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Abstract

The fiduciary duty of loyalty bars CEOs and other executives from managing companies for personal gain. In the modern public corporation, this restriction is reinforced by a pair of institutions: the independent board of directors and the business judgment rule. In isolation, each structure arguably promotes manager fidelity to shareholder interests—but together, they enable manager prioritization. This marks a particularly striking turn for the independent board. Its origin story and

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raison d'être *lie in protecting shareholders from opportunism* by *managers, but it functions as a shield* for *managers instead.*

Numerous defects in the design and practice of the independent board inhibit its ability to curb managerial excess. Nowhere is this more evident than in the context of transactions that enrich the CEO. When executive compensation and similar matters are approved by independent directors, they take on a new quality: they become insulated by the business judgment rule. This rule is commonly justified as giving legal effect to the comparative advantage of businesspeople in their domain—in determining the price of a product, for example—and it immunizes such decisions from court challenge. But independent directors can opt to extend the rule's protection beyond this narrow class of duty of care cases to domains that squarely implicate the duty of loyalty. The result is a shield for conflicts of interest that defeats the major objective of the independent board and important goals of corporate law more generally.

This Article proposes to eliminate the independent board's paradoxical shield quality by ending business judgment protection for claims implicating the duty of loyalty. Judges would apply the familiar entire fairness standard instead. The clearest rationale for this reform comes from the logic of the rule itself: comparative advantage. Judges, not businesspeople, are best situated to adjudicate conflicts of interest. More broadly, the Article's analysis suggests that the pro-shareholder reputation of the independent board is overstated and may have inadvertently fostered a sense of complacency around board power.

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I. Introduction

The business judgment rule places management decisions that implicate the duty of care, such as salary levels for the rank-and-file, all but beyond the review of courts.[1] The theory

1. *See* Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 87 (2004) ("On the one hand, the duty of care requires that directors exercise reasonable care in making corporate decisions. On the other hand, the business judgment rule mandates that courts defer to the board of directors' judgment absent highly unusual exceptions.").

underlying this policy is that businesspeople and the market are better able to decide these questions.[2] In the age of independent board governance, however, the scope of deference to board discretion no longer tracks this logic of comparative advantage.[3] Instead, decisions by management that implicate questions of loyalty—such as whether to cut the CEO a $100 million bonus check—can be placed beyond judicial review, too, simply by dint of having been approved by directors who claim nominal independence from the corporation.[4] This change has allowed CEOs and directors to shield transactions benefiting themselves and each other from shareholders, courts, and market discipline.[5]

The independent board of directors was a well-intentioned response to the special problems of the modern public corporation.[6] In the early days of the New Deal, William O. Douglas—then a professor at Yale Law School, later the Chairman of the Securities and Exchange Commission and an Associate Justice of the Supreme Court—developed a set of proposals designed "to afford additional protection against the evils of the last decade"[7] that brought the country to the brink of economic ruin.[8] In 1934, Douglas published a theory of corporate self-monitorship that would eventually become the independent board.[9] This invention responded to a problem

2. *See id.* at 117–18 (explaining the common rationale for the business judgment rule which suggests that business experts may know business better than judges).

3. *See infra* Part IV.

4. *See* Leo E. Strine Jr. et al., *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 GEO. L.J. 629, 691 (2010) (discussing the resulting duty and accountability issues created as board compositions become increasingly independent).

5. *See infra* Parts IV–V.

6. *See infra* Part II.

7. William O. Douglas, *Directors Who Do Not Direct*, 47 HARV. L. REV. 1305, 1307 (1934).

8. *See* EDWIN P. HOYT, WILLIAM O. DOUGLAS: A BIOGRAPHY 40–41, 48, 69 (1979) (detailing Douglas' employment at Yale, the SEC, and as an Associate Justice of the Supreme Court).

9. *See* Dalia Tsuk Mitchell, *Status Bound: The Twentieth Century Evolution of Directors' Liability*, 5 N.Y.U. J.L. & BUS. 63, 103–05 (2009)

identified by Adolf Berle and Gardiner Means two years earlier: shareholders in the modern corporation, who were remote from corporate operations and beset by collective action problems, struggled to effectively monitor managers.[10]

This situation left public companies effectively captive to the CEO and other insiders,[11] who could, in countless lawful ways, benefit themselves at the expense of shareholders.[12] The proposed change gathered strength over the decades, gained crucial intellectual support in the 1970s,[13] and became increasingly common in the late twentieth century.[14] In 1993, Stephen Bainbridge observed that "virtually all subsequent corporate law scholarship has focused on the extent to which corporate law ought to prevent management" from abusing its control of the corporation.[15] Early in the new millennium, U.S. stock exchanges codified what had become market practice by

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(discussing Douglas' 1934 article, *Directors Who Do Not Direct*, and its influence on the evolution of corporate boards).

10. *See* ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 6 (1932) [hereinafter BERLE & MEANS, THE MODERN CORPORATION] ("The separation of ownership from control produces a condition where the interests of owner and of ultimate manager may, and often do, diverge, and where many of the checks which formerly operated to limit the use of power disappear."). N.B. Berle was a onetime faculty colleague of Douglas'. *See* Jessica Wang, *Neo-Brandeisianism and the New Deal: Adolf A. Berle, Jr., William O. Douglas, and the Problem of Corporate Finance in the 1930s*, 33 SEATTLE U. L. REV. 1221, 1223 (2010) (discussing Berle's and Douglas' tenure at Columbia University).

11. Except where noted, this Article will use the terms managers, insiders, and executives interchangeably. All refer to top officers who are responsible for management of the corporation.

12. *See* Stephen M. Bainbridge, *Independent Directors and the ALI Corporate Governance Project*, 61 GEO. WASH. L. REV. 1034, 1034 (1993) ("Because no single shareholder owns enough stock to affect corporate decisionmaking, the firm is effectively controlled by its managers. Unchecked, management may abuse its control by benefiting itself at the expense of the shareholder-owners.").

13. *See, e.g.*, MELVIN ARON EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS 162–70 (1976) (promoting a monitoring conception of the board).

14. See *generally* Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465 (2007).

15. Bainbridge, *supra* note 12, at 1034.

requiring listed companies[16] to appoint boards consisting of a majority of independent directors.[17]

Debates over the independent board have become proxy fights over a central question in corporate law: whether corporate power should favor shareholders or managers.[18] Some commentators favor giving managers a wide berth and leaving discipline to the market,[19] while others see an independent

16. The terms "listed companies" and "public companies" will be used interchangeably to refer to companies that are subject to listing requirements imposed by stock exchanges. While the term "public companies" technically also includes companies whose stock is traded over the counter rather than on an exchange, these companies are generally much smaller and are not subject to stock exchange rules, and thus no such meaning is intended in this Article. *See, e.g.*, *Public Company*, NASDAQ, https://perma.cc/U6TT-B64M (defining a public company as "[a] company that has held an initial public offering and whose shares are traded on a stock exchange or in the over-the-counter market").

17. The independent board mandate went into effect in 2003. *See Listed Company Manual*, *§ 303A.01 Independent Directors*, N.Y. STOCK EXCH., https://perma.cc/PT36-E4VR (setting forth a requirement that New York Stock Exchange-listed companies have boards composed of a majority of independent directors); *Rulebook—The Nasdaq Stock Market*, NASDAQ, https://perma.cc/7LAW-RXUT [hereinafter *Nasdaq Stock Mkt. Rules*] ("A majority of the board of directors must be comprised of Independent Directors."). Some exceptions exist, discussed at Part II.B, *infra*.

18. *See* Leo E. Strine, Jr., *Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law*, 114 COLUM. L. REV. 449, 474 (2014); *see also* Bainbridge, *supra* note 12, at 1034 (observing that "[v]irtually all" corporate law scholarship since Berle and Means "has focused on the extent to which corporate law ought to prevent management from" abusing its control).

19. For expressions of this view generally, see, for example, Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance,* 97 NW. U. L. REV. 547, 551 (2003) (discussing the role of the market in disciplining boards); William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 659–60 (2010) (observing that the role of the manager is better suited than that of the shareholder to maximize the value of the corporation); Martin Lipton & William Savitt, *The Many Myths of Lucian Bebchuk*, 93 VA. L. REV. 733, 734 (2007) (arguing that a director-centered approach maximizes value and benefits the economy); Bainbridge, *supra* note 12, at 1069 (commenting on the conflict managers in buyout transactions face between maximizing firm rather than individual wealth); see also Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 564 (2006) (taking issue with "the characterization of shareholders as having interests that are

board elected by shareholders as a key internal counterweight to managers.[20] But this difference in philosophy, while conspicuous, masks a deeper consensus: neither perspective acknowledges—much less endeavors to address—the shield problem.[21]

The supposedly "dueling ideological mythologists" who represent the two schools take as their point of departure, as Douglas did, that the independence model in fact operates as a

fundamentally in harmony with one another"); Stephen M. Bainbridge, Unocal *at 20: Director Primacy in Corporate Takeovers*, 31 DEL. J. CORP. L. 769, 773 (2006) (proposing that the U.S. corporate law structure creates significant accountability issues through director primacy). A different view that likewise de-emphasizes shareholder power and would prioritize instead a wider swath of stakeholder interests, including not only managers, directors, and shareholders, but also employees, communities, creditors, and other outsiders to the corporate structure, can be found in the work of Margaret Blair and the late Lynn Stout. *See, e.g.*, LYNN STOUT, THE SHAREHOLDER VALUE MYTH: HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS, AND THE PUBLIC 105–06 (2012) (maintaining that the popular aim of only maximizing shareholder value is misplaced and is detrimental to the economy); Lynn A. Stout, *The Mythical Benefits of Shareholder Control*, 93 VA. L. REV. 789, 808–09 (2007) (discussing the potential danger to stakeholders that could result from ceding power from managers to shareholders); Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 315–16 (1999) ("[When] directors are limited in their ability to use their positions to benefit themselves, they may instead choose to use their positions to benefit others by promoting the joint welfare of all the stakeholders who together comprise the corporation.").

20. *See, e.g.*, Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 851 (2005) ("[S]hareholders should have the power, subject to certain procedural requirements, to initiate and adopt rules-of-the-game decisions to amend the charter or to reincorporate in another state."); Mark J. Roe, *Corporate Law's Limits*, 31 J. LEGAL STUD. 233, 242–43 (2002); Ronald L. Gilson, Unocal *Fifteen Years Later (and What We Can Do About It)*, 26 DEL. J. CORP. L. 491, 507 (2001); Melvin A. Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1479–80 (1989); EISENBERG, *supra* note 13, at 172–73. For a discussion of the role of "voice" in the governance of organizations, see ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES 30–43 (1970).

21. *See infra* Parts IV–V.

check on managers.[22] In some ways, it does.[23] But the independent board also magnifies the power of managers, the very group whose behavior it was created to constrain.[24] The emphasis on shareholder interests has yielded an unduly narrow understanding of independence.[25] Much like the fable of the blind men and the elephant, each of whom touch a separate part of the animal's body and describe its appearance differently, "touching" the interests of management adds important new information to the understanding of the board.[26]

When combined with the business judgment rule, the benefits the independent board offers to managers are extraordinary.[27] Independent director approvals confer business judgment immunity, which exempts directors and officers from liability for business decisions so long as certain low-cost procedures are followed.[28] The joint product of the independent board and the business judgment rule accomplishes a melding of the independence quality of the former with the insulation effects of the latter, producing a fortified shield.[29] This casts decisions around conflicts of interest as essentially questions for the market rather than legal regulation, which is difficult to square with principles of corporate and fiduciary law.[30]

The supercharged nature of the business judgment rule in the independence era is underappreciated, even by critics of the rule. Mark Roe, for example, has described the business judgment rule as ensuring "realistically, no liability at all for

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22. Strine, *supra* note 18, at 474. Strine served as Chief Justice of the Delaware Supreme Court from 2014–2019. *Delaware Chief Justice Leo E. Strine, Jr. to Retire from Delaware Supreme Court*, GOV'T OF DEL. (July 8, 2019), https://perma.cc/FM64-29H3.

23. *See infra* Part II.

24. *See* Bainbridge, *supra* note 19, at 559 ("[T]he vast majority of corporate decisions are made by the board of directors alone, or by managers acting under delegated authority from the board of directors.").

25. *See infra* Parts II–V.

26. *See supra* notes 19–20 and accompanying text.

27. *See infra* Part IV.B–C.

28. *See infra* Part IV.

29. *See infra* Part IV.

30. *See generally* Andrew Tuch, *Reassessing Self-Dealing: Between No Conflict and Fairness*, 88 FORDHAM L. REV. 939 (2019).

mistakes, absent fraud or conflict of interest."[31] While this protection is "nearly insurmountable," Roe notes, boards disqualify themselves from receiving it if they engage in "fraud or *conflict of interest*."[32] While correct as a statement of black letter law, this statement does not capture the ease with which conflicts can be cleansed in the era of the independent board.[33] Creative and well-advised boards can sidestep this limitation and shield their conflicts through a single additional step: by securing the approval of a majority-independent board or committee.[34] Recent data suggests they do in fact take this step regularly with regard to self-dealing transactions, for reasons relating to federal securities laws as well as state law.[35]

Notwithstanding their titular role, "independent" directors are often loath or unable to contradict management due to widely acknowledged structural limitations or behavioral biases.[36] Accordingly, managers have little to fear in seeking the blessing of independent directors and much to gain.[37] In particular, managers can enlarge the universe of decisions eligible for business judgment rule immunity.[38]

Upon approval of the relevant assemblage of independent directors, attacks on the way managers and boards handle self-interested transactions of paramount concern to them are rendered practically inert as a matter of law.[39] These decisions are in areas such as executive compensation, takeover bids (which threaten to result in the ouster of incumbent managers and directors), and shareholder lawsuits against managers and directors in their personal capacities. The relative ease of

31. Roe, *supra* note 20, at 242 (citations omitted).

32. *Id*. at 243 (emphasis added).

33. *See infra* Part IV.

34. *See* Tuch, *supra* note 30, at 943.

35. *See id*. at 973–74 (sampling and analyzing public company disclosures).

36. These limitations include the decision to appoint a given independent director; determination of her compensation; the decision to reappoint her; and subtler forms of influence, such as recommending her for appointment to other boards. *See infra* Part III.

37. *See infra* Part III.

38. *See infra* Part IV.B.

39. *See infra* Part IV.

securing independent approval in effect provides managers with a vehicle to leverage corporate assets for their highest personal priorities without effective oversight.[40] There are counterexamples, of course. Delaware courts have imposed increasingly complex requirements on management buyouts (MBOs), for instance.[41] Yet these challenges can be neutralized with additional process, the keys to which are held by managers (or in the case of MBOs, controlling shareholders).[42]

The shield quality of the independent board destabilizes the assumptions behind shareholder and director primacy alike. In important ways, the independent board continues to serve its advertised purpose of empowering shareholders.[43] But given its interaction with the business judgment rule, its presumed function as a one-way ratchet that *only* favors shareholders warrants reconsideration. Given how much corporate law turns on the assumption of a unidirectional independent board, cracks in that assumption have potentially destabilizing implications purely as a legal matter. But the independent board and its shield function are not merely legal devices; they are market mechanisms with a reach that extends across the public capital markets.[44]

The independence model and the shield it enables empowers managers beyond the realm of law.[45] Most importantly, it enhances the ability of managers and boards to evade market discipline and capture rents from inefficiencies in market structure and the independent board itself.[46] Even sophisticated investors like mutual funds and hedge fund activists cannot effectively monitor the governance of the many

40. *See infra* Part IV.

41. *See, e.g.*, *infra* Part IV.C.4; John P. Stigi II & John M. Landry, *Delaware Chancery Court Rejects Management Buyout Merger Price as Best Evidence of Fair Value in Appraisal Proceeding*, NAT'L L. REV. (June 9, 2016), https://perma.cc/SV29-F24C (describing the heightened standard of review adopted by a Delaware court in an MBO).

42. *See infra* Part IV.

43. *See infra* Part II.

44. *See infra* Parts IV–V.

45. *See infra* Part V.

46. *See infra* Part V.

thousands of publicly traded U.S. companies.[47] Proxy advisors, whose business is to advise investors on corporate governance, operate under scarce resources and intensifying regulatory pressure.[48] Because "independentness" is universally theorized as a shareholder-friendly quality, enhancing the independent character of a board is a way for managers to inexpensively signal their fidelity to that norm and thus reduce pressure from proxy advisors, mutual funds, and activist shareholders in the ongoing negotiation of corporate governance.[49]

This Article proceeds in six additional parts. Part II overviews the foundation of the independent board and its legal commands. Part III presents limitations on the efficacy of independent directors, and contends that in combination they allow managers to take advantage of the structure's power to immunize self-interested decisions. Part IV highlights the crucial domains where the independent board, in concert with the business judgment rule, furnishes a shield-like immunity to managerial conduct. Part V contends that the shield effect is even more consequential than a purely legal analysis would suggest, because it exploits the limitations of market participants, such as institutional investors, that are believed to serve a monitoring function. Part VI develops normative conclusions and proposals respecting the foregoing. Chief among these is that courts should not deem self-interested transactions to be cleansed by the approval of independents. They should instead be reviewed under a standard with a long history in corporate law, the entire fairness standard.[50] This would

47. *See* William W. Bratton & Joseph A. McCahery, *Regulatory Competition, Regulatory Capture, and Corporate Self-Regulation*, 73 N.C. L. REV. 1861, 1865 (1995) (stating that managers can take advantage of the dispersed ownership structure of the corporation to take action without owner monitoring).

48. *See* Katanga Johnson & Jessica DiNapoli, *U.S. SEC Proposes Rules that Could Limit Shareholder Voices*, REUTERS (Nov. 5, 2019, 10:10 AM), https://perma.cc/F87C-WATN (describing new SEC rules that could shift corporate power towards management).

49. *See infra* Parts III–IV.

50. *See generally* Iman Anabtawi, *The Twilight of Enhanced Scrutiny in Delaware M&A Jurisprudence*, 43 DEL. J. CORP. L. 161 (2019) (describing the entire fairness standard in Delaware law as review "for objective fairness of both price and process").

constitute a partial rejection of internal self-regulation as a substitute for external regulation, and as such has implications for that common practice in corporate and securities law doctrine and institutions more broadly. In Part VII, the Article concludes.

II. The Constitution of the Independent Board

In the early part of the twentieth century, changes in technology and communication helped drive a great dispersion in the ownership of public company equities.[51] Coordination problems emerged among the numerous shareholders of the Berle and Means corporation.[52] This yielded a form of managerial governance[53] that was relatively insensitive to shareholder preferences. Thus, managers could pursue projects that enhanced their reputations or otherwise served their personal goals at the expense of the enterprise without fear of consequence from shareholders. In the new ownership[54]

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51. *See* STEPHEN M. BAINBRIDGE, CORPORATE LAW 4–5 (3d ed. 2015).

52. *See* BERLE & MEANS, THE MODERN CORPORATION, *supra* note 10, at 47–68 (documenting the increasingly dispersed ownership of contemporary public corporations). These problems predated the arrival of the independent board, but continued afterwards. *See* Ronald J. Gilson & Jeffrey N. Gordon, *Board 3.0: An Introduction*, 74 BUS. LAW. 351, 354–55 (2019); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 331 (1976) (discussing issues arising from diffuse and detached shareholder ownership).

53. *See* EISENBERG, *supra* note 13, at 139–41 (contending that the typical board was passive and its functions manager-dominated).

54. Some critics question whether shareholders truly "own" the corporation. *See, e.g.*, Martin Lipton & Steven A. Rosenblum, *Election Contests in the Company's Proxy: An Idea Whose Time Has Not Come*, 59 BUS. LAW. 67, 94 (2003) ("[T]he shareholder as owner, principal-agent model is a flawed model as applied to the modern public company."); Blair & Stout, *supra* note 19, at 260–61 ("If 'control' is the economically important feature of 'ownership,' then to build a theory of corporations on the premise that ownership (and, hence, control) lies with shareholders grossly mischaracterizes the legal realities of most public corporations."); Bainbridge, *supra* note 12, at 1052 n.104 (contending that the corporation is a nexus of contracts rather than an entity that is owned by shareholders). This Article does not take up this distinction, which does not bear on its analysis. To the extent independent boards shield managers inappropriately, they are counterproductive from a stakeholder perspective as well as an ownership one.

pattern, where shareholders stood little chance of influencing managerial performance,[55] shareholders were said to exhibit "rational apathy" towards governance.[56] The resulting power vacuum left managers more dominant and potentially less accountable to shareholders, who were the principals of the corporation in which managers served as agents.[57] Efforts to address this form of agency costs—the gap between shareholder and manager interests—have dominated corporate governance scholarship for the better part of a century.[58]

Control of the corporation is delegated by statute to a central board of directors, to which the corporation's managerial leadership is formally subordinate.[59] In Berle and Means' time, this operated as a distinction without a difference; boards were run by top managers.[60] Beginning in the 1970s, academics and the market began coalescing around a solution that borrowed from Douglas' proposal during the New Deal: directors who were independent of managers and elected by—and thus accountable to—shareholders would be better able to supervise managers.[61] In the original model, it was virtually impossible for dispersed shareholders to influence the outcome of corporate elections, thus leaving the shareholder "'practically reduced to the alternative of not voting at all or else of handing over his vote' to the proxy committee, appointed by existing management,

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55. *See* Gilson & Gordon, *supra* note 52, at 354 (listing defining features of the "Board 2.0" model).

56. *Id.*

57. Principal-agent is the dominant but not unanimous framework for understanding the shareholder-manager relationship. *But see* Blair & Stout, *supra* note 19, at 315–16 (advancing a theory that disputes the sufficiency of agency as an analogy). Disputes over the meaning of "ownership" in the firm are beyond the scope of this Article.

58. *See supra* Part I; *infra* Part II.A.

59. *See, e.g.*, DEL. CODE tit. 8, § 141 (2020) (providing for management by a board of directors, except under certain circumstances); MODEL BUS. CORP. ACT § 8.01 (AM. BAR ASS'N 2002).

60. *See generally* BERLE & MEANS, THE MODERN CORPORATION, *supra* note 10, at 220–46 (discussing the legal position of management and of control).

