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Corporate Law for Good People

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CORPORATE LAW FOR GOOD PEOPLE

Yuval Feldman, Adi Libson & Gideon Parchomovsky

ABSTRACT—This Article offers a novel analysis of the field of corporate governance by viewing it through the lens of behavioral ethics. It calls for both shifting the focus of corporate governance to a new set of loci of potential corporate wrongdoing and adding new tools to the corporate governance arsenal. Behavioral ethics scholarship emphasizes that the large share of wrongdoing is generated by “good people” whose intention is to act ethically. Their wrongdoing stems from “bounded ethicality”—various cognitive and motivational limitations in their ethical decision-making processes—that leads to biased decisions that seem legitimate. Bounded ethicality has important implications for a wide range of topics in corporate governance, like board structure, independent directors, regulation of institutional investors and proxy advisory firms, the business judgment rule, corporate liability, and intraboard fiduciary duties. In the legal domain, corporate law provides the most fertile ground for the application of behavioral ethics. It encapsulates many of the features that the behavioral ethics literature finds to confound the ethical judgment of good people, like principal–agent relations, group decisions, victim remoteness, vague directives, and subtle conflicts of interest.

Behavioral ethics suggests a view of corporate law that is dramatically different than that portrayed by traditional legal and economic theorists. Not only does it suggest that wrongdoing can be committed by well-intentioned people who wish to do right, but also that the biases they display call for a radically different set of legal interventions than those advocated by standard economic theory. If standard theory views corporate agents as self-interest-maximizers, bounded ethicality perceives them as actors with varied and nuanced ethical motivations that could benefit from subtle legal reforms.

This Article’s assessment of corporate governance through the behavioral ethical lens proceeds in three stages. First, it exposes potential wrongdoing by good people that conventional corporate governance does not address. Second, it suggests novel corporate governance interventions supported by behavioral ethics to address wrongdoing by good people. Finally, it identifies existing interventions that, according to behavioral ethics analysis, may have unintended adverse effects on the behavior of well-meaning corporate officers and exacerbate wrongdoing instead of mitigating it.

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“Half of the harm that is done in this world / Is due to people who want to feel important. / They don’t mean to do harm—but the harm does not interest them. / Or they do not see it, or they justify it / Because they are absorbed in the endless struggle / To think well of themselves.”

—T.S. Eliot[†]

INTRODUCTION

In February 2018, Janet Yellen took an unprecedented step and prohibited Wells Fargo from expanding until “robust and comprehensive

[†] THE COCKTAIL PARTY 111 (1950).

reforms [are] in place to make certain that the abuses do not occur again.”¹ Even though the measures were unprecedented, they were not surprising, given the scope of the long-lasting corporate misconduct in the Wells Fargo case spanning over seven distinctive operations. In September 2016, various federal and state regulators announced that Wells Fargo had committed “a major breach of trust” in creating unauthorized accounts, and that a settlement including a \$100 million fine had been reached between the bank and the Consumer Financial Protection Bureau.² Following the unauthorized accounts scandal, the Department of Justice (DOJ) claimed that the bank also illegally repossessed 413 of its customers’ cars.³ In November 2016, a related Securities and Exchange Commission (SEC) investigation charged that the number of fake accounts could reach two million.⁴ In December 2016, the Department of Labor opened a separate investigation regarding Wells Fargo’s violations of the Sarbanes–Oxley Act by signing reports that did not fully disclose information regarding these unauthorized accounts. These investigations of Wells Fargo’s legal violations have been followed by a series of additional investigations and allegations.⁵

¹ Press Release, Bd. of Governors of the Fed. Rsrv. Sys., Responding to Widespread Consumer Abuses and Compliance Breakdowns by Wells Fargo, Federal Reserve Restricts Wells’ Growth Until Firm Improves Governance and Controls. Concurrent with Fed Action, Wells to Replace Three Directors by April, One by Year End (Feb. 2, 2018, 6:15 PM), <https://www.federalreserve.gov/newsevents/pressreleases/enforcement20180202a.htm> [https://perma.cc/DJQ3-8RJC].

² James Rufus Koren, *Wells Fargo to Pay \$185 Million Settlement for ‘Outrageous’ Sales Culture*, L.A. TIMES (Sept. 8, 2016, 3:10 PM), <https://www.latimes.com/business/la-fi-wells-fargo-settlement-20160907-snap-story.html> [https://perma.cc/RN9G-2HCY].

³ Jackie Wattles, *U.S.: Wells Fargo Illegally Repossessed 413 Service Members’ Cars*, CNN MONEY (Sept. 30, 2016, 2:13 PM), <https://money.cnn.com/2016/09/29/news/wells-fargo-servicemembers-cars/index.html> [https://perma.cc/XUM6-N4J9].

⁴ Matt Egan, *Wells Fargo’s Legal Mess Just Got Worse*, CNN MONEY (Nov. 3, 2016, 12:02 PM), <https://money.cnn.com/2016/11/03/investing/wells-fargo-fake-account-sec-investigation/index.html> [https://perma.cc/A3YX-KPSP]. Later on, Wells Fargo increased the estimate of fake accounts to 3.5 million. See Uri Berliner, *Wells Fargo Admits to Nearly Twice as Many Possible Fake Accounts—3.5 Million*, NPR (Aug. 31, 2017, 1:02 PM), <https://www.npr.org/sections/thetwo-way/2017/08/31/547550804/wells-fargo-admits-to-nearly-twice-as-many-possible-fake-accounts-3-5-million> [https://perma.cc/VDA4-FCCD].

⁵ Wells Fargo acknowledged that an accusation by the Department of Labor that it had retaliated illegally against whistleblowers might be true. Matt Egan, *Wells Fargo’s Whistleblower Problem Worsens*, CNN MONEY (Apr. 6, 2017, 11:45 AM), <https://money.cnn.com/2017/04/06/investing/wells-fargo-whistleblower-retaliation-osha/index.html> [https://perma.cc/2C4Y-9C8Z]. In June 2017, customers filed various lawsuits claiming that Wells Fargo modified mortgages without authorization from the mortgagors. Gretchen Morgenson, *Wells Fargo Is Accused of Making Improper Changes to Mortgages*, N.Y. TIMES (June 14, 2017), <https://www.nytimes.com/2017/06/14/business/wells-fargo-loan-mortgage.html> [https://perma.cc/ESFN-8FBV]. Wells Fargo also admitted in July 2017 that it charged customers for car insurance they did not need, which may have caused thousands of customers to default on car loans. Matt Egan, *Wells Fargo May Have Forced 570,000 Customers into Unneeded Auto*

Surprisingly, when examining the identities of the people who took blame for this massive serial wrongdoing, one does not find villains like Bernie Madoff. In the Wells Fargo case, an investigative committee of independent directors concluded that the root cause was the bank's decentralized structure and the resulting lack of transparency, failure to understand the enormity of the problem, and slow response to remedy the issue.⁶ When the Wells Fargo board decided to claw back over \$75 million in pay from former-CEO John Stumpf and Carrie Tolstedt, a retired executive who headed the community-banking department, they justified it on the grounds that the two “did not do enough to address the culture at Wells that led employees” to wrongdoing.⁷ The board report noted that “Stumpf was by nature an optimistic executive who refused to believe that the sales model was seriously impaired.”⁸ The board stopped short of attributing malicious intent to them or the four directors that were also ousted as a result of the scandal.⁹ If there was no malicious intent by the top executives and board, what caused such pervasive wrongdoing by so many of the employees of Wells Fargo, which resulted in 5,300 employees being fired?¹⁰ The Wells Fargo story teaches an important lesson: in the corporate world, legal wrongs are often committed by well-meaning executives who wish to do good; they do not consciously act to promote their narrow self-interest at the expense of the shareholders. Yet, they fail to do good, owing to what has been termed in the literature “bounded ethicality,” which includes the various cognitive

Insurance, CNN MONEY (July 28, 2017, 1:22 PM), <https://money.cnn.com/2017/07/28/investing/wells-fargo-auto-insurance-car-loans/index.html> [<https://perma.cc/78LU-XD95>]. An additional lawsuit filed in August 2017 “accuse[d] Wells Fargo of overcharging small businesses for credit card transactions.” Jackie Wattles, Ben Geier & Matt Egan, *Wells Fargo's 17-Month Nightmare*, CNN MONEY (Feb. 5, 2018, 7:28 AM), <https://money.cnn.com/2018/02/05/news/companies/wells-fargo-timeline> [<https://perma.cc/QC25-7QGQ>]. In October 2017, Wells Fargo admitted separately that 110,000 mortgage holders were erroneously fined for missing a deadline. *Id.* In June, the SEC imposed a fine of \$4 million on Wells Fargo for improperly pushing “mom-and-pop” brokerage customers to actively trade complex investments in order to generate higher fees. Matt Egan, *Wells Fargo Accused of Misconduct Again*, CNN MONEY (June 25, 2018, 5:50 PM), <https://money.cnn.com/2018/06/25/investing/wells-fargo-advisors-sec-settlement/index.html> [<https://perma.cc/8GXC-R24S>].

⁶ INDEP. DIRS. OF THE BD. OF WELLS FARGO & CO., SALES PRACTICES INVESTIGATION REPORT (2017) [hereinafter WELLS BD. REP.], <https://www.wellsfargo.com/assets/pdf/about/investor-relations/presentations/2017/board-report.pdf> [<https://perma.cc/9QK6-XYTR>].

⁷ Bob Bryan, *Wells Fargo Board Slams Former CEO Stumpf for Accounts Scandal, Claws Back Another \$28 Million*, BUS. INSIDER (Apr. 10, 2017, 7:24 AM), <https://www.businessinsider.com/wells-fargo-john-stumpf-carrie-tolstedt-accounts-scandal-2017-4> [<https://perma.cc/D6KR-2QN6>].

⁸ WELLS BD. REP., *supra* note 6, at 10.

⁹ See Bryan, *supra* note 7.

¹⁰ See Benjamin van Rooij & Adam Fine, *Toxic Corporate Culture: Assessing Organizational Processes of Deviancy*, 8 ADMIN. SCIS. 1, 2 (2018).

and motivational limitations in an actor's ethical decision-making processes.¹¹

The Wells Fargo case illustrates the need to rethink how wrongdoing emerges and spreads in the corporate context. While the Wells Fargo case may be an extreme one, it is part of an increasing number of recent corruption cases in the corporate context, a trend that includes Enron, WorldCom, Citibank and AIG, Volkswagen, and the Libor manipulation scandal involving major global banks.¹² Various reforms, such as the Sarbanes–Oxley Act of 2002¹³ and the Dodd–Frank Wall Street Reform and Consumer Protection Act,¹⁴ have attempted to address corporate misconduct. Yet, cases like Wells Fargo indicate that these reforms have not addressed some of the most fundamental aspects of corporate corruption. Indeed, behavioral ethics literature shows that wrongdoing by well-meaning actors is a ubiquitous phenomenon.¹⁵

In this Article, we argue that part of the failure to address corporate wrongdoing is based on a profound mischaracterization of its roots. The burgeoning literature on behavioral ethics shows that wrongdoing in the corporate world is not committed exclusively by calculative self-interest-maximizers who wish to enrich themselves at the expense of the

¹¹ See Dolly Chugh, Max H. Bazerman & Mahzarin R. Banaji, *Bounded Ethicality as a Psychological Barrier to Recognizing Conflicts of Interest*, in CONFLICTS OF INTEREST: CHALLENGES AND SOLUTIONS IN BUSINESS, LAW, MEDICINE, AND PUBLIC POLICY 74, 75, 90–91 (Don A. Moore, Daylian M. Cain, George Loewenstein & Max H. Bazerman eds., 2005) (“We have proposed that perceptual, cognitive, and social cognitive processes are bounded in similar, systematic ways that lead to gaps in observation and errors in decision making.”).

¹² The banks that have been fined for taking part in the Libor manipulation include Barclays, the Royal Bank of Scotland, UBS, Deutsche Bank, Société Générale, Citigroup, and JP Morgan Chase. See James McBride, *Understanding the Libor Scandal*, COUNCIL ON FOREIGN RELS. (Oct. 12, 2016), <https://www.cfr.org/backgrounder/understanding-libor-scandal> [<https://perma.cc/5RLY-9ULZ>]. Regarding the connection between these scandals, see *From Enron and WorldCom to Wells Fargo and VW Expanded Violation Tracker Covers Corporate Crime Cases Back to 2000*, CORP. CRIME REP. (Sept. 17, 2017, 6:42 PM), <https://www.corporatecrimereporter.com/news/200/enron-worldcom-wells-fargo-vw-expanded-violation-tracker-covers-corporate-crime-cases-back-2000/> [<https://perma.cc/UL72-S5MX>].

¹³ Pub. L. No. 107-204, 116 Stat. 745.

¹⁴ Pub. L. No. 111-203, 124 Stat. 1376 (2010).

¹⁵ See, e.g., Rajna Gibson, Carmen Tanner & Alexander F. Wagner, *Preferences for Truthfulness: Heterogeneity Among and Within Individuals*, 103 AM. ECON. REV. 532, 534 (2013) (finding that with no incentive to tell the truth, individuals with stronger inherent protected values of truthfulness are more resistant to lying when the economic costs of telling the truth are only marginal). Dishonesty studies have estimated that approximately 25% of individuals are (using our terminology) situational wrongdoers (e.g., sensitive to size of gains), 30% are maximizers who consistently maximize self-interest, 30% are consistent “ethical” good-doers, 10% have no recognizable pattern, and 5% lie regardless of the gains. See Uri Gneezy, Bettina Rockenbach & Marta Serra-Garcia, *Measuring Lying Aversion*, 93 J. ECON. BEHAV. & ORG. 293, 298–99 (2013).

shareholders. Rather, it is also perpetrated by well-meaning and other-regarding individuals whose ethical mores often lead them astray.

This Article constitutes the first attempt to apply the insights of behavioral ethics to corporate law. Building on behavioral ethics' findings, we unveil an alternative and surprising source of corporate misconduct: people who think of themselves as good people and normally strive to act in uncorrupt ways.¹⁶ Behavioral ethics points out that through a combination of deliberate and nondeliberate processes, many people may behave unethically with limited awareness of the unethical nature of their behavior.¹⁷ Incorporating the insights of behavioral ethics into the field of corporate law will greatly benefit research and policy analysis in this area. Indeed, from the vantage point of behavioral ethicists, the corporate scandals that occurred in the aftermath of the financial crisis of 2008 were a "perfect storm" that exposed the shortcomings of the traditional way of thinking about corporate law. The domain of corporate law displays many of the situational features that can lead "good-doers" astray, such as a conflicting set of duties, group decision-making, victim remoteness, vague directives, and subtle conflicts of interest. Thus, ignoring the ways in which "good" corporate agents allow themselves to behave unethically may cause corporate law to be ineffective.

This Article points to both structural and procedural applications of behavioral ethics to corporate governance. It lists four central structural applications, "structural" referring to the institutional design of corporations as prescribed by law. First, it explains how group decision-making on corporate boards facilitates unethical decisions and other forms of misconduct. It then suggests that these effects could be curtailed by introducing mechanisms that effectively transform board decisions into discrete sets of individual decisions and by assigning individual liability to directors for board decisions.

Second, it puts the spotlight on "softer" types of conflicts of interest that may cause greater self-interest-promotion than "stronger" types. In this context, it shows that the institution of independent directors that is widely viewed as a panacea to hard conflicts of interest may exacerbate soft or subtle conflicts of interest. Accordingly, the Article explores the options of limiting

¹⁶ Existing scholarship has taken steps in this direction by pointing to the connection between corporate culture and corporate corruption. *See, e.g.*, van Rooij & Fine, *supra* note 10, at 4 (aiming to show how corporations dealing with toxic cultures can be aided by existing social, management, and behavioral science literature); Yun Zhang, Bin He & Xu Sun, *The Contagion of Unethical Pro-Organizational Behavior: From Leaders to Followers*, 9 FRONTIERS PSYCH. 1, 7 (2018) (discussing a different perspective of the notion that organizational norms can cause people to behave less ethically).

¹⁷ *See* YUVAL FELDMAN, THE LAW OF GOOD PEOPLE: CHALLENGING STATES' ABILITY TO REGULATE HUMAN BEHAVIOR 1, 35 (2018).

the role of independent directors or significantly enhancing their independence.

Third, this Article analyzes how vague legal standards intensify wrongdoing in the corporate context. To counter this challenge, and in keeping with behavioral ethics literature, the Article advocates for the use of bright-line rules and catalogs specific lists of proscribed behaviors that would provide corporate actors with clear guidance as to how to carry out their responsibilities.

Fourth, this Article addresses the central finding of behavioral ethics that transgressions are easier to justify when they benefit other parties and examines its implications for corporate law. This insight suggests that corporate agents are more likely to engage in wrongdoing when they promote the interests of shareholders and other stakeholders. This type of wrongdoing calls for restricting the ability of managers to promote the interests of third-party stakeholders and eliminating “familial” language from firms’ ethical codes.

This Article also underscores two central procedural applications, “procedural” referring to how decisions are made or should be made in corporate settings as opposed to the content of the decision. Behavioral ethics studies suggest that individuals may have a greater tendency to cause wrongdoing by omission than by commission.¹⁸ This effect is known as the “omission bias” and has far-reaching implications for corporate law. It suggests that managers, directors, and advisory boards are far more likely to breach their duties via inaction or indecision. Hence, this Article will propose various interventions, all taken from behavioral ethics scholarship, that reframe passive situations as active ones by requiring corporate agents to assume an active role even when they elect to preserve the status quo.

Many of our suggested interventions go in the opposite direction of what conventional economic analysis would prescribe. We show that lower self-interest may exacerbate the impact of conflicts of interest rather than diminish them; vagueness and uncertainty regarding a legal norm may exacerbate wrongdoing, not improve it; and the desire to enhance the interests of third parties is more likely to lead to wrongdoing than the desire to further one’s own self-interest. Our analysis also explains how some reforms in corporate governance are not only ineffective, but even counterproductive in preventing ethical failures of corporate agents.

¹⁸ See, e.g., Daniel Kahneman & Amos Tversky, *The Psychology of Preferences*, 246 SCI. AM. 160, 173 (1982) (hypothesizing that an omission is less regretful than an action, even if the results are identical).

Structurally, the Article proceeds in two Parts. Part I presents the main findings of the innovative field of behavioral ethics. It then applies the implications of these findings to corporate law, both in terms of the situations that are most problematic for different corporate actors and in terms of the inadvertent effects of the regulatory interventions that have been used to date. Part II discusses the applications that behavioral ethics may have on numerous issues pertaining to corporate governance. Our discussion in this Part is divided into two categories: the first focuses on structural applications of behavioral ethics to corporate governance, and the second focuses on procedural applications.

We would like to clarify at the outset two important aspects of this research. First, the distinction between “good” and “bad” corporate executives is not always an easy one. There is no discrete line separating good actors from bad ones. Individuals can be calculative and act as self-interest-maximizers in certain contexts, and still believe that they act in the furtherance of others’ interests in other contexts. As we demonstrate, the nature of the specific decision they are facing may cause them to adopt different mindsets and different modes of operation. Thus, our analysis should not be perceived as a facial attack on the traditional way of thinking about and regulating corporate law. Rather, it should be deemed a critical addendum to the conventional way of thinking about corporate law.

Second, although the findings on which we base our policy recommendations are robust, many of them originate in lab experiments that emulate real-world situations, not reality itself. Despite the robustness of the studies we cite, and additional studies demonstrating that people behave similarly in real life as they behave in experiments,¹⁹ we offer our policy recommendations with the requisite degree of caution. We believe that the insights of behavioral ethics are too important to ignore. Yet, further analysis and empirical testing are required prior to the enactment of legal reform on their basis. Our goal in this Article is therefore to illuminate a new path for future research and to point to possible legal interventions that take account

¹⁹ See, e.g., Alain Cohn, Michel André Maréchal, David Tannenbaum & Christian Lukas Zünd, *Civic Honesty Around the Globe*, 365 SCIENCE 70, 71 (2019) (demonstrating the applicability of behavioral ethics in real life through field experiments); Maryam Kouchaki, Francesca Gino & Yuval Feldman, *The Ethical Perils of Personal, Communal Relations: A Language Perspective*, 30 PSYCH. SCI. 1745, 1760–62 (2019) (revealing a positive correlation between the wording of real-world ethical codes at corporations, such as the use of “we” versus “employees,” and the actual rate of corporate illegality as reported in the media, such as environmental violations and fraudulent actions); Shaul Shalvi, *Financial Temptation Increases Civic Honesty*, 365 SCIENCE 29, 30 (2019) (emphasizing how real-life data reinforce other studies that have demonstrated a correlation between experiments and real-life data).

of the complex ethical dilemmas of many real-world directors and corporate officers who strive to do good for the constituencies they represent.

