NOTES

SOCIAL TIES IN THE BOARDROOM: CHANGING THE DEFINITION OF DIRECTOR INDEPENDENCE TO ELIMINATE "RUBBER-STAMPING" BOARDS

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I. INTRODUCTION

The new millennium ushered in a parade of corporate scandals.[1] The succession of scandals, which began with the collapse of Enron, revealed a deep-seated pattern of disregard for shareholders' interests.[2] In response to

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1. *See, e.g.*, ROBERT BRYCE, PIPE DREAMS: GREED, EGO, AND THE DEATH OF ENRON (2002); BETHANY MCLEAN & PETER ELKIND, THE SMARTEST GUYS IN THE ROOM: THE AMAZING RISE AND SCANDALOUS FALL OF ENRON (2003); MIMI SWARTZ & SHERRON WATKINS, POWER FAILURE: THE INSIDE STORY OF THE COLLAPSE OF ENRON (2003).

2. *See, e.g.*, *In re* WorldCom, Inc. Sec. Litig., 388 F. Supp. 2d 319, 331–32 (S.D.N.Y. 2005) (describing the testimony of a WorldCom internal auditor who exposed WorldCom after discovering $3 billion in fraudulent accounting); Adelphia Commc'ns Corp. v. Rigas (*In re* Adelphia Commc'ns Corp.), No. 02-41729 (REG), 2004 WL 2186582, at *1 (S.D.N.Y. Sept. 27, 2004) (finding that the CEO and other senior management took the company's assets to pay for personal expenses); SEC v. HealthSouth Corp., 261 F. Supp. 2d 1298 (N.D. Ala. 2003) (finding that accounting fraud resulted in a $2.7 billion manipulation); *In re* Tyco Int'l, Ltd., Sec. Litig., 185 F. Supp. 2d 102 (D.N.H. 2002) (finding that Tyco evaded corporate income and state sales tax by reporting nonexistent income and that Tyco senior management had used company assets for personal expenses).

these events and the widespread public outcry that ensued, Congress examined corporate board structure and senior management and passed the Sarbanes-Oxley Act ("SOX") in 2002 to try to remedy problems of accountability.[3] Even after SOX was passed, corporate governance experts continued to study the role of a board of directors and how that role may be modified in order to prevent future scandals and to protect shareholders adequately.[4] They have analyzed many aspects of the board, ranging from the size,[5] to whether the chief executive officer ("CEO") should be the chairman,[6] to the importance of truly independent directors.[7]

True director independence is the critical inquiry.[8] An independent director is a type of gatekeeper, providing a check on the CEO's power, evaluating and criticizing business decisions, and ultimately protecting shareholders' interests. All of the companies involved in the recent corporate scandals shared one characteristic—they had directors who were not truly independent.[9]

3. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15 & 18 U.S.C.).

4. *See, e.g.*, Stephen M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1 (2002); Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797 (2001); Lucian Bebchuk, Alma Cohen & Allen Ferrell, *What Matters in Corporate Governance?* (Harvard Law Sch. John M. Olin Ctr. for Law, Econ., & Bus., Discussion Paper No. 491, 2004), *available at* http://www.law.harvard.edu/programs/olin_center/papers/pdf/Bebchuk_et%20al_491.pdf.

5. *See* Richard S. Saver, *Medical Research Oversight from the Corporate Governance Perspective: Comparing Institutional Review Boards and Corporate Boards*, 46 WM. & MARY L. REV. 619, 651–53 (2004).

6. *See* Jeswald W. Salacuse, *Corporate Governance, Culture and Convergence: Corporations American Style or with a European Touch?*, L. & BUS. REV. AM., Winter 2003, at 33, 57.

7. *See generally* William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953, 989–99 (2003) (arguing that there is not necessarily a connection between the "independence" of a director and the director's ability to objectively and effectively work without breaching fiduciary duties); Daniel J.H. Greenwood, *Enronitis: Why Good Corporations Go Bad*, 2004 COLUM. BUS L. REV. 773, 839–40 (stating that independent directors will only cure part of the problem and that a less "share-centered" view of the corporation needs to be adopted); Mark J. Loewenstein, *The Quiet Transformation of Corporate Law*, 57 SMU L. REV. 353, 375–77 (2004) (commenting that the adoption of independent directors has not always led to better corporate governance practices).

8. *See* Hatice Uzun, Samuel H. Szewczyk & Raj Varma, *Board Composition and Corporate Fraud*, 60 FIN. ANALYSTS J. 33 (2004) (showing, based on empirical evidence, that as the number of independent outside directors on a board's audit compensation committee increased, the likelihood of corporate wrongdoing decreased); Audio tape: Conference on Post-Enron Regulation of Board Governance and Process, held by the Northwestern University School of Law (Jan. 21–23, 2004) (on file with author) [hereinafter Conference on Post-Enron Regulation].

9. The directors fell into one of two categories: (1) when the company initially appointed the director, the director lacked independence from the CEO, the company, or the other directors; or (2) the director was initially independent, but lost that independence during the director's tenure, as was the

In an attempt to provide meaningful change to the definition of "independent," the New York Stock Exchange ("NYSE") and the NASDAQ Stock Market, Inc. ("NASDAQ") recently amended their requirements for listed companies.[10] They put forward a more comprehensive list of characteristics that disqualify an individual from being deemed independent, the core of which focused on familial and financial ties among directors, senior management, and the company.[11]

Even directors who are deemed independent under these definitions may not be truly independent, however. In addition to familial and financial ties, a director's social ties with senior management can significantly affect that director's independence. Three recent cases, *In re Walt Disney Co. Derivative Litigation*,[12] *In re Oracle Corp. Derivative Litigation*,[13] and *Hollinger International, Inc. v. Black*,[14] evidence the danger of having directors and senior managers who are not truly independent. In all three cases, social ties between some directors and senior management existed and may have interfered with the directors' abilities to carry out their duties to protect shareholders.[15]

This Note examines the function of a board of directors through the lenses of economics and social psychology and suggests that a board's ability to function effectively may greatly depend on independent directors. It further suggests an appropriate definition of "independent director" and recommends how the role of directors should be implemented and how their independence should be maintained. Part II describes the role of a board of directors and factors that may compromise a board's ability to

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case on the Enron board, which was majority-independent. The loss of independence can happen when directors become too entangled with the CEO. *See* Joseph Nocera et al., *System Failure: Corporate America Has Lost Its Way. Here's a Road Map for Restoring Confidence*, FORTUNE, June 24, 2002, at 62, *available at* 2002 WLNR 11958693 (quoting Jay Lorsch as stating, "On the surface Enron's board looked independent . . . . But everybody on that board was selected by Ken Lay."). As Enron director Norman Blake testified during the congressional hearings, "Personally, I believe that while we may have begun initially as a collection of individuals, we evolved into a cohesive and collegial group." *The Role of the Board of Directors in Enron's Collapse: Hearing Before the Permanent Subcomm. on Investigations of the S. Comm. on Governmental Affairs*, 107th Cong. 25 (2002) (statement of Norman P. Blake, Interim Chairman of the Board of Enron Corporation). This Note focuses only on director independence at the time of appointment, not loss of independence during tenure as a director.

10. *See* NASDAQ Stock Market, Inc., Marketplace Rules § 4200(a)(15) (2003), *available at* http://www.nasdaq.com/about/MarketplaceRules.pdf [hereinafter NASDAQ Rules]; NYSE, Inc., Listed Company Manual § 303A.01 (2003), *available at* http://www.nyse.com/Frameset.html?displayPage=/about/listed/1022221393251.html [hereinafter NYSE Manual].

11. *See* NASDAQ Rules, *supra* note 10, § 4350(c); NYSE Manual, *supra* note 10, § 303A.01.

12. *In re* Walt Disney Co. Derivative Litig., 825 A.2d 275 (Del. Ch. 2003).

13. *In re* Oracle Corp. Derivative Litig., 824 A.2d 917 (Del. Ch. 2003).

14. Hollinger Int'l, Inc. v. Black, 844 A.2d 1022 (Del. Ch. 2004).

15. *Id.* at 1029–30; *In re Walt Disney*, 825 A.2d at 279, 281; *In re Oracle*, 824 A.2d at 930–35.

function effectively. Part III looks at three recent corporate scandals and then analyzes the responses of the Delaware courts and the stock exchanges ("the Exchanges"). Finally, Part IV evaluates the effectiveness of these responses and proposes an amendment to the current definition of "independent director" to include an evaluation of a director's social ties to management.

II. THE FUNCTIONS OF AND CONSTRAINTS ON BOARDS OF DIRECTORS

The role of the board of directors in corporate governance and the factors that may compromise the board's ability to function effectively are a key part of corporate reform. Among the important factors that affect the quality of a board of directors are the definition of what an "independent director" is, the board's roles and responsibilities, the constraints on the behavior of the board members and their legal liability, the board selection process and how it affects director loyalty, and the incentives for directors to overcome their loyalties to the CEO.

A. THE DEFINITION OF AN "INDEPENDENT DIRECTOR"

There a number of different ways to define "independent director." Because an independent director functions as a monitor on management's power and decisionmaking authority, a basic definition must include the conditions that the director is not currently employed by the firm and is not controlled by its insiders.[16] For example, under the Securities Exchange Commission's ("SEC") definition, directors meeting any of the following criteria are not considered to be independent: (1) employment by the firm within the past five years, (2) family relationship by blood or marriage with a top manager or other director, (3) affiliation with the firm as a banker or creditor within the past two years, (4) affiliation with the firm as an investment banker within the past two years or within the upcoming year, (5) association with a law firm engaged by the corporation, or (6) stock ownership resulting in the SEC designation of "control person."[17]

16. *See* STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS § 5.5 (2002); Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U. L. REV. 898, 901 (1996). The Business Roundtable's *Statement on Corporate Governance* states, "The degree of independence of an outside director may be affected by many factors, including the personal stature of the director and any business relationship . . . with the corporation or any business or personal relationship . . . with management." BUS. ROUNDTABLE, STATEMENT ON CORPORATE GOVERNANCE 10 (1997), *available at* http://www.businessroundtable.org/pdf/11.pdf.

17. *See* Investment Company Act of 1940, 15 U.S.C. § 80a-2(a)(19) (2000).

Similarly, the American Law Institute recommends that a large, publicly traded corporation should have a majority of directors who are "free of any significant relationship" with the company and its senior executives.[18] Consequently, the American Law Institute defines "significant relationship" as (1) previous employment by the company within the past two years; (2) receipt of over $200,000 in either of the two preceding years; (3) ownership of an equity share over $200,000 in the company; (4) being the principal manager of a business that received from or paid to the company, during either of the two preceding years, five percent of the company's consolidated gross revenues or $200,000, whichever is larger; (5) professional affiliation with the company's primary outside legal firm; or (6) if "on the basis of countervailing or other special circumstances, it could not reasonably be believed that the judgment of a person in the director's position would be affected by his relationship."[19] Lastly, the Council of Institutional Investors defines an independent director as "someone whose only nontrivial professional, familial or financial connection to the corporation, its chairman, CEO or any other executive officer is his or her directorship."[20]

B. THE BOARD'S FUNCTIONS

A board of directors is charged with running a firm.[21] The board has final responsibility for the operation of the firm, which traditionally requires directors to do three things.[22] First, because of executives' temptations to engage in self-interested behavior, the board of directors monitors the behavior of top management. Scholars predict that in the absence of effective monitoring by their boards, executives may expect to find diminished investment interest in their particular companies.[23] Monitoring encompasses three distinct tasks: conflicts monitoring, employment monitoring, and oversight monitoring.[24] Conflicts monitoring

18. *See* AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 3A.01(a) (1991).

19. *Id.*

20. COUNCIL OF INSTITUTIONAL INVESTORS, CORPORATE GOVERNANCE POLICIES 19 (2005), *available at* http://www.cii.org/site_files/pdfs/policies/2005%20(November)%20CII%20Policies.pdf.

21. 8 DEL. CODE ANN. tit. 8, § 141(a) (2001).

22. *See* BAINBRIDGE, *supra* note 16, § 5.2; Langevoort, *supra* note 4, at 801–05.

23. *See* BAINBRIDGE, *supra* note 16, § 5.2; Langevoort, *supra* note 4, at 801–05; Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921, 927–28 (1999).

24. *See* AM. LAW INST., *supra* note 18, § 3.02(a)(1) (stating that the board of directors of a publicly held corporation should "[s]elect, regularly evaluate, fix the compensation of, and, where

involves preventing executives from "opportunistically pursuing their own interests rather than the interests of shareholders."[25] Employment monitoring requires making decisions regarding the selection, retention, and compensation of the CEO and other high-level executives.[26] Lastly, oversight monitoring involves managing the mechanisms—including financial reporting, accounting, auditing, and disclosure requirements—through which shareholders make assessments about the performance of the particular company and its management.[27]

Second, the board assists the firm by providing access to external resources, which are critical to the firm's success.[28] Consequently, carefully chosen board members may help to ensure that the firm's decisions appear legitimate in the eyes of key resource providers, such as labor, customers, and government officials.[29] Accordingly, the directors' connections may provide invaluable support to the firm.