61. *See* Mitchell, *supra* note 9, at 103–07 (describing Douglas' impact on the evolution of the independent board).

who can 'virtually dictate their own successors.'"[62] The new model, which Ronald Gilson and Jeffrey Gordon call "Board 2.0," promised to empower and engage shareholders by enabling them to directly elect directors to the board who would take their authority over managers more seriously.[63] It was regarded as a "necessary complement to widely distributed ownership."[64] This shift,[65] which did not fully accomplish its goals, nevertheless marked an evolution in the function of the board from the Board 1.0 advisory body to the board as supervisor.[66]

A. Background and Theory of the Independent Board

To understand the perversity of the independent board shielding what amounts essentially to executive self-dealing (a category this Article defines somewhat more expansively than the literature currently does),[67] it is instructive to examine briefly the aspirations and theory of the independent model.[68] Douglas endorsed the Berle and Means analysis and advocated

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62. Lucian Bebchuk et al., *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSPS. 89, 91 (2017) (quoting BERLE & MEANS, THE MODERN CORPORATION, *supra* note 10, at 87).

63. Gilson & Gordon, *supra* note 52, at 354.

64. *Id.*

65. *See* Gordon, *supra* note 14, at 1472–73 ("One of the most important empirical developments in U.S. corporate governance over the past half century has been the shift in board composition away from insiders (and affiliated directors) toward independent directors.").

66. *See, e.g.,* Gilson & Gordon, *supra* note 52, at 351–56 ("By the end of the period, most large public companies had an audit committee, a compensation committee, and some version of a nominating-governance committee that addressed the performance of the board itself."). Stephen Bainbridge and Todd Henderson have suggested outsourcing various functions as a solution to a lack of board skill or subject matter expertise in areas of need. *See* STEPHEN M. BAINBRIDGE & M. TODD HENDERSON, OUTSOURCING THE BOARD: HOW BOARD SERVICE PROVIDERS CAN IMPROVE CORPORATE GOVERNANCE 90–91 (2018) (introducing the concept of the specialty board services provider).

67. *See infra* Part IV.

68. Space limitations preclude a full recounting of the independent board's history and the reasons for its rise here. One treatment can be found in Gordon, *supra* note 14, at 1472–76 (documenting the shift in board composition in the latter half of the twentieth century).

a solution that would later become the independent board.[69] Directors, he wrote, lacked the authority to perform a supervisory role effectively.[70] To change this, he believed they "should have a position of dominance and power on the board rather than the subordinate position . . . [including] real power over the executive management," with the goal of "*taking the control or dominance of the board away from the executive management*."[71] Although it would take decades to become orthodoxy, this solution was offered almost immediately following the Berle and Means diagnosis.[72]

The independent board model gathered steam beginning in the middle of the twentieth century,[73] particularly in the 1970s.[74] By 2005, "the composition of large public company boards dramatically shifted towards independent directors," from roughly 20 percent independents in 1950 to 75 percent.[75] At the committee level, certain committees began to be

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69. *See* Douglas, *supra* note 7, at 1305–07 (advancing proposals to reform corporate governance, drawing in part on the work of Berle and Means).

70. *See id.* at 1313–14 (describing some shortcomings of insider directors, including that "boards wholly or dominantly filled with 'shirtsleeve' directors drawn from the executive management, without outside representation, are apt to suffer from myopia and lack of perspective.").

71. *Id.* at 1314 (emphasis added).

72. It was less than two years after the Berle and Means book was published that Douglas endorsed its analysis and advocated a solution that would later become the independent board. *See id.* at 1314 (proposing that taking control of the board by executive management would resolve some problems of power); HOYT, *supra* note 8, at 40–41, 69 (discussing Douglas' position as a Yale professor and his appointment to the Supreme Court). Before Douglas moved to Yale, he and Berle were colleagues at Columbia. *See* Wang, *supra* note 10, at 1223.

73. *See* Gordon, *supra* note 14, at 1510–15 (tracing the rise of the corporate board model).

74. Leading intellectual contributions in this era include EISENBERG, *supra* note 13 and Jensen & Meckling, *supra* note 52.

75. Gordon, *supra* note 14, at 1465. For example, "the number of manufacturing companies having a majority of nonemployee directors increased from 63% in 1966, to 71% in 1972, to 86% in 1989," though not all nonemployee directors meet requirements of independence. Bainbridge, *supra* note 12, at 1066–67 n.161 (citing THE CONFERENCE BOARD, MEMBERSHIP AND ORGANIZATION OF CORPORATE BOARDS 8 (1990)).

constituted exclusively of independent directors.[76] Later, the audit,[77] compensation,[78] and nominating and governance committees[79] were required to be so constituted, and a majority of the directors of the board as a whole were required to be independent.[80] Such directors are not employees of the corporation and lack certain other connections to it. This rule was instituted following high-profile accounting scandals at Enron, WorldCom, and Arthur Andersen in the early 2000s, and became effective in 2003.[81]

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76. *See Nasdaq Stock Mkt. Rules*, *supra* note 17, § 5605(e)(1)(B) (stating the requirement that nominating committees be fully independent).

77. *See infra* Part II.B; Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 302, 116 Stat. 745, 778 (codified at 15 U.S.C. § 7241).

78. *See infra* Part II.B; Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 952, 24 Stat. 1367, 1900 (2010) (codified at 12 U.S.C. § 78j-3).

79. *See infra* Part II.B; *Listed Company Manual*, *§ 303A.04(a) Nominating/Corporate Governance Committee*, N.Y. STOCK EXCH., https://perma.cc/LV4W-K7XQ (requiring that nominating and corporate governance committees be composed exclusively of independent directors); *Nasdaq Stock Mkt. Rules*, *supra* note 17, § 5605(e) (same).

80. *See infra* Part II.B; *Listed Company Manual*, *§ 303A.01 Independent Directors*, *supra* note 17 (requiring that boards consist of a majority of independent directors); *Nasdaq Stock Mkt. Rules*, *supra* note 17, § 5605(b)(1) (same). The requirement of a majority-independent board applies to publicly traded companies in the United States, with a significant exception: controlled companies, which are defined in this context as entities in which more than 50 percent of the voting power is held by an individual, a group, or another company. *See Listed Company Manual*, *§ 303A.00 Introduction*, N.Y. STOCK EXCH., https://perma.cc/AWE3-972G (describing the applicability of the rules); *Nasdaq Stock Mkt. Rules*, *supra* note 17, § 5615(c) (noting the exemptions for controlled companies). There are somewhat different definitions of controlled companies in other sources for other purposes, for example Delaware law, but however defined they account for a growing share of public companies and market value. *See* IRRC INSTITUTE, CONTROLLED COMPANIES IN THE STANDARD AND POOR'S 1500: A FOLLOW-UP REVIEW OF PERFORMANCE AND RISK 23 (2016), https://perma.cc/MAJ7-7A66 (PDF) (concluding that "the number of controlled companies in the S&P 1500 index increased by 16.7 percent between 2005 and 2015" using an ISS controlled company definition).

81. *See Listed Company Manual*, *§ 303A.01 Independent Directors*, *supra* note 17; *Nasdaq Stock Mkt. Rules, supra* note 17, § 5605(b)(1).

Initially proposed by prominent New Dealers as a complement to a never-realized federal incorporation statute,[82] the independent board ultimately gained traction as a form of self-regulation that substituted for deeper external oversight, both judicial and regulatory.[83] The structural implications of this shift have not gone unnoticed.[84] Lisa Fairfax argues persuasively that in cases of potential conflicts of interest, "reliance on independent directors has been inappropriately used to substitute for rigorous external regulation."[85] Urska Velikonja calls them "a poor substitute for public-regarding regulation of negative externalities," and notes that they have "pass[ed] as a substitute" nonetheless because they constitute a palatable political compromise.[86]

The promise of an independent board has been that it could stand in for shareholders, mitigating the agency costs intrinsic in separating ownership from control[87] by monitoring managers.[88] It is now the terrain on which great battles of corporate governance are fought, including over executive compensation levels, activist shareholder campaigns, proxy

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82. Berle had drafted a federal incorporation bill, but it was never enacted. *See* Robert B. Thompson, *Adolf Berle During the New Deal: The Brain Truster as an Intellectual Jobber*, 42 SEATTLE U. L. REV. 663, 671 (2019) (describing Berle's interest in, and efforts towards, implementing a federal incorporation bill).

83. Previous commentators have emphasized the inadequacy of independence as a substitute for regulation to achieve public ends. *See, e.g.*, Urska Velikonja, *The Political Economy of Board Independence*, 92 N.C. L. REV. 855, 894 (2014); Lisa M. Fairfax, *The Uneasy Case for the Inside Director*, 96 IOWA L. REV. 127, 131 (2010) ("[T]he installation of independent directors serves as a substitute for external regulation, particularly with respect to 'high risk' transactions.").

84. *See, e.g.*, Velikonja, *supra* note 83, at 894.

85. Fairfax, *supra* note 83, at 193.

86. *See* Velikonja, *supra* note 83, at 894 (contending that the independence mandate should be abolished).

87. This theory was further developed in Jensen & Meckling, *supra* note 52. Though Berle and Means did not use the term agency costs, they are credited with framing the debate over problems stemming from the separation of ownership and control.

88. *See, e.g.*, Roberta S. Karmel, *Is the Independent Director Model Broken?*, 37 SEATTLE U. L. REV. 775, 791 (2014) (describing the potential of the independent board to monitor insider behavior).

fights, and contests for control.[89] It formally intermediates not only the relationship of managers and investors (including activist and institutional investors) to the firm, but the position of outsiders, e.g., creditors and potential acquirers.[90]

Yet even for the subset of corporate decisions over which boards have say, CEOs and other top managers exercise powerful influence over their boards and can often secure approval for dubious priorities. Such moves may be excessively aggressive, but CEOs may also be excessively reticent to pursue needed changes relative to shareholder preferences.[91] Either way, core attributes of the independent board bias it towards enabling rather than checking manager preferences. The independent board thus compounds the agency costs problem at the very level (the board) where it was meant to address it;[92] it also adds a new one, at the level of the market.[93]

B. The Law of the Independent Board

The independent board structure vests in a board something virtually unique among regulated entities: the authority to exempt its members from judicial, regulatory, and shareholder scrutiny in its principal spheres of action[94] —and especially the ones most likely to pose conflicts of interest for CEOs and other insiders. Approval of a business decision by a majority of independent directors activates this exemption by triggering the business judgment rule. The details of the independent board are thus critical.

The legal regulation and definition of the independent corporate board resides in three sources: state law, federal

89. Companies that have a controlling shareholder are an exception. *See infra* Parts II–III.

90. *See* Karmel, *supra* note 88, at 791 ("[T]he independent director no longer seems to be acting on behalf of the shareholders as a check on management, but rather, is acting to insure the quality of the corporation's product ratings.").

91. *See* Michal Barzuza & Eric Talley, *Long-Term Bias*, 2020 COLUM. BUS. L. REV. 104, 122 (discussing versions of this risk).

92. *See infra* Parts III–IV.

93. *See infra* Part V.

94. Of course, many provisions of law, such as workplace and environmental regulation, are unaffected by board action.

securities law, and stock exchanges' regulations. An overview of the legal standards underlying independence helps reveal the gap between the aspiration and operation of the independent board.

1. State Law

State law is a leading source of law regulating the independent board, and Delaware and its corporate law statute, the Delaware General Corporation Law (DGCL), are preeminent among sources of state law.[95] Delaware law does not require that companies adopt an independent board model.[96] However, it encourages independent boards through the creation of de facto safe harbors for decisions rendered by independent boards or committees.[97] It further regulates the content of independence by making business judgment deference conditional on the satisfaction of certain criteria.[98]

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95. For a variety of reasons, most large public companies are incorporated in Delaware. *See About the Division of Corporations*, DEL. DIV. CORPS., https://perma.cc/PZ2M-A3KH (stating that "[m]ore than 66% of the Fortune 500" are incorporated in Delaware); Brian J. Broughman & Darian M. Ibrahim, *Delaware's Familiarity*, 52 SAN DIEGO L. REV. 273, 289–90 (2015) (citing the DGCL's "merits and predictability" and Delaware's "substantial case law, the flexibility of that law, and the expertise of the Delaware Chancery Court and Delaware Supreme Court to hand down new decisions" as reasons corporations choose Delaware). Because of the internal affairs doctrine, this also means that a large share of shareholder litigation arises under Delaware law in the Delaware Court of Chancery, which is an expert in such matters. *See* VantagePoint Venture Partners 1996 v. Examen, Inc., 871 A.2d 1108, 1112 (Del. 2005) (characterizing the internal affairs doctrine as "a long-standing choice of law principle which recognizes that only one state should have the authority to regulate a corporation's internal affairs—the state of incorporation").

96. *See* DEL. CODE tit. 8, § 141 (2020) (stating requirements for corporate boards under Delaware law); *About the Division of Corporations*, *supra* note 95 ("The Delaware General Corporation Law is the most advanced and flexible business formation statute in the nation.").

97. *See* Broughman & Ibrahim, *supra* note 95, at 281 ("[W]idespread investor and lawyer familiarity with Delaware law has an independent effect on choice of domicile apart from any network benefits associated with Delaware incorporation.").

98. *See id.* at 288 (incorporating in Delaware would allow corporations access to more case law, better legal services, and advantages of drafting efficiencies from past use of Delaware law).

Delaware law authorizes the board to immunize interested and executive directors from conflict transactions via a cleansing vote of an appropriate faction of disinterested, independent directors.[99] Depending on circumstances, the approval necessary might be by a majority of all independents, a majority of the full board (when the board is itself majority-independent), or a committee constituted only of independent directors.[100] Crucially, directors deemed independent by the board enjoy a presumption of independence unless there exist "such facts as would demonstrate that through personal or other relationships the directors are beholden to [a] controlling person."[101]

The independence inquiry is meant to ensure that "a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences."[102] Boards may debate policy amongst themselves, seek outside advice, and outsource some functions,[103] but "the end result, nonetheless, must be that each director has brought

99. DEL. CODE tit. 8, § 144(a)(1) (2020); *see infra* Part IV.C.5 (noting a larger discussion in the literature on the effect of a § 144 approval).

100. *See infra* Part IV; *see also In re* MFW S'holders Litig., 67 A.3d 496, 501 (Del. Ch. 2013), *aff'd sub nom.* Kahn v. M&F Worldwide Corp., 88 A.3d 635 (Del. 2014) ("[T]he procedural protections employed [must] qualify to be given cleansing credit under the business judgment rule. For example, if the [corporation's] special committee was not comprised of directors who qualify as independent under our law, the defendants would not be entitled to summary judgment under their own argument."); Da Lin, *Beyond Beholden*, 44 J. CORP. L. 515, 552 (2019) (noting Delaware courts use intermediate standards of review for specific, recurring, and readily identifiable situations that can subtly undermine the decisions of independent and disinterested directors).

101. Aronson v. Lewis, 473 A.2d 805, 815 (Del. 1984), *overruled on other grounds by* Brehm v. Eisner, 746 A.2d 244 (Del. 2000) (discussing independence in the context of a derivative suit demand). A more recent formulation explains beholdenness in the following way: an independent director must not be "sufficiently loyal to, beholden to, or otherwise influenced by an interested party to undermine the director's ability to judge the matter on its merits." Frederick Hsu Living Tr. v. ODN Holding, No. 12108–VCL, 2017 WL 1437308, at *26 (Del. Ch. Apr. 14, 2017).

102. *Aronson*, 473 A.2d at 816.

103. *See* BAINBRIDGE & HENDERSON, *supra* note 66, at 5 ("Outsourcing happens when other business entities can do the work at lower total cost for a given quality.").

his or her own informed business judgment to bear with specificity upon the corporate merits of the issues *without regard for or succumbing to influences* which convert an otherwise valid business decision into a faithless act."[104] At the pleading stage, it is enough for a plaintiff to marshal particularized facts that support "an inference that [a director] 'would be more willing to risk . . . her reputation than risk the relationship with the interested person.'"[105]

Delaware law's regulation of director independence eschews bright-line rules in favor of contextual inquiry. This approach is meant to account for the behavioral dynamics of board politics and professional networks. While a Vice Chancellor on the Delaware Court of Chancery, Leo Strine expanded on this duality:

> [C]orporate directors are generally the sort of people deeply enmeshed in social institutions. Such institutions have norms, expectations that, explicitly and implicitly, influence and channel the behavior of those who participate in their operation. Some things are "just not done," or only at a cost, which might not be so severe as a loss of position, but may involve a loss of standing in the institution . . . [C]orporate directors are [not], as a general matter, persons of unusual social bravery, who operate heedless to the inhibitions that social norms generate for ordinary folk.[106]

The decision made clear that the relevant inquiry is not a narrow one of whether a director feels the tug of favoritism towards the executive in question.[107] Rather, the question is

104. *Aronson*, 473 A.2d at 816 (emphasis added).

105. *In re* Oracle Corp. Derivative Litig., No. 2017-0337-SG, 2018 WL 1381331, at *15 (Del. Ch. Mar. 19, 2018) (quoting Beam v. Stewart, 845 A.2d 1040, 1052 (Del. 2004)).

106. *In re* Oracle Corp. Derivative Litig., 824 A.2d 917, 938 (Del. Ch. 2003). This case is unrelated to the *Oracle* decision from 2018.

107. *See id.* at 943

> I do not infer that Grundfest would be less likely to recommend suit against Boskin than someone without [close] ties. Human nature being what it is, it is entirely possible that Grundfest would in fact be tougher on Boskin than he would on someone with whom he did not have such connections.

whether personal ties and other affiliations were of such a character—i.e., close enough—that it was hard for the director to assess conduct neutrally, "*without pondering* his own association with [the executive] and their mutual affiliations."[108] Put another way, a court will deny a director independent status where a plaintiff pleads facts showing that "the director in question's material ties to the person whose proposal or actions she is evaluating are sufficiently substantial that she cannot objectively fulfill her fiduciary duties."[109]

In recent years, Delaware courts have made clear that the nature of a disqualifying connection need not be financial or familial and can be more generically personal. While the Delaware Supreme Court stated in a decision regarding Martha Stewart's company in 2004 that "[a]llegations of mere personal friendship or a *mere* outside business relationship, standing alone, are insufficient to raise a reasonable doubt about a director's independence,"[110] language in more recent decisions clarifies that the burden on plaintiffs is more permissive. In the *MFW*[111] case, for example, the Chancery Court (per then-Chancellor Strine) observed:

> [I]t is sometimes blithely written that "mere allegations of personal friendship" do not cut it. More properly, this statement would read "mere allegations of *mere friendship*" do not qualify. If the friendship was one where the parties had served as each other's maids of honor, had been each other's college roommates, shared a beach house with their families each summer for a decade, and are as thick as blood relations, that context would be different from parties who occasionally had dinner over the years, go to some of the

108. *Id*. (emphasis added).

109. *In re MFW S'holders Litig.*, 67 A.3d at 509.

110. Beam v. Stewart, 845 A.2d 1040, 1052 (Del. 2004) (emphasis added); *see* Grimes v. Donald, 673 A.2d 1207, 1216 (Del. 1996) (describing lack of independence in the demand futility context as the presence of "a material financial or familial interest").

111. 67 A.3d 496 (Del. Ch. 2013).

> same parties and gatherings annually, and call themselves "friends."[112]

Undoubtedly the clear-in-principle, porous-in-fact distinction the court drew between friends (acceptable) and close friends (questionable) was intended to account for the reality, acknowledged by Strine a decade earlier in *Oracle*,[113] that outside directors occupy the same small circles as the executives they are supposedly monitoring.[114] Relationships within those circles "can give rise to human motivations compromising the participants' ability to act impartially toward each other on a matter of material importance,"[115] but courts of Delaware (and other states) have nevertheless been reluctant to intervene.[116]

Delaware decisions regarding independence are characterized by a lack of consistency.[117] This is in part a consequence of the context-constrained nature of the inquiry under Delaware law. In litigation—unlike for listing purposes—the measure of independence is not taken in the abstract, but in relation to a specific board decision or transaction. It can enable or frustrate the application of the

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112. *Id.* at 509 n.37 (emphasis added). This case is discussed in greater detail in *infra* Part IV. N.B. Chancellor Strine went on to serve as Chief Justice of Delaware, from 2014–2019.

113. 824 A.2d 917 (Del. Ch. 2003).

114. This approach echoes that of earlier decisions by Delaware courts, which acknowledge the possibility of excessively close personal ties in principle but shy away from policing such connections. *See, e.g.*, Zapata Corp. v. Maldonado, 430 A.2d 779, 787 (Del. 1981)

> [W]e must be mindful that directors are passing judgment on fellow directors in the same corporation and fellow directors, in this instance, who designated them to serve both as directors and [special litigation] committee members . . . And the further question arises whether inquiry as to independence, good faith and reasonable investigation is sufficient safeguard against abuse, perhaps subconscious abuse.

115. Sandys v. Pincus, 152 A.3d 124, 126 (Del. 2016).

116. *See* Yaron Nili, *Out of Sight, Out of Mind: The Case for Improving Director Independence Disclosure*, 43 J. CORP. L. 35, 62–63 (2017).

117. *See id.* at 47 n.65 ("For instance, in *Oracle*, it was determined that personal connections rose to the level of impeding independence, while in *Beam* the opposite was held."); *see also In re MFW S'holders Litig.*, 67 A.3d at 510 n.37 ("Even in the context of personal, rather than financial, relationships, the materiality requirement does not mean that the test cannot be met.").

business judgment rule to a particular action without necessarily implying much about other aspects of governance.[118] As such, it does not purport to provide an assurance of ongoing independent monitorship in general but rather formal independence as to a particular policy or transaction.[119] Where Delaware courts address independence, they routinely dismiss charges of bias in the absence of visible financial ties, the presence of a controlling shareholder, or both.[120]

A 2016 decision, *Sandys v. Pincus*,[121] provides a mixed example. The case turned on the question whether a majority of the board of the videogame maker Zynga, Inc. was independent, and thus whether business judgment rule immunity attached to a board decision exempting directors and the CEO from company policy restricting the timing of trades of Zynga stock.[122] Plaintiffs alleged that three directors had impermissibly close ties to the CEO, one in the personal sphere and the other two for professional reasons.[123] One director co-owned a plane with the CEO, which for the court "signaled an extremely close, personal bond" that suggests "the type of very close personal relationship that, like family ties, one would expect to heavily

118. *See, e.g.*, *In re* Tesla Motors, Inc. S'holder Litig., No. 12711–VCS, 2018 WL 1560293, at *13 (Del. Ch. Mar. 28, 2018) (noting that the requisite degree of control can be shown either to exist generally or with regard to the particular transaction in question); *see also In re* Oracle Corp. Derivative Litig., No. 2017-0337-SG, 2018 WL 1381331, at *16 (Del. Ch. Mar. 19, 2018) (discussing independence in the specific context of a demand).

