ARTICLES

PROCESS OVER STRUCTURE: AN ORGANIZATIONAL BEHAVIOR APPROACH TO IMPROVING CORPORATE BOARDS

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ABSTRACT

History has shown that the scholarly and regulatory focus on board composition and structure is a dangerously incomplete solution to the problems that have caused recent corporate failures. The media and corporate scholars have assigned much of the blame for the 2008 financial crisis and the Enron-era corporate scandals to corporate boards. The conventional diagnosis of these ills is that boards were largely at fault because they failed to effectively monitor corporate officers. Unfortunately the conventional diagnosis of the problem is incomplete and the policy prescriptions flowing from this faulty diagnosis are unlikely to address the very real problems that continue to plague corporate governance.

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The principal problem is that most regulatory attempts fail to adequately consider an essential step in understanding the board's relationship to corporate failure: the process by which boards monitor corporate performance. By relying on insights from a robust organization behavior literature, this Article demonstrates that the processes boards employ to undertake their monitoring function are in need of significant improvement. In other words, how boards engage in management monitoring should be the focus of corporate regulatory reform, more so than who sits on boards or how boards are structured.

This Article makes three distinct contributions to the corporate governance literature regarding the board of directors. First, it identifies the routinely overlooked connection between board structure and composition on the one hand, and board process on the other. In doing so, the Article uses current board reform efforts to illustrate why it is a mistake to focus on board structure and composition while ignoring or discounting board process. Second, this Article identifies structure as a constraint on board process. Given the importance of process for successful board monitoring, it is important that regulatory initiatives recognize the consequences of structural regulation. Finally, it fills a hole in the literature by examining the interactions between the board of directors and others within the firm, such as the chief executive officer ("CEO"). From a practical standpoint, making these connections is crucial to closing the space between what corporate governance regulations intend and what they are able to accomplish.

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I. INTRODUCTION

One of the most persistent and vexing challenges of corporate governance is creating corporate boards of directors that effectively improve firm performance. This challenge has become even more salient since the turn of the century. The media and corporate scholars have assigned much of the blame for the 2008 financial crisis and the Enron-era corporate scandals of the early 2000s to corporate boards.[1] The conventional diagnosis of these ills is that boards were largely at fault because they failed to effectively monitor corporate officers. Based on this diagnosis, the conventional policy prescriptions—most notably in the Sarbanes-Oxley Act and the Dodd-Frank Act—have been to attempt to increase the independence of corporate boards by modifying the criteria for membership and altering the structure of the board.

Unfortunately the conventional diagnosis of the problem is incomplete, and the policy prescriptions flowing from this faulty diagnosis are unlikely to address the very real problems that continue to plague corporate governance. Most companies, including those that failed, had in fact already adopted corporate governance best practices, had boards that were almost completely comprised of independent directors, and had put in place the mandatory independent committee structures.[2] Put another way,

1. *See, e.g.*, Lisa M. Fairfax, *Sarbanes-Oxley, Corporate Federalism, and the Declining Significance of Federal Reforms on State Director Independence Standards*, 31 OHIO N.U. L. REV. 381, 382–83 (2005) ("Indeed, corporate governance scandals suggested that directors had failed to appropriately monitor corporate officers, and that such failure enabled officers to engage in fraud and other behavior detrimental to shareholders and the markets in general."); Allan D. Grody, Letter to the Editor, N.Y. TIMES, Jan. 18, 2009, at MM28 (stating that the financial crisis was properly blamed on "lack of management oversight and diligence"); Ben Stein, *It's Time to Act Like Grown-Ups*, N.Y. TIMES, Nov. 11, 2007, at 4 (wondering where were the directors when banks such as Merrill Lynch faced financial disaster); Ralph Ward, Editorial, *CEOs Got Grilled, but Let's Hear from Board Leaders, Too*, DETROIT FREE PRESS, Dec. 10, 2008, at 15 ("All our corporate disasters of the past decade, from Enron up to the current financial meltdown, have drawn the same question: Where was the board?").

2. *See* discussion *infra* notes 89–99 and accompanying text. *See also* Robert C. Pozen, *The Case for Professional Corporate Boards*, HARV. BUS. REV., Dec. 2010, at 1, 2 ("[A]t the banks that

most companies had already absorbed the conventional wisdom and undertaken the reforms suggested by that wisdom. An alternative approach to regulation and reform, grounded in organizational behavior theory, may lead to reform prescriptions that better reflect and are more responsive to the monitoring challenges faced by corporate boards.

History has shown that the scholarly and regulatory focus on board composition and structure is a dangerously incomplete solution to the problems that have caused this century's corporate failures. The principal problem is that most regulatory attempts fail to adequately consider an essential step in understanding the board's relationship to corporate failure: the *process* by which boards monitor corporate performance.[3] By relying on insights from a robust organization behavior literature, rarely employed by legal scholars,[4] this Article demonstrates that the processes boards employ to undertake their monitoring function are in need of significant improvement. In other words, *how* boards engage in management monitoring should be the focus of corporate regulatory reform, more so than *who* sits on the board or how boards are structured.

Current regulatory efforts and recommended best practices have been heavily influenced by agency theory,[5] which assumes that agency costs are

collapsed, 80% of the board members were independent, as were the members of their audit, compensation, and nominating committees."); Lucian A. Bebchuck, *Making Directors Accountable*, HARVARD MAG., Nov.–Dec. 2003, at 29, 29–31, *available at* http://www.harvardmag.com/pdf/2003/11-pdfs/1103-29.pdf.

3. For an analysis of how Delaware courts have tackled the issue of board process, see *infra* notes 71–78 and accompanying text discussing *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996) and its progeny.

4. *See* Lynne L. Dallas, *The Relational Board: Three Theories of Corporate Boards of Directors*, 22 J. CORP. L. 1, 14–15 (1996) (discussing the "three power relationships reflected on boards"); Lynne L. Dallas, *The Multiple Roles of Corporate Boards of Directors*, 40 SAN DIEGO L. REV. 781, 782–83 (2003) [hereinafter Dallas, *Multiple Roles*] (discussing a slightly different taxonomy using two categories, as opposed to three); Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 799 (2001) [hereinafter Langevoort, *The Human Nature of Corporate Boards*] (considering the impact of mandatory independence legislation for corporate boards on the team-like nature of boards from the "disciplines of organizational behavior and social cognition"); Donald C. Langevoort, *The Organizational Psychology of Hyper-Competition: Corporate Irresponsibility and the Lessons of Enron*, 70 GEO. WASH. L. REV. 968 (2002) (exploring the collapse of Enron from a social psychology and organizational behavior perspective); Lynn A. Stout, *On the Proper Motives of Corporate Directors (or, Why You Don't Want to Invite* Homo Economicus *to Join Your Board)*, 28 DEL. J. CORP. L. 1, 9–10 (2003) (describing the internal pressures that better explain how boards work by using broader social science literature, such as "psychology, sociology, biology, and anthropology," for explaining "other-regarding behavior").

5. I use agency theory in the broad sense found in economic literature as commonly attributed to Michael Jensen and William Meckling. Michael C. Jensen & William H. Meckling, *Theory of the*

an important causal factor in corporate crises.[6] Most current regulation and regulatory reform proposals attempt to reduce corporate failure by reducing agency costs, and they attempt to do this by making compositional and structural changes to corporate boards of directors. The critical assumption in this approach is that a fully independent board (and fully independent committees) will lower agency costs through effective monitoring. This lowering of agency costs, will naturally lead to better firm performance and fewer catastrophic failures, almost irrespective of the processes by which the board executes its monitoring duties. Even within agency theory, this "composition *uber alles*" model should be troubling because there is nothing about agency theory itself that would require such an approach. Yet legislative attempts at reform have considered almost exclusively those reforms that target board composition and structure. This is true even though empirical work has not shown a significant correlation between reforms such as majority independent boards, and better firm performance. The lack of significant correlation suggests that the link between compositional and structural board reforms and firm performance is not as self-evident as policymakers assume.[7] Nevertheless, legislation aimed at preventing corporate failures is frequently limited to these independence-oriented reforms.

In fact, boards face several challenges that have so far been largely ignored by regulators and scholars. These challenges are far more nuanced and organization-specific than current reform approaches reflect. Current approaches do not account for the way most boards actually operate within firms. Regulating the board without an appreciation of its practical challenges is more damaging than simply enacting ineffective legislation. Many of the structural and compositional reform efforts actually inhibit board performance by interfering with the processes by which boards—fully independent or not—would exert a positive influence within their firms.

Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. FIN. ECON. 305, 308 (1976), *available at* http://www.sfu.ca/~wainwrig/Econ400/jensen-meckling.pdf. *See also* Deborah A. DeMott, *Disloyal Agents*, 58 ALA. L. REV. 1049, 1050–52 (2007) (describing the difference between agency as used in the common law and agency as used in economics).

6. Regulators and the media often blame the board of directors for corporate failures, although this Article doubts that there is a causal connection between the board and the widely publicized scandals and failures of the recent past. This Article, however, acknowledges that policymakers have adopted this assumption, and their solutions are based on the perceived connection between proper board monitoring and better firm performance. As such, this Article seeks to enrich the common conception of the board, and by doing so, help policymakers craft more effective solutions to the problems they have identified.

7. *See* discussion *infra* Part II.C.

Current regulation results in a more formalized structure, thereby increasing the number and complexity of rules that the board must follow.[8] With this increase in formalization comes a diminution in the discretion directors can use when monitoring management. In many cases this means that boards are placed in a reactive role in which they clean up messes, rather than a proactive role, in which they help the firm avoid the mess in the first place. The board's reactive position creates an impossible situation for boards of directors. On the one hand, they are tasked with averting corporate disaster. But on the other hand, they often do not have the tools for predicting an impending crisis until it is has besieged the firm. At best, the board can react to the situation once it has materialized.

Organizational behavior offers a more comprehensive approach to improving monitoring than current policymaking initiatives. It shares with agency theory the goal of reducing agency costs, but where these reforms concentrate on structural changes, organization behavioral theory broadens the focus to include *process* as a better method of reducing agency costs. For instance, it attempts to derive a richer understanding of the processes by which groups within firms interact and acquire and process information. Without such an understanding, regulations risk unintended and harmful consequences. Independent directors, for example, are by definition not employed by or affiliated with the corporation, and have no inside knowledge of its workings. As a result, they face multiple informational disadvantages that may make it difficult for them to evaluate management's decisions.

It is unclear, and infrequently analyzed, how effectively independent directors tasked with monitoring the corporation's chief executive officer ("CEO") respond to incomplete or incomprehensible information. An organizational behavior perspective addresses this issue by doing more than simply suggesting that independent board members monitor management and assuming that board composition and structure will necessarily yield the desired result. Instead, organization behavioral theory suggests that corporate interactions, like those between independent directors and CEOs, largely determine whether effective monitoring is even possible.

An examination of intracorporate group interactions leads to a better sense of the processes necessary to provide the board with the materials it

8. *See* discussion *infra* Part III.C. *See also* STEPHEN P. ROBBINS, ORGANIZATION THEORY: THE STRUCTURE AND DESIGN OF ORGANIZATIONS 6–7 (1983) (defining formalization as the extent "to which an organization relies on rules and procedures to direct the behavior of employees").

needs to successfully perform its duties. Such an examination also suggests that alternative structures may facilitate better processes that generate the desired results more frequently and quickly. In other words, a comprehensive approach to corporate governance considers interactions between corporate actors, how these interactions impact process, and how process impacts structure. An approach that is limited to compositional and structural changes misses other key inputs, and as a result is not as effective as a process-oriented approach.

This Article makes three distinct contributions to the corporate governance literature regarding the board of directors. First, it identifies the routinely overlooked connection between board structure and composition on the one hand, and board process on the other. In doing so, the Article recognizes and describes a process that is crucial to effective board monitoring—the process used for generating, obtaining, and filtering information. Applying this information process to board reform efforts from the last ten years illustrates why it is a mistake to focus on board structure and composition, while ignoring board process.

Second, this Article argues that structure constrains board process. Given the importance of process for successful board monitoring, this Article identifies the consequences of structural regulation.

Finally, this Article fills a hole in the literature concerning corporate boards by examining the interactions between the board of directors and others within the firm, such as the CEO. From a practical standpoint, making this connection is crucial to closing the space between what corporate governance regulations intend and what they are able to accomplish. The Article demonstrates how the interdependent and often conflicted relationship between the board of directors and the CEO presents noteworthy and formerly unexplored impediments to the board's monitoring efficacy. Specifically, this Article identifies typical characteristics of the relationship between the CEO and the board. It then shows that understanding this relationship is critical to improving the competence of the board of directors, because the limitations inherent in the relationship are aggravated, not ameliorated, by structural and compositional reforms.

The Article is the first in a series that uses organizational behavior to explore the importance of process and decisionmaking to corporate governance. It sets forth the fundamental premise that process is more important than structure for board efficacy. The next article in the series identifies the specific attributes of an effective decision-making process that are essential to securing a board's de facto authority.[9] Additional articles will explore the importance of process to issues such as director accountability and how to improve board independence from the CEO. The Article proceeds as follows. Part II provides a basic overview of the monitoring board. It then analyzes several of the regulatory responses to corporate failure and identifies the weaknesses of the conventional approach to board reform.

Part III introduces an organizational behavior framework, which provides a more accurate picture of the real world dynamics within a business, as well as the practical limitations constraining boards' ability to operate. It goes on to analyze process as an intermediate step that is currently missing from the conversation on board efficacy, and shows how certain structures, such as those mandated by current legislation, can impede process.[10]

Part IV draws upon contributions from organizational behavior to analyze the interdependent relationship between the board and the CEO. Part IV then identifies several specific problems—such as information asymmetries, myopic information, and incomplete information—that are exacerbated by the board's conflicting mandates to monitor managers, rely on them for critical information, and work with them to maximize shareholder value. Part IV suggests that a process-oriented approach, cognizant of the limitations that most boards face as a result of their relationships with CEOs, can help boards achieve greater efficacy. Part V concludes.

II. THE LIMITS OF STRUCTURE AND COMPOSITION

The prevailing view in the academic literature regarding the board's role within the corporation is shaped by agency theory. Simply put, the view that the board's central role is to reduce agency costs has led to the dominant conceptualization of the board as a monitor of corporate managers. Many of the corporate governance regulations over the last ten years have been structural and compositional reforms consistent with this prevailing view. Empirical studies and illustrations from the 2008 financial

9. Nicola Faith Sharpe, *Questioning Authority: The Critical Link Between Board Power and Process* (Illinois Program in Law, Behavior and Social Science Paper No. LBSS12-02; Illinois Public Law Research Paper No. 11-14, 2012) [hereinafter Sharpe, *Questioning Authority*], *available at* http://ssrn.com/abstract=2003010.

10. *See* discussion *infra* Part III (defining process as the intermediate step between particular inputs, such as an independent board of directors, to outcomes, such as better firm performance).

crisis, however, indicate that board composition and structure is an insufficient solution to improving board monitoring. This insufficiency strongly suggests that different types of changes are necessary to make the board more effective. The most persuasive answer to solving these insufficiencies is that an intermediate step is needed. Board process is that step.

