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Usha Rodrigues
University of Georgia School of Law, rodrig@uga.edu

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The Fetishization of Independence

Usha Rodrigues*

According to conventional wisdom, a supermajority independent board of directors is the ideal corporate governance structure. Debate nevertheless continues: empirical evidence suggests that independent boards do not improve firm performance. Independence proponents respond that past studies reflect a flawed definition of independence.

Remarkably, neither side in the independence debate has looked to Delaware, the preeminent state source for corporate law. Comparing Delaware's notions of independence with those of Sarbanes-Oxley and its attendant reforms reveals two fundamentally different conceptions of independence. Sarbanes-Oxley equates independence with outsider status. An independent director is one who lacks financial ties to the corporation and is not a close relative of management. Delaware's approach to independence, in contrast, is situational. As different conflicts arise in different contexts, the focus of concern—the influence from which we wish to insulate directors—varies as well.

There are at least two lessons for corporate reformers. First, the definition of independence should be refined to address the conflict at hand. For example, if the area of concern is executive compensation, the question is not merely whether the director lacks financial ties to the corporation and familial ties to corporate executives, but also whether the director lacks financial ties to the executives being compensated. Current independence rules overlook this obvious hole. Second, and more fundamentally, independent directors are useful only in situations where a conflict exists. An independent director—a part-timer whose contact with the corporation is necessarily limited—is not inherently better suited to further the interests of shareholders than an inside director. Current rules thus over-rely on independence, transforming an essentially negative quality—lack of ties to the corporation—into an end in itself, and thereby fetishizing independence.

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I. INTRODUCTION

Consider a hypothetical major U.S. corporation that presents a textbook example of good corporate governance. Two highly knowledgeable insiders (the CEO and CFO) sit

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on the board, as does the former CEO. Also on the board are seven independent[1] directors who have no management role, thus forming a strong supermajority bloc of wholly independent board members.[2] Further illustrating corporate governance best practices, the board's chairwoman is one of the independent directors, carefully chosen to take the helm in conjunction with the ouster of the corporation's former CEO. A sophisticated and seasoned financial executive, the chairwoman has studied books on governance, attended directors' workshops, and hired consultants to update the board's handbooks. With this independent board in place—meticulously selected to right the mistakes of the recent past—the corporation's stock has soared. But then, within the course of a month, the tapestry of success unravels.[3] One independent director, a flashy, risk-loving Silicon Valley mogul,[4] clashes repeatedly with the chairwoman. Allegations of board leaks, potential criminal behavior, and internecine conflict between board members lead to the chair's resignation and scandal for the entire corporation.

This corporation, as it turns out, is not a hypothetical firm, but in fact is Hewlett-Packard (HP), the 14th largest corporation in the United States.[5] Regardless of the blame that may ultimately be assigned to the various individuals on the board, the HP story illustrates the perils of relying on "best practices" corporate governance—such as a supermajority independent board—alone. Nevertheless, a student of corporate governance discourse over the past 40 years could easily conclude that independent boards are an essential—indeed, a natural—part of good corporate governance.[6] It is now conventional wisdom that independent boards *must* run companies, so obvious that it does not even warrant discussion.[7]

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1. As Donald Clarke discusses, different jurisdictions and corporate governance norms use different terms to describe the independent director. Clarke settles on the term "non-management director" because it captures the one element all the above terms have in common: the director in question is not a member of the current senior management team. Donald C. Clarke, *Three Concepts of the Independent Director*, 32 DEL. J. CORP. L. 73, 79 (2007).

2. Hewlett-Packard, Co., Definitive Proxy Statement (Form 14A) (Jan. 23, 2006), *available at* http://www.sec.gov/Archives/edgar/data/47217/000104746906000760/0001047469-06-000760-index.htm.

3. George Anders & Alan Murray, *Boardroom Duel: Behind H-P Chairman's Fall, Clash with a Powerful Director*, WALL ST. J., Oct. 9, 2006, at A1.

4. This director is Tom Perkins, ex-husband of Danielle Steele, and author of a steamy romance novel entitled SEX AND THE SINGLE ZILLIONAIRE (2006).

5. *Largest U.S. Corporations*, FORTUNE, Apr. 30, 2006, at F1.

6. Kenneth B. Davis, Jr., *Structural Bias, Special Litigation Committees, and the Vagaries of Director Independence*, 90 IOWA L. REV. 1305, 1306 (2005) ("Since the beginning of the corporate governance movement in the mid-1970s, enhancing the independence of corporate directors and their function on the board has been at the center of corporate governance reform."); Alan R. Palmiter, *Reshaping the Corporate Fiduciary Model: A Director's Duty of Independence*, 67 TEX. L. REV. 1351, 1438 (1989) ("The institution of outside directors has received voluminous attention. In the 1970s, advocates of corporate social responsibility, corporate regulators (such as the SEC and the stock exchanges), and corporate reformers focused attention on the subject.").

7. Note, *Beyond "Independent" Directors: A Functional Approach to Board Independence*, 119 HARV. L. REV. 1553 (2006); *see also* John H. Matheson & Peter D. Favorite, *Multidisciplinary Practice and the Future of the Legal Profession: Considering a Role for Independent Directors*, 32 LOY. U. CHI. L.J. 577, 609 (2001).

> Today, it is generally accepted by all concerned that independent directors may provide effective oversight of management and promote accountability. . . . Over the past [20] years, independent directorship has evolved from being the subject of interesting speculation to an assumed "best practice" for the most successful corporations in the world.

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Even so, in some corners of academia, debate about the value of independent directors persists.[8] Empirical studies have shown that a majority independent board does not improve firm performance—that is, firms with a majority of independent directors do not perform better for shareholders than those with a minority of independents.[9] In response, proponents urge ever-stricter definitions of independence. Surprisingly, however, participants in this debate have failed to examine the role of independence in Delaware, the preeminent source of corporate law in the United States.[10] This omission is particularly notable because Delaware's theory of independence differs radically from the conventional approach. Although practitioners have parsed Delaware's independence requirements in specific areas,[11] there has been no systematic examination of the role that independent directors play in Delaware, nor has anyone compared that role with the recommendations of independence-minded corporate governance activists.

This Article uses Delaware's approach to independence to question both the means and ends of director independence as currently conceived.[12] By "means," I refer to the way that independence is defined. The Sarbanes-Oxley Act of 2002[13] (SOX) and self-regulatory organizations (SROs) such as the NASDAQ and the New York Stock Exchange (NYSE) define independence by way of status: "independence" means outsider status. The hallmark of the independent director, so conceived, is an absence of ties to those in control of the corporation. SOX and the SROs gauge this lack of ties through the use of two metrics: (1) lack of financial ties to the corporation, and (2) lack of familial ties to the managers of the corporation. For example, under the NYSE rules, directors are not independent if they have received more than $100,000 in non-director fees, or are a close relative of executive management. Delaware, by contrast, takes a more contextual approach. Under Delaware law, one cannot determine independent status ex ante, before a conflict arises. Once a conflict triggers the need for an inquiry, Delaware looks to the specifics of the situation in order to determine independence. As a result, a person not

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Id.

8. Debate began in the 1970s when the American Law Institute (ALI) recommended the monitoring model and emphasized the importance of the independent director. John H. Matheson & Brent A. Olson, *Corporate Law and the Longterm Shareholder Model of Corporate Governance*, 76 MINN. L. REV. 1313, 1363-64 (1992). The ALI reforms largely carried the day. *See infra* Part II.B. Nevertheless, a series of empirical studies have questioned the connection between firm performance and majority outside independent boards. *See infra* Part III.C. More recently, Jeffrey Gordon has suggested an alternate explanation for the value of independent directors. *See infra* note 19.

9. *See infra* Part III.C.

10. Notable exceptions include Clarke, *supra* note 1, and Lisa M. Fairfax, *Sarbanes-Oxley, Corporate Federalism, and the Declining Significance of Federal Reforms on State Director Independence Standards*, 31 OHIO N.U. L. REV. 381 (2005) (discussing the Delaware Supreme Court's decision on director independence).

11. Grover C. Brown et al., *Director and Advisor Disinterestedness and Independence Under Delaware Law*, 23 DEL. J. CORP. L. 1157 (1998) (offering a survey of interested transactions and derivative suits).

12. In the terminology of Mitchell Berman, one might say that this Article attempts to distinguish an "operative proposition" from a "decision rule." *See generally* Mitchell N. Berman, *Constitutional Decision Rules*, 90 VA. L. REV. 1, 9 (2004) (referring to "constitutional operative propositions" as "constitutional doctrines that represent the judiciary's understanding of the proper meaning of a constitutional power, right, duty, or other sort of provision"). Constitutional decision rules direct courts in how to implement constitutional operative propositions. *Id.* In this case, then, this Article would argue that there are two dueling operative propositions regarding the proper function of the independent director, and two different decisional frameworks for courts (and corporate counsel) to use in determining whether a given director is independent.

13. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).

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related to an executive and who has never taken compensation from the corporation nonetheless may be deemed to lack independence for reasons of past obligation,[14] or even friendship with key managerial personnel.[15]

Delaware's approach provides a lesson for the SROs and corporate reformers[16] generally: a genuine concern about board-member independence requires focus on the conflict at hand. Both SOX and the SROs' definitional approaches suffer from the same deficiency: they address financial conflicts with the corporation and familial conflicts with corporate managers, but overlook *financial* conflicts with *managers*. For example, the chairman of UnitedHealth's compensation committee was independent under NYSE rules, but nevertheless arguably conflicted due to financial ties to the CEO.

But it would be a mistake to extrapolate from Delaware's concept of independence merely that the SROs' definitions of independence must be tweaked. Delaware's model provides the basis for a more trenchant critique of a conventional conception of independent directors. The SROs prescribe an independent board as the safeguard of shareholder interest, but this emphasis misconceives the ends of independence. Corporate governance advocates implicitly expect the director who lacks ties to the management of the corporation to be a positive good to the corporation. Delaware reminds us of the "end" board independence is supposed to achieve: a mechanism for handling conflicting interest. Public corporations inevitably face conflict situations in which the interests of management do not align with those of shareholders. It makes sense, for example, to place independents on audit committees (in case management is cooking the books), compensation committees (so management does not set its own salary), and nominating committees (so management does not select the board that is tasked with overseeing it). It does not follow, however, that it makes sense to require independence from all or most board members, as the SEC has historically recommended. At the least, because empirical data has shown that majority independent boards do not improve firm performance, a close look at the value of the SEC approach is in order.

Thousands of widely dispersed shareholders cannot run a corporation themselves: the board and corporate executives manage it for them. Therefore, the goal of corporate governance should be to incentivize both faithful *and* capable agents. Requiring independence—defined as outsider status—to the level of majority or supermajority elevates a negative quality (in the sense of a lack of an attribute, here financial ties to the corporation and familial ties to executives) to the status of a positive virtue. It thus fetishizes independence, which rightly conceived should be only a proxy for the truly loyal and capable agent.

Fetishizing the independence proxy is not just misguided; it is also dangerous. A

14. Lewis v. Fuqua, 502 A.2d 962, 966-67 (Del. Ch. 1985).

15. Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 833 A.2d 961, 979 (Del. Ch. 2003) ("[S]ome professional or personal friendships, which may border on or even exceed familial loyalty and closeness, may raise a reasonable doubt whether a director can appropriately consider demand. This is particularly true when the allegations raise serious questions of either civil or criminal liability of such a close friend."), *aff'd*, 845 A.2d 1040 (Del. 2004).

16. I will use the generic terms "corporate governance reformers," "corporate governance activists," and "corporate governance advocates" to denote scholars and institutional groups who focus on general corporate governance reform, almost always in the public corporation context. Thanks to the Conglomerate blog and commentators for help with this terminology. Responses to Posting of Usha Rodrigues to Conglomerate Blog, http://www.theconglomerate.org/2006/10/terminology.html (Oct. 6, 2006).

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2007 *Wall Street Journal* editorial proudly trumpeted the fact that 85% of the member companies of the Business Roundtable have boards with no less than 80% independent directors.[17] The editorial used this statistic to argue against reforms that would enlarge the voting rights of shareholders. After all, the author reasoned, shareholder interests were already well protected by the best safeguard corporate governance offers to shareholders, majority independent boards. But recent corporate history teaches us that independent boards can be cold comfort. Hewlett Packard hardly stands alone in illustrating that independent boards do not ensure proper corporate governance. Many corporations with supermajority independent boards have been tainted by scandal: Enron, WorldCom, Apple, Comverse, and UnitedHealth, to name only a few.[18]

Part II of this Article describes the conventional conception of independence, that is, the idea that independence is a determinable status. It then describes how and to what extent a majority independent board has become "best practices" corporate governance. Part III explains why the question of the utility of independence warrants reexamination. It explains that qualified independent directors are scarce, and that the value of such board members has come under question, particularly in light of recent empirical scholarship. Part IV describes independence under Delaware law, creating a "taxonomy" of independence. Part V then builds on the insights gained in Part IV by offering conclusions for both how independence should be defined and the purposes for which it should be used—the means and ends of independence. First, in characterizing independence, corporate governance reformers need to make its definition more context-specific. For example, to address the compensation committee problem, directors serving on that committee should be evaluated for financial independence from corporate executives, as well as from the corporation. Second, and more fundamentally, this Part advocates that corporate governance move from simple supermajority independent boards back to focusing on where outside independence truly matters: takeovers, related-party transactions, compensation, and derivative suits. Part VI examines some potential objections to extrapolating from Delaware's independence jurisprudence, particularly given that corporate governance advocates are most concerned with public companies, while Delaware frames its corporate law for both public and private corporations. The Part argues that, although there are some friction points, comparison between the two systems is fair and useful. Part VII offers concluding thoughts.

II. THE DOMINANCE OF INDEPENDENCE

A. The Conventional Definition: Independence as Status

Corporate governance reformers generally presume (1) that outside independent boards are better than non-independent boards, and (2) that the more independent a board is, the better. These positions presume that independence is a status, something one can

17. John J. Castellani, *Market Risk*, WALL ST. J., Jan. 20, 2007, at A10.

18. For example, a recent story shows that independent directors, as well as their insider counterparts, backdated their options. Steve Stecklow, *Study Cites Role Outside Directors Had with Options*, WALL ST. J., Dec. 18, 2006, at B3 ("The study is notable because it suggests that outside, or independent, directors—who are supposed to play a special role safeguarding against cozy board relationships with management—may have been co-opted in options backdating by receiving manipulated grants themselves.").

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define ex ante and identify on a board without reference to the context of a particular transaction. Independence means independence from the corporation, period. Melvin Eisenberg is probably most identified with this movement,[19] which finds its current expression in SOX and the SRO rules.

The conventional corporate governance understanding of "independence" translates roughly as "lack of ties to the corporation."[20] Corporate law reformers tend not to question this general conception of independence and instead focus on refining the definition to arrive at "truly" independent directors. As we will see, this causes a kind of disconnect within the conversation between Delaware law and corporate reformers. Delaware refers to directors without ties to the corporation as "outside" directors. "Independent" directors are something else altogether.

Sarbanes-Oxley illustrates the conventional understanding. Under SOX, the audit committee must consist entirely of independent directors, who in order to qualify cannot accept "any consulting, advisory, or other compensatory fee" from the company on whose board they sit.[21] The SEC's rules implementing SOX go further by prohibiting not only direct, but also indirect, compensation.[22]

The NYSE and the NASDAQ elaborate on SOX, following the same underlying philosophy. The NYSE Listed Company Manual emphasizes "independence from management."[23] The NYSE adopts both a standards- and rules-based approach.[24] The

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19. Jill E. Fisch, *Taking Boards Seriously*, 19 CARDOZO L. REV. 265, 271 n.41 (1997). Jeffrey Gordon recently defended independence in Jeffrey N. Gordon, *Independent Directors and Stock Market Prices: The New Corporate Governance Paradigm* (European Corporate Governance Inst. Law, Working Paper No. 74/2006, 2006), *available at* http://ssrn.com/abstract=928100.

20. Ira M. Millstein et al., *Ten Things That Every Director Should Know for 2004*, BUS. & SEC. LITIG. (Weil, Gotshall, & Manges LLP, New York, N.Y.), Jan. 2004, at 2-3 (stating that "by definition, independent directors are outsiders who lack significant relationships to the company"), *available at* http://www.weil.com/wgm/cwgmhomep.nsf/Files/BSLJan04/$file/BSLJan04.pdf; Olivier Diaz, *Counseling the European Board and Audit Committee*, *in* PLI'S THIRD ANNUAL INSTITUTE ON SECURITIES REGULATIONS IN EUROPE: A CONTRAST OF EU & USA PROVISIONS 271, at 289 (PLI Corp. Law & Practice, Course Handbook Series No. B-1400, 2003) (stating that "[f]or the sake of simplicity, an independent director can be defined as follows: 'A director is independent of the corporation's management when he or she has no relationship of any kind whatsoever with the corporation or its group which might risk coloring his or her judgment.'").

21. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 301, 116 Stat. 745, 775-77 (2002) (codified at 15 U.S.C. § 78j-l). SOX also disqualifies another class of individuals from being independent directors: affiliated persons of the corporation or any of its subsidiaries, i.e., large shareholders. *Id.* Because only SOX classifies large stockholders as non-independent, and because it does so solely for the purposes of audit committee membership, this Article will not focus on the affiliate aspect of the SOX definition.

22. Compensation from the corporation to certain members of the director's family or to certain types of entities where the director serves a specified role (for example, a director who is a partner at a law firm that receives legal fees from the corporation), counts as indirect compensation that would render a director non-independent under SOX. Unlike the rules of SROs such as the NYSE and NASDAQ, however, there is no "look-back" period. Once a director ceases to work for the corporation, for example, he may, depending on his stock holdings, immediately qualify as independent for SOX purposes.

23. NYSE, Inc., Listed Company Manual § 303.01(B)(2)(a) (2002).

24. *Id.* § 303.01-02 (2002); NEW YORK STOCK EXCH., CORPORATE GOVERNANCE RULE PROPOSALS REFLECTING RECOMMENDATIONS FROM THE NYSE CORPORATE ACCOUNTABILITY AND LISTING STANDARDS COMMITTEE AS APPROVED BY THE NYSE BOARD OF DIRECTORS AUGUST 1, 2002 (2002), *available at* http://www.nyse.com/pdfs/corp_gov_pro_b.pdf. The NYSE has proposed a change that would require companies to "disclose affirmative reasons for its findings that its independent directors are, in fact, 'independent.'" This change was proposed to address the concern that some listing companies were using only

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standard directs the board to determine affirmatively that the director has no "material relationship" with the company, either directly or as a partner, shareholder, or officer of an organization that has a relationship with the company.[25] Elaborate rules detail automatic exclusions from independence.[26] The NASDAQ rules, similar in spirit, differ only in the details.[27] Both the NYSE and NASDAQ go two steps beyond SOX by (1) requiring that a majority of the board be independent[28] and (2) considering not only current, but also prior, relationships in assessing the independence of directors.[29]

The cumulative effect of these requirements shows the thought and attention paid to ensuring that independent directors have absolutely no ties to the corporation.

