are beginning to influence board composition, stating, "When a company is having significant trouble, . . . [investors] are not going to focus on secondary items, but will go to where the money is, which is who is on the board and who gets to decide who is on the board."[136]

Large investors are asking to be part of the nomination process. They have become more aggressive in recommending board members or alternative slates, but have stopped short of initiating proxy battles.[137] Instead, they have pressured nominating committees to conduct an external search for directors.[138] In response, nominating committees are relying less on insiders and more on external sources for recommendations of new directors.[139] Companies are preemptively reaching out to institutional investors and large shareholders to discuss governance matters, including director nominees. In 2008, 45% of companies reported reaching out regularly to their twenty to twenty-five largest shareholders to discuss board matters, from executive compensation to board composition.[140] By 2012, that share increased to 60%.[141]

Since 2004, NYSE and NASDAQ listing standards have required that independent directors, not the entire board, manage the nomination process.[142] In 2004, the SEC adopted detailed new rules that require disclosure of nominating committee practices, including the committees' process for search and evaluation of director candidates and the process for vetting candidates suggested by

134. Kahan & Rock, *supra* note 47, at 989, 992.

135. *See id.* at 992.

136. SPENCER STUART, 2004 SPENCER STUART BOARD INDEX 15 (2004), *available at* http://content.spencerstuart.com/sswebsite/pdf/lib/SSBI-2004.pdf (internal quotation marks omitted).

137. *See* 2009 SSBI, *supra* note 11, at 2.

138. *See* SPENCER STUART, 2008 SPENCER STUART BOARD INDEX 4 (2008) [hereinafter 2008 SSBI], *available at* http://content.spencerstuart.com/sswebsite/pdf/lib/SSBI_08.pdf.

139. *See id.* at 5.

140. *See id.* at 28.

141. *See* 2012 SSBI, *supra* note 11, at 32. In 2010 and 2011, the respective percentages were 53% and 56%. 2010 SSBI, *supra* note 1, at 31; 2011 SSBI, *supra* note 51, at 31.

142. *See* sources cited *supra* note 51.

shareholders.[143] An increasing percentage of firms have also disclosed the sources of director nominees.[144] In 2005, external search firms accounted for 56% of newly appointed directors, independent directors contributed another 19% of nominees, while insiders (including controlling shareholders) initially recommended 23% of newly elected directors.[145] Since then, the relative share of successful nominees by insiders has declined further.[146]

It appears that the board of directors, and not management, is increasingly in control of the nomination process. Under close investor scrutiny and pressure, boards are nominating independents over insiders for directorships.[147]

B. Alternative Explanations

Institutional investors' corporate governance policies and practices leave some room for the possibility that they would prefer more mixed boards. This Section examines other plausible explanations: legal change, pressure from proxy advisory firms, managerial capture, directors' own preferences, and sorting—exit from public markets by noncompliant firms. The Section concludes that none of the alternative explanations undermines the primary explanation offered in this Article, namely that institutional investors have propelled the supermajority independence trend.

1. The Role of Legal Mandates

Corporate law and, more controversially, federal securities regulation require and encourage some degree of independence on corporate boards. This Section describes these laws and concludes that legal change, alone, does not explain the trend.

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143. *See* Disclosure Regarding Nominating Committee Functions and Communications Between Security Holders and Boards of Directors, Securities Act Release No. 8340, Exchange Act Release No. 48,825, Investment Company Act Release No. 26,262, 68 Fed. Reg. 66,992 (Nov. 28, 2003); *see also* NYSE LISTED COMPANY MANUAL, *supra* note 2, § 303A.02 (defining independent director).

144. 2005 SSBI, *supra* note 120, at 8 (reporting a source for about one-third of nominees); 2010 SSBI, *supra* note 1, at 13 (reporting a source for half of new directors).

145. 2005 SSBI, *supra* note 120, at 8.

146. *See* 2007 SSBI, *supra* note 11, at 5 (reporting that insiders recommended 19% of nominated directors).

147. Some firms have affirmative rules in place requiring that the board have no more than one nonindependent director. *See* Murphy, *supra* note 8, at B1 (including AOL, Inc., among them).

a. Corporate Law

The debate about independent boards focuses almost exclusively on boards of listed companies,[148] the majority of which are incorporated in Delaware and subject to Delaware corporate law.[149] The first Delaware general incorporation statute, adopted in 1899, gave boards of directors the authority and the responsibility to run the corporation.[150] The board, not the managers, was the "ultimate managerial authority in the corporation,"[151] and could not delegate its authority to another corporate body.[152]

The 1974 amendment to the Delaware General Corporation Law provided that the business of the corporation be managed by or "under the direction of" the board of directors.[153] The amendment reflected the changed reality of public boards, where insiders were no longer in the majority.[154] Although Delaware law requires that all corporations have a board of directors regardless of size or ownership structure, it gives them considerable freedom to design a board to fit their needs.[155] As a result, one sees a fair degree of variation between private and public corporate boards in size, composition, and responsibilities.[156]

148. *See supra* note 5 and accompanying text.

149. *See About Agency*, DEL. DEP'T OF STATE, http://www.corp.delaware.gov/aboutagency.shtml (last visited Nov. 9, 2013) ("More than 50% of all publicly-traded companies in the United States, including 64% of the Fortune 500, have chosen Delaware as their legal home.").

150. Delaware General Corporation Law of 1899, ch. 273, 21 Del. Laws 444, 451 (1899) (requiring that a board of no fewer than three directors manage the business of the corporation).

151. Fisch, *supra* note 58, at 272.

152. *See* Larry E. Ribstein, *Limited Liability and Theories of the Corporation*, 50 MD. L. REV. 80, 93 & n.52 (1991) ("Early statutes absolutely required that corporations be managed by the board of directors . . . .").

153. *See* GEN. CORP. LAW COMM. OF THE DEL. STATE BAR ASS'N, COMMENTARY ON LEGISLATIVE PROPOSALS FOR THE 127TH GEN. ASSEMBLY SECOND SESSION, 1974, 2d Sess. (Del. 1974) *available at* http://law.widener.edu/LawLibrary/Research/OnlineResources/DelawareResources/DelawareCorporationLawDocuments.aspx.

154. *See* Kenneth M. Lehn, Sukesh Patro & Mengxin Zhao, *Determinants of the Size and Composition of US Corporate Boards: 1935–2000*, 38 FIN. MGMT. 747, 768 (2009); Gordon, *supra* note 5, at 1475.

155. Close corporations are the exception: shareholders have the option of foregoing the board of directors and managing the corporation directly, though few choose to do so. Family corporations seeking tax advantaged status (S-Corporations) are the most common to use the close corporation, though even they usually choose to appoint a board of directors. *See* DEL. CODE ANN. tit. 8, § 351 (2011). Delaware law limits the number of shareholders in a close corporation to thirty and requires that share transferability be restricted. *Id.* § 342.

156. *See* Steven N. Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 REV. ECON. STUD.

Delaware corporate law does not require independent directors.[157] It does, however, encourage boards to have disinterested directors, usually firm outsiders. If disinterested directors approve a self-dealing transaction, such as a generous CEO compensation package, they shield the firm from subsequent legal attack.[158] Similarly, Delaware courts defer to outside directors' judgment in "freeze-outs," where a controlling shareholder of a public company buys out minority shareholders,[159] so long as the process they adopted appears appropriate.[160] Independent directors also act as gatekeepers to shareholder derivative litigation. A shareholder cannot sue directors or officers for breaches of fiduciary duties of loyalty or care on behalf of the corporation without first demanding that the board file the lawsuit.[161] An independent board or board committee can refuse to do so, effectively stopping litigation, and reviewing courts generally grant the board's decision wide business judgment deference.[162]

By insulating board decisions made by disinterested directors from judicial review, Delaware law encourages boards to become more independent. But, this corner of Delaware law is settled and has been settled for decades. Change in corporate law cannot explain the

281, 288 (2003) (reporting that the average board of a VC-backed private company has six members, 23% of whom are outside directors). *See generally* Brian J. Broughman, *Independent Directors and Shared Board Control in Venture Finance*, 9 REV. L. & ECON. 41 (2013) (describing the categories of problems that arise on boards of VC-backed private firms).

157. *See* § 141(b) (listing the requirements for a corporate board of directors).

158. *See id.* § 144(a)(1). This was not always the case. Early corporate law provided that any transaction between the corporation and its officers and directors was voidable by the shareholders or the corporation. *See* James D. Cox, *Managing and Monitoring Conflicts of Interest: Empowering the Outside Directors with Independent Counsel*, 48 VILL. L. REV. 1077, 1079 (2003).

159. Professor Subramanian describes a freeze-out as "a transaction in which a controlling shareholder buys out the minority shareholders in a publicly traded corporation for cash or the controller's stock." Guhan Subramanian, *Fixing Freezeouts*, 115 YALE L.J. 2, 5 n.1 (2005).

160. *See* Weinberger v. UOP, 457 A.2d 701, 709–11 (Del. 1983).

161. *See* McKee v. Rogers, 156 A. 191, 193 (Del. Ch. 1931) ("[A] stockholder cannot be permitted . . . to invade the discretionary field committed to the judgment of the directors and sue in the corporation's behalf when the managing body refuses.").

162. *See* Aronson v. Lewis, 473 A.2d 805, 807–08 (Del. 1984). Only if shareholders can show that the majority of the board was not disinterested can they proceed with the lawsuit. *See id.* at 814. Alternatively, shareholders can show demand futility by showing that the transaction itself was an invalid exercise of business judgment. *See id.* Even if demand is excused and the derivative action is not dismissed, the board can form a special litigation committee composed of disinterested directors, who can move to dismiss the derivative lawsuit. *See* Zapata Corp. v. Maldonado, 430 A.2d 779, 785–86 (Del. 1981).

change in board composition that has occurred over the last twenty-five years.[163]

b. *Federal Securities Regulation*

Relatively recent changes to federal securities laws and listing standards have imposed a legal requirement that public companies maintain majority independent boards and fully independent audit, nominating, and compensation committees.[164]

Securities regulation historically governed the sale of securities to the public, and said very little about corporate internal affairs. Like Delaware, however, federal regulators and stock exchanges began encouraging some degree of director independence forty years ago.[165] In the 1970s, the Securities and Exchange Commission first endorsed the creation of audit committees composed of outside directors in publicly held companies,[166] and later required public companies to disclose their audit committee composition.[167] Since 1978, the New York Stock Exchange has required all listed companies to have an audit committee composed of non-management members.[168] Since

163. This is not to suggest that Delaware legal doctrine has not changed over the last twenty-five years; it has changed. Delaware courts have fleshed out fiduciary duties, in particular by making it clear that acting in bad faith exposes directors to liability for breach of the duty of loyalty. *See* Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006). The courts have explained that shareholders cannot adopt bylaw amendments that would interfere with directors' fiduciary obligations. *See* CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d 227, 238 (Del. 2008). The courts and the legislature have further reinforced the law of mergers and acquisitions, generally deferring to decisions of disinterested directors. *See, e.g.*, *In re* MFW S'holders Litig., 67 A.3d 496, 502 (Del. Ch. 2013). Perhaps the most important development is the majority voting rule, discussed in more detail *supra* in Part II.A.2. The Delaware legislature changed the General Corporation Law to prohibit boards from amending shareholder bylaw proposals adopting majority voting for directors. *See* Act of June 27, 2006, ch. 306, sec. 5, § 216, 75 Del. Laws 400, 400 (2006) (codified at DEL. CODE ANN. tit. 8, § 216 (2011)).

164. *See* Gordon, *supra* note 5, at 1482–83; *supra* note 9–10 and accompanying text.

165. *See* P.M. Vasudev, *Corporate Law and Its Efficiency: A Review of History*, 50 AM. J. LEGAL HIST. 237, 242 (2010). The United States has been debating whether the federal government should be involved in chartering corporations since its founding. James Madison proposed federal chartering during deliberations in the Continental Congress. *See id.*

166. *See* Standing Audit Committees Composed of Outside Directors, 37 Fed. Reg. 6850 (Mar. 23, 1972).