119. *See In re Oracle Corp. Derivative Litig.*, 2018 WL 1381331, at *17 (deeming each entanglement insufficient on its own "to imply lack of independence," but holding that the allegations taken together created reasonable doubt about the ability of independent directors to objectively evaluate a demand to sue).

120. *See infra* Parts III–IV.

121. 152 A.3d 124 (Del. 2016).

122. *See id.* at 128 ("To plead demand excusal under *Rales*, the plaintiff must plead particularized factual allegations that 'create a reasonable doubt that, as of the time the complaint [was] filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand.'" (quoting Rales v. Blasband, 634 A.2d 927, 934 (Del. 1993))).

123. *Id.* at 126.

influence a human's ability to exercise impartial judgment."[124] The court focused much of its analysis on the significance of this jointly owned asset, which constituted virtually the entire basis for the inference it reached that this director was not independent.[125] Given the unusual nature of this arrangement, the court's determination of its significance should not be taken to suggest that ties between independents and managers will be scrutinized more closely in general.

The court's analysis of the other two directors' relationships, however, arguably suggests a more expansive view of the independence inquiry. Plaintiffs alleged that investment and director interlocks between these directors' firm and Zynga meant the directors were not independent.[126] The court acknowledged the need for Delaware law to allow "mutually beneficial ongoing business relationship[s]," but found it "reasonable to expect that sort of relationship might have a material effect on the parties' ability to act adversely toward each other."[127] In conjunction with the controlling shareholder status of the CEO—an important factor—the court held that these linkages created reasonable doubt about the independence of Gordon and Doerr for purposes of demand excusal.[128]

Bracketing its status as a controlling shareholder case, *Sandys* may signal that Delaware courts will scrutinize more

124. *Id.* at 130 ("Co-ownership of a private plane involves a partnership in a personal asset that is not only very expensive, but that also requires close cooperation in use, which is suggestive of detailed planning indicative of a continuing, close personal friendship"). This relates to director Ellen Siminoff.

125. *See id.* at 129–31 (stating facts in support of the inference that Siminoff would not be able to act impartially when deciding whether to move forward with a suit implicating a close friend with whom she owned a private plane). The dissent's entire discussion of Siminoff, too, focused on the meaning of co-ownership of a plane. *Id*. at 137–38 (Valihura, J., dissenting).

126. In addition to owning a sizable chunk (9.2 percent) of Zynga's equity, the venture capital firm, Kleiner Perkins, also invested in a company co-founded by the CEO's wife and in a third company that (yet another) Kleiner Perkins director of Zynga is invested in and on whose board he sits. *Id*. at 131, 133–34 (majority opinion).

127. *Id*. at 134 ("Causing a lawsuit to be brought against another person is no small matter, and is the sort of thing that might plausibly endanger a relationship.").

128. *See id*. (applying *Rales*).

closely ties between managers and nominally independent directors. However, its facts included highly visible, well-evidenced personal ties and close financial and professional ties between the challenged directors and the CEO.[129] Moreover, the case does not urge or imply a reconsideration of the application of the business judgment rule to conflict transactions approved by such directors. It is unlikely that *Sandys* suggests a shift away from the independent board's shielding function.

2. Federal Securities Law

While the independentness of the board as a whole is not regulated by federal law, two sources of federal legislation require independence at the board committee level. The first is the Sarbanes-Oxley Act of 2002[130] which regulates accounting practices at public companies.[131] Implementing regulations assign the audit committee direct legal responsibility for overseeing the engagement of the company's independent auditor and prescribe certain rules designed to ensure the integrity of that process.[132] Audit firms, in turn, must be "qualified and independent of their audit clients both in fact and in appearance."[133]

Sarbanes-Oxley mandates that public companies use independent audit committees. The statute achieves this

129. *See id.* at 130 ("That argument is that owning an airplane together is not a common thing, and suggests that the Pincus and Siminoff families are extremely close to each other and are among each other's most important and intimate friends.").

130. Pub. L. No. 107–204, 116 Stat. 745.

131. *See generally id.*

132. *See* 17 C.F.R. § 240.10A–3(b)(2) (2020) (providing that audit committees "must be directly responsible for the appointment, compensation, retention and oversight of the work of any registered public accounting firm engaged" for audit purposes).

133. *See* Preliminary Note to § 210.2–01, 17 C.F.R. § 210.2–01 (2020). The test for "appearance" is the perspective of a reasonable investor, and examples are furnished. *See id.* 3(b) (stating that a reasonable, informed investor would not conclude that the accountant is "not . . . capable of exercising objective and impartial judgment," articulating standards for auditor independence, and providing a non-exclusive list of hypothetical auditor-client relationships lacking independence).

indirectly, by requiring stock exchanges to adopt rules requiring their use by listed firms.[134] All individual members of public company audit committees must, in turn, "be independent."[135] Audit committee members are specifically barred from consulting or doing other work for the company beyond their board service.[136] They also "must *otherwise* be independent,"[137] by for example, meeting stock exchange tests for independence.[138]

A second statute, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010,[139] adopted following the financial crisis and Great Recession, accomplishes something similar for public company compensation committees.[140] Like Sarbanes-Oxley, Dodd-Frank does not impose its requirement directly but rather conscripts stock exchanges into regulating independence—here, of compensation committee composition.[141] It is less interventionist than Sarbanes-Oxley, however, in that it merely directs stock exchanges to "consider" consulting relationships and other affiliations between directors and issuers, rather than requiring them to bar such relationships outright.[142] Nonetheless, the stock exchanges have

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134. *See id.* § 240.10A-3(b). The stock exchange rules requiring independent audit committees are the *Listed Company Manual*, *§ 303A.07 Audit Committee Additional Requirements*, N.Y. STOCK EXCH., https://perma.cc/A259-KHLZ and the *Nasdaq Stock Mkt. Rules*, *supra* note 17, § 5605(c)(2)(A).

135. 17 C.F.R. § 240.10A-3(b)(1)(i).

136. *See id.* § 240.10A-3(b)(1)(ii)–(iii) ("[A] member of the audit committee . . . may not . . . [a]ccept directly or indirectly any consulting, advisory, or other compensatory fee from the issuer or any subsidiary thereof . . . .").

137. *Id.* § 240.10A-3(b)(1)(i) (emphasis added).

138. *See infra* Part II.B.

139. Pub. L. No. 111–203, 124 Stat. 1376.

140. *See generally id.*

141. *See* Dodd-Frank Act § 952 (requiring that each member of the compensation committee of the board of directors of an issuer be a member of the board of directors of the issuer and otherwise be independent); 17 C.F.R. § 240.10C-1(b)(1)(i) (2020) (same).

142. Arguably, the fact that Dodd-Frank was less interventionist with regard to board independence than Sarbanes-Oxley, notwithstanding that the crisis that led to it was far more serious, is in tension with a common criticism

required that all compensation committee members be independent.[143]

3. Stock Exchange Regulation

The third major source of board independence rules is stock exchange regulation. In 2003, both leading U.S. stock exchanges, the New York Stock Exchange (NYSE) and Nasdaq, began requiring boards of listed companies to consist of a majority of independent directors.[144] NYSE's official rationale for this rule is set forth in the commentary accompanying its rule: "[e]ffective boards of directors exercise independent judgment," and independent-dominated boards "will increase the quality of board oversight and lessen the possibility of damaging conflicts of interest."[145] The Nasdaq rationale is similar.[146] Both exchanges require that directors' independent status be determined affirmatively by the board.[147]

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of crisis-driven regulation—namely, that it is excessively responsive to the passions of the moment. *See* Luigi Zingales, *The Future of Securities Regulation*, 47 J. ACCT. RSCH. 391, 397 (2009) (observing inadequacies in crisis-driven regulatory interventions).

143. *Listed Company Manual*, *§ 303A.05 Compensation Committee*, N.Y. STOCK EXCH., https://perma.cc/2V9J-YEQN; *Nasdaq Stock Mkt. Rules*, *supra* note 17, § 5605-5(d)(2)(A).

144. *See Listed Company Manual*, *§ 303A.01 Independent Directors*, *supra* note 17 ("Listed companies must have a majority of independent directors."); *Nasdaq Stock Mkt. Rules*, *supra* note 17, § 5605(b)(1) ("A majority of the board of directors must be comprised of Independent Directors . . . .").

145. *Listed Company Manual*, *§ 303A.01 Independent Directors*, *supra* note 17.

146. *See Nasdaq Stock Mkt. Rules*, *supra* note 17, § 5605(b)(1)(A) (stating that independent directors "play an important role in assuring investor confidence. Through the exercise of independent judgment, they act on behalf of investors to maximize shareholder value in the Companies they oversee and guard against conflicts of interest.").

147. *See Listed Company Manual, § 303A.02 Independence Tests*, N.Y. STOCK EXCH., https://perma.cc/34JY-HHHJ ("No director qualifies as 'independent' unless the board of directors affirmatively determines that the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company)."); *Nasdaq Stock Mkt. Rules*, *supra* note 17, § 5605(a)(2) ("The board has a responsibility to make an affirmative determination that no such relationships exist through the application of Rule 5605(a)(2).").

Crucially, satisfying the exchanges' independence rules is a *sina qua non* of listing, but does not provide much practical assurance that firms, once listed, will either maintain the required proportion of independent directors or the mandated levels of independence among those directors.[148] No meaningful mechanism exists for shareholders or others to enforce these rules at the exchange level.[149] In principle, the offending company could be delisted, but removing the company from the exchange—and for that matter, the enforcement by exchanges of any of their own rules against companies—is extremely rare.[150]

The exchanges' standards specify two categories of relationship that disqualify directors from being considered independent, one objective and the other subjective.[151] NYSE's objective rules deny independent status to anyone employed by the company (and anyone whose immediate family member was employed as an executive officer) in the previous three years;[152] anyone who has received more than a certain amount of money in direct compensation from the company during the previous three years, with certain limited exceptions;[153] anyone with

148. *See* Nili, *supra* note 116, at 40 ("[T]he current regulatory approach has also lacked effective enforcement.").

149. *See id.* ("Companies' self-designations of director independence are left uncontested and are done without proper vetting or auditing by the stock exchanges or the SEC, as they have shown no effort to proactively enforce their own requirements.").

150. *See infra* Part III.C.

151. Item 407 of Regulation S-K adds a securities regulation layer to this mandate, requiring that independent directors be identified as such on the issuer's proxy or, in the case of a company conducting an initial public offering, in its registration statement. *See* 17 C.F.R. § 229.407(a) (2020) (incorporating by reference the exchanges' own standards for their listed companies). This regulation does not constitute a freestanding federal law requirement that companies maintain independent boards, however.

152. *See Listed Company Manual, § 303A.02 Independence Tests*, *supra* note 147.

153. *See id.* § 303A.02(b)(ii) (establishing a limit of $120,000 in direct compensation in any twelve-month period during the prior three years, excluding fees paid for director or committee service or pension, "other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service)," and any compensation received for service as interim chairman or in an interim executive capacity).

close relationships to the company's independent auditor;[154] and directors with a few other types of particularly salient conflicts.[155] Nasdaq's objective rules are substantially identical.[156]

In addition to these objective criteria, both exchanges have adopted high-level, qualitative standards concerning the definition of independence. NYSE's standard provides that directors who have any "*material* relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company)" cannot be deemed independent.[157] In acknowledgment of the porousness of this definition, the commentary to the NYSE rules expresses a need to "broadly consider all relevant facts and circumstances."[158] For example, when making its independence determination, the board should consider the question of materiality "not merely from the standpoint of the director, but also from that of persons or organizations with which the director has an affiliation."[159] Relationships that should be deemed material under the NYSE standard "can include commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships, among others."[160] Notably absent from this list is direct mention of close personal friendships, though the language of the list is illustrative rather

154. *See id.* § 303A.02(b)(iii)(A) (stating that a director cannot be considered independent if he is an employee of the company's auditor).

155. *See id.* § 303A.02(b)(iv) (concerning conflicts arising from compensation committee interlocks); *id.* § 303A.02(b)(v) (concerning conflicts arising from outside employment with a company doing over $1 million in business with the listed company); *id.* § 303A.02 (noting that in certain cases, contributions to charities of which an independent director serves as an executive officer must be disclosed); *see also* Nili, *supra* note 116, at 49–50 (concerning, e.g., compensation committee membership).

156. *See Nasdaq Stock Mkt. Rules*, *supra* note 17, § 5605(a)(2).

157. *Listed Company Manual*, *§ 303A.02 Independence Tests*, *supra* note 147 (emphasis added).

158. *Id.* (noting the impossibility of gauging all factors that "might bear on the materiality of a director's relationship").

159. *Id.*

160. *Id.* ("[A]s the concern is independence from *management*, the Exchange does not view ownership of even a significant amount of stock, by itself, as a bar to an independence finding."(emphasis added)).

than exhaustive and, based on other language in the commentary, prudence demands that boards consider such relationships.[161]

The Nasdaq qualitative standard sets a higher bar for independence than its NYSE counterpart. This is clear from the plain text of the Nasdaq definition of relationships that would disqualify a director from being considered independent: it lacks a materiality requirement, instead barring *any* complicating relationship.[162] The exchange's commentary explains that this standard prohibits independent directors from having merely "*a relationship* with the listed Company that would impair [the director's] independence;" there is no discussion of materiality.[163] The only major exception to the NYSE and

161. For example, boards are required to weigh "all relevant facts and circumstances" bearing on independence. *Id.* ("It is not possible to anticipate, or explicitly to provide for, all circumstances that might signal potential conflicts of interest, or that might bear on the materiality of a director's relationship to a listed company.").

162. Nasdaq defines an independent director as "a person other than an Executive Officer or employee of the Company or any other individual *having a relationship which*, in the opinion of the Company's board of directors, *would interfere* with the exercise of independent judgment in carrying out the responsibilities of a director." *Nasdaq Stock Mkt. Rules*, *supra* note 17, § 5605(a)(2) (emphasis added).

163. *Id.* § 5605(a)(2) IM-5605 (emphasis added). The absence of a materiality requirement in both the standard and the commentary is significant. While NYSE requires relationships to be "material" to be disqualifying from an independence standpoint, Nasdaq would deny that label to a director with any relationship that would interfere with her independence, a formulation that would appear to more easily reach personal relationships. *Id.* That the Nasdaq rules use the term "material" repeatedly to refer to other types of conflicts bolsters the notion that the rule drafters deliberately omitted it in the context of independence. *See, e.g.*, *id.* § 5605(d)(2)(A) (concerning "material" relationships of compensation committee members); Gregory H. Shill, *The Golden Leash and the Fiduciary Duty of Loyalty*, 64 UCLA L. REV. 1246, 1265–66 (2017) (discussing the distinction between NYSE and Nasdaq rules concerning director relationships); *cf.* Russello v. United States, 464 U.S. 16, 23 (1983) ("[W]here Congress includes particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion." (citations omitted)).

Nasdaq requirement that listed companies adopt majority-independent boards is for controlled companies.[164]

As a formal matter, both NYSE and Nasdaq place the process of nominating directors in the hands of independent directors. NYSE accomplishes this by requiring that listed firms constitute a nominating and governance committee composed exclusively of independent directors.[165] Nasdaq requires that nominees be selected either by an all-independent nominating committee or by the independent members of a majority-independent board.[166]

Though they exclude direct management participation in the process, the degree of authentic (as opposed to formal) independence mandated by these rules is debatable. For example, both exchanges allow companies to change the decisionmakers contractually, by granting to a shareholder the exclusive right to nominate a director.[167] But the more important qualification, discussed *infra* at Part III.A., is the extraordinary influence management exercises over the process from top to bottom.

* * *

Past work urging improvements to the independent director model has tended to focus on relatively modest changes—tightening up the definition of independence and

164. *See Listed Company Manual*, *§ 303A.00 Introduction*, *supra* note 80 (exempting NYSE-listed controlled companies from the independent-board requirement); *Nasdaq Stock Mkt. Rules*, *supra* note 17, § 5615(c) (same for Nasdaq-listed controlled companies).

165. *See Listed Company Manual*, *§ 303A.04(a)–(b) Nominating/Corporate Governance Committee*, *supra* note 79 (requiring companies to establish "a nominating/corporate governance committee composed entirely of independent directors" to identify and nominate "individuals qualified to become board members"); Disclosure Regarding Nominating Committee Functions and Communications Between Security Holders and Boards of Directors, Exchange Act Release No. 8340, 81 SEC Docket 2135 (Nov. 24, 2003) (requiring disclosures for nominating committees and boards).

166. *See Nasdaq Stock Mkt. Rules*, *supra* note 17, § 5605(e).

167. *See Listed Company Manual*, *§ 303A.04(a) Nominating/Corporate Governance Committee*, *supra* note 79; *Nasdaq Stock Mkt. Rules*, *supra* note 17, § 5605(e)(4). Typically, such a right would be exchanged for something of value, such as a standstill provision in a settlement agreement with an activist shareholder that stipulates the shareholder will cease trading the company's stock.

improving the quality of disclosures around it,[168] for example, or enhancing the autonomy of the independent director in general[169] or in controlled companies in particular.[170] These commendable ideas are styled in the nature of friendly amendments to the current paradigm. As such, they do not seek to address shortcomings inherent in the independent board of substituting outside directors for judicial and regulatory oversight. Those shortcomings are most consequential in the sphere of board action where independent directors wield the power to activate the business judgment rule.

III. Limitations of the Independent Board

Independent directors must satisfy legal criteria detailed in Part II, but even the sum of these requirements falls short of authentic independence in the ordinary sense of the word. "Independent" has such meanings as "not subject to control by others," "not requiring or relying on something else," and "not looking to others for one's opinions or for guidance in conduct."[171] Independent directors labor under well-documented limitations that require them to seek management guidance and grant management a considerable measure of control over them.[172] These deficits hinder independents' capacity and

168. *See* Nili, *supra* note 116, at 70–74 (describing how disclosure requirements can be altered to improve the independent director regime). Elsewhere, Nili has cautioned against excessive reliance on the independent board. *See* Yaron Nili, *The Fallacy of Director Independence*, 2020 WISC. L. REV. 491 (2020).

169 *See* Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 865 (1991) (proposing increased independence from management through increased dependence on shareholders).

170. *See, e.g.*, Lucian A. Bebchuk & Assaf Hamdani, *Independent Directors and Controlling Shareholders*, 165 U. PA. L. REV. 1271, 1295 (2017) (describing a regime to give independent directors more power with changes such as veto rights).

171. *Independent*, MERRIAM-WEBSTER DICTIONARY (11th ed. 2019).

172. Fairfax, *supra* note 83, at 132 ("[T]here exist significant limitations on independent directors' ability to fulfill their monitoring role, and it is very difficult to overcome those limitations, especially as independent directors' responsibilities increase.").

incentives and predictably generate boards that shield managers.[173]

The aspirational literature regarding the independent board and its potential to improve governance and performance is difficult to square with the evidence. Independent directors tend to be "thinly informed, under-resourced, and boundedly motivated,"[174] and "more independent of shareholders than they are of management."[175] Proposed fixes abound.[176] Some changes—to the composition, structure, and incentives of board membership, for example—have been adopted with a view to "reduc[ing] deviations from shareholder-value maximization."[177] Yet managers may frequently "exert excessive influence over [board] governance mechanisms, exploiting a collective action barrier to effective monitoring by dispersed equity owners."[178] This Part reviews factors that chronically impair effective supervision by independent boards.

A. Structural Bias, Self-Interest, and Social Perception

Boards of directors are subject to many of the same propensities that characterize decision-making by other groups of human beings.[179] This fact colors their decisions on key

173. *See id.* at 177 ("[D]ependence, coupled with the social ties and structural bias common among directors, significantly hinders independent directors' ability to be impartial.").

174. Gilson & Gordon, *supra* note 52, at 366.

175. Gilson & Kraakman, *supra* note 169, at 873.

176. *See, e.g.*, Bebchuk & Hamdani, *supra* note 170, at 1293–95 (proposing "enhanced-independence" directors); Nili, *supra* note 116, at 70–76 (proposing to increase independent director disclosure requirements); Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 912 (2013); Bebchuk, *supra* note 20, at 151 (proposing giving more power to the shareholders); Gilson & Kraakman, *supra* note 169, at 865 (advocating reforms to "increas[e] the dependence of outside directors on shareholders").

177. Bebchuk, *supra* note 20, at 850. Questions around whether the purpose of the firm should remain solely to maximize shareholder wealth are beyond the scope of this Article.

178. Bratton & McCahery, *supra* note 47, at 1865.

179. *See* Antony Page, *Unconscious Bias and the Limits of Director Independence*, 2009 U. ILL. L. REV. 237, 259 (2009) ("Although people are

matters of corporate policy, even where their self-interest may not be directly implicated. For example, directors might ask themselves:

> [S]hould we approve the CEO compensation package? (Yes, because he is like us, a member of my group, and thus he deserves it; and for directors who are also CEOs, yes, because it may favorably affect my own compensation.) Should we approve another firm's takeover bid of our company? (No, because we have managed the firm well and because I want to retain the benefits associated with board membership.) Should we allow a derivative suit to go forward? (No, because this involves a suit against a group of which I am a member . . . .).[180]

The human frailties referenced in parentheses have been documented in an extensive literature.

1. Social Biases

Regardless of their formal status as independent, directors sometimes exhibit what psychologists call ingroup bias, or "the tendency to favor one's own group, its members, its characteristics, and its products, particularly in reference to other groups."[181] Such directors, even when acting in good faith, may be unconsciously biased in favor of other directors because they view other board members as part of their group.[182] This can contribute to a structural bias—"the bias resulting from board members' interactions with one another after joining the

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aware of many biases, they will frequently not recognize situations involving potential bias and conflict of interest.").

180. *Id.*

181. *APA Dictionary of Psychology*, AM. PSYCH. ASS'N, https://perma.cc/FWG9-9YBB.