I. WHAT IS BEHAVIORAL ETHICS?

Behavioral ethics, a growing area within psychology and management literature, demonstrates that an individual's unethical behavior is exacerbated through processes that create a gap between her actual behavior and her subjective evaluation thereof.²⁰ The central insight of behavioral ethics is that in many instances, individuals desire to behave ethically, consciously willing themselves to sacrifice their own interest for the sake of others. But psychological distortions can lead those same individuals to maximize their own self-interest, despite their contrary intent, due to "bounded ethicality." "Bounded ethicality" conceptualizes and describes the various cognitive and motivational limitations in ethical decision-making processes that lead to biased decisions that nevertheless appear legitimate to the actor, and which can cause individuals to downplay the unethical consequences of their own behavior.²¹ One of the central challenges facing behavioral ethics is detecting elements that impact ethical salience, that is, how easy it is for individuals to notice in a given situation that their action might have unethical consequences.²² Behavioral ethics, therefore, suggests that a significant amount of *wrongdoing* and *unethical* behavior stems from *ethical* individuals who are not fully deliberative in promoting their own interests at the expense of others.²³

The driving force behind these findings is individuals' tendency for ethical self-concept maintenance: their need to maintain their ethical view of themselves while promoting their materialistic self-interest.²⁴ There are two central methods through which this occurs: automatic psychological mechanisms and semi-deliberative mechanisms. Automatic psychological

²⁰ See FELDMAN, *supra* note 17, at 1–22.

²¹ See Chugh et al., *supra* note 11, at 75 (describing key aspects of bounded ethicality).

²² FELDMAN, *supra* note 17, at 11.

²³ For a discussion of people's different modes of reasoning, see generally Lutz Sommer, *The Theory of Planned Behaviour and the Impact of Past Behaviour*, 10 INT'L BUS. & ECON. RSCH. J. 91 (2011). For an excellent comparison of many of the models that attempt to compare nondeliberative behavior with the more traditional views of rational decision-making, see James S. Uleman, S. Adil Saribay & Celia M. Gonzalez, *Spontaneous Inferences, Implicit Impressions, and Implicit Theories*, 59 ANN. REV. PSYCH. 329, 330 (2008), and Sunita Sah & George Loewenstein, *Nothing to Declare: Mandatory and Voluntary Disclosure Leads Advisors to Avoid Conflicts of Interest*, 25 PSYCH. SCI. 575, 576 (2014).

²⁴ See Nina Mazar, On Amir & Dan Ariely, *The Dishonesty of Honest People: A Theory of Self-Concept Maintenance*, 45 J. MKTG. RSCH. 633, 633–34 (2008); David M. Bersoff, *Why Good People Sometimes Do Bad Things: Motivated Reasoning and Unethical Behavior*, 25 PERSONALITY & SOC. PSYCH. BULL. 28, 28–30 (1999).

mechanisms are usually employed *ex ante* and create a situation in which the individual is not even aware of her misconduct (e.g., when a director doesn't even notice that her own self-interest shapes her understanding of what is good to the corporation). Semi-deliberative mechanisms are used by actors in a stage of moral dissonance—when they are aware or partially aware of their wrongdoing—to justify suspect decisions (e.g., when a director recognizes the conflict of interest but downplays it by saying something like “everyone is doing it”).²⁵ Defining the exact border between the two mechanisms is difficult, as will be demonstrated in the coming paragraphs.

Behavioral ethics mostly applies to decisions made in what is known as “System 1,”²⁶ which is the mental mode based primarily on intuitions, in contrast to “System 2,” which is slower and more analytical, where reason dominates.²⁷ The distinction between System 1 and System 2 is widely discussed in behavioral economics literature.²⁸ In general, behavioral economics scholars suggest that the activation of System 1 can harm the individual's self-interest by not fully calculating the pros and cons for each course of action. Behavioral ethics scholars, on the other hand, discuss a similar effect that goes in the opposite direction. Behavioral ethics scholars demonstrate that System 1 is structured to *promote* the individual's self-interest in ethical contexts, even when the individual would be willing to sacrifice her own interest for the sake of others.²⁹ Yet the activation of System 1 causes the actor to eventually behave in a way that promotes her own interests at the expense of others. This occurs through one of the two aforementioned mechanisms. The automatic psychological mechanism—System 1—may cause the individual to be completely unaware of the ethical problem arising from her behavior. The semi-deliberative mechanism makes it harder to distinguish between the relative involvement of System 1 and System 2 because they cause the individual to gravitate towards an unethical

²⁵ See Bersoff, *supra* note 24, at 28–29; Shaul Shalvi, Jason Dana, Michel J.J. Handgraaf & Carsten K.W. De Dreu, *Justified Ethicality: Observing Desired Counterfactuals Modifies Ethical Perceptions and Behavior*, 115 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESS 181, 189 (2011).

²⁶ DANIEL KAHNEMAN, THINKING, FAST AND SLOW 19–30 (2011).

²⁷ *Id.* The inability to clearly distinguish between the two is one of the central arguments of those who oppose Professor Daniel Kahneman's concept of two-system reasoning. See, e.g., Arie W. Kruglanski & Gerd Gigerenzer, *Intuitive and Deliberate Judgments Are Based on Common Principles*, 118 PSYCH. REV. 97, 97–98 (2011) (providing scholarly objections to the two-system reasoning framework).

²⁸ For Professor Kahneman's book delineating these two systems, see generally KAHNEMAN, *supra* note 26. For more elaboration on the literature discussing this distinction, see FELDMAN, *supra* note 17, at 2.

²⁹ See Don A. Moore & George Loewenstein, *Self-Interest, Automaticity, and the Psychology of Conflict of Interest*, 17 SOC. JUST. RSCH. 189, 190–91 (2004).

course of action even when she is aware to some extent of the moral problem she is facing. The semi-deliberative mechanism related to justifications may make her feel better regarding her own ethicality while performing the unethical action.³⁰

Even though the theoretical framework of behavioral economics and behavioral ethics is similar, the two fields disagree over which mechanisms increase problematic behavior and how likely interventions such as nudges might succeed in the long run. In behavioral economics, nudges—the ability to predictably change peoples’ behavior through small alterations in the choice architecture of the decision they need to make³¹—have been celebrated. However, those nudges will not necessarily succeed in the behavioral ethics context. For example, one of the most successful policy implications of nudges—increasing employee participation in retirement savings plans by changing the default from opt-in to automatic enrollment³²—prompts people to overcome their cognitive limitations and save more towards their retirement. In the behavioral economics context, nudges serve a subject’s self-interest, like saving for retirement, so the subject will be receptive to them. But a subject may not be receptive to ethical nudges if their purpose is to bar the promotion of the subject’s own interest, such as limiting tax avoidance through a default payment.³³ For this reason, most of the solutions suggested in the behavioral ethics literature—and in particular the ones relevant to corporate governance—do not rely on subconscious methods like nudges, but rather on more conscious methods and mechanisms that increase awareness to achieve ethical debiasing.³⁴

We now turn to demonstrate the central behavioral ethics paradigms: those associated with automatic mechanisms as well as those based on semi-deliberative mechanisms. The exploration below is not meant to be exhaustive, but rather to illustrate how behavioral ethics mechanisms operate.³⁵

³⁰ Regarding the distinction between automatic and nonautomatic behavioral effects that cause unethicality, see FELDMAN, *supra* note 17, at 1–31.

³¹ Regarding the utilization of nudges to address bounded rationality, see RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS 6 (2008).

³² CASS R. SUNSTEIN, SIMPLER: THE FUTURE OF GOVERNMENT 104–05 (2013).

³³ See FELDMAN, *supra* note 17, at 100–01.

³⁴ For a discussion regarding ethical debiasing, see *id.* at 98–99.

³⁵ Regarding the description of the vast amount of scholarship in behavioral ethics in comparison to the more limited amount of scholarship in the field of behavioral economics, see *id.* at 7, which explains that the vast size of the literature and of dominant scholars in the field is one of the reasons it has less influence on legal scholarship: there are more competing paradigms, which prevents the emergence of one dominant paradigm.

A. “Automatic” Mechanisms

According to the behavioral ethics’ bounded-ethicality perspective, automatic mechanisms cause an individual to become unaware of the ethical dimension of a situation she is facing. The distinction between automatic mechanisms that cause ethical unawareness and semi-deliberative mechanisms that cause an individual to downplay or justify unethical behavior is very fine and, in some cases, cannot be demarcated clearly. These mechanisms are illustrated in paradigms like moral forgetting, moral fatigue, and objectivity bias, which will be discussed in the next paragraphs.

1. *Moral Forgetting*

Behavioral ethics has demonstrated how our interests and motivations affect our most basic cognitive skills, such as memory and perception. This phenomenon is referred to as “moral forgetting.”³⁶ “For example, within very short periods of time, people misremember both what they did and what they were told to do, when such misremembering allows them to believe that they had acted ethically.”³⁷ Perhaps even more surprisingly, physiological studies have demonstrated that motivation affects not just reasoning,³⁸ but also visual capabilities.³⁹ Eye-tracking mechanisms, as well as arousal studies, suggest that motivation can affect physiological processes, showing the

³⁶ See Lisa L. Shu, Francesca Gino & Max H. Bazerman, *Dishonest Deed, Clear Conscience: When Cheating Leads to Moral Disengagement and Motivated Forgetting*, 37 PERSONALITY & SOC. PSYCH. BULL. 330, 344 (2011) (“We find that bad behavior motivates moral leniency and leads to the strategic forgetting of moral rules.”). For a broader experimental and descriptive analysis of this phenomenon, see Maryam Kouchaki & Francesca Gino, *Memories of Unethical Actions Become Obfuscated over Time*, 113 PROC. NAT’L ACAD. SCIS. U.S. 6166, 6166, 6170–71 (2016), concluding that “[i]n nine studies (n = 2,109), . . . engaging in unethical behavior produces changes in memory so that memories of unethical actions gradually become less clear and vivid than memories of ethical actions or other types of actions that are either positive or negative in valence.”

³⁷ FELDMAN, *supra* note 17, at 47.

³⁸ Regarding the concept of motivated reasoning, see Ziva Kunda, *The Case for Motivated Reasoning*, 108 PSYCH. BULL. 480, 480 (1990), and Bersoff, *supra* note 24, at 28–30, which argues that “a redefinition or distorted construal of an unethical action as being morally acceptable often precedes and fosters decisions to act in an unethical manner among people generally.” For the framework that classifies automatic effect under the concept of motivated reasoning, see FELDMAN, *supra* note 17, at 47–48.

³⁹ Emily Balcetis & David Dunning, *See What You Want to See: Motivational Influences on Visual Perception*, 91 J. PERSONALITY & SOC. PSYCH. 612, 614 (2006). For a more recent account, see Guy Hochman, Andreas Glöckner, Susann Fiedler & Shahar Ayal, *“I Can See It in Your Eyes”: Biased Processing and Increased Arousal in Dishonest Responses*, 29 J. BEHAV. DECISION MAKING 322, 323 (2016).

automatic component of self-serving biases on people's cognitive capabilities.⁴⁰

A related phenomenon is “moral hypocrisy,” which is our tendency to ignore the comparison of our behavior to our preexisting moral standards, which can be viewed as an instance of “forgetting” our moral self.⁴¹ But increasing high-awareness conditions, such as viewing oneself in a mirror, has been found to decrease discrepancies between actors' ethical standards and their conduct, i.e., moral forgetting or moral hypocrisy.⁴²

2. Moral Fatigue

Other studies have found that the cognitive resources needed for ethical behavior are much greater than those needed for unethical behavior, leading to “moral fatigue.”⁴³ For example, people who make decisions after a task that requires a high level of cognitive resources tend to cheat more on a task that follows.⁴⁴ Similarly, research conducted on response time shows that subjects' responses are more likely to be honest when they are given more time.⁴⁵ Since automatic behavior is associated with shorter response times, this research supports the notion that automatic behavior is likely to cause people to be less ethical. A recent meta-analysis confirmed the intuitiveness of unethicality, at least when there are no clear victims.⁴⁶

⁴⁰ See Andrea Pittarello, Margarita Leib, Tom Gordon-Hecker & Shaul Shalvi, *Justifications Shape Ethical Blind Spots*, 26 PSYCH. SCI. 794, 795 (2015).

⁴¹ See C. Daniel Batson, Elizabeth R. Thompson, Greg Seufferling, Heather Whitney & Jon A. Strongman, *Moral Hypocrisy: Appearing Moral to Oneself Without Being So*, 77 J. PERSONALITY & SOC. PSYCH. 525, 525–26 (1999).

⁴² See *id.* at 529–32.

⁴³ See Francesca Gino, Maurice E. Schweitzer, Nicole L. Mead & Dan Ariely, *Unable to Resist Temptation: How Self-Control Depletion Promotes Unethical Behavior*, 115 ORG. BEHAV. HUM. DECISION PROCESSES 191, 192 (2011); see also Nicole E. Ruedy & Maurice E. Schweitzer, *In the Moment: The Effect of Mindfulness on Ethical Decision Making*, 95 J. BUS. ETHICS 73, 80–83 (2010) (showing experimentally how participants with a higher level of mindfulness cheated to a lesser degree).

⁴⁴ See Gino et al., *supra* note 43, at 200 (“[W]hen self-control resources are depleted, people do not have enough cognitive resources to recognize the moral component of the decision they are facing, and thus give into the temptation to cheat.”).

⁴⁵ See Shaul Shalvi, Ori Eldar & Yoella Bereby-Meyer, *Honesty Requires Time (and Lack of Justifications)*, 23 PSYCH. SCI. 1264, 1269 (2012) (“[B]eing able to deliberate led people to restrict how much they lied or avoid lying altogether. People can behave in an ethical way—they just need time . . .”).

⁴⁶ Nils C. Köbis, Bruno Verschuere, Yoella Bereby-Meyer, David Rand & Shaul Shalvi, *Intuitive Honesty Versus Dishonesty: Meta-Analytic Evidence*, 14 PERSPS. ON PSYCH. SCI. 778, 791 (2019); see also FELDMAN, *supra* note 17, at 45–46 (discussing the literature on intuitive cooperativeness and the conditions under which intuitive reasoning leads to cooperative behavior); David G. Rand, Joshua D. Greene & Martin A. Nowak, *Spontaneous Giving and Calculated Greed*, 489 NATURE 427, 428–29 (2012) (showing that people's immediate response is more cooperative than their reflective response).

3. *Objectivity Bias*

Individuals who are defined, either by themselves or by others, as “objective” are more likely to overlook their own self-interest and thus, paradoxically, reach a decision that promotes their self-interest without being aware of their actual motivation.⁴⁷ This phenomenon, called “objectivity bias,” has been observed in various professional settings. For instance, a study found that individuals who make decisions in a professional capacity are more likely to promote their own self-interest. Specifically, the study examined how gift-giving impacted managers relative to laypeople with respect to how they treat the gift-giver.⁴⁸ It found that managers are much more prone to be affected by the gift due to their greater belief that the gift does not affect their judgment owing to their professional capacity.⁴⁹ This effect is a borderline one that sometimes fits into the automatic mechanism rubric but at other times fits into the semi-deliberative rubric. The precise classification of this effect depends on what takes place on the cognitive level: does the effect disable the individual from “seeing” her conflict of interest? Or does she enter into cognitive dissonance, but the objectivity bias causes her to believe that she can overcome this conflict due to her objectivity?

B. *Semi-Deliberative Mechanisms*

The second type of mechanism in behavioral ethics literature is the semi-deliberative mechanism. This mechanism mainly applies to situations in which individuals are in a state of ethical dissonance.⁵⁰ In these situations, an individual is conscious of the fact that there is some ethical problem with the course of action she desires. Yet, certain contextual elements enable her to justify her course of action, even though that justification stands on weak analytical grounds and would not withstand a careful deliberative process. As opposed to the first mechanism, this mechanism is not automatic: the actor is more conscious of the ethical aspects of her actions or decisions, yet

⁴⁷ See generally Emily Pronin, Thomas Gilovich & Lee Ross, *Objectivity in the Eye of the Beholder: Divergent Perceptions of Bias in Self Versus Others*, 111 PSYCH. REV. 781 (2004); Joyce Ehrlinger, Thomas Gilovich & Lee Ross, *Peering into the Bias Blind Spot: People’s Assessments of Bias in Themselves and Others*, 31 PERSONALITY SOC. PSYCH. BULL. 680 (2005). For a broader account of the problem with people’s inability to recognize the problems in their own decision-making process, see generally CAROL TAVRIS & ELLIOT ARONSON, *MISTAKES WERE MADE (BUT NOT BY ME): WHY WE JUSTIFY FOOLISH BELIEFS, BAD DECISIONS, AND HURTFUL ACTS* (2015).

⁴⁸ Sunita Sah & Richard Paul Larrick, *A Sense of Professionalism Predicts Increased Acceptance and Influence from Conflicts of Interest* 3–4 (2018) (unpublished manuscript) (on file with journal).

⁴⁹ *Id.* at 13–14.

⁵⁰ See Mazar et al., *supra* note 24, at 634; Sah & Larrick, *supra* note 48, at 13–14.

limited in her ability to objectively evaluate their ethicality. This mechanism exemplifies motivated reasoning in the strong sense: mental processes do not prevent an individual from having conscious ethical awareness of the complexity of the situation; rather, a mechanism in which the internal motivation alters conscious reasoning does. Semi-deliberative mechanisms will be demonstrated in the following three contexts: subtle conflicts of interest, doing things for others, and vague circumstances.

1. *Subtle Conflicts of Interest*

The paradigm of the ethical dissonance developed above,⁵¹ where people attempt to find a balance between their conception of ethics and their material self-interest, is best exemplified in the conflict-of-interest context. According to this paradigm, people misbehave only to the extent that they can maintain their self-conception of being honest.⁵² When conflicts of interest are too obvious, people have a more difficult time justifying or ignoring their existence. But when the conflict of interest is less stark, an individual can justify her behavior more easily and disregard her conflict of interest.⁵³ Behavioral ethics predicts that an increase in an individual's own interest in a conflict of interest would decrease, rather than increase, the probability that she would promote her own interest.⁵⁴ This prediction is diametrically opposed to the standard assumption of economic analysis of law.⁵⁵

There are two dimensions in which conflicts of interest could be subtle: magnitude and quality. In addition to the level of personal interest, the salience of the conflict of interest could be sensitive to the type of personal

⁵¹ See Mazar et al., *supra* note 24, at 634.

⁵² See FELDMAN, *supra* note 17, at 193–94; see also Yuval Feldman & Eliran Halali, *Regulating “Good” People in Subtle Conflicts of Interest Situations*, 154 J. BUS. ETHICS 65, 67, 70, 75–77 (2019) (conducting a “revolving doors” experiment, in which participants are told that there is a chance that the center conducting the experiment will take them again with a higher relative pay if satisfied with their evaluations of the center, causing them to give higher evaluations of the center than other individuals, but not causing them to give higher personal evaluations of the researcher conducting the experiment or the pay he should receive, even though such evaluation may assist them more in securing their participation in the next experiment); Eyal Zamir & Raanan Sulitzeanu-Kenan, *Explaining Self-Interested Behavior of Public-Spirited Policy Makers*, 78 PUB. ADMIN. REV. 579, 580 (2017) (“[W]hen a conflict of interest is clear and unmistakable, officials are more likely to recognize and control their automatic tendency to advance their own interests. Thus, it is the less obvious cases of conflict of interest that pose a greater threat to a well-functioning public administration.”).

⁵³ See sources cited *supra* note 52.

⁵⁴ FELDMAN, *supra* note 17, at 102–03.