A. THE MONITORING BOARD

Any discussion of improving the effectiveness of corporate boards raises several antecedent questions.[11] Chief among them are what is the role of the board of directors, and based on that role, do the changes to board composition and structure of the last several decades aid the board in its duties? The legal literature covers a wide range of theories on the role of the board of directors. The spectrum ranges from the board operating as the most dominant force in corporate governance, to functioning as a mere advisory body, serving to occasionally counsel the CEO.[12] Although there is a lack of consensus among scholars regarding the board's various roles, and how to categorize those roles,[13] scholars commonly recognize three distinct theories laying out three distinct functions of the board.[14] The first is resource dependence theory, asserting the board's relational function, through which directors' connections and expertise benefit the firm by

11. One question, which has been addressed by Stephen Bainbridge, is whether we still need corporate boards. *See generally* Stephen M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1, 3 (2002) [hereinafter Bainbridge, *Why a Board?*] (arguing that a boards' "existence follows logically from the evidence on group decisionmaking"). *See also* Daniel P. Forbes & Frances J. Milliken, *Cognition and Corporate Governance: Understanding Boards of Directors as Strategic Decision-Making Groups*, 24 ACAD. MGMT. REV. 489, 490 (1999) ("[T]he very existence of the board as an institution is rooted in the wise belief that the effective oversight of an organization exceeds the capabilities of any individual and that collective knowledge and deliberation are better suited to this task."), *available at* https://carlsonmba.csom.umn.edu/Assets/48780.pdf. This Article assumes that boards will be part of the corporate governance debate for some time to come.

12. *See* STEPHEN M. BAINBRIDGE, THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE 12 (2008) (emphasizing the director primacy theory of corporate governance).

13. *See* Jelena Petrovic, *Unlocking the Role of a Board Director: A Review of the Literature*, 46 MGMT. DECISION 1373, 1375 (2008).

14. Scholars disagree on how to classify the role of the board, but these three functions are the ones most commonly used, although many scholars only concentrate on one of the three. *See* Mark Macus, *Board Capability: An Interactions Perspective on Boards of Directors and Firm Performance*, 38 INT'L STUD. MGMT. & ORG. 98, 100 (2008); Daniele Marchesani, *The Concept of Autonomy and the Independent Director of Public Corporations*, 2 BERKELEY BUS. L.J. 315, 320 (2005) (discussing the boards' monitoring, service/strategic, and resource-gathering roles and noting that the United States has adopted the monitoring model of the board); Petrovic, *supra* note 13, at 1375–76 (describing the relational function of the board in which directors facilitate business relationships, the empowerment function in which directors use their knowledge and resources to assist managers, and the monitoring function in which directors ensure that managers are dutifully working for the benefit of shareholders).

providing useful advice and access to outside resources, such as financial or supply networks.[15] The second is stewardship theory, asserting the board's empowerment function, through which board members are tasked with assisting managers in their leadership of the company.[16] Finally, the third, and most dominant in legal scholarship, is agency theory, asserting the board's control (or monitoring) function, under which the board monitors the CEO and other executive management.

The three theories adopt competing assumptions about the role of the board and the corporate governance concerns that those roles implicate.[17] The theories also differ in their view about management's disposition. Unlike stewardship and agency theory, resource-dependence theory does not take a strong stance on management's motivations. Consequently, whether managers are self-serving or good stewards is not a defining feature of resource-dependence theory. The theory focuses on the board's role in securing resources in order to eliminate uncertainty from the external environment.[18]

Stewardship theory posits that managers are generally good stewards of the firm's assets and therefore should be empowered by the board to manage the firm's assets.[19] The board can play a role in empowering managers by offering advice and suggesting strategies that support managers.[20] By contrast, agency theory assumes the opposite about managers.

Agency theory assumes that managers, who are rational actors seeking to maximize their own utility, are opportunistic. As a result, the firm and its shareholders will suffer unless managers are monitored in order to minimize agency costs.[21] This is of particular concern due to the separation

15. As Lynne Dallas has observed, boards functioning in this capacity allow their corporations to gain access to strategically important resources and relationships. Dallas, *Multiple Roles*, *supra* note 4, at 805. *See also* JEFFREY PFEFFER & GERALD R. SALANCIK, THE EXTERNAL CONTROL OF ORGANIZATIONS: A RESOURCE DEPENDENCE PERSPECTIVE (1978); Catherine M. Daily & Charles Schwenk, *Chief Executive Officers, Top Management Teams, and Boards of Directors: Congruent or Countervailing Forces?*, 22 J. MGMT. 185, 191 (1996); Melinda M. Muth & Lex Donaldson, *Stewardship Theory and Board Structure: A Contingency Approach*, 6 CORP. GOVERNANCE: INT'L REV. 5, 6 (1998).

16. BAINBRIDGE, *supra* note 11, at 10; Macus, *supra* note 14, at 101.

17. Macus, *supra* note 14, at 100.

18. *Id.*

19. James H. Davis, F. David Schoorman, & Lex Donaldson, *Toward a Stewardship Theory of Management*, 22 ACAD. MGMT. REV. 20, 24–25 (1997); Muth & Donaldson, *supra* note 15, at 6.

20. Macus, *supra* note 14, at 100.

21. *See* ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND

of ownership and control in the firm. Although shareholders are the principals and owners of the firm,[22] their agents (managers) control the day-to-day business of the firm.[23]

As a result, shareholders, who would like to maximize the return on their investment in the firm, are vulnerable to shirking by managers and the agency loss that results.[24] Shareholders experience an agency loss when

PRIVATE PROPERTY 121 (1932); Henry Hansmann & Reinier Kraakman, *Agency Problems and Legal Strategies*, *in* THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 21, 21–22 (Reinier Kraakman et al. eds., 2004) (noting that the first problem of agency is the conflict between firm owners and hired managers); James D. Cox, *Managing and Monitoring Conflicts of Interest: Empowering the Outside Directors with Independent Counsel*, 48 VILL. L. REV. 1077, 1082 (2003) (noting that monitoring managers is the "central task" of outside directors); Dallas, *Multiple Roles*, *supra* note 4, at 801 ("Manager monitoring is intended to curtail managerial self-dealing, negligence, and the lack of professionalism on the part of management in attending to the affairs of the corporation."); Michael C. Jensen & William H. Meckling, *The Nature of Man*, 7 J. APPLIED CORP. FIN. 4 (1994); Lawrence E. Mitchell, *Structural Holes, CEOs, and Informational Monopolies: The Missing Link in Corporate Governance*, 70 BROOK. L. REV. 1313, 1315 (2005) ("[C]orporate governance scholarship . . . has focused on the board as the corporate constituent best situated to manage or monitor the corporation's affairs and overcome the intrinsic conflict of interest that arises when corporate managers have access to the shareholders' money."). *But see* Jensen & Meckling, *supra* note 5, at 310 (criticizing the fundamental assumptions as being a simplification for mathematical modeling and an unrealistic description of human behavior). For criticisms to the rational actors of the firm, see Stout, *supra* note 4, at 14.

22. Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 563, 573 (2003) [hereinafter Bainbridge, *Director Primacy*] (discussing two theories of shareholder primacy; under the first theory, shareholders ultimately control the corporation, and under the second, they are the actual owners of the corporation and both versions emphasize the monitoring role of the board).

23. *Id.* at 563–64 (2003) (noting that most corporate law scholars subscribe to the theory of shareholder primacy); Melvin A. Eisenberg, *The Conception that the Corporation Is a Nexus of Contracts, and the Dual Nature of the Firm*, 24 J. CORP. L. 819, 825–26 (1999) (noting that traditional indications of property ownership as well as societal convention justify calling shareholders owners, and managers something less); Joan MacLeod Heminway, *Enron's Tangled Web: Complex Relationships; Unanswered Questions*, 71 U. CIN. L. REV. 1167, 1173 (2003). The question of who benefits from the board's monitoring is the subject of scholarly disagreement. The traditional view focuses on maximizing shareholder value, whereas the alternative view suggests that the board's work should benefit multiple stakeholders. The origins of the debate over corporate social responsibility is traced back to a debate between Adolf A. Berle and E. Merrick Dodd, who are often credited as the earliest advocates their respective positions. *See* Adolf A. Berle, *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049, 1049 (1931); E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1147 (1932).

24. A related idea is that a public corporation should maximize shareholder wealth. Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919) ("A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end."); Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 248–49 (1999) (although Blair and Stout argue for a stakeholder norm, they note that the principal-agent model has inspired two recurring themes; one is reducing agency costs and the other is the shareholder wealth maximization norm for corporations); Milton Friedman, *The Social Responsibility of Business is to Increase Its Profits*, N.Y. TIMES MAG., Sept. 13, 1970, at 32, *available*

their return is less than it would have been had they been in direct control. To help reduce the agency costs associated with the separation of ownership and control, shareholders employ directors as the primary monitoring mechanism.[25] Agency theory, and its concomitant concern with reducing agency cost, thus emphasizes the board's monitoring function. The board is the primary means of reducing the agency costs associated with separation of ownership and control.[26] The tenets of agency theory have dominated corporate governance best practices, reforms, and scholarship, easily making it the prevailing theory in corporate governance scholarship, particularly in the legal academy.

Given this customary preoccupation with ensuring that agents act in the best interests of their principals, scholars and regulators routinely focus on reducing agency costs. For example, proponents of improving board efficacy have advocated numerous methods for improving monitoring typically considered the "minimal duty of every board."[27] Such methods attempt to align director and shareholder incentives by providing directors with equity stakes in the firm,[28] improving shareholders' access to the proxy ballot,[29] and eliminating CEO/chair duality.[30] Accordingly,

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at http://www.umich.edu/~thecore/doc/Friedman.pdf (arguing in favor of a strong shareholder wealth maximization norm).

25. For a definition of agency costs see Jensen & Meckling, *supra* note 5, at 310–11 (defining agency costs "as the sum of: (1) the monitoring expenditures by the principal; (2) the bonding expenditures by the agent; (3) the residual loss"). *See also* BERLE & MEANS, *supra* note 21.

26. Bainbridge, *Director Primacy*, *supra* note 22, at 599; Dallas, *Multiple Roles*, *supra* note 4, at 801; Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1278 (1999); Langevoort, *The Human Nature of Corporate Boards*, *supra* note 4, at 802; Mitchell, *supra* note 21.

27. COLIN B. CARTER & JAY W. LORSCH, BACK TO THE DRAWING BOARD 67–68 (2003). For a more detailed examination of the monitoring model of the corporate board, see Lynn A. Stout, *The Shareholder As Ulysses: Some Empirical Evidence on Why Investors in Public Corporations Tolerate Board Governance*, 152 U. PA. L. REV. 667, 673–77 (2003) and Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 11 (2002).

28. Bainbridge, *Director Primacy*, *supra* note 22, at 562 (identifying a trend in the 1980s and 1990s to align director and shareholder interests through director stock options); R. William Ide, *Post-Enron Corporate Governance Opportunities: Creating a Culture of Greater Board Collaboration and Oversight*, 54 MERCER L. REV. 829, 840–41 (2003). *See also generally* Charles M. Elson, *Director Compensation and the Management-Captured Board—The History of a Symptom and a Cure*, 50 SMU L. REV. 127 (1996) (suggesting that equity-based compensation for directors more closely aligns directors interests with the interests of shareholders).

29. The Securities and Exchange Commission's ("SEC's") failed attempt at increasing shareholder access to the proxy ballot would have been a significant change in corporate governance. Although the Dodd-Frank Act itself did not mandate the change, it authorized the SEC to do so. *See* James D. C. Barrall, *Dodd-Frank and the 2011 Proxy Season: SEC Adopts Final Proxy Access Rules*, L.A. & S.F. DAILY J., Aug. 31, 2010, at 1–3, *available at*

conventional wisdom posits that a board engaged in effective monitoring will reduce managerial shirking, opportunism, and other self-interested conduct, and will thereby decrease agency costs. By effectively monitoring, the board maximizes firm value and prevents instances of corporate failure.[31]

In its control role,[32] the board monitors and ratifies decisions, thereby

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http://www.lw.com/upload/pubContent/_pdf/pub3705_1.pdf ("Dodd-Frank does not mandate proxy access or establish conditions for shareholder access. Instead in Section 971, Dodd-Frank amends Section 14(a) of the Securities Exchange of 1934 to expressly authorize the SEC to adopt proxy access rules and to set the terms and conditions of shareholder access."). *See generally* U.S. SEC. & EXCHANGE COMM'N, S7-10-09, FACILITATING SHAREHOLDER DIRECTOR NOMINATIONS (Aug. 25, 2010), *available at* http://sec.gov/rules/final/2010/33-9136.pdf. *See also* Lucian Arye Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43, 63 (2003) (arguing that the best way to align director interest with shareholder interest is to allow shareholders to elect them); J.W. Verret, *Pandora's Ballot Box, or a Proxy with Moxie? Majority Voting, Corporate Ballot Access, and the Legend of Martin Lipton Re-Examined*, 62 BUS. LAW. 1007, 1037–38 (2007) (noting that access to the proxy ballot is important for the success of a shareholder voting initiative). *But see* Martin Lipton & Steven A. Rosenblum, *Election Contests in the Company's Proxy: An Idea Whose Time Has Not Come*, 59 BUS. LAW 67, 68 (2003) (presenting an argument against the calls for greater shareholder access to proxy documents). In July 2011, the D.C. Circuit Court of Appeals struck down the SEC's attempt at greater proxy access. In particular, the court criticized the SEC's reliance upon "insufficient empirical data" to support a conclusion that proxy access would "improve board performance." Business Roundtable v. SEC, 647 F. 3d 1144, 1150 (D.C. Cir. 2011).

30. It has long been thought that CEO/chairperson duality has distinct advantages. *See, e.g.*, Lucian A. Bebchuk, Martijn Cremers, & Urs Peyer, *CEO Centrality* 9 (Harvard L. Sch. John M. Olin Ctr. for Law, Econ. & Bus., Discussion Paper No. 601, 2007), *available at* http://www.law.harvard.edu/programs/olin_center/papers/pdf/Bebchuk_601.pdf (noting that some of the advantages of CEO/Chairperson duality are "clarity, steadiness, and reduction in the cost of decision-making"); Brian K. Boyd, *CEO Duality and Firm Performance: A Contingency Model*, 16 STRATEGIC MGMT. J. 301, 301 (1995) (acknowledging that the CEO would be in a unique position to understand the state of the company and the industry). Recent reforms, however, have noted some disadvantages to duality and called for its elimination. *See, e.g.*, Ram Baliga, R. Charles Moyer & Ramesh S. Rao, *CEO Duality and Firm Performance: What's the Fuss?*, 17 STRATEGIC MGMT. J. 41, 42 (1996) (noting that a board with a chairman who is not also the CEO may be able to perform its monitoring function better); Wm. Gerard Sanders & Mason A. Carpenter, *Internationalization and Firm Governance: The Roles of CEO Compensation, Top Team Composition, and Board Structure*, 41 ACAD. MGMT. J. 158, 164 (1998) (arguing that the larger and more diversified a firm is, the more it can benefit from having an additional information conduit in the form of separate CEO and Chairperson).

31. Cox, *supra* note 21, at 1082. *See also* Paul E. Juras & Yvonne. L. Hinson, *Examining the Effect of Board Characteristics on Agency Costs and Selected Performance Measures in Banks*, 7 ACAD. BANKING STUD. J. 87, 89 (2008); Langevoort, *The Human Nature of Corporate Boards*, *supra* note 4, at 802; Jensen & Meckling, *supra* note 5, at 308–09.

