Proposals for Reform of Corporate Boards of Directors: The Dual Board and Board Ombudsperson

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Introduction

The debate on reforming corporate boards of directors has centered on monitoring management to ensure that corporate board members act in the interests of shareholders rather than in their own personal interests.[1] To

1. *See, e.g.*, AMERICAN LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 3A.01 (1994) [hereinafter PRINCIPLES OF CORPORATE GOVERNANCE]; AMERICAN LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS § 3.03(a) (Tentative Draft No. 1, 1982) [hereinafter Tentative Draft No. 1]; MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION — A LEGAL ANALYSIS 169-72 (1976); ROBERT A.G. MONKS & NELL MINOW, CORPORATE GOVERNANCE 178-229 (1995); ABA Comm. on Corp. Laws, *Corporate Director's Guidebook*, 33 BUS. LAW. 1591, 1625 (1978); Business Roundtable, *Corporate Governance and American Competitiveness*, 46 BUS. LAW. 241, 249 (1990); James D. Cox, *The ALI, Institutionalization, and Disclosure: The Quest for the Outside Director's Spine*, 61 GEO. WASH. L. REV. 1233, 1233-34 (1993); Ronald J. Gilson & Reiner Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV.

best monitor situations where managerial interests conflict with those of shareholders (conflicts monitoring), reformers have made numerous proposals to make boards independent of management. Two main problems confound these proposals. First, the proposals fail to deal adequately with social dynamics on boards that make independent decision making difficult when conflicted or nonindependent board members serve on the board, namely, inside (employee) directors and outside (nonemployee) directors with business relationships with the corporation or its management. Second, the proposals do not take proper account of the many important relational roles of the board other than conflicts monitoring.

In recognition of the importance of an independent board to conflicts monitoring and of the importance of the full range of relational roles of the board that requires a mix of different kinds of directors, I propose that state legislators modify state corporation statutes to permit public corporations to utilize a dual board structure. This structure would consist of two boards, each ideally composed to perform certain functions. One board, called the conflicts board, would perform conflicts monitoring and would be composed solely of independent directors, who are outside directors with no business relationships with the corporation or its management. The other board, called the business review board, would consist of a mix of different kinds of directors and would perform other relational roles. A full-time ombudsperson, selected by independent directors, would assist the independent directors in performing conflicts monitoring on the conflicts board or existing unitary boards.

Two theories of the board, contra-managerial hegemony theory[2] (hegemony theory) and agency cost theory,[3] have provided the foundation

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863, 872-76 (1991); Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187, 187 (1991).

2. *See, e.g.*, MONKS & MINOW, *supra* note 1, at 184; Lynne L. Dallas, *The Relational Board: Three Theories of Corporate Boards of Directors*, 22 J. CORP. L. 1, 4-8 (1996); Rita D. Kosnik, *Greenmail: A Study of Board Performance in Corporate Governance*, 32 ADMIN. SCI. Q. 163, 166-67 (1987); Laura Lin, *The Effectiveness of Outside Directors As a Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U. L. REV. 898, 912-17 (1996); Paul Mallette & Karen L. Fowler, *The Effects of Board Composition and Stock Ownership on the Adoption of "Poison Pills,"* 35 ACAD. MGMT. J. 1010, 1014 (1992); John A. Pearce, II & Shaker A. Zahra, *Board Composition from a Strategic Contingency Perspective*, 29 J. MGMT. STUD. 411, 413-14 (1992).

3. *See, e.g.*, Dallas, *supra* note 2, at 8-10; Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residual Claims*, 26 J.L. & ECON. 327, 327 (1983) [hereinafter Fama & Jensen, *Agency Problems*]; Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 288-89 (1980); Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 301-11 (1983) [hereinafter

for the debate on corporate board reform. Both theories are conflicts monitoring theories. While hegemony theorists have given some attention to psychological factors that may hinder independent decision making by board members, they have not gone far enough in recognizing the substantial conformity pressures on board members. Both hegemony and agency cost theorists are content with a board containing inside directors and outside directors with business relationships with the corporation or its management.[4] As this Article suggests, such a board would be less effective at conflicts monitoring than a board composed solely of independent directors.

The focus on conflicts monitoring by prevailing legal theories, however, gives inadequate attention to other important roles of corporate boards. To explore these roles, reference is made to a broader theory of the board, the power coalition theory,[5] which is widely accepted in the busi-

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Fama & Jensen, *Separation of Ownership and Control*]; Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1262-65 (1982); Kosnik, *supra* note 2, at 67-69; Mallette & Fowler, *supra* note 2, at 1014-15; Shaker A. Zahra & John A. Pearce, II, *Boards of Directors and Corporate Financial Performance: A Review and Integrative Model*, 15 J. MGMT. 291, 301-03 (1989); *see also* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior; Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308-10 (1976); Benjamin Klein, *Contracting Costs and Residual Claims: The Separation of Ownership and Control*, 26 J.L. & ECON. 367, 367-68 (1983); William A. Klein, *The Modern Business Organization: Bargaining Under Constraints*, 91 YALE L.J. 1521, 1521-26 (1982); Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 258-62 (1977).

4. *See, e.g.*, EISENBERG, *supra* note 1, at 174-75; Fama & Jensen, *Separation of Ownership and Control, supra* note 3, at 315; *see also* PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 1, § 3A.01; Tentative Draft No. 1, *supra* note 1, § 3.03(a); ABA Comm. on Corp. Laws, *supra* note 1, at 1624-25; Business Roundtable, *supra* note 1, at 249.

5. *See* Dallas, *supra* note 2, at 23-24; Zahra & Pearce, *supra* note 3, at 292-303; *see also* Lynne L. Dallas, *Two Models of Corporate Governance: Beyond Berle and Means*, 22 U. MICH. J.L. REFORM 19, 30-31 (1988) [hereinafter Dallas, *Two Models*]; Lynne L. Dallas, *Working Toward a New Paradigm, in* PROGRESSIVE CORPORATE LAW 35, 51-59 (Lawrence E. Mitchell ed., 1995) [hereinafter Dallas, *New Paradigm*]; D.J. Hickson et al., *Organization as Power*, 3 RES. ORG. BEHAV. 151, 152-57 (1981); David Jacobs, *Dependency and Vulnerability: An Exchange Approach to the Control of Organizations*, 19 ADMIN. SCI. Q. 45, 49 (1974). *See generally* RONALD S. BURT, CORPORATE PROFITS AND COOPTATION (1983); RICHARD M. CYERT & JAMES G. MARCH, A BEHAVIORAL THEORY OF THE FIRM (1963); HENRY MINTZBERG, POWER IN AND AROUND ORGANIZATIONS (1983); CHARLES PERROW, COMPLEX ORGANIZATIONS: A CRITICAL ESSAY (3d ed. 1986); JEFFREY PFEFFER & GERALD R. SALANCIK, THE EXTERNAL CONTROL OF ORGANIZATIONS: A RESOURCE DEPENDENCE PERSPECTIVE (1978); JEFFREY PFEFFER, ORGANIZATIONS AND ORGANIZATION THEORY (1982); W. RICHARD SCOTT, ORGANIZATIONS: RATIONAL, NATURAL AND OPEN SYSTEMS (1981); W. RICHARD SCOTT ET AL., ORGANIZATION THEORY: A

ness literature, but has been largely ignored by legal reformers. Whereas conflicts monitoring theories perceive the board as mediating conflicts between managers and shareholders, power coalition theory describes the board's roles in terms of the corporation's relationships with various corporate stakeholders (including shareholders) and the corporation's social environment.

Under power coalition theory, the board provides the corporation with relational resources that decrease the corporation's uncertainty and enhance its chances of survival.[6] These resources include coordination with the external environment, information access and exchange, support of corporate business, advice on various subjects, legitimacy and status in the eyes of relevant communities, monitoring, and control. Under this theory, functions of boards in addition to conflicts monitoring are economically significant. Independent directors, however, may not always be in a position to provide all of these resources. Provision of these resources often depends on a mix of inside and nonindependent outside directors serving on boards.

This analysis suggests that a board ideally composed to engage in conflicts monitoring — containing only independent directors — is not the same board best able to perform many other relational roles. The reverse is also true. A board ideally composed to perform many other relational roles is not the best board for dealing with the monitoring of conflicts of interest situations. Three possibilities are suggested by this analysis. First, the board can be limited to performing one set of functions, such as conflicts monitoring. Corporate law reformers theoretically lean in this direction by focusing mainly on the importance of conflicts monitoring. A leading scholar, for example, claims that conflicts monitoring is the most important function of the board and the only function for which the board is uniquely suited.[7]

Another possibility is for the board to perform all functions but to recognize the compromises made in achieving fully effective performance of any one set of functions. This is the current state of affairs. In response to the board reform debate, corporations have added more independent directors to their boards to perform conflicts monitoring, but also have inside and nonindependent outside directors on their boards. The problem

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STRUCTURAL AND BEHAVIORAL ANALYSIS (1981); JAMES D. THOMPSON, ORGANIZATIONS IN ACTION (1967); D.J. Hickson et al., *A Strategic Contingencies' Theory of Intraorganizational Power*, 16 ADMIN. SCI. Q. 216 (1971).

6. *See infra* Part I.B (discussing power coalition theory of boards).

7. EISENBERG, *supra* note 1, at 169-70.

with this solution is that a board so constructed is neither wholly suited to engage in conflicts monitoring nor to perform many other relational functions.

A third possibility exists that would permit all functions to be performed as effectively as possible. Corporations could establish a dual board structure with one board ideally suited for conflicts monitoring and the other board suited to perform other relational functions. Such a board structure is presented and analyzed in this Article.

I will also explain in this Article how the proposed dual board structure is fundamentally different from foreign two-board systems, such as the well-known German two-tiered board structure[8] and the less well-known two-board structure in Japan.[9] These systems operate in similar ways to

8. THE GERMAN STOCK CORPORATION ACT §§ 76-171 (Hannes Schneider & Martin Heidenhain trans., 1996); *see* EDWARD ARETZ, EUROPEAN COMPANY LAW 99-105 (1993); JONATHAN P. CHARKHAM, KEEPING GOOD COMPANY 17-25 (1994); ADRIAAN DORRESTEIJN ET AL., EUROPEAN CORPORATE LAW 112-14 (1994); JULIAN MAITLAND-WALKER, GUIDE TO EUROPEAN COMPANY LAWS 163-66 (1993); Alfred F. Conard, *The Supervision of Corporate Management: A Comparison of Developments in European Community and United States Law*, 82 MICH. L. REV. 1459, 1465-70 (1984); Klaus J. Hopt, *New Ways in Corporate Governance: European Experiments with Labor Representation on Corporate Boards*, 82 MICH. L. REV. 1338, 1344-48 (1984); Christian J. Meier-Schatz, *Corporate Governance and Legal Rules: A Transnational Look at Concepts and Problems of Internal Management Control*, 13 J. CORP. L. 431, 443-44 (1988); Dirk Schmalenbach, *Federal Republic of Germany, in* INTERNATIONAL CORPORATE GOVERNANCE 109, 110 (Joseph F. Lufkin & David Gallagher eds., 1990); J. Bautz Bonanno, Note, *Employee Codetermination: Origins in Germany, Present Practices in Europe, and Applicability to the United States*, 14 HARV. J. ON LEGIS. 947, 952 n.10 (1977); Benjamin T. Lo, Note, *Improving Corporate Governance: Lessons from the European Community*, 1 IND. J. GLOBAL LEGAL STUD. 219, 239-46 (1993).

9. Act Regarding Exceptional Rules of the Commercial Code Concerning Auditing, Etc., of Stock Corporations, Law No. 22 of 1974 (Japan), as amended, *reprinted in* 2 JAPAN BUS. L. J. 443 (H. Nakatsu trans., 1981); The Commercial Code, Law No. 48 of 1899 (Japan), as amended (Zentaro Kitagawa trans., 1994); *see* CHARKHAM, *supra* note 8, at 85-93; YUKIO YANAGIDA ET AL., LAW AND INVESTMENT IN JAPAN: CASES AND MATERIALS 274-79 (1994); Survey, *Corporate Governance in Japan: The Position of Shareholders in Publicly Held Corporations*, 5 U. HAW. L. REV. 135, 153-61 (1983); *Commercial Code of Japan Amended*, WORLD ACCT. REP., Aug. 1993, at 6 [hereinafter *Commercial Code Amended*]; *Dawning: Japanese Corporate Governance*, ECONOMIST, May 22, 1993, at 87, 88 [hereinafter *Dawning*]; *New Audit Powers Aim to Prevent "Bubble,"* WORLD ACCT. REP., Apr. 1993, at 8, 9 [hereinafter *New Audit Powers*]; Asako Ishibashi, *Firms Brace for New Breed of Shareholder: Foreign Investors, New Laws Spell End to Rubber-Stamps*, NIKKEI WKLY., June 27, 1994, at 1; Yo Makino, *Firms to Hire Outside Auditors, Directors: Commercial Law Brings Groundbreaking Changes Designed to Make Corporations More Open*, NIKKEI WKLY., June 14, 1993, at 3; Marlene Givant Star, *Japanese Mull Shareholder Rights Reform*, PENSIONS & INVESTMENTS, May 17, 1993, at 3.

unitary boards except that management is placed on a separate board. The objective of the unitary and two-tiered board structures is to separate supervision from management. All nonmanagement functions are performed by the same board. In contrast, the dual board structure requires the assignment of nonmanagement functions to two separate boards that are ideally composed to perform these functions.

Because corporate boards perform a number of different kinds of relational (including supervisory) roles, it appears that separating supervision from management is only the first step in thinking about appropriate board structures. The dual board structure attempts to take the next step. It assigns to the conflicts board supervisory authority over such matters as the hiring and firing of executive officers, the corporation's response to tender offers, and changes in accounting principles and practices, i.e., conflicts monitoring functions. These issues pose serious conflicts for managers and are, therefore, best decided by a board composed solely of independent directors. Some other relational resources, such as advice and status, may also be provided by the independent directors on the conflicts board. The business review board is assigned other supervisory functions such as reviewing the corporation's major business plans and objectives. The business review board would also perform other relational roles such as coordination or information access and exchange. These relational roles would be facilitated by the business review board's membership, which would include persons, such as suppliers and creditors, having business relationships with the corporation.

In Part I of this Article, I will present the theoretical framework for the dual board proposal. This Part will explore relational roles of boards, explained by power coalition theory, and the psychology of board decision making. This Part will also examine empirical evidence on board composition that demonstrates the importance of independent directors to effective conflicts monitoring. In Part II, I will describe and analyze the dual board proposal in depth, giving attention to the qualifications of board members, the functions of the two boards, and methods for resolving conflicts between them. In Part III, I will discuss my proposal for a board ombudsperson, specifying proposed qualifications, functions, and other requirements. This proposed ombudsperson differs in significant respects from existing corporate ombudspersons that are currently employed by a number of U.S. corporations. I will comment upon these differences and similarities. Finally, in Part IV, I will investigate different kinds of two-board systems. I will compare the two-boards system in Germany and Japan with each other, with unitary boards, and with the dual board proposed by this Article.

I. The Underpinnings of the Dual Board Proposal

The dual board proposal rests on two premises: (a) that the board performs a variety of important relational roles and (b) that board independence is important to one of these relational roles, namely, conflicts monitoring. In the following two sections, I will explore conflicts monitoring and relational (power coalition) theories of corporate boards. Following this discussion, I will examine psychological and empirical literature that demonstrates the importance of independence to conflicts monitoring.

