THE DANGERS OF INDEPENDENT DIRECTORS

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The typical board of directors of major U.S. publicly held corporations now includes a greater number and percentage of "independent" directors than ever before. That sounds like a good thing, and in some respects it is. But like most benefits, the independent director wave carries with it corresponding costs. The typical board of directors now includes a greater number of directors who lack detailed operational knowledge about the firms they serve, and a greater percentage of directors who lack firm-specific commitment to their companies and all their stakeholders. That is the danger of independent directors and the subject of this essay.

The statistics are striking. According to the Spencer Stuart Board Index, in 1987, 2% of U.S. public companies had boards with only one non-independent director, 15% had two or fewer, and 34% had three or fewer.[1] In 1997, 79% of boards had three or fewer independent directors, with 23% having only one and 56% having two or fewer.[2] In 2014, 58% of boards had only one non-independent director, 84% had two or fewer, and 94% had three or fewer.[3] The progression has been nearly constant over that twenty-seven-year span, as illustrated by the following chart.

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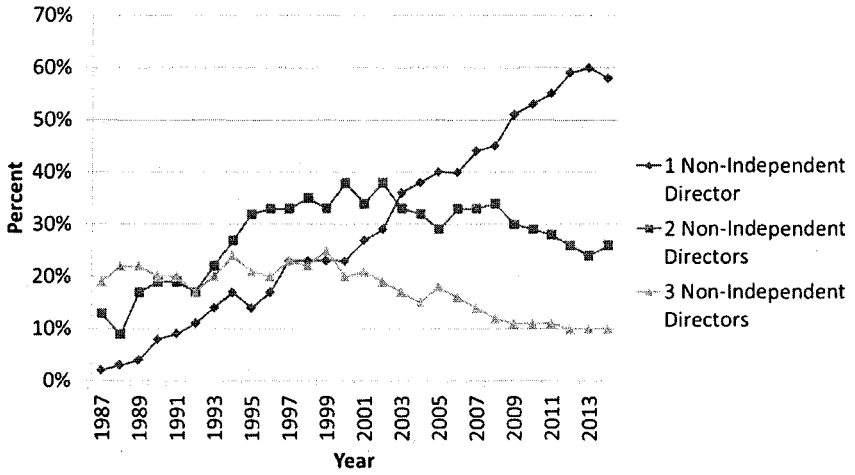
[1]SPENCERSTUART BOARD INDEX 1987 PROXY REPORT 19-23 (1987).

[2]SPENCERSTUART 1997 BOARD INDEX 17-31 (1997).

[3]SPENCERSTUART 2014 BOARD INDEX 43-60 (2014).

PERCENTAGE OF S&P 500 COMPANIES WITH NON-INDEPENDENT DIRECTORS[4]



So we have reached the point that the typical board consists of the CEO, and the rest of the directors are independent. No other members of senior management. No former CEOs. No former members of senior management. No representative of the firm's commercial bank. No outside lawyer for the company. No one else who likely has personal ties to the company's successes and failures, its growth and its struggles. No one else who comes to the boardroom with ties to the enterprise, financial or personal. Those sitting around the table with the CEO are likely to be serious about their job as directors but know too little about the company business.

We arrived at this pass largely by accident. The hostile takeover boom of the 1970s and 1980s led many observers to decry the seemingly knee-jerk negative reaction of target company boards to premium takeover bids.[5] Boards then typically included several members of current and prior senior management, even if a majority were independent under the standards of the day.[6] Courts and commentators

[4]The chart reflects data obtained from the SpencerStuart Board Index reports for the years of 1987 to 2014.

[5]*See, e.g.*, Ronald J. Gilson, *The Case Against Shark Repellent Amendments: Structural Limitations on the Enabling Concept*, 34 STAN. L. REV. 775, 775-78 (1982); Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1161-64, 1174-75 (1981).