167. *See* ABA Comm. on Corporate Laws, *The Overview Committees of the Board of Directors*, 34 BUS. LAW. 1837, 1839 (1979).

168. *See* Gordon, *supra* note 5, at 1519. Even then, the requirement merely ratified existing reality. The Conference Board found that in 1967, 19% of manufacturing companies and 31% of nonmanufacturing companies had an audit committee. By 1977, the shares increased to 93% and 94%, respectively. *See id.* at n.211 (citing JEREMY BACON, CORPORATE DIRECTORSHIP PRACTICES: MEMBERSHIP AND COMMITTEES OF

1993, Congress has barred public corporations from deducting compensation paid to executives in excess of $1 million on the corporate tax return, unless the compensation is contingent on meeting performance goals and a determination by a compensation committee "comprised solely of 2 or more outside directors" that those goals were in fact met.[169] The federal statute did not require corporations to have independent directors, but their absence deprived the firm of a valuable tax deduction.

Everything changed after the rash of accounting scandals in 2001 and 2002.[170] Under the Sarbanes-Oxley Act, Congress authorizes the SEC to prohibit exchanges from listing securities of issuers without fully independent audit committees,[171] and the SEC adopted Rule 10A-3 in 2003.[172] In addition, and at the SEC's urging, both the NYSE and NASDAQ revised their listing standards to require that listed corporations have a majority independent board of directors.[173] Since 2004, both NYSE and NASDAQ have also required that compensation and nomination decisions be made by independent directors or committees.[174]

The financial crisis of 2008 prompted another wave of lawmaking. The Dodd-Frank Act of 2010 directed the SEC to prohibit exchanges from listing securities of issuers without fully independent compensation committees.[175] The SEC complied in June 2012,[176] though by that point, the exchanges had already required that compensation be approved by independent decision-makers for the better part of the decade.[177]

THE BOARD 50 (1973) (Conf. Bd. Report No. 588); ABA Comm. on Corporate Laws, *Corporate Director's Guidebook*, 33 BUS. LAW. 1591, 1644 (1978)).

169. *See* Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, sec. 13211, § 162, 107 Stat. 312, 469–470 (codified at 26 U.S.C. § 162(m)(4)(C)(i) (2012)).

170. *See, e.g.*, Sale, *supra* note 25, at 1022–23 (describing the significance of the change).

171. *See* 15 U.S.C. § 78j-1(m) (2012).

172. *See* 17 C.F.R. § 240.10A-3 (2013).

173. *See supra* note 52.

174. *See* Order Approving NASD and NYSE Proposed Rule Changes Relating to Corporate Governance, 68 Fed. Reg. 64,154, 64,176–78 (Nov. 4, 2003).

175. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 952, 124 Stat. 1376, 1900 (2010) (codified at 15 U.S.C. § 78j-3 (2012)).

176. *See* 17 C.F.R. § 240.10C-1.

177. The NYSE rules were first approved in 2002. NYSE, Inc., *Corporate Governance Rule Proposals Reflecting Recommendations from the NYSE Corporate Accountability and Listing Standards Committee as Approved by the NYSE Board of Directors, August 1, 2002* (2002), http://www.nyse.com/pdfs/corp_gov_pro_b.pdf. Until recently, NASDAQ did not *require* firms to have a standing compensation and nominating committee. Instead, independent directors could approve executive compensation packages or nominate

Although federal mandates appear restrictive, they merely codified existing practices at the time they were adopted. By 2001, a large majority of public companies had independent board majorities[178] and nearly all had fully independent audit committees.[179] Similarly, Dodd-Frank's requirement that firms have a fully independent compensation committee has been common practice since the mid-1990s.[180] More importantly, no federal law or regulation requires or encourages companies to put in place a supermajority independent board of directors, and section 972 of the Dodd-Frank Act merely instructs the SEC to require disclosure as to whether the CEO is also the chairman of the board or not.[181] Boards have continued to become increasingly independent in the space that has remained unregulated.[182]

2. Proxy Advisors

An additional explanation for the impetus towards board independence is that proxy advisory firms, on whom institutional investors rely for advice on how to vote, have aggressively promoted greater board independence. Proxy advisory firms make

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directors by a majority vote. In addition, in exceptional and limited circumstances, a compensation or nominating committee could have one member that was not independent. NASD and NYSE Rulemaking: Relating to Corporate Governance, Exchange Act Release No. 34,48745, 81 SEC Docket 1586 (Nov. 4, 2003), *available at* http://www.sec.gov/rules/sro/34-48745.htm.

178. *See* Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Further Findings and a Reply to Symposium Participants*, 55 STAN. L. REV. 885, 896 & n.33 (2002) (citing INVESTOR RESPONSIBILITY RESEARCH CTR., BOARD PRACTICES/BOARD PAY 2001: THE STRUCTURE AND COMPENSATION OF BOARDS OF DIRECTORS AT S&P SUPER 1500 COMPANIES (2002)).

179. In fact, the NYSE has required that the audit committee be fully independent since 1977, though the definition of independence was more relaxed at the time and did not include bankers, underwriters, or others with customary relationships with the firm. *See* Gordon, *supra* note 5, at 1479–80.

180. Companies began instituting fully independent compensation committees in 1996 to take advantage of section 162(m) of the Internal Revenue Code that disallowed a deduction of executive compensation unless performance-based and approved by a fully independent audit committee. *See* Gordon, *supra* note 5, at 1480.

181. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 972, 124 Stat. 1376, 1915 (2010) (codified at 15 U.S.C. § 78n-2 (2012)). As of February 13, 2014, the SEC had not proposed a rule. *See Implementing Dodd-Frank Wall Street Reform and Consumer Protection Act—Accomplishments*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/spotlight/dodd-frank/accomplishments.shtml#cgov (last updated Feb. 13, 2014).

182. It is possible that without a federal intervention in corporate governance "extralegal social forces" would pull back the board independence trend. *See* Langevoort, *supra* note 58, at 817 (arguing against independence mandates).

recommendations to their clients, including most institutional investors, on how to vote their shares in the election of directors or any other matter on which shareholders vote.[183]

RiskMetrics and its predecessor, Institutional Shareholder Services ("ISS"), and Glass Lewis, the two largest proxy advisory firms, have been quite aggressive in advocating particular governance changes, including supermajority independent boards.[184] Their practice of recommending uniform standards for all firms has been subject to much criticism.[185]

More troubling than the existence of voting recommendations themselves was the fact that institutional investors were suspected of relying on the recommendations without properly scrutinizing them. Ira Millstein, a corporate governance guru, worried about the influence of proxy advisors and the fact that "many major funds [but not TIAA-CREF or CalPERS] rely on the anonymous advice of a handful of proxy advisers rather than thinking for themselves."[186] Voting decisions should be made by "knowledgeable money managers," not corporate governance "experts."[187] Commentators have worried that ISS exercised "tremendous clout"[188] and could influence 20–30% of votes.[189] The percentage is significant, even in the universe where management proposals ordinarily prevail by wide margins.

Professors Choi, Fisch, and Kahan have shown, however, that the purported power of ISS has been overstated.[190] They found that an ISS recommendation could move 6–10% of the shareholder vote, a relative drop in the bucket when almost 90% of directors are elected with more than 90% of the vote.[191] Recommendations by other proxy

183. *See* THEODORE ROOSEVELT MALLOCH & SCOTT T. MASSEY, RENEWING AMERICAN CULTURE: THE PURSUIT OF HAPPINESS 170 (2006) (describing proxy advisory firms and noting that they "give advice to institutional shareholders on how to vote their stock").

184. *See* Bhagat et al., *supra* note 79, at 1874.

185. *See id.* at 1862.

186. SPENCER STUART, 2006 SPENCER STUART BOARD INDEX 15 (2006), *available at* http://content.spencerstuart.com/sswebsite/pdf/lib/SSBI-2006.pdf.

187. *Id.* at 15 (quoting Ira Millstein, Senior Partner at Weil Gotshal & Manges LLP and corporate governance scholar at Yale Law School).

188. Dennis K. Berman & Joann S. Lublin, *Adviser ISS Puts Itself on Sale, Could Fetch Up to $500 Million*, WALL ST. J., Sept. 6, 2006, at C4.

189. *See* Choi et al., *supra* note 132, at 871.

190. *Id.* at 869–70.

191. *See id.* at 888 (reporting that 89% of directors received 90% or more of the votes cast).

advisors had an even smaller effect.[192] More recently, Professors Randall Thomas, Adam Pritchard, and James Cotter studied the influence of ISS in shareholder votes on executive compensation.[193] They found that a negative recommendation by ISS was correlated with a 20% decline in shareholder support.[194] But, once other factors influencing the vote are taken into account, they found the ISS's influence to be small, consistent with the Choi, Fisch, and Kahan study.[195]

But perceptions might drive the nominating committee's choices more than facts.[196] Boards also read proxy advisory reports. They might feel pressured to nominate an independent director when an insider departs. Nominating committees might be looking for independent directors to replace insiders out of a genuine concern about possible negative repercussions.

Proxy advisors' influence may have peaked in the mid-2000s. In March 2010, RiskMetrics rolled out a new corporate governance rating methodology that evaluated companies along several dimensions and provided absolute rather than relative scores.[197] The new methodology strongly favored majority independent boards, but gave less weight to supermajority independent boards.[198] In January 2013, RiskMetrics released QuickScore, reviving relative ratings and returning to its earlier position that more board independence is

192. *See id.* at 900.

193. *See generally* Randall S. Thomas, Adam C. Pritchard & James F. Cotter, *Dodd-Frank's Say on Pay: Will It Lead to a Greater Role of Shareholders in Corporate Governance?*, 97 CORNELL L. REV. 1213 (2012) (concluding that shareholders may have a growing influence on executive pay as a result of Dodd-Frank's mandate which requires shareholder vote for pay practices of top executives).

194. *See id.* at 1244.

195. *See id.* at 1247.

196. During ISS's heyday between 2004 and 2008, panicked executives lamented that ISS alone could influence "a third or more" of the vote. *See* Paul Rose, *The Corporate Governance Industry*, 32 J. CORP. L. 887, 889 (2007).

197. *See* RISKMETRICS GROUP, FAQ TRANSITION PLAN FOR CORPORATE ISSUERS, RISKMETRICS' GOVERNANCE RISK INDICATORS 2 (2010), *available at* http://www.issgovernance.com/files/FAQ-GRId-corporate.pdf.

198. *See* INST. S'HOLDER SERVS., GOVERNANCE RISK INDICATORS: A NEW MEASURE OF GOVERNANCE-RELATED RISK 30 (2010), *available at* http://www.issgovernance.com/files/GRId_Tech_Doc_Final_20100915.pdf. In 2012, RiskMetrics updated that methodology, but without change in regard to board composition. *See* Gary Hewitt, GOVERNANCE RISK INDICATORS 2.0, at 16 (2012), *available at* http://www.issgovernance.com/files/GRId2.0_TechnicalDocument20120306.pdf.

always better.[199] But, QuickScore continues to rate companies along many dimensions, likely dampening the impact of changes. Although proxy advisors continue to influence investor voting, their pressure to increase board independence appears to have declined somewhat.

It is difficult to disaggregate the effects, but ultimately, it might not matter. Companies' proxy statements from 2010 to 2013 reveal that the trend towards boards with only one non-independent director has continued, although the pressure from proxy advisors to make that particular change has declined. While proxy advisors have certainly influenced the move towards supermajority independent boards, institutional investors have been the primary impetus behind the trend.[200]

3. Managerial Capture

Historically, managers captured the board of directors and the election process. In the 1960s, the chief executive officer could have " 'exactly the kind of a board he wants.' "[201] While the CEO could never appoint directors directly, he would select nominees, and the director slate would be offered to shareholders for approval. As late as 2001, 28% of companies had no nominating committee.[202]

Today, CEOs remain an important source of new director nominees, but their influence has declined considerably over time. In 2012, CEOs selected the members of the nominating committee in 18% of firms.[203] In 2010, CEOs were identified as the source of new director recommendations in 12% of cases.[204] CEOs also interviewed director candidates in 20% of firms, regardless of the source of the recommendation.[205]

One plausible explanation for the trend towards supermajority independent boards is that CEOs are appointing loyal independent directors to the nominating committee or are continuing to control the process by some other means. The increase in board independence could be nominal, and the trend is one that managers have co-opted. Alternatively, managers' first-order preference might

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199. *See* INST. S'HOLDER SERVS., ISS GOVERNANCE QUICKSCORE: OVERVIEW 8, at 13 (2013), *available at* http://www.issgovernance.com/files/ISSGovernanceQuickScore TechDoc.pdf.