A. Conflicts Monitoring by Boards

The corporate reform debate has centered on hegemony and agency cost theories, which I briefly describe in this section. Hegemony theorists view the board as being dominated by management and, therefore, as ineffective in performing conflicts monitoring.[10] According to hegemony theorists, the solution is to decrease managerial domination by adopting structural rules that assure directoral independence from management. Attention is given to such factors as the process of selecting directors, the characteristics of the directors themselves — whether they are independent or nonindependent directors, time constraints on directors, and the availability of information and other resources to enable the board to monitor effectively.[11]

The 1982 draft of the American Law Institute's (ALI) project on corporate governance, the *Principles of Corporate Governance*,[12] reflected the influence of hegemony theory. This draft required large public corporations to have a majority of independent directors on their boards.[13] As I explain later in this Article, this draft did not go far enough in proposing a board that would effectively perform conflicts monitoring — a board composed solely of independent directors. Nevertheless, by 1984, the ALI reduced this provision from a mandatory provision to a recommendation,[14]

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10. *E.g.*, Dallas, *supra* note 2, at 4-8; Kosnik, *supra* note 2, at 166-67; Lin, *supra* note 2, at 912-17; Mallette & Fowler, *supra* note 2, at 1014; Zahra & Pearce, *supra* note 3, at 295-96.

11. EISENBERG, *supra* note 1, at 170-72; MONKS & MINOW, *supra* note 1, at 178-229; Kosnik, *supra* note 2, at 167; Lin, *supra* note 2, at 913-17; Lipton & Rosenblum, *supra* note 1, at 245-47.

12. Tentative Draft No. 1, *supra* note 1, § 3.03(a).

13. *Id.*

14. AMERICAN LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 3.04 (Tentative Draft No. 2, 1984) [hereinafter Tentative Draft No. 2].

and the provision was fortunate to survive in recommendation form in the final draft of the *Principles of Corporate Governance* in 1994.[15] This change was due mainly to the opposition of another conflicts monitoring theory, agency cost theory.[16]

While agency cost theory, like hegemony theory, focuses on conflicts monitoring by boards of directors, agency cost theory does not support legislative reforms because it relies on evolutionary market theory.[17] According to evolutionary market theory, it is through markets and not law-making that efficient governance structures can be achieved. Mandatory changes in board composition and structure that apply uniformly to a large group of corporations, such as those proposed by the 1984 ALI draft, would interfere with natural market evolution. Because I am not advocating mandating the changes I propose in this Article, I need not address these arguments.[18] Agency cost theory, however, needs to be explained because it has been important in influencing thinking about boards. Agency cost theory offers an explanation of when and how boards perform conflicts monitoring functions.[19]

Under agency cost theory, a board will perform conflicts monitoring when the performance of such functions by the board is the least costly method for the corporation to reduce agency costs.[20] Agency costs are the costs borne by shareholders (principals) when managers (agents) act in their personal interest rather than in the interests of shareholders.[21] Examples of

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15. PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 1, § 3A.01.

16. Stephen M. Bainbridge, *Independent Directors and the ALI Corporate Governance Project*, 61 GEO. WASH. L. REV. 1034, 1047-52 (1993).

17. Barry D. Baysinger & Henry N. Butler, *Corporate Governance and the Board of Directors: Performance Effects of Changes in Board Composition*, 1 J.L. ECON. & ORG. 101, 102 (1985) [hereinafter Baysinger & Butler, *Corporate Governance*]; 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, 562-68 (1984) [hereinafter Baysinger & Butler, *Revolution Versus Evolution*]; Fama, *supra* note 3, at 292-306; Fama & Jensen, *Separation of Ownership and Control*, *supra* note 3, at 313-15.

18. I critique these arguments elsewhere. *See* Dallas, *New Paradigm*, *supra* note 5, at 38-46; Dallas, *Two Models*, *supra* note 5, at 46-48.

19. For a more detailed description of this theory, see Dallas, *supra* note 2, at 8-10.

20. This is often referred to as the substitute hypothesis which predicts that least cost methods for reducing agency costs will be substituted for more costly methods. *See* Chenchuramaiah T. Bathala & Ramesh P. Rao, *The Determinants of Board Composition: An Agency Theory Perspective*, 16 MANAGERIAL & DECISION ECON. 59, 59-60 (1995); James A. Brickley & Christopher M. James, *The Takeover Market, Corporate Board Composition, and Ownership Structure: The Case of Banking*, 30 J.L. & ECON. 161, 162-63 (1987).

21. LARRY E. RIBSTEIN & PETER V. LETSOU, BUSINESS ASSOCIATIONS 4 (3d ed. 1996);

methods that substitute for the conflicts monitoring functions of the board are high corporate leverage that decreases managerial discretion,[22] stock ownership by managers that aligns the interests of shareholders and managers,[23] and high dividend payouts that require managers to return to the discipline of capital markets to finance additional corporate investments.[24] Thus, boards will perform conflicts monitoring when it is the most cost-effective mechanism for reducing agency costs as determined by competition with other ways for reducing agency costs. According to agency cost theory, when the board performs conflicts monitoring, it does so by using outside board members to act as "arbiters" among top corporate executives who compete for the chief executive officer's (CEO) position.[25] The board's function is to serve as a "top-level court of appeals of the internal agent [labor] market."[26] While agency cost literature makes reference to the importance of inside director expertise and the support that outside directors can provide to managers,[27] the theory centers on the importance of using outsider directors to monitor managerial performance. Like hegemony theory, agency cost theory is basically a theory about conflicts monitoring.

The U.S. debate on board reform has been influenced by these conflicts monitoring theories. Certainly, the tender offer phenomena of the 1970s and 80s justified enhanced attention to the management-shareholder relationship and how corporate boards serve shareholders when managerial interests conflict with those of shareholders. However, boards perform

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Jensen & Meckling, *supra* note 3, at 308-10.

22. *See* Bathala & Rao, *supra* note 20, at 62. *But see* Pearce & Zahra, *supra* note 2, at 421, 430 (finding positive association between increased leverage and boards with higher proportions of outside directors, which presumably makes boards more likely to monitor); Jeffrey Pfeffer, *Size and Composition of Corporate Boards of Directors: The Organization and Its Environment*, 17 ADMIN. SCI. Q. 218, 222-27 (1972) (finding positive correlation between proportion of outside directors on corporate boards and debt-to-equity ratios).

23. *See* Bathala & Rao, *supra* note 20, at 61-62. *But see* Benjamin E. Hermalin & Michael S. Weisbach, *The Determinants of Board Composition*, 19 RAND J. ECON. 589, 594 (1988) (finding no relationship between extent of top management shareholdings and fraction of outside directors when management family members on board are taken out of consideration).

24. *See* Bathala & Rao, *supra* note 20, at 62. *But see* Michael H. Schellenger et al., *Board of Director Composition, Shareholder Wealth, and Dividend Policy*, 15 J. MGMT. 457, 465-66 (1989) (finding no support for hypothesis that inclusion of outside directors in board composition and dividend policy serve as substitute agency monitoring mechanisms).

25. Fama & Jensen, *Separation of Ownership and Control*, *supra* note 3, at 315.

26. *Id.* at 314.

27. *Id.*

much broader functions that serve a wider group of stakeholders and go beyond monitoring. This Article is premised on the belief that the broader relational functions of the board should be taken into account in board reform if reform is to result in truly effective boards. The power coalition (relational) theory is discussed in the next section of this Article.

B. Relational Roles of Boards

The power coalition theory is widely accepted by sociologists and organizational behaviorists,[28] but has been largely ignored by legal academicians. Under this theory, coalitions or stakeholders, such as employees, suppliers, and shareholders, interact in a political, economic, and social environment to determine corporate behavior. Control over corporate decision making is determined by the corporation's dependence on various physical resources provided by these coalitions and contextual resources.[29] Coalitions attempt to become part of the dominant coalition (which generally also includes top management)[30] to control decision making with respect to certain aspects of the corporation's business. The dominant coalition with respect to particular actions becomes, for the actions it determines, the corporation.[31]

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28. *See generally supra* note 5 and accompanying text.

29. *See* Dallas, *New Paradigm, supra* note 5, at 53-54 (stating that corporate "behavior can be explained by treating the institutional and social environment of the corporation as contextual resources or influences"); *see also* Steven Brint & Jerome Karabel, *Institutional Origins and Transformations: The Case of American Community Colleges, in* THE NEW INSTITUTIONALISM IN ORGANIZATIONAL ANALYSIS 337, 359 n.15 (Walter W. Powell & Paul J. DiMaggio eds., 1991).

30. Dallas, *Two Models, supra* note 5, at 31.

31. *See* Dallas, *New Paradigm, supra* note 5, at 52. In that Article, I stated:

> To some degree the concept of the dominant coalition resolves the difficulty of reifying the corporation or defining its goals as the aggregation of individual goals. Individual and group goals are not aggregated, because individuals and groups do not necessarily resolve their conflicts or agree to common goals. . . . [C]orporations often pursue inconsistent goals. In addition, while corporate goals derive from individual and group goals, no one individual or group is usually powerful enough to impose its goals on the corporation. Through corporate processes, corporate goals emerge that satisfy the parties or coalitions comprising the dominant coalition; these goals are distinct from the goals of any one individual or group. Furthermore, goals result from the communication among individuals and groups concerning opportunities and dangers presented by or to the organizational structure itself. Organizational theorists have observed that in this respect the dominant coalition can be said to have a unified goal, which is to increase the discretion of the organizational structure and decrease the uncertainty confronting it.

The corporation so construed tends to use boards to secure various resources to decrease the corporation's uncertainties and to increase the corporation's chances of survival.[32] Board memberships are used as a "bridging" strategy to link the corporation to various stakeholders and generally to its social environment.[33] Board memberships fall somewhere between other linking strategies, namely, contract and merger, which have different integrative qualities.[34]

Board members provide various resources to the corporation. These resources include (a) coordination with its external environment, (b) information access and exchange, (c) support through identification with the corporation, (d) status within the community, (e) legitimacy in the eyes of relevant audiences, (f) advice based on the background and skills of directors, (g) monitoring, and (h) control.[35] The corporation, for example, may have representatives of its creditors and suppliers on its board. These relationships may improve coordination, further information access and exchange, supply advice, and create support for the corporation. The corporation may also have a banker on the board, which may send a signal of solvency to corporations that do business with the corporation.[36] Lawyers, investment bankers, sports figures, environmentalists, and women on boards may also serve the corporation by furnishing it with advice, information, support, status, and legitimacy in the eyes of relevant audiences. Finally,

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Id.; *see also* SCOTT ET AL., *supra* note 5, at 265-66. Professor Mintzberg states: "[T]o the extent that there is some consistency in the intentions behind the decisions and actions taken by [the corporation's] participants . . . the organization as a system can be said to pursue a certain outcome consistently." MINTZBERG, *supra* note 5, at 246.

32. *See* Dallas, *supra* note 2, at 10; Pearce & Zahra, *supra* note 2, at 415-34 (referring to strategic contingency perspective); *see also supra* note 5 and accompanying text.

33. *See supra* note 32. For an analysis of empirical support for the power coalition theory of boards, see Dallas, *supra* note 2, at 16-18. The power coalition theory predicts "a positive relationship between the level of environmental uncertainty and the number of more relational (or outside) directors on boards; a positive relationship between external resource needs and board memberships; and a positive relationship between the use of board memberships to deal with resource dependencies and corresponding measures of corporate effectiveness." Dallas, *supra* note 2, at 16. For related empirical studies generally, see Pearce & Zahra, *supra* note 2; Pfeffer, *supra* note 22; Keith G. Rovan, *Board Power and Organizational Effectiveness Among Human Service Agencies*, 23 ACAD. MGMT. J. 221 (1980); Zahra & Pearce, *supra* note 3; and Mayer N. Zald, *Urban Differentiation, Characteristics of Boards of Directors, and Organizational Effectiveness*, 73 AM. J. SOC. 261 (1967).

34. For a detailed discussion of this topic generally, see Dallas, *Two Models*, *supra* note 5.

35. *Id.*; *see also* MINTZBERG, *supra* note 5, at 67-95.

36. Pearce & Zahra, *supra* note 2, at 415.

inside directors may perform relational roles as representatives of coalitions or groups of diverse interests found within the corporate organization itself.

Power coalition theory also explains the relational role of protecting shareholders from managerial self-dealing.[37] This conflicts monitoring may occur through shareholder representatives on the board. Shareholder representatives are enabled to monitor managers because of the corporation's dependence on capital resources and because of the corporation's dependence on shareholder democracy for the legitimacy of its governance structure. For example, closely held corporations are mainly dependent on shareholders for capital resources and expertise. The publicly held corporation depends less on the shareholders' provision of capital and expertise than on the legitimacy provided to the corporation's governance structure by shareholder participation.[38] Conflicts monitoring on behalf of shareholders is a relational function that is understood by using the same general theory that explains the performance of other relational functions by the board.

Normatively, corporate reform proposals that ignore the many relational roles of the board undermine the potential effectiveness of boards of directors.[39] Board memberships may enhance the status of the corporation, legitimize its operation, and may be the most cost-effective way to achieve these objectives. For example, an environmentalist, employee, or woman on the board may convey a serious commitment to the concerns of groups that these members represent. Alternative arrangements such as advertisements or management programs addressing specific concerns may not demonstrate the same level of corporate sincerity as membership on the top decision-making body of the corporation.

The board also provides a flexible forum for the exchange of information and the provision of advice. Despite protestations to the contrary,[40] these informational and advisory functions cannot be provided as effectively by contract. Because it is not always known in advance whose information or advice will be most useful, the deliberation of the board as a body is valuable in assisting the corporation in confronting the issues it faces. The board is composed of persons with different backgrounds and expertise who can draw on relevant knowledge as the need arises. Another advantage of relational roles performed by board members is legal context. Board members who provide such resources as coordination, information, or advice

37. Dallas, *Two Models*, *supra* note 5, at 91-97.

38. *Id.* at 94-95.

39. Dallas, *supra* note 2, at 12-13.

40. EISENBERG, *supra* note 1, at 157-58.

owe broad fiduciary obligations to act in the best interests of the corporation.[41]

In addition, the corporation may not be able to acquire various resources, such as advice from fellow CEOs, except by offering board memberships to them. It is traditionally accepted for CEOs to be on the boards of other corporations, but not to enter into individual consulting contracts with them. Also, CEOs are not motivated by monetary compensation to serve on boards, but by the status, prestige, and experience that are unique to board memberships.[42]

In conclusion, board reform proposals that fail to take into account the many relational roles of the board fail to recognize a variety of significant contributions made by board members. Many of these roles are just as important to the corporation as the monitoring of conflicts between managers and shareholders. They serve the best interests of the corporation. Some relational roles are most effectively performed by a mix of different kinds of directors, namely, inside directors and independent and nonindependent outside directors.

C. Social Dynamics That Limit Outside Board Members' Independence

Not only should board reform take into account the broader relational roles of the board, it should recognize fully the impact of social influences on so-called independent directors serving on boards also composed of inside directors and nonindependent outside directors. This requires an understanding of the social psychology of groups. Because the two-process theory of influence has been widely accepted in social psychology and has substan-

41. *In re* Time Warner Inc. Sec. Litig., 9 F.3d 259, 267 (2d Cir. 1993); Joy v. North, 692 F.2d 880, 889 (2d Cir. 1982); Remillard Brick Co. v. Remillard-Dandini Co., 241 P.2d 66, 74 (Cal. Dist. Ct. App. 1952); Unitrin, Inc. v. American Gen. Corp., 651 A.2d 1361, 1373 (Del. 1995); Paramount Communications, Inc. v. QVC Network Inc., 637 A.2d 34, 42-45 (Del. 1994); Paramount Communications, Inc. v. Time, Inc., 571 A.2d. 1140, 1154-55 (Del. 1989); Marciano v. Nakash, 535 A.2d 400, 404 (Del. 1987); Revlon, Inc. v. MacAndrews & Forbes Holding, Inc., 506 A.2d 173, 179-80 (Del. 1986); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985); Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985); Weinberger v. UOP, Inc., 457 A.2d 701, 710-11 (Del. 1983); Mendel v. Carroll, 651 A.2d 297, 306-07 (Del. Ch. 1994); Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. Ch. 1963); Shlensky v. South Parkway Bldg. Corp., 166 N.E.2d 793, 799-80 (Ill. 1960); Francis v. United Jersey Bank, 432 A.2d 814, 821-22 (N.J. 1981).