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the specific tests for independence and neglecting their obligation to make their own assessment of a director's independence. *Stock Exchanges: NYSE Seeks Rule Change on Director Independence*, 9 Corp. Governance Rep. (BNA) 6 (Jan. 2, 2006).

25. Material relationships include "commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships, among others." NYSE, Inc., Listed Company Manual, § 303.01(B)(3)(b) (2002).

26. The rules specify that the director is automatically excluded if he or she: (1) is an employee of the company, or has an immediate family member who is an executive officer of the company; (2) "receives, or has an immediate family member who . . . receive[s]," more than $100,000 per year in direct compensation from the company ("other than director and committee fees" or certain "forms of deferred compensation for prior service [that] is not contingent . . . on continued service"); (3) is affiliated with or employed by, or has an immediate family member who is affiliated with or employed in a professional capacity by, the company's present or former internal or external auditor; (4) is employed, or has an immediate family member who is employed, as an executive officer of another company whose compensation committee includes an executive officer of the listed company; or (5) is employed by, or has "an immediate family member [who is an] executive officer of, a company that [makes] payments to, or receive[s] payments from," the listed company "in an amount which, in any of the last three fiscal years, exceeds the greater of $1 million, or 2% of such other company's consolidated gross revenues." NYSE, Inc., Listed Company Manual § 303A.02(b)(i)-(v) (2004).

In addition, unlike SOX, the NYSE contains a "look-back" provision, so that in each case, once the affiliation that tainted the director has ended (i.e., the director ceases to be an executive officer or her husband ceases to be an auditor of the corporation), three years must elapse before that director's ties with the corporation have "cooled off" sufficiently to qualify her as independent. NYSE, Inc., Listed Company Manual § 303A.02(b)(i) (2004).

27. Again, there is both a rule and a standards approach. The board is required to make an affirmative determination that no relationship exists that would interfere with the independent judgment of the director. NASDAQ Manual, Rule 4200(a)(15) (2007). Still, certain individuals are per se ineligible. One cannot be an independent director if one has (1) been employed by the company, a parent, or subsidiary; (2) oneself, or a close family member, been an executive officer of the corporation and accepted payments over $60,000 from the company; (3) a family member who was an executive officer of the company, or its parent or subsidiary; (4) been a partner, controlling shareholder, or executive officer of, another organization (including a nonprofit entity) if the company made payments to the organization that exceed the greater of $200,000 or five percent of the recipient's consolidated gross revenues for that year; (5) been employed as an executive officer of another entity, if any of the listed company's executive officers serve on the other entity's compensation committee; and (6) been a partner of the listed company's outside auditor in the current year, or a partner or employee of the listed company's outside auditor who worked on the company's audit. NASDAQ Manual, Rule 4200(a)(15)(A)-(F) (2007). Like the NYSE, the NASDAQ imposes a "look back" period of three years for these directors. NASDAQ, like the NYSE but unlike SOX, does not view ownership of company stock, in and of itself, as a bar to an independence finding. *Id.*

28. *See* NASDAQ Manual, Rule 4350(c)(1) (2007) (requiring that the majority of the board be comprised of independent directors); NYSE, Inc., Listed Company Manual § 303A.01 (2002) (requiring that the majority of the board be comprised of independent directors).

29. NASDAQ Manual, Rule 4200(a)(15)(A)-(F) (2007); NYSE, Inc., Listed Company Manual § 303.01(B)(3)(a) (2002).

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Legislators, SEC staff, and NYSE and NASDAQ rulemakers have constructed a labyrinth of rules in an attempt to prohibit all conceivable categories of ties: not only must the independent directors receive no money from the corporation,[30] but neither can members of their family.[31] The same rule applies to firms where they are partners or directors,[32] even if those firms are nonprofit organizations.[33]

Behind all of these rules lurks the belief that, by closing off connections to management, rulemakers can create the ideal board.[34] As discussed in Part II.B, this presumption has led to the modern ascendancy of the supermajority independent board, one free from ties to the corporation. I will argue that this move fetishizes independence by viewing outsider status as a proxy for excellence as a corporate agent. I will also argue that this approach is both insufficient and counterproductive.

B. The State of the Independence Debate

The current emphasis on independent boards has been building for many years.

30. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 301, 116 Stat. 745, 775-77 (2002) (to be codified at 15 U.S.C. § 78j-1).

31. *See generally* Rule 10A-3(e), 17 C.F.R. § 240.10A-3(e) (2007) (disallowing a spouse or child's acceptance of compensation); NYSE, Inc., Listed Company Manual § 303.01(B)(3)(d) (2002) (disallowing an immediate family member of a former executive officer from serving on a company's audit committee for up to three years following the resignation of the executive officer); NASDAQ Manual, Rule 4200(a)(15) (2007) (providing that a director who accepts any payments from a company over $60,000 in a three-year period will not be considered independent).

32. Rule 10A-3(e)(8), 17 C.F.R. § 240.10A-3(e)(8) (2007).

33. NASDAQ Manual, Rule 4200(a)(15)(D) (2007).

34. Status-defined "independent" directors also play a role in asset securitization. When an entity seeks to securitize certain assets to raise financing, it can create a "special purpose vehicle" (SPV) that receives the assets. Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133, 135 (1994). In order to protect SPV investors from the danger that the originating company will become insolvent and voluntarily petition for bankruptcy, SPVs commonly have independent directors and require the vote of these directors in order to file a voluntary petition, thus rendering the SPV "bankruptcy remote." STEVEN L. SCHWARCZ, STRUCTURED FINANCE: A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION § 3:2.1 (3d ed. 2006) [hereinafter SCHWARCZ, STRUCTURED FINANCE]. Definitions of the "independent" directors tend to be status-based. Standard and Poor's, for example, describes a "generally acceptable definition of 'independent director'" to be:

> A duly appointed member of the board of directors of the relevant entity who shall not have been, at the time of such appointment or at any time while serving as a director or manager of the relevant entity and may not have been at any time in the preceding five years, any of the following: A direct or indirect legal or beneficial owner in such entity or any of its affiliates; A creditor, supplier, employee, officer, director, family member, manager, or contractor of such entity or any of its affiliates; or A person who controls (whether directly, indirectly, or otherwise) such entity or any of its affiliates, or any creditor, supplier, employee, officer, director, manager, or contractor of such entity or its affiliates.

STANDARD & POOR'S, U.S. CMBS LEGAL AND STRUCTURED FINANCE CRITERIA 94 (2003), *available at* http://beta.standardandpoors.com/spf/pdf/fixedincome/040103_cmbslegalcriteria14.pdf. Another common status-based definition of independent SPV directors is "a person who is not a director (other than being a director of the SPV), officer, employee, or holder of 5% or more of the voting securities of the originator or of any of the originator's affiliates." SCHWARCZ, STRUCTURED FINANCE, *supra*. *But see In re* Kingston Square Associates, 214 B.R. 713 (Bankr. S.D.N.Y. 1997), for one bankruptcy court's critical examination of a supposedly "independent" director's behavior, and refusal to respect independent status alone.

Early drafts of the American Law Institute's (ALI) Principles of Corporate Governance stressed the importance of independent directors, requiring that they comprise a majority of the board of directors of large publicly held corporations.[35] In the 1980s, Delaware courts issued opinions that privileged the decisions of an independent board, adding fuel to the independence fire.[36]

These reforms arose from the perception that corporate boardrooms were insular and insider-dominated.[37] Instead of offering any real check on managers, boards were self-perpetuating institutions made up mostly of insiders handpicked by the CEO.[38] The danger of such a setup is self-evident: management plays the starring role in a morality play featuring unmonitored, and therefore faithless, agents.[39]

The arguments of independence proponents have largely triumphed.[40] Even before Enron's precipitous demise, most boards of directors of public companies had a majority, or supermajority, of independent directors.[41] Indeed, as of 2001, approximately 75% of NYSE-listed companies had independent board majorities and 65% of directors of S&P 1500 companies were independent.[42] By the time of the enactment of the Sarbanes-Oxley Act in 2002,[43] most public corporations had a supermajority independent board, with

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35. Stephen M. Bainbridge, *Independent Directors and the ALI Corporate Governance Project*, 61 GEO. WASH. L. REV. 1034, 1037 (1993) [hereinafter Bainbridge, *Independent Directors*]. Early iterations of the Principles required a majority independent board and completely independent nominating and compensation committees. *Id.* In response to criticism, the mandatory independence requirement became a recommendation, but the Principles also suggested increased deference by the courts to independent directors' decisions. *Id.* at 1043.

36. *See infra* Part IV.D.; *see also* Lawrence E. Mitchell, *Structural Holes, CEOs, and Informational Monopolies: The Missing Link in Corporate Governance*, 70 BROOK. L. REV. 1313, 1345 (2005) (stating that courts noted that independent boards received more deference).

37. Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231, 267 (2002) [hereinafter Bhagat & Black, *Non-Correlation*] (noting that in the 1960s "boards were insider dominated and usually passive").

38. Douglas M. Branson, *Enron—When All Systems Fail: Creative Destruction or Roadmap to Corporate Governance Reform?*, 48 VILL. L. REV. 989, 991 (2003).

39. Bainbridge asks and answers the rhetorical question: "Why . . . do independent directors have any corporate governance role? Because management is not perfectly faithful." Bainbridge, *Independent Directors*, *supra* note 35, at 1057.

40. Marcel Kahan & Edward B. Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U. CHI. L. REV. 871, 897-98 (2002). Note that in Kahan and Rock's narrative, the movement towards independent directors occurred at least in part because of board initiative: "Boards became increasingly independent with the acquiescence of incumbent board members; confrontational election contests designed to increase the number of independent directors are practically unheard of. In the latter case, shareholders were cheering while their board was acting." *Id.* at 902. It is worth asking why boards were so willing to bring in a watchdog of their own volition. Kahan and Rock suggest that it is because independent directors are the lesser of two evils; by adopting more independent boards, directors are spared the "less forgiving" discipline of the takeover market. *Id.* at 898.

41. Palmiter, *supra* note 6, at 1357 ("The public corporation landscape, since the 1960s, has come to be characterized by boards composed of a significant number, and often a majority, of outside directors.").

42. Lucian Arye Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Further Findings and a Reply to Symposium Participants*, 55 STAN. L. REV. 885, 897 n.32 (2002) (citing INVESTOR RESPONSIBILITY RESEARCH CTR., BOARD PRACTICES/BOARD PAY 2001: THE STRUCTURE AND COMPENSATION OF BOARDS OF DIRECTORS AT S&P 1500 COMPANIES (2002)).

43. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 301, 116 Stat. 745, 775-77 (2002) (to be codified at 15 U.S.C. § 78j-l).

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only one or two inside directors.[44]

The agency cost argument seems almost too natural to require proof from commentators: "An active and independent board of directors working for shareholders clearly would seem to benefit the corporation by reducing the losses from misdirected 'agency' inherent in the separation of ownership from control that is fundamental to the modern corporation."[45] Scholars trumpet the need for an "independent watchdog."[46] The governance industry (Institutional Shareholder Services (ISS), Standard & Poors, etc.) grades corporations on the independence of their boards via scorecards and ratings systems.[47] To oppose the institution of the independent director almost amounts to heresy.[48]

Today, scholars speak of the "norm" of a supermajority independent board,[49] while corporate governance activists clamor for boards on which independent directors make up a "substantial majority."[50] Chancellor Chandler and Vice Chancellor Strine of the Delaware Chancery Court have gone so far as to predict that SOX and related reforms will lead to a world in which the CEO is the board's *only* non-independent director.[51]

Especially against this backdrop, it is clear that recent SOX and SOX-related stock-

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44. Bhagat & Black, *Non-Correlation*, *supra* note 37, at 232 ("By 1997, the mean number of inside directors at S&P 500 firms . . . had dropped from three to two, and 56% of the S&P 500 firms had only one or two inside directors.").

45. Ira M. Millstein & Paul W. MacAvoy, *The Active Board of Directors and Performance of the Large Publicly Traded Corporation*, 98 COLUM. L. REV. 1283, 1291 (1998).

46. "Independent directors have proven their value to corporations' shareholders by serving as watchdogs over their investment." Matheson & Favorite, *supra* note 7, at 610.

47. Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921, 954 (1999) [hereinafter Bhagat & Black, *Uncertain Relationship*] (stating that "corporations are subjected to highly publicized report cards and rating systems"). ISS's U.S. Proxy Voting Manual observes that because the SROs mandate majority independent boards, the "best practices" bar has been raised, and many corporate governance groups—including the Business Roundtable, National Association of Corporate Directors (NACD), and the Blue-Ribbon Commission on Public Trust and Private Enterprise of The Conference Board, a private research firm, all recommend that a "substantial majority" of the board be independent. INST. S'HOLDER SERVS., U.S. PROXY VOTING MANUAL § 2 (2007) ("Voting on Director Nominees in Uncontested Elections"), *available at* http://www.issueatlas.com/content/subscription/usvmfiles/board-of-directors.html#AEN290. For an account of how common practices become enshrined as "best practices," see David Zaring, *Best Practices*, 81 N.Y.U. L. REV. 294, 297-98 (2006).

48. Kahan & Rock, *supra* note 40, at 892 (remarking on the claim to legitimacy of increasing independent directors and observing: "[I]t is hard to oppose more independent directors.").

49. Sanjai Bhagat & Roberta Romano, *Event Studies and the Law: Part II: Empirical Studies of Corporate Law*, 4 AM. L. & ECON. REV. 380, 403 (2002) (discussing "the norm of a 'supermajority independent' board with only one or two inside directors").

50. Bhagat & Black, *Uncertain Relationship*, *supra* note 47, at 921 (citing NAT'L ASS'N OF CORPORATE DIRS., REPORT OF THE NACD BLUE RIBBON COMMISSION ON DIRECTOR PROFESSIONALISM 9 (1996)). According to Bhagat and Black, CalPERS adopted guidelines under which the CEO would be the only inside director on an ideal board. *Id.* CalPERS appears to have modulated its position, and now advocates a "substantial majority" of independent directors. CALPERS, CORE PRINCIPLES OF ACCOUNTABLE CORPORATION GOVERNANCE 1, 8 (2007), *available at* http://www.calpers-governance.org/principles/domestic/us/downloads/us-corpgov-principles.pdf.

51. William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953, 1002 n.119 (2003).

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exchange reforms are merely the crest of a growing wave of reforms emphasizing director independence. At the same time, these changes legitimized the independence movement. As outlined in Part II.A., SOX itself mandated only the creation of a wholly independent audit committee[52] (although the law had the effect of significantly increasing the proportion of independent directors).[53] The NYSE and NASDAQ went beyond SOX: each exchange required that listing companies have (1) wholly independent nominating/corporate governance and compensation committees and (2) a majority independent board.[54] In short, while independence was the norm for large public companies even before the new rules went into effect, SOX and the exchange reforms reflect a renewed emphasis on the importance of using independent directors, at the expense of managerial control of the corporation.[55]

III. WHY REVISIT INDEPENDENCE?

If the consensus is that more outside independent directors are better, why focus on independence at all? First, anecdotal evidence suggests that the heavy demands placed on independent directors and the concomitant threat of increased liability discourage people from agreeing to serve, thus creating a scarcity of well-qualified independent candidates; it makes sense to consider how many independent directors we actually need and what their appropriate role should be. Second, and more fundamentally, there is reason to question whether—even assuming there is an ample supply of independent directors—they provide the sort of unadulterated benefit that conventional wisdom suggests.[56]

A. Lack of Candidates and Increasing Cost of Independents

The renewed focus on, and increased expectations of, independent directors may be discouraging them from service.[57] Additionally, the demands on the time of an

52. More precisely, the Exchange Act provides that if the board has no audit committee, the whole board is to be treated as an audit committee. Standards Relating to Listed Company Audit Committees, Securities Act Release No. 8220; Exchange Act Release No. 47,654; Investment Company Act Release No. 26,001, 79 SEC Docket 2876 (Apr. 9, 2003).

53. Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1588 (2005) (citing James Linck et al., Effects and Unintended Consequences of the Sarbanes-Oxley Act on Corporate Boards 16-18 (March 2005) (unpublished manuscript), on the effect of SOX on the independent directors of small and large firms)).

54. Self-Regulatory Organizations, NYSE & NASD, Order Approving Proposed Rules Changes, Exchange Act Release No. 48,745, 68 Fed. Reg. 64,154 (Nov. 12, 2003) (approving NYSE Final Rule, Final Corporate Governance Listing Standards (codified at NYSE, Inc., Listed Company Manual § 303A (2002)) and NASD Amendments to Rules 4200 and 4350(c)).

55. Stephen M. Bainbridge & Christina J. Johnson, *Managerialism, Legal Ethics, and Sarbanes-Oxley Section 307*, 2004 MICH. ST. L. REV. 299, 305 ("Taken together, Sarbanes-Oxley and the stock exchange proposals thus constitute a substantial effort to shift the balance of power from management to the independent directors.").

56. One flashpoint of controversy has been the SEC's rule proposing to require the increase in the required number of independent directors on mutual fund boards from a majority to 75%. Mutual funds are outside the scope of this Article, but it is worth questioning what role independents have on a mutual fund board, and whether that role differs from that of a corporate board.

57. *Developments in the Law—Corporations and Society: And Now, the Independent Director! Have Congress, the NYSE, and NASDAQ Finally Figured Out How to Make the Independent Director Actually*

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independent director have increased significantly, with commitments now averaging around 180 hours per year.[58] Because directors often have demanding full-time jobs, these increases in hours make serving as an independent director less appealing. Well-publicized out-of-pocket settlements by Enron and WorldCom independent directors have reinforced fears of personal liability,[59] not to mention the reputational costs of being at the helm of a scandal-plagued company.

