

THE ELUSIVE MONITORING FUNCTION OF INDEPENDENT DIRECTORS⁺

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American corporate law has long relied on independent directors as a panacea to many challenging issues of corporate governance.¹ One of the most important functions of independent board members is monitoring a company's top management to effectively protect shareholder interests.² Generally, boards consist of independent directors as well as insiders, including the CEO who typically serves as the Chairman. Often, there are existing professional or social ties between the management and independent directors.³ But, the extent to which these relationships might impair a director's judgment is difficult to assess.⁴ Therefore, regulatory efforts tend to focus on the number of independent directors and their direct ties to the company.⁵ What is not obvious is whether lack of an explicit tie to management is sufficient for the independent directors to act in the best interest of the shareholders instead of their own best interests.

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1. See Adam C. Pritchard, *Monitoring of Corporate Groups by Independent Directors*, 9 J. KOREAN L. 1, 1-3 (2009) (explaining that greater director independence has been a long-term trend in American corporate law).

2. See Nicole F. Sharpe, *The Cosmetic Independence of Corporate Boards*, 34 SEATTLE U. L. REV. 1435, 1444-45 (2011) (describing that outside directors with no material ties to the corporation can objectively make decisions to maximize shareholder wealth and not be influenced by management).

3. Jill E. Fisch, *Taking Boards Seriously*, 19 CARDOZO L. REV. 265, 270 (1997).

4. *Id.* at 280-81.

5. See Sharpe, *supra* note 2, at 1436 (explaining that there are several regulatory examples, like the Sarbanes-Oxley Act that are aimed to increase director independence).

Testing whether independent directors protect shareholder interests against self-interests of members of top management is a difficult task, in part, because the individual voting records of directors are private. We circumvent this difficulty by focusing on the purchases and sales of stock by all insiders (instead of their votes), including the independent directors, in their own firms and comparing these patterns to each other. We also focus on firms involved in class action lawsuits to refine our tests.

This Article seeks to examine these issues by empirically measuring the effectiveness of independent directors on company boards. Specifically, we test two mutually exclusive hypotheses: (1) independent directors act in favor of shareholders rather than in their self-interest, and (2) independent directors have been co-opted by management. We test these hypotheses by examining the number and profitability of insider trades by top executives and independent directors. We also compare insider trades in firms that have settled class action litigation with insider trades in firms that were not involved in class action litigation.

We analyze trades in firms involved in securities class action lawsuits that have resulted in large settlements because these events represent periods when the conflict of interest between top management and the shareholders is especially acute. In effect, class-action litigation means that top management is alleged to have engaged in fraud to enhance their own narrow self-interest at the expense of their shareholders. That top management has agreed to pay large sums to settle these cases also means it is likely plaintiffs could have won these cases upon trial. Thus, the settlement requirement reduces the likelihood of frivolous cases. Consequently, class periods in settlement cases represent times when shareholders are in special need of protection from decisions of top management. Therefore, it is important to know if independent directors live up to their monitoring responsibility when they matter most.

If independent directors are effective at monitoring other executives, then we would expect they would not be heavy sellers of company stock during the class action period. If, however, independent directors are co-opted by management, we would expect their behaviors, with respect to selling their shares of company stock, to coincide with the behavior of other members of top management. That is, we would expect that they would trade (sell) as heavily as the other insiders during the class action period and make similar abnormal trading profits as other top executives.

As analyzed in Part III, the evidence indicates that independent directors, along with management, trade (or sell) intensely and earn large abnormal profits on material non-public information during the class period, supporting the hypothesis that they have been co-opted by management.

Thus, a corporate governance system that in theory relies on the capability of independent directors to effectively monitor management behavior is seriously flawed in practice. Our evidence indicates that simply requiring a certain number of independent directors has not resulted in an effective system of monitoring, but rather, has created the illusion of it.

To address these issues, this Article is organized as follows. Part I begins with a discussion of the development of the monitoring role of corporate boards and addresses the myriad of contexts in which the law relies on the independence of outside directors to monitor management. Part II then examines empirical studies that have attempted to discern the effectiveness of independent board members in corporate governance. Parts III and IV describe and analyze our empirical study and implications for improving corporate governance. Our recommendations and concluding remarks follow.

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I. THE MONITORING ROLE OF CORPORATE BOARDS

Up until the 1970s, company boards were dominantly comprised of company executives.⁶ Inside directors are uniformly defined as directors who are currently employed by the corporation.⁷ Two events, however, triggered reform and called for the inclusion of independent board members—corporate scandals and academic publications.⁸ With the rise of

6. Brian R. Cheffins, *Delaware and the Transformation of Corporate Governance*, 40 DEL. J. CORP. L. 1, 32 (2015).

7. Lisa M. Fairfax, *The Uneasy Case for the Inside Director*, 96 IOWA L. REV. 127, 133 (2010).

8. Harald Baum, *The Rise of the Independent Director: A Historical and Comparative*

the shareholder primacy model,⁹ academic research examined managerial behavior, ownership structure, and agency costs, with a focus on the costs of dereliction in managerial behavior on shareholder value.¹⁰ As a result, these studies seem to suggest that managers should be monitored to maximize shareholder wealth.¹¹ Insiders have been presumed to be biased and lacking in objectivity with respect to decisions made by other managers and, thus, cannot be trusted.¹² In contrast, at least in theory, independent directors should be capable of impartially assessing the actions and decisions of the company, making them even better suited to monitor the organization than external regulators.¹³ In addition, the introduction of calls for corporations to examine their social responsibilities in the 1970s conceptualized the corporate board as an independent and objective decision-making authority.¹⁴ To protect shareholder value, more independent board members were needed on company boards.¹⁵

The 1978 *Corporate Director's Guidebook* was the first advisory attempt to distinguish between outsiders and insiders on the board.¹⁶ In addition, in 1994 the American Law Institute published its highly influential *Principles of Corporate Governance*, recommending rules for the composition of the boards.¹⁷ The trend for increasing the number of independent members on the board of directors gradually grew in the ensuing

Perspective (Max Planck Inst. for Comparative and Int'l Private Law, Working Paper No. 16/20, 2017), <https://ssrn.com/abstract=2814978> [<https://perma.cc/XMT7-EU84>].

9. Lynn A. Stout, *On the Rise of Shareholder Primacy, Signs of Its Fall, and the Return of Managerialism (in the Closet)*, 36 SEATTLE U.L. REV. 1169, 1177 (2013).

10. See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 306 (1976) (examining such topics as agency, social responsibility, and separation of control and ownership); see also Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 321-23 (1983) (examining separation of risk-bearing and decision-making); see generally, Michael C. Jensen, *The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems*, 48 J. FIN. 831, 839 (1993) (describing the role of the market for corporate control in affecting efficient exit).

11. See, e.g., Jensen & Meckling, *supra* note 10, at 309-10 (noting that most of the literature in this area focuses on how “to provide appropriate incentives for the agent [defined broadly] to make choices which will maximize the principal’s welfare given that uncertainty and imperfect monitoring exist.”).

12. Fairfax, *supra* note 7, at 139.

13. *Id.* at 141.

14. Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1518-19 (2007).

15. *Id.* at 1519.

16. See generally American Bar Association, *Corporate Director's Guidebook*, 33 BUS. L. 1591 (1978) (discussing the roles of inside and outside directors in a corporation).

17. Baum, *supra* note 8, at 14.

decades—the ratio of independent directors on company boards increased “from approximately 20% in the 1950s to approximately 75% by the mid-2000s.”¹⁸ As of 2017, independent members comprised up to 84% of all board members, with the CEO serving as the only insider on the boards of most S&P 500 companies.¹⁹

The primary purpose of having outsiders on company boards is to monitor the CEO and other insiders in the C-suite.²⁰ Shareholders want to minimize executive perquisites to maximize firm value.²¹ The beliefs that outsiders are well-equipped to monitor insiders and that independent supervision is the best way to increase the company’s performance became so strong in past decades that researchers have called for increasing the number of outsiders on the board.²² For example, Lipton and Lorsch recommend at least two-thirds of the membership of the board include independent directors.²³

Massive takeover activities in the 1980s emphasized the importance of independent directors in the context of evaluating the business judgment of the board.²⁴ This trend continued through the 1990s with markets concentrating on executive rights and compensation.²⁵ Corporate financial responsibility scandals in the 2000s, and the collapse of giants such as Enron and WorldCom, stimulated Congress to act against corporate fraud. The Sarbanes-Oxley Act of 2002 (SOX)²⁶ mandates complete audit committee independence.²⁷ In the wake of the 2008 financial crisis, the Dodd-Frank Act²⁸ requires independent compensation committee members.²⁹

In Delaware, the concept of independence is not statutorily defined. Instead, courts have judicially developed the doctrine and emphasized the role of independent directors in addressing many corporate governance

18. See Gordon, *supra* note 14, at 1471.

19. Yaron Nili, *Out of Sight, Out of Mind: The Case for Improving Director Independence Disclosure*, 43 J. CORP. L. 35, 45–46 (2017).

20. Kelli A. Alces, *Beyond the Board of Directors*, 46 WAKE FOREST L. REV. 783, 789 (2011).

21. Renée B. Adams & Daniel Ferreira, *A Theory of Friendly Boards*, 62 J. FIN. 217, 241 (2007).

22. Martin Lipton & Jay W. Lorsch, *A Modest Proposal for Improved Corporate Governance*, 48 BUS. LAW. 59, 67–68 (1992).

23. *Id.*

24. Baum, *supra* note 8, at 14.

25. *Id.* at 15.

26. The Sarbanes-Oxley Act of 2002, 15 U.S.C.A. § 7201 (West 2010).

27. *Id.* § 301.

28. Dodd-Frank Wall Street Reform and Consumer Protection Act, 12 U.S.C.A. § 5301 (West 2010).

29. *Id.* § 952.

challenges. The next section examines these contexts.

A. *Self-Dealing Transactions*

In the self-dealing context, to receive the protection of the business judgment rule (BJR), a director must be, among other qualifications, disinterested and independent.³⁰ The BJR provides a presumption that the director acted in good faith and in the best interest of the corporation.³¹ Where the BJR applies, courts do not second-guess business decisions of directors in the absence of gross negligence, conflict of interest, or intentional misconduct.³² The Delaware Legislature provides further protection for transactions where a director or officer has a conflict of interest in section 144(a)(1) of the Delaware Code.³³ According to this statute, a transaction between a corporation and an interested director or officer is void or voidable, unless the interest is disclosed to the board or a committee of the board, and the transaction is authorized in good faith by a majority of the disinterested directors on the board or the committee.³⁴ Thus, in a conflicted transaction, a director often seeks ratification by majority of independent directors to receive the BJR protection. According to the court in *Cooke v. Oolie*, under section 144(a)(1),³⁵ the BJR applies to the “actions of an interested director, who is not the majority shareholder, if the interested director fully discloses his interest and a majority of the disinterested directors ratify the interested transaction.”³⁶ Thus, ratification by disinterested directors resolves the conflict in the director’s favor.

Judicial deference to ratification by independent directors is explained further in *Cooke*, where the court emphasized, “the disinterested directors’ ratification cleanses the taint of interest because the disinterested directors have no incentive to act disloyally and should only be concerned with advancing the interests of the corporation.”³⁷ The court thus presumes “that the vote of a disinterested director signals that [participation in] the interested transaction furthers the best interests of the corporation despite the interest

30. *Cooke v. Oolie*, No. CIV.A. 11134, 2000 WL 710199, at *11 (Del. Ch. May 24, 2000).

31. *Moran v. Household Int’l, Inc.*, 500 A.2d 1346, 1356 (Del. 1985) (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)).

32. *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985).

33. DEL. CODE ANN. tit. 8, § 144(1)(a) (West 2010).

34. *Id.*

35. *Id.* § 144.

36. *Cooke v. Oolie*, No. CIV. A. 11134, 2000 WL 710199, at *13 (Del. Ch. May 24, 2000).

37. *Id.*

of one or more directors.”³⁸ Moreover, according to *Cooke*, the disinterested directors’ vote in favor of the proposal supported the assertion that the conflicted directors acted in good faith and in the interests of the corporation and its shareholders.³⁹ Thus, if the deal was detrimental to other shareholders, the independent directors would not have voted in favor of it.⁴⁰ Previously, in *Cede & Co. v. Technicolor, Inc.*, the Delaware Supreme Court also held that one director’s interest in a challenged transaction is not sufficient, without more, to deprive a board of the protection of the BJR presumption when the transaction was ratified by independent directors.⁴¹

B. Controlling Shareholder Transactions

Independent board member ratification plays an important role in the context of transactions instituted by controlling shareholders. In *Rosenblatt v. Getty Oil*, the court pointed out that an independent bargaining structure is powerful evidence of the fairness of a merger transaction.⁴² The case-by-case judicial review of this type of transaction focuses on factual evidence of whether the special committee appointed to evaluate the transaction was truly independent, fully informed, and had the freedom to negotiate at arm’s length.⁴³ Under Delaware law, the BJR, as opposed to entire fairness, is the standard of review that governs going-private mergers “between a controlling stockholder and its corporate subsidiary, where the merger is conditioned *ab initio* upon both the approval of an independent, adequately-empowered Special Committee that fulfills its duty of care; and the uncoerced, informed vote of a majority of the minority stockholders.”⁴⁴

Likewise, in *In re John Q. Hammons Hotels Inc. Shareholder Litigation*,⁴⁵ the court also expressly declined to extend the entire fairness review to a case involving an interested cash-out merger and the protection of minority shareholders.⁴⁶ According to the court, the BJR would be the applicable standard of review “if the transaction were (1) recommended by a disinterested and independent special committee, and (2) approved by stockholders in a non-waivable vote of the majority of all the minority

38. *Id.*

39. *Id.*

40. *Id.*

41. 634 A.2d 345, 363–64 (Del. 1993), *modified*, 636 A.2d 956 (Del. 1994).

42. *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 938 (Del. 1985).

43. *Id.* at 938–39.

44. *Kahn v. M & F Worldwide Corp.*, 88 A.3d 635, 644 (Del. 2014).