182. *See* Page, *supra* note 179, at 252 ("Directors, even those defined as independent, are members of the board of directors and, so the theory goes, are likely to be biased in favor of other directors."); Fairfax, *supra* note 83, at 153 ("[T]he psychological research with respect to structural bias is particularly relevant in the context of boards, highlighting the degree to which such bias undermines directors' ability to be critical of their fellow directors.").

board"[183]—that, in Lisa Fairfax's formulation, "makes it normatively difficult to have truly independent directors."[184]

While scholars of corporate boards often advocate changes to the incentives or independence levels of directors, "powerful psychological factors are at work within the boardroom"[185] that can render such initiatives moot. These forces "creat[e] a cohesive, loyal, conforming ingroup that will support its members for positive and negative reasons, under low and high levels of motivation and group values."[186] Personal and professional connections, typical among board members, can exacerbate ingroup or structural bias,[187] and this effect can be more pronounced where, as is often the case, boards are relatively homogeneous in makeup.[188] Efforts to address other problems in the independent board often create tradeoffs in this

183. Yaron Nili, *The "New Insiders": Rethinking Independent Directors' Tenure*, 68 HASTINGS L.J. 97, 118 (2016).

184. Fairfax, *supra* note 83, at 153; *see* Page, *supra* note 179, at 245–56 '(describing different kinds of bias).

185. James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, LAW & CONTEMP. PROBS., Summer 1985, at 99 ("Prior or ongoing interaction between individuals, called interpersonal familiarity in the psychological literature, has been repeatedly demonstrated to be a source for strong biases favoring a familiar ingroup and correlatively disfavoring a threatening or unfamiliar outgroup.").

186. *Id.*

187. *See* Page, *supra* note 179, at 252 ("Director nominees will often be friends or have social connections with other board members, thereby exacerbating biases."); Nili, *supra* note 183, at 118 (noting preexisting social ties and length of director service as factors that could affect true independence).

188. *See* Page, *supra* note 179, at 253 ("Today directors still tend to have relatively strong ties and similarities, as they tend to be fairly homogeneous. More generally, groups that are essentially self-selecting will often have homogeneous attitudes, since people naturally tend to form relationships with those who are similar."). Despite movement towards greater gender and racial diversity at the board level, in 2018, over 60 percent of directorships at the top 100 companies were held by white males. *See* DELOITTE, MISSING PIECES REPORT: THE 2018 BOARD DIVERSITY CENSUS OF WOMEN AND MINORITIES ON FORTUNE 500 BOARDS 9 (2019) ("The representation of women and minorities in the Fortune 100 has reached a high of 38.6 percent, outpacing the broader Fortune 500, which is 34 percent.").

area.[189] For example, longer director tenure, traditionally promoted as a way of enhancing director knowledge and effectiveness, can intensify this problem: over time, ties among directors are likely to strengthen, as they become more likely to identify as part of the group, thus reducing diligence and monitoring.[190]

Delaware law acknowledges the potential for structural bias among independent directors, but the response it has developed—doctrines that regulate conflicts in individual transactions—ignore the constant, systemic nature of the problem.[191] The result is that, with the exception of takeover defenses (on which more shortly), Delaware law effectively rules out structural bias as a basis for challenging the independent status of a director.

2. Directors' Desire to Be Renominated to the Board

Nowhere are social biases more consequential than in the process of determining who sits on the board. Delaware law recognizes that directors may be biased in favor of actions that preserve their seats[192] along with the pecuniary and non-pecuniary benefits they bring.[193] But the question has special bite when it comes to the question of being renominated to the board or recommended for other boards or executive roles.[194]

189. *See* Nili, *supra* note 183, at 118 (highlighting the tension and tradeoffs between tenure, social connections, and structural bias).

190. *See id.* ("Importantly, tenure potentially affects not only preexisting and newly formed social ties with management, but also increases this structural bias, making it less likely that any single director would be willing to voice an opinion if such opinion might jeopardize the close-knit atmosphere of the boardroom.").

191. *See infra* Parts III–IV.

192. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985) (discussing this phenomenon in the context of boards weighing takeover defenses).

193. *See* Page, *supra* note 179, at 253–55 (noting that directorship benefits include compensation, access to firm resources such as charitable donations, social validation, and valuable skills or contacts).

194. *See id.* at 255 ("Directors thus are likely biased in favor of decisions that allow them to continue as directors, including decisions in favor of those

As a formal matter, public company director nominations and renominations are generally committed to the independent directorate.[195] Nevertheless, CEOs "have had considerable and sometimes decisive influence over the nomination process,"[196] even when they have "not formally serv[ed] on the nominating committee."[197] In some cases it may even be said that "management effectively controls director nomination."[198] For a rational CEO, there is little more important than the identity of the company's independent directors. Such directors are uniquely positioned to cleanse conduct that falls within a gray zone of personally benefiting the CEO while producing some theoretical or minimal benefit to the corporation.[199] Managers, therefore, can be expected to prioritize the nomination and *renomination* of friendly directors.[200]

The most important step in becoming a director is being selected as a nominee. Lucian Bebchuk and Jesse Fried wrote in 2004 that "candidates placed on the company's slate by the board have been virtually assured of being reelected."[201] In recent years, this trend has not abated.[202] Directors of Russell 3000 companies received average shareholder "for" votes

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people who determine future board membership, such as a controlling shareholder or those directors serving on nomination committees."); Nili, *supra* note 183, at 122 ("Because the overwhelming majority of director elections are uncontested, inclusion in the company's ballot is paramount to a director's ability to be elected and to subsequently hold her seat.").

195. *See supra* Part II.

196. LUCIAN A. BEBCHUK & JESSE M. FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 26 (2004).

197. *Id.*

198. Nili, *supra* note 183, at 122.

199. *See id.* (describing the dependency that directors have on management to get reelected).

200. *See id.* ("This current structure of director election, where management effectively controls director nomination, puts directors in a potentially compromised position, and forces them to consider the ramifications for their reelection if they choose to confront management or their peer directors.").

201. BEBCHUK & FRIED, *supra* note 196, at 25.

202. *See* THE CONFERENCE BOARD, PROXY VOTING ANALYTICS (2016–2019) AND 2020 SEASON PREVIEW 34 fig.1.3 (2019), https://perma.cc/7SN6-DDPM (PDF) (showing that the trend to elect candidates appointed by the board has continued).

exceeding 95 percent in every year between 2016 and 2019.[203] In that window's most challenging proxy season, fewer than 3 percent of incumbent directors failed to exceed 70 percent support, and 99.7 percent—all but 54 directors out of 16,492—received majority support.[204] Directors have no serious incentive to oppose management and every incentive to stay in its good graces, since doing so virtually assures renomination and reelection.

These basic facts contradict the assumptions of Delaware law, which expects directors to pretend that no consequences will attach if they take a more active role in disciplining managers or their fellow directors.[205] Delaware law goes so far as to presume that directors are unlikely to make decisions that would jeopardize their reputation as impartial.[206] Implicit in this logic is the notion that directors are less responsible to their CEOs and director peers than to a higher-order, objective reputational interest that will judge them harshly for going along to get along. There is neither much evidence nor reason to believe that directors interpret their fiduciary duties so nobly, or that the director labor market punishes deferential directors or rewards active ones.[207] Reputation is a relational concept, and "it seems likely that the group or self-interested decision is not one that carries any reputational risk."[208] Rather, "the relevant

203. *Id.*

204. *Id.*

205. *See* Beam v. Stewart, 845 A.2d 1040, 1052 (Del. 2004) (demonstrating that directors are assumed to think there is no consequence for actively disciplining others in the company).

206. *See id.* (noting that directors are presumed not to be more willing to risk their reputation than risk the relationship with the director or officer whose conduct is challenged).

207. *See* Steven Davidoff Solomon, Andrew Lund & Robert J. Schonlau, *Do Outside Directors Face Labor Market Consequences? A Natural Experiment from the Financial Crisis*, 4 HARV. BUS. L. REV. 53, 64–75 (2014) (finding that for outside directors at financial institutions, the exogenous shock of the 2008 financial crisis only raised the probability of a director being replaced for poor firm performance a tiny amount (a difference of 40 basis points, or 0.99 percent at financial firms versus 0.59 percent at non-financials)).

208. Page, *supra* note 179, at 256.

reputation for directors is the one among their peers, who face the same issues and are likely to be quite sympathetic."[209]

Since directors, once suggested by the nominating committee, are typically nominated by the board, the recent trend towards holding director elections annually rather than every three years may exacerbate the problem of directorial bias as it can be expected to make directors more attentive to their colleagues' perceptions of them.[210] Thus, a director's desire to retain a favorable professional reputation among both the managers and her current peers on the board—and her potential future peers on other boards and C-suites—may lead to less active monitoring, in contrast to the greater diligence envisioned by the Delaware Supreme Court.

B. Evidentiary Barriers

While Delaware law admits of the potential for structural or ingroup bias to compromise the independence of directors, it makes it nearly impossible to demonstrate. One example of a situation where such bias commonly arises is where a shareholder plaintiff claims the board is incapable of passing judgment impartially on a derivative suit demand because a majority of the directors are not independent.[211] In an early case addressing the issue, the Delaware Supreme Court admonished that "we must be mindful that directors are passing judgment on *fellow directors in the same corporation* . . . who [may have] designated them to serve both as directors and committee members."[212] Read together, three cases illustrate how this language has remained largely aspirational.

First, in a civil lawsuit over allegations of insider trading at Martha Stewart's company, the court observed that

209. Julian Velasco, *Structural Bias and the Need for Substantive Review*, 82 WASH. U. L.Q. 821, 859–60 (2004).

210. *See* Nili, *supra* note 183, at 122–23 (arguing that because a majority of boards "now face annual elections," "[t]he continued dependency on management . . . could potentially make these directors even more concerned about their reelection and securing management and peer support, as they now are granted only one-year terms").

211. *See* Zapata Corp. v. Maldonado, 430 A.2d 779, 787 (Del. 1981) (demonstrating the difficulty of demonstrating ingroup bias in the law).

212. *Id.* (emphasis added).

"[i]ndependence is a fact-specific determination made in the context of a particular case."[213] Plaintiffs alleging a lack of independence face a difficult burden of proof: allegations of a "*mere* personal friendship or a *mere* outside business relationship, standing alone, are insufficient," i.e., they do not "raise a reasonable doubt about a director's independence."[214] To meet that burden, such that putatively independent directors can be found unable to act impartially, their friendship with the director or officer whose conduct is at issue must be of a "bias-producing nature."[215] Specifically, that bias must overcome a presumption of loyalty: she must be shown to prefer to risk her reputation than risk her relationship with the interested director or officer.[216]

In practice, courts have been extremely reluctant to find a conflict undermining impartiality absent an external, material signifier of a close relationship. For example, in *Sandys*, described *supra* at Part II, the Delaware Supreme Court held that shared ownership of a private plane by a putatively independent director and the company CEO "signaled an extremely close, personal bond" akin to family and supported an inference that that director would not be able to act impartially with regard to a suit against the CEO.[217] The court reached a similar conclusion regarding other directors based on financial interconnections.[218] A dissenting Justice would have found the directors, including the one who shared a plane with the CEO,

213. *Beam*, 845 A.2d at 1049.

214. *Id.* at 1050 (emphasis added)*; see id.* ("In order to show lack of independence, the complaint of a stockholder-plaintiff must create a reasonable doubt that a director is not so 'beholden' to an interested director (in this case Stewart) that his or her 'discretion would be sterilized.'").

215. *See id.* (stating that the decision in question concerned actions adverse to Stewart, to whom it was alleged the directors met the Delaware standard of beholdenness).

216. *See id.* at 1052 ("[P]laintiff must plead facts that would support the inference that because of the nature of a relationship[,] . . . the non-interested director would be more willing to risk his or her reputation than risk the relationship with the interested director.").

217. Sandys v. Pincus, 152 A.3d 124, 130 (Del. 2016).

218. *See id.* at 131–34 (finding that personal bonds and personal interconnections can produce bias).

independent (as the lower court had).[219] In another case, involving the board of Oracle Corporation, the court reached the same conclusion—that directors lacked independence—but only upon a showing of significant financial and professional interlocks, including essentially a joint investment in real property between a director and the CEO.[220]

It would be a mistake to read *Sandys* and this *Oracle* case[221] as generally suggestive of a trend towards more exacting standards of independence, for they had two unusual facts in common. In each case, the board had previously determined that one or more directors whose independence was challenged in the suit did not meet the pertinent stock exchange's standards for independence,[222] which are arguably less exacting than Delaware's.[223] In addition, the CEO in each case also had the status of (or was plausibly alleged to have been) a controller of the corporation.[224] While such a designation does not automatically trigger a finding that directors lack the requisite characteristics of independence, the court in *Sandys* emphasized that the existence of a controlling shareholder in the company was relevant to its determination that three

219. *See id.* at 134–35 (Valihura, J., dissenting) (finding that the directors were independent because the plaintiff failed to allege any facts that would establish a material relationship).

220. *See In re* Oracle Corp. Derivative Litig., No. 2017-0337-SG, 2018 WL 1381331, at *19 (Del. Ch. Mar. 19, 2018) (showing that together with her husband, one director owned two condos on an island 98 percent owned by the CEO).

221. A note of disambiguation: there are a great many Delaware corporate law cases in the past few decades to which the Oracle Corporation lends its name. They do not necessarily relate to one another.

222. *See Sandys*, 152 A.3d at 131 (noting that Zynga disclosed to the exchange on which its shares were listed, Nasdaq, that two directors were not independent); *In re Oracle Corp. Derivative Litigation*, 2018 WL 1381331, at *18 (making the same determination with regard to one director's independence under NYSE listing standards).

223. *See supra* Part II.

224. *See Sandys*, 152 A.3d at 126 (stating that the CEO was a controlling shareholder); *In re Oracle Corp. Derivative Litig.*, 2018 WL 1381331, at *16 (declining to determine whether the CEO was a controlling shareholder, but noting his status as a 28 percent owner and co-founder of the company and describing plaintiffs' allegation that he "maintain[ed] a firm grip on Oracle's day-to-day operations").

directors were not independent.[225] In sum, not only was the close nature of the relationship in each case evidenced by tangible pecuniary connections, but the company itself had determined that directors whose independence was challenged had in fact failed a key test of independence—and the specter of controller-initiated removal loomed over the directors of both boards.

As discussed *infra* at Part IV, takeovers are something of an exception to Delaware's lax treatment of structural bias. In such cases, courts take cognizance of the potential for structural bias and apply an enhanced scrutiny standard (rather than the deferential business judgment standard) when evaluating the validity of defenses adopted by the board.[226] While courts apply a formally heightened standard of review in these cases, they also validate the challenged measures even when the effect of doing so is to indefinitely entrench managers by allowing them to "just say no" to takeovers.[227]

C. Self-Interested and Uninformative Self-Designations of Independence

The systems used to define and designate directors as independent are characterized by a lack of rigor, coherence, accountability, and transparency. Under state law, federal law, and stock exchange listing requirements, the board of directors determines the independence of its own directors in the first instance.[228] This determination, which is subject to the influence

225. *See Sandys*, 152 A.3d at 133 ("[O]ur courts cannot blind themselves to that reality when considering whether a director on a controlled company board has other ties to the controller beyond her relationship at the controlled company.").

226. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985)

> Because of the omnipresent specter [when a board addresses a pending takeover bid] 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.

227. *See id.* at 954*; infra* Part IV.C.1.

228. *See supra* Part II.

of the same self-interested and ingroup propensities discussed above, is preliminary in theory but often final in fact.[229]

Under Delaware law, the only way to challenge a board's incantation of director independence is by lawsuit, where a plaintiff must identify and attack a specific board decision and satisfy procedural and substantive requirements before being entitled to any discovery on the very question she is litigating.[230] Stock exchanges retain the authority to take disciplinary measures to enforce their listing standards, up to and including delisting; in practice, however, they rarely enforce their own rules.[231] For example, "in 2017, the NYSE brought twenty-five disciplinary actions, but none of them involved disclosure/listing rules violations."[232] Exchanges are in competition for business and lack an incentive to enforce strictly,[233] and the federal securities laws do not provide a private right of action for a violation of exchange rules.[234] A plaintiff could in theory bring a federal securities fraud suit over false disclosures regarding director independence in a company's proxy statement, but an

229. *See, e.g.*, Nili, *supra* note 116, at 53–63.

230. *See id.* at 63 ("[S]tate law enforcement is limited to litigation, and while shareholders can challenge the independence of directors in Delaware courts, these challenges must be made in connection with a shareholder challenge to a specific board action, and must cross procedural and substantive thresholds before discovery.").

231. *See id.* ("[I]n the context of the stock exchange listing rules, the designation of directors as independent is designed to be difficult to enforce, and in practice is rarely enforced.").

232. Timothy J. Johnston, *Is Mandatory Real-Time Disclosure Really Mandatory? A Comparison of Real-Time Disclosure Frameworks and Enforcement*, 47 SEC. REGUL. L.J. 1, 11 (2019).

233. *See id.* at 8 ("Continuous disclosure regimes require listed companies to disclose material information as a positive, proactive, and broad obligation." (citing Gill North, *National Company Disclosure Regulatory Frameworks: Superficially Similar but Substantively Different*, 3 J. MARSHALL GLOB. MKT. L.J. 187, 218 (2015))).

234. *See, e.g.*, NASDAQ OMX Grp. v. UBS, Sec., LLC, 770 F.3d 1010, 1046 (2d Cir. 2014) (Straub, J., dissenting) ("[I]t is undisputed that the Exchange Act does not provide for a private cause of action for violations of stock exchange rules.").

even higher standard of proof attaches to such claims than to a claim of fiduciary duty breach under Delaware law.[235]

Finally, despite the fact that many sources of law mandate and regulate independence, they do not require much by way of disclosure about what makes a director independent.[236] Investors are thus in the dark over the nature of any potential director biases as well as the process by which the board reached its independence determinations.[237]

Yaron Nili has characterized this patchwork disclosure system as "*too much*, *too little*, *too late*, and *too soft*."[238] It affords boards "too much"' discretion over directors' independence status determinations;[239] provides investors "too little" information regarding the company's independence standards (and how directors satisfy them);[240] when a director's independence is challenged under state law, it is frequently *too late*, "as these assessments are done post-hoc when it is too late to address many of the issues that director independence is

235. *See* Shill, *supra* note 163, at 1265–66 ("A body of literature asserts that the ascendance of the independent-dominated board has heightened the agency costs problem, by making it easy for boards to nominate management-friendly directors who meet stock exchange and Delaware independence standards but do not act as a meaningful check on management.").

236. *See* Nili, *supra* note 116, at 63 ("[T]he current designation system of directors as independent may suffer from structural concerns, and there are numerous anecdotal examples demonstrating the deficiencies and lack of proper disclosure by companies."). The optimal level and form of disclosure is a topic all its own. For an exploration of the costs and benefits of disclosure in the context of initial public offerings, for example, see Jeremy McClane, *Boilerplate and the Impact of Disclosure in Securities Dealmaking*, 72 VAND. L. REV. 191 (2019).

237. David F. Larcker et al., *2015 Investor Survey: Deconstructing Proxy Statements—What Matters to Investors*, STAN. BUS. GRADUATE SCH. (Feb. 2015), https://perma.cc/9X9X-JNB7 (finding that 60 percent of institutional investors view company independence disclosures as somewhat or not at all effective).

238. Nili, *supra* note 116, at 53.

239. *See id.* ("It provides companies with *too much* discretion, as boards retain too much power to assert the independence of their peer directors, and they may suffer from behavioral bias in doing so.").

240. *See id.* ("It provides investors with *too little* information regarding the factual context against which a director is considered to be independent.").

meant to protect against" ex ante;[241] and "too soft," as independence designations are rarely uncontested or vetted by the stock exchanges or the SEC.[242] These drawbacks, however, are the product of larger problems upstream from the disclosure regime, which suggests limited returns to tweaking that regime.

D. Quantum and Structure of Director Compensation

In recent years, compensation of directors has risen and its structure has changed from all cash to majority equity, with the goal of incentivizing higher director performance. This transition has altered the director role somewhat.

> An independent directorship at a large company is a prestigious role asking five hours of work per week for $255,000 in median annual salary. This workload, which is reported by directors themselves, amounts to a wage of approximately $1,000 an hour . . . . As has been widely documented, this combination has led to effective capture of independent directors [by managers].[243]

The rise in director compensation complicates issues around financial ties and actual (as opposed to mere legal) independence.[244]

Compensation for a director on a single board may be considered nominal because directors typically have a high net worth.[245] However, directors frequently serve on multiple boards and may be loath to endanger their reputation as an agreeable board member on any of them, which might place seven figures of annual income at risk.[246] Even the median

241. *Id.*

242. *Id.*

243. Shill, *supra* note 163, at 1267.

244. *See id.* (explaining the salary of an independent director).

245. *See* Fairfax, *supra* note 83, at 155 ("[D]irector compensation is often characterized as nominal, and hence it may not warrant serious concern . . . . However, it cannot be considered nominal; indeed, the fact that the average directorial compensation package exceeds the thresholds for independence under federal rules reflects this.").

246. *See id.* ("[T]he fact that directors have other sources of compensation may reduce any concern that their board compensation may jeopardize their impartiality.").

quantum a director receives for service on a single large-company board is deemed material in an important, relevant sense: it is more than double the amount that stock exchanges allow outside directors to be paid in direct compensation.[247] In fact, for this reason, the exchanges specifically exempt director compensation from determinations of "material" connections to the firm.[248] If the exchanges' listing standards did not do so, virtually no directors would be considered independent under their own rules.[249]

More broadly, the trend towards paying more director compensation in equity represents a questionable mirroring of a trend in executive compensation known as "pay for performance."[250] While that model is subject to many critiques,[251] there is no great logical leap required to justify linking the pay of the head of a firm to the performance of the firm. However, the rationale for extending it into the realm of monitoring is less clear, and "the expansion of payment-for-performance plans into the director arena is puzzling."[252]

Incentive pay for monitoring directors is something of an oxymoron. Unlike executives, individual directors have little

247. *See, e.g.*, *Listed Company Manual, § 303A.02 Independence Tests*, *supra* note 147 (establishing a limit of $120,000 in direct compensation in any twelve-month period during the prior three years, but exempting fees paid for board service); Fairfax, *supra* note 83, at 154.

248. *See* Fairfax, *supra* note 83, at 155 ("This failure to account for director compensation runs counter to the clear consensus regarding the bias-producing nature of financial ties.").

249. *See id.* ("Based on these rules, if directors' board fees were not excluded, the current amount of such fees would exclude the average director from being considered independent under both [Sarbanes-Oxley] and NASDAQ.").

250. *See* Katherine M. Brown, Note, *New Demands, Better Boards: Rethinking Director Compensation in an Era of Heightened Corporate Governance*, 82 N.Y.U. L. REV. 1102, 1122–29 (2007) (summarizing tradeoffs involved in the trend towards increasing the equity component of compensation).

251. *See generally* BEBCHUK & FRIED, *supra* note 196 (analyzing the power corporate executives have to influence their own pay and the structural defects that lead to this system).