⁵⁵ See, e.g., Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169, 176 (1968) (suggesting that increasing the uncertainty of incurring the sanction for criminal activity by reducing enforcement, while offsetting it by increasing the penalty, could still increase crime deterrence overall because most people's risk aversion).

interest. For instance, monetary conflicts of interest are more salient than nonmonetary conflicts of interest that involve friendship or status.⁵⁶ As a consequence, ethical people may be reluctant to promote their self-interest when the conflict involves money, but are willing to act in their self-interest when the conflict is nonmonetary—like when it implicates favoring a friend.⁵⁷ This stands in contrast to the traditional approach to self-interest,⁵⁸ which maintains that transactions involving a monetary conflict of interest are more severe and should therefore receive greater scrutiny.⁵⁹ Nonmonetary rewards are open to interpretation since it could be argued that they have not actually benefited the wrongdoer.⁶⁰ For example, a doctor may not be willing to receive cash payments to promote a drug, but if invited to give a keynote address in a conference, she might justify the invitation not as compensation for her services, but rather as an honest expression of interest in her research.⁶¹

2. *Doing Things for Others*

Behavioral ethics has found that some individuals are more likely to behave unethically when acting for others than for themselves.⁶² In contrast to the rational-choice paradigm, where the individual's own gain from the wrongdoing increases the likelihood that she would engage in such behavior, behavioral ethics maintains that the gain to others may be even more powerful in affecting the agent's proclivity to commit wrongdoing.

In one experiment, individuals in charge of grading others' performance in problem-solving tests tended to inflate the performance of "poor" solvers—those who had lost in a lottery just beforehand—even when it decreased their own payment.⁶³ Other experiments have concluded that people are more likely to cheat when the benefits are split with another

⁵⁶ See Yuval Feldman, Rebecca Gauthier & Troy Schuler, *Curbing Misconduct in the Pharmaceutical Industry: Insights from Behavioral Ethics and the Behavioral Approach to Law*, 41 J.L. MED. & ETHICS 620, 622–26 (2013) (discussing the different self-interested motivations of pharmaceutical executives and researchers, the different types of conflicts of interest created, and the different regulatory solutions required).

⁵⁷ See James Heyman & Dan Ariely, *Effort for Payment: A Tale of Two Markets*, 15 PSYCH. SCI. 787, 787, 793 (2004).

⁵⁸ Michael C. Jensen, *Self-Interest, Altruism, Incentives and Agency Theory*, 7 J. APPLIED CORP. FIN. 40, 42 (1994).

⁵⁹ See FELDMAN, *supra* note 17, at 103.

⁶⁰ See *id.* at 102–03.

⁶¹ See Feldman, Gauthier & Schuler, *supra* note 56, at 622.

⁶² FELDMAN, *supra* note 17, at 197–98.

⁶³ Francesca Gino & Lamar Pierce, *Dishonesty in the Name of Equity*, 20 PSYCH. SCI. 1153, 1155, 1157–59 (2009).

person than when they capture the full benefit.⁶⁴ The behavioral ethics explanation of this phenomenon is that people can justify their wrongdoing and maintain their ethical self-conception by referring to the benefit to others as their actual motivation; they are not focused on their own self-interest and thus are not themselves a “bad person.”⁶⁵

3. *Vagueness*

Studies show that vagueness and uncertainty, whether factual or moral,⁶⁶ increase the likelihood that people would engage in wrongdoing.⁶⁷ For example, experiments have concluded that the probability of a promisor adopting a self-serving interpretation of an ambiguous provision in a contract is much greater in the setting of a loss than in the setting of a gain.⁶⁸ The behavioral ethics explanation for this conduct is that ambiguity provides an individual with “moral wiggle room,” which increases her ability to justify her behavior and maintain her ethical self-conception, as long as there is some view under which her actions are ethical.⁶⁹

A further example of this phenomenon can be seen in a series of experiments that examined a game in which a “dictator” could choose a payoff of \$5 or \$6, matched with an uncertain payoff of either \$1 or \$5 to

⁶⁴ See, e.g., Scott S. Wiltermuth, *Cheating More when the Spoils Are Split*, 115 *ORG. BEHAV. & HUM. DECISION PROCESSES* 157, 166 (2011) (“[P]eople may actually be more likely to behave unethically when they do not capture all the benefits that the unethical behavior yields.”).

⁶⁵ See *id.* at 167; see also Ann E. Tenbrunsel & David M. Messick, *Ethical Fading: The Role of Self-Deception in Unethical Behavior*, 17 *SOC. JUST. RSCH.* 223, 228–29 (2004) (suggesting a former tech CEO believed his fraudulent behavior was “appropriate” because it was intended to help the company).

⁶⁶ See Maurice E. Schweitzer & Christopher K. Hsee, *Stretching the Truth: Elastic Justification and Motivated Communication of Uncertain Information*, 25 *J. RISK & UNCERTAINTY* 185, 99–198 (2002) (“Our results demonstrate that the elasticity of private information plays an important role in the deception decision process . . .”). For a normative discussion of such an effect, see Yuval Feldman & Henry E. Smith, *Behavioral Equity*, 170 *J. INSTITUTIONAL & THEORETICAL ECON.* 137, 146–47 (2014).

⁶⁷ See Yuval Feldman, Amos Schurr & Doron Teichman, *Reference Points and Contractual Choices: An Experimental Examination*, 10 *J. EMPIRICAL LEGAL STUD.* 512, 532–34 (2013) (showing “the importance of prospect theory to understanding the way parties to contracts interpret vague obligations”); see also Yuval Feldman & Doron Teichman, *Are All Legal Probabilities Created Equal?*, 84 *N.Y.U. L. REV.* 980, 1000–02 (2009) (“Participants faced with legal uncertainty were more inclined to violate the law.”); Yuval Feldman & Alon Harel, *Social Norms, Self-Interest and Ambiguity of Legal Norms: An Experimental Analysis of the Rule vs. Standard Dilemma*, 4 *REV. L. & ECON.* 81, 104–05 (2008) (“Standards give people the opportunity to interpret reality in a way that supports their self-interest and hence both noncompliance norms . . . and high gains . . . exert a greater effect when people are faced with ambiguous legal norms.”).

⁶⁸ Feldman et al., *supra* note 67, at 533 (“When people are in the realm of losses, they tend to interpret their contractual obligations more selfishly, whereas when they are in the domain of gains, they are more likely to interpret their obligations in a more cooperative fashion.”).

⁶⁹ Jason Dana, Roberto A. Weber & Jason Xi Kuang, *Exploiting Moral Wiggle Room: Experiments Demonstrating an Illusory Preference for Fairness*, 33 *ECON. THEORY* 67, 69, 77–78 (2007).

the opposing player, which was generated by an external lottery.⁷⁰ Before choosing the payoffs, “dictators” were given a chance to see the lottery results, so they would know the implication for the opposing player. Most “dictators” chose not to receive this information, a behavior interpreted by the authors as a preference for “moral wiggle room” that enables a more favorable ethical construction of their choice.⁷¹ The finding that vagueness exacerbates wrongdoing and promotes self-interest is not trivial: it stands in contrast to conventional economic analysis, according to which greater uncertainty with the same expected sanction should increase deterrence and limit wrongdoing.⁷²

C. The Relevance of Behavioral Ethics to Law in General and Corporate Law in Particular

As one of us recently argued, the field of behavioral ethics has important implications for law and legal analysis.⁷³ One of the primary objectives of the law is to assure that individuals do not sacrifice the interests of others at the altar of their own self-interest. According to law-and-economics scholars, this is true of all legal fields. Contract law restrains individuals from breaching contracts when it serves their interest at the expense of the greater social benefit of trustful contracting;⁷⁴ tort law requires individuals to incur the costs of precautionary measures if they are lower than the expected cost of harm;⁷⁵ criminal law prohibits individuals from promoting their own desires and interests at the expense of victims.⁷⁶ In short, conventional economic theory assumes that the law is built around a conventional model of *homo economicus*, a person willing to promote her

⁷⁰ *Id.* at 71.

⁷¹ *See id.* at 74–76.

⁷² *See, e.g.,* Feldman & Smith, *supra* note 66, at 152–53 (arguing self-interested, “bad-faith” actors are less likely to evade the law if its rules are unclear); Nuno Garoupa, *Optimal Law Enforcement when Victims Are Rational Players*, in CONFLICT AND GOVERNANCE 123, 124, 132 (Amihai Glazer & Kai A. Konrad eds., 2003) (arguing that all else being equal, deterrence of crime increases as the certainty of payoffs for committing crimes decreases); Nuno Garoupa, *Behavioral Economic Analysis of Crime: A Critical Review*, 15 EUR. J.L. & ECON. 5, 9–10 (2003) (“[I]n the classical law and economics, individuals bear a risk premium because there is a probability of sanctioning between zero and one. In the behavioral approach, individuals also bear an ambiguity premium due to the fact that the probability of being sanctioned is itself uncertain.”); Kyle D. Logue, *Optimal Tax Compliance and Penalties when the Law Is Uncertain*, 27 VA. TAX REV. 241, 242–47 (2007) (arguing that the legal uncertainty in tax law together with risk aversion can explain the overcompliance observed in tax law).

⁷³ FELDMAN, *supra* note 17, at 8–12.

⁷⁴ *See* STEVEN SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW 297–98 (2004).

⁷⁵ *See id.* at 180.

⁷⁶ *See* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 216 (7th ed. 2007).

own interest at the expense of the public interest.⁷⁷ The law's goal is to maintain this inclination by imposing sanctions on individual actors in order to alter the costs and benefits associated with various courses of action, and thereby induce self-interest-maximizers to behave in a socially desirable manner.⁷⁸

The findings of behavioral ethics challenge this framework. These findings include a dominant pattern of individuals not acting in an entirely self-interested manner at the expense of others. Rather, individuals have been shown to consciously want to be sensitive to the interests of others and, in many cases, actually act according to those principles. In many other cases, though, they end up promoting their own self-interest despite their benevolent, other-regarding motivation. Imposing penalties on these actors is likely to be ineffective. They are not calculative wrongdoers to start with, and thus adding an additional personal cost would not necessarily alter their behavior.⁷⁹

The behavioral ethics literature identifies the mechanisms that enable “good people,” those who are sensitive to the interests of others, to ignore or justify to themselves why their actions are not wrong and why they do not harm others illegitimately. In many cases, the same conditions that diminish the wrongdoing of “good people” are conditions that conventional economic analysis points to as exacerbating wrongdoing. For example, according to conventional law and economics, disclosure reduces wrongdoing by increasing the probability of detection.⁸⁰ Accordingly, if a doctor discloses her conflict of interest with a drug company, she will have a lesser tendency to prescribe its drug to a patient when it does not serve the patient's interests. Once the patient becomes aware of the ties between the drug company and the doctor, the patient will become suspicious of the doctor's motives and will be more likely to detect instances in which the doctor prescribes the drug out of her own self-interest. Behavioral ethics suggests that disclosure may

⁷⁷ See Oliver Wendell Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 458–60 (1897) (describing a similar view that the primary function of law, according to Justice Holmes, is to restrict the bad man's behavior).

⁷⁸ See Becker, *supra* note 55, at 209.

⁷⁹ See FELDMAN, *supra* note 17, at 58–61.

⁸⁰ Regarding the influence of probability of detection on deterrence, see Becker, *supra* note 55, at 205–06. Regarding disclosure as an effective regulatory mechanism, see Colin Camerer, Samuel Issacharoff, George Loewenstein, Ted O'Donoghue & Matthew Rabin, *Regulation for Conservatives: Behavioral Economics and the Case for “Asymmetric Paternalism,”* 151 U. PA. L. REV. 1211, 1232–35 (2003), and Cass R. Sunstein & Richard H. Thaler, *Libertarian Paternalism Is Not an Oxymoron*, 70 U. CHI. L. REV. 1159, 1183 (2003). *But see* Omri Ben-Shahar & Carl E. Schneider, *The Failure of Mandated Disclosure*, 159 U. PA. L. REV. 647, 679–729 (2011) (explaining why “mandated disclosure regularly . . . fails to achieve its purpose of improving disclosees' decisions”).

have the opposite effect: if the doctor is a “good person” who does not want to take advantage of others consciously, disclosure may increase her tendency to prescribe the drug to patients even when it is not optimal to do so. The disclosure notifies the patient of the doctor’s conflict of interest, thereby enabling the doctor to promote the drug while maintaining her ethical self-conception.⁸¹

The same is also true of vague legal rules.⁸² Standard economic analysis points out that vague legal rules may increase deterrence because of risk aversion. Assuming two parallel regimes with the same expected sanction, economists would conclude that people will be more deterred by the uncertain legal regime under which there could be no sanction at all or a very high penalty, rather than by the alternative regime under which a lower sanction will be imposed but with a much higher probability.⁸³ The behavioral ethics literature reaches the opposite conclusion. “Good people” tend to engage in greater wrongdoing when it is possible to interpret the action as legitimate, even though it introduces uncertainty as to the expected sanction.⁸⁴ Good people can justify their actions due to the vagueness of the legal norms, allowing them to adopt a lenient interpretation of their behavior and weakening their internal aversion to wrongdoing.⁸⁵

II. APPLICATIONS OF BEHAVIORAL ETHICS TO ISSUES IN CORPORATE GOVERNANCE

The strong relevance of behavioral ethics to the law has been powerfully demonstrated.⁸⁶ There is a strong reason to believe that of all legal fields, the findings of legal ethics are most relevant to corporate law. The two central features of corporate law—agency and group decision-making—make it an ideal setting for the application of the insights of behavioral ethics.⁸⁷ The behavioral ethics literature suggests that wrongdoing intensifies when there is a veil of anonymity between the wrongdoer and the actual victim. This condition exists in all public corporations, where agents are required to make decisions on behalf of anonymous shareholders. The

⁸¹ See Marc A. Rodwin, *Physicians’ Conflicts of Interest: The Limitations of Disclosure*, 321 NEW ENG. J. MED. 1405, 1405 (1989).

⁸² See *infra* Section I.A.2.

⁸³ See *supra* note 55 and accompanying text.

⁸⁴ See *supra* note 54 and accompanying text.

⁸⁵ FELDMAN, *supra* note 17, at 158–61.

⁸⁶ See generally FELDMAN, *supra* note 17 (using empirical analysis to show that “good people” can be led to violate laws if they can rationalize their actions within their own moral framework, and that understanding this behavior can be used to develop more efficient enforcement regimes).

⁸⁷ See sources cited *infra* note 89 and accompanying text.

behavioral ethics literature also teaches that group decision-making leads to diluted notions of responsibility and facilitates behavior by agents that disregards their legal duties.⁸⁸ It is therefore surprising that, until recently, corporate law has gone under the radar of behavioral ethics. In the paragraphs to come, we seek to fill this gap. This Part will systematically examine the full range of behavioral ethics effects that are relevant to the corporate context, targeting two loci of corporate governance: structural applications, such as board design, and procedural applications, such as corporate decision-making processes. It will demonstrate how the behavioral ethics perspective sheds new light on these two elements of corporate governance. It will both underscore new sources of potential wrongdoing in corporations and suggest novel mechanisms for addressing them.

A. Structural Applications

We begin our discussion of the applications of behavioral ethics to corporate law by analyzing the structural implications. By “structural,” we refer to the institutional design of corporations as prescribed by law. Specifically, we examine voting and group decisions, vagueness in corporate law, partial dependence of independent directors, and transgressions for the sake of others. We show that behavioral ethics research provides important insights into each of these aspects and points to a set of policy interventions that differs from the legal norms currently in use.

1. Implications of Group Decision-Making

The central organ of the firm is the board. As Professor Stephen Bainbridge puts it, “At the apex of the corporate hierarchy stands not a single individual but a collective—the board of directors.”⁸⁹ Consequently, the most important decisions are a product of a board’s group decision-making process. This is not a by-product of the board structure but rather its primary purpose. As noted in the commentary of the Model Business Corporation Act,

A well-established principle of corporate common law accepted by implication in the Model Act is that directors may act only at a meeting unless otherwise

⁸⁸ See sources cited *infra* note 93 and accompanying text.

⁸⁹ STEPHEN M. BAINBRIDGE, CORPORATE LAW 85 (3d ed. 2015); see also Stephen M. Bainbridge, *The Board of Directors*, in THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE 275, 275 (Jeffrey N. Gordon & Wolf-Georg Ringe eds., 2018) (describing the development and importance of the board of directors in Anglo-American law).

expressly authorized by statute. The underlying theory is that the consultation and exchange of views is an integral part of the functioning of the board.⁹⁰

The treatment of the board as a unitary whole has other legal implications. As many corporate scholars have noted, “in cases involving breaches of the duty of care, courts tend to treat the board as a unitary whole and assign responsibility to all directors collectively.”⁹¹

Behavioral ethics has underscored several problematic features of group decision-making processes.⁹² For example, it reveals that individuals are more likely to engage in wrongdoing when they work in pairs than when working alone, a phenomenon labeled in the literature as “dishonesty shift.”⁹³ There are four possible explanations for this phenomenon.⁹⁴ The first explanation suggests that people are more likely to behave dishonestly when their actions benefit others, an explanation known as “payoff

⁹⁰ MODEL BUS. CORP. ACT ANN. § 8.20, at 8-120 (AM. BAR ASS'N 2008). The same approach has also been adopted in the *Restatement (Second) of Agency*, which notes that a director “has no power of his own to act on the corporation’s behalf, but only as one of the body of directors acting as a board.” RESTATEMENT (SECOND) OF AGENCY § 14C cmt. b (AM. L. INST. 1958). This principle is also reflected in Delaware law: “The vote of the majority of the directors present at a meeting at which a quorum is present shall be the act of the board of directors” DEL. CODE ANN. tit. 8, § 141(b) (current through 82 Del. Laws, ch. 281).

⁹¹ Asaf Eckstein & Gideon Parchomovsky, *Toward a Horizontal Fiduciary Duty in Corporate Law*, 104 CORNELL L. REV. 803, 808 (2019). Some scholars distinguish between violations of the duty of care, which are likely to involve the entire board, and violations of the duty of loyalty, which tend to be limited to certain directors that have benefited from a transaction. See Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 EMORY L.J. 1155, 1178 n.39 (1990). Regarding the murky boundaries under existing law between individual and collective liability for directors, see generally Darian M. Ibrahim, *Individual or Collective Liability for Corporate Directors?*, 93 IOWA L. REV. 929 (2008).

⁹² See Matthias Sutter, *Deception Through Telling the Truth?! Experimental Evidence from Individuals and Teams*, 119 ECON. J. 47, 57 (2009) (observing “more deception through sophisticated truth-telling by teams than by individuals”); Ori Weisel & Shaul Shalvi, *The Collaborative Roots of Corruption*, 112 PROC. NAT’L ACAD. SCI. U.S. 10651, 10655 (2015) (“A collaborative setting led people to engage in excessive dishonest behavior.”); Julian Conrads, Bernd Irlenbusch, Rainer Michael Rilke & Gari Walkowitz, *Lying and Team Incentives*, 34 J. ECON. PSYCH. 1, 7 (2013) (finding “that lying is . . . more pronounced under team[s] . . . than individual[s]”); Gerd Muehlheusser, Andreas Roeder & Niklas Wallmeier, *Gender Differences in Honesty: Groups Versus Individuals*, 128 ECON. LETTERS 25, 26–27 (2015) (researching gender differences in lying and finding all-male groups and mixed male–female groups lied more frequently than individuals or all-female groups); FELDMAN, *supra* note 17, at 202 (discussing Professors Ori Weisel and Shaul Shalvi’s research and how “when people work together in dyads . . . they are more likely to engage in wrongdoing than they would have individually”).

⁹³ Martin G. Kocher, Simeon Schudy & Lisa Spantig, *I Lie? We Lie! Why? Experimental Evidence on a Dishonesty Shift in Groups*, 64 MGMT. SCI. 3995, 3996 (2018).

⁹⁴ See Francesca Gino, Shahar Ayal & Dan Ariely, *Self-Serving Altruism? The Lure of Unethical Actions that Benefit Others*, 93 J. ECON. BEHAV. & ORG. 285, 291 (2013); Jörg Gross, Margarita Leib, Theo Offerman & Shaul Shalvi, *Ethical Free Riding: When Honest People Find Dishonest Partners*, 29 PSYCH. SCI. 1956, 1957 (2018); Kocher et al., *supra* note 93, at 3996.

commonality.”⁹⁵ The second explanation is “the decreased observability of one’s actions within a group.”⁹⁶ The third is that group deliberation processes are more fruitful in generating arguments justifying dishonesty.⁹⁷ This explanation is supported by the fact that increased dishonesty in groups occurs even when the first two explanations do not occur.⁹⁸ The fourth explanation is that in group settings, the responsibility for misconduct falls on the shoulders of others, an effect called “ethical free riding.”⁹⁹ At least one study indicates that even people who are honest in their individual choices might not object when a dishonest partner lies to help them get more money.¹⁰⁰

The increased tendency to engage in dishonest behavior in group settings poses a serious problem in the corporate context. As noted above, the collective nature of boards is one of the core structural features of corporations. The common wisdom behind much of corporate governance suggests that group deliberation promotes sound decision-making,¹⁰¹ an assumption directly challenged by behavioral ethics. The findings of behavioral ethics imply that there is a need to curtail the structural ethical failures of corporate boards’ decision-making processes to prevent dishonesty and self-promotion by board members at the expense of the corporation. There are a few ways to diminish the collective decision-making structure of the board—and the accompanying negative implications—that stop short of abolishing group decision-making altogether in corporations.