Third, directors help management formulate corporate strategy by listening to various proposals and providing the CEO with advice, support, and criticism.[30] The business expertise required to carry out this service function accounts for the high percentage of current and former CEOs who act as directors.[31] Often, directors consider this function the most important and the most enjoyable. As scholars have noted, "advising the CEO [is] a task that, while not as dramatic as replacing him, enables [directors] to play what many consider to be their key normal duty."[32] Firms, as well as their directors, gain from this function. Studies have found that financial performance improves when boards contribute to the strategic decision process.[33]

appropriate, replace the principal senior executives" (internal citation omitted)); Marleen A. O'Connor, *The Enron Board: The Perils of Groupthink*, 71 U. CIN. L. REV. 1233, 1242–55 (2003).

25. *See* Lynne L. Dallas, *The Relational Board: Three Theories of Corporate Boards of Directors*, 22 J. CORP. L. 1, 1–2 (1996).

26. MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS 162–68 (1976).

27. *See* Langevoort, *supra* note 4, at 802.

28. *See* Jonathan L. Johnson, Catherine M. Daily & Alan E. Ellstrand, *Boards of Directors: A Review and Research Agenda*, 22 J. MGMT. 409, 411 (1996); Langevoort, *supra* note 4, at 802.

29. *See* Dallas, *supra* note 25, at 10–16; Langevoort, *supra* note 4, at 802.

30. *See* Johnson et al., *supra* note 28, at 411.

31. JAY W. LORSCH & ELIZABETH MACIVER, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS 18 (1989).

32. *Id.*

33. *See* Johnson et al., *supra* note 28, at 426.

Some commentators doubt the utility of the board's service function, since companies also pay other experts to function in a similar capacity.[34] Although distinct from the monitoring function, the service function provides another monitoring mechanism. Social psychology research suggests that managers tend to develop biased constructions of their firm's strategic position, which causes them to become overconfident and deeply entrenched in their beliefs.[35] These biased constructions deter managers from seeking out information that might suggest that they are wrong. Granting authority to an objective group of outsiders can force managers to recognize and overcome their biases. In this way, the service function is also a type of monitoring, which may become increasingly important if a manager's own biases and self-interest increase over time.[36]

C. CONSTRAINTS ON BOARD BEHAVIOR: LEGAL LIABILITY

In order to encourage directors to perform their functions as effectively as possible, the law imposes fiduciary duties on them.[37] These fiduciary duties protect shareholders by limiting directors' power and by providing incentives for directors to act in the shareholders' best interests.[38]

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34. *See* Langevoort, *supra* note 4, at 803 (stating that firms can easily hire consultants, lawyers, and investment bankers for sources of outside judgment). Note, however, that when a firm hires experts to specifically advise the firm on business decisions, the experts implicitly become part of the management team and therefore lose some of their "objective thinking." 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, 109–10 (1985); Charles M. Elson & Christopher J. Gyves, *The Enron Failure and Corporate Governance Reform*, 38 WAKE FOREST L. REV. 855, 872–73 (2003). A similar argument may be made for independent directors, but an explicit part of an independent director's job is to monitor management's decisions and protect shareholders' interests. For a discussion on whether this is occurring, see *infra* Parts II.D and II.E.

35. Langevoort, *supra* note 4, at 803.

36. *See* Lin, *supra* note 16, at 901; Saver, *supra* note 5, at 652–53. The opposite effect may be observed, however, where a director or several directors become more critical of a CEO as time goes on, especially when a company performs poorly. *See* Laura M. Holson, *As Disney Loses Steam, Insider Loses Patience*, N.Y. TIMES, Aug. 18, 2002, at 31, *available at* 2002 WLNR 4077395 (detailing the deteriorating relationship between Disney CEO Michael Eisner and directors Roy Disney and Stanley Gold).

37. *See* Michael Bradley & Cindy A. Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance*, 75 IOWA L. REV. 1, 17 (1989); Richard T. Hossfeld, *Short-form Mergers After* Glassman v. Unocal Exploration Corp.*: Time to Reform Appraisal*, 53 DUKE L.J. 1337, 1338 (2004).

38. *See* Bradley & Schipani, *supra* note 37, at 17. A fiduciary duty is defined as "a duty to act with the highest degree of honesty and loyalty toward another person and in the best interests of the other person." BLACK'S LAW DICTIONARY 523 (7th ed. 1999). Under Delaware law, directors owe fiduciary duties to shareholders because "directors, rather than shareholders, manage the business and affairs of the corporation. . . . The existence and exercise of this power carries with it certain fundamental fiduciary obligations to the corporation and its shareholders." Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984), *overruled by* Brehm v. Eisner, 746 A.2d 244 (Del. 2000). *See also* Smith v. Van

Legal scholar John Coffee has stated that "the principal purpose of fiduciary duties has long been to constrain opportunism by management and controlling shareholders."[39] The three common law fiduciary duties are (1) the duty of good faith, (2) the duty of loyalty, and (3) the duty of care.[40] The duty of loyalty requires directors not to place their own interests ahead of the interests of the corporation, in the event of a conflict of interests between them.[41] The duty of care requires directors to perform their jobs diligently.[42]

In order for a claimant to prove that a director has not acted with sufficient thoroughness or diligence, thereby breaching fiduciary duty, that claimant needs to rebut the presumption of the business judgment rule.[43] Simply stated, under the business judgment rule, the court presumes that directors make business decisions "on an informed basis, in good faith and in the honest belief that the action was taken in the best interests of the company."[44] Therefore, a court will normally uphold a business decision, unless the plaintiffs—generally a group of shareholders—can rebut the presumption by showing that "(1) the process, independence, or good faith

Gorkom, 488 A.2d 858, 872 (Del. 1985) (stating that directors have an "unyielding fiduciary duty to the corporation and its shareholders" (citing Loft, Inc. v. Guth, 2 A.2d 225 (Del. Ch. 1938), *aff'd* 5 A.2d 503 (Del. 1939))). *See generally* Sondra J. Thorson, Note, *Protecting Shareholders: Illinois Needs a Director Liability Statute*, 26 J. MARSHALL L. REV. 105 (1992) (arguing that fiduciary duties are one of the mechanisms that limit potential abuses of power by directors).

39. John C. Coffee, Jr., *Transfers of Control and the Quest for Efficiency: Can Delaware Law Encourage Efficient Transactions While Chilling Inefficient Ones?*, 21 DEL. J. CORP. L. 359, 423 (1996).

40. Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1164 (Del. 1995). While historically a director owed shareholders only the duties of loyalty and care, *Cinerama* stated that directors do owe shareholders all three duties: loyalty, care, and good faith. *Id.* Once directors violate the duty of good faith, however, they have most likely also violated their duties of loyalty and care. Thus, only the latter two duties will be discussed in this Note.

41. *See* MODEL BUS. CORP. ACT § 8.30 (2002), *available at* http://www.abanet.org/buslaw/library/onlinepublications/mbca2002.pdf; RESTATEMENT (SECOND) OF AGENCY § 387 (1958).

42. *See generally* BAINBRIDGE, *supra* note 16, § 6.5.

43. *See id.* But, even if a director, or an entire board of directors, has breached its duty of care when making a business decision, an informed vote by a majority of disinterested shareholders may cleanse the transaction. The law gives shareholders the power to approve a decision, even in the face of negligence, if the shareholders believe that the decision is in the best interest of the company. Yet, in specific instances when there is a breach of the duty of loyalty, specifically when a controlling shareholder is involved, disinterested shareholder ratification is not sufficient to cleanse the transaction. This stringent review is justified because, in theory, shareholders may not be sophisticated enough to cleanse the transaction, particularly when a dominant shareholder or executive affects their ability to ascertain the truth or to become fully informed. *See id.*

44. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984), *overruled by* Brehm v. Eisner, 746 A.2d 244 (Del. 2000) (citing Kaplan v. Centex Corp., 284 A.2d 119, 124 (Del. Ch. 1971); Robinson v. Pittsburgh Oil Refining Corp., 126 A. 46 (Del. Ch. 1924)).

of the directors is compromised; or (2) the decision cannot be attributed to a rational business purpose."[45]

Courts justify their deference to the decisionmaking power of the board on the ground that judges do not possess the specific knowledge necessary to make business decisions and thus should not substitute their decisions for those of the directors.[46] Thus, the courts will only hold directors liable for acts of gross negligence. The argument follows that the business judgment rule further reduces a director's incentive to fully question the proposals and decisions of the CEO.[47] Although courts have recently been scaling back the protection of the business judgment rule,[48] directors still have insurance and indemnification rights to insulate them from liability.[49]

D. HOW THE BOARD SELECTION PROCESS AFFECTS DIRECTOR LOYALTY

Despite escalating attention being paid to their legal and ethical responsibilities, "directors seem paralyzed in the presence of powerful CEOs."[50] While a common belief exists that shareholders select the board of directors through voting, the reality is quite different.[51] Shareholders have far less influence in the selection of board members[52] than do CEOs.[53]

45. E. Norman Veasey, *The Defining Tension in Corporate Governance in America*, 52 BUS. LAW. 393, 394 (1997).

46. *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967 (Del. Ch. 1996) (cautioning against adoption of a rule that would "expose directors to substantive second guessing by ill-equipped judges or juries, which would, in the long run, be injurious to investor interests"). This logic is somewhat flawed in that judges, on countless occasions, do substitute their own opinions and knowledge for that of informed experts in highly technical and specialized fields. For example, in the fields of construction, products liability, and medical malpractice, judges frequently engage in evaluating the substance of the entity's decisions. But in corporate law, judges only evaluate the process by which the directors came to their decision, not the relative merits of that decision.

47. *See* Loewenstein, *supra* note 7, at 377–78.

48. *See infra* Part III.B.

49. *See* Loewenstein, *supra* note 7, at 378. Indemnification rights protect directors from judgments against them by requiring judgments to be paid from firms' assets rather than from directors' personal assets.

50. Randall Morck, *Behavioral Finance in Corporate Governance—Independent Directors and Non-Executive Chairs* 10 (Harvard Inst. of Econ. Research, Discussion Paper No. 2037, 2004), *available at* http://post.economics.harvard.edu/hier/2004papers/HIER2037.pdf.

51. Johnson et al., *supra* note 28, at 411 (stating that although shareholders are legally responsible for electing directors, under state law, shareholders are not permitted to nominate directors). *But see* Press Release, SEC, Solicitation of Public Views Regarding Possible Changes to the Proxy Rules (May 1, 2003), *available at* http://www.sec.gov/news/press/2003-59.htm (announcing the SEC proposal to change the proxy rules and regulations to allow certain shareholders to nominate directors).

52. Charles Duhigg, *SEC May Aid Rebels Seeking Board Seats*, WASH. POST, Aug. 6, 2003, at E1 (explaining that if a candidate is not selected by the corporation itself to be on the ballot, the only

Given the extensive control that CEOs exhibit over the nomination process, it is unlikely that they would nominate directors who they believe will oppose them. One scholar has noted, "Executives can easily find directors . . . who will support almost anything that the executives propose . . . ."[54] This suggests that a major criterion for selecting a director is that director's willingness to accept the corporation's positions and identify with its senior management.[55] In the quest to find the "right type of person," CEOs generally look toward current and former CEOs, which not only creates disincentives for a director to question the CEO,[56] but also produces a rather homogeneous board. More often than not, so called independent directors comply with, rather than oppose, the CEO's policies and decisions.[57]

Further, CEOs often nominate directors with whom they have previous business or social connections,[58] in an attempt to create a supportive board environment.[59] But there is increasing concern that the loyalty that directors who are colleagues and friends of their CEOs feel toward those CEOs results in unproductive or "rubber-stamping" boards.[60]

Another factor swaying directors' loyalty toward CEOs, rather than shareholders, involves the side payments directors receive from the firm in the form of corporate philanthropy to charities of their choice. The threat of stopping these payments both undermines director independence and works

way that outside candidates may exert influence on the nomination process is to undertake the lengthy and expensive process of contacting shareholders with an alternative ballot).

53. *See* Lin, *supra* note 16, at 913 (stating that "shareholders simply vote for whomever is proposed by the incumbent board or the company's nominating committee").

54. Alfred F. Conard, *Beyond Managerialism: Investor Capitalism?*, 22 U. MICH. J.L. REFORM 117, 129 (1998).

55. *See* Lin, *supra* note 16, at 913.

56. Directors who are either present or former CEOs question and criticize CEOs less because they identify with those CEOs and prefer not to be questioned or criticized in their own positions as CEOs. *See* Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 875 (1991) ("These directors are unlikely to monitor more energetically than they believe they should be monitored by their own boards.").

57. *See* James D. Westphal, *Defections from the Inner Circle: Social Exchange, Reciprocity and the Diffusion of Board Independence in U.S. Corporations*, 42 ADMIN. SCI. Q. 161, 163–64 (1997).

58. This is often the case when CEOs nominate former and current CEOs of other companies.

59. *See* Tom Abate, *Boards Get Tough with Failing CEOs: New Age of Accountability Follows Corporate Scandal*, S.F. CHRON., Feb. 13, 2005, at C1, *available at* 2005 WLNR 2026712 (quoting one veteran executive recruiter as commenting that boards are "clubby or collegial . . . on the edge of incestuousness").