252. *See* Brown, *supra* note 250, at 1132 (documenting difficulties in measuring and incentivizing director performance).

power to control or direct the corporation in any specific direction.[253] While management is tasked with driving the company forward and improving value for shareholders, directors are tasked with monitoring, which cannot be adequately judged solely through equity or other performance targets.[254] Thus, equity compensation can be expected to be a weaker motivator for directors than management.[255]

Where incentive pay for directors does motivate, there is reason to ask whether its effects are wholly benign.[256] Charles Elson, an early advocate of equity compensation for directors, wrote that it is designed to align director interests with those of shareholders.[257] However, it remains immaterial to most directors when compared to their net worth.[258] As a result, even when paid largely in equity, independent directors have little skin in the game—but where a director accumulates considerable equity in the firm (through stock grants conferred over the course of a lengthy tenure, for example), her

253. *See id.* at 1126 ("Equity compensation may simply be an insufficient motivator of director behavior.").

254. *See id.* at 1132.

255. *See* Claudia Zeitz Poster & Mark R. Ullman, *Director Pay: What Makes Sense Today*, DIRS. & BDS., 3d Quarter 2006, at 42, 46 (illustrating that payment for performance induces directors to act like managers and, thus, erodes the distinction between the two).

256. *See* Brown, *supra* note 250, at 1125–29 (arguing that director equity compensation is undesirable on net).

257. *See* Charles Elson, *Director Compensation and the Management-Captured Board—The History of a Symptom and a Cure*, 50 SMU L. REV. 127, 135 (1996) (endorsing equity-based director compensation as a mechanism for reuniting ownership and control and enhancing board engagement); Michael Barrier, *The Compensation Balance*, INTERNAL AUDITOR, June 2002, at 46 (cataloging opinions that equity ownership ties director interests more closely to shareholders).

258. *See* Brown, *supra* note 250, at 1115

> [F]inancial compensation may also influence the decision to serve on a board, though only minimally for wealthy members. The amount received as compensation for board service is generally very small relative to the director's other income and overall net worth. Most directors are "successful professionals who have built significant wealth," and do not serve on boards for the monetary rewards. (quoting Jay W. Lorsch, *The Fuss Over Director's Pay and Pensions—Is Stock Ownership Really the Answer?*, DIRECTORSHIP, June 1996, at 3).

impartiality may be dubious when she is presented with a decision that may harm the value of her equity, at least in the short run, such as by challenging a questionable ethical practice.[259] The prevailing market assumption appears to be that a "Goldilocks" mix of cash and equity aligns director and shareholder incentives without compromising director independence, but there is little evidence it accomplishes any of the above. Further, once ratified by shareholders, the quantum and structure of director compensation are protected by the business judgment rule and become essentially unreviewable.[260]

E. Asymmetries in Information and Resources

Beyond the audit committee, no regulation requires that independent directors have any particular skills or knowledge.[261] The market for directors is reasonably good at ensuring directors have general business competence, but they often lack industry or company specific knowledge that may be necessary to determine the correct course of action.[262] Thus, even when information presented about the company is accurate, complete, and free of manipulation, directors may simply lack the knowledge and skill necessary to fulfill their

259. *See* Nili, *supra* note 183, at 121 ("[D]irectors might refrain from acting diligently and independently when such actions would have a negative impact on firm value and in turn on their equity, in the short to intermediate term, even if such action would potentially improve long-term value.").

260. *See In re* Invs. Bancorp, Inc. S'holder Litig., 177 A.3d 1208, 1211 (Del. 2017) (stating that shareholder ratification triggers business judgment review "as long as the [director compensation] plan has 'meaningful limits' on the awards directors can make to themselves"); *infra* Part IV.C.2.

261. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107–204, 116 Stat. 745 (regulating the disclosure of audit committee financial experts).

262. *See* Kobi Kastiel & Yaron Nili, *"Captured Boards": The Rise of "Super Directors" and the Case for a Board Suite*, 2017 WIS. L. REV. 19, 29 (2017) ("[W]hile many outside directors . . . may have general business skills, most of them lack the relevant firm or industry-specific knowledge."); *see also* Fairfax, *supra* note 83, at 164–65 ("Thus, studies reveal that while many directors have knowledge about general business matters, few have knowledge regarding the particular industry on whose board they sit, and even fewer have knowledge about the specific company on whose board they sit.").

duties.[263] Other times, they may become better informed by serving on multiple boards in the same industry, though this raises both fiduciary and antitrust concerns[264] and overlooks alternative ways to recruit industry veterans.[265]

Independent directors are, by definition, outsiders to the corporation. They work part-time, often sit on multiple boards, are not supported by a staff of their own, and receive their information from management.[266] Proxy advisor voting guidelines only deem directors "overboarded"—and thus counsel revoking shareholder support in director elections—when they sit on five or more boards,[267] despite the obvious risk of distraction from conscientious service on fewer boards. Modern corporate governance theory deems such directors best suited to monitor the corporation.[268] However, with this outsider perspective come the natural limitations on an outsider's ability

263. *See* Fairfax, *supra* note 83, at 165 ("Corporate-governance scandals tend to confirm that many directors lack the knowledge and expertise to sufficiently appreciate the complexities associated with their business, and that such lack of knowledge impedes the effectiveness of their oversight."). In principle, this problem could be addressed through outsourcing, though directors would still need a way to select and supervise outsourcing firms. *See generally* BAINBRIDGE & HENDERSON, *supra* note 66 (proposing outsourcing of governance functions typically performed or overseen by the board).

264. *See* Yaron Nili, *Horizontal Directors*, 114 NW. U. L. REV. 1179, 1242 (2020) ("If directors serve competitor companies, even under a broader definition of competition, they may facilitate coordination between competitors to the detriment of consumers.").

265. *See, e.g.*, Shill, *supra* note 163, at 1251 (describing the recruitment of expert independent directors through the use of supplemental compensation arrangements).

266. *See id.* at 1266 ("Even where no strong personal ties exist, structural features of independent-run boards, including independent directors' minimal time investments and inferior access to information . . . ."); *see also* Kastiel & Nili, *supra* note 262, at 28 ("Independent directors are part-time employees who often sit on other boards or have other professional commitments, and thus cannot devote more than a few hours per month to their role as directors.").

267. *See* INSTITUTIONAL S'HOLDER SERVS., UNITED STATES PROXY VOTING GUIDELINES BENCHMARK POLICY RECOMMENDATIONS 12 (2018), https://perma.cc/FBY9-XK8D (PDF) (setting forth proxy voting guidelines for directors serving on multiple boards).

268. *See* Fairfax, *supra* note 83, at 130 (noting "overwhelming consensus" favoring the "dominat[ion]" of boards by independent directors).

to acquire information.[269] Consequently, while they may bring industry experience or skills to the table, independent directors lack detailed intelligence on the firms they supervise, instead relying on insiders to supply the information upon which they will make decisions.[270] This indirect reliance on insiders by definition weakens the potential of the independent board as a monitoring body.[271] Managers often have the capability and incentive to filter and shape the presentation of information for director consumption.[272] Absent outside resources, captured independent directors are susceptible to the same managerial self-interest and bias that it is their *raison d' être* to counteract.

* * *

269. *See id.* at 161 ("[T]he fact that independent directors are outsiders, and hence not engaged in the daily affairs of the corporation, means that they are dependent on the insiders that they must monitor to supply them with the information necessary to discharge their responsibilities.").

270. *See id.*; Shill, *supra* note 163, at 1266 ("[S]tructural features of independent-run boards, including independent directors' minimal time investments and inferior access to information, complicate the project of conducting meaningful oversight."); Kastiel & Nili, *supra* note 262, at 27 ("In particular, the move toward board independence generated severe informational asymmetries between top executives and outside directors that limit the ability of the board to closely monitor such executives and to properly perform their role.").

271. *See* Usha Rodrigues, *The Fetishization of Independence*, 33 J. CORP. L. 447, 460 (2008) ("[T]hey rely on corporate officers and other employees for information and tend to defer to insiders' management recommendations.").

272. *See* Fairfax, *supra* note 83, at 161 ("To the extent we are concerned that insiders may inappropriately filter or otherwise manipulate the information, independent directors may not alleviate this concern. This is because such directors' outsider status makes it difficult for them to verify the accuracy of the information, and thus difficult to be effective monitors."); Nili & Kastiel, *supra* note 262, at 27

> As a survey from 2007 demonstrates, only ten percent of directors were able to access the corporation's information independently, through an online board portal. Therefore, the ability of an independent board to effectively monitor management and discharge their oversight responsibilities is based almost exclusively on the information obtained, screened, and then shared by management.

Directors nominated by activist shareholders are less vulnerable to some (though not all) of the above limitations.[273] Such directors—known as designated or activist directors—usually qualify as independent from the companies on whose boards they sit, but are less information-poor than other outside directors because they can call upon the assistance of staff at the fund that facilitated their appointment.[274] However, as a percentage of public company directors, designated directors are rare.[275]

IV. A Shield from Shareholders and Courts

This Part examines the domains where the independent board is of the greatest utility to managers—namely, those where it makes transactions eligible for business judgment rule protection—few of which would be addressed by solutions proposed to date.

"The trouble is," as Stephen Bainbridge has written about the supervisory work of independent directors, "one can tell two radically different stories."[276] One version—the "faithful monitor" story—holds that "independent directors assiduously carry out their oversight obligations. In contrast," a second version, the "rubberstamp" story, "claims that they are little more than management puppets."[277] This second version is the one Douglas was concerned about; he compared outside directors to "business colonels of the honorary type—honorary

273. *See generally* Shill, *supra* note 163. For example, concerns around structural bias may be lower for such directors since they are frequently added to the board following an adversarial engagement and serve shorter director terms, making it harder for ingroup loyalty to gel. *See id.* at 1274–86 (discussing loyalty issues). However, they introduce other concerns, such as that of "dual loyalties." *Id.*; *see id.* at 1296–99 (suggesting mechanisms to manage loyalty issues).

274. *See id.* at 1268 ("[T]hey are less vulnerable to information capture, because their nominating fund generally supplies them with briefing books analyzing company information prior to board meetings.").

275. *See, e.g.*, Melissa Sawyer et al., *Review and Analysis of 2018 U.S. Shareholder Activism*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Apr. 5, 2019), https://perma.cc/P6DL-SEKV (detailing the number of board seats obtained by activists at U.S. issuers).

276. Bainbridge, *supra* note 12, at 1058.

277. *Id.*

colonels who are ornamental in parade but fairly useless in battle."[278] Both interpretations have explanatory value, and can even apply to the same board with respect to different topics or transactions.[279]

In 1993, Bainbridge argued that this conundrum yielded an important question: "how closely should courts scrutinize decisions made by independent directors?"[280] If such directors can be trusted to faithfully discharge their monitoring function, then a higher bar for judicial intervention can safely be set, since judges are hardly business experts and review would often be redundant at best.[281] If, however, they are not so reliable, then the cost of broad deference may be higher.[282] Bainbridge observed that the American Law Institute's Principles of Corporate Governance was ambivalent on the question of what impact the independent board should have on judicial review.[283] Indeed, this critical question remains open.

This Article argues that the law makes it trivial for captured boards to preclude judicial review, and that this has immense consequences for the allocation of rights within the corporation as between shareholders and managers. This conclusion tracks the awkward position the independent board occupies as both monitor in chief (ensuring that firm interest is placed ahead of personal interest) and bulwark of efficiency (against shareholder and judicial claims that the monitoring function is not being fulfilled).

This Part contends that for crucial transactions, Delaware law regarding the independent board counterintuitively locks in resistance to monitoring that places key actions effectively behind a shield. Part V, which follows, argues that changes in

278. WILLIAM O. DOUGLAS, DEMOCRACY AND FINANCE 46 (1940).

279. *Cf.* Bainbridge, *supra* note 12, at 1061 ("[T]he sticking point is that both stories have an element of truth.").

280. *Id.* at 1068.

281. *See id.* at 1047 ("[S]ome [scholars] argued that that judicial review is at best redundant in light of the constraints on management already provided by market forces, and at worse might impede corporate efficiency.").

282. *See id.* ("[S]ome argued that independent directors do not provide an effective check on management misconduct or, at least, that any constraints they provide are similarly redundant in the face of the market forces.").

283. *See id.* at 1068–81.

market structure towards a stewardship role for mutual funds, activist investors, and proxy advisors clad managers in additional layers of armor, placing them beyond the reach of market discipline in important ways.

A. The Independent Board as Shield

The business judgment rule itself operates as a potent shield by forcing critics of a company's practices to take the Wall Street Walk, i.e., sell the stock. Ronald Gilson wrote that it "operates to bar courts from providing additional, and *unnecessary*, constraints on management decisions through judicial review of operating decisions."[284] But courts have recognized that judicial review is not *automatically* unnecessary, and thus not all decisions are automatically eligible for business judgment treatment.[285]

Corporate policy decisions with the greatest salience to management—the determination of CEO pay,[286] the adoption of takeover defenses that preserve incumbent managers' jobs,[287] the decision to effectively block a shareholder lawsuit[288] —and the highest potential for conflicts of interest can be made secure from judicial intervention only if they are approved by a corporation's independent directors. The logic undergirding this adaptation of the business judgment rule is straightforward: the

284. Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 839 (1981) (emphasis added).

285. *See id*.

286. *See generally In re* Walt Disney Co. Derivative Litig., 906 A.2d 27 (Del. 2006) (considering whether a $130 million severance package paid to the president upon his termination was a breach of fiduciary duty and waste).

287. *See generally* Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361 (Del. 1995) (assessing a challenge to defensive actions by a target corporation's board of directors in a takeover contest); Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140 (Del. 1989) (same); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985) (same).

288. Formation of a special litigation committee is a necessary intermediate step to receiving business judgment rule deference in the decision not to bring a derivative suit. *See* Zapata Corp. v. Maldonado, 430 A.2d 779, 787 (Del. 1981) (stating that a special committee of independent, disinterested directors can obtain dismissal of a derivative suit if they determine that doing so is in the best interest of the corporation).

approval of independents provides assurance against self-dealing by managers, reducing the need for meaningful judicial review.[289] But while it imposes an additional requirement on managers, it offers so much more in exchange—namely, foreclosure of the most damaging claims.[290]

In this sense, the independent board structure now serves the same function for decisions implicating the duty of loyalty that the business judgment rule originally performed for the duty of care, and yields the same outcome: deference to managers, subject to procedural correctness.[291] Both obvious conflicts of interest and penumbral ones—that is, transactions that implicate relationships that *might* not survive an independence determination[292] —are cleansable via a vote of the independent directors.

In exchange for the extraordinary immunity conferred by the independent board, corporations must make only modest concessions in their governance: a bare majority of formally independent directors (a restriction which in turn is defined narrowly), some independent committees, the appointment of a single financial expert to the audit committee, some additional reporting.[293] The fact that business judgment immunity in high-risk transactions is conditioned on an approving vote of the company's independents leaves dissenting shareholders with little opportunity to challenge such transactions other than to attack the "independentness" of the decision-making body, but

289. *Cf.* Bainbridge, *supra* note 1, at 88 ("Although the business judgment rule comes into play with respect to [duties of care, good faith, and loyalty], it is most intimately associated with the duty of care.").

290. *See id.* ("[I]f the business judgment rule does anything, it insulates directors from liability for negligence.").

291. *See id.* at 88–89 ("The rule . . . [provides] a presumption that the directors or officers '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.'" (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984))).

292. This category is meant to extend beyond the types of relationships that *Sandys* and *Oracle* held to constitute conflicts to embrace those that require extensive litigation to clear, such as in *Disney*.

293. Technically, the corporation may decline to appoint even a single director to the audit committee who is an "audit committee financial expert" within the meaning of SEC rules, but must then explain why. *See* 17 C.F.R. § 229.407(a) (2020). In practice, companies choose to appoint such experts.

plaintiffs bear the burden of showing lack of independence[294] and, in the absence of colorful facts[295] or extensive business interconnections,[296] such linkages between directors and executives can be hard to show. Even where managers are not obligated to accept all these impositions, such as in controlled companies,[297] they often opt into the extraordinary privilege conferred by the independent model anyway.[298]

B. Interaction with the Business Judgment Rule

The business judgment rule provides immunity for boards of directors for their substantive decisions regarding corporate policy so long as they have satisfied certain procedural minima.[299] It constitutes 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.'"[300] When

294. *See infra* Part IV.B–C.

295. *See, e.g.*, Sandys v. Pincus, 152 A.3d 124, 126 (Del. 2016) (holding that co-ownership of a private airplane by a CEO and an independent director created reasonable doubt as to whether the director was sufficiently independent for demand purposes).

296. *See id.* at 134 ("When . . . pled facts suggest such a [mutually beneficial ongoing business] relationship exists and the company's own board has determined that the directors whose ability to consider a demand impartially is in question cannot be considered independent, a reasonable doubt exists . . . ."); *In re* Oracle Corp. Derivative Litig., No. 2017-0337-SG, 2018 WL 1381331, at *16–17 (Del. Ch. Mar. 19, 2018) (highlighting the "multiple layers of business connections" that cast doubt on independence).

297. *See Listed Company Manual*, *§ 303A.00 Introduction*, *supra* note 80; *Nasdaq Stock Mkt. Rules*, *supra* note 17, § 5615(c). "Smaller reporting companies," which are generally issuers that have a public float of less than $75 million, are also exempt from independence requirements. *See Listed Company Manual*, *§ 303A.00 Introduction*, *supra* note 80; *Nasdaq Stock Mkt. Rules*, *supra* note 17, §§ 5605(d)(5), IM-5605-6.

298. Undoubtedly, one reason they do so is to head off criticism all public companies face from shareholders and their advocates. *See infra* Part V.

299. *See* Brehm v. Eisner, 746 A.2d 244, 264 (Del. 2000) ("As for the plaintiffs' contention that the directors failed to exercise 'substantive due care,' we should note that such a concept is foreign to the business judgment rule . . . . Due care in the decisionmaking context is *process* due care only.").

300. Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 927 (Del. 2003) (quoting Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1373 (Del. 1995)).

the rule is activated, decisions of the board become a black box that courts will not investigate.[301] This reflects a policy choice that locates business decision authority on boards rather than with courts, given the strengths of boards relative to courts in that domain. Later court decisions, however, extend this choice to domains where that logic does not obviously apply, including in business decisions that raise questions about director and manager loyalty and conflicts of interest. Given the power of the rule to immunize board action, it is most consequential in these reaches of the sprawling kingdom of board authority, where approval by independent directors (acting as a group or on committees) is absolutely required but also virtually guaranteed.

Decisions by an independent board are "entitled to certain beneficial presumptions,"[302] and the application of the business judgment rule in contentious cases—those implicating the duty of loyalty—rests on a foundation of board independence.[303] Where conflicts are present, the approval of independent directors is a precondition to cleansing: independence "inheres in the [very] conception and rationale of the business judgment rule. The presumption of propriety that flows from an exercise of business judgment is based in part on this unyielding precept."[304] Given the sweeping universe of transactions for which independent director sanction is necessary to business judgment immunity, it is fair to say the independent board

301. *See* Shlensky v. Wrigley, 237 N.E.2d 776, 779 (Ill. App. Ct. 1968) ("In a purely business corporation . . . the authority of the directors in the conduct of the business of the corporation must be regarded as absolute when they act within the law, and the court is without authority to substitute its judgment for that of the directors." (internal quotation marks omitted) (quoting Helfman v. Am. Light & Traction Co., 187 A. 540, 550 (N.J. Ch. 1936))).

302. Donald E. Pease, *Outside Directors: Their Importance to the Corporation and Protection from Liability*, 12 DEL. J. CORP. L. 25, 35 (1987).

303. *See* Aronson v. Lewis, 473 A.2d 805, 816 (Del. 1984), *overruled on other grounds by* Brehm v. Eisner, 746 A.2d 244 (Del. 2000) (stating that independence presumes that a director will base his decisions on the "corporate merits of the subject").

304. *Id.*

supercharges the rule, especially in the most sensitive cases. It may even substitute for regulation.[305]

An examination of the rationale behind the business judgment rule underscores both the theoretical and practical significance of independence. Courts have said repeatedly that they do not wish to involve themselves in business decisions, a choice that, "at least in part, is grounded in the prudent recognition that courts are ill equipped and infrequently called on to evaluate what are and must be essentially business judgments."[306] Thus, the rationale for judicial abstention is strongest for what are "essentially business judgments," such as a choice between plowing profits back into the business and returning them to shareholders via a dividend.[307] These implicate the duty of care. In another class of cases—those implicating the interests of managers and directors, and thus the duty of loyalty—the comparative competence of businesspeople does not have any special bearing.[308] The notion that the board is the right place to cleanse duty of loyalty problems *on the board* is a category error. As advocated in Part VI, *infra*, courts are not only competent to adjudicate conflict transactions but well positioned to do so.

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305. *See* Fairfax, *supra* note 83, at 131 ("[T]he installation of independent directors serves as a substitute for external regulation, particularly with respect to 'high risk' transactions."). Previous commentators have emphasized the inadequacy of independence as a substitute for regulation to achieve public ends. *See, e.g.*, Velikonja, *supra* note 83, at 859–61 (positing that the embrace of independent directors by institutional investors and managers, "in the absence of evidence that it improves corporate performance or reduces wrongdoing," can be explained as a strategic choice favoring "marginal decreases in corporate performance [in exchange] for the reduced risk of costlier substantive regulation").

306. Auerbach v. Bennett, 393 N.E.2d 994, 1000 (N.Y. 1979).

307. *See generally* Dodge v. Ford Motor Co., 170 N.W. 668 (Mich. 1919). While the holding in this case intruded on this very choice, it is generally taught as an example of a decision that would be difficult to justify on its stated reasoning today following the ascent of the business judgment rule.

308. *See, e.g.*, Bodell v. Gen. Gas & Elec. Corp., 140 A. 264, 267 (Del. 1927) ("If in the particular case there is nothing to show that the directors did not exercise their discretion for what they believed to be the best interest of the corporation, certainly an honest mistake of business judgment should not be reviewable by the Court.")