32. Board approval in this context is part of what is often thought of as the board's control function, which is synonymous with its monitoring function. Substantial research has been devoted to analyzing whether the board actually exerts control over management's decisions. The general consensus is that boards do not exercise this control well. *See* Edward S. Adams, *Corporate Governance After Enron and Global Crossing: Comparative Lessons for Cross-National Improvement*, 78 IND. L.J. 723, 729–30 (2003) (noting that although boards are theoretically supposed to represent shareholders' interests, the various complexities of corporate governance, including the relationship

retaining decisional control over the corporation on behalf of the owners.[33] The board monitors managers through hiring and firing, setting compensation for executive managers (like the CEO), and by approving major decisions, such as mergers and acquisitions.[34] When managers propose to engage in self-interested transactions, such as engaging in business with the corporation on behalf of both the corporation and themselves, the board is empowered under Delaware corporate law to cleanse such transactions. This ensures shareholder interests are protected.[35] Additionally, the board usually approves financial statements and disclosures,[36] which Donald Langevoort notes are "the mechanisms by which investors and other stakeholders are able to make assessments about the performance of the company and its management."[37]

B. CURRENT BOARD REFORMS

As is evident from the foregoing discussion, much of the conversation

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between the board and management, creates a gulf between theory and practice); Richard Saliterman, *Perceptions Bearing on the Public Policy Dynamics of Corporation Law*, 20 HAMLINE L. REV. 261, 261 (1996).

33. Eugene F. Fama & Michael C. Jensen, *The Separation of Ownership and Control*, 26 J.L. & ECON. 301, 307–08 (1983); Forbes & Milliken, *supra* note 11, at 492.

34. SYDNEY FINKELSTEIN, DONALD C. HAMBRICK & ALBERT A. CANNELLA JR., STRATEGIC LEADERSHIP: THEORY AND RESEARCH ON EXECUTIVES, TOP MANAGEMENT TEAMS, AND BOARDS 227 (2009); Fama & Jensen, *supra* note 33, at 311; Langevoort, *The Human Nature of Corporate Boards*, *supra* note 4, at 801–02; Petrovic, *supra* note 13, at 1375. *See also* DEL. CODE ANN. tit. 8, § 251(b) (2001) ("The board of directors of each corporation which desires to merge or consolidate shall adopt a resolution approving an agreement of merger or consolidation and declaring its advisability."); *id.* § 141(a) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.").

35. *Id.* § 144.

36. For example, the SEC requires that the principal executive and financial officer, or persons performing similar functions, of each company filing periodic reports, make several certifications. The signing officers must certify that they have reviewed the report. In addition, the officers must certify that the report does not contain any untrue statement of material fact or omit to state a material fact necessary in order to ensure that the statements made, given the circumstances, are not misleading. Furthermore, the signing officers must certify that "based on such officer's knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer as of, and for, the periods contained in the report." 15 U.S.C. § 7241(a) (2006). Additionally, officers and directors can be liable for their improper influence on the conduct of company audits. *Id*. § 7242(a) (stating that it is unlawful for any officer or director of an issuer, or any person acting under their direction, "to fraudulently coerce, manipulate, influence, or mislead any independent public or certified accountant" performing an audit of the financial statements of that issuer, if the purpose of the officer or director's action is to render the financial statements materially misleading).

37. Langevoort, *The Human Nature of Corporate Boards*, *supra* note 4, at 802.

on board reform has assumed the primacy of reducing agency costs and, as a consequence, has been limited to the board's monitoring role. Following suit, policymakers for decades have focused their corporate governance reform efforts on improving corporate boards, which they hope will reduce agency costs and lead to improved board function.[38] Current reforms to the board can be grouped into three categories. The first are compositional reforms, such as stricter definitions and standards for what constitutes independence. The second are structural reforms, such as the development of independent committees tasked with overseeing the CEO or reducing the CEO's influence over certain types of important decisions, like the nomination of new directors and executive management. The third type of reform improves directors' incentives through either tightening legal liability for breaching fiduciary duties, or increasing equity-based compensation in an attempt to align directors' incentives with shareholders' incentives.[39]

The most marked change in the composition and structure of the typical board of directors has been the increased number of outside, independent directors.[40] The listing standards for the New York Stock Exchange ("NYSE") and National Association of Securities Dealers Automated Quotations ("NASDAQ") require all publicly traded corporations to have three committees—audit, compensation, and nomination/corporate governance—exclusively staffed by independent directors.[41] Prior to the collapse of the Penn Central Railroad in 1970,[42] the

38. Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 873 (1991); Mitchell, *supra* note 21, at 1315.

39. *See In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 968–70 (Del. Ch. 1996) (discussing how seriously Delaware courts were taking director liability, especially since *Smith v. Van Gorkom*); Jill E. Fisch & Caroline M. Gentile, *The Qualified Legal Compliance Committee: Using the Attorney Conduct Rules to Restructure the Board of Directors*, 53 DUKE L.J. 517, 567–74 (2003) (arguing that strengthening director liability best ensures directors will adequately monitor management); *supra* note 28 and accompanying text.

40. 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, 102 (1985) (noting that corporate board reform proposals emphasize changes to board composition and independence); Lisa M. Fairfax, *The Uneasy Case for the Inside Director*, 96 IOWA L. REV. 127, 138 (2010) [hereinafter Fairfax, *Uneasy Case*] (writing that increasing director independence has been "the principle corporate-governance response to the agency problem"); Ribstein, *supra* note 27. Improving independence is not the only response to corporate failure. *See* Ribstein, *supra* note 27, at 11–18 (describing other regulatory responses to corporate fraud); Usha Rodrigues, *The Fetishization of Independence*, 33 J. CORP. L. 447, 452 (2008) ("Corporate governance reforms generally presume (1) that outside independent boards are better than non-independent boards, and (2) that the more independent a board is, the better.").

41. *See* discussion *infra* notes 46–58 and accompanying text.

42. *The Biggest Bankruptcy Ever*, TIME, July 6, 1970, *available at* http://www.time.com/time/

corporate board was viewed more as a subset of management than as a monitoring tool of shareholders.[43] Thus, the board was unable to properly perform the function of monitoring managers on behalf of shareholders. In order to create a more optimal monitoring regime, policymakers pushed corporations to install independent directors. These independent directors would be elected by shareholders and therefore were not beholden to the CEO. The animating theory was that independent directors' incentives would be more closely aligned with shareholders' incentives, which would lead the board to keep a closer eye on executive management, and ensure that shareholder value was maximized.

The scandals that plagued the start of the new millennium were followed by legislative efforts that sought to restore the public's trust in corporations through changing the corporate board in order to improve its monitoring ability.[44] One of the most highly publicized attempts was the Sarbanes-Oxley Act of 2002 ("SOX").[45] Through invoking the Securities and Exchange Commission's ("SEC's") rule making authority, SOX required self-regulatory organizations ("SROs") like the NYSE and NASDAQ to adopt mandatory listing standards.[46] The standards were directed at ensuring director independence by altering the composition and structure of listed companies' boards.[47] Consequently, listed companies

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magazine/article/0,9171,878372,00.html. For a history of the rise of the monitoring board, including the significance of the Penn Central Railroad collapse, see Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1515–19 (2007). Gordon writes that Penn Central's directors were not aware of the financial problems that led to the company failing. *Id.* at 1515. For instance, "in the two years before the collapse, the board [] approved over $100 million in dividends . . . . [The directors] . . . had been neither advisors nor monitors, but figureheads." *Id.* The failure of the "advising board model" was instrumental in the development of the monitoring model of the board. *Id.* at 1518.

43. Daniel J. Schwartz, *Penn Central: A Case Study of Outside Director Responsibility Under the Federal Securities Laws*, 45 UMKC L. REV. 394, 396–97 (1977).

44. *See, e.g.*, Charles M. Elson & Christopher J. Gyves, *The Enron Failure and Corporate Governance Reform*, 38 WAKE FOREST L. REV. 855, 855–56 (2003) (observing that the corporate scandals of 2002 and the failure of their boards to properly monitor management resulted in a "dramatic change in approach to corporate board composition, conduct, and responsibility . . . at the legal and regulatory levels").

45. Sarbanes-Oxley Act of 2002, Pub. L. 107-204, 116 Stat. 745.

46. *See* Order Approving Proposed Rule Changes Relating to Corporate Governance, Exchange Act Release No. 34-48745, 68 Fed. Reg. 64,154, 64,175 (Nov. 12, 2003). For a discussion of how SOX and the listing exchanges emphasize director independence, see Rodrigues, *supra* note 40, at 452–55.

47. *See* Proposed Rule Changes, 68 Fed. Reg. at 64,156–61 (page references are to the NYSE changes; the NASDAQ changes described at 68 Fed. Reg. at 64,161–66 mirror those of the NYSE). *See also* NASDAQ, INC., STOCK MARKET RULES, RULE IM-5605 (2009), *available at* http://nasdaq.cchwallstreet. com; NYSE, INC., LISTED COMPANY MANUAL §§ 303A.01 & 303A.02 (2011), *available at* http://nysemanual.nyse.com/lcm/.

were required to have majority independent boards that followed a stricter definition of "independence."[48] The rules also required nonmanagement directors to meet without management in regularly held executive sessions.[49] Additional changes mandated that only independent directors could sit on the three major board committees—nominating/corporate governance, compensation, and audit.[50] The structural reforms reflect conventional wisdom that director independence, especially at the audit committee level, would reduce executive mismanagement, and decrease the likelihood of future corporate failure.[51]

SOX also has provisions, such as Section 404, which not only provide for a duty to monitor, but mandate that boards meet the duty through internal controls.[52] For instance, annual reports required by 15 U.S.C. § 78m(a) or 15 U.S.C. § 78o(d) must: "(1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and (2) contain an assessment . . . of the effectiveness of the internal control structure and procedures . . . for financial reporting."[53]

Following the same policymaking template as the listing exchange requirements and other SOX-initiated reforms, the Dodd-Frank Act ("the Act") sets forth a series of regulations geared toward altering the composition and structure of the board.[54] Specifically, Section 10C

48. This Article generally defines an independent director as an outside director without affiliations to the corporation, such as former officers of the corporation or relatives of the corporation's officers. Langevoort, *The Human Nature of Corporate Boards*, *supra* note 4, at 801; Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921, 923 (1999) [hereinafter Bhagat & Black, *Uncertain Relationship*]. *See also* Proposed Rule Changes, 68 Fed. Reg. at 64,157. In securities law and corporate law, the definition of "independent director" varies. *See* Fairfax, *Uneasy Case*, *supra* note 40, at 133. For various definitions of independence, see Sarbanes-Oxley Act of 2002, 15 U.S.C. § 78j-1(m)(3)(B) (2006) (of the definition of "independent director" excludes anyone who the corporation compensates); NYSE, INC., *supra* note 46, § 303A.02(b)(ii); NASDAQ, INC., *supra* note 47, RULE IM-5605(a)(B); Nicola Sharpe, *The Cosmetic Independence of Corporate Boards*, 34 SEATTLE U. L. REV. 1435, 1438 n.10 (2011) [hereinafter Sharpe, *Cosmetic Independence*].

49. Proposed Rule Changes, 68 Fed. Reg. at 64,158 (one example of an arguably procedural change is the requirement that certain decision be made by only independent directors and that the independent directors hold an executive session); NYSE, INC., *supra* note 47, § 303A.0.3.

50. Proposed Rule Changes, 68 Fed. Reg. at 64,158–59.

51. *See* U.S. SEC. & EXCHANGE COMM'N, S7-02-03, STANDARDS RELATING TO LISTED COMPANY AUDIT COMMITTEES 1 (Apr. 10, 2003), http://www.sec.gov/rules/final/33-8220.htm.

52. *See* Sarbanes-Oxley Act of 2002 § 404, 15 U.S.C. § 7262 (2006).

53. *Id*. *See also* 15 U.S.C. §§ 78m(a), 78o(d).

54. This Article does not attempt to provide a complete account of the Dodd-Frank Act's corporate governance changes. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 111(a), 124 Stat. 1376, 1392–94 (2010) [hereinafter Dodd-Frank Act] (to be codified

emphasizes both the compositional and structural value of an independent compensation committee through prohibiting the exchanges from listing companies that do not have independent compensation committees.[55] In addition, the Act focuses on composition in a provision designed to increase shareholder access to the proxy ballot in order to ensure that a direct shareholder appointee has the opportunity to sit for election.[56] The Act also changes the rules governing the disclosure of CEO/Chairperson duality.[57] In accordance with SEC rule making, a corporation will have to disclose why it either combines or separates the offices of board chairperson and CEO in its annual proxy statement.[58] Although this is only a disclosure requirement (it does not require nor proscribe combinations or separations), it further illustrates that Congress viewed board structure as a critical component in preventing another financial crisis.

Publicly traded bank holding companies, and "certain systemically important publicly traded financial companies"[59] with ten billion dollars or more in assets, face a more direct structural change.[60] Specifically, Section 165(h)(2)(A) states that covered banks must establish an internal risk

at 12 U.S.C. § 5321) (establishing the Financial Stability Oversight Council); § 152(a), 124 Stat. at 1413 (to be codified at 12 U.S.C. § 5342) (establishing the Office of Financial Research); § 204, 124 Stat. at 1454–56 (to be codified at 12 U.S.C. § 5384) (outlining the process for the Orderly Liquidation of Covered Financial Companies); § 1011(a), 124 Stat. at 1964–65 (to be codified at 12 U.S.C. § 5491) (establishing the Bureau of Consumer Financial Protection). Immediately following the crisis, the federal government bailed out over six hundred companies, and either selected the new board members of the company or used government trustees as board members. *See, e.g.*, Nicola Sharpe, *Rethinking Board Function in the Wake of the 2008 Financial Crisis*, 5 J. BUS. & TECH. L. 99, 102–08 (2010) (examining governmental involvement in the board of directors as a response to the 2008 financial crisis).

55. Dodd-Frank Act, § 10C, 124 Stat. at 1900–03.

56. Pursuant to the Dodd-Frank Act, the SEC adopted New Exchange Act Rule 14a-11 which provides shareholders with access to the proxy ballot. The rule mandates that shareholders who own at least 3 percent of a company's stock for three years are entitled to nominate a candidate for a directorship and have their nomination included in the company's proxy materials. *See* Facilitating Shareholder Director Nominations, Exchange Act Release Nos. 33-9136, 34-62764, 35–-37, 73 (Aug. 25, 2010), *available at* http://sec.gov/rules/final/2010/33-9136.pdf. There is a process element to this change, the process by which directors are nominated; this Article, however, focuses on improving the process of board monitoring. *See generally* U.S. SEC. & EXCHANGE COMM'N, S7-10-09, FACILITATING SHAREHOLDER DIRECTOR NOMINATIONS (2010), *available at* http://sec.gov/rules/final/ 2010/33-9136.pdf. The SEC's proxy access rule was overturned by the D.C. Circuit. *See supra* note 29.

57. Dodd-Frank Act, sec. 972, § 14B, 124 Stat. at 1915 (to be codified at 15 U.S.C. § 78n–2).

58. *Id.*

59. Robert T. Miller, *Oversight Liability for Risk-Management Failures at Financial Firms*, 84 S. CAL. L. REV. 47, 53 (2010); Wulf A. Kaal & Richard W. Painter, *Initial Reflections on an Evolving Standard: Constraints on Risk Taking By Directors and Officers in Germany and the United States*, 40 SETON HALL L. REV. 1433, 1483–84 (2010).

60. *See* Dodd-Frank Act § 165(h), 124 Stat. at 1429–30 (to be codified at 12 U.S.C. § 5365).

committee.[61] Moreover, the Board of Governors may require publicly traded bank holding companies with consolidated assets equaling less than ten billion dollars to establish an internal risk committee.[62] Such risk committees must "include at least 1 risk management expert having experience in identifying, assessing, and managing risk exposure of large, complex firms."[63] These committees are yet another example of legislative efforts at structural reform that fail to address the processual weaknesses inherent in conventional board structure.