45. Civil Action No. 758-CC, 2009 WL 3165613, at *1 (Del. Ch. Oct. 2, 2009).

46. *See id.* at *2 (explaining, however, that the procedures used in this case were not sufficient to invoke business judgment review).

stockholders.”⁴⁷ The *M & F Worldwide Corp.* court also listed approval by an independent special committee as one of the prerequisites for applying the BJR to decisions involving controlling shareholder buyouts.⁴⁸

C. *Special Litigation Committees*

The issue of independence of corporate directors has attracted much of the Delaware courts’ attention in the context of special litigation committees (SLCs) appointed to evaluate whether shareholder derivative suits should proceed. The Delaware courts have recognized the effectiveness of derivative suits as an intra-corporate means of policing boards of directors.⁴⁹ Derivative suits involve a claim of wrongdoing with a resultant injury to the corporation, as opposed an injury to the suing shareholder. Thus, the injury is indirect as to the plaintiff, and the compensation for the harm is paid to the company.

To bring a derivative action, among other standing prerequisites, the plaintiff must first demand that the board of directors pursue the cause of action on behalf of the company, unless demand is futile.⁵⁰ To demonstrate the futility of the demand, the court must affirmatively answer the questions of “(1) whether threshold presumptions of director disinterest or independence are rebutted by well-pleaded facts; and, if not, (2) whether the complaint pleads particularized facts sufficient to create a reasonable doubt that the challenged transaction was the product of a valid exercise of business judgment.”⁵¹ When lack of independence is charged, “a plaintiff must show that the Board is either dominated by an officer or director who is the proponent of the challenged transaction or that the Board is so under his influence that its discretion is ‘sterilize[d].’”⁵²

The court affirmatively answered in *Zapata v. Maldando*⁵³ the question of whether the board, after tainted by the self-interest of most of its members,

47. *Id.* at *12.

48. *Kahn v. M & F Worldwide Corp.*, 88 A.3d 635, 644 (Del. 2014).

49. 430 A.2d 779, 784 (Del. 1981).

50. FED. R. CIV. P. 23.1(3). Plaintiff must state with particularity: “(A) any effort by the plaintiff to obtain the desired action from the directors or comparable authority and, if necessary, from the shareholders or members; and (B) the reasons for not obtaining the action or not making the effort.” *Id.*

51. *Levine v. Smith*, 591 A.2d 194, 205 (Del. 1991), overruled on procedural grounds by *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000) (The reasoning behind the pleading rule, as noted in *Levine v. Smith*, is to strike a balance between the right to assert such a claim and the board of directors’ duty to decide whether they should invest the resources of the company to defend against the claim).

52. *Id.*

53. *Zapata*, 430 A.2d at 779 (Del. 1981).

could legally delegate the authority to determine if a derivative suit should proceed to a SLC that consists of two disinterested directors.⁵⁴ The court further pointed out that, “at le[a]st by analogy to our statutory section on interested directors, . . . it seems clear that the Delaware statute is designed to permit disinterested directors to act for the board.”⁵⁵ The SLC, therefore, may move to dismiss derivative litigation that is believed to be detrimental to the corporation, on the corporation’s behalf.⁵⁶

In addition, the SLC in *Zapata* was formed four years after the litigation started and demand had been excused.⁵⁷ In this context, the court noted that “we must be mindful that directors are passing judgment on fellow directors in the same corporation and fellow directors, in this instance, who designated them to serve both as directors and committee members.”⁵⁸ The question, as the court noted, naturally arises, “whether a ‘there but for the grace of God go I’ empathy might not play a role.”⁵⁹ And the further question arises whether inquiry as to independence, good faith and reasonable investigation is sufficient safeguard against abuse, perhaps subconscious abuse.⁶⁰

The *Zapata* court negatively answered the latter question in the context of the case, and thus created a two-step test to be applied in ruling on a motion to dismiss a derivative suit based on the judgment of the SLC. First, a court must look into the independence, as well as the good faith, of the committee, and a court should inquire into the bases that support the committee’s conclusions with the burden of proof on corporation.⁶¹ Second, it is important to balance legitimate claims addressed in a derivative stockholder suit with the corporation’s best interests in pursuing those claims, as judged by an independent investigating committee.⁶² *Zapata* then held the court should determine, in the court’s own business judgment, whether the motion should be granted.⁶³ Thus, the independence of the SLC is a critical factor for determining whether a court will support a motion of the SLC to dismiss a derivative suit.

54. *Id.* at 786.

55. *Id.*

56. *Id.*

57. *Id.*

58. *Id.*

59. *Id.*

60. *Id.*

61. *Id.* at 788.

62. *Id.* at 789.

63. *Id.* at 788-89.

D. The Sarbanes-Oxley Act of 2002

Though the need for independent board members and auditors gained importance after the Enron scandal,⁶⁴ independence was already an important issue in sensitive industries.⁶⁵ An example is the investment company industry.⁶⁶ In 1999, the Securities and Exchange Commission (SEC) imposed an at-least-forty-percent independence requirement on boards of directors of investment companies because boards play a critical role in the operation of funds and protecting the interests of shareholders.⁶⁷ Later, with the rash of financial scandals, independence became even a more important issue.⁶⁸

After the Enron, WorldCom, Global Crossing, and Adelphia scandals, as well as many other company failures at the beginning of 2000s, the SEC and members of the U.S. Congress began to address auditing and corporate governance principles.⁶⁹ The major outcome of this process was SOX, which codified certain standards for corporate executives, boards of directors, and audit committees.⁷⁰ Section 301 of SOX regulates audit committee independence and requires all committee members to be independent directors.⁷¹ Moreover, under SOX, the board of directors may not hire company managers for consulting services.⁷²

64. See *The Lessons from Enron*, ECONOMIST (Feb. 7, 2002), <https://www.economist.com/node/976011/print> [<https://perma.cc/4FL8-TLZJ>] (“Companies need stronger non-executive directors, paid enough to devote proper attention to the job; genuinely independent audit and remuneration committees; more powerful internal auditors; and a separation of the jobs of chairman and chief executive”).

65. Interpretive Matters Concerning Indep. Directors of Inv. Companies, Investment Company Act Release No. IC – 24083, 70 S.E.C. Docket 2017, 1999 WL 820629, at *2 (Oct. 14, 1999).

66. *Id.*

67. *Id.*

68. JOHN C. COFFEE, *GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE* 7-8 (2006) (ebook).

69. ROBERT R. MOELLER, *COSO ENTERPRISE RISK MANAGEMENT: ESTABLISHING EFFECTIVE GOVERNANCE, RISK, AND COMPLIANCE* (2d ed. 2011) (ebook).

70. The Sarbanes-Oxley Act of 2002s, 15 U.S.C. § 7201 (West 2010).

71. *Id.* § 78j-1.

72. MOELLER, *supra* note 69. SOX requires audit committees to be comprised solely of independent board members, stating “[e]ach member of the audit committee of the issuer shall be a member of the board of directors of the issuer, and shall otherwise be independent.” 15 U.S.C. § 78j-1. To be independent, “a member of an audit committee of an issuer may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee—(i) accept any consulting, advisory, or other compensatory fee from the issuer; or (ii) be an affiliated person of the issuer or any subsidiary thereof.” *Id.* § 78j-1(m)(3)(B)(i)-(ii).

Federal securities laws did not directly address issues of corporate governance before SOX was enacted, especially regarding issues of board structure, size, and independence of directors.⁷³ SOX was controversial, in part, because corporate governance had been primarily the province of state law.⁷⁴ Furthermore, courts were reluctant to dictate a board structure.⁷⁵ The importance of independent members' participation, especially in the merger context, began to arise even before the enactment of SOX, however.⁷⁶ Commentators have thus suggested that because there is a well-functioning market for directors, direct regulation, such as SOX, might be unnecessary and counter-productive.⁷⁷

The legislative history of SOX shows that Mr. Oxley, a member of the Committee on Financial Services, had a number of concerns with the bill.⁷⁸ Mr. Oxley's Report from the Committee on Financial Services (the Report) provides a section-by-section analysis of the bill. Section 15 requires the SEC to review governance practices and directs the SEC, among other things, to determine "whether the rules, standards and practices relating to determining whether independent directors are in fact independent are adequate."⁷⁹ According to Mr. Oxley, the bill lacked "provisions to ensure that independent directors are truly independent."⁸⁰ Explaining further, he stated that the bill should have eliminated the practice of compensating

73. See James S. Linck et al., *The Determinants of Board Structure*, 87 J. FIN. ECON. 308, 310 (2008) ("Prior to SOX, the securities laws did not directly address board composition, board size, and director qualifications.").

74. See Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L. J. 1521, 1527 (2005) ("In contrast to provisions in SOX entirely within the bounds of traditional securities regulation, . . . the substantive corporate governance provisions overstep the traditional division between federal and state jurisdiction, although they did not have to do so.").

75. See Roberta S. Karmel, *The Independent Corporate Board: A Means to What End?*, 52 GEO. WASH. L. REV. 534, 548 (1984) ("Board structure, however, is not a matter that has been, or . . . can be dictated by judicial decisions Thus, the board structure sections fall squarely into the grey area . . .").

76. See Jill E. Fisch, *Taking Boards Seriously*, 1205 U. PA. L. REV. 265, 273 (1997) ("This is most apparent in the merger context, in which the courts have required active participation by the board and have held independent directors accountable Particularly when independent directors serve on special committees, courts appear to take for granted active participation extending well beyond the monitoring function.").

77. See, e.g., David Yermack, *Board Members and Company Value*, 20 FIN. MARKETS & PORTFOLIO MGMT. 33, 33 (2006) ("[T]his evidence suggests that a well-functioning market for directors might already exist, making direct regulation unnecessary and possibly counter-productive.").

78. H.R. REP. NO. 107-414, at 44-45 (2002).

79. *Id.*

80. *Id.* at 49.

independent directors as “consultants” while they are members of the board.⁸¹ In addition, the Report notes that the former Chief Accountant of the SEC, Lynn Turner, and others, consider pay to directors as consultants as “back-door compensation that fundamentally undermines their independence.”⁸² Significant consulting compensation may disincentivize an otherwise independent director from challenging the same management that is paying for their consulting services.⁸³ Thus, a provision prohibiting directors from providing consulting services would help ensure that directors act in the best interests of shareholders, devoid of conflicts of interest.⁸⁴ But the amendment, prohibiting independent directors from serving as consultants, did not pass. The vote was twenty yeas and thirty-eight nays.⁸⁵

In addition, Mr. Oxley advocated for shareholder approval of compensation in the form of stock option plans.⁸⁶ But according to SEC Chairman Pitt, stock options fail to align the interests of management with those of shareholder. Pitt proposed specific measures to fix the stock option arrangements⁸⁷ requiring, in addition to shareholder approval, a committee of independent directors to make the decisions granting options to senior management.⁸⁸

Other testimony included that of Mr. Philip Livingston, President and CEO of Financial Executives International, advocating that companies be required to provide a report of key corporate governance practices. Further, he said that the current best practice was to have a governance and nominating committee composed of independent directors.⁸⁹

Jerry J. Jasinowski, President of the National Association of Manufacturers, argued that the audit committee should be composed of members who are well-informed on matters of corporate accounting and finance as well as experienced in management of corporate affairs.⁹⁰ He further contended the audit committee needs to work closely with management and the outside auditors, yet maintain necessary independence

81. *Id.*

82. *Id.* at 50.

83. *Id.*

84. *Id.*

85. *Id.* at 28.

86. *Id.* at 53.

87. *Id.* at 52.

88. *Id.*

89. *Id.* at 371 (statement of Philip Livingston, President & CEO, Financial Executives International).

90. *Id.* at 392 (statement of Jerry J. Jasinowski, President, National Association of Manufacturers).

in order to sufficiently operate in its supervisory review function.⁹¹ He concluded the independence of outside auditors and audit committees must be preserved in “the quest for providing complete and accurate information about the enterprise’s operational and financial status.”⁹²

In his testimony before the Financial Services Committee, Mr. Damon Silvers, Associate General Counsel at the American Federation of Labor and Congress of Industrial Organizations, pointed out corporate governance begins with the board,⁹³ and companies need directors who are both strong and independent.⁹⁴ He explained part of the problem at Enron was Enron “touted directors as independent who really had significant ties to Enron management, ties that Enron did not have to disclose.”⁹⁵ Therefore, boards should disclose all ties between board members, the company, and company management to investors.⁹⁶ Also, in agreement with these sentiments, Mr. Silvers further testified corporate governance is in need of more effective boards and audit committees.⁹⁷ For example, requiring independence of a number of board members and further requiring finance and financial reporting skills on the audit committee should lead to more effective monitoring of management.⁹⁸

Joseph V. Del Raso, a partner at Pepper Hamilton LLP, expressed concern about over-regulating boards of directors. Del Raso’s testimony emphasized the majority of boards take their responsibilities very seriously,⁹⁹ especially in the post-Enron and post-Global Crossing world, and independent directors “have become increasingly aggressive in acting as watchdogs over their respective shareholders interests.”¹⁰⁰ He then concluded any additional regulation may “further dampen the enthusiasm of qualified people to serve as independent directors.”¹⁰¹ Thus, he expressed concern that further initiatives, including personal liability expenses “except in the most egregious cases of willful, wanton misconduct and onerous regulatory sanctions,” are likely to discourage these individuals from serving

91. *Id.*

92. *Id.*

93. *Id.* at 494 (statement of Mr. Damon Silvers, Associate General Counsel, American Federation of Labor & Congress of Industrial Organizations).

94. *Id.*

95. *Id.*

96. *Id.*

97. *Id.* at 495-97.

98. *Id.*

99. *The Corporate and Auditing Accountability, Responsibility, and Transparency Act: Hearing on H.R. 3763 Before the H. Comm. of Fin. Servs.*, 107th Cong. 102 (2002) (statement of Joseph V. Del Raso, Partner, Pepper Hamilton LLP).

100. *Id.*

101. *Id.* at 362.

as independent directors.¹⁰²

E. Stock Exchanges

In 1998, the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) sponsored a Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (the Committee).¹⁰³ The Committee issued a report with ten recommendations to improve the effectiveness of audit committees.¹⁰⁴ The NYSE, NASD, and other exchanges revised their listing standards to comply with these recommendations.¹⁰⁵ In 2002, however, in light of high profile corporate failures, the NYSE and NASD filed further corporate governance reform proposals. In addition, pursuant to SOX, the SEC promulgated Rule 10A-3 under the Exchange Act.¹⁰⁶ This rule requires audit committees of public companies to be independent, together with other substantive rules regulating the operation of the committees.¹⁰⁷ New NYSE and NASD and other exchange listing requirements were formed based on the rule.

