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A Critique of the NYSE's Director Independence Listing Standards

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I. Introduction

The new millennium has not been kind to Wall Street. The stock market recorded back-to-back years of losses in 2000 and 2001, for the first time since 1973-74.[1] If the market suffers a third consecutive losing year in 2002, which seems quite plausible as of this writing, it do so for the first time since the Great Depression.[2] Investor confidence reportedly has been shaken by repeated accounting scandals, of which Enron is merely the most notorious.[3] A high profile investigation by New York's attorney general has called into question the integrity of stock market analysts.[4] Executive compensation remains a hot-button issue, just as several high-profile CEOs have been fired or even indicted.[5] All of which led SEC Chairman Harvey Pitt to opine that restoring investor "confidence is the No. 1 goal on our agenda."[6]

Under the New York Stock Exchange's (NYSE) aegis, a blue ribbon panel of usual suspect Brahmins rode to the rescue.[7] In turn, the panel "anointed boards of directors, especially 'independent directors' as the capitalist cavalry."[8] Among other recommendations, the NYSE Corporate Accountability and Listing Standards Committee's report proposed new stock exchange listing standards requiring that independent director comprise a majority of any listed corporation's

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1 Tom Petruno & Kathy M. Kristof, *Another Losing Year for the Stock Market*, L.A. TIMES, Jan. 1, 2002, at A1.

2 Jonathan Clements, *Bear-Proofing: Small Stocks, Foreign Markets*, VENTURA COUNTY STAR, May 5, 2002, at D4.

3 *Badly in Need of Repair—Company Accounts*, ECONOMIST, May 4, 2002, at S2.

4 Ron Insana & Eliot Spitzer, *The People v. Wall Street; New York's Attorney General Probes Analysts' Conflicts of Interest,* MONEY, June 2002, at 71.

5 Del Jones & Gary Strauss, *CEOs Are Going, Going, Gone*, USA TODAY, June 10, 2002, at B1.

6 Joseph Nocera, *System Failure*, FORTUNE, June 24, 2002, at 62, 64.

7 *See* Editorial, *The Capitalist Cavalry*, WALL. ST. J., June 7, 2002, at A10 (describing the NYSE committee as "barons of Wall Street").

8 *Id.*

board of directors.[9] Despite the considerable hullabaloo surrounding the report's release,[10] however, the report's recommendations in fact consist of little more than the warmed-over rejects of past corporate governance "reform" initiatives.[11]

This essay critiques the key provisions of the NYSE Committee's report—those relating to director independence. The paper argues that those proposals are not supported by the evidence and, moreover, adopt an undesirable one size fits all approach. Similar initiatives have been defeated in the past. The NYSE Committee's proposals deserve the same fate. The NYSE board of directors should reject them.

Part II of this paper briefly explains the significance of stock exchange listing standards. Part II then reviews the NYSE's existing listing standards relating to director independence. Lastly, Part II summarizes the NYSE Committee's proposals, comparing them to prior corporate governance initiatives. Part III presents evidence that director independence is not a *sine qua non* of good corporate governance. To the contrary, in many settings, director independence is undesirable. Accordingly, Part III concludes, the one size fits all approach mandated by the proposed new listing standards is seriously flawed.

II. NYSE Listing Standards

A. The Role and Significance of Listing Standards

Listing of a company's equity securities for trading on a prestigious stock market, such as the NYSE or NASDAQ,[12] confers significant benefits on the

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[9] REPORT OF THE NEW YORK STOCK EXCHANGE CORPORATE ACCOUNTABILITY AND LISTING STANDARDS COMMITTEE 6 (June 6, 2002), *available at* http://www.nyse.com/abouthome.html?query=/about/report.html [hereinafter cited as NYSE COMMITTEE REPORT].

[10] *See, e.g.,* Nocera, *supra* note 6, at 64 (noting that the NYSE Committee's proposals have "been widely lauded—praise, we believe, that is quite deserved").

[11] *See infra* notes 37-52 and accompanying text (comparing the NYSE Committee's proposals to those of the early drafts of the American Law Institute's corporate governance project).

[12] All securities transactions that do not take place on a stock exchange are said to occur in the over-the-counter (OTC) market. Bid and asked quotations for OTC securities traditionally were listed only daily in a publication known as the sheets or pink sheets. As a result, OTC stocks were less liquid than exchange securities. The NASDAQ is a computer network providing access (depending on the level of service chosen) to quotations and transaction reports for many OTC securities and allowing market makers to change quotations. As a result, NASDAQ-listed securities have liquidity approaching

company and its management. The greater liquidity of listed securities relative to those sold in the over-the counter (OTC) market reduces listed issuers' cost of capital.[13] Listing also confers considerable prestige on the firm and its managers.[14] Listed companies therefore desire to remain so, while many unlisted firms pursue eligibility for listing as their primary goal. By virtue of their power to set listing standards with which listed companies must comply, the exchanges thus wield considerable power over the governance of public corporations.[15]

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that or even exceeding that of exchange-listed securities. The emergence of NASDAQ as a viable alternative to exchange listing thus initiated a closing of the liquidity and prestige gap between the exchanges and the over-the-counter market. As a result, a growing number of companies that become eligible for NYSE or AMEX listings choose to remain on NASDAQ. John C. Coffee, Jr., *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145, 1257-58 (1984).

[13] *See* Gary C. Sanger & John J. McConnell, *Stock Exchange Listings, Firm Value, and Security Market Efficiency: The Impact of NASDAQ*, 21 J. FIN. & QUANT. ANAL. 1 (1986); Note, *Stock Exchange Listing Agreements as a Vehicle for Corporate Governance*, 129 U. PA. L. REV. 1427, 1437 n.48 (1981) (citing unpublished SEC study).

[14] Jeffrey Kerbel, *An Examination of Nonvoting and Limited Voting Common Shares—Their History, Legality, and Validity*, 15 SEC. REG. L.J. 37, 62 (1987).

[15] Listing standards are subject to approval by the Securities and Exchange Commission under § 19(b) of the Securities exchange Act of 1934, as amended. 15 U.S.C. § 78s (2001). Per § 19(b)(2), however, the SEC's powers with respect to corporate governance-related listing standards are quite limited. The SEC "shall approve a proposed" listing standard if the standard "is consistent with the requirements" of the Exchange Act and the rules thereunder. As nothing in the Exchange Act prohibits an exchange from regulating corporate governance through its listing standards, proposals to do so are not inconsistent with the Act. Hence, because nothing in the statute contemplates any form of merit review, the SEC effectively must rubberstamp such proposals. *See* Stephen M. Bainbridge, *Revisiting the One Share/One Vote Controversy: The Exchange's Uniform Voting Rights Policy*, 22 SEC. REG. L.J. 175, 183 (1994). For an argument that the exchange's authority to adopt corporate governance listing standards is uncertain, at best, and may be limited to provisions that "substantively relate to the operation of securities markets so as to promote investor confidence and provide reliability," however, see AMERICAN BAR ASSOCIATION SECTION OF BUSINESS LAW COMMITTEE ON FEDERAL REGULATION OF SECURITIES, SPECIAL STUDY ON MARKET STRUCTURE, LISTING STANDARDS AND CORPORATE GOVERNANCE 70-71 (MAY 17, 2002) *available at* http://www.abanet.org/buslaw/fedsec/nosearch/20020517.pdf [hereinafter cited as ABA Committee Report].