Of course, these accounts are merely anecdotal; there is an argument that these are growing pains associated with breaking down the historical barriers that have kept corporate boardrooms homogenous for so long. While progress has been made, women and minority candidates remain a largely untapped pool of talent, and it is not clear that there is a true dearth of qualified candidates.[60]

Regardless of the truth of claims of scarcity of qualified directors, it does seem clear that the perceived increase in liability exposure means higher costs, including higher director fees.[61] Director and officer (D&O) insurance premiums have risen as risk has increased.[62] Candidates for outside independent director positions may require increased insurance coverage or more robust indemnification rights, and more intangible costs lurk below the surface, such as excessive caution by independent directors fearful of

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Work?, 117 HARV. L. REV. 2169, 2203 n.88 (2004) [hereinafter *Developments in the Law*] (citing *Symposium on Corporate Elections* 14, 26-27 (Harvard Law Sch., Discussion Paper No. 448, 2003), *available at* http://ssrn.com/abstract=471640); Stephen M. Bainbridge, *A Critique of the NYSE's Director Independence Listing Standards* 7 (UCLA Sch. of Law Research Paper Series, Research Paper No. 02-15, 2002) ("Public corporations are finding it increasingly difficult to recruit and retain qualified independent directors."), *available at* http://ssrn.com/abstract=317121; *see, e.g.*, Michael T. Burr, *Securing the Boardroom*, CORP. LEGAL TIMES, June 5, 2005, at 53 (suggesting that directors are more wary of accepting board appointments following the WorldCom and Enron scandals), *available at* http://www.mtburr.com/Images/CLT/Feature_Jun05.pdf; Anne Fisher, *Board Seats Are Going Begging*, FORTUNE, May 16, 2005, at 204 (stating that there is a shrinking pool of independent directors from which companies can recruit), *available at* http://money.cnn.com/magazines/fortune/fortune_archive/2005/05/16/8260173/index.htm; Suzanne McGee, *The Great American Corporate Director Hunt*, INSTITUTIONAL INVESTOR, Apr. 1, 2005, at 32 (describing factors that encourage directors to refuse offers to join boards).

58. Sung Hui Kim, *The Banality of Fraud: Re-Situating the Inside Counsel as Gatekeeper*, 74 FORDHAM L. REV. 983, 1061 n.475 (citing MELVIN ARON EISENBERG, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS 156 (9th ed. 2005) for the proposition that outside directors spend about 180 hours per year on board work, including preparation and travel time). As Chancellor Chandler and Vice Chancellor Strine point out, the SEC's rules providing for an optional Qualified Legal Compliance Committee can create further burdens on independent directors. Chandler & Strine, *supra* note 51, at 981 n.80.

59. Bernard Black et al., *Outside Director Liability*, 58 STAN. L. REV. 1055, 1058-59 (2006) (commenting on outside directors' concern that they will be sued for oversight failures).

60. Jayne W. Barnard, *More Women on Corporate Boards? Not So Fast*, 13 WM. & MARY J. WOMEN & L. 703 (2007) (discussing the future of board diversity); Lisa M. Fairfax, *Some Reflections on the Diversity of Corporate Boards: Women, People of Color, and the Unique Issues Associated With Women of Color*, 79 ST. JOHN'S L. REV. 1105 (2005) (discussing board representation and the barriers to women, especially women of color).

61. Romano, *supra* note 53, at 1588 (discussing the financial burden imposed by SOX).

62. Risk has gone up, measured by rise in D&O insurance premiums. James S. Linck et al., Effects and Unintended Consequences of the Sarbanes-Oxley Act on Corporate Boards (May 16, 2006) (unpublished manuscript) (discussing the fact that insurance premiums more than doubled post-SOX), *available at* http://ssrn.com/abstract=902665.

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litigation.[63]

B. The Value of Outside Independent Directors

Beyond the fact that outside independent directors are an expensive, arguably scarce resource, some observers have raised fundamental questions about their utility. Critics suggest that outsiders lack the time, information, and motivation to manage the corporation effectively.[64] Independents are by definition individuals from *outside* the corporation, who generally have demanding day jobs that keep them from devoting much time to board affairs.[65] For this reason, they rely on corporate officers and other employees for information and tend to defer to insiders' management recommendations.[66]

As for incentives, two problems can emerge: a disinclination to criticize fellow executives, and a lack of motivation to do so. With respect to inclination, independent directors traditionally were nominated by insiders and, in any event, generally are selected from the business community to ensure that they will have adequate expertise. Because of structural bias, it may be difficult for them to criticize either their fellow directors or the officers of the corporation.[67] Therefore, they are often unwilling to second-guess managers. Reforms that made the nominating committee independent were designed to address the concern that directors were inherently beholden to insiders for board seats. Policies granting directors stock options or restricted stock were

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63. Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 818 (2001) (discussing the costs of subjecting directors to increased liability risk).

64. Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 26 (2002) (citing MYLES L. MACE, DIRECTORS: MYTH AND REALITY (1971), a famous study of directors).

65. *Id.*; Bainbridge, *Independent Directors*, *supra* note 35, at 1058 (noting that outside directors have neither the time nor the information to be involved in day-to-day management).

66. For an excellent treatment of the extent to which outside directors rely on inside directors for information about the corporation, and the potential negative repercussions of this reliance when there are only a few insiders on the board, see generally Mitchell, *supra* note 36, at 350 (stating that if the only insider is the CEO, then "as the sole bridge between corporate management and the board, the CEO is put in an enormously powerful position. He has a monopoly over the information delivered to the body ultimately responsible for the integrity of corporate management and information"). *See also* Palmiter, *supra* note 6, at 1437 ("[T]he board is generally dependent on the information management chooses and presents to it."); Dynamics Corp. of Am. v. CTS Corp., 794 F.2d 250, 256 (7th Cir. 1986) ("The so-called outsiders moreover are often friends of the insiders. And since they spend only part of their time on the affairs of the corporation, their knowledge of those affairs is much less than that of the insiders, to whom they are likely therefore to defer."), *rev'd on other grounds*, 481 U.S. 69 (1987).

67. Julian Velasco, *Structural Bias and the Need for Substantive Review*, 82 WASH. U. L.Q. 821, 824 (2004).

> The term "structural bias" generally refers to the prejudice that members of the board of directors may have in favor of one another and of management. It is said to be the result of the "common cultural bond" and "natural empathy and collegiality" shared by most directors, the "economic[] or psychological[] dependen[cy] upon or tie[s] to the corporation's executives, particularly its chief executive," and the "process of director selection and socialization, which incumbent management dominates."

Id. (internal citations omitted).

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implemented in order to align outside directors with shareholders. The success of these measures is debatable, at best.[68]

C. Empirical Evidence That Independence Does Not Matter

These structural concerns about the value of independence are supported by empirical research. Professor Roberta Romano and Professors Sanjai Bhagat and Bernard Black have surveyed a number of studies regarding the relationship between independence and both firm performance and particular managerial tasks.[69] The data indicate that independence does not lead to improved firm performance and may even be associated with sub-optimal performance.[70] Likewise, independence fails to correlate with improved performance in specific areas. Studies on the performance of independent audit committees, for example, found no relation between committee independence and performance.[71]

Furthermore, although supermajority outside independent boards have become the norm, empirical research suggests that their benefits remain unproven. As Bhagat and Black observe:

> No study asks whether there are behavior differences between, for instance, a board with six independent directors out of nine (67%), and a board with seven out of nine (78%) or eight out of nine (88%) independent directors. Yet current conventional wisdom calls for supermajority-independent boards, with only one or two inside directors on a typical nine or eleven member board.[72]

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68. *See, e.g.*, Charles M. Elson, *Director Compensation and the Management-Captured Board—The History of a Symptom and a Cure*, 50 SMU L. REV. 127 (1996) (discussing the link between board compensation and board passivity). Structural bias continues despite independent nominating committees, and increased option grants may not have aligned directors with shareholders as planned.

69. Bhagat & Black, *Uncertain Relationship*, *supra* note 47, at 923-33, 940-44; Romano, *supra* note 53, at 1521.

70. Romano, *supra* note 53, at 1530. Romano conducts a survey of the literature, and draws these conclusions. Still, some competing data does exist that suggests that independence may be beneficial after all. Corporate governance activists may argue that the earlier studies were flawed because they relied on earlier incarnations of board "independence" that did not truly capture the more modern notion of independence. Ira Millstein and Paul MacAvoy found a positive relationship between independent boards in the newer era of more "active" governance. Ira M. Millstein & Paul W. MacAvoy, *The Active Board of Directors and Performance of the Large Publicly Traded Corporation*, 98 COLUM. L. REV. 1283, 1318 (1998); *see also* Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U. L. REV. 898, 921 (1996) (pointing to studies showing a statistically significant relationship between the percentage of outside directors on a board and shareholder returns). For a catalogue of some of these studies, see Bainbridge, *Independent Directors*, *supra* note 35, at 1062. Bainbridge points out one study that found that majority independent boards were more likely to remove an underperforming CEO than insider-dominated boards. *Id.* at 1062 (citing Barry B. Baysinger & Henry N. Butler, *Revolution Versus Evolution in Corporation Law: The ALI's Project and the Independent Director*, 52 GEO. WASH. L. REV. 557 (1984)). The Baysinger and Butler study found that corporate financial performance initially increases as independent directors are added, but that "the optimal percentage of independent directors is well below the majority requirement championed by the reformers." Baysinger & Butler, *supra*, at 572-75.

71. Romano, *supra* note 53, at 1530. Nor does the literature generally show that completely independent audit committees reduce the likelihood of financial statement misconduct, although the results are more mixed. *Id.* at 1533.

72. Bhagat & Black, *Non-Correlation*, *supra* note 37, at 235.

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This conventional wisdom survives despite empirical indications that more independence is not necessarily better.[73]

Advocates for independence have a ready answer: existing studies are flawed because they do not measure "true" independence.[74] That is, many of the so-called "independent" directors of the 1980s and 1990s were only nominally independent:[75] they were outside legal counsel or investment bankers for the company, suppliers, or other so-called "grey" directors.[76] In defense of independence, and in the face of the empirical evidence, Professor Donald Langevoort observes: "If we could identify truly independent directors more precisely, perhaps we would find the expected correlation."[77]

Jeffrey Gordon explains the rise of the independent director by arguing that as the shareholder primacy model took hold, the monitoring function of the board became both more important and easier to implement.[78] As the SEC increased disclosure requirements, stock prices became more informative, enabling more effective monitoring. He argues that the importance of firms throughout the economy committing to shareholder wealth maximization by instituting independent directors "swamps" any advantages gained by a particular firm in having more or fewer independents.[79] Independence thus cannot be evaluated in isolation, but rather in terms of the overall improvements that this changed environment has produced.

Gordon's account, although a persuasive descriptive justification for the increasing presence of independents on boards, does not by itself justify the move to *supermajority* independent boards. While an increase in the number of independents, even to the point of a majority independent board, might lead to better monitoring, it does not follow that a two-thirds or even higher percentage of outsiders will continue to improve matters.

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73. Baysinger and Butler state that:

> [T]he addition of independent directors to a corporate board is subject to both diminishing marginal increases and absolute declines in relative performance. If this were not true, then the boards of all profit-maximizing firms would be totally independent. Our inquiry into optimal board composition revealed that the optimal percentage of independent directors is well below the majority requirement championed by the reformers.

Baysinger & Butler, *supra* note 70, at 573-74.

74. One commentator stated:

> Yet none of these studies speaks to whether a board implementing the current panoply of structural and procedural reforms would perform better than a *prereform* 'independent' board. . . . Read in this light, such studies point toward a narrower conclusion than the one that their authors seem to reach: putting independent directors on a board is unlikely to have much effect on financial performance if not accompanied by the implementation of structures and procedures to counteract the social and psychological constraints that paralyze many facially independent boards.

Developments in the Law, *supra* note 57, at 2200.

75. Bainbridge, *Independent Directors*, *supra* note 35, at 1059.

76. Bhagat & Black, *Non-Correlation*, *supra* note 37, at 239.

77. Langevoort, *supra* note 63, at 799; *see also* Charles M. Elson, *Enron and the Necessity of the Objective Proximate Monitor*, 89 CORNELL L. REV. 496, 502 (2004) ("Had [the directors] been both *truly* independent from management, and significant equity holders in the company, the Enron tale might have had a less dramatic and devastating conclusion.").

78. 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, 1469 (2007).

79. *Id.* at 1471.

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Furthermore, as Gordon himself admits, his descriptive account suggests the importance of focusing on mechanisms that lead to greater independence "in fact."[80]

D. Resisting the Fetishization of Independence

Even as corporate governance reformers champion independence, some admit to misgivings. Professor Langevoort, for example, believes that the word "independence" should connote not just a lack of financial ties to management, but also "a willingness to bring a high degree of rigor and skeptical objectivity to the evaluation of company management and its plans and proposals."[81] The imprecision inherent in the word "independence" means that the empirical studies necessarily must use "rough proxies for independence": "the simple absence of a job with the company, a lack of a close family connection, or (perhaps) the absence of a regular stream of income from the company apart from directors' fees and dividends are all that it takes to qualify."[82] Langevoort observes that "[u]nder these restrictive definitions, many directors who lack any real desire to take their monitoring role seriously—who are on the board for reasons of status-seeking, sociability, or the perquisites that come with board membership—fall into the 'independent' category, thereby muddying the data."[83] His conclusion is that independence, defined in terms of non-management status alone, does not guarantee a good monitor.

Langevoort's worries signal a fundamental divide in the discourse about boardmember independence. After examining Delaware's conception of independence, we will be able to understand better the root cause of his frustration, which has to do with the *goals* of independence. The ideal board member brings to the boardroom business expertise. She is intelligent, committed, willing to ask tough questions, but also able to work with management. As an ideal, all directors should be "truly" independent in this way, free from any extraneous influences that would prevent them from acting in the shareholders' best interest. Achieving this type of independence is the real goal of corporate governance—to create rules that will maximize the likelihood of capable and faithful agents.

Modern corporate governance discourse reduces this goal to outside independent status. In a sense, this move is defensible. Many of the conflicts that arise in public corporations are between management and shareholders. Managers might steal from the corporation, so having outsiders on the audit committee, monitoring the corporate books, makes sense. Insiders may pay themselves too much, so having outsiders on the compensation committee is beneficial. And insiders may conspire to elect their friends to the board, so an outside independent nominating committee is also logical. To presume, however, that mere outsider status—defined by lack of ties to the corporation—makes a director an ideal fit for any board, is to fetishize a mere proxy for the good agent. By reminding us of the true goals of independence, Delaware forces us to rethink the current supermajority independent board and what is fair to expect of outside directors.

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80. *Id.*

81. Langevoort, *supra* note 63, at 798.

82. *Id.*

83. *Id.* at 798-99.

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IV. "INDEPENDENCE" UNDER DELAWARE LAW

It makes sense to seek guidance in Delaware law for two reasons. First, Delaware is the dominant source for corporate law in the United States.[84] Delaware's preeminence in the field makes it a logical place to start in addressing a key question of corporate law.[85] Second, even if one rejects the idea of Delaware's as necessarily the "best" corporate law, when searching for an alternative to the national corporate governance model, it makes sense to look to the states. The focused attention that Delaware gives to its corporate code and case law,[86] coupled with the high volume of corporate law cases that the Delaware courts consider,[87] means that Delaware's law can be taken as a fair representative of state

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84. Jill E. Fisch, *Institutional Competition to Regulate Corporations: A Comment on Macey*, 55 CASE W. RES. L. REV. 617, 619 (2005). This is not the place to revisit the old debates about racing to the top or to the bottom, but if one believes that the federalism system of competition can lead to the creation of the more efficient corporate law, then the majority of corporations will presumably register under the most beneficial system. The majority of American corporations are registered in Delaware. Thus, one could argue, Delaware's corporate law provides the best definition of independence. This position is articulated in William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974) and Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 254-58 (1977). *See generally* ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (1993) (discussing "Delaware's preeminence in the corporate charter market").

85. As it turns out, almost all states follow Delaware's approach. Some states do discuss independence in their codes, but they do not define independence as status. Instead, they adopt a contextual definition. For example, a corporation's independent directors may move to dismiss a derivative suit. "Independent," for this purpose, is defined contextually, as a director who does not have an interest in the proceeding. *See* MODEL BUS. CORP. ACT § 1.43(a)(1) (2002), which defines "qualified" directors as those who do not have "(i) a material interest in the outcome of the proceeding, or (ii) a material relationship with a person who has such an interest."; *see also id.* § 7.44 cmt. 1 (1999) (stating that "[t]he concept of an independent director is not intended to be limited to non-officer or 'outside' directors but may in appropriate circumstances include directors who are also officers"). States that follow the Model Business Corporations Act's use of independence in derivative suits include: Florida (FLA. STAT. ANN. § 607.07401 (West 2007)); Georgia (GA. CODE. ANN. § 14-2-744 (West 2003)); Hawaii (HAW. REV. STAT. ANN. § 414-175 (LexisNexis 2007)); Idaho (IDAHO CODE ANN. § 30-1-744 (2007)); Iowa (IOWA CODE ANN. § 504.635 (West 2007)); Maine (ME. REV. STAT. ANN. tit. 13-C, § 755 (2005)); Massachusetts (MASS. GEN. LAWS ANN. ch. 156D, § 7.44 (West 2004)); South Dakota (S.D. CODIFIED LAWS § 47-1A-744 (2007)); Utah (UTAH CODE ANN. § 16-10a-740 (West 2007)). Tracking Delaware, mere nomination or election of the director by defendants, and the naming the director as defendants is not enough to render a director non-independent in the following states: Arizona (ARIZ. REV. STAT. ANN. § 10-850 (2007)); Georgia (GA. CODE ANN. § 14-2-744 (West 2007)); Hawaii (HAW. REV. STAT. ANN. § 414-175 (LexisNexis 2007)); Iowa (IOWA CODE ANN. § 504.635 (West 2007)); Montana (MONT. CODE ANN. § 35-1-545 (2007)); Nebraska (NEB. REV. STAT. § 21-2074 (2006)); New Hampshire (N.H. REV. STAT. ANN. § 293-A:7.44 (2007)); North Carolina (N.C. GEN. STAT. ANN. § 55-7-44 (West 2007)); Rhode Island (R.I. GEN. LAWS § 7-1.2-711 (2007)); and Wisconsin (WIS. STAT. ANN. § 181.0744 (West 2007)). Finally, Iowa (IOWA CODE ANN. § 501A.711 (West 2007)); Minnesota (MINN. STAT. ANN. § 302A.241 (West 2007)); North Dakota (N.D. CENT. CODE § 10-19.1-48 (2007)); and Wisconsin (WIS. STAT. ANN. § 193.451 (West 2007)) provide that the board may establish a special litigation committee consisting of one or more independent directors, and that all committees except the SLCs are "subject at all times to the direction and control of the board" (MICH. COMP. LAWS. ANN. § 450.1495 (West 2007)). For the two states that deviate from Delaware and take an outsider-status approach to defining independence, see *infra* note 233.