After SOX imposed independence requirements on audit committees, the NYSE and NASDAQ put more emphasis on regulation of director independence. New market listing standards required more independence than the Securities Exchange Act of 1934 (the Exchange Act)¹⁰⁸ or SOX. The NYSE mandates the boards of listed companies be comprised of a majority of independent board members¹⁰⁹ and further mandates the audit and compensation committees consist only of independent directors.¹¹⁰ To be independent, the director must not have a material relationship with the

102. *Id.* (“They are keenly aware of the realities of shareholder litigation, the parameters surrounding appropriate indemnities, and the finite limits of directors’ and officers’ liability coverage if the corporate indemnity is insufficient.”).

103. Press Release, U.S. Sec. and Exch. Comm’n, SEC Chairman Arthur Levitt, Concerned that the Quality of Corp. Fin. Reporting Is Eroding, Announces Action Plan to Remedy Problem (Sept. 28, 1998), <https://www.sec.gov/news/press/pressarchive/1998/98-95.txt> [<https://perma.cc/W8ND-2JKB>]; Press Release, U.S. Sec. and Exch. Comm’n, Pitts Seeks Review of Corp. Governance, Conduct Codes (Feb. 13, 2002), <https://www.sec.gov/news/press/2002-23.txt> [<https://perma.cc/NU5Z-2Q8M>].

104. Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness Of Corporate Audit Committees*, 54 BUS. LAW. 1067 (1999).

105. U.S. Sec. and Exch. Comm’n, Audit Comm. Disclosure, Release No. 42266 (Dec. 22, 1999).

106. 17 C.F.R. § 240.10A-3 (West 2018).

107. *Id.*

108. Securities Exchange Act of 1934, 15 U.S.C.A. § 78b (West 2010).

109. NYSE Listed Company Manual § 303A.01 (2009).

110. *Id.*

company directly or as a partner, shareholder, or officer of an organization that has a relationship with the company.¹¹¹ The determination of whether a particular relationship qualifies as “material” is left to the board to decide, leaving a significant gray zone in the definition.¹¹² The determinations are also left uncontested by the stock exchanges and the SEC, leading to the lack of proactive enforcement of their requirements.¹¹³

In addition, the NYSE manual provides a non-exhaustive list of relevant factors for determining independence of members of the compensation committee, evaluating that director’s ability to be independent from management.¹¹⁴ The NASDAQ Listing Manual utilizes a similar framework.¹¹⁵ It follows that, according to SOX and the exchange rules, independence is tied to the outsider status, as someone who lacks certain ties to those in control of the corporation.¹¹⁶

Interestingly, in *M & F Worldwide Corp.*, the Delaware Supreme Court stated that satisfaction of the NYSE standards of independence may serve as an illustrative and informative factor for the Delaware Court, although such satisfaction is not conclusive.¹¹⁷ The *Sandys v. Pincus* court also found that a determination under the NASDAQ rules that a director is independent is relevant under Delaware law.¹¹⁸ Professor Langevoort, however, argues that

111. NYSE Listed Company Manual § 303A.02 (2013).

112. Nili, *supra* note 19, at 40.

113. *Id.*

114. *Id.* These factors include the source of compensation, whether such director is affiliated with the listed company, or its employee (or has been within the last three years,) or an immediate family member is an executive officer of the listed company. In addition, if the director has received, or has an immediate family member who has received, during any twelve-month period within the last three years, more than \$120,000 in direct compensation from the listed company, other than director and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service), then such member is not independent. *Id.* at 51-52, 51 n.91.

115. NASDAQ Listed Company Manual § IM-5605 (2013).

116. See Usha Rodrigues, *The Fetishization of Independence*, 33 J. CORP. L. 447, 450 (2008) (stating that “The hallmark of the independent director, so conceived, is an absence of ties to those in control of the corporation”).

117. *Kahn v. M & F Worldwide Corp.*, 88 A.3d 635, 649 n.26 (Del. 2014). The Court stated that: “[t]he record does not support the Appellants’ contention that that [sic] the Court of Chancery “relied heavily” on New York Stock Exchange (“NYSE”) rules in assessing the independence of the Special Committee, and that the application of such rules “goes against longstanding Delaware precedent.” The Court of Chancery explicitly acknowledged that directors’ compliance with NYSE independence standards “does not mean that they are necessarily independent under [Delaware] law in particular circumstances.” The record reflects that the Court of Chancery discussed NYSE standards on director independence for illustrative purposes.

118. *Sandys v. Pincus*, 152 A.3d 124, 132–33 (Del. 2016). The court reasoned that “[t]he bottom line under the NASDAQ rules is that a director is not independent if she has a

a lack of financial or material connections to management must be supplemented with “a willingness to bring a high degree of rigor and skeptical objectivity to the evaluation of company management and its plans and proposals”¹¹⁹ to be independent.

F. Challenges to the Independence of the Board Committee Members

In determining whether a member of a SLC is independent, the Delaware courts tend to consider whether the alleged conflict of interest would likely impair the impartiality of the member’s decision-making, taking into account the situational context. For example, in *M & F Worldwide Corp.*, the plaintiffs challenged the independence of the members of the SLC selected to evaluate a merger.¹²⁰ Regarding the first committee member challenged, the court concluded that although the member had engaged in business dealings with a conflicted director nine years earlier, this relationship did not undermine his ability to evaluate the merger impartially.¹²¹ Another member of the special committee received \$200,000 in legal fees as the head of a law firm from the defendant company and another company in which the defendant owned a 37.6% stake.¹²² The court held the \$200,000 compensation was not material to the member of the special committee, finding it unlikely “that it would have influenced his decision-making with respect to the M & F proposal.”¹²³ The member was also a law professor at Georgetown. The plaintiff further alleged possible influence from the committee member’s position at Georgetown Law because a conflicted and influential director was on the Georgetown Board

‘relationship which, in the opinion of the Company’s board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director.’ The NASDAQ rules’ focus on whether directors can act independently of the company or its managers has important relevance to whether they are independent for purposes of Delaware law. Our law is based on the sensible intuition that deference ought to be given to the business judgment of directors whose interests are aligned with those of the company’s stockholders. Precisely because of that deference, if our law is to have integrity, Delaware must be cautious about according deference to directors unable to act with objectivity. To consider directors independent on a *Rule 23.1* motion generates understandable skepticism in a high-salience context where that determination can short-circuit a merits determination of a fiduciary duty claim.” *Id.* (footnotes omitted) (quoting NASDAQ Marketplace Rule 5605(a)(2)).

119. Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 798 (2001).

120. *M & F Worldwide Corp.*, 88 A.3d, at 647.

121. *Id.*

122. *Id.*

123. *Id.*

of Visitors.¹²⁴ But because the SLC member was tenured before he met the conflicted director, the court rejected the argument that the Georgetown connection would influence his independent decision-making.

In addition, the SLC member was also invited a few months after approval of the merger to join the board of directors of Revlon, Inc., a company at which one of the defendants served on the board. This fact also did not raise a triable issue, according to the court, because there was no evidence that the committee member expected to be asked to join Revlon's board at the time he served on the SLC.¹²⁵ Lastly, evidence of business relationships with another member of the board and significant stockholder of the defendant company prior to the SLC member joining the board had no bearing because there was no evidence that the committee member "had an ongoing economic relationship [with the board member] . . . that was material to her in any way."¹²⁶

According to the *M & F Worldwide Corp.* court:

[t]o show that a director is not independent, a plaintiff must demonstrate that the director is " beholden " to the controlling party Bare allegations that directors are friendly with, travel in the same social circles as, or have past business relationships with the proponent of a transaction or the person they are investigating are not enough to rebut the presumption of independence.¹²⁷

In addition, a plaintiff who is attempting to demonstrate that a director was not independent must meet a materiality standard—ties must be sufficiently substantial that a member's ability to objectively discharge his or her fiduciary duties would be impaired.¹²⁸ The court also held the presence of some financial ties between the interested party and the director, with nothing more of concern, is not sufficient to disqualify a director.¹²⁹ "The inquiry must be whether, applying a subjective standard, those ties were *material*, in the sense that the alleged ties could have affected the impartiality of the individual director."¹³⁰

Another court, however, found the compensation at issue disqualifying in *In re Emerging Communications, Inc. Shareholders Litigation*.¹³¹ This court questioned the independence of the special committee member because

124. *Id.*

125. *Id.* at 647-48.

126. *Id.*

127. *Id.* at 648-49.

128. *Id.* at 649.

129. *Id.* at 649-50.

130. *Id.*

131. No. Civ.A. 16415, 2004 WL 1305745, at *33 (Del. Ch. May 3, 2004).

of his prior significant consultant fees, received from the defendant company.¹³² In contrast, in *Citron v. Fairchild Camera & Instrument Corp.*, the Delaware Supreme Court held an independent director, who was elected by and represented one of the company's largest shareholders, was nonetheless a disinterested director.¹³³ The shareholder owned approximately 11.5% shares of the company.¹³⁴

The court went further in tightening requirements of the independence of SLC members in *In re Oracle Corp. Derivative Litigation*.¹³⁵ The issue in *Oracle* involved whether to grant the motion to dismiss the derivative suit based on the recommendation of the SLC. The court noted the question of independence "turns on whether a director is, for any substantial reason, incapable of making a decision with only the best interests of the corporation in mind," ultimately focusing on impartiality and objectivity.¹³⁶

The two Oracle SLC members, were professors at Stanford University.¹³⁷ The defendant directors also had significant ties to Stanford. One of the defendants was "another Stanford professor, who had taught one of the SLC members when the SLC member was a Ph.D. candidate and who serve[d] as a senior fellow and a steering committee member alongside that SLC member at the Stanford Institute for Economic Policy Research 'SIEPER'."¹³⁸ Another was a Stanford alumnus who directed major donations to Stanford and "serve[d] as Chair of SIEPR's Advisory Board."¹³⁹ The third defendant was the CEO of Oracle who also directed and contemplated further major donations to Stanford.¹⁴⁰

The court noted that the self-interest of a director may flow from "personal or other relationships," in addition to a financial stake.¹⁴¹ As the

132. *Id.* The court noted that: "[b]efore 1996, the percentage of total fees represented by work [the director] performed for [the defendant] was always greater than fifty percent. From 1987 through 1998, [the defendant company and its affiliates] were the largest single client of [the defendant's] firm. In 1998, [the member] became 'of counsel' at his firm and was put on a retainer arrangement wherein [the defendant's company] paid compensation of \$25,000 per month to [the member], and \$5,000 per month to his firm, to cover [the member's] office rental cost. That amount represented all of [the member's] compensation for 1998."

133. *Citron v. Fairchild Camera & Instrument Corp.*, 569 A.2d 53, 65 (Del. 1989).

134. *Id.* at 56.

135. 824 A.2d 917 (Del. Ch. 2003) *rev'd in part on other grounds*, 817 A.2d 149 (Del. 2002).

136. *Id.* at 920 (quoting *Parfi Holding AB v. Mirror Image Internet, Inc.*, 794 A.2d 1211, 1232 (Del. Ch. 2001)).

137. *Id.*

138. *Id.*

139. *Id.*

140. *Id.* at 920–21.

141. *Id.* at 938–39 (quoting *Orman v. Cullman*, 794 A.2d 5, 24 (Del. Ch. 2002)).

court acknowledged:

It is, I daresay, easier to say no to a friend, relative, colleague, or boss who seeks assent for an act (*e.g.*, a transaction) that has not yet occurred than it would be to cause a corporation to sue that person Denying a fellow director the ability to proceed on a matter important to him may not be easy, but it must, as a general matter, be less difficult than finding that there is reason to believe that the fellow director has committed serious wrongdoing and that a derivative suit should proceed against him.¹⁴²

The court considered the independence of the members of the SLC based on the facts known about them specifically, applying a so-called “subjective ‘actual person’ standard.”¹⁴³ The court then allowed the derivative action to proceed.¹⁴⁴ The connections to Stanford were enough to create concerns regarding the impartiality of the SLC.¹⁴⁵

*In re eBay, Inc. Shareholders Litigation*¹⁴⁶ is another case where plaintiffs successfully challenged the objectivity and impartiality of the independent directors participating on the SLC. The shareholders sued the directors for violation of their fiduciary duty because they usurped the opportunity from eBay of participating in the initial public offerings.¹⁴⁷ eBay had hired Goldman Sachs to underwrite its initial public offering (IPO). eBay’s board of directors consisted of seven members,¹⁴⁸ including three defendant-directors and one former director who had all received IPO allocations from Goldman.¹⁴⁹

The court concluded that directors who received IPO allocations were obviously interested in the transactions.¹⁵⁰ The other four directors of eBay

142. *Id.* at 940.

143. *Id.* at 942.

144. *Id.* at 948.

145. *Id.* at 942. In this inquiry: “a court must often apply to the known facts about a specific director a consideration of how a reasonable person similarly situated to that director would behave, given the limited ability of a judge to look into a particular director’s heart and mind. This is especially so when a special litigation committee chooses, as was the case here, to eschew any live witness testimony, a decision that is, of course, sensible lest special litigation committee termination motions turn into trials nearly as burdensome as the derivative suit the committee seeks to end. But with that sensible choice came an acceptance of the court’s need to infer that the special litigation committee members are persons of typical professional sensibilities.” *Id.* at 940 (quoting *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1167 (Del. 1995)).

146. No. C.A. 19988-NC, 2004 WL 253521, at *1 (Del. Ch. Jan. 23, 2004).

147. *Id.* at *1-2.

