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The Myth of the Unbiased Director

Regina F. Burch

THE MYTH OF THE UNBIASED DIRECTOR

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∗ Associate Professor of Law, Capital University Law School; E-mail: rburch@law.capital.edu. I would like to thank Professors Athornia Steele and Mark Strasser, and participants at the Midwestern People of Color Legal Scholarship Conference, the University of Iowa Summer Writing Conference, and the Inaugural Texas Junior Legal Scholars Conference for reviewing earlier drafts of this Article, discussing with me the substantive issues, and providing helpful suggestions. Also, I extend my gratitude to my research assistants, Tiffany Auvdel, Patrick Jones, and Angela Opalenik. Finally, I would like to thank the administration at Capital University Law School for its support.

I. INTRODUCTION

In 2006, the Securities and Exchange Commission responded to concerns over high executive compensation levels and compensation-driven conflicts of interest and promulgated new regulations requiring more disclosure about executive compensation.[1] Also, recent federal and stock exchange laws and regulations emphasize the independent monitoring board as a mechanism to curtail accounting and financial fraud. Moreover, post-Enron reforms may have led to an increase in the number of board positions available and greater opportunities for women and people of color to serve on public company boards.[2] Boards have increased diversity in an attempt to meet the product and service needs of an increasingly diverse population and thereby improve corporate bottom lines. Nonetheless, executive compensation remains high, accounting fraud and mismanagement persists, and board diversity is lacking.

This Article seeks to use social science research to better understand why these and other corporate governance problems persist. One reason may be that boards are biased as to how they respond to these issues. Social science research on risk perception informs us that individuals' "preferences among different types of risk taking (or avoiding), correspond to cultural biases—that is, to worldviews or ideologies entailing deeply held values and beliefs defending different patterns of social relations."[3] Cultural theorists have identified four

1. *See* Securities and Exchange Commission, Executive Compensation and Related Party Disclosure, 71 Fed. Reg. 6542 (proposed Feb. 8, 2006) (to be codified at 17 C.F.R. pts. 228, 229, 239, 240, 245, 249, and 274), *available at* http://www.sec.gov/rules/proposed/33-8655.pdf.

2. *See* LISA M. FAIRFAX, THE BOTTOM LINE ON BOARD DIVERSITY: A COST-BENEFIT ANALYSIS OF THE BUSINESS RATIONALES FOR DIVERSITY ON CORPORATE BOARDS, 1-2 (2005).

3. Aaron Wildavsky & Karl Dake, *Theories of Risk Perception; Who Fears What and Why?*, 119 DAEDALUS: PROCEEDINGS OF THE AM. ACAD. OF ARTS & SCI. 43, 43 (1990). *See also* Karl Dake, *Orienting Dispositions in the Perception of Risk: An Analysis of Contemporary Worldviews and Cultural Biases*, 22 J. CROSS-CULTURAL PSYCHOL. 61, 65 (1991) (describing an empirical

competing worldviews: communitarian, individualistic, hierarchical, and egalitarian.[4] The communitarian and individualistic worldviews are at opposite ends of a spectrum measuring the degree to which an individual's self-identity and preferred social relations derive from membership in a group.[5] For example, communitarians prefer to make decisions by consensus and value solidarity,[6] while individualists prefer autonomy and self-regulation, and value market relationships and the freedom to bid and bargain for themselves.[7] The egalitarian and hierarchical worldviews are at opposite ends of a scale measuring the degree to which an individual's self-identity and preferred social relations derive from social differentiation.[8] Egalitarians "value strong equality of outcome in the sense of diminishing distinctions among people such as wealth, race, gender, authority, etc."[9] By contrast, people who subscribe to a hierarchical worldview prefer "superior/subordinate" forms of social relations and role differentiation based on the distinctions (such as wealth and authority) disfavored by egalitarians.[10]

A recent empirical study conducted by the Cultural Cognition Project at Yale University suggests that one type of cognitive bias—a misperception of the risks inherent in certain types of socially charged activities—may derive from a phenomenon termed "cultural-identity-protective cognition ("CIP")."[11] Socially charged activities are those that are controversial and that carry social meaning. Social meaning refers to an activity's power to shape how one person perceives others who are engaged in that activity.[12] The theory of CIP cognition

research project to test and confirm the theory that "individuals choose what to fear (and how much to fear it) in order to support their way of life").

4. *See* MARY DOUGLAS, NATURAL SYMBOLS: EXPLORATIONS IN COSMOLOGY 62-64 (Routledge, 2d ed. 2003) (explaining in Douglas' system of classification, a communitarian worldview corresponds to a high group social dimension, an individualistic worldview to a low group dimension, a hierarchical worldview to a high grid dimension, and an egalitarian worldview to a low grid dimension). *See also* Steven Rayner, *Cultural Theory and Risk Analysis*, *in* SOCIAL THEORIES OF RISK 83, 87 (S. Krimsky & D. Goldin eds., 1992).

5. *See* DOUGLAS, *supra* note 4, at 63. *See also* Rayner, *supra* note 4, at 87.

6. Steven Rayner, *Management of Radiation Hazards in Hospitals: Plural Rationalities in a Single Institution*, 16 SOC. STUD. OF SCI. 577, 581 (1986). *See also* Rayner, *supra* note 4, at 90.

7. Dake, *supra* note 3, at 66.

8. *See* DOUGLAS, *supra* note 4, at 62.

9. Dake, *supra* note 3, at 67.

10. *Id*. at 66-67.

11. Dan M. Kahan et al., *Culture and Identity-Protective Cognition: Explaining the White Male Effect in Risk Perception*, J. OF EMPIRICAL LEGAL STUD. 1 (2007), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=995634.

12. *See* Dan M. Kahan, *Two Conceptions of Emotion in Risk Regulation*, 156 U. PA. L. REV. (forthcoming 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=962520

proposes that an individual's over or under emphasis of the risks associated with socially charged activities, such as gun ownership, abortions, and environmental pollution, may be due to the tendency for individuals to be biased in favor of or against activities in a manner that furthers social status.[13] Under this view, status is not only socioeconomic status. Status refers to the individual's self-identity and social role(s) as reflected by that individual's preferred worldview.[14] Status is dependent on cultural norms and is threatened by those holding opposing norms.[15] In other words, an individual's risk insensitivity (or oversensitivity) is tied to an individual's worldview; "insensitivity to risk" may be a "defensive response to a form of cultural identity threat."[16]

The Yale research study attempted to explain the "white male effect"—a "well documented pattern" showing that certain white men fear various risks less than women and minorities.[17] Research on risk perception has demonstrated that a group of affluent, highly educated white males, who also tend to hold very hierarchical and individualistic norms, tend to misperceive (more so than white females and people of color) the risks of certain activities in a manner that is consistent with their worldviews.[18] In fact, the research indicates that the risk perceptions of these males tends to be highly skewed in favor of activities that may be seen as advancing their status in society, and highly skewed against activities that tend to threaten their social status.[19] Evidence from the Yale study suggests that gender and race "influenced risk perception only in conjunction with distinctive worldviews that themselves feature either gender or race differentiation or both in social roles involving putatively dangerous activities."[20] Moreover, the variance among risk perceptions and the misperception of risks may derive more from variance among social norms, than from race, sex,

(listing, as an example, that listening to rap music may be one example of a socially charged activity. Rap music is the subject of some debate, and it calls to mind preconceived notions of rap artists and the kinds of activities in which rap artists engage).

13. *Id*. at 3.

14. *See* discussion *infra* Section III.C.1 (explaining the "white male" effect).

15. *See infra* note 176 and accompanying text.

16. Kahan et al., *supra* note 11, at 3. It also may be the case that oversensitivity to risk derives from perceived threats to one's cultural identity.

17. *Id*. at 1.

18. *Id*. at 30-32.

19. *Id*.

20. *Id*. at 3.

political affiliation, or any other personal characteristic.[21]

The Yale research provides evidence of the general population's CIP risk assessment bias related to gun control, environmental protection, and abortion availability policies—issues that have generated a great deal of political controversy.[22] This Article proposes that CIP risk assessment may systematically bias director decision-making. The basic premise is that directors of publicly traded U.S. corporations are not immune from the effects of bias driven by CIP cognition. In addition, this Article is grounded in the notion that directors may predominantly subscribe to hierarchical worldviews. A majority of the directors of large, publicly-held corporations are white males who are affluent and highly educated, and who hold executive positions or are retired from executive positions.[23] Demonstrated ability to lead in a hierarchical organizational structure, to act quickly and decisively, and to commit to a decision are some of the attributes of individuals who achieve top management positions.[24] These behavioral characteristics are consistent with hierarchical and individualistic norms.

Moreover, this Article argues that directors' decision-making may involve risk-taking with respect to matters that may carry a social charge. For example, director monitoring of conflict of interest transactions, decisions regarding executive and director compensation, and recommendations to pursue or, more frequently, to terminate shareholder derivative litigation are controversial corporate governance issues. Generally, the public has a negative perception of directors who award and receive high compensation packages, or who sit on boards of

21. *Id.*

22. *Id.* at 10-12. *See also* discussion *infra* Section III.C.2.

23. A recent study of Fortune 1000 companies demonstrated that women were represented on 82% of corporate boards; 76% of Fortune 1000 boards included at least one ethnic minority. *See* Lisa M. Fairfax, *Some Reflections on the Diversity of Corporate Boards: Women, People of Color, and the Unique Issues Associated with Women of Color*, 79 ST. JOHN'S L. REV. 1105, 1107 (2005). The number of companies with ethnic and gender diversity generally has increased over the last ten years. *See* Business for Social Responsibility, Issue Brief: Board Diversity Recent Developments, http://www.bsr.org/CSRResources/IssueBriefDetail.cfm?DocumentID=443 (last visited November 7, 2007). The number of women and minorities as a percentage of the total number of board seats remains small. For example, as of September 30, 2004, 1,195 board seats existed on Fortune 100 companies, 16.9% of those were held by women, 14.9% were held by minorities. THE ALLIANCE FOR BOARD DIVERSITY, WOMEN & MINORITIES ON FORTUNE 100 BOARDS 4 (2005), http://www.catalystwomen.org/files/full/ABD%20report.pdf. Moreover, individuals held an average of 1.2 board seats. *Id.* at 5. African-American directors held an average of 1.5 board seats. While only one corporation had no women on its board, it was not uncommon to find a board with no minorities, particularly no Asian-Americans or Hispanic Americans. *Id.* at 6.

24. *See* Troy A. Paredes, *Too Much Pay, Too Much Deference: Behavioral Corporate Finance, CEOs, and Corporate Governance*, 32 FLA. ST. U. L. REV. 673, 697-701 (2005).

corporations that reveal long-standing accounting fraud.

Further, the article presents two strategies to neutralize the impact of CIP risk assessment on corporate decision-making. One possible strategy may be that courts give greater scrutiny to directors' decisions that particularly may be prone to risk assessment bias. Generally, courts assume that directors' decisions may be biased due to conflicts of interest arising from financial factors and familial relationships. Courts may give greater scrutiny to directors' decisions if the board is operating under a conflict of interest at the time of the transaction, or may give more deference to decisions made by a board (or a board committee) free from conflict. However, courts also assume that other incentives, such as a need to protect one's cultural identity, will not influence directors' decisions (at least not in any way that regulation needs to address). Courts may have underestimated the extent to which such cognitive bias influences director behavior. The Yale study provides evidence that judges may need to take into account directors' worldview biases when reviewing directors' decisions.

Moreover, courts take as a given that boards engage in risk-benefit analysis when making decisions, and, absent a conflict of interest, courts only look to whether the board was properly informed about the risks and benefits. However, the Yale study's results suggest that courts should discount board risk evaluation due to "cognitive biases and errors," at least in some circumstances that currently do not receive close judicial review.[25] In these circumstances, courts should engage in some hindsight evaluation of corporate actions because there is a high probability that the board's risk evaluation expresses an inappropriate, extreme individualistic and hierarchical norm that does not comport with the best interests of the shareholders and other corporate constituencies.

If CIP risk assessment affects board behavior, then the Yale study's results suggest that boards may need to take steps to ensure diversity in worldviews, as well as gender and race diversity, on corporate boards. The second strategy may be to encourage directors to ensure that the various worldviews are well represented on corporate boards. This may be accomplished in part by educating directors about differing worldviews and about the costs and benefits of diversity in worldviews on corporate boards. Director education at least may raise awareness of bias to a conscious level. As a result, boards may seek board candidates with diverse worldviews. Also, boards may assign a director (or committee) the task of "chief naysayer"—someone whose questions

25. Kahan et al., *supra* note 11, at 35.

would arise from worldviews not represented by the majority of the board.[26]

Further, the Article suggests that although CIP cognition affects all directors, non-management directors may be better situated (after education) than management directors to provide a voice on the board to counteract the effects of CIP cognition.[27] Non-management directors generally are not involved in day-to-day corporate operations. Also, non-management directors often are free from financial ties to the corporation, other than receiving director compensation. It may be that many types of bias influence director behavior; non-management directors may have less baggage to address. Moreover, non-management directors are supposed to behave according to legal and business norms that require non-management directors to exercise unbiased oversight. However, it is conceivable that a director without financial or familial ties to the corporation or its executives may be more likely to become aware of bias and take steps to neutralize its effects.