86. Delaware has self-consciously invested in its corporate law in several ways, among them creating a separate judiciary for corporate cases, requiring the vote of two-thirds of both houses of the legislature to amend the corporate code, and deriving such a high percentage of its revenue from corporate franchise taxes. These combine to make corporate law much more important to Delaware than to the average state.

87. E. Norman Veasey & Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and*

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law, at least if a state were to prioritize its corporate law.

In contrast to the standard corporate governance definition of independence, which equates independence with outsider status, Delaware courts conduct a more nuanced inquiry into independence in two ways. First, Delaware courts examine a director's behavior as an indicator of independence, creating a contextual approach—rather than looking only to rigid proxies like the lack of a familial or financial relationship—in gauging the lack of improper influence or conflicts of interest.[88] Second, Delaware examines each conflict specifically, looking at a mix of factors rather than a preprogrammed set.[89] SOX, the NASDAQ, and the NYSE all make the blanket assumption that outsider status—that is, lack of financial or familial ties to the company—is the best indicator for independence. Delaware courts, in contrast, first focus on the reason for the independence inquiry. This focus makes their analysis less "status" driven, in the sense that it is not based on the status of independence from the corporation. Instead, Delaware courts can examine the independence of a director from a majority stockholder, from a potential acquirer, or from the current CEO. Conflicts associated with these individuals are not entirely captured by SOX's prohibitions on ties to the corporation.[90]

A. Distinguishing Between Independence and Interest

Given the current emphasis on the importance of independent directors, it may be surprising to note that the Delaware General Corporation Law (DGCL) does not contain a single reference to independent directors.[91] Instead, the DGCL speaks only of the narrower concept of "interested directors." Directorial independence is an important part of Delaware law, but the concept arises solely from judicial opinions, not statutes. As two

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Governance from 1992-2004? A Retrospective on Some Key Developments, 153 U. PA. L. REV. 1399, 1414 (2005).

88. Of course, corporate governance advocates do not have the luxury of pointing to specific behaviors in particular cases because they aim to provide guidelines for companies searching for suitable future directors. This distinction will be dealt with in Part VI.A., *infra*.

89. Parts of this comparison will remind readers of the classic rules versus standards debate. *See generally* Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685, 1685 (1976) (describing in general "the different rhetorical modes found in American private law opinions, articles and treaties"); Margaret Jane Radin, *Presumptive Positivism and Trivial Cases*, 14 HARV. J.L. & PUB. POL'Y 823 (1991) (providing a justification for legal rules-based decision making); Pierre Schlag, *Rules and Standards*, 33 UCLA L. REV. 379 (1985) (explaining why the rules versus standards debate is meaningful); Kathleen M. Sullivan, Foreword, *The Justices of Rules and Standards*, 106 HARV. L. REV. 22 (1992) (exploring the consequences of the application of legal rules and standards in a variety of constitutional issues).

90. Both Delaware and the corporate governance reforms share some baseline presumptions as to human nature, such as, for example, that a group in the majority is more likely to resist the influence of a potential dominator than is a group in the minority. For a thoughtful discussion of this point, see Leo E. Strine, Jr., *The Inescapably Empirical Foundation of the Common Law of Corporations*, 27 DEL. J. CORP. L. 499 (2002).

91. Interestingly, the Delaware Lawyers' Rules of Professional Conduct do contain a reference to independent directors, albeit in the comments. When discussing Rule 1.13, "Organization as Client," the commentary states that "[t]he organization's highest authority to whom a matter may be referred ordinarily will be the board of directors or similar governing body. However, applicable law may prescribe that under certain conditions the highest authority reposes elsewhere, for example, in the independent directors of a corporation." DEL. LAWYERS' RULES OF PROF'L CONDUCT R. 1.13 cmt. (2003). Delaware law or, at least, Delaware's statutory law, never prescribes that the highest authority of a corporation reposes with the independent directors.

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prominent Delaware jurists have explained, awareness of the difference between interest and independence is "vital."[92] A director is interested in a given transaction if she stands to gain monetarily from it in a way that other shareholders do not.[93] If a director is interested and the transaction is challenged, it will be subject to the rigorous "entire fairness" test.[94]

In contrast, the concept of "independence," as developed by the Delaware courts, is broader than that of simple financial interest; it examines whether a director, although lacking in a financial self-interest, is somehow "beholden" to an individual who is interested, or whose decisions are not based on the corporate merits, but rather are influenced by "personal or extraneous considerations."[95] The focus is therefore not always on strict financial ties; that is the ambit of "interest." Instead, for "independence" Delaware courts broaden the inquiry into more amorphous ties that can generate a sense of "beholdenness." Common membership in a university,[96] charitable giving,[97] and friendships[98] can all factor into the equation.

Interest is worth discussing in some detail because it can be looked at as a subspecies—perhaps the most archetypal example—of independence. When someone has a financial interest in a transaction, there is no need to make any further inquiry into whether the director is independent—i.e., whether there is an extraneous influence that might keep the director from acting in the best interest of the corporation. That handicap is presumed by virtue of the conflicting interest.

In contrast to the conventional account of "independence" in the corporate governance literature, the concepts of "interest" and "independence" in Delaware law are both transaction-specific and have what I call a "situational" or "contextual" character. Any application of the definitions will necessarily involve looking at the challenged transaction for guidance. In Delaware, unlike under SOX, the NYSE, or NASDAQ, one cannot determine independence or interest ex ante. One must instead ask: "Independent for what purpose? Independence from whom?"[99] Defining independence in isolation is impossible because the challenged transaction holds the key. Therefore, as we go through paradigmatic situations where Delaware courts have analyzed interest and independence,

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92. Chandler & Strine, *supra* note 51, at 997-98.

93. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (stating that "directors can neither appear on both sides of a transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally"); ROBERT C. CLARK, CORPORATE LAW § 4.1, at 147 (1986) (defining "conflict of interest" as a transaction between the corporation and another person where the allegedly interested individual has decision-making power with the corporation and "has a greater personal interest in the welfare of the other person involved in the transaction, or in certain collateral consequences of the transaction, than in the welfare of the . . . corporation").

94. Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983).

95. Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 362 (Del. 1993).

96. *In re* Oracle Corp. Derivative Litig., 824 A.2d 917, 942 (Del. Ch. 2003).

97. Lewis v. Fuqua, 502 A.2d 962, 966-67 (Del. Ch. 1985).

98. Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 833 A.2d 961, 979 (Del. Ch. 2003) ("[S]ome professional or personal friendships, which may border on or even exceed familial loyalty and closeness, may raise a reasonable doubt whether a director can appropriately consider demand. This is particularly true when the allegations raise serious questions of either civil or criminal liability of such a close friend."), *aff'd*, 845 A.2d 1040 (Del. 2004).

99. E. Norman Veasey, *Should Corporation Law Inform Aspirations for Good Corporate Governance Practices—or Vice Versa?*, 149 U. PA. L. REV. 2179, 2180-82 (2001).

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we can arrive at a better understanding of what the terms actually mean.

B. Conflicting Interest Transactions and Self-Dealing

1. Delaware's Exploration of the Nuances of "Interest"

Delaware jurisprudence has evolved from the common law rule that conflicting interest transactions are voidable to a more nuanced and contextual analysis.[100] As traditionally understood, self-dealing occurs whenever a corporate fiduciary stands on both sides of a transaction.[101] In contrast, the understanding of a conflicting interest transaction under modern-day Delaware law focuses on whether a director, officer, or controlling shareholder of a corporation has a financial interest in a transaction that is not shared by the other shareholders in a corporation. This is both a narrower and broader concept than traditional self-dealing. On the one hand, even when a fiduciary stands on both sides of the transaction, it may not obtain any special benefit from the transaction. For example, if a controlling shareholder in need of funds causes the corporation to issue large dividends, which arguably limit the expansion potential of the corporation, the decision to declare a dividend would not represent a conflicting interest transaction. Although the controlling shareholder benefits from the decision, all of her fellow shareholders will also benefit proportionate to their holdings.[102]

On the other hand, Delaware courts have gradually acknowledged that conflicting interest transactions can arise even when a party does not stand on both sides of the transaction and there is therefore no "self-dealing," as traditionally understood. For example, if a corporation is considering the purchase of a building, and the CEO's wife is the realtor, who will make a $1 million commission if the sale goes through, then the CEO may have a financial interest in the transaction, even though he has no direct financial interest in the party on the other side, the seller of the building. So, despite the lack of self-dealing, the CEO may be interested.[103]

2. Section 144: Another Example of Delaware's Flexibility

Conflicting interest transactions are vulnerable to attack in two different ways under Delaware law. First, such transactions may be void or voidable, and second, conflicting transactions do not receive the protection of the business judgment rule, and thus are

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100. Marciano v. Nakash, 535 A.2d 400, 403 (Del. 1987) (citing Kerbs v. Cal. E. Airways, Inc., 90 A.2d 652 (Del. 1952), for the common law rule, and section 144 of the Delaware Code for the statutory rule).

101. Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1169 (Del. 1995).

102. Sinclair Oil Corp. v. Levien, 280 A.2d 717, 721-22 (Del. 1971). A large number of cases deal with a subset of these transactions, where a director, officer, or controlling shareholder, rather than shareholders generally, stands to benefit exclusively from a contemplated merger. For example, a director might be appointed to a lucrative senior executive position within the company resulting from the merger. These cases will be dealt with separately in Part IV.D.1, *infra*.

103. What if the wife's commission was $1000? In *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345 (Del. 1993), and *Cinerama*, 663 A.2d 1156, the Delaware Supreme Court dealt somewhat painfully with this question. It concluded that, in the absence of self-dealing, the personal financial benefit that the director receives must be substantial in order to render that director interested. *Cede*, 634 A.2d at 363-64. The court applies a "subjective 'actual person' standard" in its analysis. That is, it decides whether the financial interest was material enough to affect the judgment of the particular director at issue. *Cinerama*, 663 A.2d at 1167.

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subject to the more rigorous "entire fairness" review.[104] Section 144 deals with the issue of whether an interested transaction is void. Early corporate law held that *any* transaction between a corporation and its director or officers was voidable at the prompting of the corporation or its shareholders, whether or not it was fair.[105] Again, modern Delaware law has a more flexible approach, articulating exceptions to the old blanket rule that conflicting transactions are automatically void, perhaps because of a recognition that self-dealing is not necessarily harmful to the corporation.[106] To take an example from Robert Clark, a board of a large public company might look askance at a proposal from a director who wishes to make a loan of $1 million to the corporation at market interest rate. After all, the corporation can get such a loan from myriad other sources. But if the corporation is the "small, young, closely held Jones Mattress Company of Podunk, Alaska," then the self-dealing loan, while still by its nature self-dealing, might represent an advantage that the corporation cannot obtain elsewhere.[107]

Lengthy articles have been written on the modern rule of conflicting interest transactions,[108] but for our purposes the salient points are simple enough: a contract is not void or voidable simply because it involves a conflicting interest if (1) a majority of the *disinterested* directors approve the transaction[109] (2) in good faith (3) with all the material facts of the transaction having been disclosed.[110] If a corporation offers ratification under section 144 as a defense, courts look to the nature of the transaction, and then determine whether the ratifying directors had an interest in the transaction, in order to determine whether the transaction is void for reasons of interest.

104. The business judgment rule is a principle of judicial deference to the decisions of the board of directors. Plaintiffs can attack the business judgment rule by alleging a conflict of interest or lack of independence in the board of directors. *See* Robert B. Thompson & D. Gordon Smith, *Toward a New Theory of the Shareholder Role: "Sacred Space" in Corporate Takeovers*, 80 TEX. L. REV. 261, 279 (2001) (noting that the "most common method used by plaintiffs to overcome the business-judgment rule is to show a conflict of interest"). Compliance with the requirements of section 144 is not enough to restore to defendants the protection of the business judgment rule, although it shifts the burden to the plaintiffs to prove that the transaction was unfair. *Cinerama*, 663 A.2d at 1169. For an excellent discussion of section 144, see *In re Cox Communications, Inc. S'holders Litig.*, 879 A.2d 604, 614-15 (Del. Ch. 2005). *See also Cinerama*, 663 A.2d at 1169 (noting that section 144 addresses self-dealing). In theory, litigation over the applicability of the business judgment rule would be a fruitful context in which to learn more about what independence and interest mean to Delaware courts. In fact, because of the demand requirement, in-depth discussions of interest arise most frequently in derivative suits. Students of corporate law will remember that *Aronson*'s second prong asks whether the challenged transaction is protected by the business judgment rule, thus re-injecting the business judgment rule analysis in the derivative suit context. *See* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (explaining that in order to invoke the business judgment rule, a director must first satisfy his or her duty to stay reasonably informed of all relevant information pertaining to the decision).

105. ROBERT CLARK, CORPORATE LAW § 5.1, at 160 (1986).

106. Brown et al., *supra* note 11, at 1163 (citing the introductory comment to MODEL BUS. CORP. ACT § 8.60 (1990)).

107. CLARK, *supra* note 105, at 165.

108. *See, e.g.*, Ahmed Bulbulia & Arthur R. Pinto, *Statutory Responses to Interested Directors' Transactions: A Watering Down of Fiduciary Standards?*, 53 NOTRE DAME L. REV. 201 (1977); Harold Marsh, Jr., *Are Directors Trustees? Conflict of Interest and Corporate Morality*, 22 BUS. LAW. 35 (1966).

109. A vote of the shareholders can also sanitize the transaction, but that is outside the scope of this Article.

110. DEL. CODE ANN. tit. 8, § 144 (2007).

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3. Interest Summarized

Delaware law is hard to summarize; my very point is that it is contextual, situational, and hard to reduce to ex ante principles. Nevertheless, Delaware interest jurisprudence teaches that one looks to the transaction to determine interest. A director on both sides of a transaction is interested—and therefore not independent—if she receives a disproportionate benefit. Even when a transaction does not involve self-dealing, a director may be interested if she has a material financial interest in the transaction. The evolution of the doctrine shows the power of Delaware's approach. First came a blanket prohibition on self-dealing, later modulated to apply only if the director receives a benefit not proportionately shared with the other shareholders. Courts then perceived the danger of a material interest in a transaction, even where no self-dealing was present, and modified the rules again.

C. Derivative Suits

1. A Brief Review of Derivative Suits' Procedural Posture: Suing to Make the Corporation Sue

Because a "cardinal precept" of Delaware law is that the board of directors, not shareholders, manages the corporation, generally directors are the ones to decide which litigation a corporation should pursue.[111] Nevertheless, under certain circumstances shareholders are allowed to sue on behalf of the corporation. Usually the underlying claim is against one or more of the existing officers and/or directors, alleging a breach of fiduciary duty. But because the corporation is managed "by or under the direction of the board of directors,"[112] shareholders cannot automatically bring this action on behalf of the corporation on their own. Plaintiffs, under what is known as the demand requirement, are required to ask the board to pursue the underlying litigation in the name of the corporation.[113]

Plaintiffs may avoid the near-fatal[114] demand requirement if they successfully allege that demand would be futile—that is, that the board in place at the time the complaint was filed (when demand would have been made) was either interested or not independent, or that the challenged transaction was not the product of a valid exercise of business judgment.[115] Thus, most plaintiffs wind up alleging demand futility, triggering an examination of board interest and/or independence.[116] We need first to focus on

111. Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984).

112. DEL. CODE ANN. tit. 8, § 141 (2007).

113. *Aronson*, 473 A.2d at 811-12.

114. If a demand is made, then directors are free to decline to pursue the lawsuit, even if it is meritorious, if they judge that forgoing litigation is in the best interests of the corporation. Telxon Corp. v. Bogomolny, 792 A.2d 964, 973 n.11 (Del. Ch. 2001). Reasons abound why lawsuits may not be in the best interests of the corporation: most obviously, the distraction to the executives caused by the suit, coupled with the associated negative publicity, could outweigh the benefits of any potential recovery. The decision not to sue is an ordinary board decision and therefore is protected by the business judgment rule. *See, e.g.*, *Aronson*, 473 A.2d at 812; Grimes v. Donald, 673 A.2d 1207, 1220 (Del. 1996). It can only be attacked by showing that the board's refusal to sue on the underlying claims was "wrongful." *Id.*

115. *Aronson*, 473 A.2d at 814. Plaintiffs may plead that the action was not a product of good faith.

116. Randall S. Thomas & Kenneth J. Martin, *Litigating Challenges to Executive Pay: An Exercise in*

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interest, but there are ramifications for independence as well.

2. Interest

The general rules against self-dealing and conflicting interest transactions still apply in derivative suits. If a director stands on both sides of the underlying transaction or will "derive any personal financial benefit from it in the sense of self-dealing," rather than a benefit shared proportionately with all other shareholders, then she is counted as an interested director.[117]

Beyond this classic understanding, because of derivative suits' peculiar procedural posture, they have the unique potential to taint almost all directors. For example, say in 2001 Director *X* approves a CEO severance package that amounts to $140 million. In 2002, while Director *X* is still on the board, shareholders file suit, alleging that the directors breached their fiduciary duties of care and loyalty in approving such a grossly excessive payout—i.e., they allege that Director *X* was grossly negligent and/or dominated and controlled by the CEO when she approved the payout. Under the demand requirement, the plaintiffs are obliged to ask Director *X* in 2002, when the suit is filed, to decide whether the corporation should pursue these claims against Director *X* based on her own actions taken in 2001. This pattern is repeated time and again in derivative suits which, in effect, require demands on directors to name themselves as defendants in high-stakes litigation.

For this reason, in a real sense, the directors in a derivative suit are on both sides of the "transaction"—that is, on both sides of the potential lawsuit. Nevertheless, Delaware courts have firmly held that the mere fact that, by default, only a board of directors is asked to determine whether to bring suit against a board member for breaching a fiduciary duty is not enough to cast doubt on the presumption that directors are disinterested actors.[118] It might appear counterintuitive, but after a few moments' thought, the reasons for this conclusion become clear. The demand requirement would be meaningless if plaintiffs could evade it merely by alleging that directors are interested simply by virtue of being directors. Delaware courts have refused to permit plaintiffs to "abrogate" the demand requirement entirely by allowing plaintiffs to "bootstrap" their way out of any demand requirement merely by asserting that the suit would require directors to "sue themselves."[119]

Another seemingly contradictory result flows from the derivative suit's nature. Merely alleging that directors have an interest in retaining their board seats (the loss of which would be threatened if the derivative suit were successful) cannot, without more, show demand futility.[120] At first blush, this might seem unjustifiable. After all, average annual director compensation is now $136,000;[121] presumably few would willingly give

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Futility?, 79 WASH. U. L.Q. 569, 577 (2001).

117. *Aronson*, 473 A.2d at 812.

118. *See id.* at 815 ("However, the mere threat of personal liability for approving a questioned transaction, standing alone, is insufficient to challenge either the independence or disinterestedness of directors . . . .").