42. *E.g.*, JAY W. LORSCH & ELIZABETH MACIVER, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS 26-30 (1989).

tial evidence to support it,[43] this section will explore this theory. The two influence processes, normative and informational,[44] are discussed generally in the following two subsections and are followed by an analysis of the relationship of these influence processes to decision making by corporate boards of directors. This analysis will demonstrate the importance of having a board composed solely of independent directors for conflicts monitoring.

1. *Normative Influences Affecting Conformity in Groups*

The traditional description of normative influences focuses on a power process whereby group members seek to please others in the group in order to obtain rewards and avoid punishment.[45] "Compliance" or outward conformity results, which does not necessarily affect the private beliefs of group members.[46] This description of normative influences views conformity as mainly tactical and instrumental — to obtain a reward or avoid punishment — rather than irrational and emotional.[47] Impression management and self-presentation theorists also maintain that compliance (or outward conformity) is manipulative.[48] The manipulation results from a member's attempts to control, through his compliance, the perceptions held of him by others in the group. To many, this form of conformity adequately describes the group dynamic process. However, as the following discussion reveals, group dynamics are much more complex.

Normative influences, for example, also result from the process of identification.[49] This is a process resulting from the attraction that a group member feels for other members of the group. The member is induced to adopt the values, ideas, and opinions of others in the group while he is part of the group. Unlike compliance, private beliefs are affected so that public conformity is congruent with private attitude changes. Under this theory, it is the desire to be similar, rather than the other members' power over

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43. *See* JOHN C. TURNER, SOCIAL INFLUENCE 37-47 (1991).

44. *See* ROBERT S. BARON ET AL., GROUP PROCESS, GROUP DECISION, GROUP ACTION 63, 67 (1992); DAVID O. SEARS ET AL., SOCIAL PSYCHOLOGY 241-44 (7th ed. 1991); ELIOT R. SMITH & DIANE M. MACKIE, SOCIAL PSYCHOLOGY 361, 364 (1995); TURNER, *supra* note 43, at 34-39.

45. BARON ET AL., *supra* note 44, at 63; TURNER, *supra* note 43, at 34-35, 37-38.

46. BARON ET AL., *supra* note 44, at 67; SMITH & MACKIE, *supra* note 44, at 357; TURNER, *supra* note 43, at 37.

47. TURNER, *supra* note 43, at 38.

48. *Id.* at 124.

49. *Id.* at 38-39, 117-18; *see* Herbert C. Kelman, *Compliance, Identification, and Internalization: Three Processes of Attitude Change*, 2 J. CONFLICT RESOL. 51, 53 (1958).

rewards or punishments, that motivates conformity.[50] According to impression management theory, a member may also seek to construct his or her public self or identity to reflect an ideal public image.[51] This image may be responsive to demands of other board members or to an audience outside the boardroom, in which case conformity to the demands of other board members may be diminished or enhanced.

In summary, conformity pressures in groups result from normative influences because group members seek to obtain rewards and avoid punishment, to identify with attractive others, and to construct an ideal public image. As we shall see below, these influences often reduce the independence of so-called independent directors in a group composed of inside directors and nonindependent outside directors.

2. *Informational Influences Affecting Conformity in Groups*

Informational influences[52] occur when members of a group are dependent on other group members for information. Conformity arises from the need for information, although the cause of this dependence on others for information is disputed. Social comparison theorists argue that dependence on others for information arises when members experience uncertainty in confronting a complex and ambiguous reality.[53] Genetic theorists maintain that it is not the ambiguity of the world but disagreement among individuals, or social conflict, that creates uncertainty.[54] Genetic theorists support their position with studies that show that subjects experience uncertainty when other group members express disagreement about unambiguous perceptual evidence.[55] Both theories are probably correct to some degree; a member's confidence may be lessened (or uncertainties created) by environmental factors, both physical and social, thereby making the member susceptible to the informational influence of others.

Informational influences may affect individual, cognitive, and nonnormative thinking (persuasion argument theory) or thinking in which group conformity or social processes play an important role (social comparison or self-categorization theories). Social comparison theory[56] argues that in am-

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50. TURNER, *supra* note 43, at 117-18.

51. *Id.* at 124-28.

52. BARON ET AL., *supra* note 44, at 67; SEARS ET AL., *supra* note 44, at 241; SMITH & MACKIE, *supra* note 44, at 361; TURNER, *supra* note 43, at 37.

53. SEARS ET AL., *supra* note 44, at 251-52; TURNER, *supra* note 43, at 26, 29-30, 37.

54. TURNER, *supra* note 43, at 84-86.

55. *Id.* at 84.

56. BARON ET AL., *supra* note 44, at 61-62; SMITH & MACKIE, *supra* note 44, at 361; TURNER, *supra* note 43, at 25-29, 50.

biguous situations group members determine what is correct, appropriate, or desirable by comparing their beliefs with others in the group who have similar attributes and who are deemed expert, trustworthy, and credible. This comparison process results in the development of shared social norms. The member's private beliefs are modified, and the resulting changes persist beyond the time of membership in the group.[57]

Arguably, findings that groups tend to polarize or move toward a position that is more extreme than the average aggregate views of group members present a challenge to the social comparison theory.[58] With social comparisons, one can expect that individual members will converge on an average position as a result of their interpersonal comparisons. One explanation of this phenomena consistent with social comparison theory is that only when members hear the extreme views of others in a group will they acknowledge their preference for that more valued, extreme position.[59] Prior to group discussion, members assume that others do not share these more extreme views and, therefore, do not express them.

Persuasion argument theory, which relies on individual, cognitive thinking rather than social processes, provides another explanation for the polarization phenomena.[60] Persuasion argument theory explains that groups tend to move toward a more extreme position because more arguments favor that position. Prior to group discussion, a member is likely to be aware of only a few arguments supporting his position. Exposure to additional novel arguments by others who agree with the member results in group movement to the more extreme position. This theory, however, has weak empirical support.[61] Evidence shows that mere exposure to the positions of other group members in the absence of argument is sufficient to result in polarization.[62] In addition, polarization takes place when persuasive arguments are not meaningful.[63] Arguments against the extreme position would also appear to be more novel to members who support the extreme position than arguments in favor of it.[64]

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57. *See* TURNER, *supra* note 43, at 37-38.

58. BARON ET AL., *supra* note 44, at 73; SMITH & MACKIE, *supra* note 44, at 372-76; TURNER, *supra* note 43, at 48.

59. *See* TURNER, *supra* note 43, at 54-58.

60. JOHN SABINI, SOCIAL PSYCHOLOGY 37 (2d ed. 1995); TURNER, *supra* note 43, at 64-71.

61. TURNER, *supra* note 43, at 61-63, 71.

62. *Id.* at 62-63.

63. *Id.* at 71.

64. *Id.* at 72-74.

In addition, the more recent self-categorization theory explains the polarization phenomena in terms of social processes.[65] Like social comparison theory, self-categorization theory sees members as moving toward a consensual position of the group based on interpersonal comparisons. However, this theory does not see this position as an average of group members' opinions. Members move toward a "prototypical" group position that reflects not only intragroup comparisons but also comparisons of the group position with relevant out-groups (i.e., intergroup comparisons). This explanation grounds informational influence on a shared group identification process.[66]

It appears from the above discussion that judgments made by groups will be informationally influenced in some way by the views held by other members of the group and group norms. As the next subsection will show, this social process can reduce the independence of so-called independent directors in a group composed of inside directors and nonindependent outside directors.

Before proceeding with the next subsection, however, it should be acknowledged that an argument can be made that the two-process theory of influence is mistaken and that there is in reality only one process.[67] Normative and informational influences are certainly related to one another. Social norms convey information.[68] Moreover, information is validated by reference to existing social norms.[69] Despite this argument, however, the motivations of members that result in normative and informational influences differ. Normative influences operate because the member desires to obtain rewards or avoid punishment, seeks to identify with the group, or attempts to construct a public identity approximating some public ideal. Informational influences stem from a member's desire to be right[70] when uncertainty arises due to a complex, ambiguous external reality or disagreement within the group. Of course, the determination of what is right and what information is relevant involves normative judgments.

3. *Normative and Informational Influences on Corporate Boards*

Substantial evidence supports the relationship between conformity and normative and informational influences.[71] Research has identified group and

65. *Id.* at 76-78.
66. *Id.*
67. *Id.* at 38-39, 46.
68. *Id.* at 47.
69. BARON ET AL., *supra* note 44, at 77; TURNER, *supra* note 43, at 47.
70. TURNER, *supra* note 43, at 35, 37.
71. *See id.* at 40-47.

task characteristics that tend to decrease the independence of group members. Some of these characteristics are discussed below in the context of corporate boards.

According to the process of normative influence, compliance is expected when a group member depends on other group members to receive valuable rewards and to avoid costs. Therefore, a member is more likely to conform to the group when the group controls valuable consequences. Corporate boards are groups characterized by their ability to provide valuable benefits to their members. Board members rely on other board members for benefits, such as the prestige that comes from being chosen as a board member,[72] business experience acquired from board membership,[73] and financial compensation for service on the board. The continuation of a member on the board depends in most cases on the opinion of other board members, particularly those on the board's nomination committee.

The degree of attraction a member feels toward other group members is also an important characteristic of groups.[74] Substantial evidence supports the importance of attraction to conformity.[75] From a normative perspective, the attraction of group members increases both the member's identification with other group members and the cost to the member of rejection.[76] Informationally, attraction increases the credibility of other group members.[77]

Attraction among members characterizes corporate boards. Recent studies have found that board members are primarily motivated to serve on boards because of the identity of other board members, rather than the financial condition of the corporation or the belief that they can make valuable contributions to the corporation.[78] Thus, it is the attractiveness of other board members that is most important to board members in accepting board positions.

Another factor that contributes to conformity is the ambiguity or complexity of the task to be performed by the group.[79] Informational influences are based on uncertainty produced by ambiguity and complexity. Solid evi-

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72. James D. Cox & Harry C. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, L. & CONTEMP. PROBS., Summer 1985, at 83, 96-97.

73. LORSCH & MACIVER, *supra* note 42, at 23-30.

74. SABINI, *supra* note 60, at 77; TURNER, *supra* note 43, at 40-42.

75. BARON ET AL., *supra* note 44, at 66, 75; TURNER, *supra* note 43, at 21, 40-42.

76. TURNER, *supra* note 43, at 121.

77. *Id.*

78. KORN/FERRY INT'L, 22ND ANNUAL BOARD OF DIRECTORS STUDY 31 (1995).

79. BARON ET AL., *supra* note 44, at 66, 75; TURNER, *supra* note 43, at 25, 44-45.

dence supports the importance of this task characteristic to conformity.[80] Corporate boards of directors usually are confronted with ambiguous and complex data on which their actions are based. Indeed, courts have recognized difficulties associated with making the kinds of judgments required of boards and have consequently adopted a deferential standard for reviewing challenged board decisions.[81]

The public surveillance of member behavior by the group also contributes to conformity. Less conformity occurs when members may act anonymously.[82] On corporate boards, member behavior is publicly observable by other members of the board, thus contributing to conformity pressures.

Certain factors may, to some degree, lessen conformity pressures on corporate boards. Although members need to coordinate their behavior to achieve group goals, the degree of coordination required (i.e., attaining a majority consensus) is not intricate or finely tuned. Also, group goals are not always clear and thus weaken group cohesion.[83] Moreover, board members are high-status, knowledgeable persons[84] whose needs for approval and information may be less than others in the general population. Nevertheless, what seems more important to group conformity than some absolute measure of status is that, on a comparative basis, some board members will be perceived as more able than others.[85]

The higher-status members on corporate boards will in most cases consist of the CEO, who often also serves as the chairperson of the board, and other inside directors who have high-level positions in the corporate hierarchy. Unfortunately, these members are also more likely to have

80. TURNER, *supra* note 43, at 44-45.

81. Reference is made to the business judgment rule, which is a "presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); *see also* Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985); Dierdre A. Burgman & Paul N. Cox, *Corporate Directors, Corporate Realities and Deliberative Process: An Analysis of the* Trans Union *Case*, 11 J. CORP. L. 311, 329 (1986); Leo Herzel & Leo Katz, Smith v. Van Gorkom*: The Business of Judging Business Judgment*, 41 BUS. LAW. 1187, 1188 (1986); Bayless Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time For Reality*, 39 BUS. LAW. 1477, 1490-91 (1984).

82. BARON ET AL., *supra* note 44, at 66; SMITH & MACKIE, *supra* note 44, at 366; TURNER, *supra* note 43, at 35-36, 44. Another factor that may contribute to conformity is the directors' interest in nonmonetary rewards. Cox & Munsinger, *supra* note 72, at 99; *see* LORSCH & MACIVER, *supra* note 42, at 23-30.

83. TURNER, *supra* note 43, at 22; *see* LORSCH & MACIVER, *supra* note 42, at 170.

84. TURNER, *supra* note 43, at 45, 66; *see* SEARS ET AL., *supra* note 44, at 257-60.

85. TURNER, *supra* note 43, at 45-46.

conflicts on matters considered by the board. The literature shows clear evidence of "a correlation between the capacity to exert influence and one's position in a hierarchical social structure."[86] Studies of conformity producing harsh results through members' compliance with legitimate (not equated to legal) authority permeate the literature.[87] Breaches of ethics often result when a member is in the "agentic state" or has ceded "control to the representative of established institutions, norms and reference groups [where] legitimate authority substitutes for the [member's] own self-regulation."[88] Levels of conformity below the agentic state are just as problematic when a board must decide issues that present serious conflicts of interest for some of its members.

Despite the great deal of attention given to board independence since the 1970s, a recent study of corporate boards has identified board norms that evidence substantial conformity pressures.[89] Jay W. Lorsch and Elizabeth MacIver, after extensive surveys and interviews of corporate board members, identified the following board norms that indicate a lack of directoral independence: (a) board members should not criticize the CEO, especially in front of inside directors; (b) board members should not seek information outside the communication channels provided by the CEO; and (c) board members should not discuss issues of accountability or the premises on which the board operates.[90]

D. Empirical Studies on the Importance of Board Independence to Conflicts Monitoring

A number of studies have attempted to determine the importance of directoral independence to effective conflicts monitoring. These studies have predicted a positive association between the proportion of outside directors or so-called independent directors on boards to an overall measure of corporate performance.[91] The results of these studies have been mixed.

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86. *Id.* at 131.

87. *Id.* at 136-41.

88. *Id.* at 140.

89. LORSCH & MACIVER, *supra* note 42, at 91-96, 170-71.

90. *Id.*

91. *E.g.*, Baysinger & Butler, *Corporate Governance*, *supra* note 17, at 114-21; Baysinger & Butler, *Revolution Versus Evolution*, *supra* note 17, at 572-76; Rajeswararao S. Chaganti et al., *Corporate Board Size, Composition and Corporate Failures in Retailing Industry*, 22 J. MGMT. STUD. 406-07 (1985); William Q. Judge, Jr., *Correlates of Organizational Effectiveness: A Multilevel Analysis of a Multidimensional Outcome*, 13 J. BUS. ETHICS 1, 3-4 (1994); Pearce & Zahra, *supra* note 2, at 412-15; Stuart Rosenstein & Jeffrey G. Wyatt, *Outside Directors, Board Independence, and Shareholder Wealth*, 26 J. FIN. ECON.