[6]*See, e.g.*, Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 598 n.4 (1982); Business Roundtable, *The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation*, 33 BUS. LAW. 2083, 2107-09 (1978).

alike pounced on board reactions to unsolicited efforts to take over "our" company, claiming that "structural conflict"—that is, an entrenchment motive—disabled management and management directors from responding to proposed takeovers in the corporate best interest.[7] At the same time, corporate scholarship's concern with "agency costs" matured into a full-blown fetish,[8] reducing to the crude claim that anyone connected with management cannot be counted on to act with integrity in the broader corporate interest.[9] As a result, takeover defense came under withering and generally unsubstantiated criticism,[10] and there was overwhelming public debate over the reasonableness of a system in which any corporation could be forced into "play" by a bid letter accompanied by an investment bank's letter opining that it was "highly confident" that it could finance a premium bootstrap acquisition.[11]

This environment spurred demands for a higher proportion of independent directors who would not feel any attachment to "our" company.[12] Critics dismissed the idea that it was natural, and valuable, for managers and directors to feel loyalty to the employees, suppliers, customers, lenders, and others who had helped build the enterprise as

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[7]*See, e.g.*, Gregory R. Andre, *Tender Offers for Corporate Control: A Critical Analysis and Proposals for Reform*, 12 DEL. J. CORP. L. 865, 901-03 (1987) (citing Norlin Corp. v. Rooney, Pace Inc., 744 F.2d 255, 258, 267 (2d Cir. 1984)). The Delaware Supreme Court acknowledged the risk of entrenchment in *Unocal Corporation v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985) ("Because of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders, there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred.").

[8]*See, e.g.*, Larry E. Ribstein, *Takeover Defenses and the Corporate Contract*, 78 GEO. L.J. 71 (1989); William J. Carney, *Controlling Management Opportunism in the Market for Corporate Control: An Agency Cost Model*, 1988 WIS. L. REV. 385; Lucian Arye Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028, 1030-31 & nn.18-19 (1982).

[9]*See* Harvey L. Pitt, *On the Precipice: A Reexamination of Directors' Fiduciary Duties in the Context of Hostile Acquisitions*, 15 DEL. J. CORP. L. 811, 848 & n.138 (1990) (citing Roberta Romano, *The Future of Hostile Takeovers: Legislation and Public Opinion*, 57 U. CIN. L. REV. 457 (1988); Bruce T. Rosenbaum, *The Presumptions and Burdens of the Duty of Loyalty Regarding Target Company Defensive Tactics*, 48 OHIO ST. L.J. 273 (1987)).

[10]*See, e.g.*, Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 821, 845-46 (1981).

[11]*See* Ronald J. Gilson, *The Political Ecology of Takeovers: Thoughts on Harmonizing the European Corporate Governance Environment*, 61 FORDHAM L. REV. 161, 161-62 (1992); *see also* Romano, *supra* note 9, at 457, 481-82 & n.62.

[12]*See* Brian R. Cheffins, *Delaware and the Transformation of Corporate Governance*, 40 DEL. J. CORP. L. 1, 9 (2015) (citing Usha Rodrigues, *The Fetishization of Independence*, 33 J. CORP. L. 447, 449 (2008); Kenneth B. Davis, Jr., *Structural Bias, Special Litigation Committees, and Vagaries of Director Independence*, 90 IOWA L. REV. 1305, 1306 (2005)).

either a fig leaf to mask entrenchment motivation, or as tritely outmoded in a world properly guided by tomorrow's share price.[13]

Then came Enron and WorldCom. Again the call went out for greater director independence from management, on the theory that vigilant independent directors would have stopped greedy short-term managers from engaging in the kind of financial maneuvers that laid low several major firms.[14] This was reflex unburdened by logic.[15] Adding directors who knew little about the business, independent though they may be, was not at all likely to check intricate and carefully masked insider misconduct. Federal legislation and enhanced listing requirements nevertheless sought salvation in independent directors.[16] Institutional investors, especially government and union pension funds, picked up the independence banner and waved it high.[17]

The governance fallout from the financial and housing crises of 2008-2009 was equally unreflective. Instead of considering the impact of the rise of independent directors, the call was heard for greater empowerment of stockholders.[18] The Chair of the SEC observed that the economic crisis had led investors to raise "serious concerns" about the accountability of boards of directors to "the interests of stockholders."[19] Senator Charles Schumer of New York introduced a "Stockholder Bill of

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[13]*See* Mary Siegel, *The Illusion of Enhanced Review of Board Actions*, 15 U. PA. J. BUS. L. 599, 647 n.195 (2013).