B. The NYSE's Current Director Independence Standards

The NYSE's current listing standards treat a director as independent unless, *inter alia*, (1) the director was employed by the corporation or its affiliates in the past three years, (2) the director has an immediate family member who, during the past three years, was employed by the corporation or its affiliates as an executive officer, (3) the director has a direct business relationship with the company,[16] or (4) the director is a partner, controlling shareholder, or executive officer of an organization that has a business relationship with the corporation, unless the corporation's board determines in its business judgment that the relationship does not interfere with the director's exercise of independent judgment.[17]

Turning to substance, the NYSE requires that all listed companies have at least three independent directors.[18] In addition, listed companies must have an audit committee comprised solely of independent directors. The committee must have at least three members, all of whom must be "financially literate." At least one committee member must have expertise in accounting or financial management.[19]

C. The NYSE's Proposed Standards

The NYSE Committee's proposals can be divided roughly into five major categories:

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[16] For this purpose, the requisite business relationships include commercial, banking, consulting, legal, and accounting relationships. New York Stock Exchange, LISTED COMPANY MANUAL § 303.01 (2000), *available at* http://www.nyse.com/listed/listed.html.

[17] *Id.*

[18] *Id.*

[19] *Id.* The SEC put additional teeth into the exchange's audit committee requirements by mandating that corporate proxy statements include a report from that committee containing a variety of disclosures. The report, for example, must state whether the committee reviewed and discussed the company's audited financial statements with management and the firm's independent auditors. The report must disclose whether the board of directors has adopted a written charter for the committee; if so, the company must include a copy of that charter in its proxy statement at least once every three years. Finally, the report must state whether the audit committee's members are independent as defined in the relevant stock exchange listing standards and, if not, why not. Exchange Act Rel. No. 42,266 (Dec. 22, 1999).

1. Enlarging the role and power of independent members of listed companies' boards of directors.[20]
2. Requiring listed companies to adopt codes of business conduct and corporate governance guidelines.[21]
3. Requiring shareholder approval of all equity-based compensation plans.[22]
4. Requiring the CEOs of listed companies to certify annually that the company is complying with NYSE listing standards and that information provided to investors is accurate.[23]
5. Encouraging the SEC and other regulatory bodies to address accounting, auditing, and disclosure standards.[24]

Although each set of proposals contains at least some problematic features, this paper focuses exclusively on the first set—i.e., those proposals relating specifically to director independence.

The NYSE Committee proposes requiring that the boards of directors all listed companies must have a majority of independent directors. The sole justification offered for this dramatic change is the Committee's belief that doing so "will increase the quality of board oversight and lessen the possibility of damaging

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[20] NYSE COMMITTEE REPORT, *supra* note 9, at 6-17.

[21] *Id.* at 18-23. Although the bulk of these provisions deal with such matters as conflict of interest transactions, two provisions likely will prove especially controversial. First, the report treads lightly into the corporate social responsibility debate through its requirement of fair dealing vis-à-vis "the company's customers, suppliers, competitors, and employees." *Id.* at 21. For a critical analysis of corporate social responsibility, see STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 418-29 (2002). Second, and even more controversially, the report argues that corporations "should proactively promote compliance with laws, rules and regulations." NYSE COMMITTEE REPORT, *supra* note 9, at 22. In addition to its failure to use the serial comma, this proposal will require corporations to expend unnecessary resources on compliance programs and/or increase their liability exposure. For a critique of mandated law compliance programs, see BAINBRIDGE, *supra*, at 291-296.

[22] NYSE COMMITTEE REPORT, *supra* note 9, at 17-18. This proposal would significantly expand the role of shareholders in compensation decisions, introducing a degree of shareholder micro-management that corporate law long has eschewed. Despite increased activism by a few institutional investors and self-appointed shareholder spokesmen, efficient corporate governance requires that the shareholder role remain highly constrained. For a fuller treatment of the argument against shareholder activism, see BAINBRIDGE, *supra* note 21, at 512-17.

[23] NYSE COMMITTEE REPORT, *supra* note 9, at 23-24.

[24] *Id.* at 25-28

conflicts of interest."[25] No evidence is offered to support that bald statement of belief, however. As we shall see, moreover, the evidence on this point is quite mixed.[26]

This proposal comes at a most inopportune time. Public corporations are finding it increasingly difficult to recruit and retain qualified independent directors.[27] Relatively low pay, compensation in stock rather than case, and increased time demands and liability exposure have all combined to render board service far less attractive than it once was. As a sop to affected companies, the report proposes allowing a two year grace period before compliance would be required.

What the report gives with one hand, however, it takes back with the other. The task of finding qualified independent directors will be significantly complicated by the proposed tightening of the definition of an independent director. The board must determine that a nominee has no material direct or indirect relationship with the listed company. A former employee of the listed company cannot be deemed independent until at least five years after the employment ended. A former affiliate or employee of the listed company's present or former auditor cannot be deemed independent until at least five years after the affiliation or auditing relationship terminated. A director may not be deemed independent if he is employed (or has been employed in the last five years) by a company in which an executive officer of the listed company serves as a member of the board of directors' compensation committee. Directors with immediate family members in any of the foregoing categories are likewise subject to a five year "cooling off period."[28]

To empower independent directors in carrying out their oversight duties, the report proposes requiring the independent directors to meet regularly outside the presence of management (including inside directors).[29] The listed company's board of directors must create a nominating and corporate governance committee comprised solely of independent directors. This committee is charged, at a minimum, with nominating new board members.[30] The board must also create a compensation committee, again comprised solely of independent directors, who

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[25] *Id.* at 6.

[26] *See infra* notes 76-89 and accompanying text (describing empirical studies of the effect of director independence).

[27] *See The Fading Appeal of the Boardroom*, ECONOMIST, Feb. 10, 2001.

[28] NYSE COMMITTEE REPORT, *supra* note 9, at 6-7.

[29] *Id.* at 8.

[30] *Id.* at 9.

minimal duties include setting the CEO's compensation. Both committees must adopt written charters specifying their roles, duties, and powers, which must at a minimum conform to the listing standard's detailed requirements.

The report also proposes a number of changes to the NYSE's longstanding audit committee standards. For example, an audit committee member may receive no compensation from the listed company other than director's fees.[31] The audit committee chair must have accounting or related financial management expertise.[32] The committee must have a written charter, meeting specified minimum standards.[33] Among the powers that must be conferred on the committee by such charter are the right to hire and fire the company's independent auditors and to perform a wide array of specified oversight responsibilities.[34]

Although the NYSE Committee's initiative attracted considerable press attention, much of it favorable,[35] they are in fact old wine in new bottles. Proposals to reform the board of directors abound—either to bring its composition and functions into line with the board's alleged real world role or, even more commonly, into line with some purported ideal.[36] The most ambitious reform effort to date remains the proposals advanced by the American Law Institute in the first tentative draft of what was then known as the "Principles of Corporate Governance: Restatement and Recommendations."[37] Virtually every provision of the ALI corporate governance project was controversial to some degree. Among

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[31] *Id.* at 11.

[32] *Id.* 12.

[33] *Id.* at 13.

[34] *Id.* at 13-16.

[35] *See, e.g.*, Robert L. Bartley, *A Silver Bullet for Human Nature*, June 10, 2002, at A17 (commending the NYSE proposals as "helpful"); Editorial, *supra* note 7, at A10 (editorializing that the NYSE report "strikes us as healthy"); Special Report, *wall Street—The Value of Trust*, ECONOMIST, June 8, 2002, at 65, 67 (opining that "the NYSE's rules are a step in the right direction").

