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A CONFLICT PRIMACY MODEL OF THE PUBLIC BOARD

*Usha Rodrigues**

The board of directors is the theoretical fulcrum of the corporate form: statutes task the board with managing the corporation. Yet in the twentieth century, CEOs and other executives came to dominate the real-world control of the corporation. In light of this transformation, in the 1970s Melvin E. Eisenberg proposed reconceiving the board as an independent monitor. Eisenberg's monitoring board is now the dominant regulatory model of the board. Recently two different visions of the board of directors have emerged. Stephen Bainbridge's "director primacy" model calls directors "Platonic guardians," and Margaret Blair and Lynn Stout's "team production model" characterizes them as "mediating hierarchs." Each of these models involves different conceptions of the board, but both theories presume that boards should play a central role in corporate governance.

The reality of today's public corporate board, however, is one of limited information, constrained time, and uncertain ability. The reforms of the past three decades have left us with supermajority independent boards—boards, that is, composed mostly of outsiders. There is no guarantee that the directors populating these boards have any knowledge of the corporation in general or of the particulars of the business they serve. With one exception (the financial expert), they need not have advanced degrees or a minimum level of experience in business or management. The only quality they must have is independence, defined as a lack of ties to the corporation. This chief strength of the board is also a weakness, because it means that most members of the board rely on the CEO for knowledge of the corporation and its business.

The centrality of independence to modern boards requires us to rethink their essential role. I do so here by articulating and defending a "conflict primacy" model of the public company board. In my view, expecting a group dominated by outsiders to oversee and vote

* Associate Professor, University of Georgia School of Law. I thank participants in the *In the Boardroom* symposium (particularly Nicola Faith Sharpe for organizing the valuable event), participants in a Georgia Law roundtable, the UCLA Junior Business Law Faculty Forum, Kelli Alces, Stephen M. Bainbridge, Dan Coenen, Peter Conti-Brown, Jim Smith, and Larry Thompson. Sajid Saleem provided valuable research assistance. Any errors are my own.

on substantive managerial decisions about the corporation—about the proper approach to labor disputes, when to expand the corporation, how to expend corporate resources—simply does not make sense. What does make sense is for the board to police situations in which the self-interest of the corporation’s day-to-day managers impedes their ability to function effectively. The board’s central role, then, should concern monitoring CEO performance and pay (including the removal power and succession planning), overseeing the audit function, and dealing with takeovers and derivative suits. In such areas of conflict of interest the board’s lack of ties to management becomes a strength, and so it is on these subjects that the board should focus. Perhaps controversially, the conflict primacy model would reduce the role of CEOs on the board, demoting them to nonvoting, ex officio status. Reconstituted in this manner as a more fully independent body, the board of directors would have a clear but circumscribed mandate that comports with its modern character. Part-timers are not well situated to second-guess executives, but are well equipped to manage conflicts of interest.

I. INTRODUCTION

With every financial crisis or scandal comes the cry “Where were the boards?” and a call for boards to “do more.”¹ This Article argues that these calls stem from a misunderstanding of what the modern board of a public corporation looks like and what it is best able to do. We ask today’s public company boards to do too much with too little. We should not, at least unthinkingly, ask them to do more.

In the view of most corporate law scholars, the ideal board engages actively in the life of the corporation. It thus should obtain exhaustive knowledge of the corporation’s inner workings, its supply chains, its customer base and potential for growth, the corporation’s industry and chief competitors. Ever alert for opportunities for growth, it should guide the corporation toward new revenue opportunities, whether in social media or around the globe. The board should plan for liquidity crises and be alert to macroeconomic trends and regulatory changes that could affect the business. It should likewise monitor natural catastrophes and political upheavals of consequence to the bottom line. It should ensure that the management team functions harmoniously, awarding compensation in a thoughtful manner calculated to create the right incentives, and stepping in swiftly when dissent occurs. One might call this the “Platonic Ideal” model of the corporate board.