A longstanding debate exists about the non-management director's proper role—protector of the shareholders or protector of other constituencies, including employees and others, sometimes at the expense of the shareholders.[28] Empirical literature on this issue has

26. Paredes, *supra* note 24, at 740-41.

27. Courts and commentators use different terms to describe non-management directors, including "independent," "disinterested," "nonexecutive," and "outside," and use different terms to describe the ability of non-management directors to render unbiased judgments. In this Article, I will borrow a term from a recent article by Donald C. Clarke that simply describes that the directors are not managers of the firm, and implies as little as possible about the directors' ability to exercise unbiased judgment, "non-management directors." *See* Donald C. Clarke, *Three Concepts of the Independent Director*, 32 DEL. J. CORP. L. 73, 83-84 (2007). Management directors hold executive positions within the corporation, such as Chief Executive Officer and Chief Financial Officer. Non-management directors do not hold executive positions within the corporation. Non-management directors are often senior executives at other corporations, public sector employees who are influential in political circles or in some other way influential in the corporation's business, well-regarded academics, or former or current counsel to the corporation. *Id*. at 79.

28. Much of this debate originally was descriptive as well as normative. Adolf A. Berle and Gardiner C. Means wrote their seminal piece on the role of directors and the agency cost problem in corporate governance at the end of a transformative period in American business. ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (Commerce Clearing House, Inc., 1933) (1934). Berle and Means argued that shareholders were becoming more numerous and more dispersed and that managers often did not have equity positions in the corporation. *Id*. at 47, 119-21. They posited that these facts would give rise to agency cost problems. *Id*. at 121-25. In other words, corporate managers no longer had the incentive to maximize value as owners, because managers generally were not owners. Instead, managers had incentives to minimize the amount of work they had to do and maximize the salary they would receive. Further, shareholders were too dispersed to take collective action easily, generally too uninterested to put out the effort to take action, and willing to let other shareholders bear the burden

sought to determine whether having a majority of non-management directors improves corporate financial performance. This literature also seeks to provide a basis for making policy decisions about the need for, and functions of, non-management directors.[29] The studies' results are mixed.[30] Some researchers suggest that non-management directors' presence on corporate boards does little to improve corporate performance, while other evidence shows some benefit gained when independent directors perform certain functions on board committees.[31]

This Article does not recommend that non-management directors are the solution to the problem of CIP risk assessment on corporate boards. Also, it does not attempt to take a position about the proper role for non-management directors. This Article suggests that, indeed, under our current corporate governance system, CIP risk assessment bias may be a difficult problem to solve. There may be very few directors who are capable of exercising unbiased judgment in any directorial role.[32] To my knowledge, there is no empirical study to determine whether non-management directors exercise more or less biased risk assessment than management directors. Risk perception studies of directors' behavior might provide answers.

Section II explores directors' various roles and functions. Empirical studies of director behavior and how they perceive their roles and functions are few and far between. Part A describes non-management directors' roles and functions as stated in best practices of corporate governance industry groups and institutional investor literature. Part B similarly discusses the roles and functions of the management director. Part C discusses state and federal review of directors' actions. Section III discusses the empirical evidence. Part A discusses some of the ways that risk assessment plays a role in corporate

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of keeping management in check. *Id*. The Berle and Means piece became the keystone for the shareholder primacy debate. *See* Clarke, *supra* note 27, at 85 n.41. The debate has transformed from one mostly that seeks to describe the role of the director in corporate governance, to one that mostly seeks to state normatively and prescriptively what the directors' role should be. *See id*. at 79 n.30, 84-85 (citing literature on the role of the board of directors in corporate governance, and the shareholder versus stakeholder primacy debate).

29. *See generally* Dennis Wright Michaud & Kate A. Margaram, *Recent Technical Papers on Corporate Governance* 2 (Brown U. Corp. Governance Program, Working Paper, 2006), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=895520.

30. *See id*. *See also* Clarke, *supra* note 27, at 75 (citing recent literature).

31. *See, e.g.*, Clarke, *supra* note 27, at 75-76; Usha Rodrigues, *The Fetishization of Independence* 1, 4 (U. Ga. Research Paper Series, Paper No. 07-007, 2007), *available at* http://ssrn.com/abstract=968513.

32. *See, e.g.*, Larry Cata Backer, *Director Independence and the Duty of Loyalty: Race, Gender, Class and the Disney-Ovitz Litigation*, 79 ST. JOHN'S L. REV. 1011, 1079-86 (2005).

law and how emotions and cognitive bias impact risk assessment. Part B introduces theoretical and empirical research on how an individual's demographic characteristics and cultural norms impact risk assessment. In addition, Part B discusses the Yale study on cultural bias and the white male effect. This part suggests that cognitive bias is inherent on publicly traded boards and effects board perception of risk-taking.[33] Section IV discusses what the Yale study may add to our understanding of cognitive bias on corporate boards. It further develops the idea that there is no such person as an unbiased director, and that bias systematically influences board decision-making. Section IV discusses possibilities for legal rule reform and director education as ways to neutralize or mitigate the effects of CIP risk assessment bias. Each subpart of Part A discusses potential strategies to neutralize the effects of CIP risk assessment bias. Part B discusses objections to the strategies offered in Part A and offers counterarguments to those objections. Section IV's mitigation strategies suggest a framework for further studies of director behavior. Possible theoretical and empirical studies are described in Section V. As one legal scholar recently warned, "caution is warranted before corporate governance is revamped radically to address CEO overconfidence or other aspects of managerial psychology."[34] The Conclusion stresses that making directors more aware of worldview bias likely requires more than one legal, cultural or cognitive change. Further study may shed light on the types of change warranted.

II. THE ROLES AND FUNCTIONS OF THE BOARD OF DIRECTORS OF PUBLICLY HELD UNITED STATES CORPORATIONS

In the United States, state law primarily defines the role of the board of directors with respect to governing the corporation, relationships with the shareholders and other corporate constituencies, and other matters of corporate governance.[35] State law does not list detailed responsibilities and functions of the board of directors; instead state corporations statutes broadly define director responsibilities and functions.[36] Specifically, matters such as appointment of the chief

33. *See infra* note 181 and accompanying text.

34. Paredes, *supra* note 24, at 681.

35. *See id*. at 147.

36. *See, e.g*. MODEL BUS. CORP. ACT § 8.01 (2005) ("All corporate powers shall be exercised by or under the authority of the board of directors of the corporation, and the business and affairs of the corporation shall be managed by or under the direction, and subject to the oversight of its board of directors. . . ."); 8 DEL. C. § 141(a) (West 2007) ("The business and affairs of every corporation

officers responsible for day-to-day corporate operations; managing the director election process; setting salaries and compensation of directors and officers; distributing corporate assets; formulating corporate strategy; recommending major corporate business action to shareholders; disseminating information about the company's finances and other important business matters; ensuring adequate information flows from the top down and the bottom up; hiring and overseeing auditors; and managing corporate litigation are all within the ultimate authority of the board under state statutes and state case law.[37]

Recently, and to a greater extent than in the past, federal law also impacts corporate governance. For example, the Sarbanes-Oxley Act ("SOA") and the Securities and Exchange Commission ("SEC") and self-regulatory rules promulgated thereunder, prescribe the composition[38] and responsibilities[39] of a publicly-traded corporation's audit committee, and the composition[40] and responsibilities[41] of the corporation's compensation committee.[42]

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organized under this chapter shall be managed by or under the direction of a board of directors. . . ."); CAL. CORP. CODE § 300(a) (West 2007).

> The business and affairs of the corporation shall be managed and all corporate powers shall be exercised by or under the direction of the board. The board may delegate the management of the day-to-day operation of the business of the corporation to a management company or other person provided that the business and affairs of the corporation shall be managed and all corporate powers shall be exercised under the ultimate direction of the board.

Id.

37. *See, e.g.*, 8 DEL. C. § 121(a) (West 2007).

> In addition to the powers enumerated in Section 122 of this title, every corporation [and] its . . . directors . . . shall possess and may exercise all the powers and privileges granted by this chapter or by any other law or by its certificate of incorporation, together with any powers incidental thereto. . . .

Id. Section 122 states that:

> [e]very corporation created under this chapter shall have power to: . . . (2) sue and be sued . . . in its corporate name; . . . (5) appoint such officers and agents as the business of the corporation requires and . . . pay . . . them suitable compensation.

8 DEL. C. § 122 (West 2007). Section 141(a) empowers directors to manage or to direct the management of the corporation. Section 170(a) authorizes directors to declare dividends. Section 213(a) empowers directors to fix the record date to determine stockholders entitled to vote at a meeting of stockholders. Section 251(b) requires that directors adopt a resolution "approving an agreement of merger" prior to submitting the agreement to the stockholders. *See* 8 DEL. C. §§ 141, 170, 213, 251 (West 2007).

38. Sarbanes-Oxley Act § 301 (codified at 15 U.S.C.A. § 78j-1(m)(3) (West Supp. 2002)) (amending the Securities Exchange Act of 1934, § 10A(m)(3)).

39. Sarbanes-Oxley Act § 301 (codified at 15 U.S.C.A. § 78j-1(m)(2) (West Supp. 2002)) (amending the Securities Exchange Act of 1934, § 10A(m)(2)).

40. *See* NYSE, Inc., Listed Company Manual § 303A.05(a) (2004), http://www.nyse.com/pdfs/section303A_final_rules.pdf.

Board members of publicly traded corporations are either employed by the corporation as corporate officers and executives or are not employed by the corporation in a management function.[43] This Article will use the term "management directors" to describe directors who are employed as corporate officers and executives; it will borrow the term "non-management directors" to describe directors who do not hold corporate management positions.[44] The distinction is important for a number of reasons. First, state and federal law envision different roles for management directors versus non-management directors.[45] Second, empirical studies investigate whether there is a relationship between disinterested and independent directors on corporate boards—as a practical matter these are usually non-management directors—and corporate performance.[46] Third, to the extent that cognitive bias deriving from management positions or conflicts of interest—such as chief executive overconfidence and structural bias—influence director decision-making, directors without such bias may be better situated to exert an unbiased influence on board decision-making processes.

A. What Do Non-management Directors Do and What Roles and Functions Does U.S. Federal and State Law Envision for Non-management Directors?

Non-management directors are in the best position to describe what

41. *See* NYSE, Inc., Listed Company Manual § 303A.05(b)(i) (2004), http://www.nyse.com/pdfs/section303A_final_rules.pdf.

42. *See* Regina F. Burch, *Director Oversight and Monitoring: The Standard of Care and the Standard of Liability Post-Enron*, 6 WYO. L. REV. 482, 504-06 (2006) (describing corporate directors' and officers' fiduciary standards of care after SOA).

43. Indeed, under SOA a corporation must have non-management directors on the board to fulfill the requirements of SOA § 301 and the stock exchange listing rules specified in *supra* notes 40-41. According to a recent survey, virtually all publicly traded corporation boards have a majority of non-management directors.

44. The term non-management director simply describes a director who currently is not part of the corporation's management team. I use the term non-management director throughout this Article because it implies nothing about whether the director is independent or disinterested as those terms are used for purposes of compliance with state or federal law requirements. The legal requirements imposed by state and federal law may limit what a non-management director may do and still be in compliance with state or federal law. *See, e.g.*, Clarke, *supra* note 27, at 78-80.

45. *See infra* note 67 and accompanying text.

46. *See supra* note 27 and accompanying text. *See also* LAWRENCE D. BROWN & MARCUS L. CAYLOR, INSTITUTIONAL SHAREHOLDER SERVICES, CORPORATE GOVERNANCE STUDY: THE CORRELATION BETWEEN CORPORATE GOVERNANCE AND COMPANY PERFORMANCE 2-4 (2004), http://www.law.harvard.edu/programs/olin_center/corporate_governance/papers/Patrick-McGurn.pdf (independent board of directors, nominating committees, and compensation committees linked to improved firm performance).

they do, how they perceive their roles and functions, the content of their communications between other non-management directors and management directors, and whether or not they explicitly recognize the potential that their decision-making will be affected by cognitive bias. However, in the absence of narrative evidence from non-management directors, corporate industry groups, institutional investors and their groups, anecdotal evidence from comments to proposed federal and stock exchange regulations dealing with the issue of independence, news reports in connection with major corporate transactions and announcements, and after-the-fact investigations into allegations of board-level wrongdoing are probably the best sources of information on the roles and functions of non-management directors.[47]

For example, the California Public Employees' Retirement System's ("CalPERS") view of the role of the non-management director contemplates that the non-management director is an "independent director"—that is, one whose relationships with the company or its management would not foreclose the director from exercising unbiased judgment.[48] "Independence is the cornerstone of accountability"[49] and,

47. The body of empirical legal, economic, and management scholarship on independent directors is growing. *See, e.g.*, Barbara R. Bergmann, *Needed: A New Empiricism*, 4 THE ECONOMISTS' VOICE 1, 1-4 (2007), *available at* http://www.bepress.com/ev/vol4/iss2/art2. This growth stems from a renewed emphasis on corporate governance and accountability combined with calls from Congress, federal agencies, most notably the Securities and Exchange Commission, and stock exchange regulatory organizations for more independence on corporate boards. *Id*.