[36] *See generally* Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?,* 95 HARV. L. REV. 597 (1982); Jill E. Fisch, *Taking Boards Seriously*, 19 CARDOZO L. REV. 265 (1997); Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors,* 43 STAN. L. REV. 863 (1991); Ira M. Millstein & Paul W. MacAvoy, *The Active Board of Directors and Performance of the Large Publicly Traded Corporation*, 98 COLUM. L. REV. 1283 (1998); James M. Tobin, *The Squeeze on Directors—Inside is Out*, 49 Bus. Law. 1707 (1994).

[37] AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: RESTATEMENT AND RECOMMENDATIONS (Tent. Draft No. 1 1982).

the most hotly debated, however, was the basic issue of what role the board of directors, especially the independent members of the board, should play in corporate governance.[38]

In Part III of tentative draft number 1, the drafters proposed scrapping state corporate law's traditionally minimalist approach in favor of a new "monitoring model." In prescribing both the board's composition and function, the drafters' main goal was to explicitly separate the task of managing large publicly held corporations from that of monitoring those who do the managing. The corporation's officers were to carry out the former set of responsibilities, while the board was charged with the latter. To promote managerial accountability, great emphasis was laid on the use of independent directors.

The first tentative draft required that independent directors comprise a majority of the board of directors of a large publicly held corporation.[39] This was intended to ensure objective board evaluation of management's performance. The same concern led the drafters to urge that, as a matter of good corporate practice, the independent directors should not have outside employment or other commitments that would interfere with their performance of their duties. Likewise, provisions allowing the independent directors to call upon corporate employees for assistance, to retain separate council or other experts on special issues, and to inspect corporate records and interview corporate personnel, were intended to allow the independent directors to bypass the company's senior executives when gathering information. The tentative draft also laid great stress on the role of three oversight committees, comprised primarily of independent directors. Specifically, the draft mandated audit and nominating committees for large publicly held corporations and recommended the establishment of a compensation committee.[40]

In response to the sharp criticism to which the first tentative draft was subjected,[41] subsequent drafts were revised in a number of respects. Some of the changes were merely cosmetic. For example, while the word monitoring no long appears in the final version's description of the board's function, the basic

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[38] For discussion of the ALI project's controversial origin and evolution, see Stephen M. Bainbridge, *Independent Directors and the ALI Corporate Governance Project*, 61 GEO. WASH. L. REV. 1034 (1993); William J. Carney, *The ALI's Corporate Governance Project: The Death of Property Rights?,* 61 GEO. WASH. L. REV. 898 (1993).

[39] *Id.* at § 3.03(a).

[40] *Id.* at §§ 3.05 - .07.

[41] *See* Bainbridge, *supra* note 38, at 1039-40 (describing the evolution of the relevant provisions).

division between monitoring and management functions was retained under new terminology.[42] The ALI thus still urges that the company be managed by its principal senior executives,[43] as well as arguing that the selection and oversight of those executives is the board's basic function.

Perhaps the most meaningful change was the conversion of virtually all of the proposed mandatory board composition and function rules into mere recommendations of corporate practice.[44] Where the first tentative draft proposed prohibiting the board of a large publicly held corporation from managing the firm on a regular basis, for example, the ALI PRINCIPLES, as adopted, restored the board's traditional power to do so.[45] Where the tentative draft required that independent directors make up a majority of a large publicly held corporation's board, the final version merely recommends such a composition as a matter of corporate practice.[46] The provisions on oversight committees were similarly watered down.[47]

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[42] Among the many striking stylistic changes introduced in Tentative Draft No. 2 was the new name given the project. Having begun life as "Principles of Corporate Governance: Restatement and Recommendations," the project became (and remains) "Principles of Corporate Governance: Analysis and Recommendations." This change made clear that the project was not merely a restatement of existing law, but in fact often recommended changes in existing law. AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (Tentative Draft No. 2, 1983). Second, recommendations concerning corporate practice were eliminated from the black letter sections; in addition, the phraseology used was changed from "good corporate practice" to mere "corporate practice." *Id.* at viii. Finally, the second draft made explicit that recommendations concerning corporate practice were "not intended as legal rules, noncompliance with which would impose liability." *Id.* at 83. As finally adopted, the ALI project retained these stylistic points. AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (1994) [hereinafter cited as ALI PRINCIPLES].

[43] ALI PRINCIPLES, *supra* note 42, at § 3.01.

[44] Tentative Draft No. 4 announced that the project's recommendations with respect to board composition and the oversight committees would be moved into a new Part III-A, to more clearly distinguish them from the provisions of Part III having legal effect. This approach was retained in the Principles as adopted. *See id.* at 109.

[45] *Id.* at § 3.02(b)(6).

[46] *Id.* at § 3A.01(a).

[47] While the final version retains the requirement that large publicly held corporation have an audit committee, for example, its composition has been broadened and its functions have been sharply limited. *Id.* at § 3.05. Where the audit committee once was to be comprised solely of independent directors, such directors now need comprise only a

In commenting on the ALI's decision to back-down from its initially proposed mandates in favor of mere precatory recommendations, I observed that some players in the ALI project seemingly hoped that their ideas "might become [binding] rules through future judicial or legislative action . . . ."[48] Because I believed the ALI proposals to be fundamentally ill-advised,[49] just as I believe the current NYSE proposals to be,[50] I opined that: "Constant vigilance thus will be necessary to ensure that the recommendations remain mere recommendations."[51] The day of reckoning is at hand, however. The parallels between the NYSE Committee's initiatives and the old ALI proposals are obvious and striking. But what were once mere recommendations of good practice will effectively be codified by incorporation into the exchange's listing standards. Because NASDAQ has already announced its intention of developing rules paralleling at least some of the NYSE's initiatives,[52] moreover, the mandate will be extended to encompass an enormous segment of U.S. public corporations.

III. Do Corporations Really Need Independent Directors?

Should a board of directors include any independent directors, let alone a board majority of such directors? They are such an ingrained part of the corporate landscape that it seems odd even to ask the question. Yet, it is still worth asking.

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majority of the committee. *Id.* at § 3.05. All committee members, however, must be outside directors. *Id*. Where the audit committee was once at the heart of the board's monitoring role, the audit committee's role is now limited to reviewing the corporation's auditing systems and the independence of the outside auditor. *Id*. (the audit committee is to periodically review "the corporation's processes for producing financial data, its internal controls, and the independence of the corporation's external auditor"). On the other hand, § 3A.03 recommends as a matter of corporate practice that the audit committee recommend the firm to be employed as the corporation's external auditor and review the results of the audit and the corporation's financial results. A nominating committee now is merely recommended and its functions have been likewise scaled back. *Id*. at § 3A.04.

[48] Bainbridge, *supra* note 38, at 1067.

[49] *See id.* at 1061-68 (criticizing ALI director independence proposals).

[50] *See infra* Part III.

[51] Bainbridge, *supra* note 38, at 1068.

[52] *See* Andrew Countryman, *NYSE on Mission to try to Restore Investors' Confidence; The NASDAQ is also Proposing Reforms to Rein in Conflicts of Interest*, ORLANDO SENT'L, June 9, 2002, at H1 (noting that the NASD has already submitted to the SEC proposed new director independence listing standards and that the NASD was considering a second round to include "provisions of the NYSE proposal").

The board of directors has two basic functions.[53] First, while boards rarely are involved in day-to-day operational decisionmaking, most boards have at least some managerial functions.[54] Broad policymaking is commonly a board prerogative, for example.[55] Even more commonly, however, individual board members provide advice and guidance to top managers with respect to operational and/or policy decisions. In addition, the board provides access to a network of contacts that may be useful in gathering resources and/or obtaining business. Secondly, the board monitors and disciplines top management.[56]

Independence is potentially relevant to both functions of the board. As to the former, outside directors provide both their own expertise and interlocks with diverse contact networks. As to the latter, at least according to conventional wisdom, board independence is an important device for constraining agency costs. On close examination, however, neither rationale for board independence justifies the sort of one size fits all mandate put forward by the NYSE Committee.