148. *Id.*

149. *Id.*

150. *Id.*

did not participate in the “spinning” and served on the SLC formed to determine whether the case against the defendant directors should proceed.¹⁵¹ The plaintiffs alleged that the non-participating directors all had “close business and personal ties with the individual defendants” and could not exercise necessary independent judgment in order to determine whether eBay should bring a breach of fiduciary duty action against the individual defendants.¹⁵²

The court noted that defendant directors (and their affiliates) owned about one-half of eBay’s outstanding common stock, and thus they had the ability to control eBay and to direct business and affairs, including electing directors and approving significant corporate transactions.¹⁵³ The SLC members were awarded stock options with the alleged value potentially running into the millions of dollars.¹⁵⁴ Many of the options awarded to the independent directors had not yet vested at the moment of transaction approval.¹⁵⁵ Thus, the court held that one could not conclude realistically that the SLC members “would be able to objectively and impartially consider a demand to bring litigation against those to whom [they were] beholden for [their] current position and future position on eBay’s board.”¹⁵⁶

Courts have also found that certain business and social relationships adversely affect the impartiality of independent directors. For example, shareholders successfully showed that a board member could not act independently of the company’s chairman where the board member “had a close friendship of over half a century with the interested party [and] the director’s primary employment (and that of his brother) was as an executive of a company over which the interested party had substantial influence.”¹⁵⁷

Deep friendship ties have also been found to impact the determination of independence. In *Sandys v. Pincus*, a director and her husband co-owned a private airplane along with the board chairman, who was also the controlling stockholder and interested in the transaction at issue.¹⁵⁸ According to the court, it created reasonable doubt about the director’s independence because “plane ownership was not common and involved partnership in [an] expensive personal asset that required close cooperation in use, which was suggestive of detailed planning indicative of continuing,

151. *Id.* at *2.

152. *Id.*

153. *Id.* at *3.

154. *Id.*

155. *Id.*

156. *Id.*

157. *Del. Cty. Emps.’ Ret. Fund v. Sanchez*, 124 A.3d 1017, 1019 (Del. 2015).

158. *Sandys v. Pincus*, 152 A.3d 124, 128-30 (Del. 2016).

close personal friendship.”¹⁵⁹

II. EFFECTS OF INDEPENDENCE ON CORPORATE GOVERNANCE - EMPIRICAL STUDIES

Scholars have been attempting to empirically discern the effect of independent boards on corporate governance issues. This Part provides a summary of some key findings within corporate governance literature.

A. *Board Composition and Firm Performance*

Empirical evidence on the relation between independent directors and firm performance is mixed. There is a significant body of literature finding a positive relation between shareholder wealth or firm performance and boards with outside independent directors.¹⁶⁰ Two studies focused solely on tender offers.¹⁶¹ These studies found a positive relation between independent

159. *Id.* at 124.

160. See Michael H. Schellenger et al., *Board of Director Composition, Shareholder Wealth, and Dividend Policy*, 15 J. MGMT. 457, 465 (1989) (finding “a direct relationship between outside directors’ representation on the board and corporate financial performance”); see also Scott W. Barnhart et al., *Firm Performance and Board Composition: Some New Evidence*, 15 MANAGERIAL & DECISION ECON. 329, 338 (1994) (concluding that their study potentially indicates a relationship between firm performance and board composition); Sanjai Bhagat & Brian Bolton, *Corporate Governance and Firm Performance*, 14 J. CORP. FIN. 257, 271-272 (2008) (stating that “if the purpose of board independence is to discipline management of poorly performing firms, then board independence has merit” but cautions against relying on independence to improve performance); Audra L. Boone et al., *The Determinants of Corporate Board Size and Composition: An Empirical Analysis*, 85 J. FIN. ECON. 66, 90-91 (2007) (finding a positive relationship between board independence and constraints on managerial influence); John W. Byrd & Kent A. Hickman, *Do Outside Directors Monitor Managers?*, 32 J. FIN. ECON. 195, 220 (1992) (finding evidence that shareholders benefit when managers and independent directors hold a fraction of the bidding firm’s common stock); James F. Cotter et al., *Do Independent Directors Enhance Target Shareholder Wealth During Tender Offers?*, 43 J. FIN. ECON. 195, 216 (1997) (concluding that independent directors, among other things, enhance shareholder wealth); Anzhela Knyazeva et al., *The Supply of Corporate Directors and Board Independence*, 26 REV. FIN. STUD. 1561, 1597 (2013) (“[W]e find that board independence has significant positive effects on firm value”); Rick Molz, *Managerial Domination of Boards of Directors and Financial Performance*, 16 J. BUS. RES. 235, 246 (1988) (noting that their study weakens arguments that a manager-dominated board increases a firm’s financial performance); Stuart Rosenstein & Jeffrey G. Wyatt, *Outside Directors, Board Independence, and Shareholder Wealth*, 26 J. FIN. ECON. 175, 190 (1990) (providing evidence that independent directors may increase the value of firms).

161. Byrd & Hickman, *supra* note 160; Cotter et al., *supra* note 160.

members and returns to shareholders during tender offers.¹⁶² On the other hand, other scholars could not find any relationship between number of independent members on company boards and performance.¹⁶³ Benjamin E. Hermalin and Michael S. Weisbach, for example, claim that even if their results are due to a measurement error, the relationship between these two variables, if any, is weak at best.¹⁶⁴ Additionally, Nikos Vafeas, could not find a relationship between board composition and earnings-return relation.¹⁶⁵

Some studies find that director independence is conditionally effective. One study found that if the cost of acquiring information is low, the addition of independent directors enhances financial performance.¹⁶⁶ Yet, a high cost of information acquisition causes independent directors to worsen financial performance. The same relationships were suggested to exist between earnings management and board independence.¹⁶⁷ Monitoring quality was also found to improve if a majority of independent directors serve on multiple monitoring committees in a company.¹⁶⁸ In addition, firms with independent directors who serve on multiple monitoring committees were found to exhibit more sensitivity to CEO compensation, CEO turnover, and earnings management.¹⁶⁹

Audra L. Boone and colleagues find a positive relation between the firms' board independence and the firms' growth and diversification, while at the same time, a negative relation between board independence and CEO

162. *Id.*

163. Benjamin E. Hermalin & Michael S. Weisbach, *The Effects of Board Composition and Direct Incentives on Firm Performance*, 20 *FIN. MGMT.* 101, 111 (1991); see also Stephen P. Ferris & Xuemin (Sterling) Yan, *Do Independent Directors and Chairmen Matter? The Role of Boards of Directors in Mutual Fund Governance*, 13 *J. CORP. FIN.* 392, 417 (2007) (finding board independence as rather insignificant in its effects on the quality of governance); Richard H. Fosberg, *Outside Directors and Managerial Monitoring*, 20 *AKRON BUS. & ECON. REV.* 24, 32 (1989) (finding essentially no relationship between managerial performance and the number of outsiders on the board).

164. Hermalin & Weisbach, *supra* note 163, at 111.

165. Nikos Vafeas, *Board Structure and the Informativeness of Earnings*, 19 *J. ACCT. & PUB. POL'Y* 139, 157-58 (2000).

166. Ran Duchin et al., *When are Outside Directors Effective?*, 96 *J. FIN. ECON.* 195, 212-13 (2010).

167. See Xia Chen et al., *Does Increased Board Independence Reduce Earnings Management? Evidence from Recent Regulatory Reforms*, 20 *REV. ACCT. STUD.* 899, 926 (2015) (finding that "the reduction in [discretionary accruals], as explained by the change in board independence and information acquisition cost, is associated with better firm performance").

168. Olubunmi Faleye et al., *The Costs of Intense Board Monitoring*, 101 *J. FIN. ECON.* 160, 169-70 (2011).

169. *Id.* at 170.

influence on board decisions.¹⁷⁰ Eliezer M. Fich and Anil Shivdasani find that the busyness of independent directors is associated with weak governance.¹⁷¹ Busy independent directors are also likely to quit boards after poor performance.¹⁷² Weisbach finds that independent directors are positively associated with resignations of CEOs after bad performance.¹⁷³

B. Board Composition and Monitoring

Some authors suggest that there are significant trade-offs between board composition and monitoring. Independent directors provide advice and counsel to executives, while at the same time they monitor them.¹⁷⁴ As independent directors monitor more, executives tend to reveal less information to them.¹⁷⁵ These studies thus suggest that management-friendly boards can be optimal depending on various conditions.¹⁷⁶ Another study attempted to address optimal board size and board composition and found that these depend on the characteristics of the firm and the particular directors.¹⁷⁷ Furthermore, transparency is another important issue in corporate governance. Research shows that transparency has a positive relation with the percentage of independent directors.¹⁷⁸

C. Board Composition and CEO Role

A positive relationship has also been found between separation of the CEO position from that of the chair of board and subsequent operating performance.¹⁷⁹ The drafters of the *Commonsense Corporate Governance Principles* (the *Principles*) argue that a board's independent directors should analyze and decide whether the roles of chairman and CEO should be

170. Boone et al., *supra* note 160, at 69, 87.

171. Eliezer M. Fich & Anil Shivdasani, *Are Busy Boards Effective Monitors?*, 61 J. FIN. 689, 691 (2006).

172. *Id.* at 711-12.

173. Michael S. Weisbach, *Outside Directors and CEO Turnover*, 20 J. FIN. ECON. 431, 457-59 (1988).

174. Adams & Ferreira, *supra* note 21, at 218.

175. *Id.*

176. *Id.* at 219.

177. Charu G. Raheja, *Determinants of Board Size and Composition: A Theory of Corporate Boards*, 40 J. FIN. & QUANTITATIVE ANALYSIS 283, 283-85 (2005).

178. See Christopher S. Armstrong et al., *Do Independent Directors Cause Improvements in Firm Transparency?*, 113 J. FIN. ECON. 383, 402 (2014) (“We present results that are generally consistent with the interpretation that an exogenous (required) increase in the proportion of independent directors results in an increase in corporate transparency.”).

179. Bhagat & Bolton, *supra* note 160, at 257.

separate or combined.¹⁸⁰ If the board chooses a combined role, the *Principles* point out that a strong lead independent director with clearly defined authorities and responsibilities is vital for the board.¹⁸¹ In addition, the *Principles* encourage boards to explain the choice to shareholders.¹⁸²

Studies have also found a negative relation between CEO compensation and the level of control from board of directors.¹⁸³ Similarly, equity ownership of board members has a negative relationship with CEO compensation.¹⁸⁴ Equity ownership of board members was found to be even more important than percentage of independent directors on the board in affecting CEO pay.¹⁸⁵ Steven Kaplan found that CEOs are indeed monitored by boards: CEO pay levels were not significantly higher than other top-income groups in 2012 compared to the levels in the early 1990s, and CEOs were rewarded for high performance and penalized for low performance.¹⁸⁶ Anil Shivdesani and David Yermack studied the CEO's role in selecting directors.¹⁸⁷ They found that a CEO on the nominating committee results in fewer independent outside directors, and more gray outsiders (those who have conflict of interests) on company boards.¹⁸⁸ They claim that CEOs reduce the pressure of active monitoring by using this mechanism.¹⁸⁹ Responding to similar criticism, the NYSE manual mandates complete independence of members of the nominating/governance committee of listed companies.¹⁹⁰ Nonetheless, CEOs are still heavily involved in appointments of new directors.¹⁹¹

180. *Common Sense Principles of Corporate Governance*, GOVERNANCEPRINCIPLES.ORG, http://www.governanceprinciples.org/wp-content/uploads/2016/07/GovernancePrinciples_Principles.pdf [<https://perma.cc/VD64-5JGU>] (last visited June 19, 2018).

181. *Id.*

182. *Id.*

183. Brian K. Boyd, *Board Control and CEO Compensation*, 15 STRATEGIC MGMT. J. 335, 340-41 (1994).

184. *Id.* at 340.

185. Richard M. Cyert et al., *Corporate Governance, Takeovers, and Top-Management Compensation: Theory and Evidence*, 48 MGMT. SCI. 453, 453 (2002).

186. Steven N. Kaplan, *Executive Compensation and Corporate Governance in the US: Perceptions, Facts, and Challenges*, NBER REP., no. 3, 2012, at 1, 3.

187. Anil Shivdasani & David Yermack, *CEO Involvement in the Selection of New Board Members: An Empirical Analysis*, 54 J. FIN. 1829, 1830 (1999).

188. *Id.*

189. *Id.* at 1852.

190. NYSE, LISTED COMPANY MANUAL § 303A.04(a) (2013) "Listed companies must have a nominating/corporate governance committee composed entirely of independent directors."

191. See, e.g., George W. Dent, Jr., *Independence of Directors in Delaware Corporate Law*, 54 U. LOUISVILLE L. REV. 73, 92-95 (2016) (discussing the relationship dynamics

D. Connections between the CEO and Board Members

Academics are generally in agreement about the relationship between connectedness of CEO with directors as well as other top executives and corporate fraud.¹⁹² Vikramaditya Khanna finds that connectedness through past employment, education, and social organizations significantly affects the incidence of corporate fraud.¹⁹³ N. K. Chidambaran and colleagues argue that nonprofessional connections, such as alma mater, increase the likelihood of fraud while professional connections from employment overlaps lower the probability of fraud.¹⁹⁴ In addition, these authors argue that independence is only a necessary, but not a sufficient element to stop corporate crime.¹⁹⁵ Randall Morck introduced social psychology theories to the analysis and claims that related literature indeed lacks evidence of the relationship between board independence and corporate performance, potentially due to hidden deep personal ties between independent directors and CEOs.¹⁹⁶

Jeffrey Coles and colleagues introduce the term “co-option” to redefine independence of boards.¹⁹⁷ Co-option is the fraction of the board comprised of directors appointed after the CEO assumed office, making them likelier to side with the CEO.¹⁹⁸ The authors argue that co-option reduces the board’s monitoring, negatively impacts the connection between CEO turnover and firm performance, but increases CEO pay and investments.¹⁹⁹ Based on the data, they conclude that co-opted independent directors are not associated with the effective monitoring.²⁰⁰

between directors and CEOs who appoint them as directors).

192. See Vikramaditya Khanna et al., *CEO Connectedness and Corporate Fraud*, 70 J. FIN. 1203, 1204-05 (2015) (finding that allowing CEOs to appoint many other executives reduces checks and balances on the executive suite); see also Cesare Fracassi & Geoffrey Tate, *External Networking and Internal Firm Governance*, 67 J. FIN. 153, 187-88 (2012) (stating that appointing directors with external ties to the CEO may undermine governance effectiveness); N. K. Chidambaran et al., *CEO-Director Connections and Corporate Fraud Not Just Whether You Are Connected But How* 31 (Fordham Univ. Sch. of Bus. Research, Working Paper No. 2010-009), <https://ssrn.com/abstract=1681472> [<https://perma.cc/3RJE-HR9P>] (finding a reduction in fraud where past professional relationships exist between the CEO and board members).

193. Khanna, *supra* note 192, at 1242.

194. Chidambaran, *supra* note 192 at 1.

195. *Id.*

196. Randall Morck, *Behavioral Finance in Corporate Governance-Independent Directors and Non-Executive Chairs* 27 (Nat’l Bureau of Econ. Research, Working Paper No. 10644, 2007).