⁹⁵ Kocher et al., *supra* note 93, at 3998.

⁹⁶ *Id.* at 3996.

⁹⁷ *See id.* at 4004.

⁹⁸ *See id.* at 4005. In an experiment, an individual watched a video of a die being rolled and received a higher payment when the number they reported observing was higher. *Id.* at 3997. They compared reported numbers when decisions were made individually to those when individuals decided collectively what to report, and still found statistically significant higher dishonesty in the group context. *Id.* at 4000. Their conclusion—that the deliberation process in the group setting, through the exchange of moral views and arguments, generated greater justification for dishonesty—was reinforced by the group communications. *Id.* at 4005. They found more arguments for dishonesty when analyzing the conversations between the group members than in the individual setting where individuals were asked to write down their thoughts before reporting. *Id.* at 4004–06.

⁹⁹ Gross et al., *supra* note 94, at 1957 (“We label this behavior *ethical free riding*, which we define as intentionally benefiting from other people’s rule-violating behavior without violating rules oneself.”).

¹⁰⁰ *Id.* at 1961–62 (“Results revealed that honest first movers systematically engaged in ethical free riding Honest first movers were less likely to ask to switch when their partner (the second mover) was a liar versus an honest person”). Other explanations that have not been raised in the literature are also possible. For example, individuals may perceive themselves as less responsible for dishonest behavior when it stems from a group interaction even when others can observe their dishonesty in the group context.

¹⁰¹ *See* sources cited *supra* notes 89–90 and accompanying text.

First, corporate decisions could be made in a two-tiered structure. Before the board can consider a certain issue, an individual member of the board must approve it. While this may sound impractical, it is not that different from current board practices that delegate certain issues to subcommittees, such as the compensation and audit committees that are comprised of board members.¹⁰² We recommend the same mechanism but with responsibility assigned to individuals, rather than subcommittees, to increase personal accountability for the board's decisions. Individual decisions would be free from the "group effects" discussed above. Our mechanism would therefore curtail both sources of group effects: the greater justification for dishonesty that group deliberation generates, and the dilution of responsibility. Unlike subcommittees, whose approval is mandatory, the decisions of individual directors would be subject to board reversal, making them more of a recommendation than a binding decision—after all, it would be highly problematic and paralyzing if one individual were to have veto power over important decisions of the firm.

Second, differential responsibility could be assigned among directors. For example, director *A* would bear the potential legal responsibility associated with decision *X* that falls under her area of specialization, while director *B* would be responsible for decisions *Y* and *Z* that fall under her fields of expertise. Differential assignment would dramatically ameliorate the "group effects" of payoff commonality and dilution of responsibility.¹⁰³ Varying the expected costs borne by each director as a result of wrongdoing would make individual directors more conscious of their corporate roles and responsibilities. It would also break the unitary structure that generates the diffusion of responsibility among individual directors.

While it is possible for a court to assign different levels of responsibility to different directors after the fact, it is rarely done.¹⁰⁴ To achieve a more effective differentiation among directors, there should be an *ex ante* process that defines how particular directors will be responsible for particular types

¹⁰² In the NYSE *Listed Company Manual*, all public companies listed on the NYSE must have a compensation committee and an audit committee, both comprised solely from independent directors. The compensation committee is responsible for reviewing and approving CEO compensation and making recommendations for non-CEO compensation. N.Y. STOCK EXCH., LISTED COMPANY MANUAL 303A.05, 303A.06 [hereinafter NYSE LISTED COMPANY MANUAL], <https://nyse.wolterskluwer.cloud/listed-company-manual> [<https://perma.cc/ZM7M-JCZB>] (follow "Section 3 Corporate Responsibility" hyperlink, then either scroll down to 303A.05, 303A.06, or click those sections on the left-hand menu). Many companies have other committees that are not mandated by any entity, such as environmental committees and social responsibility committees, that review the firm's policies and make recommendations to the board regarding these issues.

¹⁰³ See Kocher et al., *supra* note 93, at 4006.

¹⁰⁴ See Eckstein & Parchomovsky, *supra* note 91, at 826.

of wrongdoing. For example, a director with a financial background could be liable for financial misreporting, while the chairman of the compensation committee could be accountable for any excess compensation. The relevant director could be held exclusively responsible or more responsible than others, and that would break the payoff commonality of board members derived from the specific wrongdoing.

A less extreme variant of the previous proposal might be to adopt a framework of horizontal fiduciary duties.¹⁰⁵ Horizontal fiduciary duties would enable directors to sue other directors for their wrongdoing that resulted in the corporation's wrongdoing. While this proposal has been justified on different grounds,¹⁰⁶ it also has the ability to address the ethical failures associated with group decision-making. It curtails the unitary structure of the board by imposing on each board member a duty toward the other board members. It further transforms the decisions of the board into individual decisions of the directors who comprise it by establishing individual liability on the part of board members to one another.

2. *Inherent Vagueness in Corporate Law*

As suggested in Part I, the behavioral ethics literature reveals that individuals tend to promote their self-interest when facing factual or legal ambiguity.¹⁰⁷ According to the behavioral ethics literature, this happens because vagueness enables actors to justify their self-interested behavior, which scholars have labeled “elastic justification.”¹⁰⁸ The legal implications of this are far-reaching. This finding reinforces the view that the legal system in general should be based, as much as possible, on rules rather than standards, and that those rules should be clear and unambiguous.¹⁰⁹ And the vagueness effect is especially relevant to the corporate context because of two of the corporate context's distinctive features: multiple stakeholders trying to pursue the interests of all the firm's constituents and the multiple avenues to maximize those interests.

¹⁰⁵ See *id.* at 841–47.

¹⁰⁶ See *id.* at 853 (justifying horizontal fiduciary duties as a way to improve corporate boards' functioning *ex ante* and allowing individual directors to exonerate themselves *ex post* when they did not do wrong but other directors did).

¹⁰⁷ See *supra* Section I.B.3.

¹⁰⁸ See Schweitzer & Hsee, *supra* note 66, at 188 (“According to elastic justification, decisions are influenced not only by justifiable factors (those which decision makers believe they should take into consideration), but also unjustifiable factors (those which decision makers are motivated to take into consideration but do not believe they should).”).

¹⁰⁹ See FELDMAN, *supra* note 17, at 184–85.

The first source of vagueness concerns is rooted in multiple corporate stakeholders and purposes of the firm. One school of thought puts stakeholder interests on par with those of shareholders.¹¹⁰ According to it, the purpose of the firm is not solely to maximize shareholder profits, but also to pursue the interests of its workers, customers, lenders, the community in which it is located, and society at large. The vagueness created by the multiple parties whose interests the firm is obliged to further enables an agent to justify actions that are not aligned with the interests of shareholders, for example, via the adoption of more conservative policies than those that shareholders might want. And an agent, who may also have a stakeholder interest, is invited to interpret permissible corporate actions more broadly to further their own self-interest without clear guidelines.

The second source of vagueness concerns the best means to promote a corporation's business objective. Even assuming that a corporation's objective is profit-maximization, questions arise as to how best to accomplish this goal. Should the company spend more on advertising and

¹¹⁰ One of the earliest proponents of the stakeholder view was Merrick Dodd, who had a well-known dispute with Adolf Berle, the chief proponent of the shareholder-primacy view. See E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1154–56 (1932) (“[T]hose who manage our business corporations should concern themselves with the interests of employees, consumers, and the general public, as well as of the stockholders . . .”). A new wave in support of the stakeholder view rose in the late 1970s and early 1980s in response to a variety of changing social and business conditions. See R. Edward Freeman & David L. Reed, *Stockholders and Stakeholders: A New Perspective on Corporate Governance*, 25 CAL. MGMT. REV. 88, 90 (1983); see also R. EDWARD FREEMAN, STRATEGIC MANAGEMENT: A STAKEHOLDER APPROACH 90 (1984) (discussing the social factors that gave rise to the stakeholder view). The stakeholder theory of corporate law became a common topic for legal symposia in the early 1990s. See, e.g., Symposium, *The Corporate Stakeholder Conference: Introduction*, 43 U. TORONTO L.J. 297, 298 (1993) (declaring the conference's goal “was to help bridge the distance between the disciplines of corporate and labour law and theory and to contribute to a dialogue that could be mutually beneficial”); Symposium, *New Directions in Corporate Law*, 50 WASH. & LEE L. REV. 1373 (1993) (reflecting the overarching theme of Professor David Millon's 1993 article, *New Directions in Corporate Law: Communitarians, Contractarians, and the Crisis in Corporate Law*). Scholarship in support of the stakeholder view continues to be published to this day. See, e.g., Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189, 1189–90 (2002) (arguing that some of the most frequently raised arguments for shareholder primacy are inaccurate, incorrect, and unpersuasive); Thomas A. Kochan & Saul A. Rubinstein, *Toward a Stakeholder Theory of the Firm: The Saturn Partnership*, 11 ORG. SCI. 367, 384 (2000) (urging organizational researchers to “rethink[] basic concepts and practices” in order to give stakeholders a greater voice in corporate decision-making); Justin Blount, *Creating a Stakeholder Democracy Under Existing Corporate Law*, 18 U. PA. J. BUS. L. 365, 365, 366–370 (2016) (indicating the issue of private ordering and arguing that “since corporate law is largely enabling rather than mandatory,” stakeholder governance structures can “be voluntarily created within the current shareholder-centric default corporate law structure”); Iris H-Y Chiu, *Operationalising a Stakeholder Conception in Company Law*, 10 LAW & FIN. MKTS. REV. 173, 173 (2016) (arguing that “the shareholder primacy-led foundations for UK company law should be revisited, and that the adoption of a stakeholder conception in company law can be both normatively and positively supported”).

promoting its services or goods, or should it cut those costs? Should it spend more on salaries in order to recruit better talent, or should it reduce payroll costs? The source of this uncertainty is factual, but it has legal implications.¹¹¹ This vagueness over the appropriate business course for the firm may cause management to choose a path or policy that is aligned with its own self-interest, even though it is suboptimal for the firm.

The most straightforward way to address the adverse effects of vagueness is via the adoption and implementation of clearer norms of conduct. For instance, it would be desirable to clearly define the objective of corporations and set bright-line rules regarding expenses and

¹¹¹ The Delaware Supreme Court, which in regard to corporate law is the most important jurisdiction in the United States and where around half of U.S. corporations are incorporated, seems to have accepted the shareholder-primacy view. It has stated that “[t]he board of directors has the legal responsibility to manage the business of a corporation for the benefit of its shareholder owners.” *Malone v. Brincat*, 722 A.2d 5, 9 (Del. 1998); *see also* *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986) (“[C]oncern for non-stockholder interests is inappropriate when an auction among active bidders is in progress, and the object no longer is to protect or maintain the corporate enterprise but to sell it to the highest bidder.”). Even the Delaware Supreme Court has permitted directors in some cases to make decisions that seem to diverge from shareholders’ interests and that benefit other constituencies at their expense. *See, e.g.,* *Paramount Commc’ns, Inc. v. Time Inc.*, 571 A.2d 1140, 1142 (Del. 1989) (denying shareholders of Time Inc. an injunction against a merger with Warner Communication, Inc. despite Time shareholders’ interest in pursuing potentially more lucrative offers). Yet as Professor Lynn Stout has pointed out, courts have done so using shareholder-primacy rhetoric, hoping that in the long run it will also benefit the shareholders in some way. *See* Stout, *supra* note 110, at 1203. Many other scholars hold that the dominant view of the corporation’s purpose in the United States is shareholder-oriented, a view originally stated by Adolf Berle. *See* A.A. Berle, Jr., *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365, 1367 (1932) (“I submit that you can not abandon emphasis on ‘the view that business corporations exist for the sole purpose of making profits for their stockholders’ until such time as you are prepared to offer a clear and reasonably enforceable scheme of responsibilities to someone else.”); *see also* Ronald Chen & Jon Hanson, *The Illusion of Law: The Legitimizing Schemas of Modern Policy and Corporate Law*, 103 MICH. L. REV. 1, 42–46 (2004) (discussing Milton Friedman’s contributions to the stakeholder theory); Michael C. Jensen, *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, 14 J. APPLIED CORP. FIN. 8, 8–9 (2001) (comparing the value-maximization and stakeholder theories of the corporate objective and outlining a different theory called “enlightened stakeholder value,” which purports to unify the two theories); Virginia Harper Ho, *“Enlightened Shareholder Value”: Corporate Governance Beyond the Shareholder–Stakeholder Divide*, 36 J. CORP. L. 59, 72 (2010). Recently, the shareholder primacy view has undergone a reformulation from focusing on the maximization of profits to shareholder welfare. *See* Oliver Hart & Luigi Zingales, *Companies Should Maximize Shareholder Welfare Not Market Value*, 2 J.L., FIN. & ACCT. 247, 247 (2017) (“We argue that maximization of shareholder welfare is not the same as maximization of market value. We propose that company and asset managers should pursue policies consistent with the preferences of their investors.”). Regarding the implications of this view on corporate governance, *see* Adi Libson, *Taking Shareholders’ Social Preferences Seriously: Confronting a New Agency Problem*, 9 U.C. IRVINE L. REV. 699, 707–12 (2019), which points to a possible new agency problem between shareholders and management in corporations’ pursuit of social objectives desired by the shareholders and how it can be addressed.

compensation.¹¹² Yet such methods may be unrealistic in the corporate setting—if one accepts the stakeholder view,¹¹³ the standards may have to remain vague. Moreover, sacrificing flexibility may be too high a price to pay to eliminate vagueness, at least from a business perspective.

An alternative way of reducing vagueness is by relying more heavily on ex ante mechanisms than on ex post ones.¹¹⁴ Ex post mechanisms focus on the individual's after-the-fact liability. The threat of liability after the fact is intended to affect the individual's ex ante calculations and generate deterrence. Yet if individuals are not fully aware of their wrongdoing in the first place, ex post mechanisms are less effective in curtailing antisocial behavior.¹¹⁵ Furthermore, ex post mechanisms require evidence, and in cases of subtle wrongdoing, it is much more complicated to collect such evidence.¹¹⁶ The vagueness that accompanies ex post mechanisms indicates that fiduciary duties may also be ineffective in curbing conflicts of interest. Because of the uncertainty that comes with ex post liability, the agent will tend to interpret the duty as congruent with her actions, which renders the efficacy of fiduciary duties and potential liability quite limited.¹¹⁷

But there are still several instances in which ex ante mechanisms can remediate ethical failures. First, managers and boards could be required to receive shareholder approval in advance for certain gray-area actions, like compensation increases or setting compensation at a certain ratio.¹¹⁸

¹¹² This is not as far-fetched as it may seem: best practices for setting compensation and other issues partially fulfill this function. Regarding a description of the best practices advised by the NYSE and NASDAQ, see WACHTELL, LIPTON, ROSEN & KATZ, COMPENSATION COMMITTEE GUIDE 5–9 (2017), <https://www.wlrk.com/webdocs/wlrknew/WLRKMemos/WLRK/WLRK.25540.17.pdf> [<https://perma.cc/U2W9-26MA>].

¹¹³ See sources cited *supra* note 110 and accompanying text.

¹¹⁴ FELDMAN, *supra* note 17, at 206.

¹¹⁵ See *id.* at xii.

¹¹⁶ See *id.*

¹¹⁷ However, it is important to recognize that in the last year or so, a few studies by Professor Uri Gneezy and his coauthors showed that when incentives are designed effectively and behavior of an agent is observable, incentives could have an effect even on subtle unethical behavior. See, e.g., Agne Kajackaite & Uri Gneezy, *Incentives and Cheating*, 102 GAMES & ECON. BEHAV. 433, 434 (2017) (showing “that in a mind game the tendency to lie increases with incentives, indicating that some of our participants have positive and finite intrinsic costs of lying”); Uri Gneezy, Agne Kajackaite & Joel Sobel, *Lying Aversion and the Size of the Lie*, 108 AM. ECON. REV. 419, 420 (2018) (“We argue that the intrinsic cost of lying depends on the size of the lie and identify three different ways to measure this size: the payoff dimension . . . , the outcome dimension . . . , and the likelihood dimension . . .”).

¹¹⁸ The SEC has recently implemented the Dodd–Frank rule that companies have to disclose the ratio between the compensation of the principal executive officer, typically the CEO, and the average worker in the firm. See 17 C.F.R. § 229.402(u) (2020); see also Press Release, SEC, SEC Adopts Interpretive Guidance on Pay Ratio Rule (Sept. 21, 2017), <https://www.sec.gov/news/press-release/2017-172> [<https://perma.cc/FSV3-YBAC>] (describing the rule that was implemented in 2018). Other jurisdictions

A second option is the utilization of catalogs—enumerations of specific instances of conflicts of interest that management and directors would have to check as part of their disclosure protocol. The catalog would be nonexhaustive, but the specific items on it would focus the attention of managers and directors on the type of activities with which they ought to be concerned. As Professor Alex Stein and one of us recently noted, one of the primary advantages of catalogs is their ability to reduce uncertainty.¹¹⁹ For example, suppose that when making a charitable contribution, a CEO would have to complete a document inquiring into whether she received personal services from a charity, whether she has a relative working for the charity, whether she worked for the charity in the past or did business with it, and so on. The list could even contain scenarios that are not prohibited by law—like whether the charity employs a relative of the donor—to sensitize the respondent to the kind of issues of which she ought to be aware.

3. *The Curse of Partial Dependence*

Many fields have adopted a perspective of harm reduction that focuses on decreasing the expected harm from a certain activity.¹²⁰ Yet by adopting the harm-reduction approach, policymakers might inadvertently create a situation in which more “good people” are likely able to justify engaging in harmful behavior.¹²¹ Consider electronic cigarettes. From a harm reduction perspective, it is safer for smokers to switch to electronic cigarettes, which studies suggest may be healthier.¹²² However, the aggregate social effects of electronic cigarettes is unclear, as they may have induced many nonsmokers, who had avoided regular cigarettes, to try electronic cigarettes.¹²³ Similarly,

have passed more aggressive laws that do not settle for disclosing the gap, but also tax at a higher rate any executive compensation that exceeds a certain proportion in relation to the compensation for the least paid worker. *See, e.g.*, § 2b, Compensation for Executives in Financial Firms Law, SH 2552 (2016) 874 (Isr.). Israeli law limits the tax deductibility of compensation for executives in financial firms that exceeds thirty-five times the compensation for the lowest paid worker in the firm. *Id.*

¹¹⁹ *See* Gideon Parchomovsky & Alex Stein, *Catalogs*, 115 COLUM. L. REV. 165, 190 (2015) (“The upshot . . . is that catalogs offer the legal system the certainty and predictability of rules and the flexibility of standards.”).

¹²⁰ *See, e.g.*, G. Alan Marlatt & Katie Witkiewitz, *Harm Reduction Approaches to Alcohol Use: Health Promotion, Prevention, and Treatment*, 27 ADDICTIVE BEHAVS. 867, 880–81 (2002) (adopting the harm-reduction view for alcoholism treatment).

¹²¹ For a discussion of how people look for justifications, *see* Bersoff, *supra* note 24, at 36–38, and Shalvi et al., *supra* note 25, at 187–89.

¹²² *See generally, e.g.*, Jacob George, Muhammad Hussain, Thenmalar Vadiveloo, Sheila Ireland, Pippa Hopkinson, Allan D. Struthers, Peter T. Donnan, Faisal Khan & Chim C. Lang, *Cardiovascular Effects of Switching from Tobacco Cigarettes to Electronic Cigarettes*, 74 J. AM. COLL. CARDIOLOGY 3112 (2019) (pointing to the cardiovascular advantages of e-cigarettes).