The independent board can only offer enhanced legal immunity if the requirements of the business judgment rule are first satisfied. To render themselves eligible for protection, directors must discharge their duties of care and loyalty to the corporation.[309] Under Delaware law, their acts presumptively satisfy this standard.[310] To defeat this presumption, shareholder-plaintiffs must show that directors breached their fiduciary duties of loyalty or care.[311] Precise formulations vary among jurisdictions and courts within them; in general, courts "will not interfere with [boards'] discretion unless it be first made to appear that the directors have acted or are about to act in bad faith and for a dishonest purpose,"[312] both of which are difficult to prove. If the shareholder cannot meet this showing, "the business judgment rule attaches to protect corporate officers and directors and the decisions they make, and . . . courts will not second-guess these business judgments."[313] This standard sets a high bar to shareholder

309. *See, e.g.*, Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360–61 (Del. 1993); Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939) (defining the duty of loyalty as a ban on officers and directors using "their position of trust and confidence to further their private interests").

310. *See, e.g.*, Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 927 (Del. 2003) ("The business judgment rule 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.'" (quoting Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1373 (Del. 1995))).

311. *See Cede & Co.*, 634 A.2d at 361 (Del. 1993) (discussing a duty of good faith as part of directors' fiduciary duties, which is now regarded as part of the duty of loyalty), *modified,* 636 A.2d 956 (Del. 1994).

312. Kamin v. Am. Express Co., 383 N.Y.S.2d 807, 810 (Sup. Ct. 1976) (quoting Liebman v. Auto Strop Co., 150 N.E. 505, 506 (N.Y. 1926)), *aff'd,* 387 N.Y.S.2d 993 (App. Div. 1976); *accord Omnicare, Inc.*, 818 A.2d at 927 (observing that "[t]he business judgment rule, as a standard of judicial review, is a common-law recognition of the statutory authority to manage a corporation that is vested in the board of directors" (internal quotation marks omitted) (quoting MM Cos. v. Liquid Audio, Inc., 813 A.2d 1118, 1127 (Del. 2003))).

313. *Cede & Co.*, 634 A.2d at 361 (stating the law for Delaware). The business judgment rule operates in similar fashion in other states.

challenges of board decisions, elevated further by the doctrine around the independent board.[314]

The business judgment rule operates like a judicial abstention doctrine.[315] If the shareholder fails to carry her burden, the business judgment rule "operates to protect the individual director-defendants from personal liability for making the board decision at issue."[316] The rationale is that courts wish to avoid "apply[ing] 20/20 hindsight to second guess a board's decision, except 'in rare cases [where] a transaction may be so egregious on its face that the board approval cannot meet the test of business judgment.'"[317] The business judgment rule standard is closer to gross negligence than "substantive due care" or "reasonableness."[318] Once the fiduciary duty boxes have been checked, courts draw a curtain across the directors' conduct that forecloses further judicial review.[319]

The roots of the business judgment rule lie in the logic of comparative advantage. As Judge Frank Easterbrook has explained, the rule "insulates most decisions from judicial review because there is little likelihood that systematic judicial intervention would make investors better off."[320] Judges, after all, "are not selected for business acumen and are not penalized

314. *See* Arthur R. Pinto, *Corporate Governance: Monitoring the Board of Directors in American Corporations*, 46 AM. J. COMP. L. SUPP. 317, 331–32 (1998) (discussing the rare success of plaintiffs in duty of care cases and the reluctance of courts to interfere with business judgment decisions absent a showing of negligence).

315. For a more thorough discussion of this issue, see generally Bainbridge, *supra* note 1.

316. McMullin v. Beran, 765 A.2d 910, 917 (Del. 2000) (citing *Cede & Co.*, 634 A.2d at 361).

317. Brehm v. Eisner, 746 A.2d 244, 260 (Del. 2000) (alteration in original) (quoting *In re* Walt Disney Co. Derivative Litig., 731 A.2d 342, 362 (Del. Ch. 1998)).

318. *See id.* at 264 (expressly rejecting the "substantive due care" formulation and noting that the court "do[es] not even decide if [business decisions] are reasonable in this context").

319. *See id.* at 266 (articulating a narrow standard for judicial review of board decisions, stating that the alternative "would invite courts to become super-directors, measuring matters of degree in business decisionmaking and executive compensation").

320. Frank H. Easterbrook, *Comparative Advantage and Antitrust Law*, 75 CALIF. L. REV. 983, 984 (1987).

for bad decisions."[321] Giving courts more power over the daily workings of corporations would "increase the riskiness of business decisions without making decisions better."[322] This explains why the business judgment rule insulates corporate decisions implicating the duty of care, but cannot explain why it extends to decisions implicating the duty of loyalty.

The key difference between the application of the business judgment rule in claims implicating the duty of care versus the duty of loyalty is that the latter group requires the approval of a body of independent directors, whether a committee or the full board. In a duty of care case, unless the procedural presumption of the business judgment rule is rebutted, a court will not scrutinize the judgment of the board so long as the board's decision can be "attributed to any rational business purpose."[323] This has the effect of precluding duty of care claims except in the most extreme circumstances. On top of these protections for conduct implicating the duty of care, Section 102(b)(7) exculpatory provisions,[324] indemnification,[325] and insurance also shield directors from personal liability for violations of the duty of care.[326] Insurance provides a personal liability shield that can outlive even the firm itself.

The combined effect of the independent board and the business judgment rule is to make this same immunity available to managers in transactions implicating the duty of loyalty. Approving votes of independents can cure what might

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321. *Id.*

322. *Id.*

323. Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971); *see* Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 927 (Del. 2003) (noting that the business judgment rule is "powerful because it operates deferentially" and that a court will not "substitute its judgment" as long as the action in question bears a relation to "any rational business purpose" (citing Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1373 (Del. 1995))).

324. DEL. CODE tit. 8, § 102(b)(7) (2020).

325. *See* E. Norman Veasey et al., *Delaware Supports Directors with a Three-Legged Stool of Limited Liability, Indemnification, and Insurance*, 42 BUS. LAW. 399, 404 (1987) (discussing the role of indemnification, as authorized by § 145 of the DGCL, in protecting directors).

326. *See id.* at 417 (stating that insurance covering directors fills the gap where indemnification is unavailable, thereby providing fuller protection against liability).

otherwise be loyalty violations by CEOs. These apply to takeover offers, CEO pay, derivative litigation, and other conflict transactions discussed in the next subpart.

C. A Shield for CEOs and Other Executives

The independent board has the power to confer business judgment protection even on those transactions that present severe conflicts of interest. To do so, it must secure approval of independent directors, acting either as a majority of the board or as the sole members of a committee, who are meant to stand in for shareholder interests. Bainbridge has cited this division of labor approvingly as an example of judicial recognition of the superior position of boards in corporate law, above courts.[327] The experience, however, of independent directors—who are deeply influenced by managers[328] —suggests additional scrutiny of this process is warranted. This subpart examines the relevance of independent directors for board actions that present elevated risks of manager opportunism at the expense of shareholders.

1. Defensive Measures and Deal Protections

Public firms frequently acquire other firms or are themselves the target of takeover bids in the market for corporate control. The takeover market is meant to provide an essential check on managers: as articulated in its classic form by Henry Manne and later elaborated by Eugene Fama and Michael Jensen, companies that do not perform well see a decline in their market capitalization, which facilitates their own takeover by other, stronger firms.[329] For managers and directors of firms that are the target of tender offers and other takeover measures, however, the benefits to the shareholders of creative destruction may not be front of mind. When a company is acquired, the old business ceases to exist as an independent

327. *See* Bainbridge, *supra* note 12, at 1068–81.

328. *See supra* Part III.

329. *See* Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112 (1965); *see also* Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 313–14 (1983) (contending that "the takeover market provides an external court of last resort for protection of residual claimants," i.e., shareholders).

entity.[330] Its board and management are customarily reshuffled through a mix of dismissals and demotions.[331] Thus, while they are obligated to act in the best interest of the corporation, both managers and directors tend to worry about the loss of pay, prestige, and power that often attends a merger into another firm.[332] On the other hand, when they receive an offer they find attractive, they may want to protect that offer even as they take soundings for higher bids.[333] Boards and their advisors have developed several mechanisms to take control of the deal process that complicates the free market theory of corporate control. The two most common categories of devices are defensive measures and deal protections, and in both cases, courts have held that the independent board precludes serious judicial review.

The poison pill, the premier defensive measure, allows boards to block tender offers outright.[334] True to their name, poison pills are intended to deter unsolicited bids by making acquisitions of a large percentage of the firm's equity economically suicidal for the acquirer: once a threshold is crossed, the pill is triggered and huge discounts are offered to

330. *See* Leannais v. Cincinnati, Inc., 565 F.2d 437, 439 (7th Cir. 1977) ("A merger, however, involves the actual absorption of one corporation into another, with the former losing its existence as a separate corporate entity.").

331. *See* Nicholas J. Price, *What Happens to a Company's Existing Board During a Merger?*, DILIGENT INSIGHTS (Mar. 5, 2020), https://perma.cc/D354-RQ8M (describing the process of board reconfiguration at the end of a merger).

332. *See id.* ("[M]ergers trigger uncertainty and ambiguity throughout the organization. The uncertainties cause a drop in the trust level. It's common for all or most board directors, managers and other employees to go into self-preservation mode.").

333. *See* Albert O. "Chip" Saulsbury, IV, *The Availability of Takeover Defenses and Deal Protection Devices for Anglo-American Target Companies*, 37 DEL. J. CORP. L. 115, 147 (2012) ("Target companies utilize deal protection devices to reduce the risk of withdrawal of a favorable offer to purchase the company. Directors may also use these provisions as leverage to negotiate a higher purchase price, which results in a greater premium for the company's shareholders.").

334. *See, e.g.*, Chase deKay Wilson, *Marty Lipton's Poison Pill*, 3 INT'L FIN. L. REV. 10, 10 (1984) (discussing the role of Wachtell Lipton in formulating the poison pill); Lucian A. Bebchuk & Robert J. Jackson, Jr., *Toward a Constitutional Review of the Poison Pill*, 114 COLUM. L. REV. 1549, 1568 (2014) (discussing the status of the poison pill under state law as it interacts with various sources of federal law).

every other shareholder to buy stock in the firm.[335] This operates as discrimination against one bidder—the first to cross the threshold—in favor of all other shareholders.[336] Boards can also adopt poison pills that "just say no" to *any* bid.[337]

Deal protections are meant to allow boards to encourage or protect an offer from a particular bidder. These include no-shop clauses, matching rights, and, very commonly, termination fees, which "operate to deter competing bids by impeding subsequent bidders from topping a favored bidder with a more attractive offer."[338] As a matter of law, boards adopting them face less scrutiny if their intention is to increase value for shareholders, but when they contain personal benefits for the target board or C-suite—such as continued board or executive service in the merged entity—they spark a more searching review.[339]

While both defensive measures and deal protections face the possibility of invalidation by Delaware courts, independent boards can successfully deploy and defend them in practice. A pair of Delaware Supreme Court cases from the mid-1980s establish the fiduciary obligations of the target board in mergers

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335. *See* Wilson, *supra* note 334, at 10–11.

336. *See* Matt Levine, *Don't Eat the Poison Pill by Mistake*, BLOOMBERG OP. (July 25, 2018, 11:02 AM) https://perma.cc/DV2K-WT2M

> [T]he way poison pills work is . . . just sort of unbelievable. Basically, if anyone triggers the pill—if they go over 10 or 20 or 31 percent of the stock or whatever the trigger is—then every *other* shareholder of the company gets offered the right to buy a ton of the company's stock at a big discount. If people exercise these rights—and they should because they offer the chance to buy stock at a big discount—then many more shares are issued and the triggering shareholder is massively diluted . . . . It just sort of seems like this shouldn't be allowed, that companies shouldn't be able to give massively discounted shares to all of their shareholders *except* the one they don't like.

337. *See e.g.*, Moran v. Household Int'l, Inc., 500 A.2d 1346, 1355–57 (Del. 1985) (upholding a shareholder rights plan (a.k.a., "poison pill") as a legitimate exercise of business judgment by the target company's board).

338. Anabtawi, *supra* note 50, at 171 & nn.34–36.

339. *See id.* (discussing the fact that transactions that contain inherent conflicts of interest—such as a sale of control or the adoption of deal protection devices—will be subjected to a higher scrutiny because the nature of those transactions might tempt even the most independent or disinterested director).

and acquisitions.[340] *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*[341] obligates directors of a board selling the firm to pursue the highest deal value available, which subjects any defensive measures such as poison pills to enhanced scrutiny review.[342] The other case, *Unocal v. Mesa Petroleum Co.*,[343] develops and applies the enhanced scrutiny standard in the context of defensive measures.[344] The two cases govern Delaware courts' review of deal protections as well.[345] *Unocal* concludes that enhanced scrutiny applies unless directors adopted measures that were both (1) "in good faith and upon a reasonable investigation pursuant to a clear duty to protect the corporate enterprise" and (2) "reasonable in relation to the threat that the board rationally and reasonably believed was posed" by an "inadequate and coercive" tender offer.[346] If the measure does satisfy those requirements, however, it will

340. *See id.* at 170 (observing that with regard to defensive measures and deal protections, "deference to the board [via the business judgment rule] is unwarranted. Without actual conflict, however, the entire fairness review would be too stringent").

341. 506 A.2d 173 (Del. 1986).

342. *See* Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 42 (Del. 1994) (stating that enhanced scrutiny applies to "(1) the approval of a transaction resulting in a sale of control, and (2) the adoption of defensive measures in response to a threat to corporate control"); *see also* Anabtawi, *supra* note 50, at 170 & n.31 ("In an M&A transaction negotiated by a company's board of directors, the specific contexts that give rise to enhanced scrutiny are the sale of control of the company or entering into deal protection devices." (citing Sean J. Griffith, *Deal Protection Provisions in the Last Period of Play*, 71 FORDHAM L. REV. 1899, 1901 (2003))).

343. 493 A.2d 946 (Del. 1985).

344. *See id.* at 954–55 (recognizing that in the face of a possible takeover bid, directors of a corporation are necessarily faced with a conflict of interest—i.e., their fiduciary duty to shareholders on one hand and the prospect of losing their jobs on the other—that requires judicial oversight).

345. *See, e.g.*, John C. Coates IV & Guhan Subramanian, *A Buy-Side Model of M&A Lockups: Theory and Evidence*, 53 STAN. L. REV. 307, 319 (2000) ("Uncomfortable with either extreme in the takeover context, the Delaware Supreme Court set up new standards of 'intermediate' review in two landmark cases in the mid-1980s—*Unocal Corp. v. Mesa Petroleum*, and *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*—each of which bears on the legality of lockups.").

346. *Unocal*, 493 A.2d at 958.

receive business judgment deference.[347] In *Unocal* itself, the court provided a road map to that goal: a showing necessary to satisfy the first prong (good faith and reasonableness) "is materially enhanced, as here, by the approval of *a board comprised of a majority of outside independent directors*."[348] That is to say, the court considers evidence of reasonableness and good faith to be materially more credible when independent directors approved of the challenged transaction.[349]

The erosion or "twilight" of enhanced scrutiny[350] was thus perhaps foreordained. Officially, the enhanced scrutiny standard sits on a continuum between the business judgment rule's extreme deference at one end and the more exacting standard of entire fairness review (requiring "judicial scrutiny of the substance of business transactions for objective fairness of both price and process") at the other.[351] After all, as Delaware courts have acknowledged, "the realities of the decision-making context can subtly undermine the decisions of even independent and disinterested directors,"[352] necessitating this intermediate level of review. In practice, however, the independent board has rendered enhanced scrutiny closer to the simple business judgment standard.

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347. *See id.* (stating that because the board's action in undertaking a selective stock exchange was made "in good faith and upon reasonable investigation" and was "reasonable in relation to the threat that the board rationally and reasonably believed was posed by [the bidder's] inadequate and coercive two-tier tender offer," it was "entitled to be measured by the standards of the business judgement rule").

348. *Id.* at 955 (emphasis added).

349. *See* Moran v. Household Int'l, Inc., 500 A.2d 1346, 1356 (Del. 1985) ("Moreover, that proof is materially enhanced, as we noted in *Unocal,* where, as here, a majority of the board favoring the proposal consisted of outside independent directors who have acted in accordance with the foregoing standards."(citing *Unocal*, 493 A.2d at 955; Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984))).

350. *See* Anabtawi, *supra* note 50, at 210 (concluding that the heightened fiduciary duty standards for M&A transactions initially introduced by the Delaware courts have given way to more judicial deference to board decisions).

351. *See id.* at 170 ("The enhanced scrutiny standard applies in contexts that make it plausible to infer that a board is making a decision in the face of dueling loyalties to both its own interests and those of the company's stockholders.").

352. Reis v. Hazelett Strip-Casting Corp., 28 A.3d 442, 457 (Del. Ch. 2011).

Delaware courts conducting a *Revlon* review now apply a "more deferential" standard to defensive measures.[353] They ask: "Did the board act in *bad faith* in pursuing a sale by *willfully disregarding its duty* to obtain maximum value for the target shareholders?"[354] Framing it this way makes decisions hard to review. Specifically, as Iman Anabtawi has explained, this query collapses *Revlon* duties into the analysis of directors' adherence to the fiduciary duties of care and loyalty, which are the preconditions for the application of the simple business judgment rule.[355] This makes judicial review of defensive measures more akin to stock-for-stock deals. The independent board exempts such deals from *Revlon* treatment, unless a majority of the board is insufficiently disinterested and independent.[356]

The Delaware courts have likewise effectively shut enhanced scrutiny out of deal protection review, as the *Unocal* court invited them to do.[357] *Paramount Communications, Inc. v. Time Inc.*,[358] and *Unitrin, Inc. v. American General Corp.*[359] are leading examples—specifically with respect to *Unocal's* first prong, which requires that the board exercise good faith and reasonable investigation before deciding that the challenged measures are warranted.[360] In *Paramount*, the court concluded that the target's decision not to negotiate with a bidder "cannot

353. *See* Anabtawi, *supra* note 50, at 172 ("The standards of review articulated in both *Revlon* and *Unocal* have been diluted judicially over time.").

354. *Id*. (emphasis added).

355. *See id*. ("More recently, however, *Revlon* duties have been subsumed into the traditional fiduciary duties of care and loyalty." (quoting *In re* Cornerstone Therapeutics Inc., S'holder Litig., 115 A.3d 1173, 1175 (Del. 2015))).

356. *See In re* Transkaryotic Therapies, Inc., 954 A.2d 346, 363 (Del. Ch. 2008) (defining this circumstance as "a majority of the board suffers from a disabling interest or lack of independence" or the board is dominated by directors who have a "material and disabling interest").

357. *See* Anabtawi, *supra* note 50, at 172 ("The Delaware courts have also eroded the *Unocal* standard of review, which the courts use to police over-reaching deal protection measures.").

358. 571 A.2d 1140 (Del. 1989).

359. 651 A.2d 1361 (Del. 1995).

360. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985).

be fairly found to have been uninformed" under the first prong.[361] It stated that "[t]he evidence supporting this finding is *materially enhanced* by the fact that twelve of [the target's] sixteen board members were *outside independent directors*."[362] The court in *Unitrin* emphasized the same point: *Unocal's* first prong required the board to show that, "after a reasonable investigation, it determined in good faith, that [bidder's offer] presented a threat to [the target] that warranted a defensive response," and "the presence of a majority of outside independent directors will materially enhance such evidence."[363] Both cases cite to the invitation in *Unocal* to use independent directors to bolster the case for immunizing the decision via business judgment review.[364] As to the *Unocal* standard of good faith and reasonable investigation, the Delaware Supreme Court has determined that the approval of independent directors, informed by financial and legal advice, is sufficient to make out a prima facie case.[365]

Reflecting on these decisions, "many commentators now believe that *Unocal* no longer provides the same level of enhanced review [for deal protection measures] that it once promised."[366] Some proposals urge a modest broadening of the universe of transactions understood to trigger enhanced scrutiny,[367] but would continue the independent board's central

361. *Paramount Commc'ns*, 571 A.2d at 1154.

362. *Id.* (emphasis added).

363. *Unitrin*, 651 A.2d at 1375.

364. *See id*. ("This Court has held that the presence of a majority of outside independent directors will materially enhance such evidence."); *Paramount Commc'ns*, 571 A.2d at 1154 ("The evidence supporting this finding is materially enhanced by the fact that twelve of [the target's] sixteen board members were outside independent directors.").

365. *See* Polk v. Good, 507 A.2d 531, 537 (Del. 1986) ("Here, the presence of the 10 outside directors on the Texaco board, coupled with the advice rendered by the investment banker and legal counsel, constitute a *prima facie* showing of good faith and reasonable investigation.").

366. Anabtawi, *supra* note 50, at 173. Observations in the same vein were made closer to the time as well. *See generally* Pease, *supra* note 302.

367. *See, e.g.*, Fernán Restrepo & Guhan Subramanian, *The New Look of Deal Protection*, 69 STAN. L. REV. 1013, 1069 (2017) (advocating for the application of the deal protection doctrine to provisions that have a deal protection effect even if "they might have some colorable business purpose" as well).

role.[368] Thus, a "principal impact of *Unocal*" remains the way it "shifts the locus of power from the board at large, not to the shareholders or to the court, but rather to the independent directors."[369] Delaware courts, in an effort to provide greater shareholder supervision of deal protection via the independent board, placed too much weight on that structure.[370]

2. Executive Compensation

Executive compensation is a high-priority topic for managers. In recognition of the potential for managers to use the mechanisms detailed in Part III to inflate their pay, Delaware courts and the market have evolved special procedures for boards to follow to increase the likelihood that executive compensation plans will receive business judgment protection, and thus immunity from judicial review.

The blueprint for the independent board to shield executive compensation is inscribed in Delaware precedents upholding the severance payment the Walt Disney Company made to its ex-chief Michael Ovitz.[371] In October 1995, Ovitz joined Disney from a successful talent partnership, where he had an annual income exceeding $20 million and an equity stake.[372] He founded the partnership and owned a majority stake in it, and would only agree to give that up for the Disney job if he received "downside protection" in exchange.[373] His Disney employment agreement guaranteed him minimum compensation amounting

368. *See id.* at 1052 (explaining *Unocal*'s framework without questioning its efficacy).

369. Marcel Kahan, Paramount *or Paradox: The Delaware Supreme Court's Takeover Jurisprudence*, 19 J. CORP. L. 583, 587–88 (1994).

370. *See id.* at 590 (stating that the shareholders' ability to elect and remove the independent board provides a sufficient balance of power such that courts do not have to engage in substantive review of board decisions).

371. *See In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 697 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006).

372. *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 36–37 (Del. 2006).