60. *See* Arthur R. Pinto, *Corporate Governance: Monitoring the Board of Directors in American Corporations*, 46 AM. J. COMP. L. 317, 346 (1998); Usha Rodrigues, *Let the Money Do the Governing: The Case for Reuniting Ownership and Control*, 9 STAN. J.L. BUS. & FIN. 254, 260 (2004).

as an incentive for directors to endorse CEOs' plans and proposals.[61] Some scholars hypothesize that these payments weaken director independence even more than management's ability to shorten the tenure of a director.[62]

1. The Impact of Social Ties on Director Behavior

It may be true that CEOs, in an effort to create a collegial board atmosphere, nominate directors with whom they share social ties and similar characteristics. But the real concern should be whether this practice is harmful to shareholders. Social psychologist James Westphal, who studies boards of directors, has posited that appointment of a director with social ties to the CEO is not harmful to shareholders.[63] His collaborative board model hypothesizes that strong social ties increase trust and open communication among board members, including the CEO.[64] Westphal argues that strong social ties encourage a CEO to seek out the advice of the directors, even though there are social and professional risks involved.[65] Strong ties also promote more honest communication among board members, which allows the CEO to receive more positive and negative feedback.[66] Therefore, according to Westphal's hypothesis, the inclusion of independent directors who have preexisting social ties to the CEO will facilitate more effective communication and monitoring by all parties.

On the other hand, there are strong reasons to believe that a CEO's decision to nominate the "right type" of director has significant negative consequences for the company. In contrast to Westphal's collaborative board model, the independent board model postulates that strong social ties compromise an independent director's ability and readiness to objectively monitor and critique managerial ideas and performance.[67] Research has found that people with strong ties to each other attempt to avoid conflict in

61. Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233, 1241–42 (2002).

62. *See, e.g.*, *id.*

63. *See generally* Westphal, *supra* note 57.

64. *See id.* at 8.

65. *See id*. at 9. These social and professional risks include rejection, failure, and criticism—concepts that are discussed further *infra* in Part IV.B.

66. *See* Karen A. Jehn & Priti Pradhan Shah, *Interpersonal Relationships and Task Performance: An Examination of Mediating Processes in Friendship and Acquaintance Groups*, 72 J. PSYCHOL. & SOC. PSYCHOL. 775, 777–78 (1997) (finding that conflict and criticism are more likely to occur between close friends than between acquaintances or strangers). *But see* IRVING L. JANIS, VICTIMS OF GROUPTHINK 13 (1972) (finding that people who are closer socially are less likely to criticize and critically evaluate each other).

67. *See* Westphal, *supra* note 57, at 8.

order to maintain their social capital.[68] Social capital refers to the collection of relationship networks that a person maintains. It influences a group by increasing the senses of cultural norms and mutual identification, but decreases the openness among group members and the number of alternatives they consider.[69] Consequently, "friends" are reluctant to critically evaluate each other out of fear that such criticism will jeopardize their relationships.[70] This severely hampers a board's ability to function effectively, impairing its monitoring function and increasing the negative impacts associated with decisionmaking in closely connected groups.[71] If this view is correct, a board comprised of directors who lack social ties to the CEO may perform its duties better, thus benefiting the firm and the shareholders.

A recent study provides further support for the independent board model. It found that the boards of companies that are accused of committing fraud are less independent than those of no-fraud companies.[72] The researchers determined that an important factor influencing the occurrence of corporate fraud is the independence of directors in monitoring positions, not the size of the board, frequency of meetings, or separation of chairman and CEO positions.[73]

The results of this study, coupled with recent examples of actual boardroom behavior,[74] support reliance on the independent board model, as opposed to the collaborative board model, and lead to the conclusion that the relative strength of a social tie negatively alters a director's behavior and decisionmaking in the boardroom.

68. *See* Reed E. Nelson, *The Strength of Strong Ties: Social Networks and Intergroup Conflict in Organizations*, 32 ACAD. MGMT. J. 377, 380 (1989).

69. *See* Janine Nahapiet & Sumantra Ghoshal, *Social Capital, Intellectual Capital, and the Organizational Advantage*, 23 ACAD. MGMT. REV. 242, 245 (1998).

70. *See* Jehn & Shah, *supra* note 66, at 778 (stating that research has found that "group members who are friends are often preoccupied with maintaining their relationships and therefore are unwilling to critically evaluate each other's views").

71. Since the group will not utilize critical evaluation as frequently, groupthink, a common phenomenon associated with a "friendly group," may arise. *See* JANIS, *supra* note 66; Richard A. Cosier & Charles R. Schwenk, *Agreement and Thinking Alike: Ingredients for Poor Decisions*, 4 ACAD. MGMT. EXECUTIVE 60, 81 (1990). For further discussion on this topic, see *infra* Part III.D.3.

72. *See* Uzun et al., *supra* note 8 (finding correlations among independent oversight, board composition and structure, and fraud).

73. *See id.*

74. *See infra* Part III.B.

2. Analyzing the Strength of a Social Tie

A social tie is a connection linking an individual to another individual. Social ties come in different forms: "formal or informal, frequent or infrequent, affect-laden or purely utilitarian."[75]

In light of concern about social ties on boards, it is important to develop an operational definition of a director whose social ties to the CEO are so great that the director does not qualify as independent. Once such a definition is established, the most important question becomes: how is the strength of social ties measured and determined? Mark Granovetter's definition of the strength of a social tie is widely cited.[76] He defined the strength of a tie as a function of three factors: (1) the frequency of contact; (2) the emotional depth of the relationship, based on the level of intimacy and mutual confiding; and (3) reciprocity, based on favors and obligations.[77] Although Granovetter only examined positive social ties, he admitted that social ties can be both positive and negative.[78] Thus, one needs to consider the effects of strong positive ties between a CEO and a director, as well as the effects of strong negative ties.[79]

3. Does a Collegial Board or a Diverse Board Promote Efficiency?

The social ties between the CEO and an individual director are only part of the picture. Interactions among all directors, both inside and independent, also affect board dynamics. Although intuitively it seems that having diverse viewpoints and backgrounds would be advantageous for a group, such a situation actually creates several negative side effects that can diminish the quality of group decisionmaking.[80] An effective board must provide thorough analyses and make decisions quickly, due to the time constraints of the fast-paced business world. A group comprised of diverse individuals often cannot reach consensus within a reasonable

75. *See* Nelson, *supra* note 68, at 380.

76. Mark S. Granovetter, *The Strength of Weak Ties*, 78 AM. J. SOC. 1360, 1361 (1973).

77. *Id.*

78. *Id.* at 1361 n.2.

79. Negative ties are important for the same reason as positive ties. Just as a "friend" of the CEO may not wish to oppose the CEO for fear of harming the relationship, a director who harbors ill will toward the CEO as a result of previous relations may act to sabotage or injure that CEO irrespective of the CEO's merit. Although the director would then be less likely to approve the CEO's proposals, that director's behavior still would not be optimal for shareholders.

80. That is, diversity is like a factor of production that is very valuable early on, but whose marginal contribution decreases as diversity increases. This suggests that on a zero to one hundred scale of diversity, the optimal amount will be neither zero nor one hundred. *See* Langevoort, *supra* note 4, at 810.

amount of time. And while robust debate facilitates discussion and fosters variety in proposals and solutions, it also leads to decreased commitment.[81] Daniel Forbes and Frances Milliken have noted that "when a board's meetings are dominated by prolonged debates between two individuals, cognitive conflict may actually inhibit the use of members' knowledge and skills."[82] In the end, highly diverse boards[83] result in poor firm performance when compared with less diverse boards.[84]

Conversely, highly collegial boards,[85] which also tend to be more socially homogeneous,[86] generate higher levels of productivity.[87] But this increased productivity comes at a price: a greater potential for "groupthink."[88] Groupthink, a term coined by Irving Janis, signifies that defective judgment arises in unified groups because the unification fosters overoptimism and confidence in the ingroup's viewpoints and suppresses inconsistent information.[89] Although increased cohesion results from groupthink, often the group remains blind to the disadvantages of its decisions.[90]

In conclusion, the optimal solution is a combination of both diverse viewpoints, which foster meaningful debate and exploration of viable alternatives, and collegiality, which encourages compromise and a mutual commitment to reach the best result given the particular time constraint.[91]

81. *Id.* (describing studies showing that "the more dissention there is in a group, the less committed members become to it").

82. Daniel P. Forbes & Frances J. Milliken, *Cognition and Corporate Governance: Understanding Boards of Directors as Strategic Decision-making Groups*, 24 ACAD. MGMT. REV. 489, 497 (1999).

83. In this context, "highly diverse" denotes not only a majority of independent directors, but also directors whose social, professional, and other personal ties are minimal and whose viewpoints and experiences vary greatly.

84. *See* Langevoort, *supra* note 4, at 810.

85. In this context, "highly collegial" denotes not only a potential majority of inside directors, but also directors who have worked together, who come from similar backgrounds, and who may share business or personal ties.

86. *See* James D. Westphal, *Who Shall Govern? CEO Board Power, Demographic Similarity, and New Director Selection*, 40 ADMIN. SCI. Q. 60, 62 (1995) (finding that highly collegial boards also tend to be socially homogenous because people from similar backgrounds feel more comfortable with each other).

87. *See* Langevoort, *supra* note 4, at 810.

88. *See id.*

89. JANIS, *supra* note 66, at 13.

90. *See id.*; Lynne L. Dallas, *Proposals for Reform of Corporate Boards of Directors: The Dual Board and Board Ombudsperson*, 54 WASH. & LEE L. REV. 91, 106 (1997) (finding that conformity pressures in certain group situations also lead to a suppression of alternative viewpoints).

91. *See supra* Part II.D.1 (explaining that boards have difficulty achieving the correct balance, because management self-selects like-minded individuals to serve on the board).

Consequently, a new definition of independence that accounts for social ties needs to be broad enough to promote diversity, but not so narrow that boards become comprised of total strangers who cannot work together efficiently.

E. Factors Affecting Board Performance: Can the Right Incentives Persuade Directors to Overcome Their Loyalties to the CEO?

In examining the independence of boards, it is necessary to examine whether directors have proper incentives to act in the shareholders' best interests. If they have proper incentives, it should not matter whether independent directors have ties to other directors, management, and the company.

1. Reputational Capital as an Incentive for Optimal Director Behavior

Corporations rely on independent directors precisely because independent directors (ones without personal or financial stakes in the retention of current management) safeguard the long-term best interests of shareholders.[92] This has led many to ask the age-old question, "Who will monitor the monitors?"

The reputational capital theory maintains that shareholders can trust independent directors to execute their monitoring duties effectively because if they do not, the market will punish them by hindering their ability to receive future directorships.[93] Eugene Fama explains that "[i]n a state of advanced evolution of the external markets that buttress the corporate firm, the outside directors are in their turn disciplined by the market for their services which prices them according to their performance as referees."[94] Given that many independent directors serve on at least two boards, this hypothesis may seem especially persuasive. Since directors are seen as "experts in decision control," when the directors' companies perform well, other companies will seek to hire those directors.[95] Conversely, if directors' companies perform poorly, the directors' reputations will be damaged, resulting in fewer directorship opportunities.[96]

92. *See* Gilson & Kraakman, *supra* note 56, at 874.
93. *See id.*
94. Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 294 (1980).
95. *See* Lin, *supra* note 16, at 917.
96. *See id*. at 917–18.

On the other hand, because independent directors rely on management for their nominations and tenure, management will not select a director with a reputation for being truly independent over a candidate who management believes will be loyal to them. Because CEOs control the market Fama refers to, directors will still be punished for acting in a truly independent fashion. Part of the problem is that it is difficult to measure reputations and their consequences.[97] Despite this difficulty, numerous studies have attempted to correlate poor firm performance with a subsequent change in opportunities for the directors of poorly performing companies.[98]

While the empirical evidence may demonstrate the existence of reputational capital, not all studies and scholars agree as to its effect. Ronald Gilson and Reinier Kraakman believe that a perfect market, one that could absorb and interpret reputational capital, cannot exist.[99] Even if such a market existed, John Coffee states that directors "[do not] necessarily possess the reputational capital to motivate them to interdict offenses to protect their own reputations."[100] Given the conflicting evidence, shareholders should not have to rely solely on their directors' reputational capital to protect their interests.

2. Enhanced Legal Liability as an Effective Deterrent

A second source of incentives may be the fiduciary duties of independent directors that hold the directors liable for their misbehavior. Corporate governance theorists suggest that courts, through their fiduciary duties cases, effectively "sermonize" to the business community what

97. *See* Gilson & Kraakman, *supra* note 56, at 876 ("[T]here is simply no evidence that anything like an effective market for outside directors exists at all.").