¹²³ It should be noted that at least in some of the studies on electronic cigarettes, relatively few nonsmokers use them. *See, e.g.*, Martin Dockrell, Rory Morrison, Linda Bauld & Ann McNeill, *E-*

when the law suggests policy solutions that only partially solve a problem, it might cause “good people,” who would not have otherwise engaged in self-interested behavior, to reconsider behaving unethically. In the case of corporate actors, this means that partial solutions might give directors and officers who abstained from self-interested behavior an excuse to behave unethically. This caveat is relevant to a particular issue in the corporate context: partial independence. In the corporate context, the most relevant example of partial independence is independent directors.

a. Independent directors

One of the central issues regarding board structure is the role of independent directors. The purpose of independent directors is to enhance the monitoring of the board over management by appointing directors to the board that are not connected to the management and other executives in the company.¹²⁴ For a director to be considered independent, the board must determine, among other things, that: (a) the director or her immediate family member is not a current partner or employee of the company’s auditors, and did not work in the last three years on the company’s audits in a firm that is the company’s internal or external auditor;¹²⁵ (b) the director or family member is not, or was not within the past three years, an executive of a firm in which the current company’s executive officers served on the compensation committee;¹²⁶ and (c) the director or a family member is not an employee of a company that, within the last three years, received or paid to the current company more than \$1 million or 2% of the company’s consolidated gross revenues, whichever is greater.¹²⁷

The institution of independent directors is on the rise in the United States. Independent directors constituted roughly 20% of the directors in the 1950s but reached about 75% by the mid-2000s.¹²⁸ Independent directors are

Cigarettes: Prevalence and Attitudes in Great Britain, 15 NICOTINE & TOBACCO RSCH. 1737, 1744 (2013) (“While we found evidence supporting the view that e-cigarette use may be a bridge to quitting, we found negligible evidence of e-cigarette use among those who had never smoked.”).

¹²⁴ See Lucian A. Bebchuk & Assaf Hamdani, *The Elusive Quest for Global Governance Standards*, 157 U. PA. L. REV. 1263, 1301–02 (2009) (noting the different purposes of independent directors in companies with a controlling shareholder and companies without a controlling shareholder).

¹²⁵ BAINBRIDGE, *supra* note 89, at 93.

¹²⁶ *Id.*

¹²⁷ *Id.* Besides direct regulation of disqualifying relationships, increasing the presence of independent directors could be done indirectly, such as by increasing legal sanctions for a fiduciary breach, developing intraboard structures that require an independent lead director, or reducing CEO influence over nomination of directors. See Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1477 (2007).

¹²⁸ Gordon, *supra* note 127, at 1471.

viewed as such an important tool for corporate governance that the New York Stock Exchange (NYSE) and NASDAQ stock market mandated that all listed companies have a majority of independent directors, though they exempt controlled companies.¹²⁹ In practice, the share of independent directors exceeds that mandate substantially.¹³⁰

The rise of independent directors is mostly viewed as a positive development in corporate law.¹³¹ Independent directors are believed to enhance the board's monitoring capacities, which in turn reduces managerial embezzlement and tunneling.¹³² Yet a highly influential study surprisingly found that independent boards do not contribute to firm value¹³³ and even pointed to a possible negative correlation between the proportion of independent directors on the board and firm performance.¹³⁴ The correlation was especially strong in firms with only one or two insiders on a typical board.¹³⁵ Similar findings were replicated in other studies.¹³⁶

¹²⁹ NYSE LISTED COMPANY MANUAL, *supra* note 102, § 303A.01; BAINBRIDGE, *supra* note 89, at 90–91.

¹³⁰ Gordon, *supra* note 127, at 1476.

¹³¹ *Id.* at 1468.

¹³² *See id.* at 1528–40.

¹³³ Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921, 923 (1999) (“[W]e explore some possible explanations for why firms with majority-independent boards appear not to perform any better than firms without such boards, and why firms with supermajority-independent boards might even perform worse, on average, than other firms.”); *see also* Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231, 235–36, 239 (2002) (examining the correlation between independence of boards and its impact years ahead in order to address the argument that the impact of independence of the firm is mainly long-term); Ozcan Isik & Ali Riza Ince, *Board Size, Board Composition and Performance: An Investigation on Turkish Banks*, 9 INT’L BUS. RSCH. 74, 81 (2016) (finding a negative but statistically insignificant correlation between the percentage of outside directors on the board and firm performance in the Turkish banking industry); Paul M. Guest, *The Impact of Board Size on Firm Performance: Evidence from the UK*, 15 EUR. J. FIN. 385, 401–02 (2009) (finding a negative correlation between the number of outside directors on the board in UK companies and profitability measures, Tobin’s Q, and stock returns); Benjamin E. Hermalin & Michael S. Weisbach, *Boards of Directors as an Endogenously Determined Institution: A Survey of the Economic Literature*, 9 ECON. POL’Y REV. 7, 20 (2003) (finding no relationship between board composition and corporate performance from a survey of literature).

¹³⁴ Bhagat & Black, *supra* note 133, at 944–45.

¹³⁵ *Id.* at 945.

¹³⁶ *See id.* at 942–45. Studies that have contradicted this finding have been criticized for their methodological flaws. For studies that have contradicted this finding, see Ira M. Millstein & Paul W. MacAvoy, *The Active Board of Directors and Performance of the Large Publicly Traded Corporation*, 98 COLUM. L. REV. 1283, 1317–18 (1998), explaining that their “research demonstrates a substantial and statistically significant correlation between an active, independent board and superior corporate performance,” and Barry D. Baysinger & Henry N. Butler, *Corporate Governance and the Board of Directors: Performance Effects of Changes in Board Composition*, 1 J.L., ECON. & ORG. 101, 121 (1985). For scholarship criticizing the studies with the contradicting findings, see Gordon, *supra* note 127, at

A few theories have been advanced to explain the observed negative effect of independent directors on firm performance. One explanation points out that while independent directors can monitor management more effectively, this benefit is accompanied by a cost that can cancel it out: outsiders have lesser abilities, relative to corporate insiders, to perform the monitoring duty effectively, as they are less familiar with the business in which the firm is involved and with the firm's capabilities.¹³⁷ Thus, increasing the share of independent directors on the board may decrease firm performance, even if it improves the motivation of the board to monitor.¹³⁸

The second explanation is that even if independent directors may seem to have a negative impact on the performance of some firms, they may still have a net-positive systemic effect on all firms. The efficient practices that a firm adopts because of its independent board—such as lower executive compensation—would spread to its competitors, even those without independent boards, in order not to lag behind in their performance.¹³⁹ In addition to the indirect externalities independent directors generate for other firms, they are also endowed with a direct systematic role pertaining to shareholders in general. In the United States, independent directors are tasked with ensuring the reliability of financial disclosures.¹⁴⁰ Better disclosures primarily create firm-specific benefits that enable more effective

1501 n.142, which points to the fact that the Baysinger & Butler study tested the statistical significance of only one measure of performance and was not replicated by any other study. Professor Jeffrey Gordon argued that the parameter focused on in the study—the board's attitude—does not reflect the actual activity of the board, but only shows the grade that the California Public Employees' Retirement System assigned to boards based on their compliance with certain guidelines. *See id.*

¹³⁷ Even staunch supporters for the monitoring role of boards have conceded the cost of independence and have recommended some level of insider representation. *See* Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 313–15 (1983). Evidence of the disadvantages of an outsized presence of independent directors was found in the decrease of acquirers' returns when independent directors comprised over 60% of the board. *See* John W. Byrd & Kent A. Hickman, *Do Outside Directors Monitor Managers?*, 32 J. FIN. ECON. 195, 219 (1992). A parallel positive impact of insiders was found in the analysis of the relationship between the makeup of boards' strategic development committees and firms' performances: a greater presence of insiders on the committees increased firm performance. *See* April Klein, *Firm Performance and Board Committee Structure*, 41 J.L. & ECON. 275, 277 (1998).

¹³⁸ The tradeoff between monitoring and strategic input may change across firms due to the heterogeneity of firms; that is, in some firms, the monitoring effect may be more important than in others. The proper course depends on various factors, such as the effectiveness of external market monitoring and the firm's need for strategic oversight. *See* Gordon, *supra* note 127, at 1506–07.

¹³⁹ *Id.* at 1508.

¹⁴⁰ As part of the post-Enron response, the Sarbanes–Oxley Act endowed the SEC with the authority to enhance the independence of its audit committee. *See* Standards Relating to Listed Company Audit Committees, 79 SEC Docket 2876, 2881 (Apr. 9, 2003); *see also* 17 C.F.R. § 240.10A-3(b) (2007) (codifying Exchange Act Rule 10A-3(b)).

monitoring of management. Yet they also generate interfirm externalities, enabling shareholders of other companies to monitor managerial performance based on the enhanced data of their rivals.¹⁴¹ Furthermore, disclosure enables rival firms to make better allocative decisions.¹⁴² Thus, even if it does not seem that independent directors generate better performance, they may improve the functioning of the market as a whole. Therefore, firm-specific data do not constitute adequate proof that independent directors are counterproductive.

The behavioral ethics framework suggests a very different explanation for the negative effect of independent directors on firm performance. As discussed above, studies have demonstrated that subtle and nonmonetary conflicts of interest may be as problematic, and even more powerful, than strong conflicts of interest.¹⁴³ The fact that a conflict of interest is subtle makes it “invisible” to the agent. Consequently, even “good people” who do not consciously seek to promote their personal interest will end up doing so in contexts where they can either ignore the conflict or brush it aside as unimportant.¹⁴⁴ For example, people tend to favor their in-group, even when that group is based on an insignificant factor, such as support of the same sports team.¹⁴⁵ “Taking sides for no reason” and favoring others who are similar are persistent phenomena,¹⁴⁶ even when performing altruistic acts.

An agent’s objectivity illusion may be intensified by external factors aside from the subtlety of the conflict of interest itself. The CEO of Arthur Andersen—Enron’s accounting firm that collapsed after a well-documented scandal¹⁴⁷—testified before the SEC a year before the scandal “that the professionalism and objectivity of professional auditors solved the issue of auditor independence.”¹⁴⁸ The SEC seemed to be convinced by this line of reasoning and missed the opportunity to prevent the Enron scandal by declining to prevent auditing firms from consulting for the firms they audit. In this respect, a possible lesson from the Enron debacle is not only that

¹⁴¹ Gordon, *supra* note 127, at 1509.

¹⁴² *See id.*

¹⁴³ *See supra* Section I.A.1.

¹⁴⁴ *See supra* notes 29–30 and accompanying text.

¹⁴⁵ *See* Anthony G. Greenwald & Mahzarin R. Banaji, *Implicit Social Cognition: Attitudes, Self-Esteem, and Stereotypes*, 102 *PSYCH. REV.* 4, 11 (1995).

¹⁴⁶ *See* Anthony G. Greenwald, Jacqueline E. Pickrell & Shelly D. Farnham, *Implicit Partisanship: Taking Sides for No Reason*, 83 *J. PERSONALITY & SOC. PSYCH.* 367, 367–368 (2002); Greenwald & Banaji, *supra* note 145, at 11.

¹⁴⁷ Cathy Booth Thomas, *Called to Account*, *TIME* (June 18, 2002), <http://content.time.com/time/magazine/article/0,9171,263006,00.html> [<https://perma.cc/HKS8-NJR7>].

¹⁴⁸ Chugh et al., *supra* note 11, at 82–83.

professionalism does not provide immunity against wrongdoing, but that it may even entice wrongdoing by encouraging the agent to believe that she is immune from the influence of a subtle conflict of interest. In other words, it may render the conflict of interest invisible, catching the agent off-guard.¹⁴⁹

So, in the corporate context, independent directors may suffer from what we coin the “curse of partial independence.” Their status as independent directors intensifies their self-perception as “objective” agents, making them *more* susceptible to subtle conflicts of interest. As many scholars have pointed out, independent directors have a weaker type of conflict of interest.¹⁵⁰ According to behavioral ethics, this might cause those directors to be more, rather than less, biased, making it easier to ignore or justify self-interested decision-making.¹⁵¹

Even though they have no formal ties to the management or major shareholders and do not receive direct benefits from them, in many cases some degree of informal ties may exist. This may make independent directors less objective relative to ordinary directors because of the lower salience of such subtle conflicts of interest.¹⁵² Furthermore, management effectively chooses independent directors, so even without any preexisting ties, management is to some degree the benefactor of the independent director. This subtle conflict of interest may lead independent directors to “return the favor” by showing leniency toward management. As studies demonstrate, individuals have a tendency to take sides and support a certain actor who is perceived as a member of their team even when they do not derive any direct benefit from the gains of the side they support.¹⁵³ Scholars label this the “mere categorization effect.”¹⁵⁴ Such an effect may reinforce an independent director’s tendency to support management, which she

¹⁴⁹ The Enron case has been subject to numerous studies all attempting to show how Enron’s corporate governance structure failed to provide any of the needed alerts to the pervasive wrongdoing in the organization. See, e.g., Ronald R. Sims & Johannes Brinkmann, *Enron Ethics (Or: Culture Matters More than Codes)*, 45 J. BUS. ETHICS 243, 252–54 (2003).

¹⁵⁰ See Lucian A. Bebchuk & Assaf Hamdani, *Independent Directors and Controlling Shareholders*, 165 U. PA. L. REV. 1271, 1285–86 (2017); Gordon, *supra* note 127, at 1471; James D. Cox & Donald E. Schwartz, *The Business Judgment Rule in the Context of Termination of Derivative Suits by Independent Committees*, 61 N.C. L. REV. 541, 542–43 (1983); MELVIN A. EISENBERG, *THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS* 146 (1976).

¹⁵¹ Yuval Feldman & Eliran Halali, *Regulating “Good” People in Subtle Conflicts of Interest Situations*, 154 J. BUS. ETHICS 65, 76 (2019) (demonstrating that participants who had a conflict of interest were willing to promote their self-interest, but only to a certain degree—for the most part, they were not willing to write things which were obviously biased).

¹⁵² See sources cited *supra* note 150 and accompanying text.

¹⁵³ See sources cited *supra* notes 145–146.

¹⁵⁴ Greenwald & Banaji, *supra* note 145, at 378.

perceives as a member of her team, even though she does not benefit in any way from their gain. Recall that subtle conflicts of interest like these may have an even stronger impact than stark conflicts of interest. A recent study reinforces the claim that “subtle” conflicts of interest may have a stronger impact on the individual than stark conflicts of interest. In a real-life experiment involving 17,000 individuals in forty cities, researchers found that there is a greater tendency to return wallets to owners as the amount of cash in the wallet increases.¹⁵⁵ This finding stands in contrast to the conventional economic view that, everything else equal, a stronger financial incentive should have a stronger impact on an individual. In some cases, the reverse may be true.

This analysis does not necessarily lead to the conclusion that the institution of independent directors should be abolished. On the contrary, independent directors have the potential to improve corporate governance if measures are taken to address the subtle conflicts of interest that undermine their performance. A few scholars have suggested how to reinforce the independence of independent directors. First, the main suggestion arises in the context of companies with controlling shareholders. In order to eliminate the partial dependence of directors on controlling shareholders, Lucian Bebchuk and Assaf Hamdani have proposed that public shareholders solely nominate between the candidates on a given slate, and even suggest candidates for independent directorship.¹⁵⁶ This nomination process has the potential to eliminate, or at least decrease, the partial dependence of directors on controlling shareholders. Even in noncontrolled companies, it is possible to require that shareholders suggest independent directors to curb their dependence on management.¹⁵⁷

Suggestions by minority shareholders, however, may raise various practical challenges. Empowering shareholders to propose candidates may generate a flood of candidates, which would prevent a meaningful selection process from taking place. Moreover, shareholders may propose candidates who lack the necessary qualifications or, worse, abuse the process strategically.¹⁵⁸ Yet, the fact that in most companies the institutional investors—who have the capabilities and expertise to evaluate candidates—

¹⁵⁵ Cohn et al., *supra* note 19, at 70–71.

¹⁵⁶ See Bebchuk & Hamdani, *supra* note 150, at 1297–98.

¹⁵⁷ *Id.* at 1298, 1309–10.

¹⁵⁸ *Id.* at 1299, 1314.

comprise a significant portion of shareholders will reduce or even eliminate these potential problems.¹⁵⁹

Second, we could enable existing independent directors to nominate the directors who will replace them. An independent director who knows that she is leaving the firm has a weaker incentive to please management because she is not seeking reelection. More importantly, the entering independent director would not be elected by the management, and thus would not have a “subtle interest” to please them.

Third, in addition to reforms in the selection process of independent directors, alternative restrictions on the characteristics of independent directors can address the special connection between directors and management. One way to do so is by broadening the restrictions that apply to independent directors. For instance, a corporation could ban not only candidates with familial or business ties to management, but also candidates with prior personal relationships with management from serving as an independent director. This may seem like an extreme measure, but there are enough candidates for independent directorships besides those that management knows on a personal basis. Adopting this measure may, however, require proxy advisory firms to take on the additional responsibility of suggesting to management possible candidates for independent directorship with whom they have no prior acquaintance.

Fourth, corporations can address the challenge of social ties between independent directors and managers in another way. Instead of repressing interactions between directors and management, corporations can encourage social ties and interactions between independent directors and *minority* shareholders. For instance, corporations could establish an annual meeting between independent directors and minority shareholders. This sort of social interaction, dubbed as the “Woodstock for Capitalists” in the case of Berkshire Hathaway,¹⁶⁰ takes place every year with the intended purpose of reminding the executives of the company for whom they work. A social connection to minority shareholders can counterbalance the soft ties between independent shareholders and management. The behavioral ethics literature shows that the remoteness and unidentifiability of a victim increases the

¹⁵⁹ See Jill Fisch, Assaf Hamdani & Steven Davidoff Solomon, *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, 168 U. PA. L. REV. 17, 20–27 (2019) (pointing to the growing share of passive funds of institutional investors and their positive impact on capital markets and governance of firms by shareholders).

¹⁶⁰ See James Leggate, *Berkshire Hathaway Annual Meeting 2020: 5 Things to Know*, FOX BUS. (May 1, 2020), <https://www.foxbusiness.com/money/berkshire-hathaway-annual-meeting-2020-5-things-to-know> [https://perma.cc/6PSW-VKWT].

susceptibility of wrongdoing. Professor Amitai Amir found an increase in cheating when people deal with impersonal groups rather than individuals.¹⁶¹ Currently, independent directors perceive dispersed shareholders as an unidentified remote group. Organizing interactions with minority shareholders would allow independent directors to look minority shareholders in the eye and increase the level of commitment of independent directors towards them.

Behavioral ethics literature also refutes other suggested reform ideas in corporate literature, like the suggestion for “gray” directors that strike a delicate balance between inside and independent directors. Such directors have “structural sympathy” for management due to the managerial positions they held in other firms, but they are also not insiders of the firms in which they sit on the boards.¹⁶² This combination should theoretically enable “gray” directors to bridge the gap between independent directors and inside directors, which would improve the group dynamics on the board as well as the level of discussion.¹⁶³ Yet the behavioral ethics literature exposes the pitfalls of this proposal. The fact that “gray” directors have sympathy and some sense of solidarity with management while retaining a quasi-objective status may weaken their ability to monitor management. In contrast with insiders, who are aware of their inherent tendency to side with management and can therefore consciously impose internal restraints on such support, “gray” directors lack such awareness and may end up weakening the monitoring of management.

b. Proxy advisory firms

The curse of partial independence is also likely to afflict analysts at proxy advisory firms, such as Institutional Shareholder Services (ISS) and Glass Lewis. These firms provide advice to institutional investors regarding upcoming shareholder votes while also advising the firms in which the voting takes place. Many scholars have pointed out this conflict of interest.¹⁶⁴

¹⁶¹ Amitai Amir, Tehila Kogut & Yoella Bereby-Meyer, *Careful Cheating: People Cheat Groups Rather than Individuals*, 7 FRONTIERS PSYCH. 1, 6 (2016); see also Kai Chi Yam & Scott J. Reynolds, *The Effects of Victim Anonymity on Unethical Behavior*, 136 J. BUS. ETHICS 13, 20–21 (2016) (concluding after three experiments that people are more likely to engage in unethical decision-making when the victim of their actions is unknown).

¹⁶² See Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 800 (2001).

¹⁶³ See *id.*

¹⁶⁴ See Tamara C. Belinfanti, *The Proxy Advisory and Corporate Governance Industry: The Case for Increased Oversight and Control*, 14 STAN. J.L. BUS. & FIN. 384, 402 (2009); Sagiv Edelman, *Proxy Advisory Firms: A Guide for Regulatory Reform*, 62 EMORY L.J. 1369, 1384 (2013); Asaf Eckstein, *Skin in the Game for Credit Rating Agencies and Proxy Advisors: Reality Meets Theory*, 7 HARV. BUS. L. REV.