48. The California Public Employees' Retirement System is an organization that provides and administers health and retirement benefits to California's public employees and employers. *See* CalPERS Online, About CalPERS, http://www.calpers.ca.gov/index.jsp?bc=/about/home.xml (last visited August 2, 2007). CalPERS defines an "independent director" as a director who:

> [H]as not been employed by the Company in an executive capacity within the last five years;
>
> [I]s not, and is not affiliated with a company that is, an adviser or consultant to the Company or a member of the Company's senior management;
>
> [I]s not affiliated with a significant customer or supplier of the Company;
>
> [H]as no personal services contract(s) with the Company, or a member of the Company's senior management;
>
> [I]s not affiliated with a not-for-profit entity that receives significant contributions from the Company;
>
> [W]ithin the last five years, has not had any business relationship with the Company (other than service as a director) for which the Company has been required to make disclosure under Regulation S-K of the Securities and Exchange Commission;
>
> [I]s not employed by a public company at which an executive officer of the Company serves as a director; has not had any of the relationships described above with any affiliate of the Company;
>
> [A]nd is not a member of the immediate family of any person described above.

THE CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM, CORE PRINCIPLES OF ACCOUNTABLE CORPORATE GOVERNANCE 15 (1998), http://web.archive.org/web/20000918044843/www.calpers-

in CalPERS' view, accountability leads to good corporate governance. Moreover, CalPERS states that independence means the director has no "personal, financial or professional" conflicts of interest that would preclude the director from acting in the shareholder's best interests.[50]

In CalPERS' view, the non-management director is as influential as executive management, both in monitoring corporate activities and in creating strategic change. CalPERS recognizes that its vision may not be the best fit for all corporations but, significantly, stresses that the leadership of the board must embrace director independence.[51] Thus, if the lead board position—Chairman of the Board—also is held by the lead executive position—Chief Executive Officer—then CalPERS recommends that the independent directors appoint a lead independent director to coordinate the activities of the independent directors.[52] Specifically, the lead independent director would facilitate the flow of information to and among the non-management directors and between the non-management directors and the board's executive members, influence who would serve as directors on board committees and as committee chairs, and would facilitate the board's decision-making process, among other responsibilities.[53]

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governance.org/principles/domestic/us/downloads/us-corpgov-principles.pdf [hereinafter CORE PRINCIPLES].

49. CORE PRINCIPLES, *supra* note 48, at 4.

50. *Id*. at 5.

51. *Id*. at 6-7.

52. *Id*. at 5.

53. *Id*. at 14. The lead independent director's duties would include:

> [A]dvise the Chair as to an appropriate schedule of Board meetings, seeking to ensure that the independent directors can perform their duties responsibly while not interfering with the flow of Company operations;
>
> [P]rovide the Chair with input as to the preparation of the agendas for the Board and Committee meetings;
>
> [A]dvise the Chair as to the quality, quantity and timeliness of the flow of information from Company management that is necessary for the independent directors to effectively and responsibly perform their duties; although Company management is responsible for the preparation of materials for the Board, the Lead Independent Director may specifically request the inclusion of certain material;
>
> [R]ecommend to the Chair the retention of consultants who report directly to the Board;
>
> [I]nterview, along with the chair of the [nominating committee], all Board candidates, and make recommendations to the [nominating committee] and the Board;
>
> [A]ssist the Board and Company officers in assuring compliance with and implementation of the Company's [Governance Guidelines]; principally responsible for recommending revisions to the [Governance Guidelines];
>
> [C]oordinate, develop the agenda for and moderate executive sessions of the Board's independent directors; act as principal liaison between the independent directors and the Chair on sensitive issues;
>
> [E]valuate, along with the members of the [compensation committee/full board], the

According to the Business Roundtable ("BRT"), an association of chief executive officers and "an authoritative voice on matters affecting American business corporations,"[54] "making decisions regarding the selection, compensation and evaluation of a well-qualified and ethical CEO is the single most important function of the board."[55] In addition to selecting and overseeing the CEO and other corporate management who oversee the day-to-day operations of the corporation, the board's oversight responsibilities include:

> [P]lanning for management development and succession; understanding, reviewing and monitoring the implementation of the corporation's strategic plans; understanding and approving annual operating plans and budgets; focusing on the integrity and clarity of the corporation's financial statements and financial reporting; advising management on significant issues facing the corporation; reviewing and approving significant corporate actions; reviewing management's plans for business resiliency; nominating directors and committee members and overseeing effective corporate governance; and overseeing legal and ethical compliance.[56]

The directors delegate responsibility for managing the corporation's affairs to the chief senior executive.[57] However, the directors should "exercise vigorous and diligent oversight of a corporation's affairs."[58]

Similar to CalPERS, the BRT envisions that independent directors play a significant role, both in monitoring corporate affairs and in approving specific transactions.[59] According to the BRT, a board "should have a substantial degree of independence from management" when fulfilling its oversight role.[60] According to the BRT's governance principles, "[p]roviding objective, independent judgment is at the core of the board's oversight function and the board's composition should reflect this principle."[61]

> CEO's performance; meet with the CEO to discuss the Board's evaluation; and
> [R]ecommend to the Chair the membership of the various Board Committees, as well as selection of the Committee chairs in addition to the general duties of board members.

Id. at 13-14.

54. BUSINESS ROUNDTABLE, PRINCIPLES OF CORP. GOVERNANCE, 1 (2005), http://64.203.97.43/pdf/CorporateGovPrinciples.pdf.

55. *Id*. at 7.

56. *Id*. at 8-10.

57. *Id*. at 8.

58. *Id*.

59. *Id*.

60. *Id*. at 14.

61. *Id*.

The BRT's definition of independence appears narrower than the CalPERS definition, in that the BRT's definition excludes "business, employment, charitable or personal" relationships with the company or its management that in fact or appearance would render the director unable to exercise "independent judgment."[62] On the other hand, the CalPERS definition forecloses all relationships that might bias an independent director's judgment. However, the board as a whole determines whether a director is or is not independent, taking into account "the federal securities laws, securities market listing standards, *and the views of institutional investors and other relevant groups*."[63]

Furthermore, the BRT recommends that the board have independent leadership, either by separating the roles of CEO and chairperson of the board, by creating and filling a lead director position who plays a key role in evaluating the CEO's performance (among other roles), or by appointing a non-management director to preside over executive sessions of non-management directors.[64]

Federal and state laws and regulations embody various formulations of independence and envisage different roles and functions for non-management directors.[65] State statutes define independence with respect to whether the director has an interest in a particular transaction.[66] For example, non-management directors may review conflict of interest transactions and may determine if those transactions comply with a director's fiduciary duties at the state level. In this scenario, non-management directors function as "a substitute for external regulation" primarily at the state level and possibly as a gatekeeper to protect shareholders from director "overreaching."[67]

Federal law and related regulations appear to envision that non-management directors primarily protect shareholders from management's abuse of power and misuse of assets. SOA sets standards

62. *Id*.

63. *Id*. (emphasis added).

64. *Id*. at 15.

65. Clarke, *supra* note 27, at 79-84.

66. *See, e.g.*, MODEL BUS. CORP. ACT §§ 8.60-8.64; 8 DEL. C. § 144(a)(1) (West 2007). For a more detailed discussion of state law with respect to director independence in the context of conflict of interest transactions, see *infra* note 102 and accompanying text.

67. Clarke, *supra* note 27, at 80. The law may contemplate that non-management directors function as a brain trust, as protectors of minority shareholders' interests against the actions of dominant shareholders, as gatekeepers who use their voting power to ensure the corporation complies with external legal standards, as whistleblowers who alert external authorities to noncompliance with legal obligations, or as authorities who certify that the corporation is in compliance with law. *Id*. at 80-83. Conflict of interest transactions are sometimes described as "related party transactions." *See* MODEL BUS. CORP. ACT, §§ 8.60-8.64 (2005).

for audit committee independence and requires that the SEC require the stock exchange self-regulatory organizations to mandate that listed companies comply with the independence standards or face delisting.[68] Under SOA, independence is broadly defined as an absence of financial, business, and familial ties to the corporation.[69]

Stock exchange rules require independence on board committees, including the audit, nominating, and compensation committees.[70] Also, listed companies are required to have a certain number of independent directors.[71] Generally, independence is defined as a director who does not accept any compensatory fee from the corporation, other than fees accepted in his capacity as a director, and who is not an affiliate—a controlling shareholder—of the corporation.[72]

Commentators to the SEC's proposed rule implementing SOA's independence requirements point mostly to a concern among corporations that the federal rules may prove too inflexible to benefit corporations given the great variety among corporate governance structures, board compositions, and board member knowledge of auditing and accounting practices.[73] Also, commentators have

68. *See* Sarbanes-Oxley Act of 2002 § 301 (codified at 15 U.S.C. § 78j-1(m)(3)(B)). *See also* Standards Related to Listed Company Audit Committees, Exchange Act (as added by the Sarbanes-Oxley Act of 2002 § 301), 68 Fed. Reg. 18,788 (Apr. 16, 2003), *available at* http://www.sec.gov/rules/final/33-8220.htm.

69. *See* Sarbanes-Oxley Act of 2002 § 301 (codified at 15 U.S.C. § 78j-1(m)(3)(B)) (defining independence); Securities Exchange Act Rule 10A-3(b)(1) (17 C.F.R. § 240.10A-3) (defining "affiliated person" for purposes of section 301).

70. *See* NYSE, Inc., Listed Company Manual, *supra* note 40, at § 303A.04 (requiring that the nominating/corporate governance committee is "composed entirely of independent directors"). *See also id*. at § 303A.05 (requiring that the compensation committee is "composed entirely of independent directors"). The New York Stock Exchange requires that listed companies have audit committees that meet the requirements under Sarbanes-Oxley § 301. *See id*. at § 303A.06. *See also* NASDAQ, Inc., Manual § 4350(d)(2), *available at* http://www.complinet.com/nasdaq/display/display.html?rbid=1705&element_id=18 (requiring that the audit committee is composed entirely of independent directors). *See generally* Clarke, *supra* note 27, at 86-91 (comparing various committee powers under the SOA, the NYSE and Nasdaq rules). For discussion of enforcement of the independence requirements see *infra* Section II.C.3.

71. *See* NYSE, Inc., Listed Company Manual, *supra* note 40, at § 303A.01 (requiring that independent directors comprise a majority on listed company boards). *See also* NASDAQ, Inc., Manual, *supra* note 70, at § 4350(d)(2)(A) (requiring independent directors comprise a majority on listed company boards).

72. *See, e.g*., NYSE, Inc., Listed Company Manual, *supra* note 40, at § 303A.02; Securities Exchange Act Release No. 34-47516, 68 Fed. Reg. 14,451, 14,452 (Mar. 25, 2003); NASDAQ, Inc., Manual, *supra* note 70, at § 4350(c).

73. Commentators pointed out that perhaps the self-regulatory organizations were best suited to set additional independence criteria beyond the audit committee independence requirements. *See* Standards Related to Listed Company Audit Committees Exchange Act (as added by Sarbanes-Oxley Act of 2002 § 301) *supra* note 68, at § II.A.1.

expressed concerns about the potential lack of qualified individuals who could serve as independent board members.[74] However, many corporations already had some of the reforms in place.[75]

One rationale behind independence requirements at both the federal and state levels is that an independent director would be less likely to act due to cognitive bias and against shareholders' interests.[76] Whether defined on a transactional basis, as at the state level, or defined in the abstract and in the absence of a transaction, as at the federal level, all of the definitions of independence contemplate that a director truly can be systematically unbiased. However, the rules seek to address bias arising from financial and other ties to management, not worldview bias.

B. What Do Management Directors Do and What Roles and Functions Does U.S. Federal and State Law Envision for Management Directors?

According to CalPERS, the Chief Executive Officer's primary function is to manage the day-to-day operations of a company and to speak publicly on its behalf.[77] Additionally, the CEO recommends the company's policy and strategic direction, subject to board approval.[78]

The BRT provides a more detailed statement on the roles of the chief executive and senior managers. The CEO and senior management develop long-term strategic plans as well as annual operating plans and budgets and submit them to the board for approval.[79] Also, senior management is responsible for the day-to-day implementation of the strategic plan, management of the corporation's "overall risk profile," and preparation of the corporation's financial statements.[80]

The BRT emphasizes that the CEO should be "a person of integrity," who will, with senior executives, establish an ethical

74. *See, e.g.*, *id.* at § II.A.5 (discussing the SEC's attempt to balance independence requirements with the need to find qualified board nominees to serve on audit committees), § II(F)(1) (discussing the SEC's recognition that issuers may need time under the new rule to find qualified audit committee members).

75. For example, corporations increasingly had begun to appoint a majority of non-management directors on boards.

76. *See* Clarke, *supra* note 27, at 106. Clarke also discusses how the different functions give rise to different definitions of who is independent. *Id.* at 84-86.

77. CORE PRINCIPLES, *supra* note 48, at 17.

78. *Id.*

79. BUSINESS ROUNDTABLE, PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 54, at 10-11.

80. *Id.* at 11.

corporate culture.[81] To ensure ethical corporate operation, the Business Roundtable recommends that a CEO be "a person of integrity" responsible for the corporation's adherence to "the highest ethical standards."[82] Although independent directors may be ultimately responsible for a corporation's ethical climate, the senior executives are responsible for establishing and designing ethics compliance programs, and for ensuring the existence of a process to alert senior executives and the board to red flags indicating unethical corporate conduct.[83]

The standard of review for management directors' actions is the same essentially as the standard of review for non-management directors' actions. However, courts expect that management directors will be more familiar with day-to-day operations, and review management director actions with that expectation in mind.