98. *See, e.g.*, Stuart C. Gilson, *Bankruptcy, Boards, Banks, and Blockholders: Evidence on Changes in Corporate Ownership and Control when Firms Default*, 27 J. FIN. ECON. 355, 375–76 (1990) (observing that, compared to other independent directors, independent directors who left financially distressed companies held approximately one-third fewer directorships three years after departing); Steven N. Kaplan & David Reishus, *Outside Directorships and Corporate Performance*, 27 J. FIN. ECON. 389, 409–10 (1990) (determining that the ability of a director who served on the board of a poorly performing company to receive future directorships was unaffected in more than five out of every six cases); Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 EMORY L.J. 1155, 1178–79 (1990) (finding no lingering reputational effect existed for directors of poorly performing companies whose shareholders sued them); Anil Shivdasani, *Board Composition, Ownership Structure, and Hostile Takeovers*, 16 J. ACCT. & ECON. 167, 167–68 (1993) (showing that independent directors of target firms held fewer additional independent directorships in Fortune 500 or Fortune 1000 companies than did independent directors in nontarget companies).

99. *See* Gilson & Kraakman, *supra* note 56, at 875.

100. John C. Coffee, Jr., *Brave New World? The Impact of the Internet on Modern Securities Regulation*, 52 BUS. LAW. 1195, 1232–33 (1997).

being a good director entails.[101] First, courts may find directors who have acted inappropriately liable for damages, thus creating a financial incentive for directors to act properly. Second, these rulings produce a type of "buzz" around the directors involved in the cases.[102] These cases generate an additional "source of gossip, criticism, and sanction for [directors] . . . who are beyond the reach of the firm's normal systems of social control."[103] Not only could such "gossip" stigmatize a group of directors, it could also help to change expectations as to what makes a "good director" and to articulate a new set of norms for corporate boards to follow.[104] Due to indemnification statutes, however, directors rarely face personal liability and thus, they are often insulated from real effects of their actions. Even when directors contribute their own money,[105] the result may not be to make board members act better, but rather to deter otherwise qualified board members from serving. The direct and indirect costs of potential litigation may be so large as to discourage even the most honest and well-intentioned candidate from serving as an outside director.

In conclusion, because current mechanisms do not provide adequate incentives for directors to perform their job functions effectively, a new approach needs to be implemented, particularly in light of recent corporate scandals.

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101. *See, e.g.*, Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 562–63 (2003); Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1266 (1999); Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1010 (1997); Saver, *supra* note 5, at 721.

102. *See* Saver, *supra* note 5, at 721.

103. Rock, *supra* note 101, at 1013.

104. *See id.* at 1064; Saver, *supra* note 5, at 721.

105. In recent shareholder settlements, former Enron directors agreed to pay $13 million and former WorldCom directors agreed to pay $20 million. In these cases, shareholders, rather than the SEC, brought the lawsuits. This demonstrates shareholders' strong desires to use legal and financial means to hold directors responsible for their wrongdoing. But rather than acting as an incentive for other directors to behave legally and morally, these cases may act as a disincentive for individuals to accept directorships. *See* Lucian Bebchuk, *What's $13 Million Among Friends?*, N.Y. TIMES, Jan. 17, 2005, at A17, *available at* 2005 WLNR 620740. *But see* Gretchen Morgenson, *Ex-directors at WorldCom Settle Anew*, N.Y. TIMES, Mar. 19, 2005, at C1, *available at* 2005 WLNR 4264267.

III. THE RESPONSE OF THE LEGISLATURE, COURTS, AND REGULATORY BODIES TO CORPORATE AMERICA'S RECENT SCANDALS

The new era of corporate scandal[106] acted as the catalyst for a transformation in three areas of corporate law.[107] Motivated by a decreasing trust in corporate officials and an increasing interest in shareholder protection, Congress passed SOX. The courts contributed to the backlash against corporate America through a resurgence of judicial activism in the area of corporate law.[108] Finally, the Exchanges responded by amending their listing requirements to restrict the freedom of corporations and their officers in selecting directors.[109]

A. CONGRESS'S ANSWER: THE SARBANES-OXLEY ACT

SOX touches on nearly every significant corporate monitoring mechanism.[110] Yet, despite its sweeping reforms, the only area in which it defines and requires independence is with regard to audit committee members.[111] Thus, SOX provides little guidance as to what an expanded definition of "independence" should encompass.

B. THE DELAWARE JUDICIARY'S RESPONSE TO CORPORATE MISCONDUCT

Traditionally, state law is the source of corporate law in the United States, and Delaware is the state of incorporation for most of the country's largest corporations.[112] In Delaware, the judiciary, as opposed to the legislature, provides the most important contributions to rulemaking and

106. *See, e.g.*, *In re* Abbott Labs. Derivative S'holders Litig., 325 F.3d 795 (7th Cir. 2003); *In re* WorldCom, Inc. Sec. Litig., 354 F. Supp. 2d 455 (S.D.N.Y. 2005); *In re* Adelphia Commc'ns Corp., No. 02-41729 (REG), 2004 WL 2186582 (S.D.N.Y. Sept. 27, 2004); SEC v. HealthSouth Corp., 261 F. Supp. 2d, 1298 (N.D. Ala. 2003); *In re* Tyco Int'l, Ltd. Sec. Litig., 185 F. Supp. 2d 102 (D.N.H. 2002); Hollinger Int'l, Inc. v. Black, 844 A.2d 1022 (Del. Ch. 2004); *In re* Walt Disney Co. Derivative Litig., 825 A.2d 275 (Del. Ch. 2003); *In re* Oracle Corp. Derivative Litig., 824 A.2d 917 (Del. Ch. 2003).

107. *See generally* Loewenstein, *supra* note 7, at 353–54 (characterizing the changes in corporate law, on a judicial, legislative, administrative, and quasi-governmental front, as a "quiet transformation").

108. *See id.* at 353.

109. *See id.*

110. Brett H. McDonnell, *SOX Appeals*, 2004 MICH. ST. L. REV. 505, 509.

111. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 301, 116 Stat. 745, 775–77 (to be codified at 15 U.S.C. § 78j-1).

112. *See* McDonnell, *supra* note 110, at 525.

reform.[113] In the wake of criticism from scholars that Delaware was not reacting to the scandals,[114] the courts responded by issuing three rulings that heightened judicial scrutiny on directors: *In re Walt Disney Co. Derivative Litigation*,[115] *In re Oracle Corp. Derivative Litigation*,[116] and *Hollinger International, Inc. v. Black*.[117] All three cases showcase the dangers of allowing CEOs to appoint their friends as directors.

1. A Return to a Lower Level of Business Judgment Protection? *In re Walt Disney Co. Derivative Litigation*

The first remarkable case, *In re Walt Disney Co. Derivative Litigation*, concerns the highly lucrative compensation Michael Ovitz received for his unsuccessful year as president of the Walt Disney Company ("Disney") and his subsequent severance package.[118] The plaintiffs claimed that the directors breached their fiduciary duties on two occasions: first, when they "blindly" approved Ovitz's very generous employment contract,[119] and second, when they signed off on Ovitz's "non-fault" severance package from Disney, which maximized his severance benefits even though he had been with Disney for just one year of lackluster performance.[120]

After Disney's president died suddenly, the directors, who were charged with the responsibility of filling the vacancy, delegated the task to Disney's CEO, Michael Eisner. In this instance, several of the independent directors had close ties with Eisner, which raised further doubt about the board's judgment in deciding to allow him to determine Disney's next

113. Delaware's corporate law is enabling, rather than limiting, and thus depends much more on judicial interpretation. *See, e.g.*, Bernard Black & Reiner Kraakman, *A Self-enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911, 1920–21 (1996); Chandler & Strine, *supra* note 7, at 976; Conference on Post-Enron Regulation, *supra* note 8.

114. *See* Jeffrey D. Hern, Comment, *Delaware Courts' Delicate Response to the Corporate Governance Scandals of 2001 and 2002: Heightening Judicial Scrutiny on Directors of Corporations*, 41 WILLAMETTE L. REV. 207, 215 (2005).

115. *In re* Walt Disney Co. Derivative Litig., 825 A.2d 275 (Del. Ch. 2003).

116. *In re* Oracle Corp. Derivative Litig., 824 A.2d 917 (Del. Ch. 2003).

117. Hollinger Int'l, Inc. v. Black, 844 A.2d 1022 (Del. Ch. 2004).

118. *See In re Walt Disney*, 825 A.2d at 279; McDonnell, *supra* note 110, at 526.

119. The plaintiffs claimed that through this action Disney's old board violated its duty of care by failing to realize and appreciate the full costs of the Ovitz employment agreement, in particular the severance package. *In re Walt Disney*, 825 A.2d at 282–83.

120. The plaintiffs claimed that Disney's new board had breached its fiduciary duty by blindly approving the agreement between Ovitz and Disney CEO Michael Eisner, arranging for Ovitz to leave Disney on a no-fault basis, even though Ovitz's performance as president justified the new board terminating him for cause, as per the provisions in his employment contract. This distinction significantly affected the amount of money Ovitz received in his severance package, which totaled more than $140 million. *Id.* at 279, 277–85.

president.[121] Such doubt was indeed justified. Eisner unilaterally chose Ovitz, who had been a close friend of his for more than twenty-five years.[122] While Ovitz had significant business experience, he had never been the chief executive of such a large company.[123] Only after Eisner drafted a preliminary employment agreement did the board and the compensation committee briefly meet to discuss Ovitz's compensation package.[124] With only minimal information, the board approved the employment contract and allowed Eisner to negotiate the final agreement.[125] When a final employment contract was drafted several months later, neither the board nor the compensation committee reviewed it, even though it was drastically different from the preliminary employment contract.[126]

Despite the media buzz around Ovitz, he performed poorly, and even admitted on national television that he knew "'about 1% of what [he needed] to know'" in order to complete his job successfully.[127] After only fourteen months on the job, Ovitz left Disney. He then received $140 million for his services, including a severance package of $100 million.[128] The disparity between Ovitz's compensation and his dismal performance as

121. Among the "independent" directors on Eisner's rubber-stamping board were his personal attorney, his architect, and the principal of the school his children formerly attended. *See, e.g.*, Richard Verrier, *Disney Chairman Isn't in the Happiest Place*, L.A. TIMES, Sept. 17, 2004, at A1. After the Institutional Shareholder Service ("ISS") applied a more narrow definition of "independent" that requires directors to have "no present or former employment by the company, or any significant financial or personal ties to the company or its management," it concluded that only six out of the sixteen board members were truly independent. *See* Bruce Orwall & Joann S. Lublin, *Disney Faces Heated Battle from Shareholder Activists*, WALL ST. J., Feb. 20, 1998, at C1.

122. *In re Walt Disney*, 825 A.2d at 279.

123. *Id.* In fact, Ovitz was a highly successful talent agent, who represented, among others, David Letterman. *Id.*

124. *Id.* at 280.

125. *Id.* at 281.

126. *Id.* at 281–82. The largest difference between the two contracts is the severance package Ovitz was entitled to receive. In the preliminary agreement, Ovitz received the lucrative no-fault termination benefits (totaling $38 million) only if Disney wrongfully terminated him, if he died, or if he became disabled. In the new agreement, which Eisner negotiated, Ovitz was entitled to the no-fault termination benefits as long as he did not act with gross negligence or malfeasance. In sum, under the preliminary agreement, Ovitz had only a small possibility of receiving the no-fault termination benefits, whereas, under the final agreement, the probability of receiving such benefits greatly increased. *Id.* at 289–90.

127. *Id.* at 283 (quoting a comment Ovitz made during a September 30, 1996 interview on the CNN television program *Larry King Live*).

128. *Id.* at 277–79; Bernard Weinraub, *Hollywood's Next Sequel: The Return of Ovitz*, N.Y. TIMES, Dec. 7, 1998, at C1, *available at* 1998 WLNR 2961467.

president led the Disney shareholders to commence a derivative suit against the board.[129]

Ordinarily, under Delaware law, the business judgment rule would protect the directors' business decisions approving Ovitz's employment contract and compensation package. In this case, however, Chancellor Chandler ruled that the complaint adequately pleaded facts that, if proven, would show that the board's actions lacked honesty and good faith.[130] In fact, he stated that the board had failed to exercise "any business judgment or [make] any good faith attempt to fulfill [its] fiduciary duties" when it chose to hire Ovitz.[131] Specifically, he listed three of the board's actions alleged in the complaint that would give rise to a cause of action against the board: (1) the board's approval of Ovitz's hiring, even though the employment agreement had not been completed; (2) the board's permitting Eisner to independently negotiate the final provisions of the agreement, even though Eisner and Ovitz were such close friends; and (3) the board's concession to Eisner's request that Ovitz receive the "non-fault" termination benefits.[132] Consequently, the directors could lose the liability protection the business judgment rule afforded them and the indemnification rights Disney's charter provision provided them.[133]

This was a significant ruling, signaling that the Delaware court was willing to waive business judgment rule protection in a broader range of contexts than it had done in the past. As Charles Elson, head of the Weinberg Center for Corporate Governance at the University of Delaware, stated, "[The Disney decision shows] a paradigm shift in Delaware from allowing independence to enforcing oversight . . . [which] would not have happened ten years ago."[134] While one could make rational arguments to explain the actions of the board,[135] the court still held that if the factual allegations in the complaint were found to be true, the board exercised *no*

129. *In re Walt Disney*, 825 A.2d at 277–78.

130. *Id.*

131. *Id.* at 287.

132. *See id.* at 287–88, 290.