373. *Id.* at 37.

to around $24 million per year even in the event he was terminated early.[374]

Though Ovitz's arrival was greeted with great enthusiasm—Disney's stock price increased 4.4 percent on the news, adding $1 billion to its market value[375]—within about a year it became clear that "Ovitz was a poor fit with his fellow executives."[376] By fall 1996, the board was discussing the deterioration in the relationship between Ovitz and Disney, and was moving towards a dismissal.[377] Fourteen months after he was hired, Ovitz was terminated.[378] His employment agreement contained a provision that relieved Disney of the obligation to make a termination payment if he was fired "for cause," but the company was unable to find reason to activate that clause.[379] Accordingly, when Ovitz was terminated, he received a full "golden parachute" severance payment of $130 million.[380] This figure consisted of $38.5 million in cash (of which the board's compensation committee had prior knowledge) and about $91.5 million in options (as to which the knowledge picture was less clear).[381]

The litigation centered on whether the hiring and firing of Ovitz was reasonable, given among other things the size of the severance payment.[382] In examining this question, the court found it critical that a board of independent directors had approved Ovitz's contract.[383] Earlier challenges focused on alleged deficiencies in the independence of each Disney director,

374. *Id.* at 37–38, 38 n.9. For tax and other reasons, the plan was later revised somewhat. *See id.* at 38–41 (detailing the negotiations and agreement).

375. *Id.* at 40.

376. *Id.* at 41–42 (internal quotation marks omitted).

377. *Id.* at 42.

378. *Id.* at 35.

379. *Id.* at 43–44.

380. *Id.* at 35.

381. *Id.* at 57.

382. *See In re* Walt Disney Co. Derivative Litig., 825 A.2d 275, 277–78 (Del. Ch. 2003) (explaining that the complaint alleges that the directors did not exercise due care in deciding to hire and fire Ovitz).

383. *See In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 760 (Del. Ch. 2005) (applying the business judgment rule), *aff'd*, 906 A.2d 27 (Del. 2006).

but these were unsuccessful;[384] at one point, a court examined whether the former CEO, Michael Eisner, might have a biasing interest in the Ovitz contract, but concluded he did not.[385] These were important findings, since, as the Chancery court explained, Eisner had "stacked" the board "with friends and other acquaintances who, though not necessarily beholden to him in a legal sense, were certainly more willing to accede to his wishes and support him unconditionally than truly independent directors."[386] Nevertheless, because Ovitz's employment agreement—including the severance package—had been approved by a board of independent directors who met the narrow formal legal definitions of independence and disinterestedness, and was concluded upon the advice of a compensation consultant, the Supreme Court held that the business judgment rule attached to the decisions to hire and fire him, and thus to the payment of $130 million.[387] Specifically, these decisions constituted "*protected business judgments*, made without any violations of [the independent directors'] fiduciary duty," and as such they were shielded from shareholder challenge.[388]

The size of the severance in *Disney* is unusual, but that decision's reliance on the independent board to immunize executive compensation transactions is now canonical and common. Rather than exploring more deeply limitations of the independent board detailed in Part III, *supra*, Delaware courts

384. *See In re* Walt Disney Co. Derivative Litig., 731 A.2d 342, 361 (Del. Ch. 1998) ("[T]en of the fifteen directors who approved the Agreement and eleven of the sixteen who voted to honor the Agreement were independent in deciding the issues."), *aff'd in part, rev'd in part sub nom.* Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

385. *See* Brehm v. Eisner, 746 A.2d 244, 258 (Del. 2000) (affirming the lower court's ruling as to Eisner's alleged bias). To be precise, the court held the plaintiffs failed to create reasonable doubt about whether he had such an interest. *Id.*

386. *In re Walt Disney Co.*, 907 A.2d at 760.

387. *See In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 73 (Del. 2006).

388. *Id.* (emphasis added). The court also rejected plaintiffs' waste claim. *Id.* at 75.

police the boundaries of the rule.[389] For example, the Chancery court in *Amalgamated Bank v. Yahoo!*[390] observed of executive compensation plans that "a board cannot mindlessly swallow information" from third parties (such as compensation consultants), and must instead "exercise its own business judgment in approving an executive compensation transaction."[391] Another Chancery decision, *Friedman v. Dolan*,[392] explained that courts reviewing executive compensation decisions "typically defer[] to the *business judgment of independent directors* making compensation decisions."[393] Absent a breach of fiduciary duty, courts have "declined to scrutinize mere acceptance of compensation determined by an independent board or committee."[394]

In sum, the determination of executive pay is presumed proper and entitled to business judgment deference when it is made by formally independent outsiders whom the executives are widely acknowledged to influence. Courts ostensibly address the problems inherent in that process by interrogating directors' independent status, which tends to confirm the central role of independence in shielding manager decisions.

3. Derivative Litigation and Special Litigation Committees

When a shareholder believes the corporation has a legal claim against a director or officer, she can bring a derivative suit with the goal of triggering a lawsuit by the corporation against that party (or, more realistically, a settlement). Claims over Ovitz's contract in *Disney* fit this definition, as does the bulk of shareholder litigation.

389. *See id.* at 172 (stating that Delaware courts use the *Unocal* standard to "police over-reaching deal protection measures").

390. 132 A.3d 752 (Del. Ch. 2016), *abrogated on other grounds by* Tiger v. Boast Apparel, Inc., 214 A.3d 933 (Del. 2019).

391. *Id.* at 783

392. No. CV 9425, 2015 WL 4040806 (Del. Ch. June 30, 2015).

393. *Id.* at *9 (emphasis added).

394. *Id.* (footnote call omitted).

Since the claim belongs to the corporation and not the plaintiff, the board is entitled to weigh in on it.[395] The procedure to inform the board is known as a litigation demand, made by the plaintiff upon the board.[396] To evaluate the merits of the demand, the board must be independent as to the demand,[397] i.e., the directors must lack a personal interest in the litigation.[398] The directors are presumed independent at this stage, and the plaintiff bears the burden of showing that reasonable doubt exists as to the independence of a majority of the directors.[399] If the plaintiff carries that burden, then the demand requirement is excused.[400] The board at that stage will commonly constitute a committee of independent directors, typically called a special litigation committee, to consider the suit.[401] Their member-directors must be independent (under Delaware law) to perform this cleansing function, and bear the burden of showing it.[402] The determination of whether a demand

395. *See* Beam v. Stewart, 845 A.2d 1040, 1048 (Del. 2004) (stating that a plaintiff must make a demand of the directors that they pursue litigation before she can pursue a derivative suit unless that demand is excused under the *Aronson* standard).

396. *See id.*

397. *See id.* (stating that demand is excused if the directors are "deemed incapable of making an impartial decision regarding the pursuit of the litigation").

398. *See id.* at 1049 ("A director will be considered unable to act objectively with respect to a presuit demand if he or she is interested in the outcome of the litigation or is otherwise not independent.").

399. *See id*. at 1048–49 ("[T]he directors are entitled to a *presumption* that they were faithful to their fiduciary duties. In the context of a presuit demand, the burden is upon the plaintiff in a derivative action to overcome that presumption.").

400. *See id.* at 1049 ("If the Court determines that the pleaded facts create a reasonable doubt that a majority of the board could have acted independently in responding to the demand, the presumption is rebutted for pleading purposes and demand will be excused as futile.").

401. *See, e.g.*, *In re* Oracle Corp. Derivative Litig., 824 A.2d 917, 923 (Del. Ch. 2003) (describing the board's formation of a special litigation committee); Zapata v. Maldonado, 430 A.2d 779, 781 (Del. 1981) (introducing the special litigation committee procedure). An entire literature exists on the use and procedural mechanics of special committees, which will not be plumbed here.

402. *See In re Oracle Corp.*, 824 A.2d at 937 ("I begin with an important reminder: the SLC bears the burden of proving its independence. It must convince me.").

must be made turns on the independent status of the members of the board.[403]

As in the examples of mergers and executive compensation, corporate law's reliance on captured independent directors empowers managers to shield their own conduct in the highest-salience cases because independence triggers the application of business judgment immunity. As the Delaware Supreme Court said in the 1984 case *Aronson v. Lewis*,[404] "[t]he requirement of director independence [in considering litigation demands] inher[e]s in the conception and rationale of the business judgment rule. The presumption of propriety that flows from an exercise of business judgment is based in part on this unyielding precept."[405]

The independence-business judgment nexus is critical. The court explained: independence signifies "that a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences," and must reflect each director bringing her "own informed business judgment to bear with specificity upon the corporate merits of the issues without regard for or succumbing to influences which convert an otherwise valid business decision into a faithless act."[406] At the same time, it gave a sense of how difficult it would be for plaintiffs to show that a director had fallen short on independence.[407] For example, the court stated that it was not enough to show that a director had been installed directly or indirectly by a controlling shareholder, for the simple reason that (at that time) "[t]hat is the usual way a person

403. *See Beam*, 845 A.2d at 1048 (stating that demand is excused if the directors are "deemed incapable of making an impartial decision regarding the pursuit of the litigation").

404. 473 A.2d 805 (Del. 1984), *overruled on other grounds by* Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

405. *Id.* at 816.

406. *Id.*

407. *See id.* ("The shorthand shibboleth of 'dominated and controlled directors' is insufficient.").

becomes a corporate director."[408] It has scarcely become easier to challenge the independent status of a director.[409]

This process is now well established. By 1993, "courts both in and out of Delaware ha[d] ruled with near unanimity . . . that the business judgment rule is the appropriate standard of judicial review" where a majority of independents on the board decide to quash a derivative suit.[410] In practice, this means a captured board can shield managers with impunity. While one empirical study found that special litigation committees often recommend pursuit or settlement rather than dismissal of derivative suits,[411] another found that no special litigation committee "ha[d] ever recommended that derivative litigation continue against sitting directors . . . ."[412] Even the former finding is consistent with the independent board functioning as a shield: it provides managers with a way to resolve disputes against them expeditiously and with less fanfare, and the merits of the decisions to do so—once insulated by the independence board—receive business judgment immunity.

4. Management Buyouts

Acquisitions by managers of Delaware corporations they run trigger an elaborate review procedure.[413] In common with the corporate governance mechanisms described above, the availability of business judgment protection for a management

408. *Id.*

409. *See supra* Parts II–III. One arguable exception is where a controlling shareholder is present, but for reasons discussed in Part II.B.1, it is unclear whether new precedents in that area can be extended to non-controller cases.

410. Dennis J. Block et al., *Derivative Litigation: Current Law Versus the American Law Institute*, 48 BUS. LAW. 1443, 1443–44 (1993). The conclusion boards formally reach is that a lawsuit on behalf of the corporation will not serve the corporation's best interests.

411. *See* Minor Myers, *The Decisions of the Corporate Special Litigation Committees: An Empirical Investigation*, 84 IND. L.J. 1309, 1320 (2009) ("Over forty percent of the time the SLC [special litigation committee] either settled or pursued one or more claims against one or more defendants.").

412. ARTHUR R. PINTO & DOUGLAS M. BRANSON, UNDERSTANDING CORPORATE LAW 524 (4th ed. 2013).

413. *See* Kahn v. M&F Worldwide Corp., 88 A.3d 635, 644 (Del. 2014) (stating that the entire fairness standard, which is "the highest standard of review in corporate law[,]" usually applies to such mergers).

buyout (MBO) is conditioned on the use of independent directors.[414] *Kahn v. M & F Worldwide Corp.,*[415] known as *MFW*, sets forth the conditions under which a board's MBO process "qualif[ies] to be given cleansing credit under the business judgment rule."[416] This process consists of two requirements: approval by (1) an independent special committee of the board convened for the purpose of evaluating the transaction, and (2) a majority of the minority (non-controlling) shareholders.[417] The Delaware Supreme Court has described "the central objective" of *MFW* as being "to provide an incentive for controllers to embrace the procedural approach most favorable to minority investors, with the incentive of obtaining the protection of the business judgment rule standard of review."[418] Independent directors are a necessary precondition[419] for an MBO

414. *See id.* (stating that the controller must "irrevocably and publicly disables itself from using its control to dictate the outcome of the negotiations" for the transaction to be eligible for business judgment protection).

415. 88 A.3d 635 (Del. 2014).

416. *In re* MFW Shareholders Litigation, 67 A.3d 496, 501 (Del. Ch. 2013). In addition, while discussion of DGCL § 144 is reserved for Part IV.C.5, there is some possibility that that provision provides an additional mechanism of insulation for management buyouts. *See, e.g.*, Tuch, *supra* note 30, at 951–58, 981–82 (discussing the protection provided by § 144 in self-dealing transactions); Iman Anabtawi, *Predatory Management Buyouts*, 49 U.C. DAVIS L. REV. 1285, 1308 (2016) (explaining that the business judgment rule does not apply in conflict-of-interest transactions); Guhan Subramanian, *Deal Process Design in Management Buyouts*, 130 HARV. L. REV. 590, 650 (2016) (describing standards of review for MBOs under *MFW* and § 144); Matthew D. Cain & Steven M. Davidoff (now Davidoff Solomon), *Form Over Substance? The Value of Corporate Process and Management Buy-Outs*, 36 DEL. J. CORP. L. 849, 874–76 (2011).

417. *See M&F Worldwide*, 88 A.3d at 644 (setting forth the standard of review).

418. Flood v. Synutra Int'l, Inc., 195 A.3d 754, 756 (Del. 2018).

419. The full set of conditions was ably summarized in another Chancery case. *See* Se. Pa. Transp. Auth. v. Volgenau, No. CV 6354, 2013 WL 4009193, at *10 (Del. Ch. Aug. 5, 2013)

> The [*MFW*] Court held that the business judgment rule could apply if all of the following conditions were satisfied: (1) the controlling stockholder at the outset conditions the transaction on the approval of both a special committee and a non-waivable vote of a majority of the minority investors; (2) the special committee was independent, (3) fully empowered to negotiate the transaction, or to

transaction to "qualify to be given cleansing credit under the business judgment rule."[420] The underlying theory is that independence and other aspects of the process "had the effect of replicating an arms' length transaction," and thus "they had a 'cleansing' effect on the transaction that justified judicial review under the deferential business judgment rule."[421] Specifically, with regard to independent directors, the *MFW* Chancery court explained:

> [A] structure [that requires the approval of the independent directors is one] where stockholders get the benefits of *independent, empowered negotiating agents* to bargain for the best price and say no if the agents believe the deal is not advisable for any proper reason, plus the critical ability to determine for themselves whether to accept any deal that their negotiating agents recommend to them.[422]

In the MBO context, the assumption that independent directors will act in an informed manner, independent of managers, is even weaker than it is in a generic public company context.[423] As Da Lin has documented empirically, director seats are a form of "controlling shareholder patronage," which includes the prospect of future rewards as well as current

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> say no definitively, and to select its own advisors, and (4) satisfied its requisite duty of care; and (5) the stockholders were fully informed and uncoerced.

420. *See In re MFW Shareholders Litig.*, 67 A.3d at 501

> [I]t has to be clear that the procedural protections employed qualify to be given cleansing credit under the business judgment rule. For example, if the MFW special committee was not comprised of directors who qualify as independent under our law, the defendants would not be entitled to summary judgment under their own argument.

421. *See Se. Pa. Transp. Auth.*, 2013 WL 4009193, at *10 (discussing the standards set forth by the court in *In re M & F Worldwide*); *see also* Velikonja, *supra* note 83, at 882 ("Similarly, Delaware courts defer to outside directors' judgment in 'freeze-outs,' where a controlling shareholder of a public company buys out minority shareholders, so long as the process they adopted appears appropriate.").

422. *In re MFW Shareholders Litig.*, 67 A.3d at 503 (emphasis added).

423. *See supra* Part III.A.2.

rewards, that can "systemic[ally]" influence the behavior of formally independent directors.[424]

5. Related-Party Transactions Under DGCL § 144

Section 144 of the DGCL furnishes an analogous example of the board serving as a shield, via disinterested rather than independent directors.[425] This provision establishes the criteria by which transactions between the corporation and certain classes of persons, including managers and directors, can be rendered non-voidable notwithstanding the fact that they constitute so-called interested or related-party transactions.[426] Purchases by the corporation of real estate, a company, or another asset owned by a director are examples of such transactions.[427] A disinterested director is one who lacks an interest in the transaction.[428] While Section 144 applies to disinterested rather than independent directors, like the above categories it deploys the judgment of directors who are ostensibly neutral as a substitute for external oversight.

Section 144 identifies three ways for a contract with a covered party to remain valid, despite the conflict of interest: approval via a board process (the full board or a special committee approves it by a majority vote of disinterested directors); approval via a shareholder process (the shareholders approve it); and validation through a judicial process (the

424. Da Lin, *supra* note 100, at 518.

425. DEL. CODE tit. 8, § 144 (2020).

426. A fairly extensive literature exists on § 144 of the DGCL. Some commentators favor a broader read that attaches greater significance to a § 144 approval, contending that it "protects a self-dealing transaction not only from invalidation but also from distinct, additional fairness review." *See* Tuch, *supra* note 30, at 953 (distinguishing and explaining broad and narrow interpretations of § 144).

427. *See id.* at 941 ("[A]ny transaction between directors or officers and their corporation constitutes self-dealing . . . .").

428. *See* Blake Rohrbacher et al., *Finding Safe Harbor: Clarifying the Limited Application of Section 144*, 33 DEL. J. CORP. L. 719, 727 (2008) ("A director will generally be found to be 'interested'—and thus not a 'disinterested director' under section 144(a)(1)—if he or she stands on both sides of the transaction or has a personal stake in the transaction that is not shared by stockholders generally.").

transaction is later determined to be fair to the corporation).[429] None of these is sufficient on its own to activate the business judgment rule; however, any one of them will provide a safe harbor from a common law rule by which the transaction in question would have been rendered automatically void.[430] Specifically, the statute sets "a minimum requirement to retain the protection of the business judgment rule."[431] If the managers or directors wish to render the transaction eligible for business judgment shielding, the terms of Section 144(a)(1) allow them to secure the approval of an appropriate subset of disinterested directors.[432]

* * *

Management of the corporation is delegated to the board of directors by statute.[433] The reason for this is straightforward: courts are not institutionally equipped to make garden-variety business decisions, and would lack legitimacy if they attempted to do so. Substituting their judgment for that of business entities on everyday business matters also runs afoul of market principles. By its terms, however, this standard account is limited to the wisdom of *business* decisions. It properly applies to questions implicating the duty of care, but Delaware courts rightly do not extend them automatically to decisions implicating the duty of loyalty.

Yet despite the lack of any comparative advantage, the board's power to shield is not limited to "care" judgments and extends to board decisions that require independent directors to weigh their abstract loyalty to the firm against the concrete material advantages that come with supporting its managers.

429. DEL. CODE tit. 8, § 144(a) (2020).

430. *See* Tuch, *supra* note 30, at 952–53 (explaining the operation of § 144).

431. HMG/Courtland Props., Inc. v. Gray, 749 A.2d 94, 113 (Del. Ch. 1999). The provision does not conclusively determine whether business judgment or entire fairness applies, but as the court explains in *HMG/Courtland*, it does establish necessary conditions for the application of the more deferential business judgment rule. *See* Rohrbacher, *supra* note 428, at 735–36 (discussing the court's decision in *HMG/Courtland*).

432. *HMG/Courtland*, 749 A.2d at 114.

433. DEL. CODE tit. 8, § 141(a) (2020) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . . .").

Directors lack any obvious skill at determining if their CEO is acting in a self-interested way, for example—and there is reason to believe they may overlook such flaws, consciously or unconsciously.[434] In 1993, Stephen Bainbridge argued that boards are nevertheless given the ability to cleanse conflicts of interest because they exercise final authority.[435] Given the growing universe of decisions for which the independent board can be deployed as a shield, the normative case for maintaining this rule today is a harder one.

V. A Shield from Market Discipline

Shifts in market structure this century have supercharged managers' ability to deploy the combination of the independent board and the business judgment rule as a shield not only against judicial review but against market discipline.

Passive investment[436] and shareholder activism[437] have surged in terms of assets under management and broader market influence. Increasingly, outsiders to the corporation like mutual funds, institutional investors, activist shareholders, and proxy advisors invest resources in monitoring corporate

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434. *See supra* Part III.

435. *See* Bainbridge, *supra* note 12, at 1074–75 ("So long as the decisions are made by disinterested and independent directors, the net effect of the rules governing derivative litigation and the substantive standards is to preclude judicial review of the transaction."). Bainbridge favors a highly deferential standard generally. *See id.* at 1074 (arguing that shareholders benefit more from a "centralized management structure" than from close judicial scrutiny, and that "[t]he power to review . . . is necessarily the power to decide").

436. *See, e.g.*, Dorothy S. Lund, *The Case Against Passive Shareholder Voting*, 43 J. CORP. L. 493, 494 (2018) ("In the past few years, millions of investors have abandoned actively managed mutual funds . . . in favor of passively managed funds[.]"); Bebchuk et al., *supra* note 62, at 94 ("Passively managed funds increased from 1 percent of total fund assets in 1984 to 12.6 percent in 2006 . . . ."); Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 884–85 (2013) (discussing increased investment through mutual funds).

437. *See* Shill, *supra* note 162, at 1254 ("Shareholder activism is surging. By the end of 2015, activist hedge funds had come to manage $120 billion in investor capital, double the figure from three years prior, and ten times the total from 2005.").

governance matters.[438] These sophisticated actors participate in a new "market for corporate influence," and they "use the influence that accompanies their large ownership positions to discipline management."[439] They help curb "managerial slack, primarily because they identify underperforming firms as part of their investing strategy and are motivated to discipline wayward management."[440] But they have some well-documented limitations.[441]

For example, mutual funds have a limited ability to monitor and discipline portfolio companies.[442] The "Big Three" fund families, which have recently bulked up their governance ranks, have about one to two employees charged with monitoring every 1,000 of their portfolio companies.[443] It is difficult to imagine these ratios increasing to the point where funds can exercise effective discipline over all of their portfolio management teams. Activist hedge funds, which have an entirely different business model, nevertheless do not furnish much by way of counterexample: they deploy a large number of staffers per portfolio company, but invest in few companies.[444] Pershing Square, for example, has an investment team of eight who, together with other staff, monitor twelve companies.[445] Activist funds can be quite aggressive, so it is likely that their efforts

438. Activist hedge funds and mutual funds are both species of institutional investor, but operate differently. *See* Lund, *supra* note 436, at 498 n.16 (explaining different types of institutional investors).

439. *Id.* at 494–95.

440. *Id.* at 495.

441. *See, e.g.*, *id.* at 493 (arguing that passive funds lack appropriate incentives to ensure companies are well run and face collective action problems); *see also* Bebchuk et al., *supra* note 62, at 100 (same); Gilson & Gordon, *supra* note 176, at 863 (noting agency costs in institutional investment reflecting a gap in the interests of beneficial owners and the institutional investors who manage their assets).