A. The Uncertain Case for Director Independence

1. Independence, interlocks, and decisionmaking

Putting outside directors on the board creates interlocks with a variety of potential strategic partners. This is relevant not only to the board's resource gathering function, but also to its monitoring and service functions. Complex business decisions require knowledge in such areas as accounting, finance, management, and law. Providing access to such knowledge can be seen as part of the board's resource gathering function. Outside board members may either

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[53] The following analysis condenses the taxonomy suggested by Johnson who mapped "directors' responsibilities into three broadly defined roles . . . labeled control, service, and resource dependence." Jonathan L. Johnson et al., *Boards of Directors: A Review and Research Agenda*, 22 J. MGMT. 409, 411 (1996). Hence, it resembles Dallas' two component taxonomy distinguishing between the board's monitoring and "relational" roles. Lynne L. Dallas, *Proposals for Reform of Corporate Boards of Directors: The Dual Board and Board Ombudsperson*, 54 WASH. & LEE L. REV. 91, 98-104 (1997).

[54] Stephen M. Bainbridge, *Why a Board? Group Decision Making in Corporate Governance*, 55 VAND. L. REV. 1, 8 (2002).

[55] *Id.*

[56] *See* Bayless Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477, 1494 (1984) (arguing that the board's role "does not consist of taking affirmative action on individual matters; it is instead a continuing flow of supervisory process, punctuated only occasionally by a discrete transactional decision").

possess such specialized knowledge themselves or have access to credible external sources thereof.

Reliance on outside specialists is a rational response to bounded rationality. The expert in a field makes the most of his limited capacity to absorb and master information by limiting the amount of information that must be processed by limiting the breadth of the field in which the expert specializes. As applied to the corporate context, more diverse boards with strong outsider representation likely contain more specialists, and therefore should get greater benefits from specialization.[57]

Having said that, however, a full-time senior employee has other informational advantages over outsiders who devote but a small portion of their time and effort to the firm. At the minimum, the presence of outsiders on the board increases decisionmaking costs simply because the process takes longer. Outsiders by definition need more information and are likely to take longer to persuade than are insiders.[58] More subtly, and perhaps more importantly, long-term employees make significant investments in firm-specific human capital. Any employee who advances to senior management levels necessarily invests considerable time and effort in learning how to do his job more effectively. Much of this knowledge will be specific to the firm for which he works, such as when other firms do not do comparable work or his firm has a unique corporate culture. In either case, the longer he works for the firm, the more firm-specific his human capital becomes. Such an employee is likely to make better decisions for the firm

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[57] Conversely, however, note that, because their decisions are publicly observable, board members have a strong incentive to defer to expert opinion. Because even a good decisionmaker is subject to the proverbial "act of God," the market for reputation evaluates decisionmakers by looking at both the outcome and the action before forming a judgment. If a bad outcome occurs, but the action was consistent with approved expert opinion, the hit to the decisionmaker's reputation is reduced. In effect, by deferring to specialists, a decisionmaker operating under conditions of bounded rationality is buying insurance against a bad outcome. In a collegial, multi-actor setting, the potential for log-rolling further encourages deference. A specialist in a given field is far more likely to have strong feelings about the outcome of a particular case than a nonexpert. By deferring to the specialist, the nonexpert may win the specialist's vote in other cases as to which the nonexpert has a stronger stake. Such log-rolling need not be explicit, although it doubtless is at least sometimes, but rather can be a form of the tit-for-tat cooperative game. In board decisionmaking, deference thus invokes a norm of reciprocation that allows the nonexpert to count on the specialist's vote on other matters.

[58] Michael P. Dooley & E. Norman Veasey, *The Role of the Board in Derivative Litigation: Delaware Law and the Current ALI Proposals Compared*, 44 BUS. LAW. 503, 533 (1989).

than an outsider, even assuming equal levels of information relating to the decision at hand. The insider can put the decision in a broader context, seeing the relationships and connections it has to the firm as whole.

Insider access to information is particularly significant due to the nature of decisionmaking within large corporations. Nobel laureate economist Kenneth Arrow described two basic decisionmaking structures: "consensus" and "authority."[59] Consensus is utilized where each member of the organization has identical information and interests, and will therefore select the course of action preferred by all of the other team members.[60] In contrast, authority-based decisionmaking structures arise where team members have different interests and amounts of information.[61] They are characterized by the existence of a central agency to which all relevant information is transmitted and which is empowered to make decisions binding on the whole.[62] Given the collective action problems inherent in any large organization, it is difficult to imagine a corporation of any substantial size making effective use of consensus as a mode for organizational decisionmaking.[63] Hence, corporations tend to be characterized by branching hierarchies.[64]

At the apex of that hierarchy is not a single autocrat, however, but rather a multi-member body that usually functions by consensus—namely, the board of directors. Put another way, the board of directors is best understood as a collegial body using consensus-based decisionmaking. Recall that consensus works best where team members have equal information and comparable interests.[65] Insiders are more likely to have comparable access to information and similar interests than are disparate outsiders. Insiders have lots of informal contacts, which promotes team formation, and better access to information. Hence, consensus decisionmaking should work best in insider dominated boards. Insofar as efficient decisionmaking is the goal of corporate governance, independence may not be

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[59] KENNETH J. ARROW, THE LIMITS OF ORGANIZATION 68-70 (1974).

[60] Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461, 467 (1992).

[61] *Id.*

[62] ARROW, *supra* note 59, at 68.

[63] *See generally* Stephen M. Bainbridge, *Participatory Management Within a Theory of the Firm*, 21 J. CORP. L. 657 (1996) (arguing that effective corporate decisionmaking requires authority-based governance institutions).

[64] *See* Bainbridge, *supra* note 54, at 5-7 (describing role of hierarchy in corporate governance).

[65] *See supra* text accompanying note 60.

desirable. This prediction is borne out by the empirical evidence recounted in the next section.

2. Independence and agency costs

The conventional justification for director independence is grounded not in decisionmaking efficiencies but in what an economist would call agency costs.[66] Agency costs are defined as the sum of the monitoring and bonding costs, plus any residual loss, incurred to prevent shirking by agents.[67] A sole proprietorship with no agents will internalize all costs of shirking, because the proprietor's optimal trade-off between labor and leisure is, by definition, the same as the firm's optimal trade-off. Agents of a firm, however, will not internalize all of the costs of shirking: the principal reaps part of the value of hard work by the agent, but the agent receives all of the value of shirking. Economists Armen Alchian and Harold Demsetz offered the useful example of two workers who jointly lift heavy boxes into a truck.[68] The marginal productivity of each worker is very difficult to measure and their joint output cannot be easily separated into individual components. In such situations, obtaining information about a team member's productivity and appropriately rewarding each team member is costly. In the absence of such information, however, the disutility of labor gives each team member an incentive to shirk because the individual's reward is unlikely to be closely related to conscientiousness.[69] Accordingly, an essential economic function of management is monitoring the

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[66] The obligatory reference is Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

[67] Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J. L. & ECON. 301, 304 (1983). In turn, shirking is defined to include as any action by a member of a production team that diverges from the interests of the team as a whole. As such, shirking includes not only culpable cheating, but also negligence, oversight, incapacity, and even honest mistakes. Dooley, *supra* note 60, at 465. In other words, shirking is simply the inevitable consequence of bounded rationality and opportunism within agency relationships.