One study found a positive lagged effect between the proportion of independent directors on corporate boards and corporate financial performance.[92] This study also found marginal declines in relative performance for additional independent directors added to the board when the board was already thirty percent independent.[93] Other studies have found negative or no correlation between the proportion of outside or so-called independent directors on corporate boards and corporate financial performance.[94]

These studies on overall financial performance are poor measures of the importance of board independence to conflicts monitoring. The studies that consider the proportion of outside directors on boards do not exclude from their measure of supposedly independent outside directors those directors who have substantial professional and other business relationships with corporations. The studies also assume that directoral independence will contribute to overall corporate performance because independence is important to conflicts monitoring. However, some relational roles may best be performed by nonindependent directors. With conflicts monitoring or other relational roles more or less important to the corporation at different times, it is difficult to assess the importance of conflicts monitoring by independent directors through the use of overall measures of corporate performance.[95]

Other empirical studies do a better job of measuring the importance of board independence to conflicts monitoring by focusing narrowly on conflicts of interest issues addressed by boards.[96] These studies have found positive correlations between the proportion of outside directors or so-called independent directors on corporate boards and effective conflicts monitoring. A number of studies of tender offers and going private transactions that raise substantial shareholder-management conflicts found positive correlations between the proportion of independent or outside directors on

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175, 176, 190 (1990); Schellenger et al., *supra* note 24, at 457-59, 465. *See generally* Dallas, *supra* note 2; Zahra & Pearce, *supra* note 3.

92. Baysinger & Butler, *Revolution Versus Evolution*, *supra* note 17, at 572-73.

93. *Id.* at 575.

94. *E.g.*, Chaganti et al., *supra* note 91, at 411-12; Judge, *supra* note 91, at 7.

95. It is also important to acknowledge that these studies cannot be compared to draw definitive conclusions because they use different databases, were developed to test distinct hypotheses, and use different measurements of financial performance.

96. *E.g.*, Kosnik, *supra* note 2, at 180-82; Paula L. Rechner et al., *Corporate Governance Predictors of Adoption of Anti-Takeover Amendments: An Empirical Analysis*, 12 J. BUS. ETHICS 371, 374-75 (1993); Michael S. Weisbach, *Outside Directors and CEO Turnover*, 20 J. FIN. ECON. 431, 435-36 (1988); Chun I. Lee et al., *Board Composition and Shareholder Wealth: The Case of Management Buyouts*, FIN. MGMT., Spring 1992, at 58, 61-63. *See generally* Dallas, *supra* note 2.

corporate boards and positive measures of conflicts monitoring.[97] In addition, an important study of CEO turnover that also considered financial performance discovered that corporations were more likely to replace CEOs when the corporations were performing poorly and had a board dominated by outside directors.[98] Although these studies do not test whether adding more independent directors to corporate boards would improve conflicts monitoring[99] and often do not exclude nonindependent outside directors

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97. *See* Kosnik, *supra* note 2, at 179-80 (discovering greenmail payments were negatively associated with proportion of outside directors on corporate boards). The Kosnik study assumes that paying greenmail is harmful to shareholders, which may not always be the case. *E.g.*, Lin, *supra* note 2, at 933-34. Also, this study found that boards that resisted paying greenmail had more outside directors with contractual links to the corporation than boards that paid greenmail. Kosnik, *supra* note 2, at 179-80. Other kinds of outside directors that it studied were directors with family or cross-directorate relationships with the corporation's executives. *Id.* The study did not test the effect of having independent directors on boards. To the extent that outside directors are more independent than inside directors, it found a higher proportion of outside directors on boards that resisted paying greenmail. *Id.*; *see also* Rechner et al., *supra* note 96, at 376 (finding positive relationship between more inside directors on boards and corporations' use of antitakeover measures); Lee et al., *supra* note 96, at 67-68 (finding more positive abnormal returns associated with going private transaction announcement by corporations dominated by outside directors than by other corporations). The Rechner study makes the controversial assumption that antitakeover tactics are detrimental to shareholders. *See, e.g.*, Lin, *supra* note 2, at 932-36. Beneficial effects of antitakeover tactics may explain findings with respect to golden parachutes. *Id.* at 935-36 (discussing studies finding positive relationship between corporations with golden parachutes and higher proportions of outside directors on their boards). While the proportion of independent directors on boards may have little to do with the probability that corporations will adopt poison pills, *see* Mallette & Fowler, *supra* note 2, at 1023, 1029, a recent study found that the average stock market reaction to a corporation's adoption of poison pills is positive when the corporation's board is composed predominantly of independent directors and otherwise is negative. *See generally* James A. Brickley et al., *Outside Directors and the Adoption of Poison Pills*, 35 J. FIN. ECON. 371 (1994).

98. Weisbach, *supra* note 96, at 458-59; *see also* Omesh Kini et al., *Corporate Takeovers, Firm Performance, and Board Composition*, 1 J. CORP. FIN. 383, 410 (1995) (finding no relationship between CEO turnover after takeover and corporate performance prior to takeover when outside directors dominated board prior to takeover). Other studies that arguably demonstrate the importance of board independence to effective monitoring of managerial conflicts are studies involving executive compensation. *See* Brickley & James, *supra* note 20, at 179 (finding that proportion of outside directors in banks in nonacquisition states was negatively related to higher executive salaries); Hamid Mehran, *Executive Compensation Structure, Ownership, and Firm Performance*, 38 J. FIN. ECON. 163, 179 (1995) (finding that corporations with higher proportion of outside directors made greater use of equity-based compensation).

99. These studies do not test, however, whether conflicts monitoring would be best performed by a board composed *solely* of independent directors. Two studies have found that adding independent directors to the unitary board beyond some proportion of independent directors may adversely affect corporate performance. *See supra* text accompanying note 92; *see also* John W. Byrd & Kent A. Hickman, *Do Outside Directors Monitor*

from their measurements of independent directors, the studies nevertheless provide considerable support for the general proposition that board independence is important to conflicts monitoring.

II. The First Board Reform Proposal: The Dual Board

Corporate board reform should take into consideration the psychology of group decision making. It should also recognize and seek to improve the effectiveness of many relational roles that boards perform, including conflicts monitoring. At this juncture in the analysis, however, the corporate board reformer finds herself on the horns of a dilemma. Making the board independent will enhance its conflicts monitoring capabilities, but will decrease the ability of the board to perform other important relational functions. The dilemma may be resolved by thinking in terms of a two-board system. The dual board is such a system. Each board would be assigned distinct functions that would be performed by directors whose characteristics are matched to these functions. The conflicts board would consider conflicts of interest issues and would be composed of independent directors. The business review board would decide all other issues and would consist of a mix of different kinds of directors. In the following sections, I will discuss each of these boards in turn. I will discuss their membership criteria and functions. I will also explore communications between the boards, the resolution of conflicts between them, and possible concerns about introducing dissension at the top decision-making level of the corporation through a dual board structure.

A. The Conflicts Board

1. Independent Directors

The conflicts board should be composed of directors that do not have conflicts with respect to matters involving the corporation. For example,

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Managers? Evidence from Tender Offer Bids, 32 J. FIN. ECON. 195, 198 (1993) (stating that bidding firms with majority of independent directors earned significantly higher abnormal returns from takeovers than other bidding firms, but that relationship between bidding firms' abnormal stock returns and proportion of board seats held by independent outside directors is nonlinear). However, these studies did not test situations in which managers had acute conflicts with shareholders. Even if future studies were to find that a unitary board composed of more than a certain percentage of independent directors performed less well on conflicts matters than a board composed of a lesser percentage of independent directors, the reason may be related to the importance of various relational functions, such as the availability of advice and information on the unitary board, rather than the unimportance of having a determination on the conflicts transaction by a board composed solely of independent directors. Thus, a dual board structure with veto rights in a conflicts board would most likely still improve the corporate governance system.

directors who are employed by the corporation or who have other business relationships with it should be excluded from this board. Controlling shareholders should also be ineligible because their control of the corporation raises issues of potential conflicts with minority shareholders. If the conflicts board is to be objective in reviewing conflicts transactions and in making management accountable to all shareholders, the class of independent directors should not include inside directors, outside directors with business relationships with the corporation, or controlling shareholders.

The eligibility criteria for independent directors should also be narrowed to take account of business relationships between the corporation and certain persons related in important ways to the potentially conflicted director. Significant to independence are relationships between the proposed director or his related persons, on the one hand, and executive officers, business review board members, controlling shareholders, and possibly the related persons of such persons, on the other hand.

One could argue that controlling shareholders and their related persons should be eligible for membership on the conflicts board. After all, the controlling shareholder has the power to select or remove these members. The controlling shareholder's power is limited, however, to the selection and removal process. No other significant relationships may exist between the controlling shareholder and the conflicts board member. Of course, corporations may disagree with this eligibility criteria. On the one hand, corporations may allow controlling shareholders to serve on the conflicts board. On the other hand, corporations may institute stringent requirements for removal of members of the conflicts board by shareholders, longer terms for conflicts board members, or a self-perpetuating conflicts board.[100]

Corporations may obtain guidance in determining eligibility criteria for independent directors from the Revised Model Business Corporation Act

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100. *Cf.* Lawrence E. Mitchell, *A Critical Look at Corporate Governance*, 45 VAND. L. REV. 1263, 1301-17 (1992). Professor Mitchell proposes a self-perpetuating unitary board called the "mediating board." Although this proposal overlooks the importance of relational roles of the board other than conflicts monitoring, it is an interesting suggestion that could be utilized by the conflicts board. I believe, however, that both spheres of accountability — voting and fiduciary obligations — are important and that to some degree the weaknesses of one system offsets the other. *See* Lynne L. Dallas, *The Control and Conflict of Interest Voting Systems*, 71 N.C. L. REV. 1, 46-7 (1992). Professor Mitchell's proposal relies only on the latter system, namely, fiduciary obligations. Mitchell, *supra*, at 1307-08. Professor Mitchell's proposal could be evaluated by studying the many nonprofit organizations. The results of these studies, however, would not be directly applicable to for-profit corporations. Altruistic motives and goals play a large role in nonprofit corporations, which may offset diminished accountability features in the structure of these corporations.

(RMBCA), Chapter 8, Subchapter F;[101] the ALI's *Principles of Corporate Governance* definitions of "interested" directors and "significant" relationships;[102] and the Securities and Exchange Commission's regulations on disclosure of important relationships between the corporation and its directors and officers.[103] Business or legal groups may develop definitions of independent directors and conflicting interests that are specifically tailored to meet the demands of the dual board structure. Corporations are encouraged to adopt similar definitions of these terms, which will allow meaningful future studies of the effectiveness of dual boards.

The eligibility criteria for independent directors on the conflicts board will not cover some ways that directors may be influenced by others in the corporation. The fact that some influential relationships which these directors have will fall through the cracks is inevitable and unavoidable. For example, friendships and mutual associations through local community groups may link members of the conflicts board with management, business review board members, and controlling shareholders. However, the dual board structure will mitigate these influences in ways that the unitary board cannot. Normative influences on conflicts board members will be reduced by (a) separate meetings of the conflicts board, (b) distinct goals resulting from the conflicts board's separate responsibilities, and (c) the conflicts board's control over its own members' nominations and compensation. Informational influences will be mitigated by (a) social comparisons with other members of the conflicts board, (b) responsibilities of a corporate ombudsperson to provide information to conflicts board members, and (c) the receipt of information and reports from others in the organization through conflicts board procedures and at conflicts board meetings. The development of a rule or norm that conflicts board members confine their discussion of board matters to other conflicts board members and limit their information gathering from corporation-related persons to channels developed by the conflicts board itself may reinforce the latter mitigating factor.

2. *Functions of the Conflicts Board*

The board of directors of the corporation initially establishing the dual board (with the approval of shareholders) must decide which issues the CEO should refer to the conflicts board and which issues should be decided

101. REV. MODEL BUS. CORP. ACT §§ 8.60-8.63 (1990).

102. PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 1, §§ 1.03, 1.23, 1.34.

103. 17 C.F.R. 229.404 (1996).

by the business review board. I propose that the following general functions be allocated to the conflicts board:

- Select, regularly evaluate, fix the compensation of, and, when appropriate, replace the corporation's principal senior executives, external auditor, and board ombudsperson;
- Review and, when appropriate, approve corporate actions that raise duty of loyalty issues for any senior executive officer, business review director, or controlling shareholder;
- Review and, when appropriate, initiate or approve decisions that involve a change of control of the corporation;
- Review and, when appropriate, initiate or approve major changes in auditing and accounting principles and practices to be used in the preparation of the corporation's financial statements; and
- Review and, when appropriate, initiate or approve decisions respecting legal compliance and ethical standards of the corporation and its employees.

These functions are discussed in the following subsections.

a. Executive Selection and Compensation

Because the conflicts board is composed solely of independent directors, it should select and compensate the senior executive officers of the corporation. The business review board is not in a position to perform these functions. To place these functions in the business review board would mean that inside directors and nonindependent outside directors would be reviewing their own performance (or qualifications) or the performance (or qualifications) of others who have, or may have, a substantial say in their future business with the corporation.

An argument can be made opposing the allocation of these functions to the conflicts board. Through its power to oversee the senior executives of the corporation, the conflicts board may interfere with general business policies adopted by the business review board. In most cases, conflict will not occur. The conflicts board will judge executive officers on fulfilling their obligations to both boards. However, if a disagreement between boards occurs, the ultimate power over business direction is in the hands of the conflicts board through its control over the selection and compensation of executive officers. Most likely, executives officers will retain substantial influence over the business review board. Through its control over executive selection and compensation, the conflicts board provides a check and balance when, in its judgment, executive officers are not acting in the best interests of the corporation. In this respect, the conflicts board is the premier board. I discuss conflicts between boards further in Part II.C of this Article.

b. Duty of Loyalty Issues

The conflicts board, according to my guidelines, would also make all decisions raising duty of loyalty issues respecting any senior executive, business review director, or controlling shareholder (designated persons). If any one of these persons has a "conflicting interest," the matter must be directed by the CEO to the conflicts board for resolution. The same principles used to define independent director can be used to identify a duty of loyalty issue. The objective is to determine whether the designated person has a conflict of interest with respect to a particular issue confronting the corporation. Once any such conflict is identified, the issue should be handled by the conflicts board.

Most definitions of conflicting interests take into account only the financial and familial conflicts that a person has with respect to corporate transactions. Arguably, such a definition of conflicting interests is incomplete. Other sources of personal conflict exist. For example, persons may have the incentive to seek nonfinancial values such as power and prestige for themselves. Managers may expand the corporation or make a tender offer to obtain personal power and prestige. Managers may also seek greater personal security by having the corporation maintain a low debt-to-equity ratio. Some corporate scholars have argued that once a corporation decides to sell all its assets or to dissolve, managers have a conflict of interest with respect to all subsequent transactions of the corporation because no continuing business exists that would subject them to the discipline of the market after the transaction (the final period problem).[104] It is naive to believe, however, that any real world governance system can take into account all of these motivations. It is possible that certain kinds of transactions can be identified that are entered into by management primarily for these reasons and that usually bring corporations lower returns than other available opportunities.[105] These identified transactions could be allocated to the conflicts board. Of course, deciding to allocate transactions to the conflicts board assumes that members of the conflicts board do not have similar motivations concerning these transactions, at least not to the degree that business review board directors do.

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104. RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 720-21 (2d ed. 1995).

105. Dallas, *supra* note 100, at 76-77.

The burden of identifying nonfinancial conflicts probably outweighs the benefits of doing so. Practical guidelines that establish a workable system for readily identifying issues assigned to the conflicts board or the business review board need to be developed. A definition of independent directors that is drawn narrowly to take account of financial and familial conflicts moves in that direction. I believe that such a definition would permit corporations to benefit substantially from the dual board structure.

I would exclude from duty of loyalty issues assigned to the conflicts board the nomination and compensation of business review members other than inside directors.[106] The two boards should operate separately, with their own selection and compensation processes. This division will decrease the likelihood of conflicts between the boards and over-involvement with each other's affairs. It should be noted that, although business review members have a conflict of interest on these issues, so too do conflicts board members in determining their own nominations and compensation. Arguably, each board should determine the other board's compensation. At least on the part of the conflicts board, however, such a rule would destroy its desired independence from management and other nonindependent directors on the business review board.