119. *Id.* at 818.

120. A desire to retain the benefits of board membership seems to go to the issue of interest, particularly when considering whether demand is excused. However, the *Disney* court treated this primarily as a question of independence. *In re* Walt Disney Co. Derivative Litig., 731 A.2d 342, 359 (Del. Ch. 1998).

121. Lauren Etter, *Why Corporate Boardrooms Are in Turmoil*, WALL ST. J., Sept. 16, 2006, at A7. For

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up such a lucrative position and the perquisites that accompany it. Nevertheless, in *Beam v. Stewart*, the Delaware Supreme Court rejected a bright-line rule that conclusively excused the demand requirement on these grounds, and instead required plaintiffs to show that any compensation would be enough to "entice" the outside director to ignore her fiduciary duty.[122] Delaware courts have pointedly refused to find such enticement in many cases (including, for example, when the director is a person of modest means).[123]

As we have seen, the definition of interest in the derivative suit context has a counterintuitive quality. Situations in which the director would seem obviously interested—being asked whether to pursue a lawsuit where she is a named defendant, for example, or where if the suit is successful she will lose a position worth $100,000 in income a year—are not regarded as conflicting interest situations. To qualify as "interest," the director must have a more direct financial tie to the challenged transaction. Delaware courts justify their narrow reading of interest by labeling plaintiffs' arguments "bootstrapping"; because director liability and/or loss of position are present in nearly every derivative case, to recognize those factors alone as enough to satisfy demand futility would effectively abrogate the demand requirement. Happily for the purposes of this Article, Delaware's peculiar definition of interest in the derivative context brings independence to the forefront in derivative suits.

3. *Independence*

Delaware courts focus a great deal of attention on independence in derivative suits for two reasons. First, as we have seen, one of the prongs of the demand futility inquiry turns on the independence and disinterestedness of the board upon which demand must be made unless it is excused. Because the courts' interpretation of interest forecloses analysis of the most obvious examples of interest—threat of liability and loss of directorial office—independence becomes crucial. Second, an interested or non-independent board can create a committee of independent directors who are empowered to act on the board's behalf to move to dismiss the suit.[124] The fight then turns on

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large companies, it was $152,000 in 2003. Lawrence A. Hamermesh & A. Gilchrist Sparks III, *Corporate Officers and the Business Judgment Rule: A Reply to Professor Johnson*, 60 BUS. LAW. 865, 871 n.38 (2005).

122. Beam *ex rel.* Martha Stewart Living v. Stewart, 833 A.2d 961, 978 (Del. Ch. 2003), *aff'd* 845 A.2d 1040 (Del. 2004).

123. Reveta Bowers, the principal of the elementary school that Disney CEO Michael Eisner's children once attended, was not found to be beholden to Eisner simply because she received director's fees. *In re* Walt Disney Co. Derivative Litig., 731 A.2d 342, 359-60 (Del. Ch. 1998). The court observed that to hold otherwise would be "to discourage the membership on corporate boards of people of less-than extraordinary means. Such 'regular folks' would face allegations of being dominated by other board members, merely because of the relatively substantial compensation provided by the board membership compared to their outside salaries." *Id.* at 360. For more on the court's treatment of Reveta Bowers, see Larry Catá Backer, *Director Independence and the Duty of Loyalty: Race, Gender, Class, and the Disney-Ovitz Litigation*, 79 ST. JOHN'S L. REV. 1011, 1064-87 (2005).

124. In *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981), the Delaware Supreme Court held that even a compromised board (comprised of less than a majority of independent or disinterested directors) may form an independent special litigation committee (SLC) to evaluate the derivative suit. *Id.* at 786. The board must delegate its full powers to act to the special committee pursuant to section 141(c) of the Delaware Code. *Id.* If this committee recommends that the suit be dismissed, the court must inquire into the independence of the committee and the thoroughness of its investigation. *Id.* at 788. If the court is satisfied on these two fronts, then it may honor the SLC's recommendation and dismiss the suit. *Id.* at 789. The court may also, at its discretion,

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whether the putatively "independent" committee really is independent.

Understanding how the independence inquiry arises in the derivative context, we can examine what it means for directors to be independent. Early articulations by Delaware courts stressed the idea of "domination and control": plaintiffs had to allege particularized facts demonstrating "that through personal or other relationships the directors are beholden to the controlling person."[125] Obviously, one could argue that a director is beholden to the person who put her on the board. Nevertheless, the beholdenness that leads to a finding of domination and control requires more than simple indebtedness for office. In *Aronson*, the court also made clear that allegations of stock ownership alone, at least when less than a majority, are not enough to prove non-independence—even when coupled with the allegation that a proposed controller not only owned 47% of the outstanding stock of the corporation, but also had nominated the directors at issue.[126] As the court dryly observed: "That is the usual way a person becomes a corporate director."[127]

Under these authorities, a tainting beholdenness must involve more than mere debt to the alleged controller for directorial office. Inquiry focuses more on a director's behavior than on the circumstances of her appointment: "It is the care, attention and sense of individual responsibility to the performance of one's duties, not the method of election, that generally touches on independence."[128] For actionable interestedness to be shown, plaintiffs must point to a pattern of directors acting "in such a way as to comport with the wishes or interests of the corporation (or persons) doing the controlling."[129]

In practice, courts in derivative suits examine not only past director behavior, but also specific facts, beyond nomination and election, that would show the likelihood of a feeling of obligation. Courts, for example, consider whether an individual is an officer of the company or a subsidiary,[130] as well as whether consulting fees (or other payments) channeled to the director or the director's company are sufficiently material to raise a reasonable doubt as to independence.[131]

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exercise its own independent business judgment in evaluating whether the motion to dismiss should be granted. *Zapata*, 430 A.2d at 789.

125. *Aronson*, 473 A.2d at 815 (citing Kaplan v. Centex Corp., 284 A.2d 119 (Del. Ch. 1971); Chasin v. Gluck, 282 A.2d 188, 189 (Del. Ch. 1971); Mayer v. Adams, 167 A.2d 729, 732 (Del. Ch. 1961), *aff'd*, 174 A.2d 313 (Del. 1961); Greene v. Allen, 114 A.2d 916, 920 (Del. Ch. 1955); Loft, Inc. v. Guth, 2 A.2d 225, 237 (Del. Ch. 1938), *aff'd*, 5 A.2d 503 (Del. 1939)).

126. *Aronson*, 473 A.2d at 815.

127. *Id.* at 816.

128. *Id.* This behavior-centered language is commonly cited, but it may be a standard more honored in the breach than in the observance. I am pressed to find any derivative suit actually analyzing a director's behavior to discern beholdenness or independence, perhaps because it is difficult for plaintiffs to muster evidence of specific acts demonstrating beholdenness. See *infra* notes 168-82 and accompanying text for a discussion of behavior-centered language in the takeover context.

129. *Aronson*, 473 A.2d at 816 (citing *Kaplan*, 284 A.2d at 123).

130. *See, e.g.*, *In re* The Limited, Inc. S'holders Litig., No. CIV.A. 17148-NC, 2002 WL 537692, at *5 (Del. Ch. Mar. 27, 2002) (discussing whether employment as an officer of the corporation or of a wholly-owned subsidiary raises reasonable doubt as to independence).

131. *See, e.g.*, *id.* at *6 (stating that a director who is principal of a company that receives $400,000 in revenue from the company in question may be independent—further showing is needed as to whether the revenue was "material" to the business; a director who was a university official who received $150,000 in consulting fees was not independent).

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Delaware skeptics at this point might assert that Delaware's law is typically director-protective. Not even being nominated by a shareholder or receiving money from the corporation is enough, on its own, to imply that a director lacks independence. Still, later Delaware Chancery Court opinions have construed the notion of "beholdenness" more broadly, beyond simple financial indebtedness. Because each opinion involved a fact-intensive analysis, and because the analysis is so contextual, these cases sometimes seem in tension with each other, as Vice Chancellor Strine has candidly observed.[132] Still, patterns appear to be emerging. Proof of friendship alone is not enough.[133] But "beholdenness" (or "owingness," as the courts have also termed it) means more than simple financial interest.[134]

For instance, familial relationships, as in the corporate governance model,[135] can taint a director's independence for the purposes of asserting demand futility.[136] The parent-child relationship appears to be an easy case,[137] but other familial relationships can also bias a director. In one case, for example, Vice Chancellor Strine observed that (wholly apart from significant financial ties) he was "incredulous" about the independence of a director who was the CEO's brother-in-law on the question whether the corporation should sue the CEO.[138] Nevertheless, Delaware courts do not always find that bare familial relationships suffice to prove a lack of independence. In *Seibert v. Harper & Row, Publishers, Inc.*, the Delaware Chancery Court found that the mere fact that a director was the cousin of an interested director, "without more," was not enough to show domination or control.[139]

Delaware's approach to familial relationships is thus more flexible than an ex ante status-based approach. In *Mizel v. Connelly*, Vice Chancellor Strine found that a grandson was not independent for the purpose of deciding whether the corporation should

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132. In *In re* Oracle Corp. Derivative Litig., 824 A.2d 917, 939 (Del. Ch. 2003), Vice Chancellor Strine observed that:

> [I]t would be less than candid if I did not admit that Delaware courts have applied these general standards in a manner that has been less than wholly consistent. Different decisions take a different view about the bias-producing potential of family relationships, not all of which can be explained by mere degrees of consanguinity. Likewise, there is admittedly case law that gives little weight to ties of friendship in the independence inquiry.

Id.

133. Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 833 A.2d 961, 979 (Del. Ch. 2003), *aff'd*, 845 A.2d 1040 (Del. 2004).

134. *Oracle Corp.*, 824 A.2d at 938 ("Delaware law should not be based on a reductionist view of human nature that simplifies human motivations on the lines of the least sophisticated notions of the law and economics movement. *Homo sapiens* is not merely *homo economicus*.").

135. *See supra* note 31 (listing statutes describing whether familial relationships taint director's independence).

136. Grimes v. Donald, 673 A.2d 1207, 1216 (Del. 1996).

137. Chaffin v. GNI Group, Inc., No. CIV.A. 16211-NC, 1999 WL 721569, at *5 (Del. Ch. Sept. 3, 1999) (observing, in the merger context, that "most parents would find it highly difficult, if not impossible, to maintain a completely neutral, disinterested position on an issue, where his or her own child would benefit substantially if the parent decides the issue a certain way").

138. Harbor Fin. Partners v. Huizenga, 751 A.2d 879, 889 (Del. Ch. 1999).

139. Seibert v. Harper & Row, Publishers, Inc., No. CIV.A 6639, 1984 WL 21874, at *3 (Del. Ch. Dec. 5, 1984).

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sue his grandfather for rescission of an interested transaction,[140] calling the grandfather/grandson relationship "of great consequence." Interestingly, in a footnote the Vice Chancellor noted that the ALI's Principles of Corporate Governance: Analysis and Recommendations "do not include grandparents in their definitions of 'related persons'" that trigger a label of interestedness.[141] Thus, Delaware's transaction-specific, contextual inquiry can produce a *more* textured and probing analysis than the corporate governance model of what having an interest (and thus lacking independence) actually means. As Vice Chancellor Strine observed, a grandchild's relationship with his grandfather can be a close one: "I could not consider impartially such a demand as to my own grandfather . . . ."[142]

A number of key cases involving what constitutes beholdenness involve academics. Professors seem a natural choice for independent directors: they are (we can all agree) intelligent and sophisticated. When tenured, they enjoy enviable job security that would seem to render them largely impervious to financial influences from the corporation, as long as they are not relatives of the CEO or other defendants. But even they are not immune. A Duke University president was found potentially lacking in independence because he had served on several boards (including Duke's own board) with the defendant who allegedly dominated and controlled the board, who had a history of donating to Duke, and with whom he had shared "numerous political and financial dealings."[143] Even a university president's past successful solicitation of $25 million at a *former* institution from an alleged controller could create "a sense of 'owingness'" in that director.[144]

In contrast, in *Disney*, the court found that the president of Georgetown University, Father Leo O'Donovan, was independent despite a donation of $1 million from the alleged controller, and the fact that the alleged controller's son had attended the school.[145] These searching inquiries stand in stark contrast to the mechanical tests used by SOX and the exchanges' blunt tools: as long as a director does not receive money from the corporation, does not have a family relationship with a corporate executive or employee, or is not employed by another company whose compensation committee includes an executive of the corporation, then the director is safe.[146] Under this calculus, Duke's president would clearly qualify as independent.

In re Oracle Corp. Derivative Litigation[147] contains the most searching analysis of academics' independence to date. In it, Vice Chancellor Strine gave weight to various financial connections between Stanford—where both Special Litigation Committee (SLC) members were tenured professors—and the *Oracle* defendants. He dutifully examined, among other financial connections, that one defendant had given over

140. Mizel v. Connelly, No. CIV.A. 16638, 1999 WL 550369, at *4 (Del. Ch. Aug. 2, 1999).

141. *Id.* at *4 n.3. Although the term used is interestedness, upon reflection, a familial relation is better classified as independence. The idea is not that money will flow to a director by virtue of the relationship, but that the relationship will create a bias. The ALI nevertheless uses the term "interest."

142. *Id.* at *4.

143. Lewis v. Fuqua, 502 A.2d 962, 966-67 (Del. Ch. 1985).

144. *In re* The Limited, Inc. S'holders Litig., No. CIV.A. 17148-NC, 2002 WL 537692, at *7 (Del. Ch. Mar. 27, 2002).

145. *In re* Walt Disney Co. Derivative Litig., 731 A.2d 342, 359 (Del. Ch. 1998).

146. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).

147. *In re* Oracle Corp. Derivative Litig., 824 A.2d 917 (Del Ch. 2003).

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$300,000 to Stanford and was reported to be considering an additional gift of $170 million, and that another had given nearly $4.1 million to Stanford, including a donation made directly to a Stanford institute of which both of the SLC directors were members.[148] These facts were not dispositive, in part because the professors were tenured and were well-respected in their fields.[149] Because these circumstances clearly rendered the professors able to obtain employment elsewhere, the court did not find that these financial ties rendered the directors non-independent.[150]

Beyond questions of mere financial independence, however, Vice Chancellor Strine suggested that social ties between SLC directors and defendants might play a role in a court's analysis. As he explained: "[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."[151] In such a close-knit atmosphere, "[s]ome 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."[152] The fact that one of the defendant directors was a fellow Stanford professor who had formerly taught one of the SLC members raised further questions of bias.[153] These questions, coupled with the defendants' donations to Stanford, were enough to raise doubt as to the directors' independence.

Oracle very clearly reveals that Delaware courts look beyond financial interests—indeed, beyond financial or familial ties. In acknowledging the role of community and social institutions, and the real-world conflicts of interest they can produce, Delaware courts delve far deeper into what one might call "true" independence than the rules of SOX and the exchanges require.

Oracle's influence remains unclear. One could argue that *Oracle*'s searching inquiry is reserved for members of a special litigation committee which, because it is formed when the board as a whole is tainted by interest and non-independence, must be held to a higher standard.[154] Moreover, despite *Oracle*'s musings on the importance of community ties, Delaware has hastened to make clear that friendship alone is not enough to show non-independence. Before *Oracle*, Delaware courts had found that a 15-year professional and personal relationship between a CEO and a director was not enough to taint a

148. *Id.* at 931-33.

149. *Id.* at 930.

150. *Id.*

151. *Id.* at 938.

152. *Oracle Corp.*, 824 A.2d at 938.

153. *Id.* at 942-43.

154. The standard quotation is that the SLC committee members must, "like Caesar's wife, be 'above reproach.'" Lewis v. Fuqua, 502 A.2d 962, 967 (Del. Ch. 1985). The Delaware Chancery Court first used this phrase to make the point that a committee composed of a single member is held to an extremely high standard. *Id.*; *see also* Gesoff v. IIC Indus. Inc., 902 A.2d 1130, 1146 n.101 (Del. Ch. 2006) ("Vice Chancellor Hartnett first cited Caesar's famous aphorism in *Lewis v. Fuqua*."). The supreme court later used this language to mean that the entire committee has the burden of proving independence by a yardstick that is "above reproach." Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1055 (Del. 2004). In *Gesoff v. IIC Industries Inc.*, Vice Chancellor Lamb explains the derivation of the quotation as follows: "When Julius Caesar was asked why he chose to divorce his wife after a false accusation of adultery, Caesar's laconic answer is said to have been that 'Caesar's wife must be above suspicion,' or as it is usually rendered, 'Caesar's wife must be above reproach.'" *Gesoff*, 902 A.2d at 1146 n.101.

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director's independence.[155] Post-*Oracle*, the supreme court has reiterated that mere claims of friendship, without specific allegations of an exceedingly close relationship, are not enough.[156]

Still, the supreme court did not reject *Oracle*'s emphasis on social ties, suggesting that "more detailed allegations about the closeness or nature of the friendship, [and] details of the business and social interactions" between the director in question and the alleged controller, may have been enough to make a showing of a lack of independence.[157] The very ability of Delaware to reserve the power to examine these other facets of human relationships gives it bite. Delaware is not bound by ex ante proscriptions against conflicts with the corporation as a whole. Instead, it can look deeply into particular conflicts.

D. Takeovers

There are two actions involving corporate takeovers in which Delaware law emphasizes the need for independent directors: (1) a type of friendly merger called the "freezeout,"[158] and (2) the implementation of defenses to hostile takeovers. Each case involves conflicts of interest because managers or controlling shareholders are either taking over the corporation (in the case of freezeouts and management buyouts) or facing the potential loss of their positions (in the case of takeover defenses).

1. Freezeout Mergers

Freezeout mergers raise conflict of interest problems because they result from an insider's effort to gain control of a corporation. Examples include parent/subsidiary mergers, other transactions involving majority stockholders, transactions involving directors, and management buyouts. In all such cases, the directors are duty-bound to get a fair price for the shareholders, but the insiders want to pay as little as possible for the corporation. In the seminal case *Weinberger v. UOP*,[159] the Delaware Supreme Court suggested that one way to reduce the potential liability associated with this conflict was

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155. Crescent/Mach I Partners, L.P. v. Turner, 846 A.2d 963, 979-81 (Del. Ch. 2000).

156. Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 833 A.2d 961, 979 (Del. Ch. 2003), *aff'd*, 845 A.2d 1040 (Del. 2004).

157. *Id.* at 980.

158. One author states:

> A freezeout is a transaction in which a controlling shareholder buys out the minority shareholders in a publicly traded corporation, for cash or the controller's stock. Freezeouts are also known, with some occasional loss of precision, as "going private mergers," "squeeze-outs," "parent-subsidiary mergers," "minority buyouts," "take outs," or "cash-out mergers."