Proxy advisors do not only provide advice to shareholders, but also provide services to firms, such as governance ratings for which firms pay. This positions proxy advisory firms in a classic conflict-of-interest situation: recommending voting stances on issues pertaining to firm managers, who themselves purchase services from the shareholder advising firms.¹⁶⁵ Thus, recommendations to vote with management raise suspicion that they have been affected by the advisory firms' conflict of interest, while recommendations to support proposals of hedge fund activists are viewed as a substantive validation of the merits of the hedge fund's proposal.¹⁶⁶

The analysis of proxy firms' recommendations shifts when viewed through the perspective of partial independence. In addition to obvious conflicts of interest, there is also a softer conflict of interest tilting the voting recommendations of institutional investors toward the side of activists: the analysts' interests in maintaining relationships with hedge funds to preserve future employment opportunities. The hedge fund industry is one of the highest earning in the financial sector.¹⁶⁷ For example, in 2016, the top fifty hedge fund managers, by one metric, earned more than any major U.S. bank executive, including at Goldman Sachs and Morgan Stanley.¹⁶⁸ The twenty-five top earning hedge fund managers made a staggering \$11 billion.¹⁶⁹ There is no doubt that working as a hedge fund analyst is much more lucrative than working as an advisor for a proxy advisory firm or a corporate governance analyst in an institutional investment firm.¹⁷⁰ Further, analysts for proxy

221, 230–31 (2017). All three articles claim that there is a conflict of interest in the leading proxy advisory firm, Institutional Shareholders Services (ISS), which provides its services to both investors and companies.

¹⁶⁵ See Belinfanti, *supra* note 164, at 399–400; Edelman, *supra* note 164, at 1383–84; Eckstein, *supra* note 164, at 230–31.

¹⁶⁶ See Lucian A. Bebchuk, Alon Brav, Wei Jiang & Thomas Keusch, *Dancing with Activists*, 137 J. FIN. ECON. 1, 3 (2020).

¹⁶⁷ See Beecher Tuttle, *Here's How Much You Really Earn at Hedge Funds vs. Traditional Asset Managers*, EFINANCIALCAREERS (Nov. 27, 2018), <https://news.efinancialcareers.com/uk-en/3000008/hedge-fund-pay-asset-management-pay> [<https://perma.cc/S7WZ-9RAV>]. Hedge fund managers also earn significantly higher incomes in comparison to other asset managers—not only the superstars, but also on average. For example, the average annual compensation for a fixed income manager in general asset management is approximately \$0.5 million, while the same function in hedge funds earn on average \$1.06 million. Hedge funds' compensation dominates the compensation of various roles in other funds as well. *Id.* Regarding the difference in compensation between hedge fund and institutional investors in more junior jobs, see sources *infra* note 170 and accompanying text.

¹⁶⁸ Alexandra Stevenson, *Hedge Fund Managers Don't Always Beat the Market, but They Still Make Billions*, N.Y. TIMES (May 16, 2017), <https://www.nytimes.com/2017/05/16/business/dealbook/best-paid-hedge-fund-managers.html> [<https://perma.cc/NW8A-78ZK>].

¹⁶⁹ *Id.*

¹⁷⁰ According to Glassdoor, research analysts at ISS earn \$63,154 annually (based on fourteen salaries). *ISS Salaries*, GLASSDOOR, <https://www.glassdoor.com/Salary/Institutional-Shareholder->

advisory firms and institutional investment firms can certainly be candidates for a hedge fund analyst job; their Wall Street experience—surveying public firms and those firms’ proposals, including proposals from hedge funds—can be valuable for hedge funds.¹⁷¹ As such, when analysts are making decisions regarding proposals from hedge funds, they may lean toward the side of the hedge fund in order to increase the likelihood of upgrading their pay by being hired by a hedge fund.¹⁷² Prior research has emphasized the conflicts of interest of professionals working for public sector regulating agencies due to their prospects of landing lucrative jobs in the private sector firms that they regulate.¹⁷³ Here, we extend the possible impact of these “revolving doors” into the private sector to firms that provide private sector quasi-regulation. The impact of such future prospects may even take place

Services-Salaries-E14612.htm [https://perma.cc/7YGX-SEAF]. Additionally, Glassdoor reports that a Glass Lewis proxy research analyst makes only \$59,325 (based on the data of eight salaries). *Glass Lewis & Co. Salaries*, GLASSDOOR, <https://www.glassdoor.com/Salary/Glass-Lewis-and-Co-Salaries-E264399.htm> [https://perma.cc/45X5-5Y7L]. The salaries of analysts at institutional investment firms are higher than at proxy advisory services companies, but still much lower than hedge funds. An analyst at BlackRock earns an annual income of \$82,275 (based on 436 salaries). *BlackRock Salaries*, GLASSDOOR, <https://www.glassdoor.com/Salary/BlackRock-Salaries-E9331.htm> [https://perma.cc/CR6Y-3FFR]. An investment analyst at Vanguard earns \$83,643 annually (based on thirty-two salaries). *Vanguard Salaries*, GLASSDOOR, https://www.glassdoor.com/Salary/Vanguard-Salaries-E4084_P2.htm [https://perma.cc/NA2E-TDPU]. In contrast, an analyst at the hedge fund AQR Capital Management (AQR) earns \$136,722 annually (based on thirteen salaries). *AQR Capital Management Salaries*, GLASSDOOR, <https://www.glassdoor.com/Salary/AQR-Capital-Management-Salaries-E213435.htm> [https://perma.cc/2Z4A-6U7P]. At the hedge fund Bridgewater Associates, an analyst earns \$89,057 annually (based on six salaries), and a financial analyst earns \$105,345 annually (based on four salaries). *Bridgewater Associates Salaries*, GLASSDOOR, <https://www.glassdoor.com/Salary/Bridgewater-Associates-Salaries-E117647.htm> [https://perma.cc/6PKL-YNDH]. These data demonstrate how even in entry-level roles, salaries in hedge funds are 20% to 30% higher than at institutional investors, and much higher when compared to salaries at proxy services companies. These differences only grow when going up the professional ladder. See Stevenson, *supra* note 168.

¹⁷¹ For example, Jeff Dunn, a principal of AQR, a well-known hedge fund, was hired when his main experience was a research manager at QIC, one of Australia’s largest institutional investors. *Jeff Dunn*, AQR, <https://www.aqr.com/About-Us/OurFirm/Jeff-Dunn> [https://perma.cc/PG4K-MM96]. William Cashel, principal of AQR, gained prior experience at Natixis Asset Management, a large asset management firm, and Wachovia. *William Cashel*, AQR, <https://www.aqr.com/About-Us/OurFirm/William-Cashel> [https://perma.cc/U2H7-6T8P]. Aryella Frommer, who heads investors relations at Triam Partners, started her career in Lehman Brothers Holdings, Inc. as an analyst in their investment management division. *Aryella Frommer*, TRIAM PARTNERS, <https://trianpartners.com/people/aryella-frommer> [https://perma.cc/MTV2-CRD7].

¹⁷² For more data on such movement and a quantification of the conflicts of interest of analysts due to the pay gap between an analyst in an asset management company and an analyst in a hedge fund, see sources cited *supra* notes 170–171 and accompanying text.

¹⁷³ See Yeon-Koo Che, *Revolving Doors and the Optimal Tolerance for Agency Collusion*, 26 RAND J. ECON. 378, 379 (1995).

subconsciously, with no deliberate decision of the agent to enhance her prospects in the future.¹⁷⁴

Given this inadvertent effect of partial independence on the functioning of proxy advisory firms and large institutional investors, two policy changes flow logically. The first is restricting the ability of individuals who have worked in proxy advisory firms or corporate governance departments of large institutional investors to switch jobs to hedge funds or activist hedge funds. Disrupting the career pipeline should have a chilling effect on the motivations of employees to recommend siding with activists.¹⁷⁵

Such limitations may be problematic due to their profound market effects. Thus, limiting the ability of employees of proxy advisors to seek future employment with institutional investors and hedge funds may be detrimental to the functioning of the economy.¹⁷⁶ This brings us to the second, and softer, implication. Instead of attempting to curtail this sort of conflict of interest, it can simply be taken into account. Shareholders, regulators, courts, and scholars already attribute special weight to the recommendation of a proxy advisory firm or institutional investor, especially when they side with an activist. Such decisions are viewed as professional, independent, and impartial, so they are given special weight by the courts. But because our analysis suggests that their independence is not absolute, and that their decision to side with an activist may be motivated by the desire to secure future employment, courts should reduce the weight they give to such a recommendation.¹⁷⁷

4. *Corporate Transgressions for the Sake of the Others*

The behavioral ethics literature emphasizes that there is a much greater likelihood of wrongdoing when it is done for the sake of others.¹⁷⁸ This finding stands in contrast to the conventional rational-choice paradigm, which predicts that a person's willingness to engage in wrongdoing is a function of the extent to which the wrongdoing serves the interests of that person.¹⁷⁹ According to the rational-choice paradigm, as an individual gains

¹⁷⁴ *Id.*

¹⁷⁵ One of President Obama's first executive orders was to implement a cooling-off solution for the revolving-door problem in the context of government and regulated industries. *See, e.g.*, Exec. Order No. 13,490, 74 Fed. Reg. 4673 (Jan. 26, 2009) (restricting appointees to executive agencies from working in industries which they have regulated for a period of two years).

¹⁷⁶ Regarding the importance of mobility of workers to enable informational flow in complex sectors, see ANNALEE SAXENIAN, REGIONAL ADVANTAGE: CULTURE AND COMPETITION IN SILICON VALLEY AND ROUTE 128, at 29–57 (1996).

¹⁷⁷ *See supra* Section I.A.3.

¹⁷⁸ *See supra* Section I.B.2.

¹⁷⁹ *Id.*

more from wrongdoing, there is a greater likelihood that she will engage in the wrongdoing. The behavioral ethics literature argues that another paradigm of human behavior might also be true: an increase in the benefit to others from the wrongdoing may increase the likelihood that an agent will engage in the wrongdoing compared to an increase to the agent's own benefit.¹⁸⁰ People may be more likely to behave unethically when they feel comfortable about their choice, and doing something benevolent for others can be a powerful justification, making an agent in corporate contexts especially prone to behave unethically.¹⁸¹

In particular, people are motivated to engage in wrongdoing to benefit individuals who are less well-off financially, even at their own expense. In one experiment, individuals in charge of grading others tended to inflate the performance of “poor” solvers—those that had lost in a lottery just beforehand—even when it decreased their own payment.¹⁸² Other experiments have concluded that people are more likely to cheat when the benefits are split with another person than when they capture the full benefit.¹⁸³ Related to the notion of “doing it for others” is the concept of professionalism. In many ways, corporate agents operate in their professional capacity, which makes focusing on profit-maximization much easier than that of an individual working in his personal capacity.¹⁸⁴

This phenomenon has many implications for the field of corporate governance because all of the major actors are doing things for others: directors and managers act for the benefit of shareholders. In this Section, we discuss three topics in corporate governance that are fundamentally implicated by these findings: transgressions for the firm or against the firm, multiple purposes of the firm, and expectation for vicarious profit-maximization.

a. Transgressions for the firm or against the firm

As noted above, according to behavioral ethics, there is a greater tendency to promote one's self-interest when it also benefits others. In the corporate context, this implies that a person has a greater propensity to

¹⁸⁰ FELDMAN, *supra* note 17, at 197.

¹⁸¹ *Id.* at 197–98.

¹⁸² Gino & Pierce, *supra* note 63, at 1159.

¹⁸³ *See, e.g.*, Wiltermuth, *supra* note 64, at 166 (finding that “[p]eople over-reported their performance more often when the benefit of doing so was split between themselves and another person, even if they did not know the other beneficiary and had no interaction with her/him.”).

¹⁸⁴ Maryam Kouchaki Nejad Eransadati, Professionalism and Moral Behavior: Does a Professional Self-Conception Make One More Unethical? 51 (Aug. 2012) (Ph.D. dissertation, University of Utah), <https://collections.lib.utah.edu/ark:/87278/s67w6sz0> [<https://perma.cc/ZJ2C-BGQ8>].

promote their interest when it is for the firm's sake and generates value for shareholders at the expense of third parties. These actions include the adoption of harmful environmental policies, tax evasion, antitrust violations, and other illegal activity like bribes. In all of these cases, the firm benefits at the expense of society at large.¹⁸⁵

This presents major implications for corporate liability. There is an ongoing and heated debate in the corporate law scholarship over whether civil and criminal liability should be imposed on corporations because of the actions or omissions of its organs.¹⁸⁶ In many cases, there is a “de facto

¹⁸⁵ Blake E. Ashforth & Anand Vikas, *The Normalization of Corruption in Organizations*, 25 RSCH. ORG. BEHAV. 1, 42 (2003).

¹⁸⁶ Regarding the debate on corporate liability, see generally Reinier H. Kraakman, *Corporate Liability Strategies and the Cost of Legal Controls*, 93 YALE L.J. 857 (1984). See Andrew F. Tuch, *The Limits of Gatekeeper Liability*, 73 WASH. & LEE L. REV. ONLINE 619, 621–22 (2017) (responding to “Collaborative Gatekeepers” by arguing in favor of the proposal but suggesting “that its success is likely to depend on the particular ways in which it interacts with these (conventional) gatekeeping regimes”); Sharon Oded, *Coughing Up Executives or Rolling the Dice?: Individual Accountability for Corporate Corruption*, 35 YALE L. & POL’Y REV. 49, 50–53 (2016) (“[T]his Article critically examines the desirability of the policy promulgated by the Yates Memo from a social welfare maximization point of view.”); Donald C. Langevoort, *On Leaving Corporate Executives “Naked, Homeless and Without Wheels”*: *Corporate Fraud, Equitable Remedies, and the Debate over Entity Versus Individual Liability*, 42 WAKE FOREST L. REV. 627, 630–31 (2007) (arguing “that enterprise liability can and should be pared back, but that the legitimacy of the underlying policy requires that we see to it that executives who are responsible for corporate fraud or misreporting at the very least forfeit most or all of the immense wealth obtained as a result of their control over the firm during the time of the wrongdoing”). Scholars have also discussed the imposition of criminal liability on corporations. See Jennifer Arlen, *Corporate Criminal Liability: Theory and Evidence*, in RESEARCH HANDBOOK ON THE ECONOMICS OF CRIMINAL LAW 144, 190–91 (Alon Harel & Keith N. Hylton eds., 2012) (“[T]he state should employ a multi-tiered duty-based composite regime that uses a combination of criminal and civil liability to induce optimal *ex ante* and *ex post* policing.”); see also Andrew Weissmann & David Newman, *Rethinking Criminal Corporate Liability*, 82 IND. L.J. 411, 412–16 (2007) (suggesting a new reform that will focus on the goals of criminal corporate liability and the prosecutor’s role in pursuing corporate fraud); V.S. Khanna, *Corporate Liability Standards: When Should Corporations Be Held Criminally Liable?*, 37 AM. CRIM. L. REV. 1239, 1240–42 (2000) [hereinafter Khanna, *Corporate Liability Standards*] (“The primary thesis of this paper is that neither strict liability, mens rea, nor negligence are likely to be optimal liability standards across the vast majority of corporate wrongdoing and that a composite liability regime—one which mixes elements of each of the liability standards—is likely to be the most desirable standard in most instances.”); William S. Laufer, *Corporate Liability, Risk Shifting, and the Paradox of Compliance*, 52 VAND. L. REV. 1343, 1344–50 (1999) (arguing the shift towards insulating corporations from vicarious liability that occurred during the late twentieth century “risks the creation of moral hazards that, given equivocal evidence of compliance effectiveness, undermines the objectives and spirit of corporate criminal law”); V.S. Khanna, *Corporate Criminal Liability: What Purpose Does It Serve?*, 109 HARV. L. REV. 1477, 1477–79 (1996) [hereinafter Khanna, *Corporate Criminal Liability*] (“This Article compares the costs and benefits of corporate criminal liability with the costs and benefits of other possible liability strategies . . . in an effort to determine the best strategy or mix of strategies for society.”). See generally WILLIAM S. LAUFER, *CORPORATE BODIES AND GUILTY MINDS: THE FAILURE OF CORPORATE CRIMINAL LIABILITY* (2006) (proposing a rule of constructive corporate liability, instead of vicarious liability, to

unitary liability” regime in which only the corporation bears the cost of wrongdoing by its directors or management due to subsidized insurance policies and indemnification clauses.¹⁸⁷ The main justifications for imposing sanctions on a corporation for its agents’ wrongdoing are economic: incentivizing corporations to engage in internal monitoring¹⁸⁸ and allowing the “deeper pocket” to compensate third parties.¹⁸⁹ Behavioral ethics analysis provides an additional justification for imposing penalties on corporations rather than individual agents. If a key element in an individual’s motivation to engage in wrongdoing is to benefit the corporation, sanctioning the corporation for her wrongdoing may be the most effective way to deter the individual from engaging in the wrongdoing.

The behavioral ethics scholarship offers a similar argument to explain an even more extreme situation in which the agent engages in a wrongdoing out of a sense of obligation to benefit others. Managers commonly lie for the sake of saving others in the corporation because of their sense of obligation toward others in the “corporate family,” even though they do not derive any real personal benefit from lying.¹⁹⁰ A particularly famous example is the case of Enron, in which Ken Lay, Enron’s CEO, was convicted of lying (honest services fraud) even though the bulk of the fraud was engineered by others while he was not at the company.¹⁹¹ Indeed, by lying, he exposed himself to

prioritize allocation of blame between individuals and entities, thereby freeing enforcement agencies from the “gamesmanship” of “cooperation, disclosures, and audits”).

¹⁸⁷ Kraakman, *supra* note 186, at 858–62; *see also* Tuch, *supra* note 186, at 619–622 (proposing new rules for gatekeeper liability to supplement traditional direct liability for corporations and their managers); Oded, *supra* note 186, at 52 (noting corporations investigated by the DOJ for fraud face loss of cooperation credit, and thus liability, if they do not “identify individuals involved in the misconduct, and provide the DOJ with all relevant facts”); Arlen, *supra* note 186, at 161 (“Thus, even when only individuals are liable, firms bear the expected cost of both effort and crime through their obligation to pay wages equal to their employees’ expected costs when they act optimally.”); Langevoort, *supra* note 186, at 627–28 (“In reports about private securities litigation, settlements (and the rare judgments after trial) in fraud-on-the-market lawsuits are almost always paid directly by the company or out of its directors’ and officers’ (‘D&O’) insurance coverage . . . rather than by the officers or directors charged with the fraud.”); Khanna, *Corporate Liability Standards*, *supra* note 186, at 1243 (asserting that when the criteria for vicarious liability are met, “[s]uch broad liability attribution has resulted in corporations being held criminally liable for almost all crimes except those ‘manifestly requiring commission by natural persons, such as rape and murder’” (quoting Khanna, *Corporate Criminal Liability*, *supra* note 186, at 1488)).

¹⁸⁸ *See* Kraakman, *supra* note 186, at 867–68.

¹⁸⁹ *See id.* at 892–93.

¹⁹⁰ *See generally* ALEX C. MICHALOS, *The Loyal Agent’s Argument*, in *HOW GOOD POLICIES AND BUSINESS ETHICS ENHANCE GOOD QUALITY OF LIFE* 53 (2017).

¹⁹¹ *See* O.C. Ferrell & Linda Ferrell, *The Responsibility and Accountability of CEOs: The Last Interview with Ken Lay*, 100 J. BUS. ETHICS 209, 210–11 (2011).

substantial personal risk without much personal gain.¹⁹² Thus, while building an atmosphere of a corporate family and forming organizational loyalty is perceived as an important value for investors, under certain circumstances it may work to their detriment. Studies have found that corporate ethical codes that use more formal and less “familial” language—usage of the term “employee” and not “we”—are more effective in curbing unethical behavior.¹⁹³

We therefore suggest that firms limit the establishment of a “familial relationship,” for example by limiting informal vocabulary in charters and ethical codes. In addition, courts and regulators should closely scrutinize the testimony of company organs about other organs, even when there is no apparent personal interest in the issue. Courts and regulators should also make more use of external monitors when there is some suspicion of fraud, even when it seems that the managers are not involved.¹⁹⁴

b. Multiple purposes of the firm

There are two well-established views on the purpose of a corporation: (1) the shareholder primacy approach, which holds that the corporation should maximize shareholder welfare exclusively;¹⁹⁵ and (2) the stakeholder approach, under which the corporation should promote the interests of other constituencies besides shareholders, like workers, lenders, customers, and society at large.¹⁹⁶ The tendency to legitimize actions when they are done for the sake of others therefore implicates the firm’s purpose.