Under the dual board system, board members or nominees would have the responsibility for identifying conflicting interests and notifying the corporation's CEO of the conflicts. The corporation, however, should periodically provide these directors or nominees with information and work sheets that would assist them in identifying any conflicts of interest that exist.

c. *Control Changes*

The unitary board of directors acting alone or with the concurrence of shareholders may take actions that have the effect of changing control of the corporation. Under the dual board structure, the conflicts board would be responsible for these actions. These actions include those that affect the control relationship between management and shareholders, such as adopting, modifying, or deleting staggered board and board removal provisions;[107] actions that alter the control relationship between controlling and minority shareholders, such as changes in cumulative voting provisions;[108] and actions that affect both of these relationships, such as those affecting

106. Executive officers are usually not separately compensated for serving on their corporations' boards of directors.

107. Dallas, *supra* note 100, at 54-59.

108. *Id.* at 59-60.

supermajority shareholder voting provisions.[109] In addition, control changes occur when proposed transactions have any of the following four effects on corporate control: (a) a person or group emerges with a controlling interest in the corporation; (b) a person or group loses a controlling interest in the corporation; (c) management becomes entrenched as a result of the transaction, such as by the payment of greenmail or sale of stock to a friendly person; or (d) shareholder voting rights are substantially diluted or effectively nullified by the transaction.[110] Finally, defensive tactics involve control changes or managerial conflicts and, therefore, should be considered by the conflicts board. Defensive tactics may be identified as transactions or provisions that are (a) conditioned on a change of control or (b) outside the normal course of business of the corporation and are adopted when a tender offer is imminent or pending.[111] Workable guidelines can be written to allow CEOs to identify readily matters involving control changes to be allocated to the conflicts board.

One can argue that members of the conflicts board also have conflicting interests when matters involve control changes. The interests of members of the conflicts board, however, are not of the magnitude of the interests of an inside director or nonindependent outside director on the business review board, who have interests in addition to the board memberships at stake.

d. Auditing

The conflicts board should oversee the auditing processes of the corporation because of the importance of financial information to assessing the performance of the corporation's executive officers. This oversight process ensures the independence of the corporation's external auditor and the corporation's internal auditing department. Numerous legal and business groups recommend that independent directors perform these oversight functions.[112] Many corporations have organized audit committees of the

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109. *Id.* at 60-62.

110. *Id.* at 62-65.

111. *Id.* at 67-70.

112. AM. STOCK EXCH., AMERICAN STOCK EXCHANGE COMPANY GUIDE § 121 (1996); NAT'L ASS'N OF SEC. DEALERS, DEALERS MANUAL, Rule 4460(d) (1996); N.Y. STOCK EXCH., NEW YORK STOCK EXCHANGE LISTED COMPANY MANUAL § 303 (1996); *see also* PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 1, § 3.05 ("The audit committee . . . should be composed exclusively of directors who are neither employed by the corporation nor were so employed within the two preceding years, including at least a majority of members who have no significant relationship [§1.34] with the corporation's senior executives."); ABA Comm. on Corp. Laws, *supra* note 1, at 1627; ABA Comm. on Corp. Laws,

board composed solely of independent directors.[113] Thus, the importance of allocating these functions to independent directors is well established. The corporation may refer to Section 3A.03 of the ALI's *Principles of Corporate Governance*[114] for a delineation of the audit-related functions that should be performed by the conflicts board or a committee thereof.

e. Legal and Ethical Behavior

I propose that the conflicts board also consider legal and ethical matters relating to the corporation. The evidence is mixed, however, on whether a relationship exists between independent directors on corporate boards and corporate social responsibility.[115] For example, a 1988 study (1980 data) found that Fortune 500 industrial organizations with large boards dominated by outside directors were positively associated with customer, environmental, and overall social responsibility as measured by two independent judges.[116] However, a 1992 study of Fortune 500 companies (1984 data) found a positive relation between inside directors and corporate philanthropy as measured by the percentage of corporate pretax earnings devoted to charitable contributions.[117] This study also found a positive relationship between the proportion of women and minorities on corporate boards and corporate philanthropy, although the association had only moderate statistical significance.[118]

The Overview Committees of the Board of Directors, 34 BUS. LAW. 1337, 1350-61 (1979); Business Roundtable, *supra* note 1, at 249.

113. HEIDRICK & STRUGGLES, INC., THE CHANGING BOARD 6 (1988); KORN/FERRY INT'L, *supra* note 78, at 13; MKTG. DIV., N.Y. STOCK EXCH., CORPORATE GOVERNANCE — SURVEY OF CORPORATE BOARDS, STRUCTURE AND COMPOSITION 2-4, 6 (1979); Analysis of Results of 1981 Proxy Statement Disclosure Monitoring Program, Exchange Act Release No. 18,532, 47 Fed. Reg. 10,792, 10,799, tbl. 15.1 (1982).

114. PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 1, § 3A.03.

115. *See, e.g.*, Nabil A. Ibrahim & John P. Angelidis, *The Corporate Social Responsiveness Orientation of Board Members: Are There Differences Between Inside and Outside Directors?*, 14 J. BUS. ETHICS 405, 408-09 (1995); Judge, *supra* note 91, at 2-3, 5-6; Idalene F. Kesner et al., *Board Composition and the Commission of Illegal Acts: An Investigation of Fortune 500 Companies*, 29 ACAD. MGMT. J. 789, 794-98 (1986); Jia Wang & Betty S. Coffey, *Board Composition and Corporate Philanthropy*, 11 J. BUS. ETHICS 771, 775-76 (1992); Shaker A. Zahra & Wilbur W. Stanton, *The Implications of Board of Directors' Composition for Corporate Strategy and Performance*, 5 INT'L J. MGMT. 229, 233 (1988).

116. Zahra & Stanton, *supra* note 115, at 232-33.

117. Wang & Coffey, *supra* note 115, at 775-76.

118. *Id.* at 774-75, 777.

A director's interest in legal and ethical conduct by the corporation may not correlate to the director's views on corporate philanthropy. A 1995 study found that both inside and outside directors felt that corporations should behave ethically and within the law, but that outside directors were more concerned than inside directors with corporate philanthropy.[119] The study, however, tested directors' revealed intentions rather than actual behavior.

Because of the mixed results of these studies, no conclusions can be drawn from them. Also, the studies cannot be compared meaningfully because of their use of different methodologies, data, and measurements of corporate social responsibility. Nevertheless, I suggest that ethical and legal compliance issues be assigned to the conflicts board. I believe that competitive pressures of businesses are felt more deeply by inside directors than by independent directors and that these pressures often result in unethical and unlawful behavior.[120] Overview of these issues by independent directors will, I believe, contribute to corporate social responsibility.

B. *The Business Review Board*

1. *Composition*

The composition of the business review board would resemble the current unitary board. The participation of management (inside directors) in the selection of directors on the business review board is acceptable because management is often in a good position to identify directors that will provide valuable relational resources to the corporation. These directors may perform various coordination, informational, service, and cooptative roles for the corporation. Unlike conflicts board members, business review board members often contribute to the corporation because of their relationships with it. Independent directors may also serve on this board because of their expertise or objectivity.[121]

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119. Ibrahim & Angelidis, *supra* note 115, at 408-09.

120. *See* Shaker A. Zahra, *Unethical Practices in Competitive Analysis: Patterns, Causes and Effects*, 13 J. BUS. ETHICS 53, 58-59 (1994) (discussing survey that found some executives view competitors as enemies and thus believe that any means of gaining advantage is permissible).

121. In a survey of chairpersons of the nation's largest industrial and service parent corporations as listed by *Fortune*, Heidricks and Struggles, Inc. found that the most important *personality* characteristics sought in directors were objectivity, intelligence, and honesty. HEIDRICK & STRUGGLES, INC., THE CHANGING BOARD 10 (1990).

2. *Functions of the Business Review Board*

I propose that the business review board perform the following functions:

- Oversee the conduct of the business to evaluate whether the business is being properly managed;
- Review and, when appropriate, initiate or approve the corporation's major strategic plans and corporate financial objectives; and
- Review and, when appropriate, initiate or approve major disinterested corporate transactions.

The business review board oversees the overall business operations of the corporation. Some critics may argue against the composition of this board and current unitary boards. Critics may assert that the business of the corporation will suffer if persons with business relations with the corporation have a role in reviewing such issues. Nonindependent directors may influence the corporation to develop its business in ways that will benefit them personally. For example, a banker who does business with the corporation may influence the corporation to take on more debt or to avoid additional debt in order not to jeopardize the payment of debt already outstanding. A supplier of important components to the corporation may through his position on the board push the corporation toward producing products utilizing these components when more profitable opportunities are available elsewhere.

This criticism of proposed members of the business review board is not persuasive, however, because of the relational benefits to be obtained by having such members on the board. The supplier and the banker are usually on the board because management wants them there. They provide important resources on which the corporation is to some degree dependent. Like contracts and mergers, board memberships permit mutually advantageous arrangements that reduce costs and produce benefits. Without such board memberships, these parties would have to proceed through arguably inferior arrangements.[122]

Business policies also benefit from the informed input of persons with an economic stake in the enterprise. Many stakeholders are dependent on the corporation and are interested in its well-being. Board memberships assist the corporation in obtaining valued input and in pursuing policies responsive to an uncertain environment. Consistent with power coalition

122. Dallas, *supra* note 2, at 6-7, 11.

theory, these stakeholders to some degree comprise the corporation and are an integral part of it.[123]

The dual board is also an improvement over the unitary board in that it mitigates to some degree the conflicts that these directors have. The conflicts board, composed of independent directors, reviews and approves all transactions that involve the business review directors. The conflicts board also has ultimate control over policy through its responsibility for the selection and compensation of the corporation's executive officers.

C. Conflicts Between Boards

Conflicts between boards may arise in a number of situations: (a) disagreements on issues decided by either board, such as the performance of executive officers or the advisability of particular transactions; (b) characterizations of a director as independent; and (c) decisions on whether an issue involves conflicting interests so that it should be allocated to the conflicts board. This section explores communications between the boards and legal remedies for breaches of fiduciary duty when a director or CEO fails to comply with internally developed procedures for the dual board or otherwise acts contrary to the interests of the corporation. In addition, this section examines the social dynamics of conflicts to assess whether two boards will produce disadvantages that may interfere with the efficient functioning of the corporation.

1. Communications Between the Boards

Each board should have the right to obtain reports from members of the other board and employees of the corporation that pertain to matters properly before it. For example, the conflicts board, in evaluating the CEO, may want to obtain the judgment of the business review board. Similarly, the business review board may wish to understand the conflicts board's bases for rejecting a business transaction with an interested director or for agreeing to a change in accounting principles. The CEO may provide useful information to both boards. The board ombudsperson would also serve as an important source of information for the conflicts board.[124]

2. Legal Avenues for Redress

The dual board will not require a change in law concerning basic fiduciary obligations of directors. Nevertheless, the procedures for deriva-

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123. *See supra* note 31 and accompanying text.

124. *See infra* notes 158-67 (discussing functions of proposed board ombudsperson).

tive actions and the standard of review courts apply to certain challenged transactions of the corporation are likely to change. For example, courts that excuse demand on the unitary board when the majority of directors are interested will rarely excuse demand with the dual board system.[125] This is because demand can always be made on the conflicts board that is composed of independent directors. Also, in those rare cases alleging breaches of the duty of care by conflicts board members,[126] demand can be made on the business review board. With respect to standards of review, courts may apply the deferential business judgment rule[127] to decisions by the conflict board, even though business review board members have conflicts of interest with respect to those decisions.[128] The standard of review applied to change of control cases would probably not change because the standard applied already takes into account the independence of directors and the loss of board positions that may come about as a result of a control change.[129]

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125. *E.g.*, Heineman v. Datapoint Corp., 611 A.2d 950, 952 (Del. 1992); Grobow v. Perot, 539 A.2d 180, 186 (Del. 1988); Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984).

126. *E.g.*, Joy v. North, 692 F.2d 880, 884 (2d Cir. 1982); Miller v. AT & T, 507 F.2d 759, 761 (3d Cir. 1974); Smith v. Van Gorkom, 488 A.2d 858, 893 (Del. 1985); Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963); Shlensky v. Wrigley, 237 N.E.2d 776, 778 (Ill. App. Ct. 1968); Francis v. United Jersey Bank, 432 A.2d 814 (N.J. 1981); PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 1, § 4.01.

127. *See supra* note 81.

128. This result is similar to decisions of some courts to apply the business judgment rule when a majority of the disinterested directors of the corporation approve the transaction, even though the other directors on the board are interested. *See, e.g.*, Puma v. Marriott, 283 A.2d 693, 695-96 (Del. Ch. 1971); *see also* PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 1, § 5.02 (applying intermediate standard of review that falls somewhere between business judgment rule and fairness test).

129. In tender offer cases, Delaware courts usually apply an enhanced business judgment rule to review defensive decisions made by target company boards. This standard of review was first adopted by the Delaware Supreme Court in *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (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. . . .
>
> . . . In the face of this inherent conflict directors must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed because of another person's stock ownership . . . . However, they satisfy that burden "by showing good faith and reasonable investigation . . . ." Furthermore, such proof is materially enhanced, as here, by the approval of a board comprised of a majority of outside directors who have acted in accordance with the foregoing standards.
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> . . . .

With a dual board, it is conceivable that one board will sue the other board to challenge decisions by the other board allegedly made in breach of its fiduciary duties. This possibility is not unusual; under Germany's two-tiered board system, discussed later in this Article, one board may sue the other.[130] Cases of this nature, however, would be rare. Duty of loyalty issues are allocated to the conflicts board, which means that challenges to such transactions will probably be analyzed under a deferential standard of review.[131] Because of this lower standard of court scrutiny, fewer actions will be brought. Moreover, actions brought by boards rather than shareholders may discourage litigation if, as some claim,[132] the primary motivation for many shareholder actions is to obtain plaintiff attorneys fees. From the corporation's perspective, duly elected directors may be more preferable as plaintiffs than self-appointed shareholders.[133] Moreover, such actions for breaches of fiduciary duty will be simplified when brought by one board against the other because litigation is not necessary on the issue of demand and on decisions by independent litigation committees.[134]

> . . . [Moreover, if] a defensive measure is to come within the ambit of the business judgment rule, it must be reasonable in relation to the threat posed.

Id. at 954-55. For more recent tender offer decisions, see *In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 267-68 (2d Cir. 1993); *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 42 (Del. 1993); *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140, 1142 (Del. 1989); and *Revlon, Inc. v. MacAndrews & Forbes Holding, Inc.*, 506 A. 2d 173 (Del. 1986).

130. *See infra* text accompanying notes 232-33.

131. This lower standard of review is referred to as the business judgment rule. *See supra* note 81.

132. *See* John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669, 677-81 (1986); Richard W. Duesenberg, *The Business Judgment Rule and Shareholder Derivative Suits: A View from the Inside*, 60 WASH. U. L.Q. 311, 333 (1982); Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55, 57 (1991). *But see* Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiff's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1, 65 (1991) (noting that strike suits are rare).