In contrast to policymaking efforts focused primarily on changing composition and structure, Delaware courts have identified decisionmaking, and more importantly, the processes that inform the board's decisions as the core of the board's monitoring function. It is well established Delaware law that under the business judgment rule directors have a duty to inform themselves of "all material information reasonably available to them," and that whether directors have fulfilled their duty is measured by gross negligence.[64] In *Smith v. Van Gorkom*, the Delaware Supreme Court found that the decision of Trans Union's board to sell the company to Marmon Group, based entirely on Trans Union's CEO Jerome Van Gorkom's twenty-minute oral presentation and his understanding of the merger agreement (which he had never read and the board had not seen) was not an informed business judgment.[65] The court determined that the decision was a breach of the directors' fiduciary duties to the shareholders, in part due to their failure to "inform themselves of all information reasonably available to them."[66]

Despite the board's lack of process in *Van Gorkom*, the word "process" is used only once, in reference to a determination of whether the trial court's decision was "the product of an orderly and logical deductive process."[67] Although the Delaware courts have mentioned, and have even been critical of certain board processes, they have yet to provide detailed guidance on what constitutes an effective process.[68] The court held that

61. *Id.* § 165(h)(2)(A).

62. *Id.* § 165(h)(2)(B).

63. *Id.* § 165(h)(3)(C). The Act also requires all publicly traded nonbank financial companies supervised by the Board of Governors to establish a risk committee. *Id.* § 165(h)(1).

64. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984). *See also In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 122 (Del. Ch. 2009).

65. Smith v. Van Gorkom, 488 A.2d 858, 874, 878 (Del. 1985).

66. *Id*. at 893.

67. *Id*. at 871 (quoting Levitt v. Bouvier, 287 A.2d 671, 673 (Del. 1972)).

68. It is difficult to identify a process that will work for all companies, as each business is unique. Elements of an effective process, however, are generalizable and can be beneficial to many

"we do not suggest that a board must read . . . every contract or legal document which it approves, but . . . there must be some credible contemporary evidence demonstrating that the directors knew what they were doing."[69]

Since *Van Gorkom*, a series of cases have made it clear that inherent in the duty of care is an assumption that boards must follow an adequate process in making their decision.[70] Most notable is the *In re Caremark International Inc.* decision.[71] The Delaware Court of Chancery noted that "relevant and timely *information* is an essential predicate for satisfaction of the board's supervisory and monitoring role under Section 141 of the Delaware General Corporation Law."[72] More importantly, the court noted that evaluating whether a board's decision complied with the fiduciary duty of care must be done in the context of the process the board employed.[73] *In re Caremark* arguably sets forth an affirmative monitoring obligation for directors, and is the considered the basis for the board's good faith obligation to monitor the corporation.[74]

The good faith aspect of the obligation has been pivotal in subsequent decisions like in *In re Citigroup Inc.*[75] Here, the court once again emphasized the "rational process" and "all material information reasonably available" standard articulated in *Aronson v. Lewis*.[76] The court held that "a showing of bad faith is a *necessary condition* to director oversight liability."[77] Although the guidance from Delaware courts focuses on how directors can avoid liability through "good faith *or* rationality of the process,"[78] this Article assumes that by utilizing sound decision-making processes, boards can do more than simply avoid liability: they can add

corporations. *See* discussion *infra* Part IV.B.

69. *Van Gorkom*, 488 A.2d at 883 n.25.

70. *See, e.g.*, Cede & Co. v. Technicolor, Inc., 634 A.2d 345 (Del. 1993) (finding that the defendant directors breached their duty of care by reaching an uninformed decision to approve the sale of the company for a per-share sale price of twenty-three dollars). Directors "have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them. Having become so informed, they must *then* act with requisite care in the discharge of their duties." *Id.* at 367 (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)) (emphasis added).

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

72. *Id*. at 970.

73. *Id*. at 967.

74. Melvin A. Eisenberg, *The Duty of Good Faith in Corporate Law*, 31 DEL. J. CORP. L. 1, 62–63 (2006); Hillary A. Sale, *Monitoring* Caremark*'s Good Faith*, 32 DEL. J. CORP. L. 719, 720 (2007).

75. *In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106 (Del. Ch. 2009).

76. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

77. *In re Citigroup*, 964 A.2d at 123.

78. *Id*. at 122.

value to the firm.

C. PROBLEMS WITH THE CONVENTIONAL APPROACH TO BOARD REFORM

The reforms described above have not led to, and likely will not lead to, better firm performance. Companies have continued to fail despite the ubiquity of the majority independent board and related committee structures. Before the 2008 financial crisis, companies in the Fortune 1000 had supermajority independent boards.[79] Contrast this to the board of a company in 1950, where less than 25 percent of seats on a board belonged to nonaffiliated, independent directors.[80] Despite ubiquitous director independence and committee structure, many firms still have boards that suffer from short-sightedness, lack of oversight, and internal dysfunction.

Empirical research has cast doubt on the efficacy of majority independent boards.[81] A meta-analysis by Sanjai Bhagat and Bernard Black considered numerous such studies and found no significant correlation between boards composed of a majority of independent directors and firm performance.[82] Another study conducted by Bhagat and Black tested several indicators of firm performance, including accounting performance (short- and long-term),[83] Tobin's q,[84] and long-term stock market

79. KORN/FERRY INST., 34TH ANNUAL BOARD OF DIRECTORS STUDY, APP. A at 17 (2008) (finding that the average company had two inside directors and seven outside directors); Sydney Finkelstein & Ann C. Mooney, *Not the Usual Suspects: How to Use Board Process to Make Boards Better*, 17 ACAD. MGMT. 101, 101 (2003) (stating the average board of the S&P 500 is more than 75 percent independent).

80. Gordon, *supra* note 42, at 1474.

81. Michael K. Bednar & James D. Westphal, *Pluralistic Ignorance in Corporate Boards and Firms' Strategic Persistence in Response to Low Firm Performance*, 50 ADMIN. SCI. Q. 262, 263 (2005) (noting that boards are poor monitors "regardless of the number of outside directors."); Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231, 231 (2002) [hereinafter Bhagat & Black, *Non-Correlation*] ("Firms with more independent boards do not perform better than other firms"). *See also* Bhagat & Black, *Uncertain Relationship*, *supra* note 48, at 922 (their research shows that board composition and overall firm performance were not correlated and that "[i]ndependent directors often turn out to be lapdogs rather than watchdogs"); Dan R. Dalton et al., *Meta-Analytic Reviews of Board Composition, Leadership Structure, and Financial Performance*, 19 STRATEGIC MGMT. J. 269, 278 (1998) (findings did not support a systemic relationship between a firm's financial performance and the composition of the board); Finkelstein & Mooney, *supra* note 79, at 102 (studying the relationship of several indicia of board independence to shareholder returns and finding that there was "no significant differences in the number of outsiders, director shareholdings, board size, and CEO duality" between the firms that performed in the upper quartile of the S&P 500 and those that performed in the lower quartile). *See generally* John A. Wagner III, J. L. Stimpert & Edward I. Fubara, *Board Composition and Organizational Performance: Two Studies of Insider/Outsider Effects*, 35 J. MGMT. STUDIES 655, 655 (1998).

82. Bhagat & Black, *Uncertain Relationship*, *supra* note 48, at 922.

83. Bhagat & Black, *Non-Correlation*, *supra* note 81, at 242.

performance.[85] Using simultaneous-equation methods as a means of correcting for the endogenous nature of boards, their study still yielded no noticeable correlations.[86] Several other studies support these conclusions.[87] Benjamin Hermalin and Michael Weisbach failed to find a significant correlation between board composition and firm performance.[88] Going beyond board composition, Sydney Finkelstein and Ann Mooney studied the relationship of several indicia of board independence to shareholder returns and found that there was "no significant difference in the number of outsiders, director shareholdings, board size, and CEO duality" between the firms that performed in the upper quartile of the S&P 500 and those that performed in the lower quartile.[89] Other studies have found that board composition had "virtually no effect on firm performance."[90] Additionally, that study showed that the practice of a firm's CEO simultaneously serving as the chairperson of the board had no relationship to firm performance.[91]

Consistent with these empirical conclusions, the firms that were prominently featured in the scandals at the start of the century all had boards that followed structural and compositional best practices.[92] Enron Corp., Global Crossing, Ltd., Tyco International, Ltd, Qwest Communications International, Inc., and WorldCom Inc., each had boards that were composed of a majority of independent, outside directors.[93] Enron boasted a board comprised of 86 percent outside directors.[94] With the exception of Tyco, the boards of these companies had also separated the

84. *Id.* at 242 (defining Tobin's q as the ratio of the market value of a firm's assets to thereplacement value of its assets. A high Tobin's q ratio suggests good management, as managers have achieved greater value from the same underlying assets.).

85. *Id*. at 242.

86. *Id.* at 248–49.

87. Benjamin E. Hermalin & Michael S. Weisbach, *The Effects of Board Composition and Direct Incentives on Firm Performance*, 20 FIN. MGMT. 101, 111 (1991) (stating there does not appear to be a relationship between board composition and profitability as measured by Tobin's q even if board composition is treated as endogenous).

88. *Id.* at 101–12.

89. Finkelstein & Mooney, *supra* note 79, at 102.

90. Dalton et al., *supra* note 81, at 272, 278, 280. The meta-analysis considered whether firm size, the type of financial performance indicator (accounting measures or stock market performance), or different ways of defining board composition, would show a meaningful relationship between either composition or leadership structure and firm performance. It did not.

91. *Id.* at 280.

92. Finkelstein & Mooney, *supra* note 79, at 102–03.

93. *Id*. Some scholars have argued that the directors of these scandal ridden companies had not achieved "true" independence. Rodrigues, *supra* note 46, at 463.

94. Finkelstein & Mooney, *supra* note 79, at 103.

role of CEO and chairperson.[95] Equity-based compensation was a component of almost every director's remuneration.[96] Additionally, all five companies had independent nominating/corporate governance,[97] compensation,[98] and audit committees in the years preceding their respective public scandals.[99]

These illustrations provide an instructive example of theory disconnected from practice. While reforms have changed the composition of directors by tweaking the indicia of independence, they do not facilitate board processes suited to producing independent decisions and advice. For example, Tyco's failure can be understood in terms of a captured board that failed to reign in a rogue CEO and his entrenched team of directors and managers, all of whom engaged in self-serving conduct at the expense of the company's welfare. This is consistent with the paradigmatic agency cost of shirking agents who are improperly monitored and incorrectly incentivized. In other words, a legitimate criticism of the Tyco board was that it was not independent, despite the fact that 73 percent of its directors met the definition of independence set forth in the NYSE listing standards.[100] Numerous facts support the conclusion that Tyco's board did not have true, substantive independence.

Tyco's board did nothing to end CEO Dennis Kozlowski's liberal accounting practices.[101] Though the board was clearly aware of Tyco's profligate executive loan program, it did little to inform itself of the terms of those loans or determine whether they were ever repaid.[102] This (perhaps willful) ignorance, when combined with the fact that the company's internal auditors reported directly to Kozlowski and not to the board, should have prompted independent board members to ask difficult and probing questions. Many of these directors, however, had served on the board for over ten years, and professed faith in Kozlowski's honesty.[103]

95. *Id.*

96. *Id.*

97. Tyco Int'l Ltd., Proxy Statement (DEF 14A) 4–6 (Jan. 29, 2001).

98. *Id*. at 19.

99. *Id*. at 12.

100. *See* Tyco Int'l Ltd., Proxy Statement (DEF 14A) 4–6 (Jan. 28, 2002).

101. Rakesh Khurana & James Weber, *Tyco International: Corporate Governance*, HARV. BUS. SCH. CASE NO. 9-408-059 (Mar. 6, 2008).

102. William C. Symonds, *Commentary: Tyco: How Did They Miss a Scam So Big?*, BLOOMBERG BUS. WK., Sept. 30, 2002, *available at* http://www.businessweek.com/magazine/content/02_39/b3801057.htm.

103. Three-quarters of the directors had served for more ten years. Mark Maremont, *In Plain Sight—Kozlowski's Defense Strategy: Big Spending Was No Secret; His Lawyers Try to Show Evidence Doesn't Prove Criminal Intent by CEO; Prosecutors Detail Tyco's Tab*, WALL ST. J., Feb. 9, 2004, at

Tyco's board was generally aware of some of Kozlowski's activities such as his acquisition strategy and accounting practices.[104] The directors, however, did not have or seek any independent verification of the soundness or legality of those practices. In sum, the Tyco board lacked an independent information-gathering process, and therefore was limited in its ability to effectively monitor Kozlowski's conduct.

Tyco quickly moved to restructure its board in the wake of the disaster that Kozlowski and chief financial officer ("CFO") Mark Swartz visited upon the company. Its first step was to replace the entire board, and to establish new criteria for board appointments. Many of these replacement criteria went beyond mere monitoring; they reflected a particular notion of the board's purpose within the company and the skill set a board member would need to prevent future monitoring failures. For instance, Jack Krol, Tyco's lead director on the post-Kozlowski board, and Eric Pillmore, senior vice president of corporate governance,[105] instituted changes designed to give the board access to the information it had previously lacked, so that it could better assess the activities of management.[106] Specifically, Tyco created the position of a corporate ombudsman and a corporate audit vice-president.[107] These solutions were intended to place independent voices in the ranks of company management and to provide a mechanism through which those independent managers could freely share information with board members. It was believed that these process-oriented reforms—independent information-gathering mechanisms, unmediated information-sharing, and integrated activity among top-level managers and board members—were necessary to help the company move past its failed reliance on monitors that merely met the regulatory definition of independence. Edward Breen, the CEO who followed Kozlowski, along with Eric Pillmore, are considered leaders for their transformative work in the corporate governance arena.[108] With strong post-scandal governance,

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104. *Id*.

105. The position of vice president of corporate governance was also created post-Kozlowski under the new CEO, Edward Breen.

106. Khurana & Weber *supra* note 101, at 11.

107. *Id*. *See also* Lynne L. Dallas, *Proposals for Reform of Corporate Boards of Directors: The Dual Board and Board Ombudsperson*, 54 WASH. & LEE L. REV. 91, 130–36 (1997) (explaining the functions, qualifications, and benefits of an ombudsmen).

108. Tyco, along with Pillmore, has received praise for its transformative work in the corporate governance area. The company was since recognized by GovernanceMetrics International "as the most improved U.S. company in the governance area from 2002–2005." Press Release, Deloitte, Former Tyco International Corporate Governance Executive Eric Pillmore Joins Deloitte's Center for Corporate

the company has boasted above average stock performance, outperforming the S&P 500.[109]

Many of the players in the 2008 financial crisis mirrored pre-scandal Tyco by adhering to best practices in terms of board composition and board structure, but in reality were doing little to facilitate the type of decision-making processes that allow boards to effectively monitor management. Each of the publicly traded financial companies was SOX compliant.[110] Each had majority independent boards whose major committees were independent.[111] For example, American International Group's board was 81 percent independent.[112] Similarly, General Motors had only one inside director, its CEO, G. Richard Wagoner, Jr.[113] Neither company's 2007 SEC filings showed that the auditors had identified any material weaknesses.[114] Despite their independent structures, the boards of these companies were ineffective, as were the reforms that structured them.[115]

D. LIMITATIONS ON BOARD INDEPENDENCE[116]

In addition to the empirical evidence and anecdotal accounts, scholars have criticized the effectiveness of independent directors on theoretical grounds. One of the most famous criticisms of outside directors was levied

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Governance (Feb 11, 2011), *available at* http://www.prnewswire.com/news-releases/former-tyco-international-corporate-governance-executive-eric-pillmore-joins-deloittes-center-for-corporate-governance-115920784.html.