[68] Armen Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972).

[69] For a detailed treatment of the incentive effects pursuant to which rational agents will shirk, see Roy Radner, *Hierarchy: The Economics of Managing*, 30 J. ECON. LIT. 1382, 1405-07 (1992).

various inputs into the team effort—management meters the marginal productivity of each team member and then takes steps to reduce shirking.[70]

The structure just described, of course, raises the question of who will monitor the monitors?[71] In any team organization, one must have some ultimate monitor who has sufficient incentives to ensure firm productivity without himself having to be monitored. Otherwise, one ends up with a never ending series of monitors monitoring lower level monitors. Alchian and Demsetz solved this dilemma by consolidating the roles of ultimate monitor and residual claimant.[72] According to Alchian and Demsetz, if the constituent entitled to the firm's residual income is given final monitoring authority, he is encouraged to detect and punish shirking by the firm's other inputs because his reward will vary exactly with his success as a monitor.

Unfortunately, this elegant theory breaks down precisely where it would be most useful. Because of the separation of ownership and control characteristic of modern public corporations,[73] Alchian and Demsetz's model simply does not describe such firms. As the corporation's residual claimants, the shareholders should act as the firm's ultimate monitors. But while the law provides shareholders with some enforcement and electoral rights, these are reserved for fairly extraordinary situations.[74] In general, shareholders of public corporation have neither the legal

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[70] Alchian & Demsetz, *supra* note 68, at 794. Although agents ex post have strong incentives to shirk, ex ante they have equally strong incentives to agree to a corporate contract containing terms designed to prevent shirking. Bounded rationality, however, precludes firms and agents from entering into the complete contract necessary to prevent shirking by the latter. *See generally* OLIVER E. WILLIAMSON, THE MECHANISMS OF GOVERNANCE 37 (1996) (opining that the lesson of bounded rationality is that "all complex contracts are unavoidably incomplete"; emphasis removed). Instead, there must be some system of ex post governance—i.e., some mechanism for detecting and punishing shirking.

[71] Alchian & Demsetz, *supra* note 68, at 782.

[72] *Id*. at 781-83.

[73] The classic account of the separation of ownership and control remains, of course, ADOLF A. BERLE, JR. AND GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

[74] Derivative suits and proxy contests, for example, constrain managerial behavior to some extent. These remedies are so costly and their outcome so uncertain that they are invoked only episodically. Dooley, *supra* note 60, at 525.Moreover, many aspects of the legal rules governing these devices (such as the derivative suit demand requirement, the federal proxy regulations, and state rules governing reimbursement of expenses) seem calculated to discourage frequent recourse to them. *Id.*

right, the practical ability, nor the desire to exercise the kind of control necessary for meaningful monitoring of the corporation's agents.[75]

Corporate law therefore provides a series of alternative accountability mechanisms designed to constrain agency costs. Chief among them is the board of directors, especially the independent directors. To be sure, outsiders have neither the time nor the information necessary to be involved in the minutiae of day-to-day firm management. What outsiders can do, however, is to monitor senior managers and replace those whose performance is sub-par. Or so the story goes.

If independent directors effectively constrain agency costs, however, there should be an identifiable correlation between the presence of outsiders on the board and firm performance. Yet, the empirical data on this issue is decidedly mixed. Some early studies found such correlations. Rosenstein and Wyatt, for example, found that shareholder wealth increased when independent directors are appointed by management.[76] Weisbach studied board decisions to remove a CEO, finding that boards comprised mainly of independent directors were more likely to base the removal decision on poor performance, as well as being more likely to remove an under-performing CEO, than were insider dominated boards.[77] He also found that CEO removals by outsider dominated boards added to firm value, while CEO removals by insider dominated boards did not.[78] Baysinger and Butler found that corporate financial performance tends to increase (up to a point) as the percentage of independent directors increases.[79] Cotter found that boards dominated by outsiders generate higher shareholder gains from tender offers.[80]

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[75] *See generally* Stephen M. Bainbridge, *The Politics of Corporate Governance*, 18 HARV. J. L. & PUB. POL'Y 671, 694-99 (1995) (cataloging barriers to effective shareholder activism).

[76] Stuart Rosenstein & Jeffrey G. Wyatt, *Outside Directors, Board Independence, and Shareholder Wealth*, 26 J. FIN. ECON. 175 (1990).

[77] Michael S. Weisbach, *Outside Directors and CEO Turnover*, 20 J. FIN ECON. 431 (1988).

[78] *Id.*

[79] Barry D. Baysinger & Henry N. Butler, *Revolution Versus Evolution in Corporation Law: The ALI's Project and the Independent Director*, 52 GEO. WASH. L. REV. 557, 572 (1984).

[80] James F. Cotter et al., *Do Independent Directors Enhance Target Shareholder Wealth During Tender Offers?,* 43 J. FIN. ECON. 195 (1997). *See also* Bernard S. Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 UCLA L. REV. 895, 900 (1992) (asserting that boards with a majority of independent directors make better acquisition decisions, citing an unpublished study by John Byrd and Kent Hickman).

Other studies, however, such as that by MacAvoy, found that board composition had no effect on profitability.[81] Klein likewise found little evidence of a general association between firm performance and board composition.[82] She also found a positive correlation between the presence of insiders on board finance and investment committees and firm performance,[83] which is directly counter to conventional wisdom. Rosenstein and Wyatt found that the stock market experienced a significantly positive price reaction to announcements that insiders had been appointed to the board when insiders owned more than 5% of the firm's stock.[84] A meta-analysis of numerous studies in this area concluded that there was no convincing evidence that firms with a majority of independent directors outperform other firms.[85] It further concluded that there is some evidence that a "moderate number" of insiders correlates with higher performance.[86] Another recent meta-analysis likewise found no evidence that board composition affects financial performance.[87]

A recent literature review further complicated the empirical landscape by effectively splitting the baby.[88] The review's analysis of 63 correlations found that, on average, increasing the number of outsiders on the board is positively

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[81] Paul MacAvoy, et al., *ALI Proposals for Increased Control of the Corporation by the Board of Directors*, in STATEMENT OF THE BUSINESS ROUNDTABLE ON THE AMERICAN LAW INSTITUTE'S PROPOSED "PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS" C-1 (Feb. 1983).

[82] April Klein, *Firm Performance and Board Committee Structure*, 41 J. L. & ECON. 275 (1998).

[83] *Id.*

[84] Stuart Rosenstein & Jeffrey G. Wyatt, *Outside Directors, Board Independence, and Shareholder Wealth*, 26 J. FIN. ECON. 175 (1990). In another study of the relationship between director stock ownership and firm performance, Bhagat, Carey, and Elson found a significant positive correlation between stock ownership by nominally independent directors and a variety of firm performance measures. They also found that as the dollar value of such holdings increased so did the probability that poorly performing firms would fire their CEO. Sanjai Bhagat et al., *Director Ownership, Corporate Performance, and Management Turnover*, 54 BUS. LAW. 885 (1999).

[85] Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921 (1999).

[86] *Id.* at 922.

[87] Dan R. Dalton et al., *Meta-Analytic Reviews of Board Composition, Leadership Structure, and Financial Performance*, 19 STRATEGIC MGMT. J. 269 (1998).