133. Duesenberg, *supra* note 132, at 340-41.

134. *E.g.*, Peller v. Southern Co., 911 F.2d 1532, 1538-39 (11th Cir. 1990); Hasan v. Clevetrust Realty Investors, 729 F.2d 372, 378 (6th Cir. 1984); Joy v. North, 692 F.2d 880, 888 (2d Cir. 1982); Genzer v. Cunningham, 498 F. Supp. 682, 687 (E.D. Mich. 1980); Gall v. Exxon Corp., 418 F. Supp. 508, 516 (S.D.N.Y. 1976); Zapata Corp. v. Maldonado, 430 A.2d 779, 785-88 (Del. 1981); Lewis v. Fuqua, 502 A.2d 962, 966-67 (Del. Ch. 1985); Kaplan v. Wyatt, 484 A.2d 501, 508 (Del. Ch. 1984), *aff'd*, 499 A.2d 1184 (Del. 1985); Miller v. Register & Trib. Syndicate, Inc., 336 N.W.2d 709, 718 (Iowa 1983); Houle v. Low, 556 N.E.2d 51, 58 (Mass. 1990); Auerbach v. Bennett, 393 N.E.2d 994, 1001-02 (N.Y. 1979); Alford v. Shaw, 358 S.E.2d 323, 325-26 (N.C. 1987); James

What about harassment of one board by the other board through threatening or bringing lawsuits? For instance, the business review board could sue the conflicts board for rejecting an inadvisable transaction in which business review directors were personally interested. Harassment of this nature is no more likely with a dual board than with a unitary board, except that directors may have more reasons to complain because fewer interested transactions may be approved by independent directors on the conflicts board. Under the unitary board system, shareholders can bring actions against directors that are often viewed by management as harassment. These include actions brought by director-shareholders who challenge a decision of the unitary board with which they disagree.

As for actions involving the failure of a director to reveal conflicting interests that result in either the director improperly serving on the conflicts board or the improper assignment of transactions to boards, it is the director failing to disclose his conflicting interest who has potential liability. If the director has improperly assumed a position on the conflicts board, an injunction that relieves her of that position should be sufficient. A transaction decided by the business review board that should have been decided by the conflicts board should not be enjoined, unless the transaction only involves the director (or a related person) who has failed to disclose his interest. Ordinarily, approval of a transaction by the wrong board should not affect the transaction's validity. A director who knowingly or unreasonably fails to disclose his interest may be held responsible for damages suffered by the corporation that are attributed to his failure to disclose.

Under the dual board system, the two boards and the corporation's CEO will be responsible for adopting and implementing a reasonable system for identifying independent directors and for assisting directors in identifying their conflicting interests. The usual standards applicable to directors and officers would apply to the fulfillment of these responsibilities. Under existing corporate law, directors and officers must exercise the care of a reasonably prudent person in a like position under similar circumstances.[135] Directors are not often found liable under this standard.[136]

D. Cox, *Searching for the Corporation's Voice in Derivative Suit Litigation: A Critique of* Zapata *and the ALI Project*, 1982 DUKE L.J. 959, 966-69, 973; Charles W. Murdock, *Corporate Governance — The Role of Special Litigation Committees*, 68 WASH. L. REV. 79, 84-85 (1993).

135. For a detailed summary of the body of law relating to directors' duty of care, see PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 1, § 4.01, reporter's notes, at 155-61.

136. *See* Joseph W. Bishop, Jr., *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1099 (1968). *But see* Norwood P. Beveridge, Jr., *The Corporate Director's Duty of Care Riddles Wisely*

3. *Dissension at the Top?*

Although the dual board structure is designed to equip the corporation to handle conflicting interests more effectively, the reader may be concerned that a second board will introduce undue conflict at the top decision-making level of the corporation. Even with clear guidelines for the assignment by the CEO of matters to the conflicts and business review boards, the boards may disagree with each other's actions and express hostility through reports to and requests for reports from the other board, executive officers, or other employees of the corporation. Or, the CEO may try to pit the two boards against each other as a means of deflecting criticism of his performance.

Social psychologists have found that intergroup conflicts are heightened by: (a) the competition or incompatible goals among groups; (b) a desire to bolster the self-esteem of in-group members; and (c) a process of cognitive simplification in which out-group members are negatively stereotyped.[137] The dual board structure is not constructed to place the boards in competition with each other. Each board has its primary area of responsibility. Compensation to one board does not diminish compensation to the other. Moreover, the goals of the boards are not incompatible; each board is under fiduciary obligations to act in the best interests of the corporation. Even in the absence of incompatible goals or competition, some studies have found that randomly formed and arbitrarily labeled groups tend to positively value their group relative to out-groups.[138] Devaluation of the out-group is not always involved, however, but a process of increasing the feelings of belongingness of in-group members generally occurs.[139] Although this process may result in comparatively valuing one group over another, it is not necessarily related to hostility that would require interference by one group with goals sought by the other.[140]

A negative effect of group formation is that board members may be inclined to engage in cognitive simplification that results in negative stereo-

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Expounded, 24 SUFFOLK U. L. REV. 923, 946-49 (1990) (listing cases finding due care violations); John C. Coffee, Jr., *Litigation and Corporate Governance: An Essay on Steering Between Scylla and Charybdis*, 52 GEO. WASH. L. REV. 789, 796 (1984) (noting that number of reported decisions finding duty of care violations do not take account of those cases that are settled).

137. *E.g.*, BARON ET AL., *supra* note 44, at 134-38.

138. *See id.* at 135-36; Jacob M. Rabbie, *The Effects of Intergroup Competition and Cooperation on Intragroup and Intergroup Relationships*, *in* COOPERATION AND HELPING BEHAVIOR: THEORIES AND RESEARCH 123, 130 (Valerian J. Derlega & Janusz Gizelak eds., 1982).

139. Rabbie, *supra* note 138, at 131.

140. *Id.* at 133.

typing and social bias against the other board group.[141] This categorization effect occurs because of the desire of persons to simplify their environment. Due to infrequent contact between in-group and out-group members, "illusory correlations" are often made that exaggerate negative experiences with out-group members.[142] Also, "attribution errors" are made. The bad behavior of out-group members is attributed to bad character as opposed to situational factors that are often the explanation for bad behavior by in-group members.[143] It is, therefore, likely that some of this categorization will occur. Members on the conflicts board, for example, may be perceived by business review board members as fluffy, impractical, or lawyer-like. Conflicts board members may perceive business review directors as being out for themselves or insensitive to shareholder concerns. Some competition for prestige may also occur between the two boards. The methods suggested by social psychologists for mitigating these effects, such as breaking down group boundary lines and close contact among members of different groups, are not options for the dual board system. However, this kind of stereotyping can be addressed by (a) making board members aware of these findings from social psychology[144] and (b) selecting for membership on the conflicts board persons who have served on the business review board of other corporations, and vice versa.

The CEO may also use conflict between boards as a means to mask his inadequate performance. Studies have shown that threatened leaders are more likely to generate hostility toward out-groups than leaders that feel more secure in their tenure.[145] The CEO, for example, may view himself as aligned with the business review board against the conflicts board. Despite this possibility, there are clean lines of authority built into the dual board system. The conflict board has the authority to fire the CEO without the cooperation of the business review board. Such conflicts are, therefore, likely to be short-lived. Moreover, the conflicts signal the existence of a problem that needs to be addressed. In conclusion, I would not oppose the

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141. BARON ET AL., *supra* note 44, at 136-38.

142. *Id.* at 139-40.

143. *Id.* at 143.

144. *See* Jody Amour, *Stereotypes and Prejudice: Helping Legal Decisionmakers Break the Prejudice Habit*, 83 CAL. L. REV. 733, 759-60 (1995) (concluding that alerting jurors to stereotypes may reduce discrimination in jury decision making). *But see* Linda Hamilton Krieger, *The Content of Our Categories: A Cognitive Bias Approach to Discrimination and Equal Employment Opportunity*, 47 STAN. L. REV. 1161, 1245-47 (1995) ("Cognitive psychologists have told us more about the shortcomings of human social inference cognition than about how the various biases they identify can be reduced or controlled.").

145. Rabbie, *supra* note 138, at 142.

dual board structure for fear of introducing unwarranted conflict at the top decision-making level of the corporation.

D. Is Legislation Needed to Permit a Dual Board Structure?

RMBCA Section 8.01 provides that the business and affairs of the corporation shall be managed by or under the direction of its board of directors, subject to limitations in the articles of incorporation or an effective shareholders' agreement.[146] Similar provisions are found in state statutes.[147] The comments to Section 8.01 of the RMBCA provide that such a "board of directors is the traditional form of corporate governance, but it need not be the exclusive form."[148] This statement implies that public policy considerations do not preclude other forms of corporate governance, such as the dual board.[149]

Nevertheless, the RMBCA and state corporation statutes do not contemplate two-board systems. Statutory provisions that limit the delegation of board authority to board committees, for example, say nothing about the allocation of those functions among different boards.[150] Moreover, flexibility with respect to board structure, such as doing away with a board of directors altogether, is limited to closely held corporations by these statutes.[151] Therefore, modifications of state corporation law are necessary to permit public corporations to use the dual board structure proposed in this Article.

III. The Second Board Reform Proposal: The Board Ombudsperson

I also recommend that a board ombudsperson be appointed to a full-time position by independent directors on the conflicts board or unitary

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146. REV. MODEL BUS. CORP. ACT § 8.01 (1990).

147. CAL. CORP. CODE § 300 (West 1990); DEL. CODE ANN. tit. 8, § 141 (1991); IND. CODE ANN. § 23-1-33-1(b) (Michie 1995); MICH. COMP. LAWS ANN. § 450.1501 (West 1990); N.Y. BUS. CORP. LAW § 701 (McKinney 1986); 15 PA. CONS. STAT. ANN. § 1721 (West 1995); VA. CODE ANN. § 13.1-673 (Michie 1993).

148. REV. MODEL BUS. CORP. ACT § 8.01 cmts.

149. *See* F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S CLOSE CORPORATIONS §§ 5.01-.41 (3d ed. 1994 & Supp. 1996).

150. DEL. CODE ANN. tit. 8, § 141(c) (1991); IND. CODE ANN. § 23-1-34-6 (Michie 1995); MICH. COMP. LAWS ANN. § 450.1528 (West 1990); N.Y. BUS. CORP. LAW § 712 (McKinney 1986); 15 PA. CONS. STAT. ANN. § 1731 (West 1995); VA. CODE ANN. § 13.1-689 (Michie 1993).

151. DEL. CODE ANN. tit. 8, § 351 (1991); 805 ILL. COMP. STAT. ANN. 5/2A.45 (West 1993); IND. CODE ANN. § 23-1-33-1(c) (Michie 1995); 15 PA. CONS. STAT. ANN. § 2332 (West 1995); WIS. STAT. ANN. § 180.1821 (West 1992).

board. The ombudsperson should meet qualifications established to assure her independence from management. The main responsibility of the board ombudsperson would be to gather information for independent directors and to make recommendations to them based on this information. In Part III, I discuss proposed qualifications, functions, and other requirements of a board ombudsperson. I also compare this proposed ombudsperson with the corporate ombudsperson position that is currently employed by a number of U.S. corporations.

A. *Introduction to Corporate and Board Ombudspersons*

The corporate ombudsperson operates outside the corporation's formal hierarchy to solve problems requiring a certain amount of impartiality.[152] In 1993, over five hundred U.S. corporations had corporate ombudspersons.[153] These appointments were consistent with various industry trends: "increased employee participation, renewed emphasis on ethics, heightened awareness of sexual harassment, and finding alternative means of resolving disputes."[154] These ombudspersons mainly deal with management-employee relations and are hired by the corporation's CEO.[155] It is often said that the support of top-management is essential for the effective operation of these ombudspersons.[156] This may be attributed mainly to the ombudsperson's

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152. OMBUDSMAN ASS'N, OMBUDSMAN HANDBOOK 1-1, 1-4, 3-6, 5-3 (1994) [hereinafter OMBUDSMAN HANDBOOK].

153. Junda Woo, *More Businesses Use Ombudsmen to Prevent Workplace Litigation*, WALL ST. J., Feb. 19, 1993, at B10 (referring to corporations with five hundred or more employees). Ombudspersons are used in a wide variety of industries (regulated and nonregulated), nonprofit organizations, and governmental bodies. *See* John P. Flaherty & Maureen E. Lally-Green, *The European Union: Where Is It Now?*, 34 DUQ. L. REV. 923, 959 (1996) (discussing European Parliament ombudsman); Michael R. Geroe & Thomas K. Gump, *Hungary and a New Paradigm for the Protection of Ethnic Minorities in Central and Eastern Europe*, 32 COLUM. J. TRANSNAT'L L. 673, 686 (1995) (reviewing parliamentary ombudsman); Robert E. Lutz, *A Piece of the Peace: The Human Rights Accord and the Guatemalan Peace Process*, 2 SW. J.L. & TRADE AM. 183, 195 (1994) (commenting on governmental human rights ombudsman); Fred L. Morrison, *The Constitution of Bosnia-Herzegovina*, 13 CONST. COMMENT 145, 153 (1996); James T. Ziegenfuss, Jr., *The Corporate Ombudsman at Work in Health Care, Banking, Utility, and Transportation Firms*, NAT'L PRODUCTIVITY REV., Spring 1995, at 97.

154. Justin Martin, *New Tricks for an Old Trade: The Changing Role of the Ombudsman*, ACROSS THE BOARD, June 1, 1992, at 40, 42.

155. Bureau of Nat'l Affairs, Inc., *Ombuds Jobs Are Proliferating and Characterized by Diversity*, 2 PRAC. & PERSPECTIVE 198, 198-99 (1988); James T. Ziegenfuss, Jr. et al., *Corporate Ombudsmen*, PERSONNEL WORLD, Mar. 1989, at 76.

156. *E.g.*, OMBUDSMAN HANDBOOK, *supra* note 152, at 5-2; Minda Zetlin, *A Neutral Third Party*, MGMT. REV., Sept. 1, 1992, at 50, 52.

role in resolving disputes between lower-level managers and employees. Without such support, the ombudsperson may not be given the deference necessary to assist in these controversies.

The board ombudsperson proposed in this Article is also a person outside the formal structure of the corporation. The board ombudsperson's independence of management is crucial, however, to her effective functioning.[157] She is not expected to work out disputes with management on employee and other issues, but is expected to serve mainly as an information conduit for independent directors on the board. Moreover, she would be appointed by independent directors and not by management.

B. *Functions and Benefits of Corporate and Board Ombudspersons*

Important distinctions exist between the currently functioning corporate ombudsperson and the board ombudsperson proposed in this Article. Corporate ombudspersons most frequently deal with various personnel policies, such as performance evaluations, terminations, work assignments and transfers, and various forms of harassment within the workplace.[158] Corporate ombudspersons perform a number of functions in attempting to resolve these issues: communicating information, counseling, problem-solving, fact-finding, negotiating, mediating, and operating as a safety net and change agent.[159] Corporate ombudspersons are expected to perform these functions informally rather than publicly[160] and to maintain confidences.[161] These functions performed in the employment context can pro-

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157. The board ombudsperson's functions and her independence, safeguarded by an appropriate process of selection and requirements concerning eligibility, distinguish her from the ombudsperson proposed by Victor Futter. Futter's "corporate" ombudsperson that reports to the board is more similar to existing corporate ombudspersons than to my board ombudsperson. She performs similar functions to corporate ombudspersons. For example, she is expected to work closely with management to resolve problems. She also must be approved by the CEO and may be a former employee of the corporation. *See* Victor Futter, *An Answer to the Public Perception of Corporations: A Corporate Ombudsperson?*, 46 BUS. LAW. 29, 35 (1990); *see also* Elmer W. Johnson, *An Insider's Call for Outside Direction*, HARV. BUS. REV., Mar.-Apr. 1990, at 46, 54-55.