Guhan Subramanian, *Fixing Freezeouts*, 115 YALE L.J. 2, 5 n.1 (2005).

159. Weinberger v. UOP, 457 A.2d 701 (Del. 1983). In *Weinberger*, the court found that directors on both sides of a transaction

> owe the same duty of good management to both corporations, and in the absence of an independent negotiating structure, or the directors' total abstention from any participation in the matter, this duty is to be exercised in light of what is best for both companies.

Id. at 710-11.

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to employ independent directors.[160]

In *Weinberger*, the Delaware Supreme Court lamented "the absence of an independent negotiating structure."[161] Without such an independent body—or the interested directors completely abstaining from participation—any directors on both sides of the transaction must exercise their fiduciary duties "in light of what is best for both companies."[162] In a footnote, the court offered more detailed guidance for companies faced with this situation:

> Although perfection is not possible, or expected, the result here could have been entirely different if UOP had appointed *an independent negotiating committee of its outside directors* to deal with Signal at arm's length. Since fairness in this context can be equated to conduct by a theoretical, wholly independent, board of directors acting upon the matter before them, it is unfortunate that this course apparently was neither considered nor pursued.[163]

Later Delaware courts have held that the use of "a well functioning committee of independent directors"[164] shifts the burden of proof in the context of mergers with a controlling shareholder.[165] Although not fully able to claim the protection of the business

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160. In *Weinberger*, Signal was the controlling shareholder of UOP, owning 50.5% of the company. *Id.* at 704. Signal sought to acquire complete control of UOP. Because this was a conflicting interest transaction, the defendants needed to prove the entire fairness of the transaction. *Id.* at 710 ("The requirement of fairness is unflinching in its demand that where one stands on both sides of a transaction, he has the burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts."). Two UOP directors were also Signal directors, but they prepared a feasibility study for "the exclusive use and benefit of Signal," which they did not share with the UOP outside directors. *Id.* at 708. The fact that these directors stood on both sides of the transaction, and favored the parent corporation over the subsidiary, raised the possibility that a breach of fiduciary duties existed. The defendants did not meet their burden of proving the entire fairness of the transaction. *Weinberger*, 457 A.2d at 712.

161. *Id.* at 710-11.

162. *Id.*

163. *Id.* at 709 n.7 (emphasis added) (internal citation omitted).

164. Kahn v. Tremont Corp., 694 A.2d 422, 428 (Del. 1997). A special committee is not necessary for a merger, especially when a majority of the board is disinterested and independent. *See* Rosenblatt v. Getty Oil Co., 493 A.2d 929, 938 n.7 (Del. 1985) (explaining an independent bargaining structure "is strong evidence of the fairness of the merger ratio," but "the use of such a committee is not essential to a finding of fairness"); *see also* Alidina v. Internet.com Corp, No. CIV.A. 17235-NC, 2002 WL 31584292, at *7 (Del. Ch. Nov. 6, 2002) ("There is no automatic requirement that the board employ a special committee . . . especially when a majority of the board is disinterested and independent.").

165. Companies have taken the cue from these decisions, and established independent negotiating committees in a variety of conflict transactions. Gregory V. Varallo et al., *From Kahn to Carlton: Recent Developments in Special Committee Practice*, 53 BUS. LAW. 397, 397-98 (1998); *see also* Gesoff v. IIC Indus., Inc., 902 A.2d 1130, 1145 (Del. Ch. 2006) ("Since [Weinberger], parties have relied increasingly on [independent special committees] to prove entire fairness" in litigation over an alleged unfair merger.); *In re* Cox Commc'ns, Inc. S'holders Litig., 879 A.2d 604, 618-19 (Del. Ch. 2005) (describing incentive effect created by *Kahn v. Lynch* for corporations to establish independent negotiating committees). As Vice Chancellor Strine observed:

> In the main, the experience with such committees has been a positive one. Independent directors have increasingly understood and aggressively undertaken the burdens of acting as a guarantor of the minority's interest, by undertaking a deep examination of the economics of the transactions they confront and developing effective negotiation strategies to extract value for the minority from the controller.

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judgment rule, defendants in such cases nonetheless benefit because it falls to the plaintiff to prove the transaction was unfair.[166]

Here, for the first time, we see Delaware law implicating *outside* directors in its discussion of independence. Delaware law is nevertheless true to its philosophy of context-specific definition: corporations need outside directors in conflict of interest transactions only where the conflict is with insiders. The focus is on independence from the particular insider that is causing the conflict.[167]

There are two reasons why, despite the "outside negotiating committee" language, this is not independence as defined by corporate governance reformers—that is, it is not independence as outsider status alone. First, the independence tested is independence from *the acquirer*, not the corporation. Prior financial relationships with the acquirer can cause a showing of nonindependence.[168]

Second, the independence of directors is evaluated not just in terms of their lack of ties with the acquirer, but also in terms of their behavior. Delaware courts conduct a fact-intensive ex post inquiry into the special committee's actions. The key point is that courts assessing the situational interestedness of directors do not focus solely on *relationships*; they also inquire whether the directors' *actions* demonstrate "true" independence.[169]

In *Kahn v. Tremont Corp.*, the court cited *Aronson*'s derivative suit language to

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Id. at 618. Vice Chancellor Strine concluded:

> When it works well, the combination of a special committee, with general business acumen and a fair amount of company specific knowledge, with wily advisors who know how to pull the levers in merger transactions in order to extract economic advantage, is a potent one of large benefit to minority stockholders.

Id.

166. Kahn v. Lynch Commc'n Sys., 638 A.2d 1110, 1117 (Del. 1994) (describing the shift of the burden of proof).

167. *See* Orman v. Cullman, 794 A.2d 5, 21 (Del. Ch. 2002) (explaining how a board of directors can retain the deference given to their business judgment in an interested director transaction by seeking approval of the transaction by an independent special committee).

168. In *Kahn v. Tremont Corp.*, the Delaware Supreme Court found that a committee was not independent where "[a]ll three directors had previous affiliations with Simons [the alleged controller] or companies which he controlled and, as a result, received significant financial compensation or influential positions on the boards of Simmons' controlled companies." *Tremont*, 694 A.2d at 429-30. One director was paid $10,000 as a consultant to one of the controlling shareholder's affiliates, and also received over $325,000 in bonuses from it. *Id.* In *In re MAXXAM, Inc./Federated Development Shareholders Litigation*, the court refused to allow use of a special committee to shift the burden of proving entire fairness at trial, in part because each member of the special committee had "significant financial and/or business ties" with the controlling shareholder. *In re* MAXXAM, Inc./Federated Dev. S'holders Litig., Nos. 12111, 12353, 1997 WL 187317 (Del. Ch. Apr. 4, 1997).

169. *See MAXXAM*, 1997 WL 187317, at *22. In *MAXXAM*, the court explained:

> [T]hat policy [of assigning importance to the important role played by a special committee] presupposes a truly independent, well informed and properly motivated bargaining representative. That policy is not furthered by the pro forma deployment of a special committee consisting of persons who, although prominent, lack true independence. To justify relaxing the strict form of judicial scrutiny that traditional entire fairness review entails, the Court must be satisfied that the special committee was sufficiently independent, informed, and able and willing to bargain effectively with the interested party.

Id.

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justify this scrutiny of director conduct.[170] What is more, the court's analysis of the negotiating committee's actions seemed to range even further than in derivative suits.[171] In this case and others, courts have reviewed the negotiating history of the independent committee to ensure that the committee is independent "*in fact* and not merely on paper."[172] Did the committee hire advisers who are also truly independent?[173] Did they "aggressively seek to promote and protect minority interests?"[174] Chancellor Allen has said that special committees must be willing to do more than just negotiate; they must be willing to exercise the "critical power . . . to say no."[175] The goal for the corporation is to try to simulate arm's-length bargaining as closely as possible.[176] Delaware's context-specific model allows more room for the notion of "true" independence, probing the process by which an independent committee reached its decision and carefully assessing whether particular instances in the negotiation demonstrate independence, or a lack thereof.

The Delaware cases provide telling examples of the fact-specific judicial scrutiny of independent negotiating committee behavior. In *Tremont* itself, the court faulted the committee for "fail[ing] to operate in a manner which would create the appearance of objectivity."[177] In *In re Cox Communications, Inc. Shareholders Litigation*, in contrast, the court praised independent directors who negotiated more money for the shareholders, insisted that the final proposal be specifically contingent on the independent directors' approval, and requested a nonwaivable provision that the transaction be subject to the approval of the majority of the minority shareholders.[178] In *Rosenblatt v. Getty Oil Co.*, the court cited numerous facts that indicated that the parties to the merger actually "exerted their bargaining power against one another at arm's length."[179]

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170. "As this Court has previously stated in defining director independence: it is the care, attention and sense of individual responsibility to the performance of one's duties . . . that generally touches on independence." *Tremont*, 694 A.2d at 430 (citing Aronson v. Lewis, 473 A.2d 805, 816 (Del. 1984)).

171. *See supra* notes 128-29 and accompanying text. One possible reason for this difference is that it is easier to judge, in the one to three months a response to a merger overture typically takes, how independently an independent committee behaves. If a court were to take *Aronson*'s behavior language seriously, every petty disagreement a director has with a CEO could become evidence of her independence. Indeed, directors might be instructed to engineer disagreements as proof of independent behavior. The behavior test is thus more workable in the compressed timing of a merger than over the course of years of board service.

172. Varallo et al., *supra* note 165, at 400.

173. *In re* Cox Commc'ns, Inc. S'holders Litig., 879 A.2d 604, 618 (Del. Ch. 2005) ("Critical to the effectiveness of the special committee process has been the selection of experienced financial and legal advisors, who can help the special committee overcome the lack of managerial expertise at their disposal.").

174. *In re* Trans World Airlines, Inc. S'holders Litig., CIV.A. No. 9844, 1988 WL 111271, at *7 (Del. Ch. Oct. 21, 1988).

175. *In re* First Boston, Inc. S'holders Litig., CIV.A. No. 10338, 1990 WL 78836, at *7 (Del. Ch. June 7, 1990).

176. Gesoff v. IIC Indus., Inc., 902 A.2d 1130, 1145 (Del. Ch. 2006).

177. Kahn v. Tremont Corp., 694 A.2d 422, 430 (Del. 1997). There, the other two, arguably more independent members of the committee, seemed to abdicate most responsibilities to the most compromised committee member. Furthermore, the advisers to the committee also had ties to the controlling shareholder. *Id.*

178. *Cox Commc'ns*, 879 A.2d at 610-12.

179. Rosenblatt v. Getty Oil Co., 493 A.2d 929, 937 (Del. 1985). For example, directors that stood on both sides of the transaction resigned before negotiations got underway, both companies had a third party value their reserves, and the subsidiary engaged in such hard bargaining that it "nearly caused the collapse of negotiations on at least two occasions." *Id.* at 938.

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Delaware courts seem loath to trust outside independent status alone. Chancellor Allen, author of many influential takeover decisions,[180] has voiced ambivalence about independent director committees. Although he called himself "open to the possibility" that such committees could protect shareholder interests, he admitted to "a painful awareness of the ways in which the device may be subverted and rendered less than useful."[181] The Delaware Supreme Court has pointedly emphasized that corporations must do more than create a "perfunctory special committee of outside directors."[182]

Perhaps the paradigmatic conflict situation is the management buyout (MBO), where "the existence and severity of the conflict is obvious."[183] Here, the managers themselves are buying the company. Unsurprisingly, then, there is "near universal use of 'special committees' of independent [i.e., outside] directors in MBOs."[184] Delaware courts have made clear that for members of these committees lack of financial interest alone does not ensure independence.[185]

2. Defensive Measures Against Hostile Takeovers

With hostile takeovers, Delaware's independence takes a turn. As discussed in the previous section, even in friendly mergers, although Delaware gives weight to the presence of an outside independent negotiating committee, it still scrutinizes the behavior of the committee to ensure that it really did act independently. However, in cases involving hostile takeover defenses, most notably the adoption of the "poison pill," there is no such scrutiny. Independence appears to collapse into mere outside status. Even so, the courts have remained vague as to the weight actually accorded to majority outside independent board decisions simply by virtue of their independence.

In *Unocal Corp. v. Mesa Petroleum Co.*, the Delaware Supreme Court dealt with the problem of management's response to a threat of hostile takeover,[186] where the risk of management (and board) entrenchment is clear.[187] If a takeover bid is successful,

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180. Jeffrey N. Gordon, *Corporations, Markets, and Courts*, 91 COLUM. L. REV. 1931, 1935 (1991).

181. William T. Allen, *Independent Directors in MBO Transactions: Are They Fact or Fantasy?*, 45 BUS. LAW. 2055, 2056 (1990).

182. *Tremont*, 694 A.2d at 429 (internal citation omitted).

183. Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1023 (1997); *see also* Allen, *supra* note 181, at 2056 (describing the MBO as "the paradigm case of such conflict").

184. Rock, *supra* note 183, at 1026.

185. The inquiry of Delaware courts has focused on particular facts in assessing the committee's performance. Good facts include the committee hiring an independent law firm and investment bank, and repeated rejection of management's offers. Freedman v. Rest. Assoc. Indus., 1987 WL 14323, at *3-4 (Del. Ch. Oct. 16, 1987) (mem.). Bad facts include "precipitous" Employee Stock Option Program issuances with the goal of entrenching management and one member of the committee being a company-paid consultant who did not resign until after the committee had recommended the merger. *See* Greenfield v. Nat'l Med. Care, Nos. 7720, 7765, 1986 WL 6505, at *4 (Del. Ch. June 6, 1986) (describing a "precipitous" Employee Stock Option Program); EAC Indus., Inc. v. Franz Mfg. Co., 1985 WL 3200, at *9 (Del. Ch. Jun. 28, 1985) (describing a beholden consultant). Possibly the most famous, failed management buyout to date was RJR Nabisco. There, the independent negotiating committee functioned robustly; in fact, it gave the ultimate demonstration of independence from management by rejecting management's bid. *In re* RJR Nabisco, Inc. S'holders Litig., No. 10389, 1989 WL 7036, at *1 (Del. Ch. Jan. 31, 1989).

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

187. Palmiter, *supra* note 6, at 1412.

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directors may lose their directorships, with their accompanying "power, prestige and prominence, not to mention their increasingly handsome directors' fees and perquisites; they face the embarrassment of losing a fight; and they face breaking their tacit promise of fealty to management."[188] As the court worded this risk in oft-quoted language, takeover defenses raise "the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders."[189]

Given this potential conflict for the entire board, the Delaware Supreme Court announced in *Unocal* an enhanced scrutiny for takeover defense measures. The board must have "reasonable grounds for believing that a danger to corporate policy and effectiveness" exists, a burden it satisfies by showing "good faith and reasonable investigation."[190] The directors bear the burden of proof in this area of "inherent conflict"—no protection of the business judgment rule applies—but if the board is comprised of a "majority of outside independent directors," the proof is "materially enhanced."[191] The second part of the *Unocal* inquiry requires that the "defensive measure . . . must be reasonable in relation to the threat posed."[192] Building on *Unocal*, the court in *Moran v. Household International, Inc.* held that, in the absence of a specific takeover threat, adoption of a pill by a board consisting of a majority of outside independent directors shifts the burden of proof to the plaintiffs to show a breach of fiduciary duties.[193]

These anti-takeover cases reveal two key differences in analysis vis-à-vis Delaware's general approach to issues of board-member independence. First, the court's approach to derivative suits' special litigation committees, conflicting-interest transactions under section 144, and squeezeouts focuses on the make-up of special board committees. In dealing with anti-takeover measures, however, the court creates an incentive for the majority of the *board itself*—rather than a committee thereof—to be outside independent directors. Presumably this difference in approach has taken hold because of the "inherent conflict"—*all* directors, non-employee as well as employee, are susceptible to the temptation to cling to the "powers and perquisites" associated with board membership.[194] As we saw in Part II.B., the incentive structure set up by Delaware

188. *Id.* at 1413 (internal citation omitted). In a noteworthy dissent, Judge Cudahy observed:

> Directors of a New York Stock Exchange-listed company are, at the very least, "interested" in their own positions of power, prestige and prominence (and in their not inconsequential perquisites). They are "interested" in defending against outside attack the management which they have, in fact, installed or maintained in power "their" management (to which, in many cases, they owe their directorships). And they are "interested" in maintaining the public reputation of their own leadership and stewardship against the claims of "raiders" who say that they can do better. Thus, regardless of their technical "independence," directors of a target corporation are in a very special position, where the slavish application of the majority's version of the good faith presumption is particularly disturbing.

Panter v. Marshall Field & Co., 646 F.2d 271, 300-01 (7th Cir. 1981) (Cudahy, J., dissenting).

189. *Unocal*, 493 A.2d at 954.

190. *Id.* at 955 (internal citations omitted).

191. *Id.*

192. *Id.*

193. Moran v. Household Int'l, Inc., 500 A.2d 1346, 1356 (Del. 1985).

194. Kahn v. Roberts, 679 A.2d 460, 465 (Del. 1996).

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has had its effect.[195]

The second difference from the rest of Delaware jurisprudence is more striking. Having acknowledged the danger that outsiders as well as insiders will seek to entrench themselves, the court rather inexplicably asserts that a majority outside independent board creates less of a concern.[196] This move seemingly breaks with Delaware's independence jurisprudence in other areas. There is none of the searching inquiry into directors' financial ties, friendships, or other connections with management, the purpose of the independence inquiry, and how the directors measure up on the various axes of social, familial, and financial ties, that we have seen in conflicting interest transactions, derivative suits, or friendly mergers.[197]

Still, students of hostile takeover jurisprudence know that Delaware courts will inquire into the *behavior* of a board composed of outside independent directors in the hostile takeover context. In *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,[198] the court declined to find that the board consisted of "truly outside independent directors" where six out of fourteen board members held senior management positions. Additionally, two were major stockholders, and four had relationships with various companies that had done business with Revlon in the past.[199] In *Paramount*

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195. *See supra* notes 40-44 and accompanying text (discussing the predominance of supermajority independent boards).