109. Thomas Black, *Tyco Rises to Two-Week High After Profit Exceeds Estimates*, BLOOMBERG BUS. WK. (Nov. 16, 2011, 5:40 PM), http://www.businessweek.com/news/2011-11-16/tyco-rises-to-two-week-high-after-profit-exceeds-estimates.html. As of January 13, 2012, the consensus recommendation from the *Financial Times*, which polled eighteen investment analysts who cover Tyco, stated "that the company will outperform the market. This has been the consensus forecast since the sentiment of investment analysts improved on Feb 18, 2009." TYCO INTERNATIONAL LTD., FT.COM/MARKETSDATA, http://markets.ft.com/research/Markets/Tearsheets/Forecasts?s=TYC:NYQ (last visited Jan. 13, 2012).

110. Pozen, *supra* note 2, at 2.

111. *Id*.

112. Am. Int'l Grp., Proxy Statement (June 5, 2009), *available at* http://phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9Nzk4MHxDaGlsZElEPS0xfFR5cGU9Mw==&t=1; Am. Int'l Grp., Proxy Statement (Apr. 4, 2008), *available at* http://www.ezodproxy.com/AIG/2008/Proxy2008/images/AIG_Proxy2008.pdf.

113. Gen. Motors Corp., Annual (Form 10-K) (Mar. 4, 2009), *available at* http://www.sec.gov/Archives/edgar/data/40730/000119312509045144/d10k.htm.

114. Pozen, *supra* note 2, at 2.

115. *Id.*

116. This section draws heavily from the arguments I made in *The Cosmetic Independence of Corporate Boards*, which discussed the impediments to substantive director independence. Sharpe, *Cosmetic Independence*, *supra* note 48, at 1447–52 (discussing psychological, structural, and practical limitations on board independence).

by Myles Mace, in his 1971 book *Directors: Myth and Reality*.[117] Mace's findings and concerns mirror our modern criticisms.[118] Mace argued that outside directors have only nominal involvement in the companies on whose boards they sat.[119] Like their counterparts forty years later, the directors Mace studied had full-time jobs elsewhere and as a result, did not have the time to develop any "perceptive or meaningful understanding" of the challenges facing the corporation.[120]

Furthermore, the directors, who were thought of in terms that included "sympathetic with management," were not expected to make a substantive contribution to the company.[121] Instead, they were nominated because of the prestige value they added.[122] The limited impact of outside directors was compounded by the power allocation within most corporations, which resided with the president and CEO.[123] As a result, Mace was skeptical as to whether outside directors would or could meaningfully discipline managers.[124] Mace's concerns have found support with many scholars in the decades since.[125]

Concerns regarding director independence are not limited to compositional and structural questions. Directors, who meet the cosmetic definition of independence found in the listing standards, may still lack substantive independence from the CEO for numerous other reasons, which may include psychological and practical constraints.[126]

1. Psychological Limitations on Board Independence

117. MYLES MACE, DIRECTORS: MYTH AND REALITY 106–07 (1971).

118. For a discussion of modern criticisms, see *infra* notes 127–57.

119. MACE, *supra* note 117, at 109.

120. *Id.* at 107, 109.

121. *Id.*

122. *Id.* at 107.

123. *Id.* at 108.

124. *Id.*

125. *See, e.g.*, JAY W. LORSCH WITH ELIZABETH MACIVER, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS 92–95 (1989) (arguing that independent directors were more accurately labeled pawns rather than potentates); Stephen M. Bainbridge, *Independent Directors and the ALI Corporate Governance Project*, 61 GEO. WASH. L. REV. 1034, 1058–59 (1993) [hereinafter Bainbridge, *ALI Corporate Governance*]; Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 611–21 (1982); Fairfax, *Uneasy Case*, *supra* note 40, at 137–38 (arguing that increasing the number of independent directors on the board may not produce the desired outcomes because their ability to monitor managers is limited); Ribstein, *supra* note 27, at 26 (discussing the "inherent limitations on independent directors' effectiveness" and noting that "board independence has done little to prevent past mismanagement and fraud"); Rodrigues, *supra* note 46, at 461.

126. Sharpe, *Cosmetic Independence*, *supra* note 48, at 1435–37.

The relationships among board members and those between the board and management produce multiple biases that reduce the degree of the board's actual independence. These psychological limitations can stem from boardroom dynamics, such as structural bias or groupthink, or interactions between the CEO and the board.[127]

Structural bias is a form of ingroup bias where members of the "ingroup" (the board of directors) are favorably disposed toward each other and management.[128] Because directors identify more closely with other directors and managers, they prefer director and management interests over those of shareholders.[129] Another concern is that close friendship ties among board members will result in directors valuing preserving this collegial relationship at the expense of optimal decisionmaking. Structural bias makes it difficult or even impossible for directors to be impartial, and thus inhibits a director's ability to critically assess or evaluate a CEO and her decisions.[130] It reduces the likelihood that directors will support or voice opinions that oppose the majority position and ultimately constrains the board's ability to make independent decisions.[131]

Groupthink, another form of ingroup bias, also frustrates independent decisionmaking. It most often occurs in situations in which there is a highly cohesive group engaged in consensus decisionmaking.[132] A director's independence, and the likelihood that she will be willing to criticize the

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127. Structural bias has been most often discussed in the context of special litigation committees, which are used to terminate derivative suits. *See* Bainbridge, *ALI Corporate Governance*, *supra* note 125, at 1059. For more in-depth treatment of structural bias, see LORSCH WITH MACIVER, *supra* note 125, at 92–93; James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 L. CONTEMP. PROBS. 83, 91–92 (1985); Kenneth B. Davis, Jr., *Structural Bias, Special Litigation Committees, and the Vagaries of Director Independence*, 90 IOWA. L. REV. 1305, 1308 (2005); Claire A. Hill & Brett H. McDonnell, *Disney, Good Faith, and Structural Bias*, 32 J. CORP. L. 833, 834 (2006); Anthony Page, *Unconscious Bias and the Limits of Director Independence*, 2009 U. ILL. L. REV. 237, 239–40; Julian Velasco, *Structural Bias and the Need for Substantive Review*, 82 WASH. U. L.Q. 821, 824–25 (2004).

128. Velasco, *supra* note 127, at 860–62.

129. *Id.* at 861.

130. *Id.*

131. Beam v. Stewart, 845 A.2d 1040, 1050–51 (Del. 2004) (discussing how structural bias among board members may "impede independent decisionmaking."); *In re* Oracle Corp. Derivative Litig., 824 A.2d 917, 938 (Del. Ch. 2003) (although *Oracle* does not use the term "structural bias," the opinion discusses bias-creating relationships and identifies "motives like love, friendship, and collegiality" as influential in decisionmaking).

132. For a more in-depth discussion of groupthink, see Sharpe, *Cosmetic Independence*, supra note 48, at 1450; Marleen A. O'Connor, *The Enron Board: The Perils of Groupthink*, 71 U. CIN. L. REV. 1233, 1238–39 (2003). *See also* IRVING L. JANIS, VICTIMS OF GROUPTHINK: A PSYCHOLOGICAL STUDY OF FOREIGN-POLICY DECISIONS AND FIASCOES (1972); Bainbridge, *Why a Board?*, *supra* note 11, at 32.

CEO, is limited because her decisionmaking is influenced by boardroom norms. Directors thus exercise poor judgment because they allow their desire for unanimity to reduce the quality of their decisionmaking.[133]

In addition to ingroup biases, the relationship between the CEO and board may mean that directors have self-interested reasons for not challenging the CEO. Many directors can thank the CEO for their nomination to the board.[134] Directors and CEOs share additional professional ties such as interlocking directorships. These directorships, in which CEOs and executive management serve on the boards of companies other than their own, reduce the independence of outside directors.[135] For instance, an outside director may be from a company that transacts significant amounts of business with the company, curtailing the director's willingness to voice criticism of a CEO who might eliminate or reduce business opportunities.[136] Executive compensation is another example. Since many directors serve as high-level executives at other companies, they are predisposed toward higher levels of executive pay.[137] The attributes of an effective decision-making process, such as a system for constructive conflict, can help to overcome these biases and promote decisions that are substantively sound and independently made.[138]

2. Practical Limitations on Board Independence

Independent directors also face *practical* limitations which reduce

133. *See* Bainbridge, *Why a Board?*, *supra* note 11, at 32; O'Connor, *supra* note 132, at 1239 (noting that the quest for unanimity affects decisionmaking by impeding "critical reflection and reality testing"). There is scholarly disagreement on the effects of groupthink on the decision-making capabilities of groups. *See* Forbes & Milliken, *supra* note 11, at 496–97 (finding that group cohesiveness can have positive effects on group decisionmaking unless the group also experiences self-censure and pressure). Additionally, empirical research has emphasized that close social ties can provide greater board involvement in their advisor/counselor roles, though it may not have as positive an effect on their monitoring role. James D. Westphal, *Collaboration in the Board Room: Behavioral and Performance Consequences of CEO-Board Social Ties*, 42 ACAD. MGT. J. 7, 8 (1999).

134. Since many directors are nominated by CEOs, many directors worry they will not be reappointed if they challenge the CEO. *See* Fairfax, *Uneasy Case*, *supra* note 40, at 158 (noting that directors are beholden, not only to CEOs who "often dominate the director-nomination process" but also feel beholden to their co-directors); Paul Hempel & Charles Fey, *Outside Director Compensation and Firm Performance*, 33 HUM. RESOURCE MGMT. 111, 113 (1994). *See also* George W. Dent, Jr., *Corporate Governance: Still Broke, No Fix in Sight*, 31 J. CORP. L. 39, 43 (2005); James D. Westphal & Edward J. Zajac, *Who Shall Govern? CEO/Board Power, Demographic Similarity, and New Director Selection*, 40 ADMIN. SCI. Q. 60, 77 (1995).

135. Finkelstein & Mooney, *supra* note 79, at 101.

136. *Id.*

137. Rodrigues, *supra* note 46, at 485.

138. *See* discussion *infra* Part IV.B.

their monitoring efficacy. Managers are at a resource advantage over their director counterparts because of the time they are able to devote to understanding the business, the information available to them, and their company-specific knowledge.[139] Relative to managers, many directors, who are employed full-time elsewhere, do not have the time to properly monitor management.[140] In fact, directors devote less than two days a month to their work as directors.[141] Legislation, such as SOX, puts more pressure on directors' time by increasing the requirements for regulatory compliance.[142]

Outside directors' time constraints place them at an information disadvantage. In order for board members to make decisions and properly oversee executive management, they must obtain information about how the company is operated and managed, and about the competitive environment in which it operates.[143] Directors, however, receive voluminous, poorly organized information without enough time to review it.[144] The data, most of which are backward looking, are usually limited in scope to financial data.[145]

Another hurdle is the significant information asymmetries between outside directors and the CEO. Outside directors, especially independent directors, generally possess a smaller quantity and lower quality of

139. *See, e.g.*, Sharpe, *Cosmetic Independence*, supra note 48, at 1450–51.

140. CARTER & LORSCH, *supra* note 27, at 73.

141. KORN/FERRY INST., *supra* note 79, at 4–5. Corporate boards averaged eight in-person meetings per year. *Id.* at 10. The number of boards that meet monthly has sharply declined in the last two decades. In 2007, only 7 percent of companies met monthly, compared to 25 percent two decades ago. *Id.* at 4–5, 10. *See also* Part IV.A. (explaining the practical limitations that are inherent in the relationship between the board and the CEO).

142. Jay W. Lorsch & Robert C. Clark, *Leading from the Boardroom*, HARV. BUS. REV., Apr. 2008, at 104, 107 (noting that the audit committee requirements found in SOX at least double the time for audit committee meetings; as a result, directors need more than the allotted time to complete their committee work); Rodrigues, *supra* note 40, at 459 n.58.

143. G. Tyge Payne, George S. Benson & David L. Finegold, *Corporate Board Attributes, Team Effectiveness, and Financial Performance*, 46 J. MGMT. STUDIES 704, 710 (2009).

144. CARTER & LORSCH, *supra* note 27, at 27–28. *See also* David A. Nadler, *Building Better Boards*, HARV. BUS. REV., May 2004, at 102, 109; Jeffrey A. Sonnenfeld, *What Makes Great Boards Great: It's Not Rules and Regulations. It's the Way People Work Together*, HARV. BUS. REV., Sept. 2002, at 109, 109 (describing destructive information sharing practices, such as CEOs who wait until the eve of a board meeting "to dump on the directors a phone-book-size report that includes, buried in a thicket of subclauses and footnotes, the news that earnings are off for the second consecutive quarter"; these practices undermine the trust between the board and the CEO).

145. CARTER & LORSCH, *supra* note 27, at 27 (arguing that directors need, but do not receive, the competitive, strategic, product, employee, and customer information required to properly evaluate management and their strategies); Nadler, *supra* note 144, at 110.

information than their inside counterparts.[146] Other than the inferences directors make from their direct observations and knowledge about the company,[147] they rarely have channels outside of the CEO and her executives for information gathering.[148] As a result, the board's information shares the CEO's limitations.[149] An outside directors' limited involvement in the company and the information disadvantages they face make it difficult for them to exercise informed judgment, and therefore to properly monitor.[150]

Even if directors had the appropriate information, understanding that information is a difficult task, which requires more than just time. It requires in-depth knowledge of the company in question. While most directors are knowledgeable about business generally, their status as "independent" often means they lack company-specific knowledge about the firm on whose board they serve.[151] Directors develop company-specific knowledge as part of their work on the board, which can take years, given the limited time they spend on board service.[152] Despite years of service, a recent survey of directors found that directors still did not understand the fundamentals of their companies, such as how their companies earn

146. CARTER & LORSCH, *supra* note 27, at 28; Sharpe, *Cosmetic Independence*, *supra* note 48, at 1448–49; Mitchell, *supra* note 21, at 1348-49 ("With directorial independence . . . directors began to lose their network ties into the corporate structure . . . As a result, directors became more dependent on the CEO for their information.")

147. Barry D. Baysinger & Richard E. Hoskisson, *The Composition of Boards of Directors and Strategic Control*, 15 ACAD. MGMT. REV. 72, 74 (1990).

148. Delaware courts have held that in order for boards to avoid a duty of care breach, directors must "inform themselves, prior to making a business decision, of all material information reasonably available to them. Having become so informed, they must *then* act with requisite care in the discharge of their duties." Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 362 (Del. 1993) (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)) (emphasis added). In *In re Caremark International Inc.*, the Delaware Court of Chancery held that "relevant and timely *information* is an essential predicate for satisfaction of the board's supervisory and monitoring role under Section 141 of the Delaware General Corporation Law." 698 A.2d 959, 970 (Del. Ch. 1996). Boards may also rely on the expertise and information of third-party gatekeepers, such as attorneys, accountants, and other outside consultants. Fairfax, *Uneasy Case*, *supra* note 40, at 161–62. These third parties, however, do not reduce the reliance on the CEO. Like outside directors, third party consultants depend on corporate insiders for their information. They may also have conflicts of interest, such as wanting to please the CEO in order to be retained in future transactions, so they may be more likely to support management's viewpoint. *Id.* at 162. There is general consensus that outside directors are limited to information that the CEO and her management team provides. *See* Mitchell, *supra* note 21, at 1348–49; Nadler, *supra* note 144, at 110.

149. CARTER & LORSCH, *supra* note 27, at 46. *See also* Mitchell, *supra* note 21, at 1348–49.

150. *See infra* Part IV.A.3S

151. CARTER & LORSCH, *supra* note 27, at 45; Fairfax, *Uneasy Case*, *supra* note 40, at 165.

152. CARTER & LORSCH, *supra* note 27, at 45.

money.[153] CEOs shared their concerns.[154] In order to perform its oversight function, a board needs to receive comprehensive, unbiased information in a timely manner. Unfortunately, even if a board has the information it needs, the part-time nature of independent directors and their limited knowledge of the company mean the directors do not have the time necessary to review and understand it. As a result, independent directors' ability to effectively monitor is constrained because they cannot evaluate or meaningfully challenge the decisions they are asked to approve.