133. DEL. CODE ANN. tit. 8, § 102(b)(7) (2001) (allowing corporate charters to contain provisions protecting directors from personal liability for violations of the duty of care). Charters are not permitted to limit liability for acts or omissions not in good faith, however. *Id.*

134. *See* Hern, *supra* note 114, at 216.

135. *See, e.g.*, *id.* at 220. Jeffrey Hern argues that the directors "entrusted" Eisner, who was also a board member and Disney's CEO, to carry out the final negotiations because he was most qualified to do so. Additionally, although Ovitz received a very generous severance package due to the no-fault termination, the board may have reasoned that the package was less expensive and risky than being sued by Ovitz in the future. *Id.*

business judgment at all.[136] In the midst of corporate scandals and public outcry for stricter penalties for directors, the Delaware court heightened its judicial scrutiny.

In August 2005, on appeal, the Delaware Court of Chancery ruled against the Disney shareholders, finding that the business judgment rule did protect the directors' actions.[137] Despite his ruling, Chancellor Chandler still criticized the directors, stating that their conduct "fell significantly short of the best practices of ideal corporate governance."[138] Chancellor Chandler also berated Michael Eisner for his conduct. He characterized Eisner as someone who "enthroned himself as the omnipotent and infallible monarch of his personal Magic Kingdom"[139] and he determined that Eisner "stacked his (and I intentionally write 'his' as opposed to 'the Company's') board of directors with friends and other acquaintances who, though not necessarily beholden to him in a legal sense, were certainly more willing to accede to his wishes and support him unconditionally than truly independent directors."[140]

Thus, despite the legal ruling, the *Disney* case illustrates the practical problems that arise when an already dominating CEO manipulates the board composition and nominates otherwise independent directors with whom he maintains close social ties. In business circles, Eisner is notorious for being a controlling CEO, who "run[s] his company as though it were a personal fiefdom financed with shareholder money."[141] Eisner nominated people who, because of their close ties to him, found it difficult to monitor his actions and question his decisions.[142] Thus, he created a rubber-stamping board of directors.[143] Ultimately, the impact of Eisner's molding of the board around himself was more than just the derivative lawsuit, which, despite the lack of a damage award, still resulted in huge financial and personal costs. *Business Week* ranked Disney's board as one of the worst boards in corporate America and ranked Eisner himself as one of the

136. *In re Walt Disney*, 825 A.2d at 286–87.

137. *In re* Walt Disney Co. Derivative Litig., No. Civ.A. 15452, 2005 WL 2056651 (Del. Ch. Aug. 9, 2005).

138. *Id.* at *1.

139. *Id.* at *41.

140. *Id.* at *40.

141. Nina Munk, *If You Don't Like the Ride, Get Off*, N.Y. TIMES, Mar. 5, 2004, at A23, *available at* 2004 WLNR 5444137.

142. In fact, even in the recent decision in which Chancellor Chandler held against the shareholders, he found that Eisner was in large part "responsible for the failings in process that infected and handicapped the board's decisionmaking abilities." *In re Walt Disney*, 2005 WL 2056651, at *40.

143. *Id.*

worst CEOs in corporate America.[144] Additionally, Disney shareholders ranked last when *Business Week* compared shareholder return with executive compensation between 1996 and 1998.[145] These negative effects persist in part because the Delaware courts ruled against the shareholders and were not willing to protect shareholder interests above director interests.

2. Postulating a New Definition of Independence? *In re Oracle Corp. Derivative Litigation*

The second case, *In re Oracle Corp. Derivative Litigation*,[146] concerns an insider trading claim against four Oracle board members, including the chairman, Lawrence Ellison, and Michael Boskin, a Stanford University economist and professor.[147] In response to a shareholder derivative action alleging that Oracle board members engaged in insider trading, Oracle set up a special litigation committee ("SLC") to determine "whether Oracle should press the claims raised by the plaintiffs, settle the case, or terminate it."[148] Oracle appointed Joseph Grundfest and Hector Garcia-Molina, both Stanford University professors, as the two "independent directors" of the SLC.[149] The SLC, after an investigation, advised Oracle to dismiss the case.[150]

In order for the SLC to show that it was entitled to move for a dismissal of the lawsuit as a matter of law, the SLC needed to prove that its two members were indeed independent, that they acted in good faith, and that there existed a reasonable explanation for their recommendation.[151] The Delaware Court of Chancery, however, ruled that the two directors were not independent.[152]

144. *See Who Earned the Pay—and Who Didn't*, BUS. WEEK, Apr. 19, 1999, at 75, *available at* 1999 WLNR 4691264 (finding that Eisner received $595 million for his services between 1996 and 1998).

145. *Id.* It should be noted that from the 1980s through the early 1990s, Eisner engineered a tremendous turnaround of Disney. *Geppetto's in the Corner Suite*, L.A. TIMES, Oct. 25, 2004, at B10. As time went on, however, many people, including two of Disney's inside directors, began to question Eisner's performance and whether his inflated salary accurately represented his value. *See* Holson, *supra* note 36.

146. *In re* Oracle Corp. Derivative Litig., 824 A.2d 917 (Del. Ch. 2003).

147. *Id.* at 921, 932.

148. *Id.* at 923.

149. *Id.* at 920, 930.

150. *Id.* at 928.

151. *See* Zapata Corp. v. Maldonado, 430 A.2d 779, 788–89 (Del. 1981).

152. *In re Oracle*, 824 A.2d at 937–38.

Several of the defendant-directors had various ties to Stanford University—Boskin himself was a Stanford professor and fellow as well as a committee member of the Stanford Institute for Economic Policy Research.[153] Ellison was also a fellow of the Institute.[154] Ellison had made donations to Stanford in the past and was currently in negotiations to make another donation, this time totaling $170 million.[155] Another one of the charged directors was a multimillion-dollar contributor to the university, as well.[156]

The test for whether a member of an SLC qualifies as independent is "whether a director is, for *any substantial reason*, incapable of making a decision with only the best interests of the corporation in mind."[157] After applying the test, the court found that the SLC failed to show an absence of material fact regarding the SLC's independence.[158] It characterized the Stanford ties as "so substantial that they caused reasonable doubt about the SLC's ability to impartially consider whether [the defendants] should face suit."[159] As a result, the court refused to dismiss the insider trading charge based on the SLC's recommendation.[160]

In re Oracle demonstrates a court's use of judicial activism to broaden the concept of "independence" and to consider factors not customarily examined by courts when determining a director's independence. More than twenty years ago, Victor Brudney noted that "[n]o definition of independence yet offered precludes an independent director from being a social friend of, or a member of the same clubs, associations, or charitable efforts as, the persons whose [performance] he is asked to assess."[161] This statement still holds true today. While Vice Chancellor Strine emphatically

153. *Id.* at 930–31.

154. *Id.* at 931.

155. *Id.* at 932–33. During Ellison's tenure as CEO of Oracle, Oracle donated over $300,000 to Stanford. *Id.* at 933. He also created a foundation that donated $10 million to Stanford. *Id.* at 932. Finally, Ellison proposed that Stanford create the "Ellison Scholars Program," modeled after the Rhoades Scholarship. *Id.* at 933. In 2001, Ellison and Stanford were in negotiations to form this program. The program's proposed budget was $170 million. *Id.*

156. *Id.* at 931–32. Another defendant-director, Donald Lucas, donated $50,000 to Stanford Law School to show his appreciation for one of the SLC members giving a speech at his request. *Id.* at 931. Since 1981, his foundation had donated $11.7 million to Stanford. *Id.* In addition, over the previous five years he had donated $4.1 million to the school from his own personal funds. *Id.* at 932.

157. *Id.* at 938 (quoting Parfi Holding AB v. Mirror Image Internet, Inc., 794 A.2d 1211, 1232 (Del. Ch. 2001), *rev'd*, 817 A.2d 149 (2002)).

158. *Id.* at 942.

159. *Id.*

160. *Id.*

161. Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 613 (1982).

stated that he was not devising a new definition for independence in his *In re Oracle* opinion,[162] he opened the door to one day making Brudney's statement inaccurate.

Because the court examined the actions of independent directors on an SLC rather than on a board of directors, however, *In re Oracle* may not represent a drastic departure from the previous definition of "independence."[163] Vice Chancellor Strine found that it was more difficult for a director of an SLC, as opposed to a regular director, to act against senior executives because of the high stakes involved in litigation.[164] Therefore, he argued that in the context of an SLC, the court must scrutinize the definition of "independent" more carefully than it otherwise would have.[165] This analysis may be inconsistent with the social psychology findings on board member independence discussed in Part II.D.1, above. It is true that the consequences of an SLC decision may be more severe than the consequences of typical day-to-day board decisions. But research indicates that the *strength* of the tie influences a director's objective decisionmaking more heavily than the *consequences* of the decision.[166] Thus, research supports an argument that courts should apply a consistent definition of independence and focus on the strength of social ties, rather than concerning themselves with the type of board at issue (an ordinary board of directors versus an SLC).

162. *In re Oracle*, 824 A.2d at 939 n.55 ("But I do not believe that the result I reach applies a new definition of independence; rather, it recognizes the importance (i.e., the materiality) of other bias-creating factors other than fear that acting a certain way will invite economic retribution by the interested directors.").

163. *See* Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1054 (Del. 2004). The Delaware Supreme Court included a section in its opinion entitled "A Word About the Oracle Case," in which it went to great lengths to distinguish the *In re Oracle* decision from the present case, because it was in the context of an SLC. *Id.* at 1054. It stated, "An SLC is a unique creature . . . . Unlike the demand-excusal context, where the board is presumed to be independent, the SLC has the burden of establishing its own independence by a yardstick that must be 'like Caesar's wife'—'above reproach.'" *Id.* at 1054–55 (quoting Lewis v. Fuqua, 502 A.2d 962, 967 (Del. Ch. 1985)).

164. *In re Oracle*, 824 A.2d at 940.

165. *Id.* ("Denying a fellow director the ability to proceed on a matter important to him may not be easy, but it must . . . be less difficult than finding that there is reason to believe that the fellow director has committed serious wrongdoing and that a derivative suit should proceed against him.").

166. Similarly, since both Grundfest and Garcia-Molina were Stanford professors, there is not only an issue of independence from Boskin and Ellison, but there is also an issue of independence from each other. *See* Nelson, *supra* note 68, at 386.

3. Using Friends to Improperly Approve Transactions: *Hollinger International, Inc. v. Black*

The third case, *Hollinger International, Inc. v. Black*,[167] concerns the CEO, chairman, and controlling shareholder of Hollinger International, Inc. ("International"), Conrad Black, breaching his duty of loyalty in connection with a possible sale of corporate assets.[168] In 2000, British financiers David and Frederick Barclay approached Black about buying some of International's assets in the United Kingdom, specifically the Daily Telegraph ("Telegraph").[169] Not only did Black refuse to meet with the Barclays about a deal, he did not disclose to the International board that the Barclays had discussed acquiring Telegraph.[170] Instead, Black diverted the opportunity to Hollinger, Inc. ("Hollinger"), an Ontario corporation and the controlling shareholder of International.[171] The court held that Black violated his fiduciary duty of loyalty because of his "misleading and deceptive conduct toward his fellow directors."[172]

The court's decision had devastating legal and financial consequences for both Black and International. First, the court stripped Black of his control of International. Second, the court found that Black and several others may have defrauded the corporation, potentially exposing Black to a shareholders' suit.[173]

A special committee also investigated other allegations of wrongdoing. An International internal report to the board found that Black

167. Hollinger Int'l, Inc. v. Black, 844 A.2d 1022 (Del. Ch. 2004).

168. *Id.* at 1029. More specifically, Black breached his duty of loyalty through a series of acts related to the sale of the Telegraph, owned by International. *Id.*

169. *Id.*

170. *Id.* at 1061.

171. *Id.*

172. *Id.* at 1062. Specifically, the court stated that Black violated his duty of loyalty by doing the following:

> (1) purposely denying the International board the right to consider fairly and responsibly a strategic opportunity within the scope of its Strategic Process and diverting that opportunity to himself; (2) misleading his fellow directors about his conduct and failing to disclose his dealings with the Barclays, under circumstances in which full disclosure was obviously expected; (3) improperly using confidential information belonging to International to advance his own personal interests and not those of International, without authorization from his fellow directors; and (4) urging the Barclays to pressure Lazard with improper inducements to get it to betray its client, International, in order to secure the board's assent to the Barclays Transaction.

Id. at 1061–62.