200. *See infra* Part III.B.

201. Kahan & Rock, *supra* note 47, at 991 (quoting MYLES L. MACE, DIRECTORS: MYTH AND REALITY 78 (1971)).

202. *See id.* at 1025 fig.2.

203. *See* 2012 SSBI, *supra* note 11, at 27.

204. *See* 2010 SSBI, *supra* note 1, at 13.

205. *See* 2012 SSBI, *supra* note 11, at 27.

be a board staffed with more insiders. But, nominating insiders could instigate a proxy battle by activist shareholders. Even if the battle were doomed, it would consume time and resources. As a second order preference, managers, not investors, might be the ones who prefer to sacrifice an inside director to add a nominally-independent director.

There might be some truth to both theories, but there is also evidence to the contrary. Top executives appear unhappy with the shift towards a more director-controlled process.[206] Serving on the board of one's own company used to be training for junior executives in line for the top job at that corporation. To make up, companies are reaching out to other companies for outside board opportunities for their up-and-coming executives.[207] They are outsourcing training, losing the benefit of working closely with possible successors, as well as potentially losing talented executives to other firms as they build stronger external networks.[208]

In addition, the Business Roundtable and the U.S. Chamber of Commerce, organizations that represent the interests of corporate executives and small business owners, have successfully challenged the SEC's rules that required increased board independence.[209] Their persistence suggests that managers are generally uncomfortable with the independence trend. Managerial capture is therefore not a persuasive explanation for the trend of increasing board independence.

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206. *See* Murphy, *supra* note 8, at B1 (quoting Costco CFO and board member Richard Galanti, explaining that his successor will probably not hold a board position because boards need to look more "pro-shareholder").

207. *See* 2008 SSBI, *supra* note 138, at 5.

208. Some firms do not allow their executives to serve on other companies' boards because they want them to remain focused on their work and limit the risk that the executive will be recruited away. Perhaps the best known example is Apple, whose then-CEO Steve Jobs allowed only his successor, Tim Cook, to serve on a single outside board, Nike. ADAM LASHINSKY, INSIDE APPLE: HOW AMERICA'S MOST ADMIRED—AND SECRETIVE—COMPANY *REALLY* WORKS 98 (2012) (noting that Steve Jobs refused to allow Apple executives to sit on outside boards because he wanted them to remain solely focused on their work at Apple).

209. *See* Chamber of Commerce v. SEC, 412 F.3d 133, 146 (D.C. Cir. 2005) (vacating the rule requiring mutual funds to have a board with no less than 75% of independent directors and an independent chairman). In other situations, trade organizations have advocated increased board independence. I believe that the best explanation is that the Business Roundtable and the U.S. Chamber of Commerce are generally opposed to increased board independence, but they prefer independence mandates to regulatory prohibitions and restrictions of their substantive behavior.

4. Director Influence

The responsibilities of directors have increased considerably since the Sarbanes-Oxley reforms, but so has their influence over management.[210] Corporate directors are keenly aware that public companies are subject to public scrutiny.[211] As a result, they may be pushing separately for increased board independence.

Directors certainly have the ability to influence board composition. Nominating committees that manage the board nomination process have been overwhelmingly independent since at least 2003.[212] In addition, independent directors are increasingly the source of new independent director nominees. In 2010, current independent directors nominated 22% of new directors, while executive search firms which nominating committees hired to locate independent director candidates were the source of another 54% of successful nominations.[213]

But institutional investor pressure is the likely reason for directors' increased activity. Studies report that directors frequently communicate with large investors about board composition, nominations, and specific practices.[214] Big shifts in board governance are often announced after intense discussions with important shareholders, and rarely sua sponte.[215]

5. Sorting

The relative share of firms with only one nonindependent director, the CEO, has been creeping up. The argument thus far has assumed that the numerator, the aggregate number of firms with supermajority independent boards, has increased. But the denominator—the overall number of public firms—has also

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210. *See, e.g.*, Kahan & Rock, *supra* note 47, at 1025–32 (showing how boards of directors have become increasingly influential and independent from management since the mid-1990s).

211. For example, in September 2013, following months of bad press resulting from a series of missteps and enforcement actions, J.P. Morgan's board appointed a lead independent director. The appointment was in response to meetings between independent directors and activist shareholders. *See* Dan Fitzpatrick & Joann S. Lublin, *J.P. Morgan Juices Up Director's Job*, WALL ST. J. (Sept. 9, 2013), http://online.wsj.com/news/articles/SB10001424127887323864604579064941840914528.

212. *See* 2003 SSBI, *supra* note 49, at 12.

213. *See* 2010 SSBI, *supra* note 1, at 13.

214. *See supra* notes 134–41 and accompanying text.

215. *See, e.g.*, Fitzpatrick & Lublin, *supra* note 211 (reporting that shortly before J.P. Morgan appointed a lead independent director, directors held several meetings with institutional investors that demanded "a board shake-up").

decreased.[216] Perhaps companies with less independent boards have gone private.[217]

There is little reason to believe that observed changes in board composition are solely the result of exits, however. First, the share of companies with supermajority independent boards has almost tripled since 1997, from 23% to 60% in 2013.[218] Over the same period, the number of public firms in the United States declined by 38%.[219] Even if all exiting firms had boards with multiple insiders, their exits would explain only 14%, a little more than one-third, of the 37% increase in supermajority independent boards.[220] Second, the data reported include a relatively stable sample of leading companies, those in the S&P 500 Index.[221] There is no reason to believe that companies that were dropped from the Index were the ones with more insiders on their boards, and were replaced by those with fewer.[222]

Thus, the trend towards supermajority independence does not appear to be a result of insider-laden boards leaving public securities markets. And, although proxy advisory firms remain influential and

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216. *See The Endangered Public Company*, THE ECONOMIST (May 19, 2012), http://www.economist.com/node/21555562/. After the adoption of the Sarbanes-Oxley Act and stock exchange reforms, many in the academy and the business circles feared that firms have exited public securities markets to avoid the cost of compliance. *See, e.g.*, Roberta Romano, *Does the Sarbanes-Oxley Act Have a Future?*, 26 YALE J. ON REG. 229, 251–52 (2009) (citing empirical studies suggesting that the adoption of the Sarbanes-Oxley Act led many previously public firms to go private or delist to avoid the cost of compliance).

217. *See* Christian Leuz, Alexander J. Triantis & Tracy Yue Wang, *Why Do Firms Go Dark? Causes and Economic Consequences of Voluntary SEC Deregistrations*, 45 J. ACCT. & ECON. 181, 181 (2008) (finding that an abnormal number of firms ceased SEC reporting after the adoption of the Sarbanes-Oxley Act).

218. *See supra* Table 1.

219. *See The Endangered Public Company*, *supra* note 216.

220. The number could understate the effect of sorting. Some firms that delisted were replaced with new firms that were more inclined to favor board independence.

221. The list of the companies in the index changes as a result of acquisitions and spinoffs, and less often changes in market capitalization. *See* McGraw Hill Financial, S&P U.S. Indices: Methodology 5–6 (2013), *available at* http://us.spindices.com/indices/equity/sp-500 (showing that companies with $4.6 billion unadjusted market capitalization are eligible for the S&P 500, while noting that companies are removed from the index when involved in mergers, acquisitions, or significant restructuring such that they no longer meet inclusion criteria). Note that board composition in smaller public firms appears to track that of the S&P 500—there are no notable differences. *See* Kahan & Rock, *supra* note 47, at 1024 tbl.5.

222. A recent study of public firms from 1999 to 2006 found that boards increased the number of independent directors and reduced the number of insiders during that period. The dataset includes only firms that were public throughout the period. *See* Steven Schmeiser, *Board Response to Majority Outsider Regulation*, 24 APPLIED FIN. ECON. 19, 19, 21–22 (2014).

management continues to influence director nominations, it appears that the board independence trend is largely the product of institutional investors' preferences.

III. WHY INVESTORS FAVOR SUPERMAJORITY INDEPENDENT BOARDS

The compiled evidence suggests that public boards are becoming increasingly independent because that is what investors want, encouraged by proxy advisors and directors, and unopposed by managers resigned to more vigilant shareholders. What remains unanswered is *why* rational investors prefer boards with only one insider to those with two or more in the absence of empirical support that such boards improve corporate performance or reduce wrongdoing.

This Part argues that board independence displaces substantive reforms in the wake of corporate crises or scandals. The first Section explains the regulatory dynamic. The following Section then offers evidence from three crisis periods where investors and management convinced Congress to adopt corporate governance solutions, in particular independent boards, in lieu of substantive reform. The Part concludes that independence is a poor substitute for regulation it displaces, and proposes retirement of corporate governance mandates.

A. Corporate Governance as a Substitute for Substantive Regulation

"[G]ross corporate wrongdoing or ... poor national economic performance [that] is plausibly tied to corporate governance" usually triggers federal regulation, particularly when the impact spreads beyond shareholders to employees, entire industries, or the economy as a whole.[223] In the 1930s, during the Great Depression, Congress regulated securities markets to reduce the likelihood of manipulation and fraud.[224] In the 1970s, Congress passed the Foreign Corrupt Practices Act to curb corporate bribery of foreign government officials.[225] Accounting scandals led to the adoption of the Sarbanes-

223. *See* Roe, *supra* note 32, at 2529; Sale, *supra* note 87, at 147. *See generally* BANNER, *supra* note 25 (tracing the cyclical nature of financial regulation through the eighteenth and nineteenth centuries).

224. *See* Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (1933) (codified as amended at 15 U.S.C. §§ 77a-77aa (2012)); Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (1934) (codified as amended at 15 U.S.C. §§ 78a-78pp (2012)).

225. *See* Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, 91 Stat. 1494 (1977) (codified as amended in scattered sections of 15 U.S.C.).

Oxley Act, and the financial crisis in 2008 gave us the Dodd-Frank Act of 2010.[226]

Additional federal regulatory requirements and invigorated enforcement in the wake of crises and scandals can be very costly for both the firms' managers *and investors*. The risk of a federal intervention that would be costly for investors is greatest when systemic governance failures appear to have caused the crisis. Those very same governance failures often benefit diversified investors: they receive the whole upside if things work out, but their downside exposure is limited.[227]

As the crisis subsides and the most painful memories of scandal fade, regulatory momentum wanes.[228] A strategy that enables managers and investors either to reduce the perceived need for reform or to substitute for more onerous (but also more effective) federal laws is thus valuable, perhaps immensely so.[229]

To be successful, the strategy must appeal to Congress and interest groups that favor reform—it must be credible as a solution for negative externalities that corporate risk-taking and misconduct generates. At the same time, the regulation-avoidance strategy must also preserve the ability of corporate managers and investors to

226. This happened because neither regulators nor courts were willing to hold directors accountable. Donald C. Langevoort, *The Social Construction of Sarbanes-Oxley*, 105 MICH. L. REV. 1817, 1849 (2007) ("After all, neither dominant interest—managers or investors—will acquiesce in more public accountability without external pressure.").