The psychological and practical limitations discussed above are interrelated. Solutions designed to reduce the practical limitations and help directors think critically and independently also reduce the impact of the various ingroup biases.[155] Process-oriented approaches, such as those emphasized in this Article, can reduce the structural characteristics that help facilitate ingroup biases by providing better information and creating an environment that encourages conflict while maintaining collegiality.[156]

III. PROCESS-ORIENTED BOARD REFORM

There are three primary design elements on which board reforms can be based: structure, composition, and process. The three design elements are interrelated. Structure and composition can be thought of as inputs for the intermediate step of group process.[157] Structure, in the broadest sense, is the manner of separating the work in an organization into subunits and dividing the control.[158] It is usually a system of hierarchical division of control and responsibility.[159] Put another way, structure delimits organizational responsibilities and communication channels, and can be

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153. Nadler, *supra* note 144, at 110.

154. CARTER & LORSCH, *supra* note 27, at 25. A Boston Consulting Group/Harvard Business School survey of 132 CEOs in 2001 showed that CEOs question whether directors are knowledgeable enough about the business to approve strategic decisions or evaluate their company's performance. Only 46 percent agree that boards "understand the factors that drive performance in each of the [firm's] main businesses." *Id.* at 24.

155. Irving Janis argues that faulty structure contributes to groupthink. Focusing on process-oriented solutions, as this Article suggests, identifies ways to work around the structural limitations boards confront and thus reduces the likelihood of groupthink. *See* JANIS, *supra* note 132**,** at 237 (suggesting that structural flaws lead to groupthink); O'Connor, *supra* note 132, at 1265–66.

156. *See infra* Part IV.B.

157. These two inputs to process are not exclusive. Other inputs for process include, but are not limited to, group norms, rewards and incentives, and training. Conny Antoni & Guido Hertel, *Team Processes, Their Antecedents and Consequences: Implications for Different Types of Teamwork*, 18 EUR. J. WORK & ORGANIZATIONAL PSYCHOL. 253, 256 (2009).

158. RICHARD H. HALL & PAMELA S. TOLBERT, ORGANIZATIONS: STRUCTURES, PROCESSES, AND OUTCOMES 20 (10th ed. 2009).

159. *Id.* at 24.

both formal and informal.[160] Composition, which is often considered a subset of structure, focuses on the demographic makeup of the members, including the mix of insiders and outsiders, as well as their skills.[161] Process is the intermediate step between the most commonly proposed board reforms and the elusive outcome of better firm performance and fewer firm failures. Understanding the corporate board requires a more comprehensive view of how these design elements relate to each other.

This part begins by examining the broader organizational behavior approach to understanding and analyzing the role of the corporate board of directors. It then outlines a process-oriented approach to board reform. Understanding how compositional and structural requirements influence, and often limit, the decisional processes a board can employ illuminates why conventional reforms fail to achieve their intended goals. Finally, this part analyzes how the formalized structure created by regulation makes it more difficult for the board to engage in effective decisionmaking, and therefore reduces its ability to monitor management.

A. AN ORGANIZATIONAL BEHAVIOR APPROACH

An organizational behavior framework can provide scholars and regulators with greater insight into how boards function. Organizational behavior theory studies how individuals and groups function within organizations.[162] The theory studies the behavior, interactions, and characteristics of small groups (such as the board) and individuals (such as directors), in organizations.[163] Board process, one subset studied under organizational behavior theory, has a direct impact on the board's efficacy.[164] Board process scholars, who have contributed to the

160. *Id.* at 20; James W. Fredrickson, *The Strategic Decision Process and Organizational Structure*, 11 ACAD. MGMT. REV. 280, 281 (1986).

161. Content and structure are both board characteristics; as such, content is often viewed as a subset of structure. *See* CARTER & LORSCH, *supra* note 27, at 8.

162. Chip Heath & Sim B. Sitkin, *Big-B Versus Big-O: What Is Organizational About Organizational Behavior*, 22 J. ORG. BEHAV. 43, 51 (2001) (writing that organizational behavior's focus goes beyond the individual and group behavior, and looks at that behavior in the specific context of organizations. In that sense organizational behavior differs from related fields [psychology, sociology, political science, anthropology].)" *See also* GREGORY B. NORTHCRAFT & MARGARET ANN NEALE, ORGANIZATIONAL BEHAVIOR: A MANAGEMENT CHALLENGE 26 (1990); Benjamin Schneider, *Organizational Behavior*, 36 ANN. REV. PSYCHOL. 573, 574 (1985).

163. JOHN B. MINER, ORGANIZATIONAL BEHAVIOR 3: HISTORICAL ORIGINS, THEORETICAL FOUNDATIONS, AND THE FUTURE 17 (2006) (describing organizational behavior micro-theory).

164. Board process is also often associated with strategic management and organizational strategy. There is a noted lack of consistency of language in the discipline. *See* Annie Pry & Andrew Pettigrew, *Studying Board Context, Process and Dynamics: Some Challenges for the Future*, 16 BRIT. J. MGMT.

management literature on boards, argue that the board, which primarily performs conceptual tasks, should engage in particular processes that increase its effectiveness.[165] This focus on process has yet to be applied to legal scholarship studying the impact and effectiveness of board reform measures.

Board process scholars have challenged the usefulness of relying on agency theory on several grounds.[166] For example, critics assert that agency theory is decontextualized from the actual interactions and behaviors of corporate actors.[167] In other words, agency theory reduces the interactions between firm participants to a handful of simplifying (and hence unrealistic) assumptions.[168] Most notably, the actions of the principals and agents are "assumed to be economically rational and only minimally influenced by relationships and social context."[169]

The decontextualized nature of agency theory is due in part to its focus on a single basic issue. It looks to only one board function—monitoring—to address the theory's underlying concern. Organizational behavior theory, on the other hand, recognizes that boards are much more complex and dynamic groups.[170] Additionally, critics argue that agency theory assumes linear connections between structural and compositional changes and better firm performance. Stated differently, agency theory assumes that structural and compositional changes to the board directly, singularly, and necessarily lead to fewer corporate failures, less corporate fraud, and higher corporate profits.

Taken together, application of agency theory to board function leads to the conclusion that regulations based on agency theory assumptions will necessarily lead to desirable performance outcomes.[171] An example of this is the contemporary model of corporate board reform, which assumes that changing the composition and structure of the board by increasing board

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S27, S33 (2005) (proposing board process as a more inclusive alternative to agency theory).

165. Finkelstein & Mooney, *supra* note 79, at 103.

166. For a broader critique of the neoclassical economic approach to the firm, see RICHARD M. CYERT & JAMES G. MARCH, A BEHAVIORAL THEORY OF THE FIRM 214–16 (2d ed. 1992) (arguing for the integration of "bounded rationality," and other aspects of behavioral theory into the theory of the firm).

167. *E.g.*, Michael Lubatkin et al., *An Embeddedness Framing of Governance and Opportunism: Towards a Cross-Nationally Accommodating Theory of Agency*, 28 J. ORG. BEHAV. 43, 46 (2007).

168. *Id*. at 46–47.

169. *Id.* at 46.

170. *See* Macus, *supra* note 14, at 101 (identifying board process as an "important element" in analyzing firm performance).

171. Lubatkin et al., *supra* note 167, at 47.

independence will directly lead to better firm performance.[172] In reality, this approach misses the "co-evolutionary" nature of governance mechanisms,[173] because there are actually multiple factors that simultaneously work together to produce governance outcomes. Agency theory critics assert that co-evolutionary models identify factors that are endogenously determined (factors that are influenced by other variables within the firm), that causality is multidirectional as opposed to linear (several inputs converge to bring about a particular outcome), and that outcomes are in part dependent on the social context of the corporate actors, including past interactions and the relationships between them.[174]

Models based on an organizational behavior approach attempt to examine the organization as a whole, rather than reducing it to smaller, isolated parts. Although a board may be comprised of a majority of independent directors, each of these is an individual who brings a different set of motivations, knowledge, and skill to the job. Like most individuals, directors are sensitive to the expectations and attitudes of those around them.[175] Endogenous factors, such as each director's relationship with the CEO, can influence a director's and, as a result, a board's efficacy.[176] In other words, many corporations succeed or fail based on factors other than board composition and structure. Conventional reforms miss these factors, especially the influence of relationships and interactions on overall board performance.[177] As already explained in Part II.C, empirical evidence and illustrations from recent corporate failures further undermine the linearity implicit in modern corporate board reform. At best, the evidence of a link between board independence and firm performance is inconclusive, and, at worst, it shows that compositional and structural changes have no correlation to firm performance at all.[178]

Proponents of a comprehensive, dynamic approach to studying corporate governance accordingly assert that conventional approaches

172. *See* discussion *infra* Part III.B.

173. Lubatkin et al., *supra* note 167, at 47–48.

174. *Id.*; Stout, *supra* note 4, at 13.

175. Stout, *supra* note 4, at 13.

176. Benjamin E. Hermalin & Michael S. Weisbach, *Boards of Directors as an Endogenously Determined Institution: A Survey of the Economic Literature*, 9 ECON. POL'Y REV. 7, 20 (2003). *See also* discussion *infra* Part IV.A. for an analysis of how board/CEO interactions directly limit the board's monitoring efficacy.

177. *Id.*

178. *See* discussion *supra* Part II.C.

ignore the multiple forces that explain an individual's behavior.[179] An organizational behavior approach recognizes that a full accounting of corporate interactions and the social context in which they occur, provides a better picture of the constraints on firm actors.[180] In sum, an organizational behavior approach to corporate governance is distinct from one conducted through the lens of agency theory in that it is contextualized, multitheoretic, and holistic rather than linear.[181]

B. DEFINING BOARD PROCESSES

While studying board characteristics and their connection to firm performance is a difficult and inexact task, it is clear that there is something missing between the regulatory inputs to board composition and structure, and the desired regulatory outcomes of improving firm performance and preventing corporate failures. One of the primary lessons to be learned from an application of organizational behavior theory to board function is that insufficient attention has been paid to board process as compared to board structure and composition.[182] To be sure, organizational behavior recognizes that board reforms can be based on board structure and composition, but moves the conversation beyond board content, and toward board process.

Generally speaking, process is the intervening variable that explains a causal relationship.[183] Process scholars have defined board process in both static and dynamic terms. Under the static meaning, process is used to explain the causal relationship between independent variables (inputs) and their dependent variables (outcomes).[184] It is a clearly defined fixed

179. Ruth V. Aguilera & Gregory Jackson, *The Cross-National Diversity of Corporate Governance: Dimensions and Determinants*, 28 ACAD. MGMT. REV. 447, 448–49 (2003).

180. *Id.* (arguing for an embeddedness theory of corporate governance that goes beyond economic action, and criticizing agency theory in particular because it reduces corporate players to "ontological actors, frozen in space and time and isolated from social and cultural context").

181. MINER, *supra* note 163, at 3–5 (describing organizational behavior theory); Heath & Sitkin, *supra* note 162, at 54, 56 (suggesting limitations of prior approaches and promoting a more organizational approach).

182. Heath & Sitkin, *supra* note 162, at 54, 56 (explaining how important it is to "understand how groups of people organize and carry out their goals" and noting that to understand important organizational issues we must understand how "processes take place among individual, groups, and the organization as a whole").

183. Andrew H. Van de Ven, Research Note, *Suggestions for Studying Strategy Process*, 13 STRATEGIC MGMT. J. 169, 169 (1992). According to Van de Ven, process can have three meanings: "(1) a logic that explains a causal relationship between independent and dependent variables, (2) a category of concepts or variables that refers to actions of individuals or organizations, and (3) a sequence of events that describes how things change over time." *Id.*

184. *Id.* at 170.

variable that can be measured and tested. A static approach does not examine the nature of the actual process, but instead qualitatively or quantitatively assesses whether the presence of a specified process variable results in a particular change.[185] An example of this definition would be a particular aspect of a board's decision-making process, such as how it generates or gathers information.

The independent variable would be the board's structure (an independent board of directors, which is a proxy for effective monitoring) and the dependent variable would be the desired outcome (better firm performance). An effective process for gathering and generating information would explain why an independent board leads to better firm performance. An empirical study might examine the actual effect that a particular structure, using the specified information process, had on firm performance.[186] An empirical study could be conducted by looking at different types of information-gathering processes (such as whether the board independently interacts with senior managers and other firm employees) and determining their correlation with firm performance, which could be measured through stock performance. Here process is both a mediator variable and a moderator variable, meaning that it simultaneously accounts for the relationship between the independent and dependent variable (mediator), and influences the strength of the relationship (moderator).[187] Stated differently, a moderator explains "when certain effects will hold" and a mediator explains "how or why such effects occur."[188] This is considered a static approach to process because once the process of information gathering/generation is identified, it does not change for purposes of the analysis. Overall, the static approach can be summarized as a description of *why* things change and *whether* they change.

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185. *Id.*

186. *See* Harry Sminia, *Process Research in Strategy Formation: Theory, Methodology, and Relevance*, 11 INT'L J. MGMT. REVS. 97, 99 (2009) (claiming that prior research on firm decision-making processes have been too descriptive).

187. Ruben M. Baron & David A. Kenny, *The Moderator-Mediator Variable Distinction in Social Psychological Research: Conceptual, Strategic and Statistical Considerations*, 51 J. PERSONALITY & SOC. PSYCHOL. 1173, 1174–76 (1986). "[A] moderator is a qualitative (e.g., sex, race, class) or quantitative (e.g., level of reward) variable that affects the direction and/or strength of the relation between an independent or predictor variable and a dependent or criterion variable."). *Id.* at 1174. "In general, a given variable may be said to function as a mediator to the extent that it accounts for the relation between the predictor and the criterion . . . . Whereas moderator variables specify when certain effects will hold, mediators speak to how or why such effects occur." *Id.* at 1176**.**

188. *Id.* at 1176.

In contrast to the static definition of process, the dynamic definition focuses on sequences of incidents that unfold over time. In other words, it takes a "developmental event sequence."[189] It has a dynamic quality in that it examines the development and changing nature of the process in question.[190] In sum, it is a description of *how* things change. The dynamic definition considers how the board's information gathering and generation process has evolved over time in response to changes in the external and internal environment. For instance, one external change is regulation that has mandated independent board composition and structure. An examination of how boards have gathered and generated information in response to an altered structure could identify holes in boards' ability to properly evaluate the actions and decisions of the managers they are tasked with monitoring. For instance, if insider dominated boards relied on well-established relationships with other executives and mid-level employees within the firm for their information, and no alternative method of informing has been proposed for outsider-dominated boards, it would be apparent then that outsider-dominated boards have been less informed than their predecessors, and may be less equipped to systematically monitor executive management.

The static and dynamic meanings of process share a common quality: each is concerned with understanding the *means* by which a particular input is likely to result in a desired outcome. In the context of corporate governance, the meanings of process emphasize the connection between independent board structures, which have served as proxies for effective monitoring, and firm performance. This Article shares that common concern and articulates a definition of process that draws from both meanings. It appreciates the explanatory aspect of the static definition, as well as the holistic and temporal aspect of the dynamic definition. When a board adopts a particular sequence of steps (a process) in response to the firm's endogenously determined needs and goals, it is better situated to improve its efficacy and thereby overall firm performance. Although the explanatory value of the static definition is important, the purpose of the present discussion is not to provide an empirically testable definition of process. This Article adds a critical dimension to the discussion on boards by identifying process as an intermediate step, linking major board reforms to an increased likelihood of firm success.