The above discussion highlights that different behavioral norms exist for management and non-management directors, and that different expectations exist for management and non-management directors with respect to bias. The next section examines how state and federal law reviews director behavior, especially with regard to board risk evaluation and shareholder claims of structural bias.

C. State and Federal Review of Directors' Actions

1. State Court Review

Corporate directors owe a duty to act with due care, with loyalty, and in good faith.[84] Directors as a group are expected to exercise care in decision-making and to fully deliberate making the rational decisions of a reasonable director under like circumstances.[85] If they do, then absent a conflict of interest, courts grant their decisions deferential review under the business judgment standard of review.[86] If they do not, then directors may be required to prove that their actions are fair.[87]

81. *Id*. at 12.

82. *Id*.

83. *Id*.

84. *See, e.g.*, MODEL BUS. CORP. ACT § 8.30 cmt. (2005); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (overruled on other grounds).

85. *See* MODEL BUS. CORP. ACT § 8.30 cmt. (2005).

86. *See* Burch, *supra* note 42, at 503-06 (describing business judgment doctrine and court review of directors' decisions).

87. *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858, 893 (Del. 1985), *superseded by statute*, 8 DEL. C. § 102(b)(7) (West 2007). While Delaware's statute (and other states' statutes) authorizes corporations to eliminate directors' personal liability for breaches of the duty of care, the statute

Courts have at times applied an explicit or implicit, traditional, cost-benefit approach to review director decision-making.[88] Courts may examine whether directors engaged in proper deliberation of costs and benefits; however, under business judgment review, courts will not question whether directors properly weighed those costs and benefits.[89] Courts have found that those decisions lack due care in only a handful of cases.[90] For example, in *Joy v. North*, Judge Winter explained that the business judgment rule provides incentives for directors not to undertake "overly cautious" decisions.[91] The case involved a series of loans by Citytrust to Katz Corporation, a property developer that was undergoing increasing financial difficulties.[92] Judge Winter evaluated the plaintiff's likelihood of success in proving that the directors breached their duty of care by comparing the potential benefit of the loans—"the interest [that Citytrust] could have earned in less risky, more diversified loans"—to the potential risks—the loss of an increasingly large of amount of principal loaned to Katz.[93] Judge Winter found that the plaintiff's chances of success were high. (The bank was in a classic "no win" situation.)[94]

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does not authorize corporations to eliminate liability for breach of the duty of loyalty. *Id*. Further, in theory the statute *only authorizes* corporations to limit directors' personal liability—it does not eliminate directors' personal liability for due care breaches. In practice, directors rarely face personal liability for breach of due care.

88. For explicit cost-benefit analysis dealing with the application of the business judgment rule, see *Joy v*. *North*, 692 F.2d 880 (2d Cir. 1982), in which the court stated:

> [B]ecause potential profit often corresponds to the potential risk, it is very much in the interest of shareholders that the law not create incentives for overly cautious corporate decisions. Some opportunities offer great profits at the risk of very substantial losses, while the alternatives offer less risk of loss but also less potential profit. Shareholders can reduce the volatility of risk by diversifying their holdings. In the case of the diversified shareholder, the seemingly more risky alternatives may well be the best choice since great losses in some stocks will over time be offset by even greater gains in others. Given mutual funds and similar forms of diversified investment, courts need not bend over backwards to give special protection to shareholders who refuse to reduce the volatility of risk by not diversifying. A rule which penalizes the choice of seemingly riskier alternatives thus may not be in the interest of shareholders generally.

Id. at 886.

89. Proper evaluation of risk in these circumstances involves full consideration of the pros and the cons of a particular course of action.

90. *See* Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability*, 58 STAN. L. REV. 1055, 1089-93 (2006).

91. *Joy*, 692 F.2d at 886.

92. *See id*. at 882.

93. *Id*. at 896.

94. The court stated:

> The loss to Citytrust resulted from decisions which put the bank in a classic "no win" situation. The Katz venture was risky and increasingly so. By

Judge Winter compared the case to *Litwin v. Allen*, another example of explicit court review of director risk-taking strategies.[95] In *Litwin*, a bank purchased bonds with a seller's option to repurchase at the sale price.[96] If the market value of the bonds increased above the sale price (the option price) then the seller would repurchase the bonds at the lower price (the option price) and resell them at the market price. Thus, the purchaser would lose the difference between the sale price (the option price) and the value of the bonds at the time of repurchase. If the market value of the bonds decreased, then the seller would not repurchase the bonds. The buyer would sell the bonds on the market for less than the price at which he purchased them. The court found that the defendant directors who agreed to the terms of this deal breached their fiduciary duty to the shareholders because the directors entered into a transaction in which there was no possibility of a gain on the original sale.[97]

Management directors may be held to a higher standard of care under some state statutes.[98] Management directors are expected to know more about day-to-day operations and to use that knowledge fully when making decisions.[99] Courts at times, again implicitly or explicitly, indicate that management directors' actions will be reviewed under a somewhat more exacting standard.[100] Nonetheless, management directors are protected by the business judgment doctrine, exculpatory provisions, and directors' and officers' liability insurance.[101]

If a plaintiff claims that directors breached the duty of loyalty,

> continuing extensions of substantial amounts of credit the bank subjected the principal to those risks although its potential gain was no more than the interest it could have earned in less risky, more diversified loans. In a real sense, there was a low ceiling on profits but only a distant floor for losses.

Id.

95. Litwin v. Allen, 25 N.Y.S.2d 667 (N.Y. 1940).

96. *See id*. at 676.

97. *Id*. at 697-98. In the traditional language of investment risk assessment, the court stated:

> Although, as I have said, there is no case precisely in point, it would seem that if it is against public policy for a bank, anxious to dispose of some of its securities, to agree to buy them back at the same price, it is even more so where a bank purchases securities and gives the seller the option to buy them back at the same price, *thereby incurring the entire risk of loss with no possibility of gain* other than the interest derived from the securities during the period that the bank holds them.

Id. (emphasis added).

98. *See, e.g.*, MODEL BUS. CORP. ACT § 8.31.

99. *See id*.

100. *See, e.g.*, Smith v. Van Gorkom, 488 A. 2d 858, 889 (Del. 1985), *superseded by statute*, 8 DEL. C. § 102(b)(7) (West 2007) (all directors took a unified position on the legal issues and so were treated as one).

101. *See* Black et al., *supra* note 90, at 1089-94.

courts first review whether the directors (or a board committee) were disinterested and independent with respect to the challenged transaction.[102] Definitions of disinterest and independence vary, but generally a director is interested in the transaction if he or she has a financial interest in the transaction (or if he or she has a familial relationship with someone who has a financial interest in the transaction), and a director lacks independence if the director cannot make a decision uninfluenced by management.[103] For example, a significant financial interest in the transaction, including a philanthropic interest, may render a director not disinterested.[104] A significant incentive to remain on the board of directors, such as stock options that only vest if a director remains on the board, may render a director non-independent.[105] However, "[a]llegations of mere personal friendship or a mere outside business relationship, standing alone, are insufficient to raise a reasonable doubt about a director's independence."[106]

Common law rules require a review of the entire fairness of directors' decisions if there are conflicts of interest, absent approval or ratification of the transaction by disinterested and independent directors, or by a majority of disinterested shareholders.[107] One rationale for strict review is that if a conflict of interest exists, then there is a higher risk that director self-interest will bias assessment of the costs and benefits of a decision. Entire fairness review is the mechanism state courts use to

102. *See, e.g.*, MODEL BUS. CORP. ACT §§ 8.60-8.63. Historically at common law, conflict of interest transactions were void. Over time, courts developed a doctrine of judicial review of conflict transactions. Under this review, conflict transactions were voidable if the transactions were "unfair" to the corporation or to shareholders. In reviewing these transactions, courts examine whether the price and other terms of the deal are fair, and whether the negotiations (between the parties) were fair. Moreover, courts have developed mechanisms by which directors, officers and controlling shareholders may seek from shareholders or independent directors prior approval or ratification of self-interested transactions. MELVIN AARON EISENBERG, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS 434-63 (Foundation Press, 9th ed. 2001).

103. *See* MODEL BUS. CORP. ACT § 8.60.

104. Michael Bobelian, *Uncompromising Friendship*, 4 CORP. COUNS. 6, 38 (2004) ("Last summer a Delaware Chancery Court judge ruled that Joseph Grundfest couldn't be considered an independent director at Oracle Corporation because the company had significant philanthropic ties to Stanford University, where Grundfest is a law professor ["Non-Independence Day," August 2003].").

105. *Id.* ("[T]his past January another chancery court judge found that Scott Cook wasn't an independent director at eBay, Inc., because he held stock options in the company that would vest only if he remained on the board." Cook's future appointment as a director, "in turn, rested with eBay's non-independent directors ["Spinning into Trial," April].").

106. Beam v. Stewart, 845 A.2d 1040, 1050 (Del. 2004) (noting that directors' personal ties to Stewart did not render them non-independent and unable to make unbiased decisions about whether derivative litigation should proceed).

107. *See, e.g.*, Lewis v. Austen, 1999 WL 378125, at *4 (Del.Ch. June 2, 1999).

ensure that corporations and shareholders are not harmed by directors' pecuniary conflicts of interest.[108] Under this standard, courts review directors' actions to determine whether, in the course of a transaction, the shareholders on the whole received a fair value for their investment and if the process by which directors negotiated the transaction mimics an arms length bargaining process.[109] Director action—for example, compensation decisions, special litigation committee recommendations, and management buy-outs and other related-party transactions—which would otherwise receive review under the entire fairness standard, are subject to the more deferential business judgment standard if the transaction is approved or ratified by independent and disinterested directors (or majority shareholders).[110]

As a practical matter, non-management directors often are disinterested and independent with respect to conflict of interest transactions.[111] Non-management director review and approval cleanses board decisions that may be subject to shareholder attack due to board conflicts of interest.[112] Thus, in practice, a disinterested, independent, non-management director's most important function from a state court litigation perspective is to monitor related party transactions for compliance with law and insulate the board from shareholder suits for conflict of interest transactions.[113] Again, under statutory approaches, an unfair transaction that has not been reviewed and approved by independent and disinterested non-management directors may be overturned by the court. In these situations directors may be subject to monetary penalties.[114]

2. State Judicial and Legislative Approaches to Shareholder Claims of Director Bias

Bias is commonly viewed as "a particular tendency or inclination, esp[ecially] one that prevents unprejudiced consideration of a question;

108. *See* Clarke, *supra* note 27, at 104 (explaining whether state law independence requirements work to protect shareholders from overreaching depends on whether shareholders sue and whether courts fairly will judge the case).

109. *See In re* Walt Disney Co. Deriv. Litig., 907 A.2d 693, 751 (Del. Ch. 2005).

110. *See Lewis*, 1999 WL 378125, at *4.

111. *See* Clarke, *supra* note 27, at 106 (explaining protection from litigation may be one reason why corporations appoint independent directors to boards).

112. *See* MODEL BUS. CORP. ACT §§ 8.61-8.63.

113. *See* Clarke, *supra* note 27, at 107-08.

114. *See* MODEL BUS. CORP. ACT § 8.31.

prejudice."[115] Social science researchers have identified several forms of bias, including status quo bias, overconfidence bias, availability effect, and probability neglect. Also, courts have recognized the threat that cognitive bias may "corrupt the directors' judgment."[116] However, legal norms reflect a limited view of influence-corrupting bias, whereas, social science research suggests a broader view of bias that distorts decision-making and risk perception.[117]

Given the availability and use of mechanisms to cleanse conflict transactions, state courts have taken a somewhat skeptical view to shareholder claims that directors' decisions are nonetheless biased.[118] A plaintiff who challenges whether a director is disinterested and independent may succeed on her claim if she can prove facts demonstrating that the board either lacked independence or had a financial, business, or personal interest in the transaction.[119] In contrast, courts often disregard claims that directors are biased due to a "there but for the grace of God go I"-type sympathy for defendant directors, or due to other incentives.[120] Certain types of bias fail to indicate a conflict of interest without additional evidence of improper influence.[121]

3. Federal Review

Corporate boards face different requirements with respect to director independence under federal law.[122] The rules contemplate that there is a need for systematic board independence, regardless of the existence of related-party and other conflict of interest transactions.[123] Thus, under federal law the distinction between non-management directors and management directors is important for compliance with stock exchange rules.

A cause of action for breach of fiduciary duty *per se* does not exist under federal statutes or federal common law. Enforcement of federal independence requirements includes liability under the federal securities

115. THE RANDOM HOUSE WEBSTER'S UNABRIDGED DICTIONARY 202 (2d ed. 2006).

116. James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 L. & CONTEMP. PROB. 83, 108 (1985).

117. *See id*. at 85-108.

118. *See* Lewis v. Austen, 1999 WL 378125, at *4 (Del.Ch. June 2, 1999).

119. *Id*.