442. *See infra* note 443 and accompanying text.

443. *See* Bebchuk et al., *supra* note 62, at 100 ("Vanguard employs about 15 staff for voting and stewardship at its 13,000 portfolio companies; BlackRock employs 24 staff for voting and stewardship at 14,000 portfolio companies; and State Street Global Advisors employs fewer than 10 staff for voting and stewardship at 9,000 portfolio companies.").

444. *See infra* note 445 and accompanying text.

445. Lund, *supra* note 436, at 516 n.112.

generate some *in terrorem* effect on companies outside their portfolio. Even this dynamic, though, focuses boards on highly visible weaknesses in their governance. In the market's view, insufficient independentness is a prominent example of such a weakness.

In all, the population of companies whose stock trades on the major U.S. stock exchanges numbers in the thousands.[446] The corporate governance of many flies under the radar of the limited teams monitoring them. Even proxy advisory firms like Institutional Shareholder Services (ISS) and Glass Lewis, whose business is to advise investors on companies' corporate governance, operate in an environment of scarce resources[447] and intensifying regulatory pressure, including new regulations of the industry from the SEC.[448]

Managers are well positioned to capture rents from these inefficiencies. With Big Three funds assigning small teams to monitor 9,000 to 14,000 portfolio companies,[449] the growing focus on corporate governance has created an information assimilation challenge. It expanded the market for information about governance without a way to effectively manage it. After all, firms are constantly advised that "[o]utside directors can bring expertise and independence to the board, which can

446. Shares of approximately 6,500 companies are traded on the New York Stock Exchange and Nasdaq combined; stock of a further 339 companies are traded on NYSE American (formerly the American Stock Exchange). *See Company List (NASDAQ, NYSE, & AMEX)*, NASDAQ, https://perma.cc/XJ9D-8S6E.

447. Their impact is often overstated. *See, e.g.*, Stephen Choi, Jill Fisch & Marcel Kahan, *The Power of Proxy Advisors: Myth or Reality?*, 59 EMORY L.J. 869, 869–71 (2010) (estimating on the basis of empirical evidence that industry leader Institutional Shareholder Services shifts 6–10 percent of shareholder ballots, and characterizing the firm's primary influence as that of an information aggregator).

448. *See* David Bell et al., *SEC Tightens Regulations on Proxy Advisory Firms*, HARV. L. SCH. F. CORP. GOVERNANCE (Aug. 18, 2020), https://perma.cc/TLZ9-PBN5; Exemptions from the Proxy Rules for Proxy Voting Advice, Exchange Act Release No. 34-89372, 85 Fed. Reg. 55,082 (to be codified at 17 C.F.R. pt. 240); Supplement to Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers, Investment Company Act Release No. 5547 (to be codified at 17 C.F.R. pt. 276).

449. *See supra* note 443 and accompanying text.

reduce agency costs and improve firm performance."[450] But how do firms prioritize? How do they avoid the crosshairs of an activist or proxy advisor,[451] which could in turn stimulate interest at a mutual fund that could tip a director election?

While complicated in principle, in practice staying in the good graces of corporate governance opinion leaders (proxy advisors and others) is straightforward. A version of this phenomenon began decades ago with federal requirements that mutual funds engage in informed voting, which in turn created demand for proxy advice and thus firms specializing in it.[452] ISS, Glass Lewis, and other proxy advisors prepare research and report cards on companies' governance structures to advise funds and other investors on voting their shares, and to advise companies on their own and one another's exposure.[453] Given an extraordinary volume of information and a need to facilitate comparisons, these materials tend to stress features of governance that can be readily standardized across public companies, and about which information is publicly disclosed and easy to ascertain.

Corporate governance by check box has attracted considerable criticism, but in a universe of scarce monitoring resources it is natural for market interest to coalesce around standardized, comparable metrics. ISS' voting guidelines are organized into seven categories.[454] The range of topics they touch is vast, but the level of board independence rates highly.[455] ISS recommends avoiding overboarding (director membership

450. DAVID F. LARCKER & BRIAN TAYAN, INDEPENDENT AND OUTSIDE DIRECTORS 15 (2015), https://perma.cc/K2QV-8KTP (PDF).

451. Arguably, the new SEC rule pertaining to proxy advisors makes it easier to avoid pressure from them. *See* Bell et al., *supra* note 448.

452. *See* Lund, *supra* note 436, at 517 (discussing how voting guidelines are influenced by proxy advisors like ISS and Glass Lewis).

453. *See generally ISS Governance*, INSTITUTIONAL S'HOLDER SERVS., https://perma.cc/UTL3-WYQB; *Glass Lewis: Company Overview*, GLASS LEWIS, https://perma.cc/3HQC-GSNL.

454. *See* INSTITUTIONAL S'HOLDER SERVS., UNITED STATES PROXY VOTING GUIDELINES BENCHMARK POLICY RECOMMENDATIONS 2–6 (2019) https://perma.cc/7JZT-LUQ9 (PDF) (listing categories); *see also id.* at 5–6 (listing an eighth category for mutual fund proxies).

455. *See id.* at 8 (listing independence as the first fundamental principle to apply when voting on the board of directors).

on an excessive number of boards), separating the roles of board chair and CEO, facilitating shareholder access to the proxy, and other highly visible, highly salient features of governance that are nevertheless relatively low cost to implement.[456] Pension funds similarly adopt guidelines that emphasize independence.[457] Investment banks, law firms, accounting firms, and other market intermediaries echo this message.

Since independentness currently codes as a quality favoring shareholders, enhancing the officially independent character of a board (under flawed definitions) is a cheap signal by managers that they are prioritizing that goal. Boards can obtain favorable voting recommendations from ISS and Glass Lewis—and thus avoid the spotlight—by following their guidance, thus virtually guaranteeing the reelection of their directors. In the overwhelming majority of cases, directors are reelected.[458]

The above dynamics have created a market for corporate governance information and influence that prizes independence. Just as in other markets, market actors can minimize scrutiny by complying with expectations. What is somewhat unusual in the case of corporate governance, however, is the focus on the level of board independence. This focus both reflects and intensifies the parallel emphasis on independent directors in Delaware law. Filtered through the limitations of the independent board[459] and the power of the business judgment rule,[460] it enables managers to place important aspects of their conduct—including decisions that create the potential for self-dealing—beyond the reach of market discipline.

456. *See id.* at 7–11, 19–20 (giving guidelines on the composition and independence of boards and shareholder proxy access).

457. For example, the voting guidelines of CalPERS, the California public employees' pension fund and one of the largest such funds, as of 2016 imposed an elevated disclosure expectation of companies with regard to independence. They asked companies to explain why any directors serving in excess of twelve years should still be considered independent. CA. PUB. EMPS. RET. SYS., GLOBAL GOVERNANCE PRINCIPLES 20 (Mar. 4, 2016), https://perma.cc/5C36-CN8E (PDF).

458. *See, e.g.*, James B. Stewart, *Bad Directors and Why They Aren't Thrown Out*, N.Y. TIMES (Mar. 29, 2013), https://perma.cc/T7XV-H8CU (noting that over 99 percent of directors were reelected in 2012).

459. *See supra* Part III.

460. *See supra* Part IV.

VI. Courts, Not Boards, Should Adjudicate Conflicts

Too much of modern corporate governance depends on the presumed virtues of outside independent directors. Such directors are increasingly called upon to clear transactions that create actual or penumbral conflicts of interest for them—and changes in market structure[461] since the rise of the independent model make this error more consequential than before. Managers exert tremendous influence over independent directors' status on the board, their pay, whether they are considered for future board and executive opportunities, and their ability to learn information about the firm and the managers they are charged with supervising.[462] Delaware courts are hardly unaware of this issue;[463] indeed, they have identified each of these as a problem.[464] In *Unocal*, for example, the court warned of the "omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders."[465] Yet in negotiating this tension, Delaware courts have settled on processes[466] that all hang on the same thin reed: the judgment of an independent board that has often been captured by managers and converted to a shield.[467]

In view of the combined danger posed by the independent board and the business judgment rule, this Part urges an end to business judgment deference in transactions implicating the duty of loyalty and a return to robust judicial review via the entire fairness standard. In the alternative, it proposes an expansion of shareholder voting.

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461. *See supra* Part V.

462. *See supra* Part III.

463. *See, e.g.*, *supra* Parts III–IV.

464. *See supra* Parts III–IV; *In re* Oracle Corp. Derivative Litig., 824 A.2d 917, 938–43 (Del. Ch. 2003) (commenting on various types of biasing ties).

465. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985).

466. *See, e.g.*, *In re* MFW S'holders Litig., 67 A.3d 496, 509 (Del. Ch. 2013) (articulating a standard that "the director in question's material ties to the person whose proposal or actions she is evaluating [must not be] sufficiently substantial that she cannot objectively fulfill her fiduciary duties").

467. *See, e.g.*, *supra* Parts II–V.

The best way to address the shield problem is by subjecting transactions with high self-dealing potential to review for entire fairness.[468] This standard calls for "judicial scrutiny of the substance of business transactions for objective fairness of both price and process."[469] It is the standard of review that Delaware courts apply when a transaction fails to receive business judgment deference.[470] If the possibility of business judgment review is removed, entire fairness becomes the logical, appropriate vehicle for assessing transactions that are currently shielded. When litigated, the decision by a company like Disney, for example, to enter into an agreement to pay $130 million in severance to a former CEO who was only briefly associated with the firm would be reviewed to determine whether it was entirely fair to the corporation and its shareholders.

Pressures on independent directors that Delaware courts (and stock exchanges) have spent decades dancing around[471] should, under Delaware law at a minimum, be considered conflicts of interest that render board decisions on conflict transactions ineligible for business judgment immunity. Unlike in ordinary business matters,[472] boards have no comparative advantage in deciding such questions. Courts—neutral decisionmakers who, especially in Delaware, are regularly called upon to adjudicate matters of equity—are a more desirable institution in which to vest such authority. Judge Easterbrook has emphasized this distinction. While we "praise" measures that align managers' incentives with those of shareholders, he observed, the notion of incentivizing *judges* with money is anathema to judging: "If a judge should bet on the

468. Today, once approved by the independent board, review of such transactions is essentially limited to waste. *See In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 73–74 (Del. 2006) (noting that appellants' waste claim is "rooted in the doctrine that a plaintiff who fails to rebut the business judgment rule presumptions is not entitled to any remedy unless the transaction constitutes waste").

469. Anabtawi, *supra* note 50, at 170.

470. *See id.* at 169–70 (discussing when the business judgment rule is applied compared to the entire fairness standard).

471. *See supra* Parts II–IV.

472. *See* Fairfax, *supra* note 83, at 140–41 (discussing greater legitimacy, expertise, and proactive capacity of boards to manage corporations, relative to courts).

astuteness of his business judgments by holding stock in the firms that appeared before him, we would hustle the judge off to jail."[473] Unlike generic business decisions that do not pose conflicts, decisions that present the prospect of self-dealing should be reviewable by judges and not only by those who stand to gain from the self-dealing. As Judge Easterbrook says, "[s]elf-interest is a powerful spur."[474]

It will be objected that companies are simply compelled by the market to guarantee large sums of money to prospective CEOs if they are to lure top talent (indeed, the *Disney* court seemed to think this was plausible).[475] Even if true today, this position excludes the possibility of dynamic reactions to change. If such packages were to come under more intense judicial and shareholder scrutiny, they would be required to meet elevated standards of fairness to the corporation. Boards would likely respond with fairer terms and greater transparency, both of which would be desirable. The risk that this new equilibrium would fail to produce an adequate quantity of qualified CEOs seems low.

Restoring entire fairness review would also place the determination of a legal question—whether a transaction constitutes self-dealing—into the appropriate hands: those of judges. Judges are uniquely well positioned to adjudicate conflicts of interest as a matter of competence and institutional role. Not only do they have deep experience in the area, they have taken an oath to pursue justice and fairness without partiality.

Even if imperfectly realized, the ideal of the judge and the institution of the judiciary is one of fairness. The four canons of the Delaware Judges' Code of Judicial Conduct command judicial neutrality by mandating "integrity," "independence," "impartiality," and the absence of judicial conflicts of interest.[476]

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473. Easterbrook, *supra* note 320, at 984.

474. *See id.* (explaining his support for pay-for-performance in executive compensation).

475. *See supra* Part IV.C.2.

476. DEL. JUD. ETHICS ADVISORY COMM., DELAWARE JUDGES' CODE OF JUDICIAL CONDUCT 9–20 (2008), https://perma.cc/QUA3-QE2S (PDF).

The canons of the federal counterpart are similar.[477] Corporate directors and managers, by contrast, are not valorized for fairness but for other qualities. They pursue shareholder wealth maximization. More specifically, self-dealing in the gray zones detailed in this Article does not run afoul of the legal constraints they currently operate under because any infirmities can be eliminated by independent directors.[478] And even when operating diligently and in good faith, they face structural, behavioral, and financial headwinds and incentives that compromise their ability to fairly adjudicate conflicts.[479]

It will also be objected that entire fairness will ensure more litigation. This is likely correct. In recent years, many reforms have been proposed to reduce shareholder litigation, and some have been adopted. There may be room for a welfare-maximizing change that simultaneously dials up the scrutiny of decisions currently shielded while dialing down other channels. In re *Trulia*, which limits the availability of disclosure-only settlements that do not make shareholders whole, may provide a model.[480] Inevitably, however, some certainty would be lost if the proposed shift is adopted. But the powerful shield furnished by current law allocates the benefit of that certainty almost wholly to managers, at great cost to shareholders and other stakeholders. This is hard to square with the principles underlying either the fiduciary duty of loyalty or shareholder wealth maximization (to say nothing of other theories of corporate purpose).

Recommended fixes to date that propose targeting the independence channel alone would be helpful but are insufficient. Yaron Nili, for example, suggests more robust disclosure of independents' potential conflicts of interest.[481] Lucian Bebchuk and Assaf Hamdani suggest the creation of "enhanced-independence" directors who would play a key role in

477. *See generally Code of Conduct for United States Judges*, U.S. CTS., https://perma.cc/ZG6J-UKKT (Mar. 12, 2019).

478. *See supra* Part IV.

479. *See supra* Part III.

480. *See In re* Trulia, Inc. S'holder Litig., 129 A.3d 884, 897–99 (Del. Ch. 2016).

481. Nili, *supra* note 116, at 70–72.

cleansing conflict transactions in controlled companies.[482] These solutions build broadly on enhancements to the independent board proposed a generation earlier by Ronald Gilson and Reinier Kraakman.[483] However, their common limitation is the expectation that independent directors can productively serve as a cleansing device for a wide range of conflict transactions. When independent directors decide on transactions of great personal interest to managers, such as CEO pay, they are *inherently* conflicted. This is not the kind of problem for which an internal solution, like disclosure, is a practical remedy. Other scholars, such as Lisa Fairfax, have counseled more structural solutions, for example a revival of governance by inside directors, though she has acknowledged the case is an "uneasy" one and has also called for more "rigorous review" by courts.[484]

A next-best solution would be to condition business judgment deference on shareholder ratification. Boards could have the option to submit decisions concerning CEO pay, poison pills blocking tender offers that shareholders would support, derivative lawsuits, and other matters implicating independent directors' interests to shareholders for express approval at an annual or special shareholder meeting. Delaware law already requires boards to submit many bet-the-company corporate decisions[485] and quasi-constitutional changes[486] to shareholder

482. Bebchuk & Hamdani, *supra* note 170, at 1290 ("Enhanced-independence directors should play an active role when a conflict arises between the interests of the controller and those of public investors.").

483. Gilson & Kraakman, *supra* note 170, at 883 (recommending "the introduction of outside directors to actively monitor public corporations in the shareholders' interest.").

484. *See* Fairfax, *supra* note 83, at 186.

485. The most prominent example concerns decisions that could conceivably transform or destroy the corporation before the next meeting. *See, e.g.*, DEL. CODE tit. 8, § 251(c) (2020) (merger requires approval of target's shareholders); *id.* § 271 (sale of substantially all the corporation's assets requires shareholder approval); *id.* § 275 (dissolution requires shareholder approval).

486. These include amendments to the corporation's articles of incorporation (DGCL § 242(b)(1)), changes to the bylaws (DGCL § 109(a)), the exculpation of directors or officers (DGCL § 102(b)(7)), authorizations of additional shares (DGCL § 242(a)(3)), and the election and removal of directors (DGCL § 141(k)), among other changes.

votes, and stock exchange rules[487] and federal law[488] further require shareholder approvals for executive compensation and other matters of special shareholder salience. This would be a modest extension, amply precedented.[489] Some of these votes would replicate ones, such as on executive compensation,[490] that are already mandatory under stock exchange or federal rules. However, if business judgment immunity were conditioned on favorable outcomes one would expect these votes to better reflect shareholder wishes. At the moment, federally mandated shareholder votes on executive pay are advisory and lack any legal effect.[491]

As a practical matter, this solution would likely trigger litigation over whether the stockholder vote was fully informed. The Delaware Supreme Court held in *Corwin v. KKR Financial Holdings*[492] that a fully informed vote of disinterested, uncoerced public shareholders forecloses claims of fiduciary duty breach—essentially, that it operates as a

487. *See Listed Company Manual*, *§ 303A.08 Shareholder Approval of Equity Compensation Plans*, N.Y. STOCK EXCH., https://perma.cc/585T-9NC4 (requiring shareholder approval of equity compensation plans).

488. *See, e.g.*, 26 C.F.R. § 1.422–3 (2020) (requiring shareholder approval of equity compensation plans).

489. For example, courts already consider board decisions regarding independent director compensation to implicate self-interest, and thus condition business judgment treatment on an informed, approving vote of shareholders. *See In re* Invs. Bancorp, Inc. S'holder Litig., 177 A.3d 1208, 1211 (Del. 2017) (holding that upon submission by the board of "specific [i.e., non-discretionary] compensation decisions for approval by fully informed, uncoerced, and disinterested stockholders, ratification [by shareholders] is properly asserted as a defense in support of a motion to dismiss" and thus business judgment immunity available). The MBO and related-party transaction contexts provide further precedent. *See* Kahn v. M&F Worldwide Corp., 88 A.3d 635, 642–54 (Del. 2014) (detailing MBO procedure); DEL CODE tit. 8 § 144(a)(2) (2020) (addressing submissions of related-party transactions to shareholders); *supra* Part IV.C.

490. *See, e.g.*, *supra* notes 487–488 and accompanying text.

491. *See* 17 C.F.R. § 240.14a–21 (setting forth procedures for shareholder consideration of executive compensation).

492. 125 A.3d 304 (Del. 2015). For an argument that *Corwin* does not amount to a reversal of shareholder protections, see generally Matteo Gatti, *Did Delaware Really Kill Corporate Law? Shareholder Protection in a Post-*Corwin *World*, 16 N.Y.U. J. L. & BUS. 345 (2020).

shareholder-approved shield.[493] Since that time, litigation has shifted away from the question of breach to the question of whether the shareholder vote was adequately informed.[494] If adopted, this change would likely provoke a similar shift, which should lower the expected value of this already modest change.

The shareholder ratification model, increasingly popular in Delaware,[495] also equates the approval of shareholders with permission to engage in transactions that verge on self-dealing. However, since it is an appropriation of *their own* assets that the conduct they are voting on potentially authorizes, this is not as objectionable as it may seem. An analogy would be allowing crime victims to negate the prosecution of those accused of victimizing them, a practice that prosecutors de facto permit in some cases even as it substitutes a private interest for the public interest. But there is some evidence to suggest the value of shareholder approval is significantly overstated and thus Delaware's "obsession with the shareholder vote" misplaced.[496] To be clear, this alternative suggestion is much less desirable than the primary reform advocated by this Article, but it is also more consonant with prevailing trends in Delaware law.

The better reform would be to make the broader category of self-dealing transactions this Article introduces[497] subject to judicial review for entire fairness. However, either change proposed here would address a longstanding mistake: the expectation that an "independent" board that is indebted to managers and has the power both to make corporate policy

493. *See Corwin*, 125 A.3d at 311–14 (holding that all facts regarding the board's interests, KKR's interests, and the negotiation process, were fully disclosed).

494. *See* Edward B. Micheletti et al., Corwin*,* MFW *and Beyond: Developing Trends in Delaware Disclosure Law*, SKADDEN INSIGHTS (Nov. 19, 2019), https://perma.cc/FTL2-F4X7 (discussing how courts in recent cases focus on whether shareholder votes were fully informed).

495. *See* James D. Cox et al., *Understanding the (Ir)relevance of Shareholder Votes on M&A Deals*, 69 DUKE L.J. 503, 528 (2019) (discussing how various factors caused Delaware courts to "put shareholder ratification on a pedestal").

496. *See id.* at 504 (contending that trades by merger arbitrageurs on the eve of a deal have "a positive and statistically significant impact on the likelihood of merger deals garnering the required shareholder approval").

497. *See supra* Part IV.

decisions that enrich managers and to shield them from review would reliably resist that temptation.

VII. Conclusion

While proponents and skeptics of shareholder power disagree on the effectiveness of the central institution of modern corporate governance—the independent board—both groups assume that it protects shareholders from opportunistic and predatory managers.[498] The legal requirements of "independence," however, set forth a standard that is very forgiving of potential conflicts of interest, and many reasons exist to believe directors are frequently incapable of overcoming those conflicts. Thus, once an independent board is seated and other procedural minima are satisfied, managers can use the board to shield self-interested transactions through the business judgment rule.[499] In short, the independent board's vision has been captured by the very cohort—managers—it was designed to constrain.[500] This paradox applies not only in the realm of law, but in the capital markets, where changes in market structure enable the independent board to frustrate both traditional and emerging mechanisms of market discipline.[501]

Previous proposals that advocate tweaks to the independence standard are unlikely to alter this dynamic.[502] Fortunately, Delaware law already provides good alternatives for managing conflict transactions.[503] The best choice is to simply submit such decisions to judges for review under the well-established entire fairness standard. Doing so would end the dubious use of the independent board as a vehicle for shielding corporate conduct from shareholders, courts, and markets. It would also constitute a step towards addressing the larger problem of which misplaced faith in the independent

498. *See supra* Parts I–II.
499. *See supra* Part IV.
500. *See supra* Parts III–IV.
501. *See supra* Part V.
502. *See supra* Parts III–VI.
503. *See supra* Part VI.

board is a symptom: the pervasive use in corporate and securities law of self-regulation as a substitute for traditional safeguards, like judicial review.