173. Eric Herman, *Black to Appeal Court Ruling that Blocked Sale of Papers*, CHI. SUN-TIMES, Mar. 13, 2004, at 37.

improperly took over $200 million for himself and his associates.[174] The composition of Black's board allowed him to execute these illicit transactions, illustrating the overlapping boundaries between his social, political, and business lives.[175] In the 1990s, among International's directors were Black's own wife,[176] as well as his longtime friends, Henry Kissinger,[177] James Thompson,[178] and Richard Perle.[179] Not only were all the men friends, but they were also like-minded individuals, sharing similar backgrounds and political beliefs, which created a very homogeneous board.[180] Thompson, the head of the company's audit committee, failed to question hundreds of millions of dollars in fees.[181] The internal report stated that the committee "[held] a perfunctory meeting each year in the time needed to consume a tuna sandwich,"[182] and it characterized Thompson himself as "ineffective and careless."[183] Moreover, Perle, a close friend of Black's, served on the executive committee, enabling Perle to approve Black's improper transactions, which resulted in Black taking hundreds of millions of dollars for himself.[184] The internal report on Black's role at International stated, "It is difficult to imagine a more flagrant abdication of duty . . . ."[185] The result was a rubber-stamping board that approved all deals Black endorsed and signed documents without even reading them. Ultimately, the board members' apathy cost International more than $400 million.[186]

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174. *See* Stephen Labaton, *Under Attack, Director Says Hollinger's Black Misled Him*, N.Y. TIMES, Sept. 6, 2004, at C1, *available at* 2004 WLNR 5588753; Jacques Steinberg & Geraldine Fabrikant, *Friendship and Business Blur in the World of a Media Baron*, N.Y. TIMES, Dec. 22, 2003, at A1, *available at* 2003 WLNR 4631235.

175. Steinberg & Fabrikant, *supra* note 174.

176. Even though Black's wife, Barbara Amiel Black, was an inside director, it is nonetheless relevant because it demonstrates the lengths Black went to in order to surround himself with people who would do little to oppose his authority.

177. Henry Kissinger was the Secretary of State under President Richard Nixon.

178. James Thompson was a former governor of Illinois and chairman of the Chicago law firm, Winston & Strawn.

179. Richard Perle was the head of the Pentagon's Defense Policy Board under President Ronald Reagan—a top Pentagon position. Labaton, *supra* note 174.

180. *Id.*

181. John Saunders, *The Hollinger Report: The Directors*, GLOBE & MAIL (Toronto, Can.), Sept. 1, 2004, at B5, *available at* 2004 WLNR 18413089.

182. *See id.*

183. *Bloomberg News*, PITTSBURG POST-GAZETTE, Sept. 5, 2004, at D7, *available at* 2004 WLNR 4798192.

184. Labaton, *supra* note 174.

185. Louis Lavelle, *Lessons of the "Hollinger Chronicles,"* BUS. WEEK, Sept. 13, 2004, at 42, *available at* 2004 WLNR 4026801.

186. *See id.*

A specific example of the board's acquiescence to Black's intermingling of his personal affairs with those of the business is International's $8 million purchase of a set of Franklin Delano Roosevelt's personal papers.[187] International purchased the papers while Black was writing a Roosevelt biography. While that act in itself may not be considered egregious by some,[188] the fact that the board never had an independent appraisal of the papers' value before signing off on the deal certainly transformed the purchase into an egregious act. In fact, the only valuation the board reviewed was an October 22, 2002 letter from the seller himself, who wrote that "[n]othing of this magnitude and quality [had] ever appeared in the market" and judged the collection to be worth $12 million to $14 million.[189] International eventually sold the collection for a mere $2.4 million.[190] The board's duty was to make profitable decisions for the corporation, rather than to finance Black's pet projects. The board was driven by its personal loyalty to Black, however, and put his interests above the interests of the shareholders it was supposed to protect.

The story of *Hollinger* illustrates the dangers of a CEO surrounding himself with a star-studded board, composed of friends and like-minded individuals, who lack the proper incentives to question the CEO's authority.

C. THE STOCK EXCHANGES TIGHTEN THEIR REQUIREMENTS FOR BOARD INDEPENDENCE

The NYSE and NASDAQ issue listing requirements for all companies that wish to be listed on their exchanges.[191] The listing standards largely regulate board structure, procedures, and composition. On February 13, 2002, in response to corporate scandals, then-SEC Chairman Harvey Pitt wrote a letter to the NYSE and NASDAQ asking them to review their listing standards, asserting "we believe that there are a number of ways that

187. Geraldine Fabrikant, *A "Yes, Lord Black," Board Says "No,"* N.Y. TIMES, Feb. 16, 2004, at C1, *available at* 2004 WLNR 5432713.

188. If the board had obtained appraisals and predetermined that the papers were already quite valuable and were going to appreciate in value, there is an argument that the papers may have been a good investment for the company. Because the board did not receive any independent valuation of the papers until almost two years after the approval of the deal, however, no such argument can be advanced.

189. SPECIAL COMM. OF THE BD. OF DIRS. OF HOLLINGER INT'L INC., REPORT OF INVESTIGATION 504 (2004), *available at* http://www.sec.gov/Archives/edgar/data/868512/000095012304010413/y01437exv99w2.htm [hereinafter HOLLINGER REPORT]; Fabrikant, *supra* note 187.

190. HOLLINGER REPORT, *supra* note 189, at 11 n.9.

191. *See* NASDAQ Rules, *supra* note 10; NYSE Manual, *supra* note 10.

current corporate governance standards can be improved to strengthen the resolve of . . . the directors who oversee management's actions."[192] The NYSE responded by establishing its Corporate Accountability and Listing Standards Committee, which ultimately set forth recommendations to amend their listing standards.[193] After several amendments, the SEC approved the final listing standards on November 4, 2003.[194] During this process Pitt stated, "The commission strongly commends the NYSE board's creative and far-reaching proposals to improve the level and quality of corporate governance in America. This was precisely the kind of effort we hoped would result when we asked the exchanges to rethink their listing agreements last February."[195] Eventually, the Exchanges revised the listing standards in two ways: (1) they elucidated and tightened the definition of "independent" directors, and (2) they required that listed-company boards be composed of a majority of independent directors.

Both exchanges offer a broad definition of "independence"[196] and list "bright-line standards" that automatically disqualify a company from calling a director independent. These bright-line standards include (1) employment or other individual compensation,[197] (2) business relationships,[198] (3) auditor relations,[199] and (4) family members.[200]

192. Press Release, SEC, Pitt Seeks Review of Corporate Governance, Conduct Codes (Feb. 13, 2002), *available at* http://www.sec.gov/news/headlines/codereview.htm.

193. NYSE, *Accountability Report Sets Higher Bar*, EXCHANGE, June 2002, at 1, 1, *available at* http://www.nyse.com/pdfs/xnlv9n06.pdf [hereinafter *Accountability Report*].

194. *See* NYSE Manual, *supra* note 10, § 303A.00.

195. *Accountability Report*, *supra* note 193. It should be noted that the SEC has little jurisdiction over corporate law. It appears, however, that the Exchanges drew up rules that reflect the desires of the SEC, in response to the SEC's clear appeal to the Exchanges it regulates.

196. NASDAQ Rules, *supra* note 10, § 4200(a)(15) (requiring that the director have no "relationship, which, in the opinion of the company's board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director"); NYSE Manual, *supra* note 10, § 303A.02(a) (requiring that the director have "no material relationship with the listed company"). Clearly, the NASDAQ definition offers the board more freedom to evaluate relationships that are outside the traditional definition of materiality, focusing more on financial ties. It still leaves determining the materiality of nonfinancial ties to the discretion of the board, however.

197. Both Exchanges preclude directors who are currently employed or who, in the prior three years, have been employed by the company. NASDAQ Rules, *supra* note 10, § 4200(a)(15)(A); NYSE Manual, *supra* note 10, § 303A.02(b)(i). The Exchanges also disqualify directors who have received a certain level of compensation (excluding board or committee fees or certain types of deferred compensation) from the listed company within the previous three fiscal years. NASDAQ Rules, *supra* note 10, § 4200(a)(15)(B) (setting the threshold level of compensation at $60,000 per year, but exempting "payments arising solely from investments in the company's securities"); NYSE Manual, *supra* note 10, § 303A.02(b)(ii) (setting the threshold level of compensation at $100,000 per year).

198. The NYSE's and NASDAQ's requirements for the types of business relationships that disqualify a director differ significantly. The NYSE states that a director is "not independent" if the director is currently an executive or an employee "of a company that makes payments to, or received payments from, the listed company for property or services in an amount which, in any single fiscal

For the NYSE, these changes represent a radical departure from the old listing standards. Before the reforms, the definition of "independent" was noticeably weaker, precluding "any relationship with the company that may interfere with the exercise of a director's independence from management and the company."[201] The definition only applied to audit committee members. Additionally, the only independence-related rule that is explicitly present in both the old and the new listing standards regards audit committee membership.[202] While NASDAQ's old and new standards share some similarities, the old standards did not contain any of the structural changes discussed below.

The Exchanges also enacted structural changes. First, they now require a majority of the board of any listed company to be independent.[203] Furthermore, they require independent directors to make some decisions about director nomination and executive compensation.[204] The NYSE, however, requires that only independent committees make such decisions,[205] whereas NASDAQ allows companies to choose between

year exceeds the greater of $1 million, or 2% of such other company's consolidated gross revenues." NYSE Manual, *supra* note 10, § 303A.02(b)(v) (noting that once the director terminates employment with the company or three years after the payments have fallen below the threshold, the NYSE considers the director independent). NASDAQ's definition includes more types of organizations than the NYSE rule does. NASDAQ Rules, *supra* note 10, § 4200(a)(15)(D) (including directors who are currently partners, controlling shareholders, or executive officers of any organization, including nonprofit organizations, that have received payments from the firm in the current or prior three fiscal years that "exceed 5% of the recipient's consolidated gross revenues for that year, or $200,000, whichever is more").

199. The NYSE prohibits any director from being "a current partner of a firm that is the company's internal or external auditor" or from being a partner who "personally worked on the firm's audit" within the past three years. NYSE Manual, *supra* note 10, § 303A.02(b)(iii). The NASDAQ provision, which is to some degree narrower, prohibits a director "who is . . . a current partner of the company's outside auditor, or was a partner or employee of the company's outside auditor who worked on the company's audit at any time during any of the past three years." NASDAQ Rules, *supra* note 10, § 4200(a)(15)(F).

200. Both exchanges disqualify directors whose family members are, or were within the last three years, employed by the listed company as an executive officer. They define "family member" as the director's spouse, parents, children, siblings, in-laws of all types, and anyone else residing in the director's home (although the NYSE rule exempts "domestic employees"). NASDAQ Rules, *supra* note 10, § 4200(a)(15)(C); NYSE Manual, *supra* note 10, § 303A.02(b)(i).

201. By contrast, the new definition is stricter in that it precludes a director who has a "material relationship" with the company, regardless of whether it may interfere with the director's independence from that company. NYSE CORPORATE ACCOUNTABILITY & LISTING STANDARDS COMM., CORPORATE ACCOUNTABILITY AND LISTING STANDARDS COMMITTEE REPORT 6, 7 n.3 (2002), *available at* http://www.nyse.com/pdfs/corp_govreport.pdf [hereinafter NYSE ACCOUNTABILITY REPORT].

202. *Id.*

203. *Id.* at 6.

204. *Id.* at 7.

205. *See* NYSE Manual, *supra* note 10, §§ 303A.04–.05.

using either independent committees or a majority vote of all independent directors.[206]

The second major structural change centers around "stifling boardroom norms." To combat these problems, the Exchanges require boards to hold regular "executive sessions" of nonmanagement directors without the presence of management.[207] While NASDAQ explicitly limits these meetings to independent directors,[208] the NYSE provision only requires that one meeting per year be limited strictly to independent directors.[209]

Certainly, the new amendments represent a positive change in corporate governance. They make "boards more independent and accountable."[210] But even under these new, tighter definitions, directors who qualify as independent still lack true independence.[211] As a result, these new listing requirements should mark the beginning—not the end—of an era of corporate governance reform.

IV. REDEFINING TRUE INDEPENDENCE

A. WHY SHAREHOLDERS CANNOT TRUST DELAWARE TO SAFEGUARD THEIR INTERESTS

Chief Justice of the Delaware Supreme Court, E. Norman Veasey, recently stated, "Directors who are supposed to be independent should have the guts to be a pain in the neck and act independently."[212] This may propel

206. *See* NASDAQ Rules, *supra* note 10, §§ 4350(c)(3)(A)–(B), 4350(c)(4)(A); NYSE Manual, *supra* note 10, §§ 303A.04 cmt., 303A.05.

207. NASDAQ Rules, *supra* note 10, § 4350(c)(2); NYSE Manual, *supra* note 10, § 303A.03.

208. NASDAQ Rules, *supra* note 10, § 4350(c)(2). NASDAQ, however, weakens this otherwise more stringent requirement by commenting that it contemplates that such sessions would "occur at least twice a year, and perhaps more frequently." *Id.* § 4350, IM-4350-4.

209. NYSE Manual, *supra* note 10, § 303A.03 cmt.

210. Nell Minow, *Stockholders Would Benefit from More Board Flexibility*, USA TODAY, Sept. 16, 2002, at A13, *available at* 2002 WLNR 4498005. *See* Special Report, *The Value of Trust*, ECONOMIST, June 8, 2002.

211. Portfolio manager Linda Killian commented that when analyzing companies, she looks at independence factors beyond the current Exchange rules. She found that while many of the directors qualify as independent under the rules, "when you look at [the directors] in a reasonable way, you'll see that they are buddies with management." Gretchen Morgenson, *New Stocks, Same Old Problems*, N.Y. TIMES, Jan. 23, 2005, at 31, *available at* 2005 WLNR 933756. *See* John R. Emshwiller & Joann S. Lublin, *In Boardrooms, "Independent" Is Debatable*, WALL ST. J., Mar. 3, 2005, at C1 (finding that even under the new financial disqualifications, directors who lack independence are still considered independent).