[88] John A. Wagner et al., *Board Composition and Organizational Performance: Two Studies of Insider/Outsider Effects*, 35 J. MGMT. STUD. 655 (1998).

associated with higher firm performance. On the other hand, increasing the number of insiders on the board had the same effect. A second meta-analysis confirmed that greater board homogeneity was positively associated with higher firm performance, which is not what conventional wisdom would predict.[89]

If independent directors are not effective monitors of senior management, why not? One obvious answer is that shirking is an endemic problem. Monitoring the performance of the firm's officers and employees is hard, time-consuming work. Moreover, most outside directors have full-time employment elsewhere, which commands the bulk of their attention and provides the bulk of their pecuniary and psychic income. Independent directors therefore may prefer leisure or working on their primary vocation to monitoring management. As Adam Smith observed three centuries ago,

> The directors of [joint stock] companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private co-partnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.[90]

Other factors impede an independent director from monitoring management, even if he wishes to do so. Board meetings are few and short. According to one survey, directors in large manufacturing companies average a total of 14 board and committee meetings per year, with the average board meeting lasting only three hours.[91] Moreover, outside directors are generally dependent upon management for information.[92]

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[89] *Id.*

[90] ADAM SMITH, THE WEALTH OF NATIONS 700 (Modern Library ed. 1937).

[91] THE CONFERENCE BOARD, MEMBERSHIP AND ORGANIZATION OF CORPORATE BOARDS 25 (1990).

[92] CHARLES N. WALDO, BOARDS OF DIRECTORS: THEIR CHANGING ROLES, STRUCTURE, AND INFORMATION NEEDS 95-118 (1985). As the old joke puts it, management should treat directors like mushrooms: "You grow [them] in the dark and you feed [them] horse manure." Alison Leigh Cowan & Reed Abelson, *Enron's Many Strands: A Board Member; Professor Who Led Audit Panel Failed to Spot Smoke and Mirrors*, N.Y. TIMES, February 7, 2002, at C7.

Finally, even when nominally independent directors are not actually biased in favor of the insiders, they often are at least predisposed to favor insiders. Most of the learning on this phenomenon, known as structural bias, arises out of the use of special litigation committees to terminate shareholder derivative litigation against officers or directors. Outside directors tend to be corporate officers or retirees who share the same views and values as the insiders.[93] A sense of "there but for the grace of God go I" therefore is said to be a likely response to litigation against fellow directors.[94]

Query, however, whether the derivative litigation context is really all that special. All outside directors—not just those who serve on SLCs—are nominated by the incumbent board members and passively elected by the shareholders, which supposedly biases the selection process towards directors whose cooperation and support the incumbents can count on.[95] As such, if purportedly independent directors are likely to favor their fellow directors when the latter are sued, they are equally likely to do so in any conflict of interest situation. Consider, for example, the hostile takeover context. According to a survey taken during the "merger mania" days of the 1980s, over 50 percent of responding companies believed they were possible takeover targets, 45 percent had been the subject of takeover rumors, and 36 percent had experienced unusual or unexplained trading activity.[96] Where a nominally independent director's principal occupation is serving as an officer of another corporation, the "there but for the grace of God go I" syndrome again rears its head. Despite being an outsider, fears for his own firm may often render an independent director sympathetic to insiders' job security concerns when a hostile takeover threatens the firm.[97]

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[93] Joy v. North, 692 F.2d 880, 888 (2d Cir. 1982); George W. Dent, Jr., *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit*, 75 NW. U. L. REV. 96, 111-13 (1980).

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

[95] *See* Nocera, *supra* note 6, at 72 (quoting business professor Jay Lorsch's observation that "everybody on [Enron's] board was selected by Ken Lay"); *see also* Barry Baysinger and Robert E. Hoskisson, *The Composition of Boards of Directors and Strategic Control: Effects on Corporate Strategy*, 15 ACAD. MGMT. REV. 72, 72-73 (1990) (arguing that senior "managers dominate their boards by using their de facto power to select and compensate directors and by exploiting personal ties with them").

[96] S. Rep. No. 265, 100th Cong., 1st Sess. 79 (1987) (additional views of Sens. Sasser, Sanford & Chaffee).

[97] *See* Dynamics Corp. v. CTS Corp., 794 F.2d 250, 256 (7th Cir. 1986), *rev'd on other grounds,* 481 U.S. 69 (1987) (noting conflict of interest in takeovers); *see generally*

To be sure, the potential for shirking and bias easily can be overstated. Not all directors are biased—actually or structurally—and the annals of corporate law are replete with instances in which seemingly biased directors nevertheless did the right thing.[98] Better still, independent directors have affirmative incentives to actively monitor management and to discipline poor managers. If the company fails on their watch, for example, the independent directors' reputation and thus their future employability is likely to suffer.[99]

Michael P. Dooley & E. Norman Veasey, *The Role of the Board in Derivative Litigation: Delaware Law and the Current ALI Proposals Compared*, 44 BUS. LAW. 503, 534 (1989) (objecting that "the structural bias argument has no logical terminus").

[98] During the 1980s and 1990s, several trends coalesced to encourage more active and effective board oversight. Much director compensation is now paid in stock, for example, which helps align director and shareholder interests. Charles M. Elson, *Director Compensation and the Management-Captured Board: The History of a Symptom and a Cure*, 50 SMU L. REV. 127 (1996). Courts have made clear that effective board processes and oversight are essential if board decisions are to receive the deference traditionally accorded to them under the business judgment rule, especially insofar as structural decisions are concerned (such as those relating to management buy-outs). *See* Bainbridge, *supra* note 38, at 1068-81 (describing how judicial review of management buyouts and other conflict of interest transactions focuses on role of independent directors). Third, director conduct is constrained by an active market for corporate control, ever-rising rates of shareholder litigation, and, some say, activist shareholders. Daniel P. Forbes and Frances J. Milliken, *Cognition and Corporate Governance: Understanding Boards of Directors as Strategic Decision-making Groups*, 24 ACAD. MGMT. REV. 489 (1999). As a result, modern boards of directors typically are smaller than their antecedents, meet more often, are more independent from management, own more stock, and have better access to information. These developments culminated in a series of high-profile board revolts against incumbent managers at such iconic American corporations as General Motors, Westinghouse, and American Express. Ira M. Milstein, *The Evolution of the Certifying Board*, 48 BUS. LAW. 1485, 1489-90 (1993). As boards become stronger and more independent of top management, moreover, the process builds momentum. For example, Westphal and Zajac have demonstrated that as board power increases relative to the CEO—measured by such factors as the percentage of insiders and whether the CEO also served as chairman—newly appointed directors become more demographically similar to the board. James D. Westphal & Edward J. Zajac, *Who Shall Govern? CEO/Board Power, Demographic Similarity, and New Director Selection*, 40 ADMIN. SCI. Q. 60 (1995) (cautioning that CEO control over director selection remains the general rule).

[99] Eugene F. Fama & Michael C. Jensen, Separation of Ownership and Control, 26 J. L. & Econ. 301, 315 (1983) (suggesting that "outside directors will monitor the management

Yet, even so, recent history teaches that board independence is hardly a panacea:

> No director can be expected to catch sophisticated fraud by company insiders. The head of Enron's audit committee, Robert Jaedicke, is a professor of accounting at Stanford University, who could hardly have been more qualified for the job.[100]

And we all know what happened at Enron.

B. The Continuing Legitimacy of Insider Representation

Taken to its logical extreme, the conventional wisdom suggests that boards should consist almost solely of independent directors whose oversight of senior management should approach the adversarial. But while supervision of management is one of the board's functions, it is only one of those functions. Economist Oliver Williamson in fact suggests that one of the board's functions is to affirmatively "safeguard the contractual relation between the firm and its management."[101] Many adverse firm outcomes are beyond management's control. If the board is limited to monitoring management, and especially if it is limited to objective measures of performance, however, the board may be unable to differentiate between acts of god, bad luck, ineptitude, and self-dealing. Insiders' greater knowledge and firm-specific human capital would help draw such distinctions. Under such conditions, a variety of adverse outcomes may result. Risk averse managers may demand a higher return, for example. Alternatively, managers may reduce the extent of their investments in firm-specific human capital, so as to minimize nondiversifiable employment risk.