An important contributing factor to the repeated failure of board

189. Sminia, *supra* note 186, at 99.
190. *Id.*

regulatory reforms is the failure to recognize that these processes form the bridge between regulatory inputs (the composition and structure of boards) and the desired regulatory outputs (higher profits and fewer corporate failures). The differences between customary regulatory approaches and the one recommended by this Article are graphically represented by figures 1 and 2, below. The conventional approach illustrated in figure 1 addresses structural and compositional inputs, but it does not consider the intermediate steps that lead to outcomes. Unlike the conventional approach, figure 2 introduces an additional step to the conversation on board reform—board process. Although there are many processes that can contribute to a more effective board, board process as represented in figure 2 deals mostly with the manner in which boards gather information and make decisions.[191]

191. *See* discussion *supra* at notes 143–54 and accompanying text. *See also* CARTER & LORSCH, *supra* note 27, at 8 (proposing that boards should reevaluate not only board process, but also board structure and composition).

FIGURE 1. Conventional Approach to Board Reform

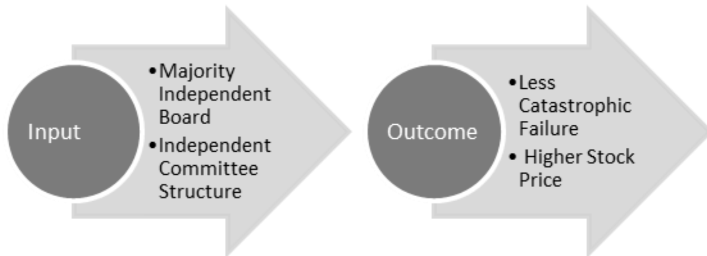
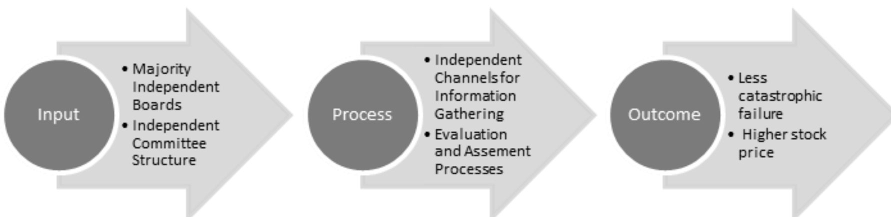


FIGURE 2. Process as an Intermediate Step



Process—defined as the intermediate step leading from goals to desired outcomes—can include several practical activities undertaken by corporate boards.[192] One such process is decisionmaking, which can include director communications, both with other directors and with other groups within the organization, such as top-level management,[193] information-gathering systems, and methods of constructive conflict.[194] Within each of these processes there are elements, such as interpersonal dynamics and self-motivation, which are endogenous, and therefore not as susceptible to external regulation by SROs or governmental regulatory bodies. Some processes, such as conflicts management, have a higher degree of endogeneity than others. Other processes, like information gathering, are more easily regulated.

192. Danny Miller, *Strategy Making and Structure: Analysis and Implications for Performance*, 30 ACAD. MGMT. J. 7, 8 (1987).

193. Antoni & Hertel, *supra* note 157, at 256 ("Among potential group processes, team communication, within-team cooperation, and intrateam conflict are important elements of team interaction.").

194. Annie Pry & Andrew Pettigrew, *Studying Board Context, Process and Dynamics: Some Challenges for the Future*, 16 BRIT. J. MGMT. S27, S33 (2005).

C. STRUCTURE AND ITS IMPACT ON PROCESS

Conventional policymaking initiatives that change board composition and structure are intended to help the board fulfill its monitoring role; however, they do not focus on the processes necessary for the board to do so. The processes that are most likely to improve board function are in fact inhibited by contemporary structural and compositional regulatory efforts.

Regulation has in large measure determined board structure and composition, both of which have had a significant impact on board process. Formalized structure can either facilitate or inhibit directors' decisionmaking.[195] Legal reforms and scholarship typically address the contextual elements of structure, or determinants, including board size, leadership of the board, and the relevant committees along with their responsibilities.[196] These determinants heavily influence the broader structural dimensions of an organization, which in turn influence the processes an organization employs.

There are three well-recognized structural dimensions—complexity, formalization, and centralization—each of which affects an organization's process differently.[197] Formalization refers to the extent to which a group or organization uses rules and procedures to determine who makes decisions and when they are made.[198] The more formalized the organization or group, the more heavily it relies on rules that "specif[y] how, where and by whom tasks are to be performed."[199]

195. This Article relies on Richard Hall, Pamela Tolbert, and James Fredrickson for their seminal insights into formalization. Whereas these authors discuss formalization more generally, this Article applies their general discussion of formalization within organizations to effective group decision-making processes. Additionally, it applies both to the board of directors and discuss the implications for modern corporate governance. HALL & TOLBERT, *supra* note 158, at 112 ("The aspects of formal structure . . . are important because they provide the mechanisms through which organizations shape and control individuals' decision-making."); Fredrickson, *supra* note 160, at 292–94.

196. CARTER & LORSCH, *supra* note 27, at 8. *See also* John P. Workman Jr., Christian Homburg & Kjell Gruner, *Marketing Organization: An Integrative Framework of Dimensions and Determinants*, J. MARKETING, July 1998, at 21, 36–38 (considering various marketing structure placements within firms and cautioning that firms should not limit concerns to organizational structure formations); discussion *supra* Part II.B (discussing board reforms).

197. HALL & TOLBERT, *supra* note 158, at 27, 33, 37; ROBBINS, *supra* note 8, at 6–7 (noting that the three dimensions are complexity, formalization, and centralization; complexity is the degree "of differentiation within the organization"; centralization relates to "where the locus of decision-making authority lies"). Sometimes the three definitions are referred to as "Professional Bureaucracy," "Machine Bureaucracy," and "Simple Structure" respectively. Fredrickson, *supra* note 160, at 290.

198. HALL & TOLBERT, *supra* note 158, at 33; ROBBINS, *supra* note 8, at 290; Miller, *supra* note 192, at 12.

199. Fredrickson, *supra* note 160, at 283; Danny Miller & Cornelia Droge, *Psychological and*

Listing standards and legislative enactments increase the degree of formalization of a board by specifying the composition of the board, requiring specific committees, and articulating the tasks that both the board and the committees must address. The rules and the structure they impose shape the range of issues a board is able to consider and restricts the decisions on which directors can exercise their judgment.[200] Board structure directly affects the board's ability to perform its monitoring duty.

Arguably, the most important decisions directors must make are strategic decisions that are generally classified by organizational theorists as unstructured or nonprogrammed decisions.[201] Nonprogrammed decisions respond to nonroutine problems.[202] These are problems that have not been previously encountered. These decisions require creative problem solving that is specifically tailored to the unique problem that has arisen.[203] Nonprogrammed decisions do not have a predetermined response.[204] They have a high degree of uncertainty, particularly in regard to whether deciding on action A will result in outcome B and only outcome B.[205] In other words, with nonprogrammed decisions, there is a lack of certainty about cause and effect.[206] Nonprogrammed decisions require a much greater level of information and information processing than programmed decisions.[207]

Structure inhibits the types of processes the board can employ. This is

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Traditional Determinants of Structure, 31 ADMIN. SCI. Q. 539, 543 (1986).

200. Miller, *supra* note 192, at 12. Formal structures limit the extent to which individuals can exercise their own judgment. *Id*.; ROBBINS, *supra* note 8, at 61 (noting that a formalized job means that an employee "has a minimum amount of discretion over what is to be done, when it is to be done, and how he or she should do it"); Fredrickson, *supra* note 160, at 287.

201. For definitions of unstructured decisions, see Henry Mintzberg, Duru Raisinghani & Andre Theoret, *The Structure of "Unstructured" Decision Processes*, 21 ADMIN. SCI. Q. 246 (1976). ("*Unstructured* refers to decision processes that have not been encountered in quite the same form and for which no predetermined and explicit set of ordered responses exists in the organization."). For definitions of strategic decisions, see HALL & TOLBERT, *supra* note 158, at 115 (defining strategic decisions as "big, high-risk decisions made at high levels of organizations that significantly affect organizational outcomes") and Mintzberg, Raisinghgani & Theoret, *supra*, at 246 ("And *strategic* simply means important, in terms of the actions taken, the resources committed, or the precedents set.").

202. JAMES G. HUNT, RICHARD N. OSBORN, JOHN R. SCHERMERHORN, ORGANIZATIONAL BEHAVIOR 302 (10th ed. 2008).

203. *Id.*

204. Mintzberg, Raisinghgani & Theoret, *supra* note 201, at 246.

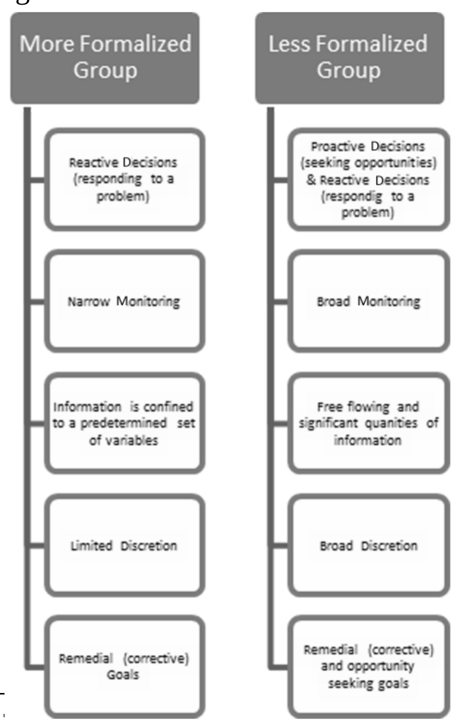
205. Adapted from Hall and Tolbert's description of certainty and uncertainty in the cause and effect relationship. HALL & TOLBERT, *supra* note 158, at 114.

206. *Id.* (describing the effect of bounded rationality on an individual's decision-making process).

207. Jay R. Galbraith, *Organizational Design: An Information Processing View*, *in* READINGS IN ORGANIZATIONS: BEHAVIOR, STRUCTURE, PROCESSES 244 (James L. Gibson, John M. Ivancevich & James H. Donnelly eds., 3d ed. 1979).

in large part due to the fact that structure limits the resources available to the board, particularly the information necessary for effective decisionmaking. A higher degree of board formalization affects the board's discretion, its decision-making stance (reactive instead of proactive), the scope of its monitoring, information flow, and goal setting. Groups with a highly formalized structure are better suited to making programmed decisions, which is the opposite of what an effective board must do.[208] In instances where decisions address unprecedented situations or unpredictable problems, less formalization is better.[209] A comparison of decision-making characteristics that result from more or less formalization is illustrated in table 1 below.

TABLE 1. Comparison of the Effect of Formalization on Group Decisionmaking[210]



208. HALL & TOLBERT, *supra* note 158, at 59 ("[O]ne disadvantage of formalization is that it may prevent members from responding to problems in an effective way, especially when the problem is not one that was anticipated by the rule-makers.").

209. *Id.*

210. Characteristics of formalized structure are adapted from Hall and Tolbert and Fredrickson. *See id.*; Fredrickson, *supra* note 160, at 283–84.

Generally, a higher degree of formalization tends to work best for reactive decisionmaking, and for addressing narrow, predetermined circumstances. As a result, the information a board receives is limited to those circumstances. In other words, the board receives information that is limited in scope to the obvious and programmed decisions that the board must address, and the board in turn is asked to make decisions on a fairly confined set of questions.[211] As a result, the decision-making process that the board is likely to engage in is reactive instead of proactive. For example, one task a board performs is approving financial statements. In performing this task, the information they receive will relate to the supporting documentation for the financial statements. It is unlikely that the information will extend much deeper than what is needed to explain or justify the budget at the departmental level. This means the board will miss important strategic implications for the various organizational subunits that based their budget on more detailed strategic planning. If a particular unit fails, the board would then have an opportunity to examine the source of failure more closely—acting in response to the failure.

The scope of the board's decisions will be narrowed to the circumstances or situations that the formalized monitoring structure has assigned to the board. This limits both the incentives and ability of directors to be creative and proactive in their approach to governance. In contrast, a less formalized structure would allow the board to engage in proactive behaviors such as seeking opportunities for improvement or identifying areas of potential concern for future problems.[212]

In addition to framing the type of decisions a board makes and delimiting the scope of its monitoring responsibilities, structure is also a key determinate in the flow of information.[213] A more formalized structure means the universe of information a board receives will be limited to reactive, or backwards looking information, and it will be confined to the specific monitoring tasks already assigned to the board. The change to a

211. Generally the board concerns itself with setting compensation, evaluating, hiring, and firing the CEO, approving large capital expenditures, approving long-term strategy, approving budgets, and ensuring compliance with legal requirements. CARTER & LORSCH, *supra* note 27, at 60. Under an authority-based decision-making structure, "efficient flows of information are critical to the success" of the decision-making structure. Stephen M. Bainbridge, *Participatory Management Within a Theory of the Firm*, 21 J. CORP. L. 657, 669 (1996).

212. Even more troubling is that formalization can, in fact, go so far as to discourage organizations and groups from seeking opportunities. Fredrickson, *supra* note 160, at 287.

213. *Id*. at 281.

supermajority independent board also impacts information flow, because it affects the interactions between organizational participants.[214] Specifically, the change limits the channels of information available to the board and alters the interactions between the CEO and the board.

Boards can best address nonroutine situations when they have multiple sources for selecting information. When boards are limited to information that is gathered by the CEO and her management team, the board is subject to management's decisions about how to screen, evaluate, and condense the information.[215] CEO and management team biases play a role in how information is filtered and what is passed on to the board. Nonprogrammed decisions are best made under a more open information process. These decisions need significant quantities of information that come from varied channels, which formalized structure typically does not provide.

Not only does increased formalization harmfully constrain the issues addressed and types of decisions made, it also constrains the board's goals. The goals of formalized structures tend to be reactive, remedial measures designed to improve existing problems, as opposed to goals that are meant to make positive future changes.[216] The variables that are likely to spur boards into action are predetermined by the formalized structure, as are the board's responses. The responses themselves are limited, in that they are incremental improvements.[217] The troubling result is that boards have limited discretion over the issues they monitor and the range of alternatives they can consider when crafting their response.

We want boards to effectively monitor managers and add value to the firm. Instead of allowing effective decision-making processes to take place, regulators have imposed a structure on the board that facilitates decision-making processes that are the opposite of those that add the most value under the monitoring function. In other words, formalized structure has limited the board's ability to engage in strategic, nonprogrammed decisionmaking. Although the current regulatory structure does not explicitly restrict firms from implementing effective processes, it has imposed a structure that makes the optimal process more difficult to achieve. One place this can be seen is in the relationship between the CEO and outside directors, which presents important challenges to effective

214. Miller, *supra* note 192, at 7–8.

215. CYERT & MARCH, *supra* note 166, at 128–29 (describing the importance of who gathers information within the broader organizational and the procedures that govern information flow).

216. Fredrickson, *supra* note 160, at 287.

217. *Id*.

board governance. These challenges are addressed in Part IV below.

IV. ORGANIZATIONAL BEHAVIOR APPLIED

Organizational behavior is useful in analyzing how boards interact, obtain information, and make decisions within larger organizations. One of the most important contexts in which this exchange of information and integrated decisionmaking can influence a board's monitoring success is the interaction between the board and the CEO. This part analyzes this interaction, providing an important example of how board structure negatively affects board process, specifically the process boards use for sharing, gathering, and generating information.[218] After examining this relationship, this part posits that the regulatory efforts to reform the composition of the board of directors through structural changes do not take account of how those changes constrain the board, especially in the context of its interactions with the CEO and other top-level management. The part concludes by briefly identifying the attributes of a process that would improve board efficacy.