One of the economic arguments against the stakeholder view is that it undermines the ability to monitor agents effectively. When the firm considers purposes besides maximization of profits, which lack clear parameters, it is more complicated to assess the performance of an agent, which provides her greater leeway to promote her own self-interest.¹⁹⁷ The

¹⁹² See *id.* at 214.

¹⁹³ Maryam Kouchaki, Francesca Gino & Yuval Feldman, *The Ethical Perils of Personal, Communal Relations: A Language Perspective*, 30 PSYCH. SCI. 1745, 1762–64 (2019).

¹⁹⁴ See, e.g., Ferrell & Ferrell, *supra* note 191, at 216–18 (“An ethical culture can prevent complacency through codes of conduct, training, and identification of potential ethical issues, as well as the development of systems to monitor and enforce ethical standards.”).

¹⁹⁵ Regarding the proponents of the shareholder-centered view of the corporation, the stakeholder view, and the view of the Delaware Supreme Court regarding this matter, see sources cited *supra* note 111 and accompanying text.

¹⁹⁶ See sources cited *supra* note 111 and accompanying text.

¹⁹⁷ See Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733, 736, 740 (2005); see also STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 421–22 (2002) (explaining that when decisions are based on criteria other than profits, review of those decisions will necessarily be made in “hindsight” and the actor has minimal ability to predict to what extent their

inclination to serve one's own interest when others benefit therefore exacerbates the problem of having multiple purposes and multiple audiences because, in addition to weakening external monitoring, it weakens internal monitoring. As there are more audiences that an agent can serve, it is easier for the agent to justify any of her actions. For example, an economically conservative manager's preference for job security may be at odds with that of diversified shareholders who are risk-neutral and care only about maximization of expected outcomes. The manager may justify the conservative strategy *to herself* by invoking bond-holders who are more risk-averse and prefer a conservative strategy. On the flip side, a manager who prefers self-aggrandizement may opt to make significant charitable contributions that will generate positive media coverage. Such a manager may justify this to herself by invoking the interest of the company in benefitting society at large. The fact that others are likely to benefit from otherwise self-serving actions thus weakens her own internal attentiveness to the self-serving motivation that underlies her actions.

An additional finding from the behavioral ethics literature also supports limiting the number of purposes that a company has. People tend to engage in greater misrepresentation of facts when there is greater ability to engage in elastic justification.¹⁹⁸ The more purposes the firm has, and thus, the more space the agent has for elastic justification, the more likely it will be that a person misrepresents the facts. The behavioral ethics analysis—the tendency to promote one's own interest both when others gain and when there is flexibility regarding the standards of how one should act—therefore provides an additional justification for accepting the shareholder-primacy view of corporate law. The shareholder-primacy view, unlike the stakeholder approach, limits the ability of corporations to serve the interests of other constituencies besides shareholders.

c. Expectation for vicarious profit-maximization

There is an important side effect to the fact that corporate agents are obligated to maximize profits. This obligation creates an expectation that agents should do *anything* to achieve this goal, including engaging in illicit behavior. The actual expectation of how people *should* behave is known as

behavior is legal); Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1191–92 (1981) (arguing that a stakeholder-oriented approach would cause management to “sacrifice the interest of the shareholders,” which “would greatly prejudice shareholders by decreasing the incentive of management to act in their best interest”).

¹⁹⁸ See Schweitzer & Hsee, *supra* note 66, at 198.

the “injunctive norm” in social psychology.¹⁹⁹ Scholars have argued that injunctive norms have greater impact on actual behavior in comparison to “descriptive norms”—the expectation of how people *do* behave.²⁰⁰

Studies have shown that people apply the injunctive norm to individuals differently than they apply it to corporations when the law or norm is unclear. They expect individuals to abstain from ethically unclear behavior, while they have no such expectation from corporations.²⁰¹ For this reason, people will tend to sue individuals for all types of violations, but often only sue corporations when they violate a clear law.²⁰² Similarly, people attribute different levels of unethicality to a failure to repay an investment based on whether an individual or a corporation is involved, judging the latter as less unethical than the former. The same was shown with intentional harms by individuals as compared to corporations: people tend to find individuals’ conduct more severe.²⁰³ The expectation that managers strive to maximize

¹⁹⁹ See Robert B. Cialdini, Renee J. Bator & Rosanna E. Guadagno, *Normative Influences in Organizations*, in SHARED COGNITION IN ORGANIZATIONS: THE MANAGEMENT OF KNOWLEDGE 195, 199–203 (Leigh L. Thompson, John M. Levine, David M. Messick eds., 1999). For an examination of the ramifications of these two sets of norms in the legal context, see Yuval Feldman & Janice Nadler, *The Law and Norms of File Sharing*, 43 SAN DIEGO L. REV. 577, 598–601 (2006), examining the impact of legal intervention in the field of copyright law, in which a gap may exist between the injunctive norm and the descriptive norm in the example of file-sharing, and Amos Schurr & Ilana Ritov, *Winning a Competition Predicts Dishonest Behavior*, 113 PROC. NAT’L ACAD. SCI. U.S. 1754, 1757 (2016), claiming that individuals in competitive settings are more likely to behave dishonestly.

²⁰⁰ Terry L. Boles, *Themes and Variations*, in SHARED COGNITION IN ORGANIZATIONS, *supra* note 199, at 327, 336 (“In empirical studies that compared descriptive and injunctive norms . . . injunctive norms were found to be the stronger of the two in influencing behavior.” (citations omitted)).

²⁰¹ See, e.g., Uriel Haran, *A Person–Organization Discontinuity in Contract Perception: Why Corporations Can Get Away with Breaking Contracts but Individuals Cannot*, 59 MGMT. SCI. 2837, 2844 (2013) (“According to the different ethical standard account, a person who honors a contract is merely meeting expectations. In contrast, an organization that does so is going above and beyond expectations, and as such, it should be judged at least as favorably as, if not more than, the person.”). This conclusion is in line with prior research in the field of experimental philosophy, which has demonstrated that people expect corporations to be less constrained by emotion and thus they judge transgressions by individuals more harshly than those by corporations. See Joshua Knobe & Jesse Prinz, *Intuitions About Consciousness: Experimental Studies*, 7 PHENOMENOLOGY & COGNITIVE SCI. 67, 77 (2008) (“The problem is simply that they don’t think corporations are capable of genuinely *feeling* anything.”); see also Heather M. Gray, Kurt Gray & Daniel M. Wegner, *Dimensions of Mind Perception*, 315 SCIENCE 619, 619 (2007) (showing a correlation between perceived agency and “[d]eserving punishment for wrongdoing”).

²⁰² Haran, *supra* note 201, at 2837 (“[T]his paper suggests that the contract’s moral component is weighted more heavily for individuals than for organizations.”).

²⁰³ Uriel Haran, Doron Teichman & Yuval Feldman, *Formal and Social Enforcement in Response to Individual Versus Corporate Transgressions*, 13 J. EMPIRICAL LEGAL STUD. 786, 804–05 (2016) (finding corporations are judged less harshly than an individual if the transgression is intentional, but that the reverse is true in the context of negligence); see also V. Lee Hamilton & Joseph Sanders, *The Second Face of Evil: Wrongdoing in and by the Corporation*, 3 PERSONALITY & SOC. PSYCH. REV. 222, 229–30

profits at the expense of their commitment to third parties serves as a self-fulfilling prophecy.

There are two possible responses to the injunctive-norm problem. The first is simply to raise the sanction a corporation receives for wrongdoing. If corporations take advantage of the uneven application of the injunctive norm, then according to the classical deterrence framework, we can offset the increase in likelihood of illicit behavior by increasing the sanction. There are two problems with this response, however. Increasing external sanctions may backfire. Increasing the “price” of a behavior may decrease the manager’s sense that there is any wrongdoing.²⁰⁴ The increase in “price” may activate agents’ “calculative” mode, causing them to see the decision of whether to engage in misconduct as a business decision, not an ethical one.²⁰⁵ The problem of deactivating an agent’s ethical frame of mind is especially pressing in the context of injunctive norms, in which the central problem is that the expectation of misconduct by corporate agents diminishes the ethical wrongness of the action. Thus, further diminishing the ethical mindset by increasing sanctions may, in some cases, exacerbate the problem. Another problem with increasing the sanction is an ethical one. Injunctive norms make an agent less aware of the wrongness of her action—to her it seems that she is doing what she *should* be doing. So, on retributive grounds, it is problematic to increase the sanction when the agent is not fully cognizant of the unethicity of an action.

The second response is informal sanctions like shaming. The SEC or DOJ could publish the names of managers or boards who have adopted an especially aggressive approach to profit-maximization irrespective of the cost to third parties.²⁰⁶ These informal sanctions have been proven to be especially successful in dealing with the problem of injunctive norms, as

(1999) (“It is precisely [when we consider an actor’s behavior negligent] that respondents appear to hold corporate actors to higher levels of foresight and responsibility.”).

²⁰⁴ See Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1797–98 (2001).

²⁰⁵ See Ann E. Tenbrunsel & David M. Messick, *Sanctioning Systems, Decision Frames, and Cooperation*, 44 ADMIN. SCI. Q. 684, 697–98, 701–04 (1999) (describing how sanctions can evoke a calculative business frame of mind and drive down social cooperation). This is similar to the “price” effect discovered later but tailored for the business context. See Uri Gneezy & Aldo Rustichini, *A Fine Is a Price*, 29 J. LEGAL STUD. 1, 8 (2000) (finding parents were more likely to pick up their children late from daycare when a fine was imposed than when there was no fine).

²⁰⁶ Regarding a shaming mechanism of individual managers, see David A. Skeel, Jr., *Shaming in Corporate Law*, 149 U. PA. L. REV. 1811, 1832–35 (2001). The say-on-pay mechanism adopted in the Dodd–Frank Act could also be viewed as utilizing a shaming mechanism: the board could approve a compensation package that a majority of the shareholders objected to, but it would be stigmatized as a board that does not fully serve shareholders. See *supra* Section I.A.2.

illustrated by the publication of wrongdoers' names in order to curb the norm of peer-to-peer file-sharing.²⁰⁷ Informal sanctions, such as reputational ones, directly address the weakness of injunctive norms by increasing the ethical salience of the wrongdoing.

B. Procedural Applications

In this Section, we discuss the procedural implications of behavioral ethics. The term “procedural” refers to how decisions are made or should be made in a corporate setting as opposed to the content of the decisions. Of course, there is a tie between the two: improved decision-making processes that take account of bounded ethicality should, on average, lead to better outcomes for the corporation. We discuss specific examples related to omission bias and the balancing between deliberation and speed.

1. Omission Bias

The phenomenon of omission bias—people's tendency to judge harmful actions as worse than equally harmful omissions—is well documented in the behavioral economics literature.²⁰⁸ It can lead individuals to act against their own welfare—preferring to cause harm through passive means rather than causing the same harm through active means.²⁰⁹ Scholarship offers several explanations for omission bias, such as status quo bias and loss aversion.²¹⁰ One particular explanation may be especially relevant here: the greater moral attribution and responsibility associated with

²⁰⁷ Feldman & Nadler, *supra* note 199, at 609.

²⁰⁸ See, e.g., Kahneman & Tversky, *supra* note 18, at 160 (“The regret associated with a loss that was incurred by an action tends to be more intense than the regret associated with inaction or a missed opportunity.”); Ilana Ritov & Jonathan Baron, *Reluctance to Vaccinate: Omission Bias and Ambiguity*, 3 J. BEHAV. DECISION MAKING 263, 263 (1990) (“[T]he tendency to favor omissions (such as letting someone die) over otherwise equivalent commissions (such as killing someone actively).”). The omission bias's effect on corporate actors might be exacerbated because once someone has done nothing at an early stage of a process, he is more likely to do nothing again in later stages. See, e.g., Orit E. Tykocinski & Thane S. Pittman, *The Consequences of Doing Nothing: Inaction Inertia as Avoidance of Anticipated Counterfactual Regret*, 75 J. PERSONALITY & SOC. PSYCH. 607, 607 (1998) (finding that “[h]aving passed up one opportunity to gain, the person becomes more likely to pass up another opportunity to gain,” assuming the second opportunity is of lesser yet still positive value to the person). Regarding the omission bias's application to the legal context, see generally Adi Libson, *Missing Inaction: Internalizing Beneficial Omissions*, 32 YALE L. & POL'Y REV. 427 (2014) (arguing for legal mechanisms to credit beneficial omissions).

²⁰⁹ See Kahneman & Tversky, *supra* note 18, at 173; see also Ritov & Baron, *supra* note 208, at 263 (finding subjects reluctant to vaccinate if the possibility of bad outcomes exists, despite worse expected outcomes if no vaccine is given).

²¹⁰ EYAL ZAMIR, LAW, PSYCHOLOGY AND MORALITY: THE ROLE OF LOSS AVERSION 17–20 (2015).

a commission relative to an omission.²¹¹ The lower degree of moral attribution and responsibility in cases of omissions may imply that individuals will be especially prone to pursue their self-interest through passive behavior. This lower degree of moral attribution likely enables people to maintain their moral self-perception while promoting their own interest.²¹²

The behavioral ethics explanation of omission bias has many ramifications for the field of corporate governance. It predicts that individuals positioned to have a conflict of interest, such as managers and directors, will be more prone to promote their self-interest through omissions than through commissions, even if the latter will permit them to promote their self-interest more effectively. Consequently, corporate governance should be molded to provide greater scrutiny of passive decisions of directors and managers. A recent study showed that where participants learned that there might be some justification to lie in a game due to technical problems in the game's framework, participants were far more likely to withhold information than to positively provide false information.²¹³ Another study found a statistically lower level of attendance among directors with possible conflicts of interest at board meetings—evidence that supports the existence of an ethical omission bias.²¹⁴ This surprising finding could be explained by

²¹¹ See David B. Sugarman, *Active Versus Passive Euthanasia: An Attributional Analysis*, 16 J. APPLIED SOC. PSYCH. 60, 72–73 (1986) (finding individuals perceived doctors who assisted patients with euthanasia as more responsible for a patient's death, and morally condemned them more harshly, than if the doctor had tried to heal the patient); see also Mark Spranca, Elisa Minsk & Jonathan Baron, *Omission and Commission in Judgment and Choice*, 27 J. EXPERIMENTAL SOC. PSYCH. 76, 103 (1991) (suggesting "omission bias in the moral sphere allows people to feel righteous by abstaining from sins of commission"); Johanna H. Kordes-de Vaal, *Intention and the Omission Bias: Omissions Perceived as Nondecisions*, 93 ACTA PSYCHOLOGICA 161, 169 (1996) (suggesting individuals view acts of commission as intent whereas acts of omission are viewed more as nondecisions); Ritov & Baron, *supra* note 208, at 275 (noting that many subjects did not write arguments for why they chose not to vaccinate at the optimal level, but those who did argued mainly about responsibility).

²¹² See also Nina Mazar & Scott A. Hawkins, *Choice Architecture in Conflicts of Interest: Defaults as Physical and Psychological Barriers to (Dis)honesty*, 59 J. EXPERIMENTAL SOC. PSYCH. 113, 113–117 (2015) (documenting greater likelihood of dishonesty in the context of omission than in the context of commission and hypothesizing that people would be more prone to approve a false financial statement that benefits them if it required an act of omission than if they had to actively assert false financial information).

²¹³ See Andrea Pittarello, Enrico Rubaltelli & Daphna Motro, *Legitimate Lies: The Relationship Between Omission, Commission, and Cheating*, 46 EUR. J. SOC. PSYCH. 481, 483–84 (2016).

²¹⁴ Adi Libson, *Conflict of Interests Between Banks and the Stock Exchange: Manifestations, Implications and Policy Recommendations*, 47 HEBREW U. L. REV. 491, 512–16 (2018) (demonstrating how the conflicts of interest of directors on the Tel-Aviv Stock Exchange—those representing banks—may be manifested by omission, like a lower level of attendance, which weakens the ability to execute reforms that would harm the banks, rather than commission of actively passed decisions that would benefit the banks).

the omission bias: directors are not willing to actively promote their self-interest but are willing to passively promote their self-interest by not attending board meetings.²¹⁵ Even if they could promote their interests more effectively by their active participation in the decision-making process, they opt to promote it via passive behavior. For instance, if they have an interest in a competing company to theirs, they may not promote policies that provide an advantage to the rival company, but if the company has to change in order to maintain its market position, they might choose not to bring this up until somebody else does. Even though the active promotion of their own interests might subjectively seem worse to a director, in both cases their behavior promoted their interests at the expense of others.²¹⁶

The omission bias has implications for corporate governance and provides a better justification for some prevailing practices. For example, directors effectively nominated by management may never authorize a self-dealing transaction, but may demonstrate weak oversight of management through omission.²¹⁷ And shareholders of a company that have a conflict of interest due to their holdings in rival companies are unlikely to pressure the company to act in a way that harms the company to the benefit of its competitors, but may influence the company not to take certain competitive actions at the expense of the rival companies. This bolsters one of the arguments against institutional investors: that their holdings of shares in rival companies causes their firm's management to abstain from executing certain competitive strategies.²¹⁸ In the following Section, we describe the ways in which the omission bias can be addressed in various contexts: transforming passivity to activity, the business judgement rule, and a duty to vote on financial institutions.

²¹⁵ *Id.* at 510.

²¹⁶ *Id.*

²¹⁷ See, e.g., *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 967, 971–72 (Del. Ch. 1996) (finding the board had exercised appropriate oversight and established appropriate information and reporting systems regarding pervasive illegal practices of employees—providing doctors with kickbacks for prescribing the company's drugs—even though “the Board was to some extent unaware of the activities that led to liability”). Though the court found no evidence of bad faith, *id.* at 972, allowing such practices to take place may benefit managers by increasing the sales of the company. Even though the board may be willing to promote the managers' interest via passive behavior of not executing any oversight, it may have never been willing to promote the management's interests actively, like by approving a conflicted transaction.

²¹⁸ See Einer Elhauge, *Horizontal Shareholding*, 129 HARV. L. REV. 1267, 1273–74 (2016); see also José Azar, Martin C. Schmalz & Isabel Tecu, *Anticompetitive Effects of Common Ownership*, 73 J. FIN. 1513, 1558–59 (2018) (presenting evidence from the airline industry that horizontal shareholding by institutional investors has chilled competition).

a. Transforming passivity to activity

i. Board absence

The most effective way to address the omission bias is by transforming passive behavior patterns into active ones. For instance, in the above example, conflicted directors are more prone to promote their self-interest in passive ways, like by not attending board meetings.²¹⁹ Studies have shown that signing requirements, which alert agents to potential unethical behavior beforehand, curb unethical behavior.²²⁰ So, requiring absent directors to sign a form stating that they understand that their absence may have a negative impact on the firm may curb their indirect promotion of self-interest. In other words, transforming absence into an active form of behavior increases the salience of the self-interest that may be driving it. In this case, it may increase the directors' aversion to being absent and the indirect promotion of self-interest that results.

ii. Management of earnings

We can also reframe passive behavior into active behavior in the prevention of earnings management. Firms have a higher tendency to manage earnings to meet or exceed analyst forecasts when ethical considerations are less salient, as measured by the concurrent incidence of political scandals.²²¹ If ethical salience affects the management of earnings, salience could be enhanced through the method suggested above: requiring managers to actively sign a certification that they did not manage earnings.²²²

²¹⁹ See *supra* notes 217–218 and accompanying text.

²²⁰ See, e.g., Keri L. Kettle & Gerald Häubl, *The Signature Effect: Signing Influences Consumption-Related Behavior by Priming Self-Identity*, 38 J. CONSUMER RSCH. 474, 474–75 (2011) (demonstrating that signing can increase one's identification with her in-group); Lisa L. Shu, Nina Mazar, Francesca Gino, Dan Ariely & Max H. Bazerman, *Signing at the Beginning Makes Ethics Salient and Decreases Dishonest Self-Reports in Comparison to Signing at the End*, 109 PROC. NAT'L ACAD. SCIS. U.S. 15197, 15197–98 (2012) (conducting studies replicating tax filing and filing forms for insurance companies and finding that cheating decreased when participants were asked to sign at the beginning of the form rather than the end).