227. *See id.* at 1836–37 (explaining that institutional investors favor reforms that generate increases in share prices, but are uncomfortable with compliance reforms designed to limit aggressive risk-taking); John M. Connor & C. Gustav Helmers, *Statistics on Modern Private International Cartels, 1990–2005*, at 35 (Am. Antitrust Inst., Working Paper No. 07-01, 2007), *available at* http://ssrn.com/abstract=1103610 (finding that median sanctions for cartels amounted to less than 21% of the overcharges); Bernadette A. Minton, Jérôme P.A. Taillard & Rohan Williamson, *Do Independence and Financial Expertise of the Board Matter for Risk Taking and Performance?* 28–36 (Fisher Coll. of Bus., Working Paper No. 2010-03-014, 2011), *available at* http://ssrn.com/abstract=1661855 (finding a negative relationship between director independence and financial expertise and corporate performance during the most recent financial crisis, and concluding that the evidence is consistent with directors with financial expertise recognizing the residual nature of shareholders' claim on a bank's highly leveraged balance sheet that is guaranteed by the government); Karpoff et al., *supra* note 27, at 4–5 (explaining that a firm's probability of getting caught for paying bribes is a mere 6.4%, but those that are caught face sanctions lower than the benefit from bribe-payment).

228. *See* Stephen Labaton & Richard A. Oppel, Jr., *Enthusiasm Waning in Congress for Tougher Post-Enron Controls*, N.Y. TIMES, June 10, 2002, at A1 (explaining that by June 2002, the regulatory momentum to regulate in the aftermath of Enron had waned).

229. *See id.* (arguing that "Enron's moment as a galvanizing issue has quickly passed" and that "[a]bsent a spate of further disclosures . . . the issues may remain too remote to change many voters' minds").

continue sharing the rents generated by the firm to the exclusion of others.

The remainder of this Article argues that the supermajority independent board satisfies all of these requirements. Despite the popularity of independent directors in corporate institutional design, they are, in fact, a poor substitute for public-regarding regulation of negative externalities.[230] They can, however, pass as a substitute.[231] To be sure, supermajority independent boards are not costless to investors—they may be negatively correlated with corporate performance—but that cost is small in comparison with the far greater cost that more restrictive federal laws would entail.

1. Competing Interests in Corporate Governance

American corporate law authorizes managers and shareholders to make decisions in the interest of the corporations they represent. Shareholders cannot manage firms directly, so they elect directors, who, in turn, select managers to run the day-to-day business operations while directors monitor them. The separation of ownership and control engenders agency costs, but incentive compensation and boards responsive to shareholder concerns reduce these costs.[232] Although the agency problem remains a core feature of corporate law and theory, most of the time the interests of managers and investors are aligned to a considerable extent.[233] When times are good, the two interest groups can decide to govern firms in a way that maximizes each group's benefit: high stock prices for investors and high compensation for executives.[234]

But shareholder wealth and social welfare are not synonymous. High stock prices can reflect higher expected revenues from bringing innovative new products to market and improving efficiencies in production and distribution, but they can also result from rent-

230. *See infra* Part III.A.2.

231. *See* Brudney, *supra* note 24, at 654 ("To accept the independent director as a [substitute to] government regulation ... will—in many areas certainly, and in most probably—result in less protection for consumers, suppliers, workers, and the general public."); Roberta S. Karmel, *The Independent Corporate Board: A Means to What End?*, 52 GEO. WASH. L. REV. 534, 553 (1984) (summarizing critical views that "the independent board as a surrogate for the legislature in determining public policy is likely to do a poor job, both economically and politically").

232. *See generally* Kahan & Rock, *supra* note 47, at 989 (observing that since 2000, CEO power has weakened and their responsiveness to shareholder interests increased).

233. *See* Roe, *supra* note 32, at 2515–16.

234. *See* Edward B. Rock, *Adapting to the New Shareholder-Centric Reality*, 161 U. PA. L. REV. 1907, 1917 (2013).

seeking value transfers from nonshareholders. In addition, stock prices do not incorporate negative externalities, unless the firm is forced to internalize them. Even if they do not want managers to break the law, shareholders benefit from activities that reduce overall social welfare, including price fixing, bribery, polluting the environment, and externalizing risk. Those harmed—competitors, workers, consumers, environmentalists, financial creditors, and public-interest-minded politicians—thus have an economic interest in how corporations behave and a related political interest in restricting corporate freedom.

a. Investors

Investors want high risk-adjusted returns as measured by stock prices.[235] Efforts to reduce agency costs and maximize returns to shareholders increase the social surplus,[236] but only if the expectations of others who provide inputs to the firm (creditors, employees, suppliers, consumers) and those affected by firm activities (the environment, local governments, taxpayers) are fully protected by contracts or regulation. If contracts are incomplete and regulation is missing, limited, or circumvented, as is often the case, shareholders can benefit not only by increasing overall firm productivity, but also

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235. Several books and articles argue that the interests of long-term shareholders and short-term shareholders diverge. *See, e.g.*, LYNN STOUT, THE SHAREHOLDER VALUE MYTH: HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS, AND THE PUBLIC 74 (2012); Martin Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 104 (1979); Mark J. Roe, *Corporate Short-Termism—In the Boardroom and in the Courtroom*, 68 BUS. LAW. 977, 986–87 (2013); Leo E. Strine, Jr., *One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?*, 66 BUS. LAW. 1, 17 (2010). But Usha Rodrigues makes a good case that long-term investors do not exist. Instead, even investors saving for retirement or college are "more properly seen as short-term investors with long-term *interests*." Usha Rodrigues, *Corporate Governance in an Age of Separation of Ownership from Ownership*, 95 MINN. L. REV. 1822, 1826 (2011).

236. *See* Fisch, *supra* note 31, at 658 (analyzing the theory that maximizing firm value equally maximizes shareholder value, thereby giving residual claimants an incentive to maximize firm value); Gordon, *supra* note 5, at 1535 (observing that the claim "that shareholder wealth maximization . . . in fact maximize[s] social surplus" is normatively attractive). Bill Bratton and Michael Wachter argued that the notion leads to predictable problems: stock prices send reliable governance signals only in a small subset of cases where the issue is clear-cut and information asymmetries are minimal. *See* William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 689 (2010).

by transferring value from nonshareholders to themselves, producing social welfare losses in the process.[237] Stock prices rise in either case.

The easiest way to transfer value from nonshareholders to shareholders is by increasing the level of risk.[238] Shareholders can benefit by gambling with value that would otherwise be paid to employees, creditors, or the government. For example, banks and insurance companies are required to keep reserves to cover loan defaults and expected future claims.[239] When profits are otherwise lagging, banks have been known to release reserves to boost profitability, while simultaneously depleting the cushion for economic downturns.[240] Insurance companies successfully lobbied to reduce statutory reserves and plan to use "billions of dollars for acquisitions, stock buybacks, dividend increases," and otherwise to boost investors' returns.[241] Lower reserves increase the risk of failure, debt default, layoffs, and taxpayer bailouts.[242]

In addition, current shareholders generally have an economic incentive to underinvest in monitoring to the extent that they reap the full benefit of corporate wrongdoing, but externalize part (or all) of the cost to nonshareholders.[243] For example, shareholders (as

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237. *See* Fisch, *supra* note 31, at 659; *see also* Nalin Kulatilaka & Stephen Gary Marks, *The Strategic Value of Flexibility: Reducing the Ability to Compromise*, 78 AM. ECON. REV. 574, 574 (1988) (explaining that "incomplete contracting is the norm [in] the labor market"). "A transfer of value from one party to another is not a social cost per se. But, a zero-cost transfer assumes perfect competition, information, substitution, and rationality, as well as zero transaction costs. When these assumptions are relaxed, as they must be, all transfers will produce social deadweight losses." Velikonja, *supra* note 29, at 1902 n.60.

238. *See* Fisch, *supra* note 31, at 659–60.

239. *See* N.Y. INS. LAW §§ 1404, 4310 (McKinney 2013); 12 C.F.R. §§ 204.1, 204.4(f) (2013).

240. *See* Michael Rapoport, *Banks Depleting Earnings Backstop*, WALL ST. J., Feb. 3, 2012, at C1.

241. Leslie Scism, *Insurers Add Reserve Power*, WALL ST. J., Dec. 3, 2012, at C1.

242. Several studies have found that financial firms with the most shareholder-friendly governance and higher incentive-based executive pay were more likely to get into trouble and be bailed out during the financial crisis. *See, e.g.*, Rüdiger Fahlenbrach & René M. Stulz, *Bank CEO Incentives and the Credit Crisis*, 99 J. FIN. ECON. 11, 11 (2011) (finding some banks whose CEOs' incentives were better aligned with the interests of their shareholders actually performed worse both in terms of stock returns and in terms of accounting return on equity); Reint Gropp & Matthias Köhler, *Bank Owners or Bank Managers: Who Is Keen on Risk? Evidence from the Financial Crisis* 1 (Eur. Bus. Sch. Research Paper No. 10-02, 2010), *available at* http://ssrn.com/abstract=1555663 (finding that shareholder-controlled banks had higher profits in the years before the crisis, and incurred larger losses and were more likely to require government assistance during the crisis).

243. *See* Donald C. Langevoort, *Internal Controls After Sarbanes-Oxley: Revisiting Corporate Law's "Duty of Care as Responsibility for Systems*, 31 J. CORP. L. 949, 960

shareholders) ordinarily benefit from cartels, which transfer value from consumers,[244] or from paying bribes for prime government contracts, which transfer value from other businesses that are not willing or able to compete with bribes. Absent public ordering, private liability, or reputational sanctions, firms underinvest in preventing activities that benefit shareholders at the expense of nonshareholders.[245] Absent a clear legal mandate in regard to the quality of oversight and conflict-free oversight, corporations maximizing shareholder wealth underspend on compliance.[246]

b. Managers

All else being equal, managers prefer broad autonomy to manage corporate affairs.[247] They prefer the quiet life and stability over aggressive risk-taking.[248] This preference is shifted, however, when compensation is tied to measures of performance, such as bonuses tied to revenues or profits, or when managers receive equity-based compensation, like stock options or restricted stock grants.[249]

Managers are willing to trade autonomy for money and maximize the stock price when they are rewarded for doing so.[250] Some efforts to boost the stock price are socially valuable, such as product innovation or new ways of generating revenues from existing product lines. Others are not, whether they are illegal (e.g., earnings

(2006) (observing that existing investors suffer rather than benefit from discovery of wrongdoing and prefer "less-than-full transparency ex post").

244. *See* Connor & Helmers, *supra* note 227, at 35 (finding that median sanctions for cartels amounted to less than 21% of the overcharges). Since individual shareholders are also consumers, price fixing imposes a cost as well as a benefit. The net balance depends on how much of the relevant product or service they purchase, directly or indirectly, and on how much equity in the price-fixing company they own. On net, shareholder-consumers benefit from cartels the more equity they own and the less of the affected product or service they consume.

245. The argument does not rely on shareholders affirmatively desiring managers to break the law. Rather, investors have an interest to underinvest in compliance designed to prevent illegality that benefits the firm. While they might prefer that managers do not pay bribes or fix prices, shareholders as a class have a powerful incentive to spend only as much on compliance as is in their private interest, not as is socially optimal. Since enforcement of bribes and cartels is meek and sanctions moderate compared to the benefit derived from illegality, the incentive to underspend is all the greater.

246. For a more complete discussion, see Velikonja, *supra* note 29, at 1915–29.

247. *See* Roe, *supra* note 32, at 2504–06.

248. *See* Marianne Bertrand & Sendhil Mullainathan, *Enjoying the Quiet Life? Corporate Governance and Managerial Preferences*, 111 J. POL. ECON. 1043, 1043 (2003).

249. *See* Bratton & Wachter, *supra* note 236, at 710–11; Rock, *supra* note 234, at 1935.

250. *See* Gordon, *supra* note 5, at 1533–34 (observing that during the 1990s, compensation contracts shifted managers' preferences towards shareholder value at the expense of managerial autonomy).

manipulation) or not (e.g., increasing leverage in banking). To a large extent, equity compensation aligns the interests of managers with those of investors, and neither investors nor managers want to share decision-making in corporate governance with others: they "usually do not want corporate law to go federal."[251]

c. Everybody Else

Corporate activities in public firms also affect the well-being of noninvestors. Employees and labor unions want higher wages and job security, financial institutions as creditors want greater stability, consumers want low prices, environmentalists want improved air and water quality, productivity-promoting policymakers want to foster "competition and strong capital markets," and public interest groups want to limit corporate power to advance social responsibility.[252] Although the specific goals of outsiders diverge, they are generally in favor of federal regulation that would limit the ability of firms to engage in anticompetitive practices, bribery, and rent-seeking, thus reducing the harm to their physical and social environments.[253]

The interests of investors and the public diverge, and financial crises tend to expose that disparity. Financial regulation in the aftermath of crisis is virtually inevitable, but the shape it takes is not predetermined. "Good" corporate governance, whether voluntarily implemented or mandated by law, can satisfy the public demand for regulation while otherwise maintaining the pre-crisis status quo. Independence mandates have been a particularly useful tool for deflecting regulation that would be more costly for investors but arguably more effective at forcing firms to internalize costs.[254]

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251. Roe, *supra* note 32, at 2518.