196. Perhaps at the time of *Unocal*, a majority of independent directors seemed like enough of a protection, given that courts still reserved the right to review whether there were reasonable grounds to believe that a danger to corporate policy existed, and that any defensive measure was reasonable in relation to the threat posed. *Unocal*, 493 A.2d at 954-55. However, subsequent cases showed that almost any threat would do, including the risk that shareholders would accept an acquirer's non-coercive offer "in ignorance or a mistaken belief of the strategic benefit which a business combination." Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140, 1153 (Del. 1989). More generally, this danger, known as substantive coercion, is "the risk that shareholders will mistakenly accept an underpriced offer because they disbelieve management's representations of intrinsic value." *Id.* at 1153 n.17 (citing Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1384 (Del. 1995)); Ronald J. Gilson & Reinier Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 BUS. LAW. 247, 267 (1989). Recognizing this rationale as a threat adequate to justify defensive measures virtually guaranteed that directors would be able to survive *Unocal*'s first prong. Thompson & Smith, *supra* note 104, at 291. Courts also appear to have been reluctant to prevent defensive measures as unreasonable in relation to potential threats, perhaps because it puts them in the position of engaging in a form of substantive analysis. *Id.* at 293. Thus, defensive tactics are rarely overturned. *Id.* at 326.

197. Sometimes Delaware courts' review of the independence of boards in the *Unocal* setting is quite cursory: the courts dutifully add up the numbers of outside independents, cite the *Unocal* language regarding the ability of an outside independent board to enhance the burden of proof, and proceed with the analysis. They do not delve into the question of whether the outside directors are "truly" independent. *See* Carmody v. Toll Bros., 723 A.2d 1180 (Del. Ch. 1998) (where five of nine directors were outside directors, although one was an outside attorney who had received $128,000 in fees from the company in 1996, the court did not reach the independence question); *Unitrin*, 651 A.2d at 1375 n.15 (outlining the tests for outside directors and independent directors, acknowledging that the chancery court had found that the directors were independent, explaining that these issues are usually settled at trial, and then turning to the second part of the test). *Mentor Graphics Corp. v. Quickturn Design Systems, Inc.*, 728 A.2d 25 (Del. Ch. 1988), addresses the subject in greater depth than most cases, but it reduces the definition of independence to "in any significant way financially beholden" to the corporation or its CEO or president—there is no reference to the possibility that independence could mean more than financial interest. *Mentor Graphics*, 728 A.2d at 46.

198. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

199. *Id.* at 177 n.3.

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Communications, Inc. v. Time Inc.,[200] the court seemed to consider a majority of outside independent directors to be an important factor, but not a dispositive one. The opinion first considered the board's "zealousness" in seeking to preserve Time's corporate culture.[201] Not only was this an important corporate policy worthy of defense, but Time's "lengthy" prior investigation of merger candidates, including Paramount, the eventual hostile suitor, meant that Time was exercising an informed judgment in rejecting that suitor's overtures.[202] The court concluded that the board had met its fiduciary burdens as articulated in *Unocal*—that is, it had acted reasonably.[203] After citing these factors, the court did, it is true, cite *Unocal* for the proposition that having 12 of 16 outside independent directors materially enhanced the finding, but the court then went on to inquire into the reasonableness of the board response.[204] Board independence was only one factor the court considered.[205]

Furthermore, in some of the cases where Delaware courts have given only cursory consideration to analysis of independence in *Unocal*'s first step—the requirement that the board show it had reasonable grounds for believing that a danger to corporate policy existed—the same courts have invalidated some defenses as not reasonable in relation to the threat posed, the second step of the *Unocal* analysis.[206] In short, the deference accorded to outside independent directors does not necessarily carry the day; indeed, one feels that the courts rushed through the independence analysis in order to reach the question whether so-called "dead hand"[207] or "no hand"[208] poison pills were permissible under Delaware law.

In sum, Delaware courts say that boards with a majority of outside independent directors in the defensive measures context have an easier burden of proof, despite the inherently conflicted situation, but it is not clear how much this jurisprudence deviates from the contextual approach to independence in other areas. Delaware law adds to the pressure on boards to acquire independent directors, but maintains flexibility in its ultimate analysis.

E. Independence Summarized

Delaware rejects corporate governance advocates' attempts to reduce independence to status. Chancellor Allen wrote that the protection of the business judgment rule is not available

200. *Paramount Commc'ns*, 571 A.2d 1140 (holding that a board did not lose the protection of the business judgment rule when it made a tender offer in preparation for a merger when the shareholders bringing suit alleged a corporate threat based only on inadequate stock value).

201. *Id.* at 1152.

202. *Id.*

203. *Id.*

204. *Id.*

205. *Paramount Commc'ns*, 571 A.2d at 1152.

206. *See, e.g.*, Carmody v. Toll Bros., 723 A.2d 1180 (Del. Ch. 1998) (holding that a pre-suit demand was not required where the shareholders' claims were not derivative, but individual); Mentor Graphics Corp. v. Quickturn Design Sys., Inc., 728 A.2d 25 (Del. Ch. 1988) (holding the defendant company's deferred redemption plan defense invalid on fiduciary duty grounds).

207. *Carmody*, 723 A.2d at 1182.

208. *Mentor Graphics Corp.*, 728 A.2d at 27.

> to a fiduciary who could be shown to have caused a transaction to be effectuated (even one in which he had no financial interest) for a reason unrelated to a pursuit of the corporation's best interests. Greed is not the only human emotion that can pull one from the path of propriety; so might hatred, lust, envy, revenge, or, as is here alleged, shame or pride. Indeed any human emotion may cause a director to place his own interests, preferences or appetites before the welfare of the corporation.[209]

This eloquent rejection of the notion that independence can be reduced to financial or familial relationships is purely Delawarean. The bright-line rules of the NYSE, SOX, and the NASDAQ hold no attraction for Chancellor Allen and his fellow Delaware judges.

I have asserted that articulating a simple, non-contextual definition of Delaware's independence is impossible. Nevertheless, patterns emerge. In areas like derivative litigation and freezeout mergers, courts have examined the extent of a director's relationships, personal as well as financial and familial, in order to determine whether the director is capable of a truly independent assessment. In the freezeout merger context, they have examined the specific behavior of independent directors. Delaware courts do not rely on status alone to ascertain independence; indeed, they are suspicious of nominally independent committees that fail to show sufficient determination to safeguard shareholders' interests. Mindful of the specific conflict at issue, they focus the independence inquiry in order to determine whether a relevant form of bias exists.

This fact-intensive definition-as-process approach is one that Delaware jurists have steadfastly defended. Vice Chancellor Strine lauded the "contextual approach" as "a strength of our law," observing:

> even the best minds have yet to devise across-the-board definitions that capture all the circumstances in which the independence of directors might reasonably be questioned. By taking into account all circumstances, the Delaware approach undoubtedly results in some level of indeterminacy, but with the compensating benefit that independence determinations are tailored to the precise situation at issue.[210]

In fact, when the Council of Institutional Investors asked the Delaware Supreme Court to adopt a definition of independence, the Supreme Court resisted.[211] Proposals for Delaware to require independent directors on the board have also failed.[212]

V. LESSONS LEARNED

What can be learned from Delaware's independence jurisprudence? Our focus, as set out in the Introduction, is two-fold. First, we consider the "means" of independence, i.e., how it should be defined. Generally, corporate governance has it right; there are three main areas of obvious potential conflict with outsiders: company audits, compensation of

209. *In re* RJR Nabisco, Inc. S'holders Litig., No. 10389, 1989 WL 7036, at *15 (Del. Ch. Jan. 31, 1989).

210. *In re* Oracle Corp. Derivative Litig., 824 A.2d 917, 941 (Del. Ch. 2003).

211. Veasey, *supra* note 99, at 2182-83.

212. Lawrence A. Hamermesh, *Corporate Democracy and Stockholder-Adopted By-Laws: Taking Back the Street?*, 73 TUL. L. REV. 409, 482 n.312 (1998).

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senior executives, and nominating future directors. But we need to focus more precisely on the nature of the relevant conflict. For the audit committee, an independent director must be independent of the auditors as well as the managers of the company. For nominating committee purposes, independents should not have ties to other directors or nominees. And for the compensation committee, not only should the independents not have ties to the corporation, but they should not have ties to the executives whose pay they are setting. The next section takes executive compensation as a case study.

A. Refining the Definition: The Executive Compensation Case Study

The NYSE and NASDAQ both require an outside independent compensation committee for what should be self-evident reasons. Taking CEO compensation as an example, a corporation would not want anyone dependent on the corporation to set executive pay because of the danger that there would be threats of retribution for lowering pay, even if being stingy was in the shareholders' best interest. Even when outside directors are used, however, they may not automatically rein in compensation. Some commentators believe that outside directors are biased towards excessive executive compensation. Outside directors are often CEOs or high-placed executives at other large public corporations, and therefore have an interest in reinforcing a generally high level of executive compensation.[213] The group dynamics of the board further reinforce the unlikelihood that directors will challenge a CEO's compensation.[214]

Delaware's approach to independence provides clues on how compensation committees might be reformed. For example, UnitedHealth's CEO, William McGuire, recently resigned because of a backdating scandal.[215] The head of the compensation committee and the "ad hoc" committee that negotiated McGuire's back-dated-option-laden 1999 employment contract was William G. Spears, who served as trustee for two trusts benefiting the CEO's children and managed between $15 and $55 million of the CEO's family fortune.[216] In June 1999, only months before the employment contract was renegotiated, McGuire also invested $500,000 "to help Mr. Spears repurchase his money management firm from a financial conglomerate."[217] Spears was an "independent" director by SOX and SRO standards because he was financially independent of UnitedHealth and he was not a relative of an executive officer. But he lacked sufficient independence from the CEO, particularly when, as chair, he should have been the most independent compensation committee member. While it is true that the NYSE's standard required that the board affirmatively determine that an independent director has no "material relationship" with a corporate officer, apparently this requirement did not have its intended effect; UnitedHealth's board judged Spears to be an independent director for

213. LUCIAN BEBCHUK & JESSE FRIEDMAN, PAY WITHOUT PERFORMANCE 33 (2004). These authors refer to "cognitive dissonance," the idea that executives and former executives will have preconceived ideas that large salaries are "desirable and serve shareholders."

214. Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 768-69 (2002).

215. Backdating involves granting stock options not at current market price (as tax laws require), but at an earlier, more favorable date when the stock exercise price is cheaper.

216. Alan Murray, *How UnitedHealth Spotlights Gap in Reform*, WALL ST. J., Oct. 18, 2006, at A2.

217. *Id.* "The employment agreement authorized backdated options, which arguably result in a windfall to the CEO." *Id.*

compensation committee purposes.

The failure of SOX and the SROs to pick up cases like UnitedHealth reveals their internal weakness. Independence is defined by the lack of financial ties to the corporation and familial relation to management, but not the lack of financial ties to management. This omission is most troubling in the case of executive compensation, but also raises questions with regard to audit committees and nominating committees. Corporate governance advocates who are willing to learn from Delaware's contextual approach should redefine independence in the compensation committee context to reflect the particularities of that context. What matters in compensation is not only independence from the corporation, but also from the CEO and other executives whose salaries are being negotiated.

B. The Ends of Independence and Revisiting the Fetishization of the Proxy

It would be tempting to conclude only that we must refine regulatory definitions. Indeed, the recent history of SOX and SRO independence definitions are a testament to the belief that corporate regulators can define their way to a better board. Modern corporate governance law has made independence a goal in and of itself. A majority independent board is presumed to be the answer. The problem is, the data suggest that independence alone does not improve firm performance. Worse, it can distract from more useful reforms. Corporate governance activists emphasize the need for outside independent directors, without regard to why they are needed.

Donald C. Clarke describes the different ends an independent (defined as "non-management") director can serve. She can protect small shareholders against large shareholders, serve as a "brain trust or consultant," or implement external regulation.[218] In the United States, the traditional purpose of the non-management director has been to protect shareholders from management.[219] Clarke asserts that the main justification for having non-management directors is that they will better represent shareholder interests because they are not motivated by preserving their jobs.[220] However, as Clarke points out, the SROs and SOX structure their rules so that "a particular motivation—that of pleasing management—is absent."[221] They do not ensure that the chosen directors have the motivation to monitor or manage effectively.[222]

Delaware's jurisprudence, "far more developed" than that of independence-as-status,[223] focuses on particular conflicts. It teaches that the outside independent director is crucial *only* in the specific situations where a conflict exists between the interests of management and those of the shareholder. If the main justification for having these directors is, indeed, that they will resist management's efforts to preserve their own jobs at a cost to shareholders, then there appears to be little need for majority independence—merely an independent committee to decide questions of takeovers—and even less justification for supermajority independence.

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218. Clarke, *supra* note 1, at 81-82.

219. *Id.* at 81.

220. *Id.* at 106.

221. *Id.* at 88.

222. *Id.* at 94.

223. Clarke, *supra* note 1, at 108.

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I am not the first to point to the perils of supermajority independence. As Jill Fisch and others have argued, focusing on board independence means a board full of outsiders who lack the internal knowledge of the company to manage effectively.[224] The supermajority independent board thus necessarily must focus on the monitoring role of the board, at the expense of the board's management role.[225] Lawrence Mitchell has argued that supermajority independent boards paradoxically give CEOs more power and make it *less* likely that the board can fulfill its monitoring role.[226] With so few insiders on the board, CEOs become practically the only avenue for providing internal information about the corporation to the outside board members.[227] This reliance on the CEO makes fraud more likely.[228]

This Article offers another argument against supermajority independent boards. Independence matters for a reason: to deal with conflict. The board's role is to manage the corporation.[229] Outside independent directors need only be front and center in areas of conflict with management—but these situations form only a small proportion of the work of managing the corporation. By unduly stacking the managing entity of the corporation with directors only suited for one function, current rules create an organization that cannot deal as well with the task of running the corporation. Furthermore, to the extent that the independent directors' limited time is taken up with general management tasks, they are less likely to be able to focus on their true purpose, dealing with management conflicts.

Take the case of Enron, where the independent directors received requests from the company that the board approve waivers of the ethics code to allow Andrew Fastow, the corporation's CFO, to enter into transactions with the corporation. The board-approved transactions allowed the creation and functioning of the special purpose entities (SPE) that helped lead to Enron's undoing.[230] Fastow's SPE transactions with the corporation constituted classic self-dealing. Because they involved a corporate insider doing business with the corporation, they should have triggered intense scrutiny from the independent directors. Instead, approval was viewed as a mere formality.[231]

Similarly, in the case of Disney, the compensation committee, charged with setting the compensation of incoming CEO Michael Ovitz, largely abdicated its role as negotiator to Michael Eisner, and did not attempt to negotiate with Ovitz regarding the

224. *See, e.g.*, Stephen M. Bainbridge, *A Critique of the NYSE's Director Independence Listing Standards*, 30 SEC. REG. L. J. 370 (2002) (critiquing the NYSE Corporate Accountability and Listing Standards Committee's report promoting new stock exchange listing standards); Lucian Arye Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Further Findings and a Reply to Symposium Participants*, 55 STAN. L. REV. 885, 901 (2002) (arguing that effective, staggered boards provide a powerful deterrent against takeovers); Fisch, *supra* note 19, at 267 (examining the corporate governance movement in relation to the role of the board of directors); Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1282-83 (1982) (discussing developments in the corporate governance movement).

225. Fisch, *supra* note 19, at 267.

226. Mitchell, *supra* note 36, at 1345-48.

227. *Id.* at 1345.

228. *Id.*

229. DEL. CODE ANN. tit. 8, § 141(a) (2007).

230. Ribstein, *supra* note 64, at 4.

231. BETHANY MCLEAN & PETER ELKIND, THE SMARTEST GUYS IN THE ROOM 197 (2004).

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terms of his departure or even obtain information about them.[232] With the more conflict-centric perspective of Delaware, those outside directors would have realized that their role lay precisely in this area of conflict. In cases of conflict, outsiders' negative quality—their lack of ties to the corporation and management—does indeed become a positive virtue. But the board does much more than just handle conflict: it makes high-level strategic decisions for the corporation. In making decisions as to product line-up, acquisitions, or marketing strategy, outside directors should have at most an advisory role. These are areas for management, the full-time agents of the corporation. Independents, defined as outsiders, should ensure that none of the managers have a special interest in a given transaction or connection to those on the other side. Beyond that, their lack of ties to the corporation or management gives them no particular insights or expertise.

VI. POTENTIAL OBJECTIONS TO GENERALIZING FROM DELAWARE'S INDEPENDENCE TO CORPORATE GOVERNANCE

A. Apples and Oranges

Critics may argue that there is something inherently flawed with using Delaware's corporation law as a model for federal law and exchange-created corporate governance rules. Corporate governance activists are concerned with proscriptive solutions, about making things better for shareholders in general. Delaware courts are courts: they are in the businesses of deciding particular disputes. They necessarily discuss independence only ex post, on a case-by-case basis, and have the luxury of being able to craft fine-tuned independence standards that work for particular situations, such as the behavior of independent negotiating committees in a management buyout, for example. It makes no sense, then, to compare Delaware's approach with that of the corporate governance reformers. They address two completely different situations.

This objection draws a false line between the effect of statutory and common law rules. Delaware's case law, like all case law, is prospective in nature. Delaware courts attempt to craft rules for future litigants and for future boards who would like to avoid litigation and liability. In fact, Delaware, by virtue of its calculated desire to compete with other states in corporate law, is deeply invested in crafting the best rules for future corporate actors so as to make itself attractive to corporations. If Delaware's law is competing to be the best, then if independence-as-status really was a benefit, a prospective prescription for it (e.g., "each board shall be composed of a majority of independent directors") should have made it into the Delaware code or case law.[233]

232. *In re* Walt Disney Co. Derivative Litig., 825 A.2d 275 (Del. Ch. 2003).

233. Two states take the independence-as-outside-status approach, but only in a limited form. The Michigan Business Corporation Act defines independent directors in terms of their financial and familial relationships with the corporation, financial, business, or legal expertise, and length of board service. MICH. COMP. LAWS ANN. § 450.1107 (West 2002). However, Michigan does not require that a corporation have an independent director, but merely provides that any director designated as independent may receive additional compensation, and may communicate with shareholders at the corporation's expense. The Act also provides that an independent director does not have any greater duties or liabilities than any other director. *Id.* § 450.1505. Independent directors can also approve interested transactions. *Id.* § 450.1545a. Independent directors not party to the proceeding also approve indemnification. *Id.* § 450.1564a. Connecticut is the only state that *requires* an

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Delaware would then have the benefit of ex ante outside directors, and also be able to apply ex post independence analysis as the need arose.[234] Against this backdrop, Delaware's refusal to rely on independence defined as outside status should give corporate reformers pause.