197. Jeffrey L. Coles, et al., *Co-Opted Boards*, 27 REV. FIN. STUD. 1751, 1752 (2014).

198. *Id.*

199. *Id.* at 1753.

200. *Id.* at 1754.

A positive relationship has been also found between stock ownership of independent board members and the probability of disciplinary actions toward management in the case of poor performance.²⁰¹ These findings suggest that stock ownership provides additional incentives for the board members to monitor management actions.

E. Insider Trading

Enrichetta Ravina and Paola Sapienza analyze insider trading of independent directors and other executives.²⁰² Their results show that there is very little difference between the insider trading profits of independent directors and executives; the profits for both groups are also higher in companies with weaker corporate governance.²⁰³ Another study analyzes insider trading of independent directors who serve on multiple boards.²⁰⁴ Douglas C. Cook and Haubing Wang find that audit and compensation committee memberships increase trading performance.²⁰⁵ Moreover, multi-firm directors outperform single-firm directors in their insider trading profitability.²⁰⁶

F. Earnings Fraud

A number of studies have found that firms are less likely to commit earnings management tactics or financial statement fraud if they have boards or audit committees with independent directors.²⁰⁷ On the other hand, Stephen P. Ferris' and Xuemin Yan's study leads to the opposite conclusion,

201. Bhagat & Bolton, *supra* note 160 at 257.

202. Enrichetta Ravina & Paola Sapienza, *What do Independent Directors Know? Evidence from Their Trading*, 23 REV. FIN. STUD. 962, 963-64 (2010).

203. *Id.*

204. Douglas C. Cook & Huabing Wang, *The Informativeness and Ability of Independent Multi-Firm Directors*, 17 J. CORP. FIN. 108, 108-09 (2011).

205. *Id.* at 120-21.

206. *Id.*

207. See Patricia M. Dechow et al., *Causes and Consequences of Earnings Manipulation: An Analysis of Firms Subject to Enforcement Actions by the SEC*, 13 CONTEM. ACC. RES. 1, 3 (1996) (finding that firms without an audit committee or with board members closely connected to management are more likely to commit fraud); see also Anup Agrawal & Sahiba Chadha, *Corporate Governance and Accounting Scandals*, 48 J. LAW & ECON. 371, 374 (2005) (stating that companies with boards or audit committees that have an independent director who is a financial expert are less likely to restate earnings); Mark S. Beasley, *An Empirical Analysis of the Relation Between the Board of Director Composition and Financial Statement Fraud*, 71 ACC. REV. 443, 463 (1996) (showing that boards with a higher percentage of independent directors are less likely to commit financial fraud).

claiming no significant relationship between board independence and financial statement fraud.²⁰⁸ Another study found that family affiliations may also play a role in the likelihood of financial fraud—firms with CEOs from the founding family are more likely to restate financial statements.²⁰⁹

III. OUR EMPIRICAL STUDY

As described above, independent directors have been relied upon to monitor management and to thus maximize shareholder wealth.²¹⁰ Where there is a conflict of interest between managers and shareholders, independent directors are thought to be able to prohibit managers from acting in their self-interest.²¹¹

Some studies find a positive relationship between directors' compensation and directors' monitoring of the executives.²¹² Yet other studies reveal that independent directors are not as efficient as in protecting shareholder wealth as projected.²¹³

We test two mutually exclusive hypotheses to measure the effectiveness of independent directors on company boards. The first hypothesis is that independent directors act in favor of shareholders. That is, they act in the corporate interest and do not seek to personally profit when doing so. The second hypothesis is that directors, when presented with certain circumstances and have the same opportunities as executives to act in their self-interest, behave the same as the executives.

If the first hypothesis is true, then independent directors act good faith, and including them on corporate boards creates value for shareholders. However, if instead the second hypothesis is true, then reliance of independent directors as effective corporate monitors should be questioned.

We test these hypotheses by examining the insider trading by top executives, independent directors and all officers excluding outsiders in the presence of a class-action lawsuit that resulted in a settlement. We also compare securities class actions (SCAs) of firms that settled class action claims with the firms that were not involved in SCAs. If independent

208. Ferris & Yan, *supra* note 163, at 393.

209. Agrawal & Chadha, *supra* note 207, at 371.

210. Alces, *supra* note 20, at 789.

211. *Id.*

212. Shin Rong Shiah Hou & Chin Wei Cheng, *Outside Director Experience, Compensation, and Performance*, 38 *MANAGERIAL FIN.* 914, 932 (2012).

213. See Hermalin & Weisbach, *supra* note 163, at 111 (discovering no apparent connection between firm performance and board composition); see also Ferris & Yan, *supra* note 163, at 393 (finding no connection between director independence and reduction in fraud).

directors are good monitors of executive behavior, we would expect independent directors to refrain from trading company stock during the class action period. If the second hypothesis is correct, we would expect independent directors to behave similarly to insiders and sell company stock during the class action period.

A. Data

This study analyzes the insider trading activities of top executives, officers, dependent directors, and independent directors of the companies listed in the Stanford Law School Securities Class Action Clearinghouse (SCAC).²¹⁴ SCAC keeps track of more than 4000 class action lawsuits filed in Federal Court since the enactment of the Private Securities Litigation Reform Act of 1995.²¹⁵

An SCA is a claim filed on behalf of a group of shareholders. The complaint contains allegations that the company or its managers violated at least one federal or state securities law, but most are brought under federal law.²¹⁶ Commonality of interest is required to certify a class and plaintiffs must demonstrate that the claims of the representatives of the class are typical of every class member.²¹⁷

The analysis period of the study is 1996–2016, our data set contains 4041 filed cases. Law firms often file a class action lawsuit if any large

214. Stanford Law School, *About Us*, SEC. CLASS ACTION CLEARINGHOUSE, <http://securities.stanford.edu/about-the-scac.html#about> [<https://perma.cc/W53M-7UCC>] (last visited Feb. 25, 2017).

215. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.).

216. Vanessa Wong, *Halliburton v. Erica John P. Fund, Inc., Fraud-on-the-Market Presumption of Reliance Established; What Now?*, 43 RUTGERS. L. REC. 148, 154 n.45, 155 (2016) (noting that federal law preempts “most state-filed class actions involving nationally traded securities”); *Fast Answers: Class Actions*, U.S. SEC. EXCHANGE COMM’N, <https://www.sec.gov/fast-answers/answersclasshtm.html> [<https://perma.cc/S7PN-UU5Q>] (last visited June 27, 2018).

217. Rules 23(a) and (b) of the Federal Rules of Civil Procedure govern the requirements for class certification. There are four threshold requirements for class certification, each of which must be met: (1) the class is so numerous that joinder of class members is impracticable (numerosity); (2) there are questions of law or fact common to the class (commonality); (3) the claims or defenses of the class representatives are typical of those of the class (typicality); and (4) the class representatives will fairly and adequately protect the interests of the class (adequacy). FED. R. CIV. P. 23(a). Courts have added additional requirements: (1) that a definable class exists, (2) the named representatives are members of that class, and (3) the claim of the class is live, rather than moot. Shriver Center, *7.2 Rule 23 Class Certification Requirements*, FED. PRAC. MANUAL FOR LEGAL AID ATTY’S, <http://www.federalpracticemanual.org/node/42> [<https://perma.cc/8JQ3-DCKY>] (last updated 2017).

negative shock occurs in share prices, thus it is not likely that any large class-action lawsuit would be excluded from this data set.²¹⁸ After obtaining data from the SCAC, we applied filters to account for frivolous cases. We eliminated dismissed and ongoing cases, private company cases, and cases with settlement amounts lower than \$25 million. We set a minimum settlement amount to ensure that damages are sufficiently large, enabling insiders to predict a drop in share prices. We are left with 131 companies after the filters.

We collected insider trading data from Thomson Reuters (TFN) from 1996 to 2017.²¹⁹ Between 1975 and 1995, we have obtained insider trading data from the National Archives. We combine these two datasets to create a continuous record of insider trading covering the period from 1975 to 2017. Our database consists of legally-mandated reporting of the universe of all insider transactions; it contains the date, the volume and amount of purchases and sales of insider trades, names and titles of insiders, the name and CUSIP number of the firm, and other information.²²⁰ We use the information on insider trading of top executives, independent directors, dependent directors, and other officers as follows. Top executives, dependent directors, other officers, and independent directors are classified using role codes in the TFN database. Top executives are limited to officer and director (OD), officer, director, and beneficial owner (H), chairman of the board (CB), CEO (CEO), CFO (CFO), controlling person (CP), general partner (GP), and president (P). Independent directors are coded with (D). Inside directors and other officers are defined as all other officers. We include any large shareholder with any officer title. We exclude outside large shareholders (SH) and outside beneficial owners of more than 10% of a class security (B). These outside groups are typically harmed by corporate fraud and thus they are not likely to be aware of any ongoing corporate fraud.

Next, we combine the SCAC and insider trading information and we are left with the trading activities of insiders from companies that were involved in fraud settlements after enactment of the Private Securities Litigation Reform Act of 1995.²²¹ We construct pre-class and post-class

218. Stephen J. Choi et al., *The Screening Effect of the Securities Litigation Reform Act*, 6 J. EMPIRICAL LEGAL STUD., 46 (2009); Paul A. Griffin et al., *Stock Price Response to News of Securities Fraud Litigation: Market Efficiency and the Slow Diffusion of Costly Information*, 2 (Stanford Law & Econ. Olin Working Paper No 208, 2000), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=251766 [<https://perma.cc/JN55-L6Y3>].

219. THOMSON REUTERS, WHARTON RESEARCH DATA SERVICES, <http://www.whartonwrd.com/datasets/thomson-reuters-2/> [<https://perma.cc/CH7Q-9ZSD>] (last visited June 27, 2018).

220. Securities and Exchange Act of 1934, 15 U.S.C.A § 78p (West 2010).

221. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737

periods as control periods. The pre-class, class, and post-class periods have the same number of days. For example, if class period is 100 days, so are the pre-class and post-class periods. The pre-class period starts from 100 days before the class period begins and ends the day before the class action starts. Similarly, the post-class period starts the day after the class period ends and lasts 100 days. We test the timing of insider trading activities for the pre-class period before the class action starts, during the class action period, and for the post-class period.

B. Methodology: Measuring Insiders' Abnormal Stock Profits

We use a standard event study model to measure abnormal returns of insiders around trade dates.²²² The event date, day 0, is the insider trade day for each transaction. We measure cumulative abnormal returns around event days by using market-adjusted daily returns as follows:

$$CAR_{i,T} = \sum H_{i,t} (r_{i,t} - r_{m,t})$$

where $H_{i,t}$ takes value 1 for insider purchases and -1 for insider sales. The variable $r_{i,t}$ is the return to stock i on day t . $r_{m,t}$ is the market return, which is with-dividend return to the CRSP equally-weighted portfolio of the NYSE, American Stock Exchange, and NASDAQ stocks for day t . An insider purchase is profitable if the stock return outperforms market return, and an insider sale is profitable if stock return is less than market return for day t .

(codified as amended in scattered sections of 15 U.S.C.).

222. There are many studies examining the profitability of insider trading. See, e.g., H. Nejat Seyhun, *Insiders' Profits, Costs of Trading, and Market Efficiency*, 16 J. FIN. ECON. 189, 210 (1986) (finding that insiders can predict abnormal rise in stock prices); Arturo Bris, *Do Insider Trading Laws Work?* 23 (Yale ICF Working Paper No. 00-19, 2010) (demonstrating that regulators make insider-trading more profitable by prohibiting it); H. Nejat Seyhun, *The Information Content of Aggregate Insider Trading*, 61 J. BUS. 1, 22 (1988) (investigating the information content of aggregate insider trading); H. Nejat Seyhun, *Why Does Aggregate Insider Trading Predict Future Stock Returns?*, 107 J. ECON. 1302, 1329 (1992) (demonstrating a strong relation between past aggregate insider trading and future excess stock returns); Bin Ke et al., *What Insiders Know About Future Earnings and How They Use It: Evidence from Insider Trades*, 35 J. ACCT. & ECON. 315, 315 (2003) (providing evidence that insiders possess, and trade upon, knowledge of specific and economically significant forthcoming accounting disclosures); John E. Core et al., *Stock Market Anomalies: What Can We Learn from Repurchases and Insider Trading?* 25 (2005), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=533323 [<https://perma.cc/GRT6-3UD3>] (finding managers' trading decisions to be correlated with strategies suggested by operating accruals); Albert S. Kyle, *Continuous Auctions and Insider Trading*, 53 ECONOMETRICA 1315, 1315 (1985) (arguing that insider makes positive profits by exploiting monopoly power in a dynamic context); H. Nejat Seyhun & Michael Bradley, *Corporate Bankruptcy and Insider Trading*, 70 J. BUS. 189, 203, 214 (1997) (finding that corporate insiders engage in significant sales prior to filing a bankruptcy petition).

Next, we cumulate all abnormal returns for 10, 20, 50, 100, 150, 200, and 250 days after the event to compute abnormal profits gained from insider trades.

C. Overall Comparisons

Table 1 displays the sample characteristics of insider trading in all public firms between 1996 and 2017. This table provides information about trades of officers and directors, top executives, and independent directors. Purchases and sales are reported separately. We also classify companies into three categories. Small-cap firms are firms with less than \$1 billion market capitalization. Midcap firms are defined by market capitalization between \$1 billion and \$5 billion. Large cap firms have higher than \$5 billion in market capitalization.