158. Ziegenfuss et al., *supra* note 155, at 78-79.

159. OMBUDSMAN HANDBOOK, *supra* note 152, at 1-5, 1-6; Ziegenfuss et al., *supra* note 152, at 78.

160. OMBUDSMAN HANDBOOK, *supra* note 152, at 1-3, 1-4.

161. *Id.* at 1-3, 3-1 to 3-4. For articles exploring the issue of whether communications with a corporate ombudsperson should be privileged, see Brenda V. Thompson, Comment, *Corporate Ombudsmen and Privileged Communications: Should Employee Communications to Corporate Ombudsmen Be Entitled to Privilege?*, 61 U. CIN. L. REV. 653 (1992); *Privileged Communication Extended to the Corporate Ombudsman-Employee Relationship Via Federal Rule of Evidence* 501, 1991 J. DISPUTE RESOL. 367.

duce a number of benefits for the corporation, such as productivity improvements, savings of management time by defusing potentially disruptive personnel problems, employee turnover improvements, litigation cost savings in deflecting possible labor lawsuits, feedback to senior management resulting in beneficial changes in corporate policies and procedures, and evidence under the U.S. Sentencing Guidelines of a compliance program designed to ferret out wrongdoing that may decrease corporate liability resulting from employee misconduct.[162]

In contrast, board ombudspersons would assist boards in performing conflicts monitoring, which would involve conflicts of interest situations, changes of control, auditing and accounting issues, and legal and ethical compliance matters. The board ombudsperson's functions would include the following:

- Communicating information to the conflicts board to provide useful feedback on the implementation of corporate policies and other matters relevant to the conflicts board's responsibilities;
- Investigating facts in areas brought to the conflicts board's attention by management or others;
- Serving as a safety net and early warning device for problems facing the corporation by providing an information outlet for whistleblowers; and
- Operating as a change agent through recommendations to the board on corporate policies, actions, and procedures.

The board ombudsperson is also expected to maintain confidences and to proceed informally rather than publicly, although the board may permit her to report to shareholders in the corporation's annual report.[163] To perform her functions effectively, the board ombudsperson should have access to employees at all levels of the organization and to the books and records of the corporation.[164] She should also be permitted to attend all board and committee meetings (including those of the business review board).[165] A board ombudsperson may provide substantial benefits to the board, which include: (a) an independent, informed perspective on performance of senior executive officers; (b) facts on whether matters have been properly allo-

162. *See* OMBUDSMAN HANDBOOK, *supra* note 152, at 4-2 to 4-6; Robert Coulson, *Can Employee Lawsuits Be Avoided?*, N.Y.L.J., Apr. 1, 1993, at 3, 7; Carole M. Trocchio, *Just What Is an Ombudsman?*, FRANCHISING WORLD, Mar.-Apr. 1993, at 36.

163. *Accord* Futter, *supra* note 157, at 36-38.

164. *See id.* at 36; *see also* OMBUDSMAN HANDBOOK, *supra* note 152, at 3-1, 5-5.

165. Futter, *supra* note 157, at 36; *see also* Richard D. Greenfield, *The Case for the Corporate Ombudsman*, LEGAL TIMES, Aug. 7, 1989, at 19.

cated between boards; (c) information concerning transactions to be considered by the board, including the identity of others interested in the transactions and on whether the board should hire outside experts; (d) follow-up on audit-related matters and recommendations thereon; and (e) early identification of unlawful or unethical activity. The latter benefit results from the board ombudsperson's position outside the corporate hierarchy. Whistleblowing is encouraged concerning misconduct which often involves lower-level employees responding to competitive pressures from higher-level managers.[166] The board ombudsperson's function could also serve to eliminate or diminish corporate liability for employee misconduct under the U.S. Sentencing Guidelines.[167]

C. Selection and Qualifications of Corporate and Board Ombudspersons

As previously noted, the CEO usually appoints the corporate ombudsperson because the support of top management is considered essential for her to function effectively. Most corporate ombudspersons are long-time employees of the corporation who have worked for the corporation for ten to twenty years.[168] These ombudspersons are chosen for their detailed knowledge about how things are done within the corporation.[169] They are also selected because of their excellent interpersonal skills.[170]

Although neutrality and lack of conflicts are considered important to the corporate ombudsperson, emphasis is often placed on "perceptions" of independence, personal characteristics of the ombudsperson, and possibly naive agreements. The handbook of the Ombudsman Association (Handbook), for example, states that the ombudsperson should be "perceived" as fair "with *integrity* to withstand pressures from senior management."[171] The Handbook reports that mid-career ombudspersons are often hired with the "clear" understanding that actions taken as an ombudsperson will not affect their future careers.[172] While tradeoffs might be justified between independ-

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166. Futter, *supra* note 157, at 35-37.

167. Frank J. Navran, *Develop an Ethics Policy Now*, TRANSP. & DISTRIBUTION, Feb. 1992, at 27.

168. Ziegenfuss et al., *supra* note 155, at 79; *see also* OMBUDSMAN HANDBOOK, *supra* note 152, at 1-9 ("An estimated 90 percent of corporate ombudsmen worked for their employer before being chosen to be the ombudsman."); Zetlin, *supra* note 156, at 52 (discussing MIT survey that shows average tenure of sixteen years).

169. Bureau of Nat'l Affairs, Inc., *supra* note 155, at 198-99; *see* OMBUDSMAN HANDBOOK, *supra* note 152, at 1-3; Zetlin, *supra* note 156, at 52.

170. OMBUDSMAN HANDBOOK, *supra* note 152, at 5-1, 5-6.

171. *Id.* at 2-3 (emphasis added).

172. *Id.* at 1-9.

ence and expertise in this context, such a tradeoff is not justified for the board ombudsperson.

The board ombudsperson should truly be independent. She should have no significant relationship with the corporation[173] for at least three years prior to and after her tenure as ombudsperson. Eligibility requirements developed for conflicts board members should also be applied to board ombudspersons. Board ombudspersons may be former executive officers of other corporations, retired judges, lawyers,[174] accountants, public officials, and academicians. The board ombudsperson would operate most effectively with an open and inquiring mind and not a mind influenced by long association with the corporation's way of doing things. Moreover, unlike corporate ombudspersons, she would have ready access to corporate books and records, business meetings, and employees at all levels of the corporation.

The need for independent, outside persons to perform the board ombudsperson function is supported by the identity of ombudspersons chosen by corporations to monitor ethical business conduct in the defense and finance industries. The board ombudsperson's responsibilities include this subject. Some signatories of the Defense Industry Initiatives on Business Ethics and Conduct, including McDonnell Douglas Corporation and General Dynamics Corporation, have appointed ombudspersons to assure ethical business conduct.[175] An independent ombudsperson, a retired Army colonel who was previously employed as the Army's chief trial attorney, was appointed as an ombudsperson by one such signatory.[176] In the finance industry, Kidder Peabody & Company, in response to an insider trading scandal, hired a partner of a New York law firm on an outside consulting basis to serve as an ombudsperson.[177] This attorney explains that "[i]t's desirable to have someone [as ombudsperson] with a little distance and perceived independence."[178] Even in some labor situations, corporations have hired outside or "contract" ombudspersons to deal with issues relating to downsizing.[179]

These ombudspersons are not long-standing employees of the corporation and, therefore, can be distinguished from most ombudspersons concerned with employee-related issues. However, Kidder Peabody's attorney-

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173. *Accord* Greenfield, *supra* note 165, at 19.

174. *Id.* ("Ideally, the corporate ombudsman would be a lawyer with substantial business sophistication capable of interacting with and obtaining the respect of the board.").

175. Martin, *supra* note 154, at 42.

176. *Id.*

177. *See id.* at 42-43; *see also* Futter, *supra* note 157, at 42-43 (discussing appointment by Drexel Burnham Lambert of Judge Muligan as its ombudsperson).

178. Martin, *supra* note 154, at 43.

179. OMBUDSMAN HANDBOOK, *supra* note 152, at 1-9; Trocchio, *supra* note 162, at 36.

ombudsperson or his law firm may have performed, or expected in the future to perform, services for Kidder Peabody. Top executives of Kidder Peabody may also have had a substantial role in selecting the attorney-ombudsperson and may have been more concerned with "perceived," rather than actual, independence. The attorney-ombudsperson did not serve full-time. In contrast, the board ombudsperson proposed in this Article would work full-time, would meet strict eligibility criteria concerning independence, and would be appointed by truly independent directors. She would have full access to corporate information and the corporation's employees and would have a broader range of subject area responsibilities.

D. Compensation, Tenure, and Liability of Corporate and Board Ombudspersons

A study based on questionnaire responses of private-sector ombudspersons shows that ombudspersons' salaries (excluding benefits and bonuses) ranged in 1986 from $25,000 to more than $100,000, with $75,000 being the median figure.[180] The typical (median) budget of an ombudsperson in 1986 was $100,000, with a range from $5000 to $350,000.[181] Salaries varied depending on the ombudsperson's position within the organization, her prior salary, the nature of the organization, and the number of employees served by the ombudsperson.[182]

The board ombudsperson's compensation should be determined by the conflicts board (or independent directors on the unitary board) in an amount sufficient to attract well-qualified and motivated ombudspersons. Ombudspersons should not be compensated by a method that would affect their independence adversely. I recommend a fixed salary rather than a salary based on some percentage of the CEO's salary, corporate profits, or stock value of the corporation, all of which may pose conflicts for the board ombudsperson. The board ombudsperson's performance should periodically be reviewed by independent directors, and her compensation should be revised accordingly.

Corporations hire corporate ombudspersons either for fixed or indefinite terms;[183] some hire employees near retirement.[184] Indefinite terms and mid-career assignments can impact an ombudsperson's independence. Long terms of office could also produce a "coziness" between the ombudsperson

180. Ziegenfuss et al., *supra* note 155, at 79.

181. *Id.*

182. *Id.*

183. OMBUDSMAN HANDBOOK, *supra* note 152, at 5-3, 5-4.

184. *Id.* at 1-9, 5-4; Zetlin, *supra* note 156, at 52.

and management.[185] Board ombudspersons should, therefore, be outside persons, as previously described, and should be appointed for fixed, nonrenewable terms, possibly not exceeding three years.[186] These terms can be analogized to the rotating assignments of external auditors.

The liability of ombudspersons for dereliction of duty should be the same as for any other employee of the corporation. The board ombudsperson's responsibilities, however, are not determined by senior executives but by the conflicts board (or the independent directors of a unitary board).

IV. Foreign Systems

In evaluating the dual board proposal of this Article, business persons will inevitably comment that two-board systems have been tried in other countries. Foreign two-board systems, however, differ significantly from the dual board structure proposed in this Article. Foreign systems attempt to separate supervision from management, but do not take sufficient account of the importance of independence to effective conflicts monitoring. Foreign systems also place all nonmanagement functions in one board unlike the dual board, which allocates these functions among two boards. In this Part, I discuss two different two-board systems — the German two-tiered board structure[187] and the Japanese two-board structure, which consists of a board of directors and a board of auditors.[188] I compare these structures with each other, with unitary boards, and with the proposed dual board. I also compare the qualifications, functions, and responsibilities of members of the Japanese board of auditors with those of the board ombudsperson proposed in this Article.

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185. Greenfield, *supra* note 165, at 19.

186. Greenfield proposes a nonrenewable, three-year term. *See id.* Futter proposes a five-year, nonrenewable term. *See* Futter, *supra* note 157, at 39.

187. THE GERMAN STOCK CORPORATION ACT §§ 76, 95 (Hannes Schneider & Martin Heidenhain trans., 1996); ARETZ, *supra* note 8, at 99-120; CHARKHAM, *supra* note 8, at 17-25; DORRESTEIJN ET AL., *supra* note 8, at 112-14; MAITLAND-WALKER, *supra* note 8, at 163-66; Conard, *supra* note 8, at 1464-70; Hopt, *supra* note 8, at 1344-45; Meier-Schatz, *supra* note 8, at 443-44; Schmalenbach, *supra* note 8, at 110; Lo, *supra* note 8, at 239-40.

188. *See* Act Regarding Exceptional Rules of the Commercial Code Concerning Auditing, Etc., of Stock Corporations, Law No. 22 of 1974 (Japan), as amended, *reprinted in* 2 JAPAN BUS. L.J. 443 (H. Nakatsu trans., 1981); The Commercial Code, Law No. 48 of 1899 (Japan), as amended (Zentaro Kitagawa trans., 1994); CHARKHAM, *supra* note 8, at 85-93; YANAGIDA ET AL., *supra* note 9, at 274-79; Survey, *supra* note 9, at 159-61; *see also* Ishibashi, *supra* note 9, at 1; Makino, *supra* note 9, at 3; Star, *supra* note 9, at 3.

A. *Germany's Corporate Two-Tiered Board Structure*

Private corporations with five hundred or more employees and public corporations organized under German law are required to have a two-tiered board structure.[189] This structure places supervisory functions in the first-tier board, the aufsichtsrat (supervisory board), and management functions in the vorstand, the second-tier board (management board).[190]

The organization of this two-board system is similar to current U.S. unitary boards. The basic division is between supervision and management functions. In the United States, the board of directors is designed to supervise management. Managerial functions are performed by top executive officers or, in some cases, by executive committees composed of the corporation's senior executives officers. The German supervisory board is analogous to the U.S. board of directors because it also supervises management.[191] The management board, which consists mainly of executive officers of the corporation, provides managerial services.[192] The force of the analogy between the U.S. unitary board structure and the German two-tiered board system is further illustrated by the line relationship between the supervisory body and management. U.S. boards appoint and determine the compensation of senior executives. Likewise, the German supervisory board appoints[193] and determines the compensation[194] of directors on the management board.

The German supervisory board, however, has less control over management and the corporation than the U.S. board has. Whereas the U.S. board of directors may intervene and manage the corporation if it so desires, the German supervisory board may not do so.[195] Managerial responsibilities may not be assumed by the German supervisory board.[196] The powers of the German supervisory board are limited to consenting to specific types of transactions requiring the supervisory board's consent,[197] including the extension of credit by the corporation to management board directors,[198] and approving or objecting to the corporation's financial statements and to the

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189. *See* CHARKHAM, *supra* note 8, at 17-18; DORRESTEIJN, *supra* note 8, at 109, 112.

190. *See* CHARKHAM, *supra* note 8, at 17-18; MAITLAND-WALKER, *supra* note 8, at 163, 165.

191. THE GERMAN STOCK CORPORATION ACT § 111(1).

192. *Id.* §§ 76(1), 78.

193. *Id.* § 84(1); Conard, *supra* note 8, at 1465.

194. THE GERMAN STOCK CORPORATION ACT § 87(1); Conard, *supra* note 8, at 1465.

195. THE GERMAN STOCK CORPORATION ACT § 114(4); Conard, *supra* note 8, at 1465.

196. THE GERMAN STOCK CORPORATION ACT § 111(4).

197. *Id.*

198. *Id.* § 89(1).

allocation of profits to dividends and reserves.[199] Moreover, the German supervisory board may not remove members of the management board during their terms, which are often for five years,[200] except "for cause."[201] Cause requires a showing of gross breaches of fiduciary duties or inability to manage the corporation properly. The U.S. board has greater flexibility and may usually remove senior executives of the corporation for any reason. Thus, the U.S. board has greater control over management than does the German supervisory board. Both boards, however, mainly perform supervisory rather than management functions.

The U.S. board of directors and the German board structure are also similar in that both conflicts monitoring and other relational roles are expected to be performed by the same board. In performing its relational duties, the German supervisory board accommodates employee participation.[202] Detailed statutory provisions specify the appropriate number of employees that must be on the supervisory board and their qualifications and manner of selection to the board.[203] Bankers or other persons who are selected by banks are also present on German supervisory boards.[204] This bank involvement derives from the deposited voting rights system whereby German corporate shares, usually in bearer form, are deposited with banks and voted on by them.[205] A 1988 study of thirty-two of Germany's one hundred largest quoted firms with approximately a quarter of the market's nominal capital revealed that banks collectively represented 82.67% of all votes present at shareholder meetings and that the biggest three banks accounted for 45% of these votes.[206]

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199. *Id.* § 171.

200. *Id.* § 84(1); CHARKHAM, *supra* note 8, at 21.