212. Marc Gunther, *Boards Beware: A Lawsuit by Disney Shareholders Is Shaking Up Much More than the Mouse House*, FORTUNE, Nov. 10, 2003, at 171.

some to argue that recent actions taken by the Delaware courts to increase director liability will provide adequate incentives for directors to modify their behavior, making additional regulation unnecessary. But this argument overlooks a key problem. In the past, the Delaware courts, when faced with mounting pressure from the media, the public, and the federal government, have temporarily subjected corporations to harsher penalties and restrictions, only to loosen them once the backlash against corporations and pressure from various groups has subsided.[213]

A brief historical analysis illustrates this phenomenon. By the mid-1970s Delaware had attracted substantial attention for the large number of corporations chartered in its state, the perceived leniency of its corporate law, and the relationship between the two.[214] In 1976, Richard Jennings noted that "no shareholder in his right mind will litigate a shareholder grievance in a Delaware state court if some other forum is available."[215] As concern about state law's inability to effectively protect shareholders grew, federal law attempted to compensate by expanding the securities laws. It was during this period, from 1976 through 1982, that the Delaware courts began to exhibit the first wave of their proshareholder decisions in order to convince federal legislators that they could adequately protect shareholder interests without federal intervention.[216] This strategy was successful as the public began to perceive Delaware as being proshareholder.[217]

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213. *See* Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 739 (2002). This problem results from how dependent Delaware currently is, and has been for over thirty years, on corporations incorporating within its state. In 2003, fifteen to twenty percent of Delaware's revenue came from the hundreds of millions of dollars it collected in franchising fees. *See* Gunther, *supra* note 212; Gordon Moodie, *Forty Years of Charter Competition: A Race to Protect Directors from Liability?* 30–31 (Harvard Law Sch. John M. Olin Ctr. for Law, Econ., & Bus., Discussion Paper No. 1, 2004), *available at* http://www.law.harvard.edu/programs/olin_center/fellows_papers/pdf/Moodie_1.pdf.

214. *See* Moodie, *supra* note 213.

215. Richard W. Jennings, *Federalization of Corporation Law: Part Way or All the Way*, 31 BUS. LAW. 991, 997 (1976).

216. *See* Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 617 (2003) (finding that the court's pattern of suddenly altering their decisions to become more shareholder-friendly "fits a pattern of awareness, pressure and reaction"). The court rendered numerous proshareholder decisions during this period. *See, e.g.*, Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981) (rejecting the application of the business judgment rule to protect an SLC's decision to dismiss a derivate suit); Lynch v. Vickers Energy Corp., 383 A.2d 278 (Del. 1977) (holding directors to a "remarkably high standard of candor" when communicating with shareholders); Singer v. Magnavox Co., 380 A.2d 969 (Del. 1977) (holding that freeze-out mergers required a business purpose beyond specifically ridding the corporation of minority shareholders), *overruled by* Weinberger v. UOP, Inc., 457 A.2d 701, 713 (Del. 1983).

217. *See, e.g.*, John C. Coffee, Jr., *The Future of Corporate Federalism: State Competition and the New Trend Toward de Facto Federal Minimum Standards*, 8 CARDOZO L. REV. 759, 768 (1987);

The combination of decreased attention from federal legislators, coupled with increased doubts from the business community about the value of incorporating in Delaware,[218] prompted Delaware courts to once again adopt a policy of leniency toward corporations by either overruling or softening their previous proshareholder decisions.[219] Consequently, while no NYSE firm reincorporated in Delaware in 1982, eleven did in 1983, three did in 1984, and fourteen did in 1985.[220]

In 1986, however, after a period of leniency, the Delaware courts entered their second wave of proshareholder decisions that began with the Delaware Supreme Court's decision in *Smith v. Van Gorkom*,[221] which reduced business judgment protection for directors. The Delaware court then extended its *Van Gorkom* holding to the context of takeovers, with *Unocal Corp. v. Mesa Petroleum Co.*[222] and *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,[223] creating the stringent "*Revlon* duties."[224] But, once again, the Delaware courts showed how easily they respond to the threat of corporations leaving Delaware for more management-friendly states. After New York City takeover attorney Martin Lipton suggested in a memorandum to his clients (which later became public) that "perhaps it [was] time to migrate out of Delaware,"[225] the Delaware courts resumed their management-friendly ways. The Delaware legislature also responded to the *Van Gorkom* decision by increasing liability protection for directors with the passage of section 102(b)(7) of the Delaware Code.[226] Similarly, the Delaware Supreme Court weakened the stringent *Unocal* and *Revlon* duties through subsequent decisions,[227] just as it had done after the first wave of proshareholder decisions.

Ralph C. Ferrera & Marc I. Steinberg, *The Interplay Between State Corporation and Federal Securities Law—*Santa Fe, Singer, Burks, Maldonado*, Their Progeny, & Beyond*, 7 DEL. J. CORP. L. 1, 3 (1982).

218. *See* Coffee, *supra* note 217, at 768 (recalling that corporate lawyers advised their clients to incorporate in Texas, rather than Delaware, because Delaware judges had become too "moralistic").

219. *See* Aronson v. Lewis, 473 A.2d 805, 815–17 (Del. 1984), *overruled by* Brehm v. Eisner, 746 A.2d 244 (Del. 2000); Weinberger v. UOP, Inc., 457 A.2d 701, 713 (Del. 1983).

220. *See* Moodie, *supra* note 213, at 36.

221. Smith v. Van Gorkom, 488 A.2d 858, 874 (Del. 1985) (holding that a highly esteemed board of directors exercised no business judgment in connection with a leveraged buyout).

222. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

223. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

224. "*Revlon* duties" require "the maximization of short term value to shareholders when the company is broken up or sold." Sean J. Griffith, *The Costs and Benefits of Precommitment: An Appraisal of* Omnicare v. NCS Healthcare, 29 J. CORP. L. 569, 577 (2004).

225. Gunther, *supra* note 212.

226. DEL. CODE ANN. tit. 8, § 102(b)(7) (1999).

227. Stroud v. Grace, 606 A.2d 75, 78 (Del. 1992); Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140, 1142 (Del. 1989).

After public outcry from the recent scandals, the Delaware courts entered their third wave of proshareholder decisions in 2003.[228] Yet as early as August 2005, Delaware began to back away from its proshareholder trend. After a year in which WorldCom and Enron directors faced millions of dollars in personal liability stemming from shareholder suits, and the Delaware courts, as well as corporate governance advocates, received criticism on the grounds that recent decisions scared away qualified directors and discouraged risk taking, the Court of Chancery of Delaware reversed the trend by ruling against the Disney shareholders.[229] This most recent decision may signify the end of the third wave and a return to the tradition of courts granting broad, and often unjustified, deference to directors' decisions. In coming to its decision, the court observed that the events leading to the board's poorly thought out decision to hire Ovitz took place ten years ago, prior to the recent changes in corporate governance laws and practices.[230] The court is now attempting to justify its own fear to stand up to corporate America by hiding behind reliance on other forms of corporate governance, which, as demonstrated above, have not adequately addressed the monumental problems shareholders face.

Particularly in light of the August 2005 *Disney* decision, shareholders cannot rely on Delaware to produce the meaningful change in corporate governance that needs to be implemented in the wake of recent corporate scandals.[231] Due to Delaware's increased reliance on the income that corporations provide the state, the courts constantly attempt to please both management and shareholders.[232] After analyzing the pattern of Delaware decisions over the past thirty years, one thing remains crystal clear—the

228. *See, e.g.*, Hollinger Int'l, Inc. v. Black, 844 A.2d 1022 (Del. Ch. 2004); *In re* Walt Disney Co. Derivative Litig., 825 A.2d 275 (Del. Ch. 2003); *In re* Oracle Corp. Derivative Litig., 824 A.2d 917 (Del. Ch. 2003).

229. *In re* Walt Disney Co. Derivative Litig., No. Civ.A. 15452, 2005 WL 2056651 (Del. Ch. Aug. 9, 2005). *See* Review & Outlook, *Judging Disney*, WALL ST. J., Aug. 11, 2005, at A12.

230. Bruce Orwall & Merissa Marr, *Judge Backs Disney Directors in Suit on Ovitz's Hiring, Firing*, WALL ST. J., Aug. 10, 2005, at A1.

231. After the August 2005 *Disney* decision, Jeffrey Sonnenfeld, a senior associate dean at the Yale School of Management stated, "This creates an aura of ambiguity at a time when boards and corporate leaders need to have a bright line of proper conduct drawn for them." *Id.*

232. Laura Thatcher, head of the corporate governance practice at Alston & Bird, LLP, an Atlanta law firm, said the following after the most recent *Disney* decision:

> The court was obviously in a tenuous position, having already shaken directors awake by letting [the *Disney*] case get to court to begin with. . . . I think the court recognized the importance, on the other hand, of not scaring off directors who have to be able to make decisions without fear of undue liability.

Ben White, *Judge Calls Ovitz Pay Breathtaking but Legal*, WASH. POST, Aug. 10, 2005, *available at* 2005 WLNR 12537210.

Delaware courts cannot remain steadfast in their protection of shareholders because the state simply has too much to lose by alienating management.

Additionally, as *Disney* illustrated, another problem arises from relying on the Delaware courts to increase liability for directors. The court's first decision in *Disney*[233] was premised on the fact that the board had not exercised any business judgment, so presumably the directors could have protected themselves by "debating" alternatives before arriving at the very same conclusion.[234] This sets a bad precedent that directors can simply pretend to engage in a meaningful debate in order to shield themselves from liability, particularly when a controlling CEO is manipulating them. Intuitively, this outcome seems more likely when there are only nominally independent directors sitting on the board, whose social ties to the CEO make it extremely difficult to confront that CEO.[235] Consequently, to enable change in *actual* behavior, the definition of "independent" needs to be modified to reflect that social ties can carry great weight and influence over a director's ability to represent shareholders.

The Exchanges—not the courts—need to put forth meaningful change through a new, narrower definition of "independent." Unlike Delaware, which depends on corporations for its wealth, corporations depend on the Exchanges for their wealth.[236] Through their listing standards, with which listed companies are required to comply, the Exchanges exert tremendous power over the governance practices of listed companies. Consequently, the Exchanges, unlike any of the states, particularly Delaware, are in a unique position to further develop new listing standards that will impose meaningful change on the governance of public companies.[237]

233. *In re Walt Disney*, 825 A.2d at 291.

234. Although the most recent *Disney* decision determined that the board had exercised some business judgment, rather than no business judgment, the danger of directors engaging in a phony debate just to satisfy the legal requirements exists, irrespective of the ultimate ruling. In fact, the most recent decision highlights this problem even more because, ultimately, the Disney directors were able to escape liability by showing that they had exercised some business judgment, even though evidence exists to dispute that claim. *See In re Walt Disney*, 2005 WL 2056651.

235. This extreme difficulty stems from their reluctance to jeopardize their valuable relationship outside the boardroom. *See supra* Part II.D.1.

236. Listing on the Exchanges confers considerable benefits on corporations and their management, including greater liquidity of the listed securities and increased prestige of the corporation and its management. Additionally, companies regularly state that their desire to become listed is a top priority. *See* Stephen M. Bainbridge, *A Critique of the NYSE's Director Independence Listing Standards* 3 (UCLA Sch. of Law, Research Paper No. 02-15, 2002), *available at* http://www.ssrn.com/abstract_id=317121.

237. Although the Exchanges do compete with each other for listings to some degree, firms generally will not choose an exchange based on the leniency of its standards. First, the NYSE is considered to be the most prestigious stock exchange in the United States and, thus, confers certain

B. LOOKING TO THE EXCHANGES FOR MEANINGFUL CHANGE

Despite the fact that the Exchanges' new listing requirements narrow the definition of "independent" and mandate some separation between management and the independent directors, they do not go nearly far enough. First, while the definitions do aim to correct some of the problems that arise from the close relationships between a CEO and independent directors, they do not solve the core problem.[238] While the rules do create an opportunity for directors to meet freely and frequently without management present, they do not attempt to address the "aversion of independent directors to confront management face-to-face by asking tough questions."[239] Second, the rules only limit, rather than eliminate, side payments to directors. The continued availability of side payments to influence directors makes it nearly impossible for directors to be truly "independent" and to avoid becoming "entangled" with the CEO and other senior management. Third, and most importantly, these definitions make no explicit mention of social ties. The NYSE's definition of "independent" disqualifies a director who has a "material" connection with the company,[240] which, in theory, disallows any director whose social ties to the CEO are strong enough to rise to the level of being deemed material. In practice, however, this is not the case. James Duffy, Senior Vice President and Deputy General Counsel for the NYSE, noted that since implementing the new listing standards, companies consistently do not examine a director's independence beyond the bright-line standards, making the absence of social ties from those standards a significant issue.[241] Therefore, in order to promote meaningful change, the Exchanges need to amend the laundry list of factors disqualifying a director to include social ties.