252. *See* Roe, *supra* note 32, at 2496. Public policymakers include the Federal Reserve, the Council of Economic Advisors, Congress's General Accounting Office, and the SEC. Competition and strong capital markets should not be confused with corporate profitability. Neither managers nor shareholders want product-market competition, for example, and textbook-perfect competition would eliminate all economic profits.

253. *See* Roe, *supra* note 32, at 2495 ("Those outsiders often have a regulatory agenda.").

254. During the early days of the independence trend, SEC Chairmen repeatedly stressed that the independent director was "the savior of corporate legitimacy and an appropriate substitute for regulation." Brudney, *supra* note 24, at 621 & n.62. Increasing the racial and gender diversity on corporate boards is another example of firms using board composition to score political points. *See generally* Lisa M. Fairfax, *The Bottom Line on Board Diversity: A Cost-Benefit Analysis of the Business Rationales for Diversity on Corporate Boards*, 2005 WIS. L. REV. 795 (2005) (explaining that boards have become more diverse despite the absence of empirical support that diversity improves corporate performance).

2. Strategic Potential of Independence

A tactic (or an asset) has strategic potential if it enables the one who uses it to benefit more from it than others anticipated, either because of better information or the ability to control and direct the outcome.[255] Strategic value is a term used to describe competitive behavior, R&D expansion, and even military tactics, but it is also useful to consider the strategic use of corporate governance improvements in the aftermath of corporate scandal or crisis in national politics.

Corporations use a variety of tools to avert a regulatory response to crisis. Lobbying is one much-used tool. In the aftermath of the 2008 financial crisis, banks took a keen interest in agency rulemaking designed to restrict profitable but risky practices.[256] Public relations campaigns designed to frame failures as outliers are another tool. In the aftermath of accounting fraud scandals in 2002, then-President George W. Bush blamed "a few bad apples," emphasizing individual wrongdoing over systemic problems.[257] As part of their outreach in the wake of scandal or crisis, manager and investor groups often voluntarily initiate reforms through self-regulatory organizations ("SROs")—the exchanges, National Association of Securities Dealers ("NASD"), and Financial Industry Regulatory Authority ("FINRA")—to convince Congress that intervention is unnecessary.[258] Where voluntary efforts are too weak to preempt federal legislation, institutional investors—either individually or, more often, through SROs—put pressure on Congress to adopt corporate governance reforms in lieu of substantive requirements.

Congress can intervene in a variety of ways. The most intrusive is substantive regulation of corporate activities. It is also the method that limits rent-seeking opportunities of investors and managers the

255. *See* Jay B. Barney, *Strategic Factor Markets: Expectations, Luck, and Business Strategy*, 32 MGMT. SCI. 1231, 1234 (1986) (observing that in any market, a firm can avoid losses or exploit profit opportunities if it has better information or more accurate "expectations about the future value of the strateg[ies]").

256. *See* Kimberly D. Krawiec, *Don't "Screw Joe the Plummer": The Sausage-Making of Financial Reform*, 55 ARIZ. L. REV. 53, 59 (2013) (observing that investment banks "actively lobbied agencies to adopt favorable definitions, interpretations, and exemptions" to the Volcker Rule before the notice of the proposed rule was published and comments were sought).

257. *See* Madelaine Drohan, *Knowing When to Stop Reporting About Scandal*, 59 NIEMAN REP. 117, 118 (2005), *available at* http://www.nieman.harvard.edu/reports/article/100610/Knowing-When-to-Stop-Reporting-About-a-Scandal.aspx/.

258. *See* Ribstein, *supra* note 78, at 57–61.

most.[259] For example, Congress could require public companies to incorporate federally or eliminate limited liability for federally insured financial institutions.[260] It could ban risky derivatives or mandate federal licensing for complex financial instruments.[261] It could prescribe rules for preparing and reviewing financial statements and empower (and fund) an IRS-like federal agency to audit financial reporting.[262] Congress has, in fact, taken control over anticompetitive behavior[263] and public tender offers,[264] restricted the ability of corporations to purchase non-audit services from their auditors,[265] provided for clawback of bonuses and other incentives in the event of a material restatement,[266] and considerably limited the highly profitable ability of financial institutions to trade financial instruments on their own account, rather than on their customers' accounts.[267]

Considerably less costly for investors are disclosure requirements and formal corporate governance mandates, such as statutory requirements that corporations maintain a fully independent audit committee[268] or regulatory instructions to exchanges to mandate

259. There are few effective substitutes for government regulation of negative externalities and public goods, and not for the lack of trying. Behavioral law and economics has tried to develop a third way for regulating the economy and has produced unsatisfactory solutions—solutions that fall short of government mandates. *See* Ryan Bubb & Richard H. Pildes, *How Behavioral Economics Trims Its Sails and Why*, 127 HARV. L. REV. (forthcoming 2014).

260. *See* Peter Conti-Brown, *Elective Shareholder Liability*, 64 STAN. L. REV. 409, 409 (2012) (proposing "elective shareholder liability" whereby shareholders would cover the cost of a bank's failure).

261. *See* Saule T. Omarova, *License to Deal: Mandatory Approval of Complex Financial Products*, 90 WASH. U. L. REV. 63, 66 (2012).

262. *See* Robert B. Ahdieh, *From "Federalization" to "Mixed Governance" in Corporate Law: A Defense of Sarbanes-Oxley*, 53 BUFF. L. REV. 721, 755 (2005).

263. *See* Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 607–08 (2003) (describing the late nineteenth century trust movement and the impetus for federal involvement).

264. In 1968, Congress adopted the Williams Act, and the federal government remained a major player in mergers and acquisitions until 1987. *See* Mark J. Roe, *Delaware and Washington as Corporate Lawmakers*, 34 DEL. J. CORP. L. 1, 7 (2009).

265. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 201, 116 Stat. 745, 771–72 (codified at 15 U.S.C. § 78j-1(g) (2012)).

266. *See id.* § 304 (codified at 15 U.S.C. § 7243 (2012)); Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 954, 124 Stat. 1376, 1904 (2010) (codified at 15 U.S.C. § 78j-4 (2012)).

267. *See* Sarbanes-Oxley Act § 619. *See generally* Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Covered Funds, 77 Fed. Reg. 8332 (proposed Feb. 14, 2012) (to be codified at 17 C.F.R. pt. 75) (implementing the so-called "Volcker Rule").

268. *See* Sarbanes-Oxley Act § 301 (codified at 15 U.S.C. § 78j-1(m) (2012)).

majority independent boards of directors and independent committees.[269] Disclosure is believed to least disrupt the balance of power between managers and investors, and the rest of us.[270] Section 972 of the Dodd-Frank Act, for example, authorizes the SEC to require firms to explain why the CEO also serves as chairman of the board.[271] The purpose of disclosure is to inform shareholders and thereby improve their ability to control managers. Generally, disclosure does little to constrain the ability of corporate managers to transfer value from nonshareholders to shareholders.[272]

Similarly, rational investors should favor corporate governance solutions to substantive prohibitions because independent boards and the managers they supervise are expected to maximize shareholder wealth, not social welfare.[273] Independent boards can be coopted for shareholder purposes far more easily than an independent agency implementing new financial legislation.[274]

Where congressional intervention is inevitable, as it was when WorldCom's fraud was exposed nine months after Enron,[275] the ability to convince Congress to choose regulation that preserves investors' and managers' freedom is valuable. At that juncture, investors have a financial interest in promoting corporate governance

269. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act § 952 (codified at 15 U.S.C. § 78j-3 (2012)).

270. *See* Romano, *supra* note 78, at 1527–28 (arguing that corporate governance mandates are "a different and more costly regulatory approach" compared with disclosure).

271. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act § 972 (codified at 15 U.S.C. § 78n-2 (2012)).

272. *See* Rodrigues, *supra* note 235, at 1850. *But see* Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859, 872–74 (2003) (describing how disclosure requirements can sometimes force substantive changes).

273. *See* Brudney, *supra* note 24, at 652; *see also* Robert B. Reich, *Corporate Accountability and Regulatory Reform*, 8 HOFSTRA L. REV. 5, 30–31 (1979) (arguing that corporate governance reform is "justified by virtue of what it accomplishes for the corporation in the long run: Avoiding additional governmental regulation and achieving long-term profitability").

274. Financial institutions have mounted a mighty and expensive lobbying campaign to water down the Volcker Rule. Despite the industry's best efforts, the final rule appears to be more detailed, lengthier, and more stringent than industry expected. *See* Matthew Goldstein & Ben Protess, *Near Vote, Volcker Rule Weathering New Attacks*, N.Y. TIMES, Dec. 9, 2013, at B1.

275. *See* Romano, *supra* note 78, at 1557–58 & n.97 ("Senator Jon Corzine, a member of the Banking Committee, was described as having 'said the [Sarbanes-Oxley Act] would have lost momentum without WorldCom and the other scandals that followed Enron.' " (quoting Spencer S. Hsu & Kathleen Day, *Senate Vote Spotlights Audit Reform and Sarbanes*, WASH. POST, July 15, 2002, at A1)).

mandates over substantive prohibitions because they are better able to contain the cost of implementation and control the outcome.[276] This is so because corporate law and capital markets make it difficult for independent directors to further the public interest over the interests of investors, whose wealth they are expected to maximize. Shareholders elect directors, and only shareholders can sue the board of directors for breaches of fiduciary duties.[277] Nonshareholders such as employees cannot sue the board of directors for breaches of fiduciary duties—only shareholders can.[278] The SEC and federal prosecutors, likewise, have been reluctant to pursue independent directors for monitoring failures.[279]

Moreover, directors are increasingly paid in stock and stock options to "align[] directors' interests with those of stockholders."[280] In 2012, 58% of director compensation was in equity and the rest in cash, usually as retainers.[281] The trend developed in the 1990s[282] and

276. While many corporate law scholars rallied against the independence requirements after the passage of Sarbanes-Oxley, business interests were considerably more troubled by the requirements of CEO and auditor certification. *See* Bainbridge, *supra* note 74, at 1781; Langevoort, *supra* note 243, at 950.

277. *See, e.g.*, DEL. CODE ANN. tit. 8, § 211(b) (2011) ("[A]n annual meeting of stockholders shall be held for the election of directors on a date and at a time designated by or in the manner provided in the bylaws."); § 327 ("In any derivative suit instituted by a stockholder of a corporation, it shall be averred in the complaint that the plaintiff was a stockholder of the corporation at the time of the transaction of which such stockholder complains or that such stockholder's stock thereafter devolved upon such stockholder by operation of law.").

278. *See, e.g.*, Fisch, *supra* note 31, at 653 (explaining that Delaware courts have rejected fiduciary duty claims by non-shareholders). And even shareholder lawsuits for fiduciary duty breaches against independent directors rarely succeed. *See* Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability*, 58 STAN. L. REV. 1055, 1063–64 (2006) (finding that between 1980 and 2005, outside directors contributed out-of-pocket to settlements for fiduciary breaches in only thirteen cases).

279. *See* SEC, REPORT PURSUANT TO SECTION 704 OF THE SARBANES-OXLEY ACT OF 2002, at 2–3 (2003), *available at* http://www.sec.gov/news/studies/sox704report.pdf (showing that the SEC named 705 individuals in enforcement actions for securities fraud it initiated between 1997 and 2002, and none were reported as independent directors). For proposed solutions to this problem, see also Urska Velikonja, *Leverage, Sanctions, and Deterrence of Accounting Fraud*, 44 U.C. DAVIS L. REV. 1281, 1324–26 (2011) (proposing that the SEC could use leverage against independent directors to get access to information about wrongdoing).