201. THE GERMAN STOCK CORPORATION ACT § 84(3).

202. *See id.* § 96; *see also* An Act Concerning Co-Determination of Employees of May 4, 1976, *reprinted in* THE GERMAN CO-DETERMINATION ACT (Hannes Schneider & David J. Kingsman eds. & trans., 1976); Michael Gruson & Wienand Meilicke, *The New Co-Determination Law in Germany*, 32 BUS. LAW. 571, 573 (1977); Benjamin A. Streeter, III, *Co-Determination in West Germany — Through the Best (and Worst) of Times*, 58 CHI.-KENT L. REV. 981, 1001 (1982).

203. THE GERMAN STOCK CORPORATION ACT § 96.

204. Professor Conard explains: "Although the banks cast most of the ballots, the supervisors whom they elect are predominantly shareholders, with a sprinkling of banks' representatives, experts (lawyers, accountants, engineers, etc.), and others." Conard, *supra* note 8, at 1470. "A significant number of directorships are also held by representatives of governmental bodies that hold shares in 'mixed economy enterprises.'" *Id.* at 1470 n.79.

205. *See* CHARKHAM, *supra* note 8, at 37-38; Conard, *supra* note 8, at 1469-70; Schmalenbach, *supra* note 8, at 114, 117.

206. *See* CHARKHAM, *supra* note 8, at 40-41.

U.S. law does not provide for employee participation on the boards of U.S. corporations. Moreover, bankers play less of a role in selecting persons to the board. Shares of U.S. corporations are in registered form, and although many of those are held in street names (including bank nominee names), elaborate procedures are required by law to encourage voting of those shares by beneficial owners or trustees.[207] U.S. boards, however, are composed of a high percentage of outside directors[208] that are selected to perform a variety of functions, including providing advice, information, and status to the corporation as well as engaging in conflicts monitoring.[209] Over two-thirds of U.S. boards of directors of large industrial corporations are composed of outside directors.[210] Both the German supervisory board and the U.S. board of directors provide a variety of relational functions for the corporation.

In addition to performing a variety of relational functions, the German and U.S. boards are expected to perform conflicts monitoring. The German supervisory board is responsible for the supervision of management[211] and is obligated to determine the compensation[212] and extension of credit by the corporation to members of the management board.[213] The German supervisory board also represents the corporation in and out of court against the management board.[214] The business and affairs of U.S. corporations must be managed by, or under the direction of, corporate boards.[215]

The U.S. board of directors and the German supervisory board, however, are impeded in their ability to perform conflicts monitoring effectively. A significant percentage of U.S. board members are inside directors.[216] In fact, CEOs often serve on corporate boards. CEOs often act as chairmen of the board[217] and determine the board's agenda and what information will be distributed to other directors.[218] Moreover, some outside directors have

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207. *See* 17 C.F.R. § 240.14a-13 (1996); *id.* § 240.14b-1; *id.* § 240.14b-2; American Stock Exchange Rules 575-77, 2 Am. Stock Ex. Guide (CCH) ¶¶ 9528, 9529, at 2708-17 (1996); New York Stock Exchange Rules 451-52, 2 N.Y.S.E. Guide (CCH) ¶¶ 2451, 2452, at 3805-15 (1996).

208. *See* KORN/FERRY INT'L, *supra* note 78, at 10.

209. *See supra* text accompanying note 35.

210. *See* KORN/FERRY INT'L, *supra* note 78, at 10.

211. THE GERMAN STOCK CORPORATION ACT § 111(1).

212. *Id.* § 87(1).

213. *Id.* § 89.

214. *Id.* § 112.

215. *See supra* note 147.

216. KORN/FERRY INT'L, *supra* note 78, at 10.

217. LORSCH & MACIVER, *supra* note 42, at 2 & n.1.

218. *Id.* at 13.

business and other relationships with the corporation or its management[219] that interfere with their ability to provide effective conflicts monitoring. The German supervisory board may not contain members of the management board,[220] but may consist of persons with professional and business relationships with the corporation,[221] including employees[222] and creditors of the corporation.[223] Thus, both boards contain persons with conflicts of interest that impede effective conflicts monitoring.

In conclusion, U.S. boards of directors and German two-tiered boards are similar in their attempt to separate management from supervision and in placing conflicts monitoring and other relational functions in the same board. They both have drawbacks in performing conflicts monitoring because of the characteristics of board members expected to perform this function. Unlike the U.S. board, however, the German supervisory board's powers are more limited. The German supervisory board also may be less effective than the U.S. board in providing some relational roles because members of the management board are excluded from membership on that board.[224]

The dual board structure proposed in this Article differs from the two-tiered board system used by German corporations in the following aspects:

- The proposed dual board provides for the separation of supervision from management, but unlike the German system, this is not accomplished through a separate board that performs management functions. In this respect, the dual board is more like the U.S. board, which typically does not manage the corporation, but has the authority to do so. Management authority is delegated by the U.S. unitary board to executive officers of the corporation. The dual board also delegates managerial power to executive officers.
- All nonmanagement functions are placed in the same board under the German system. The dual board system assigns conflicts monitoring to one board and other relational functions to the business review board.
- The German system provides for employee participation on the supervisory board. The dual board could similarly facilitate employee participation by providing for employee directors on the business review

219. Baysinger & Butler, *Revolution Versus Evolution*, *supra* note 17, at 569.
220. THE GERMAN STOCK CORPORATION ACT §§ 100, 105.
221. *Id.* § 114.
222. *Id.* § 96.
223. *Id.* § 115.
224. *Id.* §§ 100, 105.

board. Benefits of the dual board systems may be obtained, however, without adopting the German system of employee codetermination.

- The German supervisory board consists of a mix of different kinds of directors, except that top executives (members of the management board) are excluded from this board. In contrast, the business review board would contain top executives of the corporation as well as other kinds of directors. Because top executives may not serve on the German supervisory board, it would be less effective in performing some relational functions than the business review board, which does contain such executives.
- Conflicts monitoring by the German supervisory board must be performed by nonindependent directors on its board. The conflicts board is composed solely of independent directors.
- The German supervisory board's authority to monitor is limited by legal rules, such as its inability to remove members of the management board except for cause. The conflicts board is not subject to these limitations.[225]
- In the German system, one board appoints members of the other board and determines their compensation. Each board in the dual board structure makes its own nominations and determines its own compensation.[226] The conflicts board is the premier board only through its ability to hire and fire the CEO and other executive officers of the corporation.[227]

The German supervisory board has some features in common with the dual board's conflicts board. It has access to the books and records of the corporation[228] and may hire experts[229] (called inspectors)[230] to review these documents. It has effective authority over some areas involving managerial conflicts of interest, such as the hiring and removal of managers and determining compensation and loans by the corporation to them.[231] Both boards are entitled to report on various subjects from the other board[232] and may

225. *See supra* Part II.A.2.a (discussing role of conflicts board in executive selection and compensation).

226. *See supra* Part II.A.2.b (noting that each board should determine its own compensation).

227. *See supra* Part II.A.2.a (explaining dominance of conflicts board).

228. THE GERMAN STOCK CORPORATION ACT § 111(2).

229. *Id.*

230. CHARKHAM, *supra* note 8, at 22.

231. *See supra* notes 193, 198.

232. THE GERMAN STOCK CORPORATION ACT § 90.

represent the corporation in actions by or against the other board's members.[233] These features of the dual board system, therefore, should not cause concern because of their novelty.

B. *Japan's Corporate Board of Directors and Board of Auditors*

Large corporations in Japan have two boards, a board of auditors and a board of directors. In 1993, Japanese law was amended to strengthen the powers and duties of statutory auditors (kansayaku).[234] This amendment required large corporations to establish a board of auditors consisting of at least three auditors.[235] Statutory auditors should not be confused with external or internal accounting auditors concerned with auditing the corporation's finances. Statutory auditors "audit the directors' performance of their duties."[236] Japanese boards of directors often consist of a large number of directors who are usually inside (employee) directors of the corporation. These boards are often ceremonial, with control residing in a top management committee called the jomukai.[237]

The Japanese two-board system differs substantially from the German two-tiered board. While both the Japanese board of directors and the German management board consist mainly of inside directors, the German management board is more actively involved in the management of the corporation.[238] The German supervisory board is also different from the Japanese board of auditors. The board of auditors is not intended to perform relational functions. Unlike the German supervisory board, the Japanese board of auditors is not composed of various employee or bank directors. It is really not a board of "directors" at all. Other than determining audit policy and methods for investigating the business and assets of the corporation,[239] the board of auditors does not direct the corporation in its business.

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233. *Id.* § 112.

234. *See, e.g., Commercial Code Amended, supra* note 9, at 6; *Dawning, supra* note 9, at 87; *New Audit Powers, supra* note 9, at 8, 9; Ishibashi, *supra* note 9, at 1; Makino, *supra* note 9, at 3; Star, *supra* note 9, at 3.

235. Act Regarding Exceptional Rules of the Commercial Code Concerning Auditing, Etc., of Stock Corporations, Law No. 22 of 1974 (Japan), as amended, § 18, *reprinted in* 2 JAPAN BUS. L. J. 443 (H. Nakatsu trans., 1981); YANAGIDA ET AL., *supra* note 9, at 277.

236. The Commercial Code, Law No. 48 of 1899 (Japan), as amended, § 3734 (Zentaro Kitagawa trans., 1994).

237. CHARKHAM, *supra* note 8, at 85.

238. *Id.* at 19.

239. Act Regarding Exceptional Rules of the Commercial Code Concerning Auditing, Etc., of Stock Corporations, Law No. 22 of 1974 (Japan), as amended, § 18-2(2). In

The role of the statutory auditor is mainly restricted to reporting on certain subjects to the board of directors[240] and to the shareholders[241] of the corporation. In some situations, however, the statutory auditor may demand that directors cease certain activities[242] and may represent the corporation in actions by or against directors.[243] However, the scope of the statutory auditor's responsibilities is limited. The statutory auditor focuses on directoral violations of law, ordinances, and the corporation's articles of incorporation.[244]

Although the board of auditors is expected to assure legal compliance by directors of the corporation, which is also one of the responsibilities of the conflicts board, the board of auditors, unlike the conflicts board, is poorly composed to perform that function. Although the auditors may not be currently employed by the corporation,[245] only one auditor is required not to have been employed by the corporation for at least five years prior to taking office.[246] No requirements exist concerning employment of auditors by the corporation after serving their terms. Moreover, the law does not preclude other business relationships with the corporation or its management by auditors during their term of office.

Although the law has been strengthened to subject auditors to liability for acting in bad faith and in gross neglect of their duties,[247] the ability of auditors to perform their functions effectively is problematic until greater attention is given to their independence. Statutory auditor positions are normally filled by retiring employees who do not have the status to be on

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addition to determining audit policy and methods of investigation, the board of auditors may also determine "other matters concerning the execution of the duties of the board of auditors." *Id.*

240. The Commercial Code § 260-3.

241. *Id.* §§ 275, 275-3.

242. *Id.* § 275-2.

243. *Id.* § 275-4.

244. *Id.* §§ 260-3, 275, 275-2. After examining proposals and documents to be submitted to shareholders at a general meeting of shareholders, the auditor may also report to shareholders matters in those proposals or documents that are "grossly improper." *Id.* § 275. There must be "a likelihood that serious damage might be done" to the corporation before the auditor may demand that the director cease to act. *Id.* § 275-2. This latter power also extends to finding that a director is performing an act that is "not within the scope of the business purpose" of the corporation. *Id.*

245. *Id.* § 276.

246. *See* Act Regarding Exceptional Rules of the Commercial Code Concerning Auditing, Etc., of Stock Corporations, Law No. 22 of 1974 (Japan), as amended, § 18; *see also* YANAGIDA ET AL., *supra* note 9, at 277.

247. The Commercial Code §§ 277, 280(1). The Commercial Code Section 280(1) specifically refers to Section 266-3(1).

the corporation's board of directors.[248] Sometimes the positions are filled by mid-level directors who are not going to be promoted.[249] These low-status individuals with long histories with the corporation and its management often are ineffective auditors.[250]

The Japanese two-board system is different from this Article's dual board proposal in the following ways:

- The dual board structure consists of two boards of "directors." One board under the Japanese system is a board of "auditors" that has more limited powers and responsibilities than either board under the dual board system.
- The Japanese board of directors is composed mainly of inside directors and thus is more analogous to the German management board than either the dual board's conflicts or business review boards.
- Independence requirements for members of the board of auditors are substantially weaker than the standards proposed for the conflicts board.
- The business review board will most likely consist of a substantial number of outside directors, whereas the Japanese board of directors is composed largely of inside directors.

The Japanese board system has some similarities to the dual board. The board of auditors is given access to books and records of the corporation.[251] It may also represent the corporation in actions by or against directors of the corporation.[252] Moreover, each board is legally entitled to nominate its own members.[253]

Also, the role of the board ombudsperson can be compared to that of the Japanese statutory auditor. The board ombudsperson would be concerned with a broader range of issues than the statutory auditor. The ombudsperson would gather information on conflict of interest transactions, changes of control, and ethical practices, in addition to information on

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248. CHARKHAM, *supra* note 8, at 93; Survey, *supra* note 9, at 159.

249. Survey, *supra* note 9, at 159.

250. CHARKHAM, *supra* note 8, at 93; Survey, *supra* note 9, at 159.

251. The Commercial Code § 274(2) ("An auditor may at any time call on the directors, managers and other business employees for a report on the business of a company, or investigate the conditions of the affairs of the company and its property.").

252. *Id.* § 275-4.

253. Act Regarding Exceptional Rules of the Commercial Code Concerning Auditing, Etc. of Stock Corporations, Law No. 22 of 1974 (Japan), as amended, § 18(2). In addition, "[a]t a general meeting of shareholders, an auditor may state an opinion regarding the appointment or removal of an auditor." The Commercial Code § 275-3.

auditing and legal compliance issues. The board ombudsperson, however, would not have the power of the statutory auditor. The ombudsperson could neither demand that directors cease to act nor represent the corporation in an action by or against directors, unless authorized to do so by the conflicts board. Also, whereas the statutory auditor may attend and speak at board meetings,[254] the ombudsperson may attend those meetings only to collect information. Any further participation by the ombudsperson at these meetings is a matter for the conflicts board to approve.

The board ombudsperson would report to the conflicts board, which has the ultimate responsibility for conflicts monitoring. This structure separates information gathering and evaluation from action based on that information. The structure facilitates the ombudsperson's job, which is limited to gathering, evaluating, and reporting information to an independent conflicts board that is responsible for decision making. It would be beneficial to borrow from Japanese law a requirement that managers immediately report to the ombudsperson facts they discover that "give rise to an apprehension that significant damage may be incurred by the stock company,"[255] but otherwise the board ombudsperson structure is preferable. Under the Japanese two-board system, the Japanese auditor is responsible for both functions, gathering and acting on the basis of the information that he finds. In addition, unlike the Japanese auditor, the board ombudsperson must meet strict eligibility criteria concerning his independence.

Conclusion

The dual board attends to various aspects of the corporation's environment. The dual board maximizes the possibility of fulfilling the many functions that a board is well situated to perform. Unlike the unitary board, the dual board divides its functions among two boards, each more capable of performing a subset of functions than the unitary board. These relational functions are divided into conflicts monitoring, which requires independent directors, and other business review monitoring functions, which benefit from the participation of both inside directors and nonindependent outside directors.

Board systems that separate supervision and management are supplemented through the dual board structure by a system that allocates supervisory functions among two boards. The dual board structure implements a more finely tuned system that recognizes the variety of functions that boards perform and are expected to perform by corporations. The dual

254. The Commercial Code § 260-3.
255. *Id.* § 274-2.

board proposal takes seriously what boards do and the appropriate qualifications of directors who serve on them.

The board ombudsperson proposal is applicable to both dual boards and unitary boards. Board ombudspersons would be selected by independent directors on these boards to gather and evaluate information on matters relevant to the boards' responsibilities. By decreasing the substantial informational dependence that directors have on corporate management, the board ombudsperson would assist independent directors in more effectively monitoring situations in which the interests of managers conflict with the interests of shareholders.