[14]*See, e.g.*, Cheffins, *supra* note 12, at 38-40 (discussing the push for various committees to be "staffed entirely by independent directors" in the wake of Enron and WorldCom).

[15]*See* Steven Davidoff Solomon, *Corporate Governance Issues Grow More Complex*, N.Y. TIMES DEALBOOK (Oct. 21, 2011), *archived at* http://perma.cc/5RGM-TB9Z:

> [An] unintended consequence is related to corporate governance's focus on procedure rather than substance. Many who advocate independent directors as the cure-all for corporate governance do not look at or care about the substance of the decision. How you get there is sufficient even if the board's decision is ultimately a foolish one. The problem with this approach is that we get boards like the one at Enron, which was highly rated for corporate governance but made foolish—and ultimately disastrous—decisions.

[16]*Id.*

[17]*See, e.g.*, Rodrigues, *supra* note 12, at 494 ("[T]he Council of Institutional Investors calls for at least two-thirds of the board to be independent.").

[18]*See* Leo E. Strine, Jr., *Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law*, 114 COLUM. L. REV. 449, 469-70 (2014) (citing Lucian A. Bebchuk, *How to Fix Bankers' Pay*, DAEDALUS, Fall 2010, at 52, 57-58).

[19]Facilitating Shareholder Director Nominations, Exchange Act Release Nos. 33-9046, 34-60089 (June 10, 2009).

Rights Act"[20] that pinned the blame for the recession on corporate leaders taking "too many risks" while "stockholders had too little say."[21] Increased stockholder rights—to nominate directors in the corporation's proxy, to do away with staggered boards, to require say on pay, to mandate majority voting for director elections—were heralded as the cure.[22]

But these calls were accompanied by no reasoned connection between the apparent ill and the proposed cure.[23] Like generals fighting the last war, the "best practice" visionaries seem to always be looking backwards. Their focus on the problems of the past has been relentless, even as their prescriptions led to, or at least did nothing to alleviate, the problems of the present and the future.

We think that it should be uncontroversial that populating corporate boards with directors with little or no knowledge or relationship to a firm and its business is an odd prescription for improved governance.[24] No one could imagine the old-style boards of directors—with seasoned current and former senior executives, bankers, lawyers, and the like—presiding over the kinds of debacles that were only possible because boards seemed not to understand how their corporations made money. The old-style board had professional and reputational commitments to care about the employees, customers, suppliers, and other constituents on which the enterprise had depended for its sustainability and growth. Such relationships can easily be attacked as creating "conflicts" with stockholder interests if a hostile bid arrives in the mail. But these relationships also bring with them not just deep knowledge of the corporation's business, but also the kind of personal attachment that can help resist excessive risk-taking and the siren song of short-term gain.

More generally, directors are supposed to be able to advise management on substantive business matters, to approve significant decisions, and to assess management and company performance.[25] With

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[20]*See* Martin Lipton, *The Proposed "Shareholder Bill of Rights Act of 2009"*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (May 12, 2009), *archived at* http://perma.cc/8Z4E-ZC4Y.

[21]*See U.S. Sen. Schumer Unveils Shareholder Bill of Rights*, REUTERS, May 19, 2009, *archived at* http://perma.cc/C4EZ-FQXF.

[22]*See id.*

[23]*See* Lipton, *supra* note 20.

[24]*See, e.g.*, Lisa M. Fairfax, *The Uneasy Case for the Inside Director*, 96 IOWA L. REV. 127, 164-67 (2010) (discussing independent directors' "knowledge deficit").