120. Zapata Corp. v. Maldonado, 430 A.2d 779, 787 (Del. 1981).

121. Beam v. Stewart, 845 A.2d 1040, 1053-54 (Del. 2004).

122. *See* discussion *supra* note 44 and accompanying text.

123. *See* Clarke, *supra* note 27, at 84 (explaining that a theme in corporate law scholarship is that independent directors serve as a check on the agency cost problem).

laws for false or misleading disclosures and delisting for noncompliance with self-regulatory organization rules.

III. EMPIRICAL APPROACHES AND EVIDENCE

The body of empirical research on the relationship between outside directors, independent directors, and corporate performance has grown in recent years.[124] This research is not wholly persuasive that the presence of outside or independent directors has a positive impact on economic measures of firm success, such as stock price or higher tender offers for target company stock.[125] Thus, some use the research results to question the value of rules-based independence regimes, such as that exemplified by SOA and the listing exchanges.[126]

Others point to the fact that some studies rely on directors' reports of independence; boards may use inconsistent standards to determine if directors are independent. Also, cross-study comparisons are difficult because some examine whether having *non-management* directors on the board has a positive impact on economic measures of firm success, while other studies examine whether having *independent and disinterested* directors on the board has a positive impact on economic measures of firm success. As described above, non-management directors are not necessarily disinterested or independent under state and federal law. To some degree, the studies try to determine whether value exists when unbiased (as in independent and disinterested) directors monitor corporate executives.

Recent empirical research conducted by Yale Law School's Cultural Cognition Project may provide a different view of cognitive bias on corporate boards. The Yale researchers sought (and continue to gather) data to test a theorized connection between a respondent's cultural identity, demographic characteristics such as gender and race, and perceptions of risks attributed to certain socially charged policies—gun control, environmental control, and access to abortions. The researchers sought an explanation for the "white male effect"—a phrase that refers to research findings that a discrete group of white males consistently rate the risks of a variety of hazards (e.g., climate change, cigarette smoking, street drugs, and AIDS) at a much lower level than females and nonwhites.[127] When compared to the rest of the study

124. *See* Michaud & Margaram, *supra* note 29, at 5-10.

125. *See* Rodrigues, *supra* note 31, at 19-21.

126. *See id*. at 53-54.

127. Melissa L. Finucane, Paul Slovic, C.K. Mertz, James Flynn & Theresa A. Satterfield,

population, these men were more highly-educated, affluent, and politically conservative than the other respondents. The Yale researchers hypothesized that the "white male effect" may be an artifact of the norms generally held by this group of white males and the social roles threatened or supported by certain social policies embedded in regulation. Corporate law also embodies certain policy choices; these policy choices have lately become hotly contested.[128] The Yale study may illuminate how cultural norms, race, and gender interact to influence board evaluation of risks and decision-making.

After a discussion of how risk evaluation operates in corporate law, the section summarizes the theory of CIP cognition and the results of the Yale study on this type of cognitive bias.

A. The Role of Risk in Corporate Law

Generally, risk is narrowly defined as "exposure to the chance of injury or loss."[129] In this narrow context, risk is assessed by weighing the expected benefits versus the expected costs. A more expansive definition of risk includes not only an assessment of an expected benefit versus an expected cost, but also "considerations such as uncertainty, dread, catastrophic potential, controllability, equity [and] risk to future generations."[130] Risk is often defined in the context of a specific field.[131] For example, in the context of investment decisions an accepted definition of risk is "the chance that an investment's actual return will be different than expected."[132]

Gender, Race and Perceived Risk: The 'White Male' Effect, 2 HEALTH, RISK & SOC'Y 159, 160 (2002). The complete list of twenty-five hazards, from higher perceived risk to lower perceived risk, is: cigarette smoking, street drugs, AIDS, stress, chemical pollution, nuclear waste, motor vehicle accidents, drinking alcohol, sun tanning, ozone depletion, pesticides in food, outdoor air quality, blood transfusions, coal/oil burning plants, climate change, bacteria in food, nuclear power plants, food irradiation, storms and floods, genetically engineered bacteria, radon in homes, high-voltage power lines, VDTs [video display terminals], medical X-rays, and commercial air travel. *Id*. at 161.

128. The policy choices perhaps are not as hotly contested as the policies underlying the regulation of abortions, the environment, and access to guns. However, recent changes in federal corporate law have been highly politicized.

129. THE RANDOM HOUSE WEBSTER'S UNABRIDGED DICTIONARY 1660 (2d ed. 2006). A review of several sources reveals that risk is generally defined as a weighing of expected loss or injury.

130. Paul Slovic, *Trust, Emotion, Sex, Politics, and Science: Surveying the Risk Assessment Battlefield*, 1997 U. CHI. LEGAL F. 59, § I.C. (1997).

131. *See, e.g.*, Dictionary.com, Risk, http://dictionary.reference.com/browse/risk (last visited Aug. 16, 2007) (listing thirteen definitions of risk, in several contexts including insurance, medicine, crime, and investments).

132. *Id.*

The notion of risk—defined as weighing the expected benefits of a transaction versus the expected costs—in the context of corporate governance is part of the foundation of corporate law. For example, the "traditional" conception of the corporation is that it exists for the pecuniary benefit of its shareholders. A corollary is that the function of corporate management is to operate the corporation to maximize shareholders' pecuniary gain. Some disagree with this traditional conception of the function of corporations and corporate executives. But even these commentators use the language of risk assessment; that is, they discuss corporate and executive goals in terms of maximizing shareholders' or stakeholders' gain given the risk characteristics of certain strategies.[133]

Shareholders are expected to diversify to minimize investment risks due to economic cycles, bad management, and other risk factors.[134] For example, in *Basic v. Levinson*, the United States Supreme Court adopted the notion that public securities markets are efficient – that is, all publicly known information is reflected in the price of shares.[135] This efficient capital markets theory presupposes that shareholders may diversify stock holdings, and reduce shareholder's risk of bad decision-making on the part of the management of any particular company.[136] The notion of shareholder diversification underlies elements of a federal cause of action against public company directors and management for misstatements and omissions in violation of the Securities and Exchange Act of 1934 Section 10(b).[137]

Courts, at times explicitly but more often implicitly, acknowledge that boards engage in risk assessments.[138] Courts reason that generally directors are in a better position to weigh the costs and benefits of a particular business decision—from selling the corporation's assets to devising internal controls—than are judges and legislators.[139] Under the business judgment doctrine, courts give great deference to the unbiased, good faith decisions of directors—even if later events prove that the directors' assessment of the risks was incorrect.[140] Courts give lesser

133. Henry T.C. Hu, *New Financial Products, The Modern Processor Financial Innovation, and the Puzzle of Shareholder Welfare*, 69 TEX.L.REV. 1273, 1278-83 (1991).

134. Joy v. North, 692 F.2d 880, 886 (2d Cir. 1982).

135. Basic, Inc. v. Levinson, 485 U.S. 224, 245-49 (1988).

136. *Joy*, 692 F.2d at 886.

137. *Id.*

138. *See infra* note 229. *See also* Cox & Munsinger, *supra* note 116, at 85-86, 108-09.

139. Cox & Munsinger, *supra* note 116, at 109.

140. *See* Smith v. Van Gorkom, 488 A. 2d 858, 873 (Del. 1985), *superseded by statute*, 8 DEL. C. § 102(b)(7) (West 2007)).

deference to decisions involving board conflicts of interest and little or no deference to fraud, illegal conduct, and bad faith board decisions.[141] For example, if the risks are entirely business risks, courts and legislatures defer to the judgment of business persons and the risk of loss for bad or negligent director decision-making falls on the shareholders.[142] Alternatively, if a business risk arises from conflicts of interest, courts and legislatures give less deference to the judgment of business persons; the risk of loss for fraudulent, illegal, and bad faith conduct falls on the directors.[143]

The above discussion is not an exhaustive explanation of the positive and normative values assigned to the function of risk in corporate law. Instead, it offers some illustrations of the importance of the risk assessment concept in regulating and governing corporations.

B. Emotions and Risk Perception

Recent studies show that individuals lack information, time, and capacity to maximize their utility and make decisions in their own best interests—that is, to act as rational economic actors.[144] Instead they resort to heuristic substitutes to evaluate risks.[145] One heuristic substitute is emotion—i.e., individuals often act out of their emotions and not out of a rational evaluation of utility-maximizing strategies.[146] When individuals rely on an affective response, their actions reflect bias because emotions distort information processing.[147]

A court may be willing to tolerate a certain amount of emotionally distorted information processing. For example, courts may assume that the greater the amount of compensation received, the more likely the compensation will influence the director's judgment.[148] Director

141. *See, e.g.*, *Joy*, 692 F.2d at 886 ("[B]usiness judgment rule extends only as far as the reasons which justify its existence. Thus, it does not apply in cases in which corporate decision lacks business purpose, is tainted by conflict of interest, is so egregious as to amount to a no-win decision, or results from obvious and prolonged failure to exercise oversight or supervision." (internal citations omitted)).

142. *See* Cox & Munsinger, *supra* note 116, at 108-09.

143. Bernard Black, Brian Cheffins, and Michael Klausner recently conducted a study that shows that boards rarely bear the risk of loss due to a combination of exculpatory provisions, insurance provisions, and state statutes that allow indemnification of directors' expenses for the costs of defending a law suit. *See supra* note 90 and accompanying text.

144. Kahan, *supra* note 12, at 2.

145. *Id*.

146. *Id*.

147. *Id*. at 2-3.

148. *See, e.g.*, Beam v. Stewart, 845 A.2d 1040, 1050-54 (Del. 2004) (balancing evidence of friendship versus evidence of a professional reputation to be upheld).

compensation of $250 per hour may be high enough to constitute bias,[149] but a nominal fee, which directors may even agree to return, may be too small for courts to perceive an emotionally distorted decision.

Emotions aid cultural evaluations of risk.[150] Individuals draw on their emotions "to perceive what stance toward risks coheres with their values."[151] Values derive from cultural norms.[152] Individuals use emotions to form "rational attitudes about what it would mean for their cultural worldviews for society to credit the claim that that activity is dangerous and worthy of regulation."[153] An individual takes emotions into account in deciding whether a particular set of values or norms expressed by a particular legal rule is congruent with her own set of norms.[154] For example, if an individual values egalitarian norms, then the person is more likely to favor increasing environmental regulation.[155] Such regulation would limit commercial activities; if those activities were limited, then there would be fewer distinctions in wealth and economic status and a more egalitarian world. On the other hand, if an individual values hierarchical and individualistic norms, then the person is less likely to favor increasing environmental regulation because such regulation would signal, "a challenge to the prerogatives and competence of social and governmental elites."[156]

Classical economic theory is a theoretical basis for much of corporate law. The theory suggests that emotions (such as those that might arise if one's social status is threatened) do not play a role in the cognition of risk.[157] Instead, cognition of risk may produce emotions as a "reactive byproduct."[158] Under this view, individuals "process information about risky undertakings in a way that maximizes their expected utility."[159] In other words, when making decisions, emotions do not sway rational individuals. Rational individuals engage in a "utilitarian balancing of costs and benefits."[160] Thus, more information

149. *See* Telxon v. Meyerson, 802 A.2d 257, 265-66 (Del. 2002).
150. Kahan, *supra* note 12, at 2-10.
151. *Id*. at 9.
152. *Id*.
153. *Id*.
154. *Id*. at 9-10.
155. *Id*.
156. Kahan et al., *supra* note 11, at 10.
157. As described above in Section II, much of corporation law is grounded in classical theories of economics.
158. Kahan, *supra* note 12, at 5.
159. *Id*.
160. *Id*.

regarding the costs and benefits of certain courses of action should lead to a correct assessment of the risks of certain courses of action. However, a growing body of research suggests that, contrary to economic theories, more information does not make for better decisions or better risk evaluations. Rather, emotions play a role in this cognitive process.

Corporate law has a renewed emphasis on ensuring the adequate flow of information. While this is a good thing, more information about board roles, the risks of engaging in certain borderline activities, and the costs and benefits of certain corporate strategies may not lead to better evaluation of the risks.

C. The Yale Law School Cultural Cognition Project's Study on Cultural Bias and the White Male Effect

Empirical research shows that risk perceptions are skewed across gender and race.[161] In particular, evidence shows that "race and gender differences in risk perception can be attributed to a discrete class of highly risk-skeptical white men . . . [who] hold certain anti-egalitarian and individualistic attitudes" in comparison to members of the total population.[162] This skewing of risk perception has been referred to as the "white male effect."[163] Dan M. Kahan, Donald Braman, John Gastil, Paul Slovic and C.K. Mertz, researchers at Yale Law School, built upon this body of work by conducting an empirical study to determine whether gender and race alone or cultural norms account for varying risk perceptions, and in particular for the "white male effect."[164]

1. The Study

The Kahan study was designed to test whether the "white male effect" was an artifact solely of race and gender or an artifact of cultural norms that may well "feature either gender or race differentiation or both in social roles involving putatively dangerous activities."[165] "The core idea, which can be called the *cultural cognition thesis*, is that culture is

161. Kahan et al., *supra* note 11, at 1.
162. *Id.* at 2.
163. *Id.*
164. *Id.*
165. *Id.* at 2-3.

prior to fact on charged policy issues."[166] Cultural cognition shapes beliefs about the value of certain laws and policy, and "what individuals believe the consequences of such policies to be."[167] The cultural cognition thesis derives from two lines of social science research: research on cultural norms and risk perception, and research on how group membership affects cognitive processes.[168]

Research on cultural norms and risk perception (known as the cultural theory of risk perception) shows that "individuals . . . selectively credit and dismiss claims of societal danger based on whether the putatively hazardous activity is one that defies or instead conforms to their cultural norms."[169] According to this position, competing norms are classified across two dimensions: "group" and "grid."[170] In this typology:

> [A] high group worldview supports a communitarian society, in which collective needs trump individual ones. A low group worldview, in contrast, coheres with an individualist social order, in which persons are expected to secure their own needs without collective assistance and without collective interference. A high grid worldview favors a hierarchical society, in which resources, opportunities, duties, rights, political offices and the like are distributed on the basis of conspicuous and largely fixed social characteristics—such as gender, race, class, lineage. A low grid worldview favors an egalitarian society, in which such characteristics are denied significance.[171]

Research on group membership and cognitive bias demonstrates not

166. Posting of Dan Kahan to Empirical Legal Studies Blog, http://www.elsblog.org/the_empirical_legal_studi/2006/06/cultural_cognit.html (June 6, 2006 , 5:57 EST) (emphasis in original).