B. The Interest Group Objection

Jonathan Macey and Geoffrey Miller's interest group theory of Delaware law offers a more provocative reason to conclude that Delaware's approach to board member independence offers little of value to rulemakers outside the state.[235] These commentators argue that Delaware is captured by lawyers; both plaintiffs' attorneys and defense attorneys have an interest in keeping legal rules unclear.[236] Delaware's highly contextual independence jurisprudence fits this pattern. A clear, ex ante standard like that of the NYSE or SOX presents little to consult over or advise on. (One either has or hasn't received $100,000 in compensation from the corporation in the past three years.[237]) Plaintiffs' attorneys can spill much ink, and garner a proportionate amount of fees, making arguments that an SLC member's relationship with a defendant CEO is more like the *Oracle* situation than it is like the defendant director's friendship with Martha Stewart in *Beam*. Although this indeterminacy creates a cost to defendant corporations, who sometimes settle claims of little merit, it also creates a benefit for corporate counsel who can bill hours upon hours advising clients on how their board should be structured in light of this uncertainty. Within the corporation, clients generally defer to their lawyers as to choice of state of incorporation. Because lawyers have a great deal of power over changes to the Delaware corporate code, their interest wins out.

The interest group theory is only one explanation of Delaware's legal indeterminacy. Ehud Kamar has suggested the uncertainty associated with Delaware law aids in its competition with other states by "stymying their compatibility with Delaware law."[238]

outside independent director, defined as one who has not in the past two years had financial or familial (defined only as spouse, parent, or child) relationships with the corporation; a 10% holder of corporate securities; or a business relationship resulting in payments to the director and family exceeding the lesser of $40,000 or 5% of the director's income. CONN. GEN. STAT. ANN. § 33-753 (West 2005). Interestingly, independent directors also may not serve as independent directors on the boards of more than five corporations, a nod to the problem of the demands on a director's time. *Id.* Crucially, the independent director requirement *only* applies to corporations with more than 100 shareholders, and then the requirement is only that the corporation have an audit committee composed of at least one independent member. *Id.* At the 100 shareholder level of share ownership, the corporate structure has significantly diverged from the traditional private corporation structure where the same individuals are shareholders, officers, and board members, and the corporation seems to look more like a public corporation. *See infra* Part VI.C..

234. Conversely, if Delaware is engaged in a race to the bottom, pandering to company management, one might expect to find that other states that have not sunk so low would adopt the status-based approach. However, only two states have done so, and then only to a limited extent. *See supra* note 233 (stating that Michigan and Connecticut adopted the status-based approach).

235. *See generally* Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 498-502 (1987) (suggesting that Delaware's corporation law developed in response to unique interest-group pressures).

236. *Id.* at 504.

237. NASDAQ Manual, Rule 4200(a)(15)(B) (2006), *available at* http://nasdaq.compliment.com/nasdaq/display/display.html?rbid=1705&element_id=18.

238. Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L.

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Delaware competes not on its laws alone, but also with a specialized and expert judiciary and a wide array of cases.[239]

But even assuming for the sake of argument that lawyers drive the uncertainties underlying Delaware's contextual approach, compelling reasons nevertheless remain for assessing the value of Delaware's approach and its potential applicability in other settings. First, the empirical data suggests that a rules-based definition of independence seems to be inadequate, at least when coupled with the requirement of a majority independent board. The logical alternative to a rule-governed regime is a standard, and standards necessarily involve uncertainty.[240] The fact that uncertainty also benefits lawyers should not be enough, alone, to condemn it.

Furthermore, almost all the states take Delaware's contextual approach. Only two states take the independence-as-outside-status approach,[241] and only one, Connecticut, requires that boards actually have independent directors. Even this requirement applies only to corporations with more than 100 shareholders, and only requires that the audit committee have at least one independent member.[242] If almost all of the other, presumably non-lawyer-captured, states adopt a form of Delaware's contextual approach, the interest group theory should not fatally discredit it.

C. Apples and Oranges Redux: The Public/Private Divide

The fact that almost all states follow Delaware's approach, while a useful counter to the interest group objection, raises a new problem. Perhaps Delaware is reluctant to impose an outside independence requirement on the board and to define independence as outside status not because it disagrees with these measures, but because it must respond to the needs of private corporations in a way that national actors need not. After all, the DGCL, unlike SOX, the NYSE, or NASDAQ, but like the law of all 50 states, governs both public and private corporations.[243]

Private corporations are very different creatures from public corporations. Public corporations, by definition, are traded on a national exchange. A single corporation can have thousands of shareholders in different countries, all trading in its shares. In contrast, private corporations often have relatively few shareholders,[244] who are frequently family

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REV. 1908, 1910 (1998).

239. *Id.* at 1911. Kamar states that:

> This allows Delaware judges both to utilize their superior skills and to sharpen them. If another state adopted Delaware's indeterminate law, the relative inexperience of its judiciary would become apparent, and it still could not ensure compatibility of outcomes with Delaware. If it adopted clear law, it would explicitly forgo compatibility with Delaware.

Id.

240. *See generally* discussion of the rules versus standards debate, *supra* note 89.

241. *See supra* note 233 and accompanying text (discussing the Michigan and Connecticut approaches).

242. CONN. GEN. STAT. ANN. § 33-753 (West 2005).

243. Of course, all 50 states face a similar issue in that the corporate codes cover public and private corporations. The contrast is simply starker in Delaware because so much of the state's revenue comes from corporate law. See *supra* notes 85 and 233 for further discussion of other states' treatment of independence.

244. AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 1.06 (1994) ("'Closely held corporation' means a corporation the equity securities [§ 1.20] of which are owned by a small number of persons, and for which securities no active trading market exists."). Although many close

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members.[245] Shareholders often have direct representation on the board, and serve as the officers of the corporation as well.[246]

The DGCL, then, is framed for multiple audiences, and so faces a bit of a dilemma. In terms of sheer volume, close corporations dominate the corporate world.[247] To the extent that theorists have postulated that Delaware is motivated by franchise fees to create a corporate law that is either efficient or management-friendly in order to attract revenue in the form of incorporation and corporate franchise fees, then its lawmakers must take into account the interests of close corporations. Still, public corporation law creates a national reputation for a state—if Delaware is to claim proudly that "more than 50% of all U.S. publicly traded companies and 60% of the Fortune 500" incorporate in Delaware,[248] then it must also cultivate laws that work for public corporations.[249]

Generally there is little difference between the laws of public and private corporations. Basic corporate law concepts like fiduciary relationships, duties of care and loyalty, and the business judgment rule all translate from the public realm to the private realm, and back again with little loss of utility. In contrast, in the intimate environment of the close corporation, independence means something very different than it does in the harsh spotlight of the public corporation.

In public corporations, agency costs pose a problem—perhaps the central problem of corporate law.[250] Widely dispersed shareholder-owners cannot control their agents, the officers of the corporation. They lack the incentive to monitor them effectively because any gain from increased monitoring is usually only a fraction of their total wealth.

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corporations are small, not all are. F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL AND THOMPSON'S CLOSE CORPORATIONS AND LLCS: LAW AND PRACTICE § 1:3 (rev. 3d. ed. 2004) (citing, among others, Milliken & Co., Inc., a textile operating and holding company; Mars, Inc., producer of various candies and other foods; and Hallmark Cards, Inc., and discussing the rise of "going private" transactions affecting many large, formerly public, companies).

245. Douglas K. Moll, *Shareholder Oppression and "Fair Value": Of Discounts, Dates, and Dastardly Deeds in the Close Corporation*, 54 DUKE L.J. 293, 330 n.135 (2004).

246. Susanna M. Kim, *The Provisional Director Remedy for Corporate Deadlock: A Proposed Model Statute*, 60 WASH. & LEE L. REV. 111, 151 (2003).

247. ROBERT A. RAGAZZO & DOUGLAS K. MOLL, CLOSELY HELD BUSINESS ORGANIZATIONS: CASES, MATERIALS, AND PROBLEMS 1 (2006) (stating that "the number of closely held businesses in this country vastly exceeds the number of publicly held businesses").

248. Delaware Division of Corporations, http://www.corp.delaware.gov/ (last visited Jan. 26, 2008).

249. Generally, of course, all state corporate codes address private and public corporations—Delaware is not unique in this respect. Delaware is, for well-rehearsed reasons, one of the few states to compete seriously on the basis of corporate charters. Delaware is a small state, and corporate franchise fees make up 15% to 20% of its revenue. Wells M. Engledow, *Handicapping the Corporate Law Race*, 28 J. CORP. L. 143, 146 (2002). When corporate service organizations and Delaware bar interests are factored in, one can argue that a uniquely large percentage of the state economy depends on making Delaware an attractive site for incorporation. Macey & Miller, *supra* note 235, at 503-05. Because it has achieved such dominance, it is the most fruitful code to compare with general corporate governance practices. Two states—Michigan and Connecticut—define independence in an ex ante manner. *See supra*, note 233. For our purposes, given the dominance of Delaware corporate law, it is relatively insignificant that two states not known for their competition for corporate charters define independent status in their codes. It is significant, however, that the only state to *require* independent directors does so only for corporations with over 100 shareholders—corporations that start to resemble public corporations. CONN. GEN. STAT. ANN. § 33-753(c)(1) (West 2005).

250. Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 248 (1999).

Finding "outsiders" to monitor their inside agents is thus enormously appealing:[251] the outsider (at least in theory) will help ensure that the agents remain faithful to the owners. Much of corporate governance—public corporate governance, at least—is focused on making sure that these watchers indeed do their jobs. But the tools that public corporate law uses are ex ante, status-based definitions: financial independence and lack of familial relationships are proxies for faithful monitoring.

In a private corporation, in contrast, there is often near identity between large shareholders, officers, and directors. To introduce an outsider into this mix would be enormously intrusive. Close corporations forge delicate equilibria that balance who will sit on the board, and which directors and which shareholders must approve certain actions, and who will receive a salary. These careful contractual arrangements would be thrown into disarray by a requirement that the board be composed of a majority of outsiders. For close corporations, Delaware's situational definition of independence makes much more sense. "Independence" matters only when it is needed, and the court's analysis is flexible enough to adjust to various contexts.

The exception proves the rule. Delaware defines independence as status only in the area of hostile takeovers.[252] Such a definition is obviously not applicable to private corporations because hostile takeovers are solely the concern of public corporations. Private corporations are not subject to the risk of hostile takeover, that is, of an outside entity buying up shares and thus taking control of the company. For this reason, Delaware can break with its general director-independence jurisprudence to favor defensive measures adopted by a majority outside board without fear of any repercussions for private corporations.[253]

Although the public/private story is attractive, it is also flawed. Delaware does not rely on outside independent status even in the public-only case of hostile takeovers. As discussed in Part IV.D.2, it focuses most of its inquiry on the behavior of the board in adopting the takeover defensive measure. More broadly, the argument seems to prove too much. If outside independent status really conveyed special benefits in the public-firm context, Delaware could create separate tests for public and private corporations. Indeed, Delaware, like most states, has a specialized close corporation statute.[254] Still, no state

251. Elson, *supra* note 77, at 499 (arguing that proper monitoring requires objectivity and that independence creates this objectivity).

252. *See supra* Part IV.D.2.

253. While it is true that *Weinberger* encouraged the creation of special negotiating committees made up of outside independent directors, these committees are something that the corporation can create when the situation calls for it. It need only be one or two directors, and they could be hired specifically for this task. So a private corporation looking to be acquired by a controlling shareholder could quickly appoint outside independences when the need arose.

254. *See generally* DEL. CODE ANN. tit. 8, §§ 341-56 (2007). Corporations can elect statutory close corporation status in their certificate of incorporation. They may not have more than 30 shareholders, their shares must be subject to restrictions on transfer, and they must not make a "public offering" of shares under the Securities Act of 1933. *Id.* § 342. But only a very small percentage of Delaware corporations actually become statutory close corporations because the form offers few advantages not obtainable under the general corporation law. F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL AND THOMPSON'S CLOSE CORPORATIONS AND LLCS: LAW AND PRACTICE §1.20 (rev. 3d. ed. & Supp. 2007). "The evidence suggests that the great majority of corporations eligible for statutory close corporation coverage do not elect to be covered, probably five percent or less in most states." *Id.* This is not to imply that public corporations are the predominant type of corporation. Although hard numbers are difficult to obtain, the "great majority" of

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requires close corporations to be governed by one statute, and public corporations by another. Default rules are provided by general corporation law, which applies to both public and private corporations. Furthermore, most of the Delaware cases dealing with independence are public company cases.[255]

Finally, even accepting that Delaware (and all 49 other states) does, in fact, address a different audience from SOX and the SROs, Delaware's model is still worth learning from for several reasons. First, Delaware's model reminds us why it is important to focus on the conflict at hand. It allows us to determine certain settings in which outsider status is valuable to the public company—in executive compensation committees, nominating committees, and audit committees. Second, given the weight of the empirical studies, the top-down one-size-fits-all prescription of supermajority outsider-status independence seems misguided. Delaware offers the best alternative approach.

D. A False Dichotomy

Another possible objection is that this Article has disingenuously described an either/or situation, failing to recognize that federal and state corporate laws overlap and act in tandem. In reality, Delaware's jurisprudence takes into account national corporate governance rules, and federal law provides a gatekeeping or screening mechanism for Delaware's courts.

While it may be true that SOX and the SROs do some of the initial sorting in keeping many inside directors from serving on the board, Delaware courts both pre- and post-SOX do not simply presume either that outside directors are necessarily independent, or that inside directors are automatically not independent.[256] For example, even where a director is a corporate employee, courts will conduct an analysis into whether such employment results in a lack of independence.[257]

On the flipside, perhaps SOX and the SROs are only an initial screen that relies on state laws and state courts to enforce the particulars of independence. It would then be

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corporations are close corporations. *Id.* §§ 1.2, 1.19.

255. For examples of the application of Delaware's corporation law to public companies, see *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984), *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 833 A.2d 961 (Del. Ch. 2003), *aff'd* 845 A.2d 1040 (Del. 2004), and *In re Oracle Corp. Derivative Litigation*, 824 A.2d 917 (Del. Ch. 2003); *see also supra* Part IV.C.3 and accompanying text.

256. However, sometimes its jurists occasionally refer to outside directors as independents. "Simply put, to be an inside or non-independent director is not a crime, it is a status." *In re* Toys "R" Us, Inc. S'holders Litig., 877 A.2d 975, 1003 (Del. Ch. 2005).

257. *See* Rales v. Blasband, 634 A.2d 927, 936 (Del. 1993) (examining whether the corporation's president and CEO were independent); Desimone v. Barrows, 924 A.2d 908, 947 (Del. Ch. 2007) (examining whether two inside directors, although not "among the most highly-compensated corporate executives in America," were independent of the interested outside directors, and concluding that they had a "strong interest in remaining in their corporate offices"); Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 833 A.2d 961, 977-78 (Del. Ch. 2003) (examining the question of whether the corporation's president, chief operating officer, and director were independent), *aff'd*, 845 A.2d 1040 (Del. 2004); *In re* Walt Disney Co. Derivative Litig., 731 A.2d 342, 356-57 (Del. Ch. 1998). The *Disney* court cites "the general Delaware rule that . . . "hold[ing] positions with the company . . . [controlled by Eisner] . . . is no more disqualifying than is the fact that he designated them as directors." *Id.* at 356. The *Disney* court found that Roy Disney's substantial stockholdings in Disney outweighed any control Eisner may have exerted over his compensation, and that two other inside directors "do not necessarily lose their ability to exercise independent business judgment merely by virtue of their being officers of Disney and Disney's subsidiaries." *Id.* at 357.

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unfair to criticize them for not defining independence as Delaware does. It is true that public corporations operate under the rules of state and federal law, as well as their own SRO, and that to look at one regulatory regime without awareness of the others gives only a partial view of reality. The danger of the corporate governance movement's approach to independence is that it elevates independent status as the best that shareholders can hope for in directors. So, for example, the Council of Institutional Investors calls for at least two-thirds of the board to be independent.[258] CEOs can proudly proclaim that their companies are models of corporate governance simply by virtue of having an independent board—a board that lacks ties to the corporation. But as the HP example vividly illustrates, an independent board is not always a capable or well functioning board. Elevating the absence of a quality to a positive virtue, and promoting that as the "ultimate goal" of regulation,[259] misleads investors into thinking that independent-status boards correlate with shrewd investment.

E. Administrability

SOX's rules-based approach at least has the virtue of certainty. Corporate attorneys can clearly identify directorial candidates that fulfill the requirements of the NYSE. The uncertainties of Delaware's standards-based approach are not fatal, however, for several reasons. First, as Jill Fisch points out, indeterminacy has benefits: most obviously, it permits results that are carefully tailored to the particular situation.[260] Second, fuzzier standards force parties to the bargaining table, encouraging them to negotiate rather than litigate.[261]

Perhaps most important, Delaware's general-standard approach does not leave corporate planners completely in the dark. Delaware jurisprudence offers clear guiding principles for corporate planners: focus on the transaction. Determine if a board member has a conflict. If so, then that board member should not participate in decision making. Even if the board member lacks a conflict of interest, delve deeper to see if anyone who might be seen to dominate or control that board member—an employer, a major supplier, a former donor, even a close friend—has a conflict of interest that would taint the director's independence. This analysis of independence places us in the realm of uncertainty, it is true. But by forcing the board, and corporate counsel, to examine conflicts as they occur, Delaware encourages decision makers to assess conflict in an active, reflective way. In this function of guiding the decisions of corporate planners, Delaware's jurisprudence is just as "ex ante" as SOX's. The difference is that evaluation of independence is made *at the time of the conflict*, and it is made with an understanding of the particular interests at stake. The insidiousness of the rules-based approach is that it removes responsibility from the board members at the critical point, the time a conflict arises; if one qualifies as independent initially by virtue of lack of ties to the corporation

258. COUNCIL OF INSTITUTIONAL INVESTORS, THE COUNCIL OF INSTITUTIONAL INVESTORS CORPORATE GOVERNANCE POLICIES, http://www.cii.org/policies/CII%20Policies%20-%20Board.pdf (last visited Oct. 25, 2007).

259. Bonnie Hill, Comment, *A View From the Board Room: The Success of Corporate Governance*, 55 CASE W. RES. L. REV. 551, 555 (2005).

260. Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. CIN. L. REV. 1061, 1082 (2000).

261. *Id.* at 1083.

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and management, one is independent.[262]

VII. CONCLUSION

It would be tempting to conclude that the solution to the "problem" of independence is to define independence to include independence from management. The lesson to be learned from Delaware is far deeper than that. In terms of the definition of independence, Delaware teaches us to focus on what the conflict is for the given transaction. In terms of the ends that independence serves, it also cautions us against overreliance on independence as the answer. Independence is a tool, useful for a specific function. To expect independence to achieve more, to require supermajority independent boards and expect them to make better business decisions and govern the corporation better, is to misconceive the role of the independent director and to fetishize independence.

262. It is true that both the NYSE and the NASDAQ require the board to make a standards-like determination of independence of its members each year, but the determination is made in a vacuum. This approach has the vice of Delaware's approach—indeterminacy—without the compensating virtue of focusing on a particular conflict.

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