[25]*See, e.g.*, H. Lowell Brown, *The Corporate Director's Compliance Oversight Responsibilities in the Post Caremark Era*, 26 DEL. J. CORP. L. 1, 31-32 (2001) (discussing Chancellor Allen's view of the role of corporate directors); Stephen P. Lamb & Andrew J.

deep knowledge of the company's business and its industry, directors are likely to be able to do their jobs well. From this core perspective, lack of extensive personal knowledge is a hindrance, not a benefit. And it also means that independent directors are more likely to rely for information and insight on the very management they are meant to be governing. These flaws are not present in all boards and may not be fatal in many. But they make it harder for directors to play the roles they are expected to perform.

This is not to blink at the structural risk of disloyalty by "insider" directors. But the equally omnipresent specter is the danger of independent directors who feel only slight personal stake in the sustainability of the enterprise and may be too averse to the risk of fighting for corporate independence in the face of an aggressive bidder or, in the more recent incarnation, the activist prescription for short-term gain.[26] Perhaps whether such director pliability is a good or bad thing can be debated, but at least one fact is free from doubt: it's a new thing. And it seems fair to ascribe it, in part or more, to the decreasing sway in boardrooms of directors whose willingness to defend the corporation reflected a lifetime of service to it.

The problems are exacerbated by the current calls for board "refreshment,"[27] which have the effect of pushing out the most experienced directors, independent or not. In a January 2015 report, Institutional Shareholder Services observed that concerns with refreshment issues came to a boil following the financial crisis "as many boards sought to hold on to their most experienced members for guidance in weathering the market storm."[28] How surprising to learn that that's a bad thing! ISS noted that this "boardroom logjam" led some investors to express concerns that longer tenures weakened director independence due to "capture" and allowed directors' skills to atrophy "as

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Turczyn, *Revlon and Hanson Trust: Unlocking the Lock-ups*, 12 DEL. J. CORP. L. 497, 498-501 (1987) (discussing the role of directors in the takeover context).

[26]*See* Ian D. Gow, Sa-Pyung Sean Shin & Suraj Srinivasan, *Consequences to Directors of Shareholder Activism* 19 (Harvard Bus. Sch. Working Paper 14-071, 2014), *archived at* http://perma.cc/3NFD-62SQ (discussing how independent directors may be more sensitive to shareholder activism).

[27]*See, e.g.*, EDWARD KAMONJOH, INSTITUTIONAL S'HOLDER SERVS., BOARDROOM REFRESHMENT: A REVIEW OF TRENDS AT U.S. FIRMS (2015), *archived at* http://perma.cc/D6XL-3LJW; Annie Gasparro, *McDonald's Shareholder Group Calls for Changes to Board of Directors*, WALL ST. J. (Feb. 13, 2015), http://www.wsj.com/articles/mcdonalds-shareholder-group-calls-for-changes-to-board-of-directors-1423862292; Martin Lipton, *Some Thoughts for Boards of Directors in 2014*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Nov. 29, 2013), *archived at* http://perma.cc/9W7L-3QKP (discussing how ISS, the Council of Institutional Investors, and CalPERS are pushing for "refreshment").

[28]KAMONJOH, *supra* note 27, at 1.

their actual marketplace experience became more remote."[29] Ominously, the report notes that several major global markets (including the United Kingdom) make director tenure a factor in defining independence, while the United States has left the issue to the broad discretion of the boards themselves.[30]

The call for refreshment reacts to the reality that directors are likely to become collegial over a period of collective service. What is peculiar in the "refreshment" response—and also unexplained—is the assumption that board collegiality is something to be avoided, by structural constraints if necessary. It is not intuitive, and we do not believe it is true, that collegiality contradicts independence. And stringent "refreshment" requirements of course means more director turnover, more new directors, and hence more directors at such an informational disadvantage that they risk succumbing to management's view, unarmed by their own experience.

Our simple point is that the generations-long "good governance" focus on director independence has marginalized company-specific and industry knowledge and discouraged the retention of directors with financial and emotional ties to the companies they serve. This approach is misguided. There is nothing wrong, and much that is good, about directors who care about the company and its past and its future, who feel a kinship to the company and its employees, who are prepared to manage the enterprise for success over the long term, and who have the heart to resist takeover attempts or activist initiatives if warranted by sound analysis of their company's circumstances. There may be no checklist that proves both informed objectivity and determined commitment. But it is counterproductive to disqualify or penalize the people most likely to bring those attributes to bear.