Table 1				
Sample Characteristics of Insider Trading in All Firms (1975 to 2017)				
	Small- Cap Firms	Mid-Cap Firms	Large-Cap Firms	All Purchase Firms
	Market Capitalization is less than \$1 Billion	Market Capitalization is between \$1 Billion and \$5 Billion	Market Capitalization is more than \$5 Billion	
Purchases				
Number of Firms	17,361	1,915	588	21,332
Number of Trades	807,206	95,066	35,354	894,623
Average Trade Size (Shares)	13,217	14,811	38,553	12,722.64
Total Shares Traded by Officers and Directors (Million)	2,651	521	964	4,136
Total Shares Traded by Top Executives(Million)	2,891	409	163	3,463
Total Shares Traded by Independent Directors (Million)	5,127	478	236	5,841
Total Shares Traded (Million)	10,669	1,408	1,363	13,340
	Small- Cap Firms	Mid-Cap Firms	Large-Cap Firms	All Sale Firms
	Market Capitalization is less than \$1 Billion	Market Capitalization is between \$1 Billion and \$5 Billion	Market Capitalization is more than \$5 Billion	
Sales				
Number of Firms	16,443	1,954	617	19,014
Number of Trades	1,432,961	864,635	596,265	2,893,861
Average Trade Size (Shares)	11,601	10,655	31,566	14,378
Total Shares Traded by Officers and Directors (Million)	7,049	5,022	4,142	16,213
Total Shares Traded by Top Executives(Million)	5,712	3,352	4,002	13,066
Total Shares Traded by Independent Directors (Million)	5,300	3,786	3,243	12,329
Total Shares Traded (Million)	18,061	12,160	11,387	41,608

The table shows that both the number of firms involved in insider trading and the number of trades is decreasing with market capitalization, while the average trade size is increasing with market capitalization. The number of sales is more frequent than the number of purchases. Insider sales to purchase ratio numbers are slightly more than 3-1. The ratio of purchases to sales is highest for large-cap firms (17-1); lower for mid-cap firm (9-1)

and lowest for small firms (1.7-1) and it follows similar patterns for officers, directors, top executives, and independent directors. This pattern shows that independent directors behave like other insider traders.

Next, we compare the overall profitability for independent directors and other insiders.²²³ Table 2 shows insiders' abnormal profits computed in all publicly listed firms between 1975 and 2017. Our evidence shows that all officers, top executives and independent directors trade profitably. Following these transactions, all officers earn about 4.0% in abnormal returns, top executives earn around 4.9% and independent directors earn around 4.1%. Overall, our evidence indicates that for the 43-year period from 1975 to 2017, independent directors trade in a similar fashion and earn comparable profits as other insiders. There is no evidence of any "independent" behavior by independent directors.

223. There is a growing literature that ties the profitability of insider trading to corporate governance. See generally Taylan Mavruk & H. Nejat Seyhun, *Do SEC's 10b5-1 Safe Harbor Rules Need to be Rewritten*, 2016 COLUM. BUS. L. REV. 153 (2016) (finding that, on average, insider trading under safe harbor plans appears to be motivated by non-public information); Cindy A. Schipani and H. Nejat Seyhun, *Defining "Material, Nonpublic": What Should Constitute Illegal Insider Information?*, 21 FORDHAM J. CORP. & FIN. L. 327 (2016) (arguing that the ambiguity of what constitutes illegal insider information enables corporate insiders); S. Burcu Avci, Cindy A. Schipani & H. Nejat Seyhun, *Ending Executive Manipulations of Incentive Compensation*, 42 J. CORP. L. 277 (2016) (showing that as a result of manipulative devices executives can increase compensation by about 6%); S. Burcu Avci, Cindy A. Schipani & H. Nejat Seyhun, *Manipulative Games of Gifts by Corporate Executives*, 18 U. PA. J. BUS. L. 1131 (2016) (finding executives use legal loopholes to maximize the value of their tax deductions for gifts of stock); Hollis A. Skaife et al., *Internal Control over Financial Reporting and Managerial Rent Extraction: Evidence from the Profitability of Insider Trading*, 55 J. ACCT. & ECON. 91, 107 (2013) (examining the association between ineffective internal control over financial reporting and the profitability of insider trading); Enrichetta Ravina & Paola Sapienza, *What Do Independent Directors Know? Evidence from Their Trading*, 23 REV. FIN. STUD. 962, 1001 (2010) (demonstrating that executives and independent directors make higher returns in firms with the weakest governance); Anup Agrawal & Sahiba Chadha, *Corporate Governance and Accounting Scandals*, 68 J. L. & ECON. 371, 403 (2005) (assessing whether certain corporate governance mechanisms are related to the probability of a company restating its earnings); Scott L. Summers & John T. Sweeney, *Fraudulently Misstated Financial Statements and Insider Trading: An Empirical Analysis*, 73 ACCT. REV. 131, 144 (1998) (finding that insiders reduce their holdings of company stock in the presence of fraud).

Insiders' Abnormal Profits in all Publicly Listed Firms between 1975 and 2017.								
	Number of Observations	10- days	20- days	50- days	100- days	150- days	200- days	250- days
Officers (except Independent Directors)	1,423,271	0.44% (4.41)	0.69% (4.91)	1.50% (6.71)	2.37% (7.49)	2.86% (7.35)	3.35% (7.46)	4.04% (8.04)
Top Executives	1,316,440	0.70% (6.78)	1.00% (6.86)	1.80% (7.77)	2.88% (8.79)	3.62% (9.00)	4.20% (8.99)	4.92% (9.43)
Independent Directors	1,091,776	0.65% (6.82)	0.90% (6.64)	1.57% (7.30)	2.34% (7.65)	2.83% (7.51)	3.26% (7.49)	4.11% (8.44)

*Bold are statistically significant at the 5% level or better.

D. Class-Action Subsample Comparisons

Table 3 displays the sample characteristics of insiders in firms that settled securities fraud class actions during the same period (1996 through 2017). Once again, insider sales are more than insider purchases. Insider sales to purchase ratios now number more than 10-1. Thus, firms involved in class action lawsuits are three times more likely to experience insider selling than the overall sample. The number of firms and the number of trades are higher for firms with higher market capitalization, indicating higher insider trading activity in large SCA-settled firms. The average class period is around 612 calendar days. The class period generally increases along with market capitalization.

Table 3				
Sample Characteristics of Insider Trading in Firms with Securities Fraud Settlements (1996 to 2017)				
	Small- Cap Firms	Mid-Cap Firms	Large-Cap Firms	All Purchase Firms
	Market Capitalization is less than \$1 Billion	Market Capitalization is between \$1 Billion and \$5 Billion	Market Capitalization is more than \$5 Billion	
	Purchases			
Number of Firms	19	43	53	115
Length of Class Period (Days)	501	686	591	611
Average Settlement (\$Mill.)	65.9	107.1	253.0	167.5
Number of Insider Trades	927	992	1074	2,993
Average Trade Size (Shares)	17,522	25,509	46,875	34,036
Total Shares Traded by Officers (Million)	10.2	9.5	19.0	38.7
Total Shares Traded by Top Executives (Million)	4.5	8.6	12.1	25.2
Total Shares Traded by Independent Directors (Million)	1.6	7.2	19.3	28.1
Total Shares Traded (Million)	16.3	25.3	50.4	92.0
	Sales			
	Mid-Cap Firms	Large-Cap Firms	All Sale Firms	Small- Cap Firms
	Market Capitalization is less than \$1 Billion	Market Capitalization is between \$1 Billion and \$5 Billion	Market Capitalization is more than \$5 Billion	
Number of Firms	33	45	54	132
Length of Class Period (Days)	431	654	583	569
Average Settlement (\$Mill.)	179.7	115.3	275.0	196.7
Number of Insider Trades	2,313	14,014	15,393	31,720
Average Trade Size (Shares)	11,601	10,654.6	31,565.9	19,445.8
Total Shares Traded by Officers (Million)	8.6	65.0	132.0	205.6
Total Shares Traded by Top Executives (Million)	9.7	53.0	228.7	291.4
Total Shares Traded by Independent Directors (Million)	8.4	31.3	125.2	164.9
Total Shares Traded (Million)	26.7	149.3	485.9	661.9

The average settlement amount is increasing monotonically with market capitalization. The average settlement amount is around \$60-\$90

million for small-cap stocks. This amount grows to about \$250-275 million for large-cap stocks. This finding indicates that larger firms with deeper pockets tend to settle for larger amounts.

Next, we turn our attention to profitability of insider trading in SCA-settled firms. Table 4 displays insiders' abnormal profits in firms subject to securities fraud lawsuits between 1996 and 2017 and settled for at least \$25 million. We examine insider trading separately before the class period, during the class period, and after the class period. The first column shows the number of observations in each column. The number of insider trades by officers and top executives are comparable, while independent directors have engaged in about half as many insider trading transactions as officers or top executives.

Table 4								
Insiders' Abnormal Profits in Firms Subject to Securities Fraud Lawsuits that Resulted in Settlements Exceeding \$25 Million between 1996 and 2017								
	Number of Observations	10-days	20-days	50-days	100-days	150-days	200-days	250-days
Officers- Before Class Period	4,656	0.91% (1.16)	0.45% (0.40)	0.04% (0.02)	-1.73% (-0.70)	-1.62% (-0.53)	-3.48% (-0.99)	-1.94% (-0.50)
Officers- During Class Period	6,747	1.28% (1.63)	2.19% (1.98)	5.43% (3.10)	11.12% (4.49)	20.58% (6.78)	28.09% (8.02)	35.05% (8.95)
Officers- After Class Period	1,424	1.16% (1.66)	1.35% (1.37)	2.71% (1.75)	11.45% (5.20)	16.48% (6.11)	23.58% (7.57)	31.26% (8.97)
Top Executives- Before Class Period	3,464	- 0.01% (-0.01)	-0.97% (-0.83)	- 0.15% (-0.08)	0.76% (0.29)	3.77% (1.18)	0.32% (0.09)	4.94% (1.20)
Top Executives- During Class Period	6,485	2.00% (1.92)	4.41% (3.00)	7.50% (3.23)	10.37% (3.15)	17.64% (4.38)	21.86% (4.71)	23.14% (4.45)
Top Executives- After Class Period	2,295	2.63% (5.44)	1.87% (2.74)	4.74% (4.42)	16.04% (10.48)	23.59% (12.62)	32.66% (15.13)	43.77% (18.08)
Independent Directors - Before Class Period	1,903	- 0.03% (-0.05)	-0.12% (-0.15)	- 0.22% (-0.18)	-2.15% (-1.24)	-2.04% (-0.96)	-0.86% (-0.35)	-0.96% (-0.35)
Independent Directors - During Class Period	3,700	1.09% (0.99)	1.11% (0.71)	2.19% (0.89)	3.17% (0.92)	5.01% (1.18)	14.45% (2.95)	16.42% (3.00)
Independent Directors - After Class Period	1,670	2.54% (2.58)	2.93% (2.10)	1.59% (0.72)	1.64% (0.52)	8.54% (2.23)	9.59% (2.17)	5.31% (1.07)

*Bold are statistically significant at the 5% level or better.

The number of insider trades is greater during the class period as compared to pre- and post-class periods even though the length of the periods is the same. This indicates that the class period involves more information asymmetry and thus more profitability from insider trading than pre- and post-class periods. This fact is valid for all insider groups; however, it is more pronounced for top executives and independent directors.

The first three lines of Table 4 show the abnormal returns of insider trading to officers (except independent directors) in pre-class, class, and post-class periods. Pre-class period abnormal returns are statistically not different from 0 for 4,656 observations. The number of insider trading transactions increase to 6,747 in the class period. The abnormal returns of all officers reach up to 35% during the 250 days after insider trading transaction. Moreover, abnormal profitability for 20 to 250 days is statistically significant for this insider trading group. This finding shows that officers use material nonpublic information to make profits in the class period. There are 1,424 insider trading transactions in the post-class period, which do not show profitability for the first 50 days after insider trading. We observe significant profits after 100-, 150-, 200- and 250-day event periods. The profitability reaches up to 31% for the 250-day period.

The profitability of top executives is shown in the next three lines. There is no significant profitability in the pre-class period for 3,464 observations. The number of transactions of top executives increase to 6,485 during the class period. Abnormal profitability of top executives rises up to 23% after 250 days of insider trading. Further, top executives' transactions display statistically significant abnormal returns immediately after the insider trading day. This finding indicates that top executives do not refrain from trading based on material non-public information. During the post-class period, top executives engage in 2,295 insider trading transactions. Profitability of insider trading to top executives continue in the post-event period and reaches up to 44% 250 days after insider trading. Once again, top executives' transactions display profitability immediately after the insider trading day.

Finally, we can see the trades of independent directors in the last three rows. There are 1,903 pre-class period insider trading transactions and their abnormal returns are not statistically different from zero. Hence, independent directors do not profit in the pre-class period. The number of transactions increase up to 3,700 in the class period. Abnormal returns to independent directors reach up to 16% in the 250-day event period. However, independent directors do not attain any significant profitability until about 200 days after the insider trading day. This evidence indicates that independent directors trade intensely based on material non-public information. Independent directors conduct 1,670 transactions in the post-class period. Profitability is fluctuating, yet always positive in this period. Profitability after 200 days is about 9% and, after 250 days, it is about 5%. Moreover, the independent directors' profits display statistically significant results immediately after the insider trading days. This evidence shows that abnormal profits continue with breaks even after the class period.

Next, we analyze whether the adoption of SOX impacted the trading behavior of the insiders of SCA-settled firms. Table 5A shows abnormal returns from insider trading before enactment of SOX. Hence the analysis period is January 1996 to September 2002 for this table. The number of transactions among insider groups varies from 173 to 1,817. For all three groups, insiders always display profitable trading during the class period. All officers earn 33%, top executives earn 48%, while the independent directors earn 23%. All officers and top executives continue to trade during the post class periods, while independent directors' transactions during the post class period do not attain statistical significance. This evidence confirms that once again all three groups behave similarly, and earn abnormal trading profits apparently from using the inside information regarding the class action lawsuits.