280. 2012 SSBI, *supra* note 11, at 36; *see* Charles M. Elson, *Director Compensation and the Management-Captured Board—The History of a Symptom and a Cure*, 50 SMU L. REV. 127, 130–31 (1996) (proposing that companies compensate outside directors primarily in restricted stock to induce them "to think more like shareholders").

281. 2012 SSBI, *supra* note 11, at 36.

282. *See* Gordon, *supra* note 5, at 1487 & n.79 (citing Eliezer M. Fich & Anil Shivdasani, *The Impact of Stock-Option Compensation for Outside Directors on Firm Value*, 78 J. BUS. 2229, 2229 (2005) (observing that the share of Fortune 1000 firms that

has served as a strong signal to directors for what matters: high share prices, not stability, quality products, or long-term growth.[283]

When used as a substitute for government regulation, independent boards lead to "less protection for consumers, suppliers, workers, and the general public."[284] For investors, however, the cost-benefit of independent boards compared with alternatives that they displaced is decidedly positive.

3. Popular Appeal of Independence

Independent boards of directors are the most common policy response to corporate governance crises.[285] Several reasons combine to make independent directors a popular compromise solution for failures of corporate governance: the normative appeal of independence, the vagueness of purpose and flexibility of independence, the ubiquity of independent institutions in institutional design, and the low cost of implementation.

First, independence has become a synonym for something "noble," "expert," "objective," and "fair."[286] Independent directors are believed to "tolerate less fraud and illegality,"[287] and to "promote the firm's compliance with legal norms," despite limited evidence that this is in fact true.[288] The normative appeal of the notion of independence makes it difficult to oppose.[289]

Second, independence is an underspecified concept.[290] It means "different things to different people."[291] In the context of corporate boards, it is defined as a "lack of ties to the corporation"[292] or a lack

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compensated directors with equity increased from approximately 20% to 50% between 1992 and 1997)).

283. *See, e.g.*, Lucian A. Bebchuk, Yaniv Grinstein & Urs Peyer, *Lucky CEOs and Lucky Directors*, 65 J. FIN. 2363, 2363–65 (2010) (showing that certain equity compensation schemes such as opportunistic timing create perverse incentives for directors to accept practices that inflate stock prices).

284. Brudney, *supra* note 24, at 654.

285. *See* Lucian A. Bebchuk & Michael S. Weisbach, *The State of Corporate Governance Research*, 23 REV. FIN. STUD. 939, 943 (2010).

286. *See* Peter Conti-Brown & Ronald J. Gilson, The Limits of Independence in Institutional Design 6 (unpublished manuscript) (on file with the North Carolina Law Review).

287. Langevoort, *supra* note 226, at 1831.

288. Gordon, *supra* note 5, at 1509.

289. *See* Fairfax, *supra* note 58, at 131.

290. *See* Conti-Brown & Gilson, *supra* note 286, at 1.

291. WILLIAM BERNHARD, BANKING ON REFORM: POLITICAL PARTIES AND CENTRAL BANK INDEPENDENCE IN THE INDUSTRIAL DEMOCRACIES 19 (2002) (discussing the popularity and the use of independence in central banking).

292. Rodrigues, *supra* note 23, at 453 & n.20.

of ties to management.[293] Independent directors are conceptualized as individuals without interests who can provide a "fresh, unbiased, expert perspective to the task of corporate management."[294] They are superior to all other dependent groups with clear *interests*: managers, shareholders, employees, public interest groups, and creditors. While special interests are suspect, independent directors are not.

Third, the vagueness of the concept of independence, combined with capacious judicial deference standards and a low risk of liability for independent directors, makes the independent board a very flexible institution. The roles that independent directors play in the corporation's governance have dramatically expanded over the last forty years.[295] Independent directors are a plausible fix for any and all problems, and they can credibly be sold as such. Independent directors are viewed differently by various constituencies: investors view them as advocates for shareholder wealth maximization; employees view them as advocates for institutional stability; financial creditors view them as a voice of reason against excessive risk-taking; environmentalists view them as stewards of our environment; and still other interests view them as representatives of the public interest.[296] Their appointment placates all interested constituencies, from shareholders to populists, and satisfies the demand for regulation.

In addition, independent representatives, in one form or another, are used in a stunning variety of legal institutions including central banks,[297] administrative agencies,[298] federal[299] and state judges,[300] accountants,[301] expert witnesses,[302] banking analysts,[303] journalists,[304]

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293. *See* Elizabeth Cosenza, *The Holy Grail of Corporate Governance Reform: Independence or Democracy?*, 2007 BYU L. REV. 1, 18–19.

294. Rodrigues, *supra* note 10, at 1060.

295. *See* Gordon, *supra* note 5, at 1490–96; Conti-Brown & Gilson, *supra* note 286, at 2.

296. *See* Langevoort, *supra* note 226, at 1820 (discussing the public interest values of independent directors).

297. *See* Conti-Brown & Gilson, *supra* note 286, at 12–13 (discussing the different aspects of central bank independence).

298. *See* Jacob E. Gersen, *Designing agencies*, *in* RESEARCH HANDBOOK ON PUBLIC CHOICE AND PUBLIC LAW 333, 347 (Daniel A. Farber & Anne Joseph O'Connell eds., 2010) (explaining that independence in the context of administrative agencies means that the President cannot remove heads of agencies without cause).

299. *See* U.S. CONST. art. III, § 1 (establishing the independence of the judiciary by providing that federal judges hold their offices "during good Behaviour," and prohibiting pay reductions while in office).

300. States differ in the mechanisms used to insulate their judges from the political process. *See* Daniel Berkowitz & Karen Clay, *The Effect of Judicial Independence on Courts: Evidence from the American States*, 35 J. LEGAL STUD. 399, 402 (2006).

301. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §§ 201–09, 116 Stat. 745, 771–75 (codified as amended in scattered sections of 15 and 18 U.S.C.) (providing for

government employees,[305] redistricting commissions,[306] and trustees in corporate bankruptcies.[307] The ubiquity of independence as well as its relative success make it more likely to be well-received as a matter of institutional design in all contexts[308]—the fourth explanation for the popularity of the independent board.

Finally, independent directors are perceived as inexpensive.[309] They are inexpensive from Congress's point of view because no new appropriations are needed. They are inexpensive from investors' point of view, who benefit from independent directors' willingness to pursue shareholder interests over those of other stakeholders. They are inexpensive from the point of view of managers, who continue to play a part in director selection and who sit on the board with independent directors, shaping their views about the firm and how it should be governed. While independent directors generally constrain

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mechanisms to preserve independence of accountants of public companies under the title "Auditor Independence"); *see also* Don A. Moore et al., *Conflicts of Interest and the Case of Auditor Independence: Moral Seduction and Strategic Issue Cycling*, 31 ACAD. MGMT. REV. 1, 3 (2006) (describing that independent auditors should be unbiased).

302. *See, e.g.*, Steven Lubet, *Expert Witnesses: Ethics and Professionalism*, 12 GEO. J. LEGAL ETHICS 465, 467–68 (1998) (emphasizing the importance of "independence and objectivity" of expert witnesses).

303. *See, e.g.*, Jill E. Fisch, *Does Analyst Independence Sell Investors Short?*, 55 UCLA L. REV. 39, 43 (2007) (giving a broad overview of the effects of analyst independence).

304. *See* SCOTT GANT, WE'RE ALL JOURNALISTS NOW: THE TRANSFORMATION OF THE PRESS AND RESHAPING OF THE LAW IN THE INTERNET AGE 118 (2007) (describing state "shield" laws that allow journalists to refuse to uncover their sources).

305. *See, e.g.*, Dennis F. Thompson, *Paradoxes of Government Ethics*, 52 PUB. ADMIN. REV. 254, 255 (1992) (describing government employees' ethics requirements, designed for "creating and maintaining confidence in government").

306. *See* Scott M. Lesowitz, *Independent Redistricting Commissions*, 43 HARV. J. ON LEGIS. 535, 540–42 (2006) (assessing the pros and cons of independent redistricting commissions).

307. *See* 11 U.S.C. § 101(14)(A), (C) (2012) (defining "disinterested person"); *id.* § 327(a), (c) (providing that persons managing the debtor's affairs in bankruptcy be disinterested and without any material interest adverse to those of the debtor, equity holders, or creditors).

308. For example, in Dodd-Frank alone, the terms independent and independence appear 120 times, in contexts as varied as the independence of credit rating agencies, the independence of members of the Municipal Securities Rulemaking Board, the designation of the Consumer Financial Protection Bureau as an independent agency, the independence of home value appraisals, and the independence of Inspectors General. *See, e.g.*, Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 §§ 939C, 975(b)(1)(B), 1100D(a), 1472, 1505, 124 Stat. 1376, 1888, 1916, 2111, 2187, 2222 (2010) (codified as amended in scattered sections of the U.S. Code).

309. *See* Brudney, *supra* note 24, at 659 (concluding that independent directors are perceived to cost less than regulation but are an inefficient "substitute for regulation in the interest of investors or society").

managers more than insiders, that is a small price to pay to avoid more onerous federal regulation.[310]

These factors combine to make the independent board a viable compromise remedy for problems associated with corporate governance: illegal payments, fraudulent financial statements and complicit audits, excessive corporate risk-taking, and runaway executive compensation. Independent directors have been asked to oversee compliance with legal and regulatory requirements and catch wrongdoing, to evaluate an auditor's conflicts of interest and supervise its work, to set the standards of social responsibility of the company, and monitor performance and compliance with those standards.[311]

But while the cost is low, the benefit of supermajority independent boards is trivial at best. The capacity and willingness of independent boards to prevent management from engaging in inefficient rent-seeking behavior that increases stock prices but reduces welfare (e.g., cartels, bribery and corruption, earnings manipulation, and excessive leverage) is relatively small.[312] Unlike independent agencies that arguably have no master and serve the public interest, corporate boards owe fiduciary duties only to shareholders. When the interests of shareholders diverge from those of the economy as a whole, even the best independent boards will

310. Manager groups have taken an ambivalent position on independent boards. They joined the independence bandwagon after Enron, but opposed SEC's rule requiring mutual funds to maintain 75% independent boards and authorizing proxy access. *See* Gordon, *supra* note 5, at 1539; *see also* Bus. Roundtable v. SEC, 647 F.3d 1144, 1156 (D.C. Cir. 2011) (vacating the rule authorizing proxy access); Chamber of Commerce v. SEC, 412 F.3d 133, 145 (D.C. Cir. 2005) (vacating the rule requiring mutual funds to have a board with no less than 75% of independent directors and an independent chairman). The ambivalence is consistent with the hypothesis that I advance: independence is useful politically, but costly economically (assuming no regulatory threat).

311. *See* Memorandum from Martin Lipton, Steven A. Rosenblum & Karessa L. Cain *The Future of Corporate Governance and the Board of Directors*, Wachtell, Lipton, Rosenblum & Katz (Nov. 17, 2010), *available at* http://www.wlrk.com/webdocs/wlrknew/WLRKMemos/WLRK/WLRK.18080.10.pdf.

312. *See, e.g.*, Sonali Hazarika, Jonathan M. Karpoff & Rajarishi Nahata, *Internal Corporate Governance, CEO Turnover and Earnings Management*, 104 J. FIN. ECON. 44, 44 (2012) (finding that boards are more likely to replace managers who aggressively manipulate earnings before manipulations lead to costly external consequences, but the effect is relatively modest); Minton et al., *supra* note 227, at 6 (finding a negative relationship between director independence and financial expertise and corporate performance during the most recent financial crisis, and concluding that the evidence is consistent with "directors recognizing the residual nature of shareholders' claim on a bank's highly leveraged balance sheet").

usually produce outcomes that are consistent with investors' preferences but reduce welfare.[313]

Increases in board independence, whether voluntary or legally imposed, are a rational and, in fact, highly successful political strategy for investors to avert federal regulation that is more costly for investors but potentially more effective at resolving negative externalities of corporate behavior and misbehavior.[314]

4. Overcoming the Collective Action Problem

The narrative explaining the move towards supermajority independent boards assumes that institutional investors pushing for such boards are willing to incur an immediate cost in exchange for a future regulatory benefit. This presents a collective action problem: good firms—the ones that adopt supermajority independent boards—are generating a positive externality for the bad firms.