This analysis suggests support for a less adversarial relation between board and management. The analysis also suggests the legitimacy of insider representation on the board. Insider representation encourages learned trust between insiders and outsiders, which in turn provides the board with a credible source of information necessary to accurate subjective assessment of managerial performance. In addition, however, it also serves as a bond between the firm and the top management team. Inside directors presumably will look out for their own

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that chooses them because outside directors have incentives to develop reputations as experts in decision control").

[100] Special Report, *Corporate Governance—Designed by Committee*, THE ECONOMIST, June 15, 2002, at 69, 71.

[101] OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 298 (1985).

interests and those of their fellow managers. Board representation thus offers some protection against dismissal for adverse outcomes outside management's control. Such considerations likely explain the finding by Klein of a positive correlation between the presence of insiders on board committees and firm performance.[102] They also help explain the finding by Wagner that increasing the number of insiders on the board is positively correlated with firm performance.[103]

To be sure, the NYSE Committee did not propose banning insiders from the board. Overall, however, the Committee's proposals would tend both to limit the involvement of inside directors and to promote a more adversarial relationship between board and management. Insiders are limited to a board minority, despite the Wagner's evidence that insider dominated boards may be just as beneficial to investors as outsider dominated ones. Insiders are barred from key committees, despite Klein's evidence that their presence on such committees leads to better performance. Independent board members must caucus periodically outside the presence of insiders, despite evidence that such caucuses may lead to polarization between the groups and groupthink within them.[104]

C. Implications for the NYSE Committee's Proposals

1. One Size Does Not Fit All

The NYSE Committee's initiatives are premised on the conventional wisdom that board independence is an unalloyed good. As the preceding sections demonstrated, however, the empirical evidence on the merits of board independence is mixed (at best). Indeed, the clearest take-home lesson to be gleaned from that evidence is that one size does not fit all.

This result should not be surprising. On one side of the equation, firms do not have uniform needs for managerial accountability mechanisms. The need for accountability is determined by the likelihood of shirking, which in turn is determined by management's tastes, which in turn is determined by each firm's unique culture, traditions, and competitive environment. We all know managers whose preferences include a penchant for hard, faithful work. Firms where that sort of manager dominates the corporate culture have less need for outside accountability mechanisms.

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[102] *See supra* notes 82-83 and accompanying text.

[103] *See supra* notes 88-89 and accompanying text.

[104] On polarization and groupthink within groups, see Bainbridge, *supra* note 54, at 31-32.

On the other side of the equation, firms have a wide range of accountability mechanisms from which to choose. Independent directors are not the sole mechanism by which management's performance is monitored. Rather, a variety of forces work together to constrain management's incentive to shirk: the capital and product markets within which the firm functions; the internal and external markets for managerial services; the market for corporate control; incentive compensation systems; auditing by outside accountants; and many others. The importance of the independent directors' monitoring role in a given firm depends in large measure on the extent to which these other forces are allowed to function. For example, managers of a firm with strong takeover defenses are less subject to the constraining influence of the market for corporate control than are those of a firm with no takeover defenses. The former needs a strong independent board more than the latter does.

The critical mass of independent directors needed to provide optimal levels of accountability also will vary depending upon the types of outsiders chosen. Strong, active independent directors with little tolerance for negligence or culpable conduct do exist. A board having a few such directors is more likely to act as a faithful monitor than is a board having many nominally independent directors who shirk their monitoring obligations.

The NYSE Committee's initiatives, however, strap all listed companies into a single model of corporate governance. By establishing a highly restrictive definition of director independence and mandating that such directors dominate both the board and its required committees, the NYSE fails to take into account the diversity and variance among firms. The NYSE Committee's recommendations therefore should be scrapped in favor of allowing each firm to develop the particular mix of monitoring and management that best suits its individual needs. Assuming that markets have any power to affect market actors, this framework will result in optimal levels of accountability. Rational investors will not purchase, or at least not pay as much for, securities of firms lacking management accountability mechanisms. Nor will lenders lend to such firms without compensation for the risks posed by management's lack of accountability. Those firms' cost of capital will rise and their earnings will fall. Corporate managers have many strong incentives to prevent this from happening, not the least of which is that management compensation and wealth are often closely tied to firm earnings and performance.[105] Because monitoring by independent

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[105] Managers' human capital cannot be diversified. Because their wealth is thus dependent upon their firm's success, they have strong incentives to ensure that the firm does not fail. Dooley, *supra* note 60, at 525-26. Accordingly, if greater management accountability lowers the risk of firm failure, managers will voluntarily install

directors is an important source of accountability, market forces will lead management voluntarily to support the election of independent directors and to implement firm-specific mechanisms designed to ensure that their directors are able to carry out their monitoring function.

Having said that, however, there may still be a minor role for the exchanges to play. Because good corporate practices are something of a public good, there is a role for standard-setting organizations to play in identifying and promulgating such practices. As noted above, the ALI corporate governance project ultimately settled for promulgating the bulk of its director independence provisions as recommendations of good corporate practice rather than as proposed changes in law.[106] The Business Roundtable and the American Bar Association's committee on corporate law have each promulgated broad compilations of good corporate practice recommendations encompassing, *inter alia*, issues relating to director independence.[107] Recently, an ABA committee study of corporate governance listing standards recommended that the exchanges approach corporate governance issues via precatory best practice guidelines rather than via mandatory listing standards.[108] This is a provocative and potentially very useful solution to the problem. The exchanges are well-positioned to draw on the insights of issuers, investors, market professionals, and academicians. The exchanges' prestige would give their recommendations high visibility. Yet, because good practice guidelines are nonbinding, issuers would not be strapped into an ill-fitting "one size fits all" model.

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accountability mechanisms. This is why the capital markets have a disciplinary function. If potential debt or equity investors demand a higher rate of return to compensate them for the risks of continued suboptimal performance, the firm is more likely to founder-taking the incumbent managers down with it.

[106] *See supra* note 42 and accompanying text.

[107] Business Roundtable, *The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation*, 33 BUS. LAW. 2083 (1978); ABA Comm. on Corporate Laws, *Corporate Director's Guidebook*, 33 BUS. LAW. 1591 (1978); ABA Comm. on Corporate Laws, *The Overview Committees of the Board of Directors*, 34 BUS. LAW. 1837 (1979).

[108] ABA Committee Report, *supra* note 15, at 1-2. Because they express doubts as to the scope of the exchanges' authority to adopt corporate governance standards, the ABA committee proposed limiting such guidelines to those necessary to protect the integrity of the securities markets. *See id*. at 71.

2. Impact on State Corporate Law

The NYSE should be especially cautious about promulgating corporate governance listing standards because such standards effectively preempt state corporate law by creating a uniform quasi-federal law of public corporations. There is no reason to believe that the exchanges will do a better job of creating corporate law than do the states; indeed, there is good reason to belief that they will do a worse job. In addition, by virtue of the SEC's considerable influence over the exchanges, the expansion of exchange listing standards in the corporate governance area permits a backdoor power grab by the SEC over matters the Congress and the courts have left to the states.