A. BOARD OF DIRECTORS AND CEO INTERACTIONS

Organizational behavior can help us conceptualize the relationship between the board of directors and top-level management, especially the CEO. The relationship between the board and the CEO has several key attributes, but three are most important for present purposes. First, boards and CEOs are highly interdependent.[219] Second, the board has an inherent conflict of interest, both with respect to intra-board interactions and board-CEO interactions, due to its various roles.[220] Finally, the interaction between the board and the CEO is limited due to time constraints and information asymmetries.[221]

1. The Board and the CEO: An Interdependent Relationship

Consistent with policymaking efforts intended to improve monitoring,

218. This Article analyzes information processes, which are complementary and necessary to decision-making processes, because the Delaware courts have repeatedly emphasized the informational aspect of the board's decision-making process. For an analysis of the importance of information processes to board monitoring in Delaware see discussion *supra* Part II.B.

219. Anneloes M. L. Raes et al., *The Interface of the Top Management Team and Middle Managers: A Process Model*, 36 ACAD. MGMT. REV. 102, 103 (2011) (offering an analogy to top management team and middle managers and double roles). *See also infra* Part IV.A.1.

220. *Id.* (using an analogy on conflict of interest). *See also infra* Part IV.A.2.

221. Raes et al., *supra* note 219 (using an analogy on restricted interaction). *See also infra* Part IV.A.3.

the board's rallying cry is to maximize shareholder value.[222] If we accept agency theory's formulation that top-level managers are agents of the owners, such managers share a similar goal to the board of directors. Although they may be prone to opportunistic behaviors, the managers' primary purpose is to manage the day-to-day operations of the firm in the interests of the principals, shareholders.[223] In other words, the shareholder wealth maximization norm extends beyond the board, and should inform the decisions of management. Therefore, it can be said that the two groups are partnered in a common goal and task. Both the board and management seek to maximize profits and ensure that the shareholders' best interests are served, and both make important decisions concerning the company's welfare.[224]

Delaware law empowers the board to manage or direct the management of the corporation.[225] The board delegates the majority of this work to the top-level managers within the firm. Specifically, overseeing the day-to-day operations of the company, setting strategy, ensuring firm profitability, and managing employees, are all tasks left to the CEO and her closest advisors. In order for managers to retain their jobs and receive increases in compensation, they must secure the approval of the board of directors. Similarly, board approval is necessary if managers seek to sell

222. *See supra* notes 22–26 and accompanying text (describing the shareholder versus stakeholder debate). Even if we were to assume a shareholder wealth maximization norm, there is debate about which shareholder's value to maximize. There has been a debate over whose preferences should govern when the preferences of various shareholder constituencies diverge. A consensus on the impact of institutional investors has not definitively been reached. *See* Onnig H. Dombalagian, *Can Borrowing Shares Vindicate Shareholder Primacy?*, 42 U.C. DAVIS L. REV. 1231, 1247 (2009) (arguing that the economic interests of institutional investors and shareholders are generally in line with one another); Deborah A. DeMott, *Guests at the Table?: Independent Directors in Family-Influenced Public Companies*, 33 J. CORP. L. 819, 823 (2008) (discussing the complexity of the shareholder wealth maximization norm in family owned publicly traded companies).

223. BERLE & MEANS, *supra* note 21, at 121–22 (establishing that shareholder interests are the dominant interests in the corporation and managers are there to take care of the day-to-day operation of the firm in the shareholders' best interest). *See generally* Adams, *supra* note 32, at 729 (noting that top management, lead by the CEO, handle the day-to-day affairs); Donald C. Langevoort, *Agency Law Inside the Corporation: Problems of Candor and Knowledge*, 71 U. CIN. L. REV. 1187, 1201 (2003) (acknowledging that day-to-day operations fall within the purview of the CEO and do not generally need board approval).

224. CARTER & LORSCH, *supra* note 27, at 51 (noting that these decisions include reviewing and improving strategic plans, management succession, executive compensation, capital commitments, and budgets).

225. DEL. CODE ANN. tit. 8, § 141(a) (2001) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.").

the firm or acquire another firm.[226] Although management and the board of directors share the same goal, boards base their decisions on information formulated and communicated from management. For instance, boards depend on managers for the information required in setting compensation, and for approving strategic initiatives. While certain indicators of firm success are easily observable (such as stock price), other indicators (such as performance evaluations and the viability of strategic plans) are often heavily influenced by management's own views and cannot be independently verified by the board.

The boards' reliance on management for information and management's reliance on boards for approval leads to a high level of interdependence between the two groups. Directors are responsible for monitoring management through reviewing the corporation's financial statements, approving committee reports, and possibly approving major strategic decisions. In order for boards to effectively ensure that managers engage in conduct that maximizes shareholder welfare, boards must gather and understand complex information, which usually comes from the CEO. In fact, very few directors have information-gathering channels outside of management and are therefore limited to the information managers choose to share.[227] The information directors receive and the asymmetries they confront leave them unprepared to engage in effective oversight.[228] As a result, many directors feel they are ill-equipped to assess the costs and benefits of strategic decisions before they are asked to approve them.[229] If anything, board dependence on management for information-gathering causes rather than mitigates this problem.

2. The Board's Inherent Conflict of Interest

The board simultaneously acts as management's partner in helping to maximize shareholder value, and acts as management's monitor, making sure that managers are not shirking, and are working in the best interests of

226. *Id.* § 271(a) ("Every corporation may at any meeting of its board of directors or governing body sell, lease or exchange all or substantially all of its property and assets, including its goodwill and its corporate franchises, upon such terms and conditions and for such consideration, which may consist in whole or in part of money or other property, including shares of stock in, and/or other securities of, any other corporation or corporations, as its board of directors or governing body deems expedient and for the best interests of the corporation . . . ."); *id.* § 51(b) ("The board of directors of each corporation which desires to merge or consolidate shall adopt a resolution approving an agreement of merger or consolidation and declaring its advisability.").

227. Nadler, *supra* note 144, at 110.

228. *See supra* notes 142–50 and accompanying text.

229. Nadler, *supra* note 144, at 110.

shareholders. These simultaneous roles for the board create an inherent conflict of interest. Boards are placed in the position of being both participant and judge.[230] As part of the board's monitoring function, the board reviews and approves the strategic plans proposed by management.[231] In other words, monitoring is not passive, but rather requires the board's active participation.[232] This leads to what Colin Carter and Jay Lorsch call "asymmetric accountability."[233] The board actively participates in major decisions through evaluation and approval, but is rarely held accountable for the decisions it makes.[234] If things go wrong, it is the CEO and her management team that are held accountable.[235] Although we frequently hear, "Where was the board?," the board rarely resigns, but instead is able to penalize and even terminate the CEO.[236] This creates tension between the board as an active monitor that approves decisions proposed by managers, and as the ultimate judge of management's performance.[237] This tension is also evident in the board's interactions with the CEO.[238] The CEO may have misaligned incentives because of the board's monitoring function. Since the law dictates that management's decisionmaking is subordinate to the board's, and that the board holds the CEO's fate in its hands,[239] managers are often reluctant to share the full extent of their plans or thinking with the board.[240] The limitations on quality, quantity, and timeliness of information that the

230. JONATHAN R. MACEY, CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN 54 (2008) (describing that the modern responsibilities of the board of directors includes "both monitoring management and participating in management decisions in the ordinary course of a firm's business"). *See* Jill E. Fisch, *Taking Boards Seriously*, 19 CARDOZO L. REV. 265, 280 (1997) ("[T]here is a natural inconsistency between the board's monitoring and managing functions."). Although both Macey and Fisch are describing two separate board functions and this Articles argues that monitoring has both a passive, observational component, and an active, participatory component, the argument still holds true. The conflict is even more pervasive as we consider the additional roles that boards play. For a description of board function, see discussion *supra* Part II.A.

231. CARTER & LORSCH, *supra* note 27, at 51.

232. *Id.*

233. *Id*. at 52.

234. *Id*.

235. *Id*.

236. *Id*. at 51–52.

237. MACEY, *supra* note 230, at 54.

238. CARTER & LORSCH, *supra* note 27, at 52. Supermajority boards have also increased the distrust between CEOs and directors. Mitchell, *supra* note 21, at 1319.

239. Bainbridge, *Director Primacy*, *supra* note 22, at 563.

240. CARTER & LORSCH, *supra* note 27, at 52; BUILDING BETTER BOARDS: A BLUEPRINT FOR EFFECTIVE GOVERNANCE 84 (David A. Nadler et al. ed., 2006) [hereinafter BUILDING BETTER BOARDS].

board receives negatively impacts its ability to monitor management.[241]

3. Practical Constraints on Board/CEO Interaction

Boards face several practical challenges. The CEO is primarily in charge of disseminating information to the board, which results in asymmetrical information skewed towards the CEO's viewpoint. As discussed above, the volume, timing, and type of information provided to board members do not prepare them to properly perform their monitoring responsibilities.[242] Time is a limited resource for most boards.[243] In addition to the ways that time limits a director's independence, it also constrains the relationship between boards and their respective CEOs. Specifically, there are few opportunities for interaction between boards and CEOs, which can lead to mistrust. In addition to supplemental committee meetings, directors meet on average eight times per year.[244] Given that the average director spends approximately sixteen hours a month on board-related work, which includes travel time back and forth from meetings, it may take years for directors to develop a strong working relationship with executive management.[245] The realities of independent director life mean that we must consider how much interaction a part-time director can actually devote to developing a good working relationship with her co-directors and the CEO of the company on whose board she sits.[246]

As a first step toward reorienting the discourse on boards as monitoring mechanisms, as well as their role in the success or failure of a corporation, we must critically examine the limitations on boards resulting from their interaction with management. The characteristics of the interactions between the CEO and the board have important implications for board process. Their interdependence means that the CEO and the board rely on each other, and more troublingly, share the same dataset of information.[247] In order for board members to consider alternative viewpoints, and even more importantly, identify possible failings in the CEO's plans, boards need independent mechanisms for generating and

241. CARTER & LORSCH, *supra* note 27, at 52; BUILDING BETTER BOARDS, *supra* note 240, at 85.

242. *See supra* Part II.D.2 (discussing the practical limitations on boards generally).

243. CARTER & LORSCH, *supra* note 27, at 73.

244. KORN/FERRY INST., *supra* note 79, at 10. U.S. companies hold an average of eight board meetings a year not including telephonic meetings. Two decades ago the Korn/Ferry survey showed 25 percent of U.S. companies held board meetings every month. By 2003, only 9 percent of surveyed U.S. companies held monthly meetings and that number declined to 7 percent by 2007.

245. *Id.*

246. *Id*. at 4–5.

247. *See supra* Part IV.A.1.

gathering information.

The conflicted nature of the relationship between the board and the CEO supports the same conclusion. The tension that arises from a board that serves as both an active approver of decisions and a police force charged with preventing and punishing management's bad behavior, results in a CEO who is very careful with what she shares with the board. The information may be intentionally limited, or unduly optimistic, making it difficult for the board to properly evaluate strategy, capital commitments, executive compensation packages, or budgets. Finally, the practical constraints on boards limit the time they have to develop a relationship with the CEO and how heavily they must rely on her for information.

B. ATTRIBUTES OF A PROCESS-ORIENTED APPROACH

Solutions aimed at changing the inputs of composition and structure of the board do not appreciate the practical realities faced by most boards. The realistic operation of the board in the life of the firm means that adjusting the content of the board is of limited utility for improving the board's efficacy. Many directors believe that they do not have the right information to properly understand and evaluate management's recommendations.[248] These limitations, which are also inherent in the relationship between the CEO and the board, can be remedied by adopting a process-oriented approach to board reform.

Adopting a process-oriented approach means that directors should employ a decision-making process that has at least four elements: (1) a forward looking approach to information and data; (2) independent information-gathering mechanisms; (3) directors that play a proactive role in organizational goal setting; and (4) a constructive conflict generation and resolution system.[249]

As discussed, boards add the most value to the firm when they encounter and resolve nonroutine situations. The decision-making processes and information needs differ in routine and nonroutine situations. Similarly, what is required to respond to a crisis is different than what is required to prevent one. Groups that lack the information they need to make decisions or find alternatives to the problems they confront, are limited in their ability to perform well.

248. Nadler, *supra* note 144, at 110; CARTER & LORSCH, *supra* note 27, at 23.
249. Sharpe, *Questioning Authority*, supra note 9.

Past information, such as organizational records, are of tremendous value when the situation is familiar, but the individual lacks prior experience. Yet reliance on this type of information greatly impedes rapid adjustment to new circumstances.[250] When groups confront nonroutine problems, they tend to adapt more slowly and less creatively than if they are able to utilize forward-looking, strategic information. In order for a board to better monitor managers, it should utilize forward-looking information, in addition to the backward looking information it typically receives.[251]

Like forward-looking information, independent information channels are a core component of effective decisionmaking. How a board obtains information and from whom affects the types of information available for decisionmaking, and, just as with forward- looking information, determines the range of alternatives and outcomes available to the board. Limiting the information channels to those that are directly filtered through the CEO burdens the board with the same failings at the CEO. Independent information-gathering channels would substantially enhance the board's monitoring capabilities.[252]

Goals frame the choices an organization makes. Passive involvement in the form of approving strategic plans and goals, places the board in a reactive decision-making posture. Directors respond to the priorities and strategies already established by management. In contrast, active involvement in the form of collaborative planning and goal setting facilitates more proactive decisionmaking by directors. Proactive involvement in this particular aspect of organizational decisionmaking complements the information needs of the board by increasing directors' awareness of the types of information necessary for monitoring the progress and outcomes of the goal setting process.[253]

Finally, corporations that create a robust process for conflicts management are more likely to facilitate the type of open and honest discourse necessary to adjust strategic decisions. Finkelstein and Mooney's term coined "constructive conflict" is essential for a company to grow and

250. CYERT & MARCH, *supra* note 166, at 126.

251. For a more detailed analysis of forward-looking information and how it improves the board's decision-making process, see Sharpe, *Questioning Authority*, *supra* note 9.

252. For a more in-depth analysis of information-gathering channels, see Sharpe, *Questioning Authority*, *supra* note 9.

253. *See* Sharpe, *Questioning Authority*, *supra* note 9 (discussing the necessity of board involvement in goal setting for a proactive and effective decision-making process).

to change direction in the face of better information.[254] Constructive conflict is a nonconfrontational way of encouraging diverse options and challenges to the path dependency that might govern most board decisionmaking, and a means to overcoming structural biases such as groupthink. Importantly, constructive conflict distinguishes between the process of deciding and the outcome of the decision.[255] It encourages a process that values investigation and critical analysis, which improves the quality of decisions.[256]

V. CONCLUSION

Current attempts to fix corporate boards are doomed to failure. This is because the conventional approaches to improve corporate boards are based on a dangerously incomplete understanding of board behavior, which looks to structure and composition at the exclusion of process. Process and structure are deeply intertwined. The processual aspect of corporate governance, however, has largely been ignored. Form should follow function, and structural changes that attempt to do otherwise actually inhibit a board's ability to engage in effective decision-making processes and properly monitor managers. Structural and compositional changes insufficiently empower the board to perform its oversight function. This Article has identified the importance of previously unrecognized process-oriented methods of overcoming the limitations inherent in a structural approach to improving board monitoring. It is time to focus on board process as a way of increasing board efficacy. Unless we do so, regulations that change corporate board structure while ignoring the negative implications for board process will inevitably continue to fail.

254. Finkelstein & Mooney, *supra* note 79, at 103.

255. Timothy S. Kochery, *Conflict Versus Consensus: Process and Their Effect on Team Decision Making*, 4 HUM. RES. DEV. Q., 185, 186 n.2 (1993).

256. *See* Sharpe, *Questioning Authority*, *supra* note 9 (analyzing the benefits of a conflicts management system and arguing that it is a critical attribute of the board's decision-making process).