The collective action problem is easily overstated. First, the cost of supermajority independent boards to firms appears to be relatively small, while the benefit is not. Second, the collective action problem is largely overcome because of the involvement of SROs and investors' trade organizations in the development of corporate governance best practices. The NYSE, NASDAQ, the Council of Institutional Investors, National Association of Corporate Directors, and even the Business Roundtable have endorsed supermajority independent boards.

B. *Evidence in the Wake of Crisis*

Congress became involved in corporate law after every scandal in recent decades and threatened to change its landscape

313. Investors' appetite for risk is considerably higher than that of the economy. Their downside is limited through diversification and bailouts, and often, they recover their losses relatively quickly after scandal. They reap the benefits during bull times, but do not bear the full cost of bear times. *See, e.g.*, Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247, 252 (2010) (explaining that shareholders' benefit from risk externalities); Rock, *supra* note 234, at 1911 (suggesting that managers nowadays have high-powered incentives to maximize shareholder value, even when it reduces firm value and social welfare); Alla Golub, Joshua Detre & John M. Connor, The Profitability of Price-Fixing: Have Stronger Antitrust Sanctions Deterred? 11 (Apr. 8, 2005), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1188515 (finding the share prices of 87% of the firms in a sample involving indictments between 1981 and 2001 had regained 100% of their pre-indictment levels within one year).

314. *See* Brudney, *supra* note 24, at 652–53 (observing that proponents of independent boards conceded that "the institutional change is urged to avoid political pressure for imposition of substantive regulation" of externalities and public goods).

considerably. At every turn, increasing the independence of the board of directors has worked to deflect other regulation.[315]

1. The "Questionable Payments" Scandal and Internal Accounting Controls

In 1972, a handful of large corporations funded the break-in of the Democratic headquarters.[316] The investigations that followed the Watergate scandal revealed a widespread practice of bribery, corruption, and shady accounting practices.[317] Ultimately, more than fifty firms were indicted or faced an SEC enforcement action, and hundreds voluntarily revealed that they made illegal campaign contributions, paid bribes, and falsified their accounting statements.[318]

During the early days of the scandal, the SEC Chairman suggested that the NYSE "take the lead in this area by appropriately revising its listing policies."[319] As more misbehavior was revealed, the pressure on Congress to intervene increased. Congress considered a variety of regulatory options, including federal incorporation.[320] Recognizing the threat, the American Bar Association and the Business Roundtable, an organization of corporate executives, advocated the use of internal compliance programs and independent

315. *See, e.g.*, Karmel, *supra* note 231, at 546 (illustrating an early example from the mid-1970s, when the business community and corporate lawyers "began considering voluntary measures that might ward off federal legislation," notably federal chartering of corporations). All three statutes considered in this Part included important substantive requirements and prohibitions, in addition to corporate governance mandates. The argument is that independent boards deflected some substantive regulation. Hard evidence is difficult to assemble because of missing data on the various proposals that may have been considered behind closed doors because of the impossibility to observe fluid coalitions in real time, and because the costs and benefits of regulatory alternatives under consideration are essentially unknowable. The evidence offered, however, is consistent with the hypothesis offered in this Article that the rise of independent boards is politically motivated.

316. *See* Joel Seligman, *A Sheep in Wolf's Clothing: The American Law Institute Principles of Corporate Governance Project*, 55 GEO. WASH. L. REV. 325, 333–34 (1987) (exploring the nature of the illegal contributions); Carl Bernstein & Bob Woodward, *FBI Finds Nixon Aides Sabotaged Democrats*, WASH. POST, Oct. 10, 1972, at A1 (reporting that campaign contributions for President Nixon's reelection were used to fund a political spying and sabotage campaign against Democratic presidential contenders).

317. *See* Gordon, *supra* note 5, at 1516.

318. *See id.*; Seligman, *supra* note 316, at 334–36.

319. SEC, SPECIAL SUPPLEMENT NO. 353, REPORT OF THE SECURITIES AND EXCHANGE COMMISSION ON THE QUESTIONABLE AND ILLEGAL CORPORATE PAYMENTS AND PRACTICES 45 (1976).

320. *See* 15 U.S.C. § 78m (2012).

directors' oversight over those programs to "ward off federal legislation."[321]

Congress ultimately adopted the Foreign Corrupt Practices Act in 1977 ("FCPA").[322] The FCPA response was moderate: it required corporations to maintain accurate books and to self-police by implementing a system of internal accounting controls.[323] The NYSE followed in 1978 and required listed companies to maintain a fully independent audit committee to implement and oversee internal control systems.[324] Independent directors were installed as a control mechanism for corporate misbehavior, without evidence that independent directors are, in fact, able to prevent and detect wrongdoing better than alternatives,[325] and without articulating clearly "for whose benefit [internal controls] exist, and to what end."[326]

Using the corporate board of directors to police corruption and bribery is curious because bribe-paying harms a firm's competitors, not investors.[327] The revelation of bribes tends to reduce the stock price of the disclosing firm in the immediate aftermath,[328] but bribe-

321. Karmel, *supra* note 231, at 546 ("In reaction to the SEC's corporate governance hearings [in 1976 following the foreign bribery scandals] and to threats of corporate chartering legislation, the business community and corporate lawyers began considering voluntary measures that might ward off federal legislation."); *see also* ABA Comm. on Corporate Laws, *Corporate Director's Guidebook*, 33 BUS. LAW. 1591, 1605, 1619–25 (1978) (overviewing some ways to provide appropriate director oversight); Statement of the Bus. Roundtable, *The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation*, 33 BUS. LAW. 2083, 2101–02, 2108 (1978) (emphasizing the need for policies and procedures implementing corporate law compliance programs).

322. *See* Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, 91 Stat. 1494 (codified as amended at 15 U.S.C. §§ 78m(b), (d)(1), (g)-(h), 78dd-1 to -3. 78ff (2012)).

323. *See* 15 U.S.C. § 78m(b)(2).

324. *See* Statement of the Bus. Roundtable, *supra* note 321, at 2109–10.

325. *See* William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275, 1337 (2002) (arguing that it is impossible for outside directors to oversee the audit); Brudney, *supra* note 24, at 616.

326. Langevoort, *supra* note 243, at 950.

327. *See* Susan Rose-Ackerman, *The Law and Economics of Bribery and Extortion*, 6 ANN. REV. L. & SOC. SCI. 217, 221 (2010) (explaining that by paying a bribe, the high-cost supplier gets the government contract, rather than its lower-cost competitor); David Barstow & Alejandra Xanic von Bertrab, *The Bribery Aisle: How Wal-Mart Used Payoffs To Get Its Way in Mexico*, N.Y. TIMES, Dec. 18, 2012, at A1 (reporting that wherever Wal-Mart de Mexico moved by bribing government officials, it tended to displace "small neighborhood shops and a traditional public market in the central square").

328. *See* Aaron Smith, *Wal-Mart Shares Drop After Mexico Report*, CNNMONEY (Apr. 23, 2012), http://money.cnn.com/2012/04/23/markets/walmart_stock/index.htm (reporting that Wal-Mart's stock price declined 4.7% after bribery allegations surfaced).

paying is enormously profitable for investors and management.[329] For example, Wal-Mart de Mexico grew at a breakneck pace and built in locations out of reach to other companies because it was willing to grease the wheels of Mexican local governments, and its stock price followed.[330] Wal-Mart's stock price declined immediately after the scandal broke, but it soon rebounded and has remained high since then, despite considerable expense of internal and external investigations.[331]

The FCPA and the federal Organizational Sentencing Guidelines give corporations credit for having a reasonable system of internal controls in place to investigate internally reported wrongdoing, and oversight by the independent board is a key element of the defense.[332] From the investors' point of view, it is efficient for a corporation to comply only cosmetically without stopping too many bribes.[333] The value of an independent board as a bribery-prevention mechanism appears slight, but so is its cost to investors.

2. Accounting Scandals and the Dark Side of Shareholder Value

The decade-long bull period during the 1990s was followed by jarring revelations of accounting scandals at dozens of large U.S. corporations.[334] Executives aggressively managed their financial statements to match investors' expectations of ever-rising stock

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329. *See, e.g.*, Matt Taibbi, *The Scam Wall Street Learned from the Mafia*, ROLLING STONE MAG. (June 21, 2012), http://www.rollingstone.com/politics/news/the-scam-wall-street-learned-from-the-mafia-20120620#ixzz2L4sJ6VsH ("[A] $10,000 bribe to a politician—a couple of Super Bowl tickets and a limo—scored CDR [Financial Products, Inc.] a total of $665,000 of the public's money.").

330. *See* David Barstow, *Vast Mexico Bribery Case Hushed Up by Wal-Mart After Top-Level Struggle*, N.Y. TIMES, Apr. 22, 2012, at A1.

331. *See Historical Price Lookup*, WALMART.COM, http://stock.walmart.com/stock-information/historical-price-lookup/. On April 20, 2012, the day before the New York Times published the report on bribery, Wal-Mart's stock price closed at $62.45. *Id.* By April 25, 2012, the price declined and closed at $57.36. *Id.* By May 18, 2012, the stock was back up to pre-scandal level at $62.43, and it has since continued to increase. *Id.*; *see also* Stephanie Clifford, *The Annual Shareholders' Meeting for Wal-Mart, Like Its Stock, Is Buoyant*, N.Y. TIMES, June 2, 2012, at B3.

332. *See* Langevoort, *supra* note 243, at 951–52.

333. *See* William S. Laufer, *Corporate Liability, Risk Shifting, and the Paradox of Compliance*, 52 VAND. L. REV. 1341, 1407–10 (1999); *see also* Kimberly D. Krawiec, *Cosmetic Compliance and the Failure of Negotiated Governance*, 81 WASH. U. L.Q. 487, 513–14 (2003) (explaining that organizations can even use internal compliance structures to hide management participation in illegal activity).

334. *See* Kathleen F. Brickey, *From Enron to WorldCom and Beyond: Life and Crime After Sarbanes-Oxley*, 81 WASH. U. L.Q. 357, 358 (2003) (noting that federal and state regulators initiated fraud investigations at "dozens of corporations").

prices.[335] Ambiguous accounting obligations and captured auditors, the widespread use of financial derivatives and special purpose entities, and the inherently flawed self-regulatory system of corporate governance made it relatively easy for executives to hide losses and inflate earnings.[336]

Toward the end of the millennium, the number of material accounting restatements increased from 49 per year to 156 in 2000.[337] In the late 1990s, the SEC Chairman Arthur Levitt proposed significant limits on consulting by audit firms to improve auditors' ability to conduct independent audits and increase audit quality.[338] The Big Five accounting firms lobbied aggressively and prevented an outright ban.[339] In 2001, the SEC prohibited only the two most obvious problematic subcategories of nonaudit services: information system design and internal audit services.[340]

The push for reforms increased as the public learned in October 2001 that Enron issued false accounting statements and its auditor shredded relevant documents. Congress considered a complete restructuring of the audit industry, including a total ban on the provision of nonaudit services by the audit firm, a complete separation between audit and consulting, and mandatory rotation of the audit firm, but political gridlock stopped progress.[341]

While it was clear that the audit industry was facing transformative regulation, investor and management groups aggressively lobbied against additional reforms. The American Bar Association recommended increasing director independence.[342] The Business Roundtable emphasized the importance of independent directors and suggested that the board had an important role to play by "[f]ocusing on the integrity and clarity of the corporation's

335. *See* Bratton, *supra* note 325, at 1359–60.

336. *See id.* at 1283; William W. Bratton & Adam J. Levitin, *A Transactional Genealogy of Scandal: From Michael Milken to Enron to Goldman Sachs*, 86 S. CAL. L. REV. 783, 787 (2013).