The legal system has long responded to the problem of director "conflicts" not by disqualifying directors with various backgrounds but by demanding of all directors that they be loyal to the corporation.[31]

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[29] *Id.*

[30] *Id.* at 3.

[31] *See, e.g.*, William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Function over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 26 DEL. J. CORP. L. 859, 874-75 (2001):

> Claimed breaches of the duty of loyalty, on the other hand, [are] reviewed under a far more exacting standard—entire fairness. The policy reason for applying that standard is that a board that is not conflicted is motivated to achieve the highest transaction price the market will permit. Because in those circumstances the board's interests and the interests of the shareholders are aligned, there is no reason for courts to engage in a substantive review of the board's decision. Where, however, a majority of the

Loyalty may be a blunt test, and the legal system may not be able to ferret out every instance of disloyalty in an efficient or effective way. Nonetheless, the duty of loyalty should serve as a reminder that directors were never obliged to be disconnected from the company. The entire business judgment rule is built on the premise that directors possess superior knowledge about the corporation's business;[32] a governance regime that insists on an overwhelming majority of directors who lack that special knowledge runs contrary to that sound principle.

To be sure, the legal system may provide a thumb on the favorable side of the scale when reviewing decisions made, or approved, by a majority of independent directors or a special committee of independent directors. Independence is a critical virtue when the issue is conflict, real or possible, of management, other directors, or a controlling stockholder. A majority of independent directors makes good sense, even if only for the benefit of legal burden shifting in such circumstances. But these circumstances are the exception. And the utility of an independent majority to account for them in no respect diminishes the need to reassess the takeover of corporate boards by independent directors.

These tensions have not gone entirely unrecognized in the literature. The 2009 Walker report on governance at UK financial institutions pointedly noted the negative impact of the applicable independence criteria that excluded from board service all executives recently employed by the company.[33] Others have noted that emphasizing director independence may result in management being less inclined to share information with the board, so that reforms aimed at increasing independence may decrease shareholder value.[34] And studies have shown no evidence that greater board independence correlates to greater profitability or growth and no empirical support for firms to limit

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board is conflicted, i.e., where a majority have personal interests in the transaction that are adverse to the interest of the shareholders, it cannot be presumed that the board will be motivated to achieve the highest transaction price the market will permit. Because in such cases it is difficult to ascertain at what maximum price the transaction could have been effected in the market, the law imposes upon the directors the burden of showing that the transaction is entirely fair as to both process and price. Thus, in conflict transactions that implicate the directors' duty of loyalty, the court engages in the most searching review of the substance of the board's decision, and in close cases it resolves the doubt against the directors.

[32]*See* Siegel, *supra* note 13, at 603-06.

[33]DAVID WALKER, A REVIEW OF CORPORATE GOVERNANCE IN UK BANKS AND OTHER FINANCIAL INDUSTRY ENTITIES FINAL RECOMMENDATIONS 41 (2009), *archived at* http://perma.cc/V4JX-DFEN.

[34]*See, e.g.*, Renée B. Adams & Daniel Ferreira, *A Theory of Friendly Boards*, 62 J. FIN. 217 (2007).

an insider to one or two board seats.[35] One noted scholar has posited that the trend toward independent directors reflects the shift to "shareholder value" as the "primary corporate objective," with stock price performance viewed as the best measure.[36] That development can be argued to drive the emergence of a new corporate governance paradigm, as independent directors are more likely to look to stock price signals than actual knowledge of management, the company, and its business.[37]

What is needed is a thorough rethinking of the optimal board composition. The drive for independent directors has proven itself suspect, even dangerous. We cannot at once demand so much of our directors and at the same time exclude from the boardroom the women and men best equipped to meet the challenge.

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

[36]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, 1563 (2007).

[37]*See id.* at 1563-65.