167. *Id*. In a recent blog posting, Dan Kahan offered the following hypothesis:

> On guns, for example, hierarchical and individualist worldviews predict the view that guns are "safe" among both men *and* women; however, the effect of those worldviews on men is much much [sic] larger. That fits our theory insofar as we say hierarchical and individualist men have a bigger investment in access to guns to perform roles that are status-enhancing for them. But insofar as inividualist and hierarchist women still are more disposed to see guns as "safe" than are solidarist and egalitarian ones, it seems strange to say they are holding back on status-anxiety grounds; female hierarchs and individualists are motivated by status-anxiety relative to egalitarians and solidarists, but not nearly *as much* as male hierarchs and individualists.

Posting of Dan Kahan to Empirical Legal Studies Blog, http://www.elsblog.org/the_empirical_legal_studi/2006/06/white_male_stat.html (June 5, 2006, 10:51 EST).

168. Kahan et al., *supra* note 11, at 3.

169. *Id*. at 4.

170. *Id*.

171. Kahan, *supra* note 166.

only that individuals adopt as their own the beliefs of certain groups to which they belong—"in groups"—but also individuals tend to reject factual information when the information reflects beliefs held by "out groups."[172]

The authors posited that gender and race in and of themselves are insufficient to explain why certain individuals perceive risks differently from other groups.[173] Instead, individuals are biased in a manner that furthers an individual's status in society.[174] Status is dependent on cultural norms subscribed to by the "in-group."[175] Thus, status is threatened by those holding opposing norms.[176] This phenomenon is known as "cultural-identity-protective cognition."[177]

The Yale researchers investigated the existence of a correlation between gender, race, and certain cultural norms or worldviews, and between cultural norms and perceptions of risk.[178] The aim of the study was to determine whether identity-protective cognition might account more closely for differences in risk perception.[179]

The study tested norms classified across two dimensions—hierarchical versus egalitarian and individualistic versus communitarian.[180] The authors of the Yale study theorized that individuals are members of one of four groups, classified as hierarchical-individualists, hierarchical-communitarians, egalitarian-individualists, and egalitarian-communitarians; that members of each group hold distinctly different views about the risks of putatively dangerous activities; and that those views conform to the values and norms associated with a particular worldview.[181] Further, the authors of the

172. Kahan et al., *supra* note 11, at 6.
173. *Id*. at 2.
174. *Id*. at 6.
175. *Id*.
176. *Id*.
177. *Id*. at 6-8.
178. *Id*. at 8-9.
179. *Id*. at *9-10*.
180. *Id*. at 8-9.
181. *Id*. at 4-6. The theory of cultural identity protective risk perception posits that "individuals adopt beliefs congenial to the groups to which they belong precisely because their holding such beliefs promotes their groups' interests." *Id*. at 7. Also, the theory of risk perception identifies those group-held norms and values that are most salient to influence individuals' perceptions of what beliefs are in the individual's own best interests.

> [I]n the real-world we associate with myriad diverse groups . . . . It's not merely implausible but logically impossible for persons to react with identity-protective cognition with respect to all the beliefs that might predominate among all such groups . . . . "Group-grid" furnishes a parsimonious typology of highly salient commitments that are likely to shape individuals' identities, and determine their group-based affinities, in a

Yale study theorized that gender and racial variance in risk perception might correlate with worldviews. Moreover, gender and racial variance within a worldview might occur depending on "whose cultural identity . . . is being enabled or interfered with by some putatively dangerous activity."[182] In other words, while cultural norms adhering in a worldview may account for differences in risk perception more than any other personal characteristic, cultural norms in combination with other characteristics—such as race and gender—may motivate risk perceptions especially "when their shared norms feature gender or race differentiation with respect to social roles involving such an activity."[183]

Also, the Yale study examined individuals' perceptions of risks to societal and personal health and safety posed by gun control, environmental dangers, and abortions—highly contentious social issues.[184] For example, assertions of environmental risk may be perceived as "symbolizing a challenge to the prerogatives and competence of social and governmental elites."[185] Thus, hierarchical persons should be more dismissive of environmental risks than egalitarians.[186] Moreover, male hierarchists should be more dismissive of environmental risks than female hierarchists, because "[w]ithin a hierarchical worldview, women are primarily assigned to domestic roles, men to public ones within civil society and within the government."[187] Racial variance in perceptions of environmental risks may be due to a tendency for "minorities . . . to be disproportionately egalitarian in their outlooks . . . ."[188] As another example, "[t]he social roles that guns enable and the virtues they symbolize are stereotypically male roles and virtues."[189] Moreover, gun ownership historically has been associated with prerogatives belonging to white, hierarchical males.[190] Therefore, white, hierarchical males should be highly skeptical of the risks

manner that transcends the scores of associations they might happen to form with like- and unlike-minded persons.

Id.

182. *Id.* at 8.
183. *Id.* at 10.
184. *Id.* at 36-37.
185. *Id.* at 10.
186. *Id.* at 10.
187. *Id.*
188. *Id.*
189. *Id.* at 11.
190. *Id.*

associated with gun ownership and disfavor gun control, much more so than female hierarchists or hierarchists of color disfavor gun control.[191]

Finally, the abortion debate may reflect tension between "norms conferring status on women who successfully occupy professional roles . . . with . . . patriarchal norms that assign status to women for occupying domestic roles."[192] Thus, relatively hierarchical individuals would disfavor the free availability of abortions.[193] In addition, female hierarchists "would be the most receptive of all to the claim that abortion is dangerous" because "they are the ones whose identities are most threatened by abortion's symbolic denigration of motherhood."[194] The authors predicted that "commitment to hierarchical norms . . . would have a less dramatic impact in accentuating the abortion-risk concerns of men."[195] Finally, "any race effect on abortion risk perceptions would originate in either the correlation of race with cultural outlooks or an interaction between race and cultural worldviews."[196]

The Kahan study on the influence of cultural norms on risk perception was just one of several conducted in the Cultural Cognition Project at Yale University.

2. Study Design

Eighteen hundred people nationwide participated in a telephone survey.[197] The researchers collected information on various personal demographic characteristics of the participants and on the norms each held.[198] The telephone survey collected other personal characteristics that have been known to correlate with predilection for risk.[199]

The questionnaire was designed to measure worldviews with respect to three hypotheses. The first hypothesis was "that relatively hierarchical and individualistic worldviews would diminish concern with environmental risks, whereas relatively egalitarian and communitarian worldviews would accentuate it."[200] The second was that:

> [p]ersons of hierarchical and individualistic orientations should be

191. *Id.*
192. *Id.* at 12.
193. *Id.*
194. *Id.*
195. *Id.*
196. *Id.*
197. *Id.* at 9.
198. *Id.*
199. *Id.* at 14.
200. *Id.* at 10.

> expected to worry more about being rendered defenseless because of the association of guns with hierarchical social roles . . . and with hierarchical and individualistic virtues . . . . Relatively egalitarian and communitarian respondents should worry more about gun violence because of the association of guns with patriarchy and racism and with distrust of and indifference to the well-being of strangers. [201]

The third hypothesis was that egalitarian individualistic women would see abortion as safe, in line with their commitment to norms that confer status on women "who master professional roles," while relatively hierarchical individuals would see abortion as more risky. [202]

3. Study Results

The study's results indicated that while individuals of certain races and genders might be more likely to perceive risks in certain ways as a group, race and gender alone did not account for differences in risk perception.[203] Instead, perceptions of risk correlated positively with norms that furthered social status, and not with objective measures of risk.[204] In other words, individuals tended to minimize the risks of an activity if the cultural status of the individuals as a group depended on that activity.[205]

Generally, "[d]ifferences in the perceptions of white males and others for all risks were relatively muted among persons holding egalitarian and communitarian worldviews and were nonsignificant with respect to gun risks and abortion risks."[206] However, "[t]he difference between the mean risk perceptions of white men those of white females and minorities was pronounced among persons subscribing to hierarchical worldviews for each of the risks examined."[207] Also, African-Americans were disproportionately egalitarian and communitarian.[208]

The researchers found that "cultural orientations explain gun-risk perceptions better than any other factor, including one's gender, race, region of residence, community type, political ideology, personality

201. *Id*. at 11.
202. *Id*. at 12.
203. *Id*. at 30-31.
204. *Id*. at 30.
205. *Id*.
206. *Id*. at 18.
207. *Id*.
208. *Id*. at 22, 25.

type, and so forth."[209] In addition, gender and race operated on worldviews to influence risk perception. Indeed, male hierarchists and individualists were motivated by status anxiety relative to male egalitarians and solidarists, and much more so than female hierarchs.[210] Also, individualists were motivated by status anxiety relative to female egalitarians and solidarists.[211] Further, "increasing hierarchical and individualistic worldviews induce[d] greater risk-skepticism in white males than in either white women or male or female nonwhites."[212] Moreover, "risk skepticism about guns was most pronounced among *white male* hierarchists and *male* individualists."[213] This finding was consistent with the researchers' hypothesis about gun-risk perceptions.[214]

The findings on environmental risks also confirmed the researchers' hypotheses. First, "individualistic men *and* individualistic women react with status-protecting skepticism when commerce and industry are attacked as dangerous," and more so than communitarians.[215] Second, hierarchical men and hierarchical women worried less about environmental risks than did egalitarians, but "women discounted environmental risk less than men [discounted such risks] as their respective orientations became more hierarchical."[216] Third, race variance "was attributable to the disproportionately egalitarian and communitarian worldviews of African-Americans."[217] In sum, the statistical analysis revealed that "the white male effect for environmental risks observed in the sample as a whole was, as hypothesized, attributable in its entirety to the extreme risk skepticism that hierarchical commitments induce in white males."[218]

The results on perceptions of abortion risks also were consistent with the researchers' hypotheses.[219] As respondents' worldviews became more hierarchical, they became more concerned about abortion risks, and as their worldviews became more individualistic, they became

209. Kahan, *supra* note 166.

210. *See* Kahan, *supra* note 167.

211. *See id*.

212. Kahan et al., *supra* note 11, at 25.

213. Kahan, *supra* note 167. Kahan further explained that "the hierarchic associations that guns bear have historically been confined to whites, white male hierarchs have the biggest investment of all in seeing guns as safe (indeed, we found, that such individuals believe that gun ownership enhances rather than reduces public safety)." *Id*. (emphasis in original).

214. *Id*.

215. *Id*.

216. Kahan et al., *supra* note 11, at 22.

217. *Id*.

218. *Id*. at 23.

219. *Id*. at 27.

less concerned about abortion risks.[220] The cultural orientation scales added to the predictive power of the researchers' cultural-identity-protective cognition theory.[221] Moreover, gender and race interacted with cultural worldviews. For example, as their respective orientations became more hierarchical, women worried about abortion risks more than men worried about these risks.[222] Indeed, "all of the gender-related variance in the sample was attributable to the extreme risk sensitivity associated with being a white female Hierarch."[223] However, "being an African-American heighten[ed] concern about abortion risks independent of cultural worldviews."[224]

IV. MITIGATING THE EFFECTS OF CIP COGNITION THROUGH EDUCATION AND LEGAL RULES

Could CIP risk perception impact board decision-making in some way that one really needs to worry about? Perhaps it could. To the extent that certain cultural norms predominate on corporate boards, the theory would suggest that CIP risk assessment bias may systematically influence director decision-making. Further, the theory may allow predictions about the kinds of decisions and scenarios that risk bias is most likely to influence.

A. What Does the Study Add to Our Understanding of How Cognitive Biases May Operate in Director Decision-making?

The "white male effect" is a well documented form of risk bias. A growing literature documents other types of bias. Yet, courts are reluctant to give more scrutiny to directorial decision-making; some explicitly disregard the effect of cognitive bias on board decision-making in certain contexts, including director review of conflict of interest transactions and special litigation committee recommendations. Where this disregard is not explicit, it is implicit in the operation of business judgment doctrine.