Table 5A								
Insiders' Abnormal Profits in Firms Subject to Securities Fraud Lawsuits that Resulted in Settlements Exceeding \$25 Million between 1996 and 2002 (Pre-SOX)								
	Number of Observations	10-days	20-days	50-days	100-days	150-days	200-days	250-days
Officers- Before Class Period	1,817	0.57% (0.68)	-1.44% (-1.21)	0.37% (0.20)	1.82% (0.68)	4.28% (1.31)	4.05% (1.07)	6.60% (1.56)
Officers- During Class Period	1,535	2.68% (4.40)	5.78% (6.74)	9.37% (6.86)	14.21% (7.34)	21.10% (8.90)	26.55% (9.69)	33.00% (10.78)
Officers- After Class Period	173	8.04% (4.65)	12.14% (4.96)	12.71% (3.26)	16.37% (2.96)	17.35% (2.56)	21.72% (2.78)	28.83% (3.30)
Top Executives- Before Class Period	1,219	-0.75% (-0.63)	-2.42% (-1.46)	1.46% (0.55)	7.17% (1.92)	19.38% (4.25)	18.42% (3.49)	23.46% (3.98)
Top Executives- During Class Period	943	3.73% (4.14)	6.75% (5.32)	9.93% (4.92)	14.86% (5.22)	28.58% (8.18)	35.56% (8.83)	47.91% (10.63)
Top Executives- After Class Period	524	2.11% (1.37)	1.05% (0.49)	-0.81% (-0.24)	7.39% (1.53)	23.03% (3.88)	29.84% (4.35)	38.05% (4.97)
Independent Directors- Before Class Period	887	-0.20% (-0.23)	-0.43% (-0.36)	-1.67% (-0.88)	-4.15% (-1.54)	-4.94% (-1.49)	-4.44% (-1.16)	-3.14% (-0.73)
Independent Directors- During Class Period	468	2.56% (2.86)	4.40% (3.48)	7.43% (3.71)	6.63% (2.34)	13.99% (4.03)	14.73% (3.68)	22.84% (5.09)
Independent Directors- After Class Period	120	-0.53% (-0.22)	-1.10% (-0.33)	-9.86% (-1.88)	- 15.75% (-2.13)	-7.71% (-0.85)	0.12% (0.01)	3.96% (0.34)

*Bold are statistically significant at the 5% level or better.

Next, we test whether the enactment of SOX made any difference in the behavior of independent directors. Table 5B displays the abnormal returns in the post-SOX period, between September 2002 and December 2017. First, we notice that all three groups of insiders trade the greatest number of transactions during the class period. For all three groups, the number of

transactions during the class period, doubles or trebles compared to pre- and post-class periods. This evidence indicates that, if anything, all three groups of insiders have apparently become more aggressive in exploiting their securities-lawsuit related information during the class period than after the enactment of SOX.

Table 5B								
Insiders' Abnormal Profits in Firms Subject to Securities Fraud Lawsuits that Resulted in Settlements Exceeding \$25 Million between 2002 and 2017 (Post-SOX)								
	Number of Observations	10-days	20-days	50-days	100-days	150-days	200-days	250-days
Officers-Before Class Period	2,839	1.12% (0.97)	1.66% (1.02)	-0.17% (-0.07)	-4.01% (-1.10)	-5.40% (-1.21)	-8.29% (-1.61)	-7.41% (-1.29)
Officers-During Class Period	5,212	0.86% (0.86)	1.14% (0.81)	4.27% (1.92)	10.21% (3.24)	20.43% (5.29)	28.55% (6.40)	35.66% (7.16)
Officers-After Class Period	1,251	0.21% (0.27)	-0.14% (-0.13)	1.33% (0.79)	10.77% (4.47)	16.35% (5.54)	23.83% (6.99)	31.59% (8.28)
Top Executives-Before Class Period	2,245	0.39% (0.36)	-0.18% (-0.12)	-1.02% (-0.42)	-2.72% (-0.80)	-4.70% (-1.12)	-9.51% (-1.98)	-5.11% (-0.95)
Top Executives-During Class Period	5,542	1.70% (1.42)	4.01% (2.37)	7.08% (2.64)	9.61% (2.54)	15.78% (3.40)	19.54% (3.65)	18.97% (3.16)
Top Executives-After Class Period	1,771	2.79% (3.75)	2.11% (2.00)	6.37% (3.83)	18.58% (7.89)	23.76% (8.26)	33.49% (10.09)	45.46% (12.22)
Independent Directors-Before Class Period	1,016	0.12% (0.17)	0.16% (0.16)	1.05% (0.67)	-0.41% (-0.19)	0.49% (0.18)	2.27% (0.73)	0.94% (0.27)
Independent Directors-During Class Period	3,232	0.88% (0.70)	0.63% (0.35)	1.42% (0.51)	2.67% (0.68)	3.71% (0.77)	14.40% (2.58)	15.49% (2.48)
Independent Directors-After Class Period	1,550	2.78% (2.67)	3.24% (2.20)	2.47% (1.06)	2.99% (0.90)	9.80% (2.43)	10.32% (2.22)	5.42% (1.04)

*Bold are statistically significant at the 5% level or better.

Table 5B shows that abnormal profitability of insider trading continues at high levels even after the passage of SOX. All officers earn 36%, top executives earn 19%, while independent directors earn 15% from insider trading during the class period after the passage of SOX. Once again, both the abnormal profitability of trading as well as the number of transactions by independent directors follow very similar patterns as those for all officers and top executives. Independent directors behave similarly to all other top management groups both before and after the passage of SOX. This evidence is consistent with the conclusion that independent directors' interests continue to appear to be aligned with other members of top management and not with shareholders.

Although not shown, we also explore insiders' purchase and sales transactions separately. Our evidence indicates that the overwhelming majority of insider trading in class-action involved firms come from sales, and not purchases. Furthermore, abnormal profits from insiders' purchase transactions never attain positive statistical significance for firms involved in class action lawsuits. Instead, all abnormal profitability is restricted to insiders' sales only. Thus, our evidence indicates that insiders exclusively exploit their negative information regarding the potential lawsuits, sell their own firms' stock and earn abnormal profits from these sales. Earning abnormal profits from their sales transactions represents a further conflict of interest between shareholders and top management.

As a sensitivity test, we analyze the profitability of insider trading where companies settled for smaller amounts. Table 6 presents the abnormal profitability of insider trading for company settlements between three million and twenty-five million dollars. The evidence shows that profitability continues even when companies settle for smaller amounts. Abnormal profitability of insiders with smaller company settlements in the class period is 36%, 19%, and 15% for all officers, top executives, and independent directors, respectively. Comparing abnormal returns of insiders from companies with larger settlements, we observe that profitability of insider trading is somewhat higher when the SCA is settled for a smaller amount. One possible explanation for these results is that insiders may be viewing the costs of profitable trading to be less in smaller settlement cases. Consequently, all three groups of insiders are taking more aggressive trading positions to exploit their asymmetric information advantage.

Table 6								
Insiders' Abnormal Profits in Firms Subject to Securities Fraud Lawsuits that Resulted in Settlements Between \$3 Million and \$25 Million between 1996 and 2017.								
	Number of Observations	10-days	20-days	50-days	100-days	150-days	200-days	250-days
All Officers- Before Class Period	2,839	1.12% (0.97)	1.66% (1.02)	-0.17% (-0.07)	-4.01% (-1.10)	-5.40% (-1.21)	-8.29% (-1.61)	-7.41% (-1.29)
All Officers- During Class Period	5,212	0.86% (0.86)	1.14% (0.81)	4.27% (1.92)	10.21% (3.24)	20.43% (5.29)	28.55% (6.40)	35.66% (7.16)
All Officers- After Class Period	1,251	0.21% (0.27)	-0.14% (-0.13)	1.33% (0.79)	10.77% (4.47)	16.35% (5.54)	23.83% (6.99)	31.59% (8.28)
Top Executives- Before Class Period	2,245	0.39% (0.36)	-0.18% (-0.12)	-1.02% (-0.42)	-2.72% (-0.80)	-4.70% (-1.12)	-9.51% (-1.98)	-5.11% (-0.95)
Top Executives- During Class Period	5,542	1.70% (1.42)	4.01% (2.37)	7.08% (2.64)	9.61% (2.54)	15.78% (3.40)	19.54% (3.65)	18.97% (3.16)
Top Executives- After Class Period	1,771	2.79% (3.75)	2.11% (2.00)	6.37% (3.83)	18.58% (7.89)	23.76% (8.26)	33.49% (10.09)	45.46% (12.22)
Independent Directors- Before Class	1,016	0.12% (0.17)	0.16% (0.16)	1.05% (0.67)	-0.41% (-0.19)	0.49% (0.18)	2.27% (0.73)	0.94% (0.27)
Independent Directors- During Class	3,232	0.88% (0.70)	0.63% (0.35)	1.42% (0.51)	2.67% (0.68)	3.71% (0.77)	14.40% (2.58)	15.49% (2.48)
Independent Directors- After Class	1,550	2.78% (2.67)	3.24% (2.20)	2.47% (1.06)	2.99% (0.90)	9.80% (2.43)	10.32% (2.22)	5.42% (1.04)
		(0.27)	(-0.13)	(0.79)	(4.47)	(5.54)	(6.99)	(8.28)

*Bold are statistically significant at the 5% level or better.

IV. IMPLICATIONS FOR IMPROVING CORPORATE GOVERNANCE

The presence of independent directors on the board has advantages and disadvantages. Some commentators argue that insiders also play a vital role, even considering their lack of independence, because they act as a source of important firm-specific information for the board.²²⁴ Insiders also have the information, knowledge, and resources that may allow them to more accurately monitor their fellow insiders.²²⁵ On the other hand, dependent members are directly involved with daily operational management and related decision-making, and therefore may lack objectivity or worse. The following part discusses various critiques of the role of independent boards, including the infrequency of judicial findings of liability for failure of oversight, with implications for improving corporate governance.

A. Critiques of Independent Boards

Heavy reliance by independent board members on the insider's financial analysis is a weakness of the current monitoring model, making supervision more problematic. For example, independent members are less informed than insiders about the firm's constraints and opportunities.²²⁶ Whether American boards need more independent members remains unclear.

The CEO's informal influence over board appointments provides another challenge for board independence. Agency theory posits that as long as the CEO is the leader of the board, his or her influence remains high.²²⁷ On the other hand, management theory advocates for a single strong leader of the company to assure unity of command at the top.²²⁸ Regulatory efforts, such as mandating independent nominating committees, majority voting, and certain changes of proxy access, may reduce the tension between board members and the CEO. As mentioned above, both the NYSE and NASDAQ require firms either to appoint a nominating committee, or employ a process under which nominations are made by independent members of the board.²²⁹

There is evidence that the number of outsiders on the board increases

224. Linck, et al., *supra* note 73, at 310.

225. Fairfax, *supra* note 7, at 132.

226. Linck, et al., *supra* note 73, at 310.

227. See Sydney Finkelstein & Richard A. D'Aveni, *CEO Duality as a Double-Edged Sword: How Boards of Directors Balance Entrenchment Avoidance and Unity of Command*, 37 ACAD. MGMT. J. 1079, 1081-83 (1994) (discussing the agency theory's concern of management dominating the board).

228. *Id.* at 1083.

229. NYSE, Listed Company Manual § 303A.00 (2018).

as the CEO's influence increases over top management.²³⁰ Independent members of the board are also encouraged to meet without managerial members in order to keep managerial influence at minimum.²³¹

Lucian A. Bebchuk contends that to enhance monitoring of the CEO, it is important to decrease the degree to which the CEO informally influences independent director appointments, and to "make these directors accountable to public investors."²³² Furthermore, in the controlled firms, there is a slightly different set of issues.²³³ Bebchuk further argues that the manner of electing board members decreases the effectiveness of independent director oversight²³⁴—because controllers have a strong influence on selection of board candidates, independent members have weighty incentives to support the controller, undermining their strength in conflicted decisions.²³⁵

The assumption that independent outside directors will monitor the actions of management to minimize agency costs and maximize shareholder value may find its roots in public perception rather than facts.²³⁶ The underlying logic behind that notion presupposes that because independent members are less committed to company operations and management, they are not subject to agency problems, and are thus expected to monitor dependent members.²³⁷ On the other hand, as practice demonstrates, they can be passive and ineffective when they lack enough information about company activities²³⁸ and further, they may hinder efficient operations.²³⁹

B. Liability of Independent Directors for Failure of Oversight

Independent directors are rarely found liable for violation of their oversight duties in either civil or criminal contexts.²⁴⁰ And even if

230. Linck, et al., *supra* note 73, at 312.

231. Gordon, *supra* note 14, at 1497.

232. Lucian A. Bebchuk & Assaf Hamdani, *Independent Directors and Controlling Shareholders*, 165 U. PA. L. REV. 1271, 1276-77 (2017).

233. NYSE defines a controlled company as a company of which more than fifty percent of the voting power for the election of its directors is held by a single person, group or another entity. NYSE, Listed Company Manual § 303A.04(a) (2013).

234. Bebchuk & Hamdani, *supra* note 232, at 1274.

235. *Id.*

236. Steven T. Petra, *Do Outside Independent Directors Strengthen Corporate Boards?*, 5 CORP. GOVERNANCE: INT'L J. BUS. SOC'Y 55, 62 (2005).

237. Adams & Ferreira, *supra* note 21, at 221-22.

238. See Gordon, *supra* note 14, at 1541 (noting that in one area "[as] [t]he independents' information debilities decrease . . . their monitoring advantages become more apparent").

239. *Id.*

240. See Fairfax, *supra* note 7, at 167-71 (discussing the lack of independent director liability in various contexts).

independent board members are charged with a violation, because of insurance, indemnification, and statutory protections, their liability rarely leads to out-of-pocket damages.²⁴¹ Given the infrequency of the independent director's liability, effectiveness of their monitoring activities is questionable. Some authors point out, however, that the threat of increased liability may discourage people from directorships, leading to a lack of well-qualified independent candidates in future.²⁴² But because government regulators shift significant policing function to the hands of independent directors, their least accountable status in corporate law is concerning.

Potentially, director liability for a breach of the duty to exercise appropriate attention may, in theory, arise in two distinct contexts.²⁴³ As the court in one case explained:

First, such liability may be said to follow *from a board decision* that results in a loss because that decision was ill advised or “negligent.” Second, liability to the corporation for a loss may be said to arise from an *unconsidered failure of the board to act* in circumstances in which due attention would, arguably, have prevented the loss.²⁴⁴

But the BJR applies to the first group of cases, effectively eviscerating the risk of liability if the decision made was from a process that was deliberately considered in good faith or rational.²⁴⁵ The “business judgment rule is process oriented and informed by a deep respect for all *good faith* board decisions.”²⁴⁶

Thus, where a director exercises a good faith effort, in fact, to be both informed and enable them to exercise appropriate judgment, the duty of care is satisfied.²⁴⁷ If shareholders are not satisfied with the judgment, as the court in *In re Caremark International Inc. Derivative Litigation* noted, they “should have elected other directors.”²⁴⁸ Thus, the “core element” of any corporate law duty of care inquiry is whether a good faith effort was made to be informed and exercise appropriate judgment.²⁴⁹

The *Caremark* court went on to note that the “second class of cases in which director liability for inattention is theoretically possible entail

241. *Id.* at 168.