337. Bratton, *supra* note 325, at 1284–85.

338. *See* Arthur Levitt, Editorial, *Who Audits the Auditors?*, N.Y. TIMES, Jan. 17, 2002, at A29.

339. *See* Bratton, *supra* note 325, at 1351.

340. *See id.* at 1351–52. It is an obvious conflict of interest for the auditor to prepare financial statements and then opine on their consistency with the GAAP.

341. *See id.* at 1355–56; Labaton & Oppel, Jr., *supra* note 228, at A1.

342. *See* ABA TASK FORCE ON CORPORATE RESPONSIBILITY, PRELIMINARY REPORT 13–23 (2002).

financial statements and financial reporting."[343] In 2002, the NYSE set up a corporate governance task force to restore public confidence by showing that private regulation could address governance failures without need for federal legislation.[344] The new listing standards mandated a majority independent board, independent oversight committees, and tightened the definition of independence itself.[345]

By June 2002, six months after Enron filed for bankruptcy, all bills that were introduced in Congress to regulate the audit industry and reduce conflicts of interest in financial intermediaries stalled.[346] On June 25, 2002, however, WorldCom announced a massive accounting restatement and Congressional intervention became certain.[347] Congress considered far-reaching restrictions, and the Sarbanes-Oxley Act that it ultimately passed "could have been much worse [for investors] .... [A]lmost anything would have passed on the floor of the Senate."[348]

The Act restructured the governance of the audit industry and prohibited accounting firms from providing certain nonaudit services to public corporations they audit.[349] It required public firms to have an independent audit committee and banned most loans by corporations to their executives.[350] Notably, the Act did nothing to limit the use of financial derivatives that helped conceal Enron's fraud and led to its ultimate demise, and it did very little to limit the widespread use of special purpose entities.[351]

Many commentators have pointed out that the Act's corporate governance provision would not have prevented the accounting

343. BUS. ROUNDTABLE, PRINCIPLES OF CORPORATE GOVERNANCE 5 (2002), *available at* http://www.ibm.com/ibm/governmentalprograms/pdf/Principles_of_Corp_Gov.pdf.

344. *See* Gordon, *supra* note 5, at 1482. The NYSE spent two years revising the proposed listing standards, and responding to suggestions from issuers, the SEC, and institutional investors, who were very much involved during the process. *See id.*

345. For a contemporaneous discussion of the listing standards see generally Bainbridge, *supra* note 10.

346. *See* Labaton & Oppel, *supra* note 228, at A1.

347. Ten days before the Sarbanes-Oxley Act was enacted, Senator Jon Corzine, a member of the Banking Committee, said the bill's momentum would have been weakened if not for the scandals following Enron like WorldCom. *See* Spencer S. Hsu & Kathleen Day, *Senate Vote Spotlights Audit Reform and Sarbanes*, WASH. POST, July 15, 2002, at A1.

348. 148 CONG. REC. S7354 (daily ed. July 25, 2002) (statement of Sen. Gramm).

349. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 201, 116 Stat. 745, 771 (2002) (codified at 15 U.S.C. § 78j-1(g) (2012)).

350. *See id.* § 301, 116 Stat. at 775–76; *id.* § 402, 116 Stat. at 787.

351. *See id.* § 401, 116 Stat. at 785–86 (requiring disclosure of off-balance-sheet transactions).

scandals that led to their adoption.[352] Critics have argued that these provisions in the Act are flawed.[353] But the provisions make sense when viewed as a substitute for laws avoided, including the regulation of derivatives, which remained under-regulated until the financial crisis exposed their risks.[354]

3. Financial Crisis and Executive Compensation

In 2008 and 2009, financial innovation, excessive leverage, opaque risk-shifting, and outright fraud pushed major banks and financial institutions into insolvency, producing the deepest recession since the Great Depression.[355] Financial derivatives and lopsided compensation in financial institutions—pay packages that reward excessive risk-taking—were identified among the culprits for the recession.[356]

The Dodd-Frank Act of 2010 responded to this crisis by bolstering the independence of compensation committees in all firms, not just financial institutions, authorizing shareholder say-on-pay vote and vote on payments to executives who are asked to leave (i.e., golden parachutes), and requiring exchanges to delist any firm that does not provide for a clawback of excess compensation in the event of an accounting restatement.[357] Institutional investors strongly supported these new corporate governance mandates.[358]

Several economic studies have shown that shareholders want managers of federally insured financial institutions to take on more risk than is socially optimal: shareholders and managers receive the full upside benefit of risky activities, but bear little of the downside cost because of deposit insurance.[359] Legal academics have argued

352. *See* Ahdieh, *supra* note 262, at 725–26.

353. *See id.* at 730.

354. *See* Frank Partnoy, *A Revisionist View of Enron and the Sudden Death of "May,"* 48 VILL. L. REV. 1245, 1249–50 (2003).

355. *See* CAROLYN B. MALONEY, JOINT ECONOMIC COMMITTEE, UNDERSTANDING THE ECONOMY: STATE-BY STATE SNAPSHOTS 4 (2010), http://www.jec.senate.gov/public/index.cfm?a=Files.Serve&File_id=9af838f8-03b7-448f-9265-bd81c14d2729.

356. *See* FIN. CRISIS INQUIRY COMM'N., THE FINANCIAL CRISIS INQUIRY REPORT xix, xxiv (2011), *available at* http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf; Bebchuk & Spamann, *supra* note 313, at 247.

357. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 951, 954, 124 Stat. 1376, 1899–1900, 1904 (2010) (codified at 15 U.S.C. §§ 78n-1, 78j-4 (2012)).

358. *See* Bainbridge, *supra* note 74, at 1815.

359. *See* George A. Akerlof & Paul M. Romer, *Looting: The Economic Underworld of Bankruptcy for Profit*, 24 BROOKINGS PAPERS ON ECON. ACTIVITY, no. 2, 1993, at 2–3; Bebchuk & Spamann, *supra* note 313, at 255–57; Timothy Swanson & Robin Mason, *Long*

that it is absurd to further empower shareholders as the Dodd-Frank Act did. Instead, critics believe it would be more efficient to force managers of financial firms to be more risk averse, while investors prefer them to be less so.[360] Yet the Dodd-Frank Act further empowered investors.

Alternative proposals were considered, and in some cases adopted, by legislators at the time: compensation caps,[361] expanded compensation clawbacks,[362] a ban on proprietary trading,[363] reinstituting the Glass-Steagall separation between investment banking and federally insured retail banking,[364] simplification and standardization of derivatives,[365] and corralling all derivatives in clearinghouses and subjecting them to SEC regulation and oversight.[366] All of these alternatives were potentially more effective

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Tail Risks and Endogenous Liabilities: Regulating Looting, 23 GENEVA PAPER ON RISK & INS. 182, 187 (1998).

360. *See* Bainbridge, *supra* note 74, at 1818–19; Bebchuk & Spamann, *supra* note 313, at 255.

361. *See* Press Release, U.S. Dep't of Treasury, Treasury Announces New Restrictions on Executive Compensation (Feb. 4, 2009), *available at* http://www.treasury.gov/press-center/press-releases/Pages/tg15.aspx (capping compensation of senior executives of banks needing exceptional assistance at $500,000, not including restricted stock).

362. *See* Emergency Economic Stabilization Act of 2008 ("EESA"), Pub. L. No. 110-343, § 111(b)(2)(A), 122 Stat. 3765, 3777 (2008), *amended by* American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, sec. 7001, § 111, 123 Stat. 115, 516–20 (2009) (codified at 12 U.S.C. § 5221 (2012)) (requiring sellers of troubled assets to have "[l]imits on compensation that exclude incentives for senior executive officers of the TARP recipient to take unnecessary and excessive risks that threaten the value of such recipient during the period in which any obligation arising from financial assistance provided under the TARP remains outstanding"); American Recovery and Reinvestment Act of 2009, secs. 7000–02, §§ 111, 109(a), 123 Stat. at 516–21 (amending EESA and limiting incentive payments to the CEO and the twenty next-highest-paid executives of large TARP recipients to one-third of the executive's salary (other than payments required under earlier contracts and restricted stock), prohibiting golden parachutes and defined "luxury" expenditures, and mandating "say on pay" votes).

363. *See* Nick Paraskeva, *U.S. Volcker Rule places major new demands on compliance*, REUTERS (Dec. 17, 2013), http://blogs.reuters.com/financial-regulatory-forum/2013/12/17/u-s-volcker-rule-places-major-new-demands-on-compliance/.

364. On December 16, 2009, Senators John McCain and Maria Cantwell proposed the "Banking Integrity Act of 2009," a bill that never made it past the Committee on Banking, Housing, and Urban Affairs. *See* S. 2886, 111th Cong. (2009), *available at* http://thomas.loc.gov/cgi-bin/bdquery/z?d111:SN02886:@@@D&summ2=m&/.

365. *See Securitization of Assets: Problems and Solutions: Hearing Before the Subcomm. on Sec., Ins. & Inv. of the S. Comm. on Banking, Housing & Urban Affairs*, 111th Cong. 39 (2009) (prepared statement of Patricia A. McCoy, Professor and Director, Insurance Law Center, University of Connecticut School of Law).

366. *See Over-the-Counter Derivatives: Modernizing Oversight to Increase Transparency and Reduce Risks: Hearing Before the Subcomm. on Sec., Ins. & Inv. of the S. Comm. on Banking, Housing & Urban Affairs*, 111th Cong. 6 (2009) (testimony of Mary L. Schapiro, Chairman of the U.S. Securities and Exchange Commission).

at preventing the next financial crisis, but would have been considerably more costly for investors than Dodd-Frank's corporate governance solutions.

Unlike during the Sarbanes-Oxley debates, where institutional investors played a minor supporting role,[367] they aggressively advocated corporate governance solutions during the Dodd-Frank congressional debates.[368] Because the financial crisis was so profound and economically destructive, it is not surprising that the Dodd-Frank Act nonetheless included a plethora of substantive prohibitions, many costly for investors. But the Act could and would have gone a lot farther without institutional investors' lobbying for corporate governance mandates.

C. Summary

The board independence trend has continued unabated. This Part has shown that the trend is at least in part a product of a collective effort by institutional investors and management to deflect federal regulation. Through clever use of political lobbying and advocacy of corporate governance solutions, they have convinced lawmakers and the public that board independence is superior to command-and-control regulation despite the absence of evidence in support.[369]

CONCLUSION

Institutional investors, exchanges, and government regulators have pushed for increased board independence. The push has continued despite inconclusive evidence that independent boards improve corporate performance or reduce corporate malfeasance. This Article suggests that institutional investors value director independence because it displaces more meaningful reform.

Regulatory reform is inevitable after corporate scandals and crises. But, the content of that regulation is not inevitable. Institutional investors and managers have successfully convinced lawmakers to rely on corporate governance reforms in lieu of more

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367. *See* Romano, *supra* note 78, at 1569.

368. *See generally* Bainbridge, *supra* note 74, at 1801 (examining six corporate governance reforms implemented by Dodd-Frank and explaining that their passage was due, in large part, to institutional investor activism).

369. *See* Melvin Aron Eisenberg, *New Modes of Discourse in the Corporate Law Literature*, 52 GEO. WASH. L. REV. 582, 591 (1984) (citation omitted) ("The real hidden agenda of the independent director movement is to stave off more radical change by convincing politicians and the public that independent directors are a reformer's panacea.").

stringent substantive regulation. Reforms involving independent boards have been popular with Congress and regulators because independence has connotations of objectivity, expertise, and fairness, because independence is familiar, and because Congress wants to minimize the cost of regulation and independence is inexpensive.

Independence may be inexpensive, but it is also ineffective. Corporate profit and efficiency are not synonymous. Neither are shareholder wealth and social welfare. Managerial disloyalty to investors is only one type of welfare-reducing agency cost. Since boards put the interests of investors first, the board may not stop misconduct that siphons resources from other groups to investors, from price fixing and bribes to excessive risk-taking and fraud. Future corporate and financial reform should not aim to protect investors from management. Rather, it needs to control externalities that investors themselves impose on others. Board independence mandates should be retired because they are inefficient at best and damaging at worst.