The SEC has repeatedly tried to federalize corporate law in whole or in part.[109] As I have argued elsewhere, however, the legislative history of the Exchange Act demonstrates that the Commission has no authority to directly regulate corporate governance.[110] Consistent with this clear congressional intent, the Supreme Court has routinely rejected efforts to create a federal law of corporations.[111] Because "state regulation of corporate governance is regulation of entities whose very existence and attributes are a product of state law,[112] the court has consistently reaffirmed that:

> It . . . is an accepted part of the business landscape in this country for states to create corporations, to prescribe their powers, and to define the rights that are acquired by purchasing their shares.[113]

Of particular relevance to the problem at hand, the Supreme Court has consistently emphasized that state law governs the rights and duties of corporate directors:

> As we have said in the past, the first place one must look to determine the powers of corporate directors is in the relevant State's corporation law.

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[109] *See* Stephen M. Bainbridge, *The Short Life and Resurrection of SEC Rule 19c-4*, 69 WASHINGTON UNIVERSITY LAW QUARTERLY 565, 602-04 (1991) (tracing history of SEC attempts to federalize corporate law).

[110] *Id.* at 598-604.

[111] *See id.* at 613-16 (summarizing case law).

[112] CTS Corp. v. Dynamics Corp., 481 U.S. 69, 89 (1987).

[113] *Id*. at 91. *See also id*. at 89 (holding that "[n]o principle of corporation law and practice is more firmly established than a State's authority to regulate domestic corporations.").

> "Corporations are creatures of state law" and it is state law which is the font of corporate directors' powers.[114]

State law thus defines the directors' powers over the corporation and the qualifications of directors. State law also establishes the vote required to elect directors, whether shareholders have the right to cumulative voting in the election of directors, whether the corporation's directors may have staggered terms of office, and the power of the shareholders to remove directors prior to the expiration of their term of office.

The country as a whole benefits from state regulation of corporate governance. The markets that facilitate national and international participation in ownership of corporations are essential for providing capital not only for new enterprises but also for established companies that need to expand their businesses. This beneficial free market system depends at its core upon the fact that corporations generally are organized under, and governed by, the law of the state of their incorporation.[115]

This is so in large part because ousting the states from their traditional role as the primary regulators of corporate governance would eliminate a valuable opportunity for experimentation with alternative solutions to the many difficult regulatory problems that arise in corporate law. As Justice Brandeis pointed out many years ago: "It is one of the happy incidents of the federal system that a single courageous State may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of country."[116] So long as state legislation is limited to regulation of firms incorporated within the state, as it generally is, there is no risk of conflicting rules applying to the same corporation. Experimentation thus does not result in confusion.

Experience teaches that this process of state experimentation tends to result in efficient corporate law rules.[117] Just as investors and lenders will demand higher

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[114] Burks v. Lasker, 441 U.S. 471, 478 (1979) (citations omitted).

[115] CTS Corp. v. Dynamics Corp., 481 U.S. 69, 90 (1987).

[116] New State Ice Co v. Liebmann, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting).

[117] To be sure, some scholars contend that state corporate law is tainted by the so-called "race to the bottom." As the story goes, the more charters the state grants, the more franchise and other taxes it collects. According to this view, because it is corporate managers who decide on the state of incorporation, states compete by adopting statutes allowing corporate managers to exploit shareholders. *See generally* William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974) (the classic statement of race to the bottom hypothesis); *see also* Lucian Ayre Bebchuk,

rates of return from firms that do not voluntarily adopt optimal governance structures, they will also do so with respect to firms incorporated in states with lax corporate governance standards. Because much of management's wealth tends to be tied up both in firm securities and firm-specific human capital, it thus is management that will ultimately bear the cost of choosing to incorporate in such a state.[118] Corporate managers therefore have a strong incentive to assure that their state of incorporation offers rules preferred by investors, which should force excessively pro-management rules to gradually fall by the wayside.

In contrast, the uniformity threatened by the NYSE Committee's initiatives will preclude experimentation with differing modes of regulation. As such, there will be no opportunity for new and better regulatory ideas to be developed—no "laboratory" of federalism.[119] Instead, we will be stuck with rules that may well be wrong from the outset and, in any case, may quickly become obsolete.

Exchange regulation of corporate governance listing standards is also troubling because such standards could become a backdoor mechanism by which the SEC finally achieves *de facto* regulatory control over corporate governance—the very control the courts and Congress have denied it *de jure*. By virtue of the

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Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law, 105 Harv. L. Rev. 1437 (1992) (an updated account). Many legal scholars reject the race to the bottom hypothesis. *See, e.g.,* Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977) (the seminal response to Cary); *see also* William J. Carney, *The Political Economy of Competition for Corporate Charters*, 26 J. LEGAL STUD. 303 (1997); Frank H. Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540, 654-71 (1984); Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913 (1982); Roberta Romano, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709 (1987). On balance, empirical research appears to bear out this view of state competition, suggesting that efficient solutions to corporate law problems win out over time. *See* ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (1993) (setting forth both an empirical analysis and theoretical arguments challenging race to the bottom hypothesis).

[118] *See supra* note 105.

[119] In theory, the exchanges could use listing standards to compete with one another. *See* Bainbridge, *supra* note 15, at 193-94 (suggesting that exchanges ought to compete with respect to voting rights standards). In practice, however, the exchanges have shown no interest in such competition. Indeed, as already noted, NASDAQ likely will adopt listing standards tracking the NYSE Committee's proposals. *See supra* note 52 and accompanying text.

unique relationship between the SEC and the exchanges, the Commission naturally exercises considerable informal influence over exchange rulemaking. The late Donald Schwartz aptly referred to this influence as the SEC's "raised eyebrow" power.[120] If the NYSE Committee's initiatives are adopted, the exchanges role in corporate governance—and, hence, the SEC's ability to influence the rules by which corporations are governed—will expand dramatically. Federal preemption of state corporation law will have finally arrived, at least *de facto*.

IV. Conclusion

In St. Matthew's account of the Sermon on the Mount, Jesus taught:

> "Why do you see the speck in your neighbor's eye, but do not notice the log in your own eye? Or how can you say to your neighbor, 'Let me take the speck out of your eye,' while the log is in your own eye? You hypocrite, first take the log out of your own eye, and then you will see clearly to take the speck out of your neighbor's eye."[121]

The NYSE would do well to take this advice before adopting the proposals made by its Committee. Investor confidence doubtless has been shaken, which doubtless has been bad for both the NYSE's member firms and the exchange itself. Yet, the NYSE Committee's proposals are poorly-suited to redressing investor discontent. Even if one accepts the Committee's pollyannaish view of director independence standards, much of what troubles investors—lax accounting standards, unfair IPO share allocations, broker-analyst conflicts of interest, and the like—is simply outside the purview of listed company directors (independent or not). Before regulating listed companies, the NYSE would do well to reform the practices of its member firms.

Independent directors are not—and likely cannot be—all the Committee cracks them up to be. One size does not fit all. Firms have unique needs and should be free—as state law now allows—to develop unique accountability mechanisms carefully tailored for the firm's special needs. The SEC should not be further empowered to use its "raised eyebrow" regulatory powers as a vehicle to

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[120] Donald E. Schwartz, *Federalism and Corporate Governance,* 45 OHIO ST. L.J. 545, 571 (1984). In the mid-1990s, the SEC used that power to coerce the exchanges into adopting uniform voting rights listing standards. *See* Bainbridge, *supra* note 15, at 183-86 (criticizing the role played by SEC Chairman Arthur Levitt in the exchanges' adoption of voting rights listing standards).

[121] MATTHEW 7:3-5 (NRSV).

federalize corporate law. For all of these reasons, the NYSE should reject the Committee's proposals and leave development of corporate governance to state law and market forces.