242. Usha Rodrigues, *The Fetishization of Independence*, 33 J. CORP. L. 447, 458 (2008).

243. *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 967 (Del. Ch. 1996).

244. *Id.*

245. *Id.*

246. *Id.* at 967-68.

247. *Id.* at 968.

248. *Id.*

249. *Id.*

circumstances in which a loss eventuates not from a decision but, from unconsidered inaction.”²⁵⁰ In this case, the court held that without some reason to suspect deceit, corporate boards and senior officers cannot be charged with any wrongdoings only because they incorrectly assumed employees were acting with honesty and integrity on the company’s behalf.²⁵¹ Yet, the board must “exercise a good faith judgment that the corporation’s information and reporting system is in concept and design adequate to assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary operations, so that it may satisfy its responsibility.”²⁵²

In *Stone v. Ritter*,²⁵³ the court noted that the phrase in case law, which describes an absence of good faith as a “necessary condition to liability,”²⁵⁴ is intentional.²⁵⁵ The court concluded, that *the necessary conditions* for director oversight liability include the following: “(a) the directors utterly failed to implement any reporting or information system or controls; *or* (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention.”²⁵⁶ For both tests, imposing liability requires a showing that directors knew that they were failing to meet their fiduciary duties.²⁵⁷ If directors do not act when they know they have a duty to do so, they fail to discharge their fiduciary obligations in good faith and thus breach their duty of loyalty.²⁵⁸

In *Horman v. Abney*,²⁵⁹ also known as the *UPS* case, shareholders brought a derivative action against board members of UPS, alleging the UPS board members breached their duty of loyalty by knowing failure of monitoring and managing UPS’s compliance with state and federal laws concerning delivery and transportation of cigarettes. The shareholders sought to recover losses borne by the company from a pending enforcement action that arose out of this breach of duty.²⁶⁰ The court explained that the *Caremark* liability standard for violating a duty to actively monitor corporate

250. *Id.*

251. *Id.* at 969.

252. *Id.*

253. 911 A.2d 362 (Del. 2006).

254. *Id.* at 364 (quoting *Caremark*, 698 A.2d 959).

255. *Id.* at 369.

256. *Id.* at 370.

257. *Id.*

258. *Id.*

259. No. CV 12290-VCS, 2017 WL 242571, at *1 (Del. Ch. Jan. 19, 2017) (mem.).

260. *Id.*

affairs is very much related to a director's failure to act in good faith.²⁶¹ Therefore, the court held that to state a claim under *Caremark*, the facts pled by the plaintiff must give rise to, or at least allow, a reasonable inference that a director acted in contradiction to his or her fiduciary duties, and knew he or she was acting in contradiction to these duties.²⁶²

The *UPS* court further stated, however, that even if directors exercise their oversight responsibilities in good faith, this does not mean that employees will not commit crimes, or that employees will not cause the corporation to sustain substantial financial liability.²⁶³ Accordingly, Delaware courts routinely reject the argument that just because there was an incident of illegal behavior, internal controls must have been insufficient, and the board must have had knowledge of this.²⁶⁴ Rather, a plaintiff must "plead with particularity" about how the illegal corporate conduct is related to the board's actions.²⁶⁵

Explaining the first *Caremark* prong, the court held that "the board cannot be held liable for breaching its duty, under the first prong of *Caremark*, unless it can be proven that its members 'utterly failed to implement any reporting or information systems or controls.'"²⁶⁶ It is not a *Caremark* claim to show that a system that was implemented with care and seemed to be working well just failed to detect some fraud that occurred.²⁶⁷ In this case, as the court stated, "at best, the complaint might support an inference that employees charged with the responsibility to implement UPS's oversight systems failed to report issues to the board. That is not enough to sustain a *Caremark* claim."²⁶⁸

Thus, in Delaware, it appears that the only way liability could be established for failure to monitor is if the plaintiff shows that the board knew of corporate misconduct but consciously disregarded its duty to address this misconduct, thereby acting in bad faith.²⁶⁹ In this context, "bad faith means 'the directors were conscious of the fact that they were not doing their jobs,

261. *Id.* at *7 (quoting *Stone ex rel. AmSouth Bancorp. v. Ritter*, 911 A.2d 362, 369-70 (Del. 2006)).

262. *Id.* (quoting *In re Massey Energy Co.*, No. 5430-VCS, 2011 WL 2176479, at *22 (Del. Ch. May 31, 2011)).

263. *Id.* (quoting *Stone*, 911 A.2d at 373).

264. *Id.* (quoting *Desimone v. Barrows*, 924 A.2d 908, 939-40 (Del. Ch. 2007)).

265. *Id.* (quoting *38 La. Mun. Police Emps. Ret. Sys. v. Pyott*, 46 A.3d 313, 340 (Del. Ch. 2012), *rev'd on other grounds*, 74 A.3d 612 (Del. 2013)).

266. *Id.* at *9 (quoting *Stone*, 911 A.2d at 370).

267. *Id.* (quoting *David B. Shaev Profit Sharing Acct. v. Armstrong*, No. Civ.A. 1449-N., 2006 WL 391931, at *5 (Del. Ch. Feb. 13, 2006)).

268. *Id.* at *10.

269. *Id.* (quoting *Reiter ex rel. Capital One Fin. Corp. v. Fairbank*, No. 11693-CB, 2016 WL 6081823, at *8 (Del. Ch. Oct. 18, 2016)).

and that they ignored red flags indicating misconduct in defiance of their duties.”²⁷⁰ However, typically:

[T]he red flag analogy depicts events or reports that serve as warning signs to the Board of corporate wrongdoing after a system of reporting and compliance is in place. These red flags put the board on notice that the system is not working properly. If the members of the board become aware of the red flags and do nothing in response, and thereby consciously disregard their fiduciary duties, then they each individually are subject to liability for a failure of oversight.²⁷¹

Thus, under the second prong of *Caremark*, the question is whether the board knew of red flags and then whether the board attempted to address them.²⁷² In *In re Citigroup Inc. S’holder Derivative Litig.*, the court held that:

There are significant differences between failing to oversee employee fraudulent or criminal conduct and failing to recognize the extent of a company’s business risk. Directors should, indeed must under Delaware law, ensure that reasonable information and reporting systems exist that would put them on notice of fraudulent or criminal conduct within the company. Such oversight programs allow directors to intervene and prevent frauds or other wrongdoing that could expose the company to risk of loss as a result of such conduct.²⁷³

More recently, the court in *Reiter v. Fairbank*, held that “imposing *Caremark*-type duties on directors to monitor business risk is fundamentally different from imposing on directors a duty to monitor fraud and illegal activity.”²⁷⁴ The case here involved an allegation that the “directors breached their fiduciary duty of loyalty and unjustly enrich themselves by consciously disregarding their responsibility to oversee Capital One’s compliance with the Bank Secrecy Act and other anti-money laundering laws ‘(BSA/AML)’.”²⁷⁵ Allegedly, these directors ignored the red flags related to these violations, and the plaintiff alleged certain inadequacies in provision of the services which in turn, allegedly exposed the bank to liability for

270. *Id.* (quoting *Armstrong*, 2006 WL 391931 at *5).

271. *Id.* at *11 (citing *South v. Baker*, 62 A.3d 1, 15 (Del. Ch. 2012)).

272. *Id.* at *14.

273. 964 A.2d 106, 131 (Del. Ch. 2009).

274. 2016 WL 6081823, at *8 (Del. Ch. Oct. 18, 2016) (quoting *In re Goldman Sachs Group, Inc. S’holder Litig.*, No. 5215-VCG, 2011 WL 4826104, at *22 (Del. Ch. Oct. 12, 2011) (internal quotation omitted)).

275. *Id.* at *1.

money-laundering activities.²⁷⁶

The court held, however, that directors, while acting in good faith, cannot always prevent employees' wrongdoings, and therefore, a plaintiff asserting a *Caremark* claim must demonstrate "a sufficient connection between the corporate trauma and the board."²⁷⁷ To show the connection, the board must have known about the evidence of corporate misconduct, and yet consciously disregarded its duty to address that wrongdoing.²⁷⁸ According to the court, the directors did not violate their fiduciary duties because the evidence involved at best yellow flags, and the plaintiff failed to show that "defendants *consciously* allowed Capital One to violate the law so as to sustain a finding they acted in bad faith."²⁷⁹

RECOMMENDATIONS AND CONCLUSION

Currently, the reliance in corporate law on the role of independent directors to serve as gatekeepers in their monitoring role over management, is flawed. Our empirical study provides new evidence that not only may independent directors be ill-equipped to engage in serious oversight of the activities of management, they may also be easily co-opted when they have the opportunity to personally participate in self-interested transactions to the detriment of the shareholders. Our current study provides evidence that independent directors are not likely immune from the temptation to profit from insider trading and especially insider selling. Our prior research also demonstrates that they were similarly likely to manipulate stock option compensation when the opportunity arose.²⁸⁰ Our results are also consistent with and reinforce the conclusions reached by M.P.Narayanan and H. Nejat Seyhun and Lucian A. Bebchuk, Yaniv Grinstein and Urs Peyer, where they found opportunistically timed stock option grants awarded to inside and independent directors.²⁸¹ And as described above in Part II, numerous other empirical studies have been critical of the ability of independent directors to effectively serve a monitoring function. Moreover, the current legal

276. *Id.*

277. *Id.* at *8 (quoting *Pyott*, 46 A.3d at 340).

278. *Id.*

279. *Id.* at *14.

280. See generally S. B. Avci, Cindy A. Schipani, & H. N. Seyhun, *Do Independent Directors Curb Financial Fraud? The Evidence and Proposals for Further Reform* 93 *IND. L. J.* 757 (2018).

281. M.P. Narayanan & H. N. Seyhun, *The Dating Game: Do Managers Designate Option Grant Dates to Increase Their Compensation?*, 21 *REV. FIN. STUD.*, 1907, 1909-10 (2008); Lucian A. Bebchuk, Yaniv Grinstein, & Urs Peyer, *Lucky CEOs and Lucky Directors*, 65 *J. OF FIN.* 2363, 2363-66 (2010).

doctrines providing deference to independent directors appear not to offer much in the way of a check on their behavior. Finally, even the definition of an independent director appears ineffective for avoiding conflicts of interest which arise from personal and social relationships.

Thus, independent status is not a sufficient condition for proper monitoring. Informed oversight of management may also depend on other characteristics necessary for the performance of director's functions, such as experience in the firm's industry. One should not lean toward the other extreme, however, and mandate the experience as a prerequisite to the directorship. As the drafters of the *Principles* correctly point out "some of the best ideas, insights and contributions can come from directors whose professional experiences are not directly related to the company's business."²⁸² But industry background may be particularly helpful in curtailing corporate fraud, allowing independent members to catch certain red flags or inconsistencies in the company's performance that may not be apparent to the industry outsider. The director's experience may also deter management from manipulating and misleading the boards.

In addition, the current disclosure model has a significant flaw—companies do not explain their reasoning for the designation of a director as independent nor disclose information they considered during their deliberations.²⁸³ The current disclosure requirements by the SEC about independence designations are incomplete as well.²⁸⁴ Because of this, Aaron Nili calls for an enhanced disclosure system, mandating disclosure of the entire set of information that the company relied on in making their judgment about a director's independence, thus allowing its shareholders and outsiders to subsequently check their designations.²⁸⁵ As a 2015 survey of institutional investors found, 62% of respondents read the director independence section of the proxy statement before voting.²⁸⁶ In addition to imposing significant personal liability upon a director for failing to disclose connections a court

282. *Common Sense Principles of Corporate Governance*, *supra* note 180, at 1.

283. Nili, *supra* note 19, at 40.

284. *Id.* at 71. Nili provides the following reasons for the lacking system. "First, companies are only required to disclose what they considered as potentially material information. Second, companies can escape the need to provide detailed information by adopting categorical standards to assist them in making determinations of independence and then may make only a general disclosure if a director meets these standards. Third, currently a company can report different information about the director in various locations in its filing—making it harder for shareholders to easily review the information. Finally, . . . many companies provide no information to shareholders, potentially violating the current disclosure regime, but these practices are not enforced by the SEC." *Id.*

285. *Id.*

286. *Id.* at 46.

later finds material, making publicly available all information related to the determination of independence, may lead to a more scrutinized nomination process, thereby providing for a more fully informed vote.²⁸⁷

An enhanced disclosure system may, however, create a certain chilling effect on the willingness of future candidates to become directors on the board. But if directors have something to hide, then as Nili argues, perhaps the chilling effect would be a positive development.²⁸⁸

We also recommend a more nuanced definition of independence. A director should be banned from serving as an independent director by the stock exchanges and SEC if a director fails to reveal a relationship, later found to be material by a court. The prospect of liability and reputational risks should provide a director with incentives to offer complete disclosures, particularly of one's social and casual connections to the company and its insiders. In addition, we agree with the *eBay* and *Oracle* contextual analyses of independence.²⁸⁹ Even if a director passes a general test of independence, independence must be determined, case by case, in the context of the events litigated.

Finally, as proposed in our prior work,²⁹⁰ we continue to recommend more power be given to the shareholders to act as corporate monitors. These recommendations include eliminating shareholder multi-class voting structures, making shareholder resolutions binding, eliminating plurality voting for board membership and replacing this with majority voting and requiring companies to set up secure websites to allow shareholders to review corporate issues and vote their choices.²⁹¹ Of course, we realize that many shareholders do not care to participate in corporate governance. Yet, there are institutional and activist shareholders who do care and the current regime does not provide for a full opportunity for their voices to be heard

287. See Matthew Heller, *Investors Want More Disclosure on Director Qualifications*, CFO (Mar. 18, 2015), <http://ww2.cfo.com/governance/2015/03/investors-want-disclosure-director-qualifications/> [<https://perma.cc/VDB9-C9HH>] (discussing a survey of institutional investors calling for more information on both candidates and incumbents).

288. *Id.* at 75.

289. See Dana M. Muir & Cindy A. Schipani, *Fiduciary Constraints: Correlating Obligation with Liability*, 42 WAKE FOREST L. REV. 697, 736-38 (2007) (discussing the contextual approach of the Delaware courts in the *eBay* and *Oracle* cases).

290. Avci et al., *supra* note 280, at 4.

291. *Id.* at 4-5.