²²¹ See David C. Cicero & Mi Shen, *Do Executives Behave Better when Dishonesty Is More Salient?* 28 (June 17, 2016) (unpublished manuscript), <https://papers.ssrn.com/a=2748258> [<https://perma.cc/V2CH-979Q>] (finding a negative correlation between the level of exposure to political scandals in the media and inflation of firm's earnings through various manipulations, though the effect was only temporary and disappeared during the second year following a scandal).

²²² In order to increase the effectiveness of such an affirmation, it could be done after providing an example in which earnings were managed.

iii. *Reference point for proxy advisory firms*

Numerous scholars have underscored the conflict of interest that proxy advisory firms face.²²³ While these firms are supposed to advise shareholders, much of their income comes from advising management and other services paid directly by firms, such as corporate governance ratings.²²⁴ The omission bias may exacerbate the problem because when proxy advisory firms agree with the board's recommendations, they are relatively passive. Their "active" mode is activated only when they oppose a management recommendation, which requires affirmative effort. Accordingly, proxy advisory firms are much more prone to promote their own interest by siding with management.

But an intervention can address this conflict of interest. Instead of treating the company's management or directors as the reference point, proxy advisory firms can use the activist's recommendation for how to vote on a certain issue as the reference point. The default view, or the one that would be accepted in the absence of any objection, would not be the managerial view but the activist view. Here, the more passive behavior of accepting the recommendation used as the reference point works against the direction that the advisors' own interests lean.²²⁵ Under this framework, passivity will not exacerbate the conflict-of-interest problem.

b. *Redefining the business judgment rule*

The ethical omission bias also underscores a profound problem with the business judgment rule.²²⁶ The business judgment rule effectively immunizes business decisions from judicial review if they are informed, adopted in good faith, and without a conflict of interest. The business judgment rule also applies to decisions not to decide.²²⁷ Accordingly, if new information is

²²³ See sources cited *supra* note 164 and accompanying text.

²²⁴ See sources cited *supra* notes 165–166 and accompanying text.

²²⁵ Such a method of overcoming the omission bias in situations where a decision does not require active justification is fairly close to the accountability method for debiasing ethical biases mentioned in the behavioral ethics literature. Under the accountability method, the individual is informed prior to making a decision that he will have to justify his decision after the fact. This may influence him to deliberate more carefully before making his actual decision and reduce the probability that he will succumb to System 1 pitfalls. See Jennifer S. Lerner & Philip E. Tetlock, *Accounting for the Effects of Accountability*, 125 PSYCH. BULL. 255, 257, 270–71 (1999); Katherine L. Milkman, Dolly Chugh & Max H. Bazerman, *How Can Decision Making Be Improved?*, 4 PERSPS. ON PSYCH. SCI. 379, 381–82 (2009); FELDMAN, *supra* note 17, at 89–92.

²²⁶ This is in addition to the general inefficacy of ex post liability mechanisms—from which the imposition of fiduciary duties also suffers—that tend to be vague and, as such, less effective in curbing “wrongs” by good people. See *supra* Section I.B.3.

²²⁷ See Elizabeth A. Nowicki, *A Director's Good Faith*, 55 BUFF. L. REV. 457, 499–503 (2007) (pointing to courts' rulings that have interpreted the good-faith condition of the business judgment rule

brought to the attention of the board or company's management and they erroneously decide not to respond to it, they are sheltered from liability. As noted, the behavioral ethics literature demonstrates that there is a difference between decisions to stay the course and decisions to change it: when harm is caused by omission, it is viewed less severely than an identical harm caused by commission. This finding suggests that corporate executives approach decisions to preserve the status quo differently than they treat decisions to depart from it. Yet, the same level of scrutiny—the very lenient business judgment rule—is applied to both types of decisions.

A legal regime that takes into account omission bias²²⁸ should differentiate between corporate decisions that change the status quo ante and decisions that preserve it. To be sure, the business judgment rule should apply to decisions of the former type, as it does now. But decisions falling in the latter category should be reviewed under the more demanding enhanced scrutiny standard. The enhanced scrutiny standard, also known as “the enhanced business judgment rule,” shifts the burden of proof to the corporate executives, requiring *them* to show that their decision was adequately informed, taken in good faith, and without a conflict of interest.²²⁹ Applying the enhanced scrutiny regime to decisions not to act should sensitize corporate executives to the decision they are facing, prompting them to think about the justifications they have for the decision not to act and their ability to convince a court of law that the decision was preceded by a serious deliberation process.

c. Justifying the imposition of a duty to vote on financial institutions

The omission bias may also help shed light on current legal practices in the realm of corporate governance. An example is the mandate imposed on institutional investors to vote the proxies of the shares they hold. The Department of Labor first required proxy voting for institutional investors managing defined-benefit retirement plans in 1988.²³⁰ In 2003, the SEC

broadly, excluding only cases of explicit *mala fides* (bad faith) and thus effectively protecting almost all cases of omission, for which proving *mala fides* is much harder).

²²⁸ See *supra* Section I.A.1.

²²⁹ *Unocal Corp. v. Mesa Petrol. Co.*, 493 A.2d 946, 954–55 (Del. 1985). *Unocal* is the typical case for the enhanced scrutiny standard: the creation of a poison pill by the board in case of a hostile takeover. The poison pill is prone to serve the special interest of the board and management of keeping their positions in the firm, but may also serve the interests of the shareholders by maximizing their share value in the future by avoiding the current hostile takeover.

²³⁰ Letter from Alan D. Lebowitz, Deputy Assistant Sec'y, Pension & Welfare Benefits Admin., U.S. Dep't of Lab., to Helmuth Fandl, Chair of the Ret. Bd., Avon Prods., Inc. *2 (Feb. 23, 1988), 1988 WL 897696. The Department of Labor serves as the regulator of defined-benefit retirement accounts under

imposed a similar mandate on other institutional investors, including mutual funds and defined contributions plans.²³¹ One of the reasons typically given for mandating institutional investors to vote is their lack of incentive to do so. Typically, institutional investors prefer to focus on portfolio building rather than on actively participating in the management of the companies in which they invest, including exercising their voting rights in such companies.²³² This is unsurprising because their revenues from portfolio building—attracting funds and earning profits based on their portfolio performance—are much higher than from portfolio management, developing the profitability of businesses in their portfolio.²³³

The efficacy of mandating voting is, however, not immediately apparent. If it is not worth it for institutional investors to invest in voting, they are unlikely to meaningfully invest in informing their vote.²³⁴ While it is possible to regulate actions, it is not possible to regulate effort.

Nonetheless, the omission bias justifies the imposition of this mandate. Even though institutional investors do not prioritize the management of their investments due to their self-interest, this omission is in conflict with the interest of their investors, to whom they are obligated. The decision of institutional investors to promote their own interest at the expense of their investors may be context-sensitive. Because of their obligation toward their investors, they will not actively harm their investors' interests, but they may tend to violate their interests through passively deprioritizing investment management. But once they are required to vote, and the true unethicity of voting irresponsibly is shown, institutional investors would account for their beneficiaries' interests.

the Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (codified as amended in scattered sections of 26 and 29 U.S.C.). For the codification of this voting mandate, see 29 C.F.R. § 2509.08-2 (Oct. 17, 2008), *superseding* 59 Fed. Reg. 32,607 (June 23, 1994).

²³¹ Final Rule: Proxy Voting by Investment Advisers, Release No. IA-2106, 17 C.F.R. § 275 (Jan. 31, 2003) [hereinafter Investment Advisers Act Release], <http://www.sec.gov/rules/final/ia-2106.htm> [<https://perma.cc/T5NA-94UB>].

²³² See, e.g., Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 889–95 (2013) (explaining that the main reason institutional investors' interest in intervening with governance issues is weak is because they are mainly interested in relative performance to their peers, and that any increase in a company's value that is generated by their intervention also benefits peers who have a position in their company, while they themselves bear all the costs).

²³³ *Id.* at 895. Regarding the conflict of interest between managers in financial institutions and their beneficial investors, see Lucian A. Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSPS. 89, 90 (2017), which differentiates between the incentives of managers of index funds and actively managed funds.

²³⁴ See Paul H. Edelman, Randall S. Thomas & Robert B. Thompson, *Shareholder Voting in an Age of Intermediary Capitalism*, 87 S. CAL. L. REV. 1359, 1424–25 (2014).

2. *Balancing Deliberation and Speed*

In Part I, we discussed the role of System 1 in explaining unethical behavior and showed that decisions made with limited cognitive resources are likely to be less ethical.²³⁵ This issue came up in one of the most famous cases in corporate law, *Smith v. Van Gorkom*,²³⁶ a key element of which was what Delaware courts have later labeled “process due care.”²³⁷ Behavioral ethics may provide an additional justification for the court’s questionable ruling.

In *Van Gorkom*, Trans Union Company faced an offer—the “Pritzker Proposal”—to purchase the company at a considerable premium over its market price: \$55 per share when the market price was \$38. The offer had a very narrow time frame, though—the board had only three days to consider it.²³⁸ The board considered the offer two days later, based on oral presentations of the CFO and Van Gorkom, the chairman and CEO, without a detailed valuation opinion or other documents.²³⁹ The board approved the deal on the condition that it could solicit and accept higher offers in a market-test period.²⁴⁰

The majority of the court concluded that the “[b]oard was grossly negligent in that it failed to act with informed reasonable deliberation in agreeing to the Pritzker merger proposal.”²⁴¹ It pointed to procedural flaws, such as the lack of any proper valuation assessment²⁴² and the haste in which the meeting to discuss the offer had been called, which eliminated the possibility of processing the subject matter in advance.²⁴³ The majority ruled that the directors breached their fiduciary duty “by their failure to inform themselves of all information reasonably available to them and relevant to their decision.”²⁴⁴

²³⁵ See Shalvi et al., *supra* note 45, at 1269; see also Ruedy & Schweitzer, *supra* note 43, at 82.

²³⁶ 488 A.2d 858 (Del. 1985).

²³⁷ *Brehm v. Eisner*, 746 A.2d 244, 264 (Del. 2000) (“Due care in the decisionmaking context is *process due care* only.”); see also BAINBRIDGE, *supra* note 89, at 129 (“Numerous Delaware decisions confirm that judicial references to a requirement of due care really go to the adequacy of the decisionmaking process—what the court has begun calling ‘process due care.’”).

²³⁸ *Van Gorkom*, 488 A.2d at 867, 875.

²³⁹ *Id.* at 864–65, 868.

²⁴⁰ *Id.* at 869.

²⁴¹ *Id.* at 881.

²⁴² *Id.* at 877–78.

²⁴³ *Id.* at 875.

²⁴⁴ *Id.* at 893.

Judges John McNeilly and Andrew Christie dissented.²⁴⁵ Judge McNeilly criticized the majority's analysis of the transaction as a "fast shuffle" in which the directors were duped, and labeled this characterization "the beginning of the majority's comedy of errors."²⁴⁶ Judge McNeilly noted that such transactions are typical to "the corporate world of then and now [that] operates on what is so aptly referred to as 'the fast track.'"²⁴⁷ As some scholars have noted, flexibility in decision-making enables decision-making "at the speed of business," thus allowing firms to capitalize on opportunities that otherwise would have been lost.²⁴⁸

The majority's finding that time constraints adversely affect the quality of board decisions has been reaffirmed elsewhere. In *McMullin v. Beran*, the Delaware Supreme Court opined that "[h]istory has demonstrated boards 'that have failed to exercise due care are frequently boards that have been rushed.'"²⁴⁹

The behavioral ethics literature sheds new light on whether corporate law should require an inflexible level of deliberation for certain decisions or allow companies to move "at the speed of business" to avoid missing out on business opportunities. It highlights an additional dimension: lengthy deliberations tend to prevent unconscious promotion of self-interest. Deliberations executed through more controlled processes tend to be more ethical than intuitive processes, which tend to promote the individual's self-interest.²⁵⁰ When people are under a time constraint or fatigued, they tend to

²⁴⁵ *Id.* (McNeilly, J., dissenting); *id.* at 898 (Christie, J., dissenting).

²⁴⁶ *Id.* at 894 (McNeilly, J., dissenting).

²⁴⁷ *Id.* at 895.

²⁴⁸ Jonathan R. Macey, *Smith v. Van Gorkom: Insights About C.E.O.s, Corporate Law Rules, and the Jurisdictional Competition for Corporate Charters*, 96 NW. U. L. REV. 607, 620 (2002). Some scholars have gone even further in their criticism of the decision and cynically renamed the majority's decision in *Van Gorkom* the "investment bankers' full employment doctrine." Lynn A. Stout, *In Praise of Procedure: An Economic and Behavioral Defense of Smith v. Van Gorkom and the Business Judgment Rule*, 96 NW. U. L. REV. 675, 676 n.5 (2002). Scholars critique the majority's decision. See Fred S. McChesney, *A Bird in the Hand and Liability in the Bush: Why Van Gorkom Still Rankles, Probably*, 96 NW. U. L. REV. 631, 631 (2002) ("Considered a legal disaster in 1985, [*Van Gorkom*] is judged no less disastrous today." (footnote omitted)); Daniel R. Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 BUS. LAW. 1437, 1441 (1985) (arguing that it is not possible to specify performance obligations for informed decisions). For another critique of the majority's decision, see Robert W. Hamilton, *Reliance and Liability Standards for Outside Directors*, 24 WAKE FOREST L. REV. 5, 28–29 (1989).

²⁴⁹ *McMullin v. Beran*, 765 A.2d 910, 922 (Del. 2000) (quoting *Citron v. Fairchild Camera & Instrument Corp.*, 569 A.2d 53, 67 (Del. 1989)).

²⁵⁰ See, e.g., Kees van den Bos, Susanne L. Peters, D. Ramona Bobocel & Jan Fekke Ybema, *On Preferences and Doing the Right Thing: Satisfaction with Advantageous Inequity when Cognitive Processing Is Limited*, 42 J. EXPERIMENTAL SOC. PSYCH. 273, 286 (2006) (finding that when appraising a situation, people have an almost automatic preference for outcomes that benefit themselves and only

behave more dishonestly,²⁵¹ a relationship that has been reaffirmed in meta-analyses.²⁵²

These findings may support lengthy deliberations processes, but only when there is concern that the individual will make a decision that promotes her own self-interest at the expense of the company's interest, such as in a self-dealing transaction. This is not the case in *Van Gorkom* and similar cases. The central question was whether the board was negligent and violated its duty of care without any reference to a conflict of interest, which typifies violations of duty of loyalty. Yet, as some scholars have noted, a soft conflict of interest was lurking in the background of *Van Gorkom* and may have been motivating the whole transaction. Van Gorkom's rush to sell the company may be explained by the fact that he was very close to the mandatory retirement age and thus wanted to liquidate his significant holdings in the company before retiring.²⁵³ Such "soft" self-interests may be relevant to a large array of cases. In these cases, like in *Van Gorkom*, it may not be sufficient to treat the case as a violation of the duty of loyalty, but it is

later—i.e., a few seconds—correct their views to take into account fairness toward others); Yoella Bereby-Meyer & Shaul Shalvi, *Deliberate Honesty*, 6 CURRENT OP. PSYCH. 195, 196 (2015) (finding that people's intuitive reasoning makes them more likely to cheat and that being given time to deliberate reduced cheating).

²⁵¹ See, e.g., Shalvi et al., *supra* note 45, at 1267 (finding participants who had to respond quicker were more unethical than those with more time); Gino et al., *supra* note 43, at 192 (describing self-regulation, or self-control, as a finite resource which depletes as an individual continuously exerts it); Bereby-Meyer & Shalvi, *supra* note 250, at 195–96 (asserting that with respect to the energy individuals require for self-control, "[d]epletion leads to dishonesty"); Maryam Kouchaki & Isaac H. Smith, *The Morning Morality Effect: The Influence of Time of Day on Unethical Behavior*, 25 PSYCH. SCI. 95, 100–01 (2014) ("[W]e found evidence across four experiments that, provided with the opportunity, people are more likely to engage in unethical acts in the afternoon than in the morning."). Regarding how this effect is curtailed in settings that lead agents to more deliberation, such as when they are primed with the concept of time rather than the concept of money, see Francesca Gino & Cassie Mogilner, *Time, Money, and Morality*, 25 PSYCH. SCI. 414, 419–20 (2014), and in settings when performing the task in a foreign language, see Yoella Bereby-Meyer, Sayuri Hayakawa, Shaul Shalvi, Joanna D. Corey, Albert Costa & Boaz Keysar, *Honesty Speaks a Second Language*, 12 TOPICS COGNITIVE SCI. 632, 638–40 (2020).

²⁵² Kristina Suchotzki, Bruno Verschuere, Bram Van Bockstaele, Gershon Ben-Shakhar & Geert Crombez, *Lying Takes Time: A Meta-Analysis on Reaction Time Measures of Deception*, 143 PSYCH. BULL. 428, 444 (2017) (distinguishing between the mental resources required for making a decision, where truth-telling requires more resources, and the cognitive resources required for executing an action, where executing an action based on a lie requires greater cognitive resources); Köbis et al., *supra* note 46, at 792–93 ("Our results suggest that 'thinking fast' amplifies the force of self-interest leading to ethical rule violations, as long as those violations do not directly harm others.").

²⁵³ See, e.g., BAINBRIDGE, *supra* note 89, at 130 n.75 (stating that "[o]ne could perhaps construct a self-dealing argument by focusing on the fact that Van Gorkom was very close to the mandatory retirement age and owned 75,000 shares of Trans Union Stock . . . [which] meant that he had an incentive to sell the company," but concluding "his self-interest was directly in-line with the interests of the shareholders, who presumably also would want the best possible price").

worthwhile to consider the potential influence of the conflict of interest on the agent's decision.

Further, mandating lengthy deliberations processes for merger and acquisition agreements that include an external valuation as well as an opportunity for the board to read the full agreement and other documents may eliminate decisions that are self-serving for management and other key members in the corporation.²⁵⁴ This additional advantage may outweigh the costs of inflexible lengthy deliberations in the form of foregone business opportunities.

CONCLUSION

The introduction of misconduct by “good people” with benevolent motivations into corporate law gives rise to a more complete and accurate account of the corporate world. It reveals that the motivations of corporate executives and employees are far more nuanced and varied than traditional analysis suggests, as are their failures. Behavioral ethics' potential impact on the law is immense—as scholars have already demonstrated, it can shift the focus of legal policy and transform the ways in which law regulates behavior.²⁵⁵ Corporate law, on account of its reliance on agency relationships and group decision-making, is a natural target for the application of behavioral ethics. The behavioral ethics literature teaches that corporate law should not be exclusively concerned with stark conflicts of interest but should also pay much closer attention to subtle conflicts of interest that are much more common in the day-to-day operations of corporations.

Under the conventional framework, the central objective of corporate governance is assumed to be the deterrence of “bad people”—calculative self-interest-maximizers—from promoting their own goals at the expense of the shareholders. So legal interventions are largely based on a Beckerian

²⁵⁴ This notion of increasing awareness and reflection through organizational procedures is discussed to some extent in management literature. *See, e.g.*, Kenneth D. Butterfield, Linda Klebe Treviño & Gary R. Weaver, *Moral Awareness in Business Organizations: Influences of Issue-Related and Social Context Factors*, 53 HUM. RELS. 981, 1008 (2000) (finding “that management can increase moral awareness in the workplace,” and that their employees could be influenced “by the magnitude of consequences of issues, by working in a highly competitive context, by framing using moral language, and by perceived social consensus that an issue is ethically problematic”); Ann E. Tenbrunsel & Kristin Smith-Crowe, *Ethical Decision-Making: Where We've Been and Where We're Going*, 2 ACAD. MGMT. ANNALS 545, 546–48 (2008) (“The purpose of this paper is to review the literature on ethical decision making in organizations, specifically focusing on behavioral, or descriptive, ethics . . .”). For a discussion of the technological ways to slow executives' decision-making in order to decrease unethical decision-making, see Todd Haugh, *The Ethics of Intracorporate Behavioral Ethics*, 8 CALIF. L. REV. ONLINE 1, 1–3, 10 (2017).

²⁵⁵ FELDMAN, *supra* note 17, at 1–31.

model, in which enhanced sanctions raise the expected cost of wrongdoing.²⁵⁶ But the behavioral ethics literature suggests other forms of intervention that are not concerned with the magnitude of the sanction, including increasing the salience of the wrongdoing and addressing and altering the circumstances that enable subtle unethicity to be ignored. Building on these insights, we propose a series of reforms in corporate law that span a broad range of topics from the role of independent directors, to decision-making processes, to judicial review standards.

²⁵⁶ Becker, *supra* note 55, at 208–09.