Why should the results of the Yale study have any greater influence over court review of decisions than previous research on risk perception, cognitive bias, and emotion? The Yale study may add detail to our understanding of the nature of the "common cultural bond" shared, and

220. *Id.*
221. *Id.*
222. *Id.* at 28.
223. *Id.* at 30.
224. *Id.*

it points to evidence of the impact of bias on decision-making, specifically as it relates to risk evaluation. For example, the Yale research has provided evidence of group bias that may lead to structural bias on boards. Structural bias "generally refers to the prejudice that members of the board of directors may have in favor of one another and of management . . . [because of a] common cultural bond and [the] natural empathy and collegiality shared by most directors," the management-dominated director selection and socialization process, and "economic or psychological dependence upon or ties to the corporation's senior executives."[225] Structural bias is particularly an issue "[w]henever the interests of the directors are in conflict with those of shareholders . . . ."[226]

In a sense, the study makes structural bias more than just a theory because it proves the existence of the effect of cultural norms on risk perception, even if it does not prove the effect of the bond in specific cases. Moreover, the study suggests that the type of bias resulting from cultural status anxiety operates regardless of whether or not there is a conflict between the board and shareholders.

The Yale study adds empirical support to the notion that cognitive bias impacts board decision-making in a way that may harm shareholders and perhaps that courts should recognize "the full variety of influences" on director behavior.[227] This support did not exist at the time the more influential cases dealing with executive conflict of interest transactions were decided. For example, systematically underestimating the risks of conflict transactions may lead a board to ignore red flags indicating financial problems within the corporation. These problems might have been correctable had the board earlier identified and addressed the problem. Systematic under or overestimation of risk in a particular institution indicates cognitive flaws in decision-making, which should be addressed in a systematic and cognitive way.

The theory of CIP cognition may offer a social psychology explanation for certain dysfunctional board mental processes and behavior. Additionally, it may offer ways to neutralize the effects of

225. Julian Velasco, *Structural Bias and the Need for Substantive Review*, 82 WASH. U. L. Q. 821, 824 (2004). Velasco identifies three "paradigms for understanding structural bias": implicit conspiracy (directors "consciously" pursue group interests), relationship bias (directors "favor friends and colleagues over distant shareholders"), and unconscious, cognitive bias (a "manifestation of ingroup bias"). *Id*. at 855.

226. *Id*. at 821.

227. J. Robert Brown, *Disloyalty Without Limits: "Independent" Directors and the Elimination of the Duty of Loyalty*, 95 KY. L.J. 53, 100 (2006-2007).

identity-protective cognition on individual and group decision-making. The next section addresses how CIP risk assessment may affect board behavior in three specific situations. It describes how director education and changes in legal rules may mitigate the effects of CIP risk assessment. It also addresses theoretical and practical objections to the proposals.

B. Specific Applications

1. Compensation Decisions

Directors might minimize the risks of overcompensation in order to protect, by proxy, their own economic status. Hierarchical norms assign males the breadwinner role. Attempts to limit the economic potential of that role may threaten directors' cultural identity. Thus, directors may underestimate the risk that a compensation package is overvalued. Current legal rules requiring independent compensation committee review of executive compensation decisions, and the norms reflected in those rules, would not mitigate the risk of bias.

A controversial implication of identity-protective cognition suggests that courts should be less sanguine about according deference to directors when reviewing claims that directors have breached their fiduciary duty of care and wasted corporate assets by awarding excessive compensation.[228] To the extent that the Yale study identifies a systematic cultural-identity and status protective bias distorting director business risk perception, courts should be alert to the possible need for closer review of directors' decision-making processes. The standard of review would not require liability for mere mistakes or for negligent decisions. The idea is to ensure that directors make more balanced business judgments, not to replace directors' business judgments with the business judgment of the courts. Gross negligence could remain the standard of review; this is merely an evolutionary, not revolutionary, change in what it means to be reasonably informed.[229]

228. The legal scholarship on structural bias suggests that court review of directors' business judgment might go beyond mere review of the procedural aspects of business decision-making and touch on the substantive aspects. For example, Julian Velasco proposed a "substantive reasonableness" standard, under which "the plaintiff should have to establish that the directors' decision was unreasonable." Velasco, *supra* note 225, at 876.

229. If courts articulate these norms as setting a standard of good practice, then "reasonable" boards would follow these practices or risk liability (putting aside the issue of exculpatory statutes, indemnification, and insurance). *See* Burch, *supra* note 42, at 527-28.

In undertaking this review, courts could ask whether management and the board sought arguments against a proposed course of action and whether the board or board committee fully considered those arguments. For example, courts could weigh evidence presented by directors that the board "considered arguments against a course of action" and challenged management on more controversial decisions.[230] Further, courts routinely engage in weighing factors and so are well-positioned to determine if boards appropriately identified and weighed a variety of viewpoints. Moreover, plaintiffs should not bear the burden of demonstrating that the decision-making process was flawed. Courts should require directors to show balanced risk appraisals.

2. Independent Director Approval of Conflict of Interest Transactions

As described in Section III of this Article, plaintiffs' arguments in favor of entire fairness review as a mechanism to address cognitive bias generally have been unsuccessful even though courts have become more willing over the last twenty years to entertain those arguments.[231] However, the bias resulting from identity-protective cognition may indeed cause directors to underestimate the risks of conflict transactions, even if the directors have no pecuniary interest in the transaction.

Historically, conflict transactions were presumptively void.[232] Today, a director's ability to engage in conflict transactions reasonably may be viewed as a necessary component of doing business and as essential to maintain or enhance a director's status in business and in society. Legal rules have established the norm that directors without certain financial, business, and personal conflicts may review related-party/conflict of interest transactions. By judging whether a conflict transaction is in the best interests of the corporation, a director may signal not only that he or she believes that the transaction is fair, but also that it is fair for the director to make that judgment. This further establishes financial, business, and personal conflicts—and not other sources of bias—as the criteria that determines if the director is impartial. These criteria become part of the status quo. Adherence to this framework for evaluating bias reinforces stability, a hierarchical norm, and protects a director's hierarchical self-identity. Therefore, a

230. Paredes, *supra* note 24, at 750-51.
231. Velasco, *supra* note 225, at 840-41.
232. *See supra* note 181 and accompanying text.

director may be predisposed to discount the impact of CIP bias and other forms of cognitive bias on decision-making.

To the extent that a court requires an independent board committee to show transactional fairness regardless of independent director approval, the court is taking steps to counteract the effects of identity-protective cognition bias. Jurisdictions that require this showing may offer plaintiffs more protection against the CIP risk assessment bias. Jurisdictions adopting the Model Business Corporation Act, which shifts the burden of proof to the plaintiffs to show waste, may not adequately account for the risk of identity-protective cognition bias.

3. Special Litigation Committees

In a number of jurisdictions, derivative plaintiffs must make a demand on the board when bringing a derivative lawsuit unless demand is excused. In these jurisdictions, demand is excused if it would be futile, i.e., the board operated under a conflict of interest when undertaking the transaction and that conflict might be expected to interfere with unbiased operation of the board's business judgment. Other jurisdictions require that demand is made on the board in all cases.[233]

If a shareholder names a majority of the board as defendants because they had an interest in the transaction at the time, the board may appoint a special board committee to review the shareholder's demand. The purpose of the committee is to determine if pursuing the litigation would be in the best interests of the corporation as a whole.[234] If a disinterested board makes a fully informed and reasonable decision not to pursue the litigation, then the business judgment rule may fully protect that decision.

Plaintiffs have argued, and some courts (a minority) have reasoned, that members of special litigation committees might be reluctant to bring derivative lawsuits not because the lawsuits are illegitimate, but because the members of the special committee might identify with the defendants and think, "there but for the grace of God go I."[235] The study raises the additional possibility that directors might seek dismissal to protect the status of the firm as a hierarchy. Hierarchs, and hierarchical institutions, tend to value the status quo and incremental moves. Suing management is unlikely to be an incremental move. Also, hierarchies tend to value

233. MODEL BUS. CORP. ACT § 7.42 (West 2006).
234. MODEL BUS. CORP. ACT § 7.42 cmt. (West 2006).
235. Zapata Corp. v. Maldonado, 430 A.2d 779, 787 (Del. 1981).

stability and rational order. Management may perceive the derivative lawsuit as disruptive.[236] Also, shareholder lawsuits may be a threat to the hierarchical system of governance in which the CEO and directors, not the shareholders, appear to be at the top of the corporate hierarchy. Thus, CIP risk assessment creates a danger that the special litigation committee will dismiss a lawsuit properly brought to vindicate legitimate shareholder rights.[237]

A majority of states (and federal courts applying state rules) recognize the special litigation committee defense.[238] Several states have codified the defense.[239] Most of these statutes are based on the Model Business Corporation Act § 7.44. A minority of states recognize a modified version of the defense. These states allow a trial court to review the committee's decision recommending that litigation be terminated. The level of review varies and generally requires independence and some proof of fairness.[240] In these jurisdictions, the

236. *See* Cox & Munsinger, *supra* note 116, at 89 (stating that "directors perceive the typical derivative suit to be the unscrupulous strike suit," feel an "affinity" with the defendants, and are "particular[ly] concern[ed] that the defendants not be subjected needlessly to the opprobrium and inconvenience of litigation").

237. *See* Rafael La Porta et al., *Investor Protection and Corporate Valuation*, 57 J. FIN. 1147, 1166-69 (2002) (evidence shows firms who protect minority shareholders have higher valuations).

238. *See, e.g.*, Roberts v. Alabama Power Company, 404 So.2d 629, 631-36 (Ala. 1981); Hirsch v. Jones Intercable, Inc., 984 P.2d 629, 636-38 (Colo. 1999); De Moya v. Fernandez, 559 So.2d 644, 645-46 (Fla. Dist. Ct. App. 1990); Millsap v. American Family Corporation, 208 Ga. App. 230, 231-33 (Ga. Ct. App. 1993); Allied Ready Mix Company, Inc. *ex rel*. Mattingly v. Allen, 994 S.W.2d 4, 8-10 (Ky. Ct. App. 1998); Auerbach v. Bennett, 47 N.Y.2d 619, 630-31 (N.Y. 1979); Miller v. Bargaheiser, 70 Ohio App.3d 702, 705-08 (Ohio Ct. App. 1990); Cuker v. Mikalauskas, 547 Pa. 600, 611-14 (Pa. 1997).

239. *See* ALASKA STAT. § 10.06.435(f) (2007)(independent scrutiny standard); ARIZ. REV. STAT. ANN. § 10-3634 (2007); CONN. GEN. STAT. ANN. § 33- 724 (West 2007); FLA. STAT. ANN. § 607.07401(3) (West 2007); GA. CODE ANN. §§ 14-2-744, 14-3-744 (2007); IDAHO CODE ANN. § 30-1-744 (2007); ME. REV. STAT. ANN. tit. 13-A, § 632 (2007) (amended by 13-C § 755 and further amended by S.P. 608, 2007 Me. Legis. Serv. Ch. 289); MINN. STAT. ANN. § 302A.241 (West 2007); *see also* Drilling v. Berman, 589 N.W.2d 503, 506-07 (Minn. Ct. App. 1999) (construing MINN. STAT. § 302A.241); MISS. CODE ANN. § 79-4-7.44 (2007); MONT. CODE ANN. §§ 35-1-545, 35-2-1304 (2007); NEB. REV. STAT. ANN. § 21-2074 (2007); N.H. REV. STAT. ANN. § 293- A:7.44 (2007); N.C. GEN. STAT. ANN. § 55-7-44 (2007); TEX. BUS. CORP. ACT. art. 5.14, subs. F, H; VA. CODE ANN. § 13.1-672.4 (2007); WIS. STAT. ANN. §§ 180.0744, 181.0744 (West 2007).

240. Joy v. North, 692 F.2d 880, 887-91 (2d Cir. 1982) (applying Connecticut law; trial court is to weigh likely recovery, discounted by the probability of liability, against the costs to the corporation of continuing the action), *cert. den. sub nom*., 460 U.S. 1051, 103 S. Ct. 1498 (1983), *and superseded by statute*, CONN. GEN. STAT. ANN. § 33-724; Zapata Corp. v. Maldonado, 430 A.2d 779, 787-89 (Del. 1981) (trial court is to apply its own "independent business judgment"); Houle v. Low, 407 Mass. 810, 814-26 (Mass. 1990) (trial court must determine whether committee's decision was "reasonable and principled"); *In re* PSE & G Shareholder Lit., 315 N.J. Super. 323, 335-36 (N.J. Super. Ct. App. Div. 1998) (trial court must determine whether committee's decision was "reasonable and principle[d]"); Alford v. Shaw, 320 N.C. 465, 468-74 (N.C. 1987) (trial court

additional protections offered shareholders may counteract the effects of CIP risk assessment bias.

C. Critique

In any proposal that may expose directors to real liability, criticism abounds. If boards are systematically and structurally dysfunctional, then structural changes may be needed to neutralize the problem. The question is not only whether the above legal and educational changes would work, but whether the "cure" would be worse than the dysfunction.[241]

1. Shareholders Can Diversify Away the Risk that Non-management Directors Will Not Exercise Unbiased Judgment

Shareholders freely chose the companies in which to invest. Therefore, in theory, shareholders can choose to increase their investment in companies that demonstrate more balanced decision-making. Moreover, shareholders could choose to construct a diversified investment portfolio consisting of corporations assuming that some corporations have better corporate governance and decision-making practices than others. Thus, the shareholders' risk may be reduced.