Opponents to these more stringent amendments may cite theories such as the collaborative board model to explain why further listing requirements are unnecessary. They may also claim that sufficient

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benefits on its listed companies. Second, other American exchanges follow the NYSE's lead. For example, when NASDAQ initially proposed less extensive changes to its listing standards than the NYSE's, NASDAQ changed its requirements to be more in line with those of the NYSE almost immediately. Lastly, because the SEC regulates the Exchanges, they cannot go too far without pressure from the SEC. *See id. But see* Kurt Eichenwald, *Reform Effort at Businesses Feels Pressure*, N.Y. TIMES, Jan. 14, 2005, at A1, *available at* 2005 WLNR 521218 (reporting that several foreign companies, including Air China, have declined to list on the NYSE because of the new, more stringent listing requirements).

238. *See* McDonnell, *supra* note 110, at 524.

239. *See* O'Connor, *supra* note 24, at 1300.

240. *See* NYSE ACCOUNTABILITY REPORT, *supra* note 201, at 6–8.

241. Conference on Post-Enron Regulation, *supra* note 8.

incentives exist for directors to take their monitoring role seriously, in spite of social connections between directors and the CEO. Clearly, however, incentives such as the director's reputational capital and enhanced legal liability are not working. Despite research supporting the validity of these various theories and incentives, the real-world examples of the Disney, Oracle, and Hollinger boards demonstrate that social ties between directors and the CEO do stifle honest debate and communication, thereby negatively affecting director performance.

The inevitable question is, What constitutes a social tie strong enough to exclude a potential director from being independent? Defining the parameters of acceptable and unacceptable social ties is far more problematic than forming an objective list of financial factors that disqualify a director. For instance, do a CEO and a director who belong to the same country club share a strong social tie? What if their children are playmates? What if they run in the same social circles, attend weddings together, and describe themselves as friends?[242] The obvious answer is that it depends. All of these situations are highly context-specific. Consequently, in order to enact a listing standard that would have a meaningful impact on corporate governance practices, the definition of independence adopted by the Exchanges would need to provide for fact-specific flexibility. Bright-line lists of acceptable and unacceptable relations are not sufficient.

Mark Granovetter's three-factor approach to analyzing social ties between CEOs and nominated directors, purported to be independent, proves instructive.[243] It would allow the Exchanges to formulate a definition containing a sliding scale of interests based on (1) the length and frequency of the social contact between the parties, (2) the emotional depth of the relationship, and (3) the reciprocity of the relationship.

First, the longer the two individuals have known each other, the more they risk by opposing each other in a situation such as the boardroom where pride, respect, and reputation are at stake. The same reasoning applies regarding the frequency of the contact between the two individuals.

242. It should be noted that this is the same scenario that occurred in the recent Martha Stewart case, in which the court declared, "Allegations that Stewart and the other directors moved in the same social circles, attended the same weddings, developed business relationships before joining the board, and described each other as 'friends,' even when coupled with Stewart's ninety-four percent voting power, are insufficient, without more, to rebut the presumption of independence." Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1051 (Del. 2004). Despite the Delaware court's viewpoint on the subject, for reasons already discussed in Part IV.A, *supra*, the Delaware courts may not be the best watchdogs of shareholder interests.

243. *See supra* notes 76–77 and accompanying text.

If two people rarely see each other, they are not going to be risking a tremendous amount of "social capital" when a conflict arises in the boardroom.

Second, the deeper the relation between two individuals, the more they confide in each other and rely on each other for emotional support, and the more they will safeguard that relationship and attempt to keep it intact. When balancing whether to protect that relationship or to protect one with a group of stranger shareholders, psychology predicts that the individual will shield the personal relationship—at the expense of the stranger relationship.[244] In spite of directors' fiduciary obligations instructing them not to act in this manner, the strength of the social connection influences an individual's behavior so strongly that the director will subconsciously disregard fiduciary duties. Third, when a history of reciprocity—a series of favors and obligations—exists between the CEO and the director, the director feels a strong sense of loyalty and an obligation to return the CEO's past favors.

While this list of social connections is not comprehensive, social psychology has shown these factors to be highly influential in decisionmaking processes. Thus, these factors offer a schema for examining and evaluating the relationship between a CEO and a director in a meaningful way.

Because this analysis does not offer an objective list of criteria that would automatically exclude a director, there is also a question of how to implement such a system. Just as there exist bond-rating agencies, whose primary function is to evaluate the creditworthiness of various bonds on the market, there exist board-rating agencies, whose primary function is to evaluate the corporate governance practices of a company.[245] Like bond-rating agencies, certain board-rating agencies have reputational capital, and thus, may be relied upon to supply high-quality, unbiased ratings. Currently, board-rating agencies evaluate companies in several different areas using various criteria, such as board structure, response to

244. Nelson, *supra* note 68, at 386.

245. Examples of such agencies include the Investor Research Responsibility Center, Standard & Poor's, and The Corporate Library. Although the ISS is also an example of such an agency, there is growing concern that since the ISS both consults companies and rates them, a conflict of interest exists. Adam Lashinsky, *ISS Wants Business Both Ways*, FORTUNE, June 16, 2003, at 24, *available at* 2003 WLNR 13891590 (reporting that "there is a growing chorus of complaints that both selling to and rating companies compromises ISS's integrity and its standing as a corporate watchdog"); Conference on Post-Enron Regulation, *supra* note 8.

shareholder proposals, and director compensation.[246] The Exchanges, in modifying their listing requirements, should explicitly require listed companies to use an outside, independent board-rating agency, and evaluate director independence according to Granovetter's guidelines,[247] before shareholders are permitted to vote on a potential director. An organization that already engages in this type of corporate evaluation would possess the expertise, experience, and impartiality to undertake such a task.[248]

All factors would be evaluated on a scale of one through ten (one meaning the CEO and the director have no connection and ten meaning that the CEO and the director have a very strong connection). Later, companies would disclose these scores, along with a detailed explanation of the factors used to evaluate the directors, and a specific listing of the directors' connections to the shareholders before an actual vote occurred; thus, they would provide a level of transparency that the process currently lacks. Directors receiving a composite score above a certain level would automatically be disqualified from being considered independent.

Why should directors above a certain threshold be disqualified when other directors are not? Established corporate law allows for disinterested, informed shareholder ratification to overcome certain breaches of fiduciary duty.[249] Shareholders possess the ultimate decisionmaking authority—rather than the board-rating agency conclusively approving or disapproving every nominated independent director. But policy arguments justify not allowing shareholder ratification alone to approve the transaction where a CEO attempts to nominate a director with whom that CEO has exceedingly close relations. Shareholders do not always act in their best interests and may not be well suited to protect themselves. The same rationale applies for not allowing an informed, disinterested shareholder vote to cleanse a

246. Many of the agencies base their analyses on NASB Financial Inc.'s *Blue Ribbon Report*, specifically looking at the following criteria: board composition, board structure, board size, response to shareholder proposals, executive and director compensation, and stock ownership, among other criteria. Conference on Post-Enron Regulation, *supra* note 8.

247. Granovetter, *supra* note 76, at 1361.

248. Although the same logic was applied to the big accounting firms, board-rating agencies differ in an important respect. The principal function of board-rating agencies is to protect investors, not to make money. As a result, they will not be as susceptible to taking the illegal measures to please their clients that the accounting firms took.

249. DEL. CODE ANN. tit. 8, § 144(k)(1)–(2) (1999); Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 366 n.34 (Del. 1993) ("Under this statute, approval of an interested transaction by either a fully-informed disinterested board of directors, or the disinterested shareholders, provides business judgment protection." (internal citations omitted)).

director's breach of the duty of loyalty.[250] The need to protect shareholders who may not protect themselves validates the paternalistic approach of eliminating CEOs' ability to nominate their close friends onto a rubber-stamping board.

1. The Direct Benefits of Evaluating Director Independence

Rating the social ties between CEOs and directors offers the benefit of having an outside organization—whose primary goal is shareholder protection—evaluate candidates so that shareholders can make a truly informed decision. It also provides the benefit of a flexible system, thus avoiding the negative consequences that occur when regulations force firms to operate within guidelines that are inappropriate for their particular circumstances.[251] Furthermore, it prohibits CEOs from nominating interested directors in order to create an overly friendly board. At the same time, it permits shareholders to decide whether a board comprised of nominally independent directors is beneficial to the firm. Most importantly, under this proposal, the Exchanges would force companies to pay greater attention to social ties by explicitly mentioning such ties in the listing requirements, along with the other bright-line standards.

This proposal is paternalistic, and its implementation will be time consuming and expensive. But the recent corporate scandals demonstrate that shareholders cannot trust companies to adequately protect shareholder interests. Shareholders have lost tremendous amounts of money as well as their confidence in investing in publicly held corporations. Disclosing the true nature of the relationship between the CEO and nominated directors would protect shareholders, while still maintaining a flexible system in which firms could operate. The added disclosure would increase shareholder confidence, which would in turn benefit the market. In light of the recent scandals, these tremendous benefits outweigh the costs of such a process.

2. The Indirect Benefits of Evaluating Director Independence

Some may comment that adding social tie restrictions exacerbates an existing problem. Placing boundaries on who can serve as a director further reduces the already limited number of people who have the business

250. *See supra* note 43.

251. Given that a different structure may be appropriate for a subsidiary whose parent corporation owns seventy-five percent of the stock than for a corporation whose largest shareholder owns no more than twenty percent of the corporation, shareholders could determine which board members were appropriate for the firm in light of its structure.

knowledge to serve effectively as a director. But fostering diversity on boards may be a positive, unintended consequence of limiting the social ties between CEOs and directors. This proposal may certainly restrict many white men who currently serve as directors from serving on various companies' boards, but it may also force management to search through other qualified pools of potential directors.[252] While defining "qualified" as sitting CEOs or other senior executives would admittedly result in a shortage of available candidates, there are several reasons that this definition is actually detrimental to the company. Sitting senior executives have tremendous responsibilities to their own firms and are unlikely able to devote sufficient time to adequately performing their board duties. Additionally, they usually have stronger ties with management, which may compromise their independence.[253] Extending board positions to people who have strong business experience, but who are not currently sitting senior executives, may actually be a positive change for the firms, and it would provide them with greater numbers of qualified women and minorities.[254] Based upon the latest filings of public companies with the SEC, women hold only ten percent of the board seats and minorities hold even fewer.[255] But research shows that a mix of women and men on boards actually results in better performance.[256] This finding supports psychological research that indicates that heterogeneous groups offer several advantages as compared to homogeneous ones.[257]

In conclusion, disqualifying directors from being deemed independent based on their close social ties to CEOs would have a direct effect on corporate governance practices. It would increase true director independence by acknowledging the reality that, in the boardroom,

252. *See* Bruce Meyerson, *A Shortage of 'Qualified' Directors? Maybe Companies Aren't Looking Hard Enough*, PITTSBURGH POST-GAZETTE, Aug. 1, 2004, at D2, *available at* 2004 WLNR 5007632. Meyerson notes that since SOX has been in effect, corporations are using executive search firms (as opposed to relying on personal referrals) twice as often as they were before.

253. In fact, some industry experts already regard a director who is also a sitting CEO as being less independent. *See* Morgenson, *supra* note 211.

254. Deborah Soon, vice president for executive leadership at Catalyst, stated, "If the criteria for board service is to be a sitting CEO of a major Fortune 500 corporation, then there's not enough candidates. But if you want people with experience at running a business, then there are in fact lots of qualified women." Meyerson, *supra* note 252.

255. *Id.*

256. *See* Beverly Topping, *Incorporate Women: Canadian Businesses Need More Female Board Members if They Want to Understand Their Markets*, GLOBE & MAIL (Toronto, Can.), Feb. 26, 2004, at A19, *available at* 2004 WLNR 18392633 ("It is not that women per se make the difference; it is the mix of women and men from a range of backgrounds on the top management team that results in better corporate performance over the long haul.").

257. Cosier & Schwenk, *supra* note 71, at 69.

directors demonstrate loyalty to CEOs who are their close friends. And it will have the further indirect effect of improving corporate governance practices by essentially forcing management to look beyond the "usual suspects" to fill their boards.

V. CONCLUSION

Recent corporate scandals have shattered investor confidence. Moreover, the scandals have cost employees, companies, and shareholders hundreds of millions of dollars. Courts have tried to solve this problem by scrutinizing board decisions more carefully, while the Exchanges have examined the independence of board members. Although the Exchanges focused on the critical problem—director independence—they only addressed familial and financial factors when amending their listing requirements. But any solution likely to work must also address the social ties between directors and senior management. The only solution that ultimately resolves the issue involves evaluating the true nature of the ties between board members. The Exchanges must require all listed companies to have board-rating agencies score the independence of director nominees before shareholders can vote.

Clearly, there are many benefits to implementing such a system. First, it specifically examines the true relations of director nominees and CEOs. Second, it promotes transparency by providing shareholders with greater information. Given the already high price companies and shareholders have paid for the corporate scandals, these benefits would come at a relatively low cost. Because it is crucial to prevent corporate scandals, from both economic and investor-confidence standpoints, the Exchanges must realize that their new standards represent the first step, rather than the solution, toward improving corporate governance. Therefore, further amendment of their standards is required to force companies to examine the true nature of CEO-director social ties and to allow shareholders to evaluate whether a director will actually safeguard their interests when faced with the conflicting interests of the CEO.