However, cognitive bias may be a structural problem across corporations. If uncorrected, investment portfolio diversification across U.S. publicly traded corporations would not defuse this problem.

2. Closer Judicial Scrutiny Will Lead to Greater Liability and Fewer Qualified Individuals Will Want to Serve as Directors

The concern here is that greater scrutiny of directors' decisions will lead to the possibility of more director liability. This concern was raised in the seminal case of *Smith v. Van Gorkom*.[242] However, several counterarguments may be raised in response. First, although liability insurance costs increased after *Smith*, this insurance protects directors from personal liability. Second, although there was a decrease in the

must consider totality of circumstances, including committee's report, in deciding whether directors' action was "just and reasonable"); Lewis v. Boyd, 838 S.W.2d 215, 222-26 (Tenn. Ct. App. 1992) (trial court must determine whether committee's decision was "reasonable and principled").

241. It is difficult to change a dysfunctional system, especially if it appears to those holding power within the system that they are acting functionally.

242. Smith v. Van Gorkom, 488 A. 2d 858, 881 (Del. 1985), *superseded by statute*, 8 DEL. C. § 102(b)(7) (West 2007).

number of qualified directors who continued to serve, the decrease was temporary. Third, although some directors may leave their positions due to a concern that they would no longer be able to fulfill their increased directorial functions, perhaps directors who do continue to serve will understand their companies better and will make more legitimate decisions, which should lead to less potential liability.

3. Directors Would Take Even Fewer Risks, at Shareholders' Expense

Directors "might be dissuaded from taking even prudent risks and might become too tentative" once more attention is focused on risk.[243] Alternatively, directors may realize that activities once regarded as too risky have more value than previously seen.[244]

Further, to the extent that evidence bears out that management is already risk averse, some cognitive bias towards underestimation of risk may balance out risk aversion.[245] It is not clear to what extent insensitivity to risk impacts corporate profitability, shareholder wealth, or other measures of corporate financial success. However, a more balanced approach to risk-taking may result in greater profitability, and likely would result in better considered decisions.[246]

4. Other Gatekeepers are Better Monitors

This argument suggests that other gatekeepers are better monitors of corporate behavior than directors themselves. It may be true that the best monitors are individuals who have no connection with the corporation, and can evaluate corporate and director performance without bias due to financial and other ties described above. But outside monitors would not address the issue that CIP risk assessment operates on a day-to-day level as well as at the oversight and strategy levels. Further, these outside monitors would bring their own biases to the boardroom.

243. Paredes, *supra* note 24, at 682.

244. *See* Steven A. Ramirez, *The End of Corporate Governance Law: Optimizing Regulatory Structures for a Race to the Top*, 24 YALE J. ON REG. 313, 339-40 (2007) (citing to numerous studies drawing a connection between gender and racial diversity on corporate boards and corporate profitability).

245. Paredes, *supra* note 24, at 682.

246. David A. Carter et al., *Corporate Governance, Board Diversity and Firm Value*, 38 FIN. REV. 33, 51 (2003) (presence of women or minorities on boards has direct positive effect on firm value).

V. DIRECTIONS FOR FUTURE RESEARCH

The research on cultural norms and risk perception, increased attention to directors' monitoring role, and questions raised about the impact of independence requirements all heighten the need for studies of director behavior. This Article suggests directions for this and other research, including empirical research on board interaction in the course of decision-making and oversight and studies of gender and racial diversity on boards.

A. How Do Board Members Perceive their Roles and Functions?

This Article draws from the Kahan study's conclusions on how members of the general public perceive abortion, gun, and environmental risks, and applies those conclusions to corporate executive assessment of business risk. In essence, this is an armchair exercise. Its value lies in applying insights from empirical scholarship to test certain assumptions about boardroom behavior.

However, the boardroom is a "black box" and little scholarship investigates the connection between behavioral assumptions in corporate governance law, how board members perceive their roles and functions, and the actual content of board communication derived from observation.[247] Empirical research should be conducted to capture how members of boards of directors, corporate officers, and executives actually perceive and deliberate various business risks.[248] This research could relate how courts expect directors to behave to actual director behavior, and ultimately may be useful in formulating rules related to independent boards.

In addition, the research could relate behavior to worldviews. One hypothesis is that public company boards in the United States, which tend to be dominated by white males, also tend to value hierarchical and individualistic norms over other worldviews. This statistical finding would be consistent with the fact that board members are part of a paradigmatic hierarchy. Further, "[p]ersons who have a high hierarchical orientation expect resources, opportunities, respect and the like to be 'distributed on the basis of explicit public social classifications, such as sex, color, . . . holding a bureaucratic office, [or]

247. *See, e.g.*, Dalvir Samra-Hendriks, *Doing 'Boards-in-Action' Research, An Ethnographic Approach for the Capture and Analysis of Directors' and Senior Managers' Interactive Routines*, 8 CORP. GOV. 244, 244-46 (2000).

248. Posting of Gordon Smith to Conglomerate Blog, http://www.theconglomerate.org/2007/07/gordon-gee.html (July 11, 2007).

descent in a senior clan or lineage.'"[249] Such expectations would be consistent with corporate norms that reward ascension through the ranks. Another hypothesis might seek to relate patterns and content of communication on a particular board to norms held.

Further, a research project might compare content of board communications for non-profit versus for-profit boards. In addition, research might compare the content of board communications in a number of different countries, and relate the content of communication to corporate governance law.

B. How Do Boards Really Perceive Decision-making Risk?

Building from the behavior studies described above, in-depth research could be conducted to answer a number of questions about how boards weigh risks when making decisions. Do boards strive to act on the basis of empirical evidence? Do boards discount statements from senior executives that risks are low—do boards consider that senior executives may be understating the risks? Do boards make riskier decisions than would otherwise be in the best interests of shareholders? What is the appropriate level of risk?

The decision-making process appears to be routinized, even when a decision should be given more scrutiny. More transparency is needed regarding how corporate boards function in their decision-making and oversight capacities.[250]

C. Gender and Racial Diversity on Corporate Boards

Would more diversity lead to "better" decision-making? This Article argues that cognitive bias stemming from cultural norms leads public company boards to underestimate risks. However, cognitive bias affects everyone to some degree. To the extent that there is significant diversity on the board of a publicly traded corporation, in terms of worldviews as well as race and gender, the board may make decisions that are more legitimate because the board fully considered—and questioned—various perspectives.[251] While the Yale study demonstrates

249. Kahan et al., *supra* note 11, at 4.

250. Paul Gompers et al., *Corporate Governance and Equity Prices*, 118 Q.J. ECON. 107, 108-09 (2003) (study using twenty-four different corporate governance elements concludes that companies with superior corporate governance measures have higher market valuations).

251. Carter, supra note 246, at 36 (diverse board could help "evaluate more alternatives and more carefully explore the consequences of these alternatives"). See also Daniel P. Forbes & Frances J. Milliken, Cognition and Corporate Governance: Understanding Boards of Directors as

that diversity may have that effect, insights derived from critical race and feminist theory show that diversity alone is not enough. Board members holding diverse views must view each other with legitimacy.

What barriers to legitimacy and effective communication among board members exist, and would those barriers negate the positive impact of greater diversity in terms of worldviews, race, and gender? Studies of director behavior, as well as critical race and feminist theory, may shed light on these questions. The results of the studies could impact legal scholarship concerning race and gender diversity on corporate boards.

D. Director Education

Post-SOA, there has been a push to ensure that adequate information flows to the board and to educate directors on their responsibilities under the new rules. Director education programs may be an ideal vehicle to disseminate factual information about contested matters such as the value of independent directors and the value of derivative litigation. But, would dissemination of empirical information during director training matter? Would better internal information systems improve information flow to the board and neutralize the bias? Empirical evidence of under-evaluation of risks might include evidence that share prices fell due to a particular decision (harming shareholders); that assets were depleted and the corporation forced into bankruptcy (harming shareholders and creditors); that facilities were forced to close and that jobs were lost (harming employees and communities). The same bias that results in the under-emphasis of risks also means that empirical evidence that does not support cultural status will be rejected. Therefore, dissemination of empirical information about risks, if it can be found, may not change board decision-making.

Others have proposed educating directors on their cognitive tendencies and training directors to overcome those tendencies.[252]

Strategic Decision-Making Groups, 24 Acad. Mgmt. Rev. 489, 494-99 (1999) (boards benefit from conflict derived from thorough consideration of alternatives).

252. *See* Paredes, *supra* note 24, at 740-41 (expressing the view that the psychology of decision-making should be a corporate governance concern, and that in order to "make risks more salient" directors should be trained to consider the opposite—seek dissenting views, search for disconfirming evidence, and interrogate assumptions more rigorously). Stanford University has a well-known Directors' College and the Roberts Program in Law, Business and Corporate Governance at Stanford University. *See* Stanford Law School, Directors' College (2008), http://www.seeuthere.com/rsvp/invitation/invitation.asp?id=/m2c523-652769787287. The recent

Dissemination of information about cognitive bias and its effect on risk perception—metacognition—may be ineffective to change behavior. Mere awareness of bias created by cultural norms need not lead to changed norms or values.

Scholars of behavioral economics have proposed identity affirming as a way to overcome cultural bias. Identity affirming may be a more effective way to achieve change in board behavior. In any event, research on director behavior and on CIP risk assessment would inform the content of education programs.

VI. CONCLUSION

Although courts and commentators make assumptions about director behavior, little is known publicly about how corporate boards actually function and the content of board communication.[253] Those of us who are not public company directors, who have not sat on corporate boards, and who have not conducted a case study of corporate boards probably know little about how directors themselves perceive their roles and functions. While few, if any, would argue that there is less transparency today than there was in, say, 1934 when Justice Brandeis opined that "the best disinfectant is sunlight"[254] and when the Securities Exchange Act became law, many probably would agree that corporate directors could provide needed insight into not only their degree of independence and disinterest, as defined in federal and state law, but also about how they perceive their roles and functions as members of the board and of board committees.

This Article applies the findings generated by the Yale study on identity-protective cognition to corporate director behavior, and analyzes corporate governance policy and legal doctrine to further align executive decision-making with behavioral norms that would increase value for all corporate constituencies. More research on director behavior is needed

Directors College (held in June, 2007) did not include explicit mention of metacognition training (e.g., training in cognitive tendencies at play in decision-making) in the introductory materials.

253. Quite a bit has been written about what directors, and "independent" directors should do. Much of the literature begins with the Berle and Means study, *see* BEARLE & MEANS, *supra* note 28, and continues through the 90s with the shareholder primacy versus director primacy debate. In this scholarship, there is much speculation and quite reasonable conclusion-drawing about what directors actually do. But there is little empirical research on how directors actually perceive their roles and functions vis-à-vis board committees, other directors, shareholders and other constituencies.

254. Louis D. Brandeis, *Other People's Money and How the Bankers Use It*, HARPER'S WKLY. (1913) ("Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.").

to determine the extent of cognitive bias on board decision-making, and on the interactions among board members.

This Article has proposed a number of reasons why courts should give greater recognition to the effects of cognitive bias on director behavior on corporate boards. While it may still be too early for wholesale corporate governance changes, it is not too early to examine more closely CIP risk perception and other cognitive biases as an explanation for the type of misperception of risks underlying director behavior in Enron, Worldcom, Hewlett-Packard, and most recently, Whole Foods.[255]

Nonetheless, given the tentativeness of the evidence with respect to corporate directors as opposed to members of the general public, it is unlikely that a court would fully credit a derivative plaintiff's cognitive bias argument, supported by the empirical evidence on cultural cognition's effect on risk perception.[256] However, it is reasonable to hypothesize that cultural norms do effect directors' risk perceptions. In addition to further study of this issue, the Article proposes a number of steps that courts and corporations could take to deal with cognitive bias, including enhanced review of directors' decisions, and director education as a method to counteract cognitive bias on corporate boards.

255. Enron and Worldcom have come to epitomize financial and accounting fraud and the lack of director perception of that fraud, in part due to directors' inattention. Hewlett-Packard has become the "poster child" to illustrate pretexting—an investigative practice involving gathering confidential information through the use of invented stories. *See* Yuki Noguchi & Ellen Nakashima, *House Panel Digs Deep in HP Spy Case*, WASH. POST, Sept. 29, 2006, at D01. Hewlett-Packard's former board chair, Patricia Dunn, former general counsel, Ann Baskins, and former chief ethics officer, Kevin Hunsacker, resigned after it was revealed that they had used pretexting to determine the source of a board leak of confidential information regarding Hewlett-Packard's long-term strategic plans. *Id*. (The source was Hewlett-Pakard board member George Keyworth.) Whole Foods and the SEC are investigating Whole Foods' Chief Executive Officer, John Mackey's anonymous internet postings attacking rival Wild Oats' management as "clearly doesn't known what it is doing" and the company "has no value and no future." *See Whole Foods CEO's Anonymous Online Life*, ASSOCIATED PRESS, July 12, 2007, *available at* http://www.msnbc.msn.com/id/19718742/. Whole Foods later attempted to purchase Wild Oats. *Id*. In time, HP and Whole Foods behavior may come to be seen as hubris, underestimation of risk, overconfidence, or another type of cognitive bias.

256. A study also could determine if business law decisions reflect a cognitive bias on the part of the judiciary.