1. Eric J. Pan, *A Board’s Duty to Monitor*, 54 N.Y.L. SCH. L. REV. 717, 718–19 (2009/2010) (asking whether the board did its job in the wake of the Citigroup bailout); Jennifer S. Taub, *Able but Not Willing: The Failure of Mutual Fund Advisers to Advocate for Shareholders’ Rights*, 34 J. CORP. L. 843, 864 (2009) (noting the increased concern over conflicts after the collapses of Enron and WorldCom); John Schnatter, Editorial, *Where Were the Boards?*, WALL ST. J., Oct. 25, 2008, at A11 (blaming the boards of directors for failure to oversee management during the financial crisis).

To achieve this Platonic Ideal, reform efforts over the past three decades have moved in one direction: increasing independence.² Independence has gone from a recommended “best practice” to a legal requirement, enshrined in Sarbanes-Oxley and in the listing requirements of the stock exchanges.³ Regulators also have defined independence ever more stringently, assiduously addressing the problem of “grey” directors, or directors who are independent only as a matter of technical labeling.⁴

I am skeptical that we can define our way to “true” independence, but assume for the sake of argument that we can at least come close. Independence is the *lack* of a quality—the absence of ties to management. It does not ensure creation of the Platonic Ideal board. If a corporation were to select nine undergraduates—or tinkers or tailors or soldiers or sailors—at random, it would probably wind up with a perfectly independent board. It is considerably less likely to have created the Platonic Ideal board.

When I say that we ask public company boards to do too much with too little, I mean that the dominant regulatory philosophy pushes corporations towards the unattainable Platonic Ideal and then takes boards to task when they fall short. By fetishizing independence, we have created boards of individuals especially ill-suited to monitoring the corporation’s full range of work. By definition, independent directors have no internal ties to the corporation. Rather, they have outside employment, unless they are retired. We cannot fairly expect a board of part-timers to function as the Platonic Ideal board. Some of today’s public corporations may have such boards. But if so, it is all but a miracle.

There is, I argue, a profound problem at work here. It is that corporate law theory is out of touch with corporate practice reality. Corporate law tasks the board with running the corporation; it delegates the day-to-day management to the chief executive officers and their executive team,

2. I have in prior work distinguished between an outside director and an independent director. See Usha Rodrigues, *The Fetishization of Independence*, 33 J. CORP. L. 447 (2008). In that article, I differentiate outside director status from the notion of independence as applied by Delaware courts. In this piece, I bow to the prevailing wording and use the term “independence” to denote outside director status.

3. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 301, 116 Stat. 745, 775–77 (codified at 15 U.S.C. § 78j-1(m)) (requiring that an audit committee be comprised of independent directors); see NYSE LISTED COMPANY MANUAL § 303A.06 (2012), available at <http://nysemanual.nyse.com/LCM/Sections> (audit committee); *id.* § 303A.05 (compensation committee); *id.* § 303A.04 (nominating committee); NASD DEALERS MANUAL § 4350(d) (2006), available at http://nasdaq.cchwallstreet.com/NASDAQ/pdf/predecessor_rule_text.pdf (audit committee); *id.* § 4350(c) (compensation and nominating committees); see also NYSE MKT LLC COMPANY GUIDE § 803 (2010), available at <http://wallstreet.cch.com/AMEX/CompanyGuide> (audit committee); *id.* § 804 (requiring all nominating committee members to be independent); *id.* § 805 (requiring all compensation committee members to be independent).

4. Listing Standards Relating to Audit Committees, 17 C.F.R. § 240.10A-3 (2012) (defining independence for members of audit committees); Listing Standards for Compensation Committees 77 Fed. Reg. 38,422 (July 27, 2012) (to be codified at 17 C.F.R. § 240.10C-1) (compensation committees); Carlo Osi, *Family Business Governance and Independent Directors: The Challenges Facing an Independent Family Business Board*, 12 U. PA. J. BUS. L. 181, 194–95 (2009).

but the board remains in charge. Melvin Eisenberg's revolutionary vision of the board as independent monitor now dominates corporate governance.⁵ Two notable new theories of corporate governance—Margaret Blair and Lynn Stout's team production model⁶ and Stephen Bainbridge's director primacy model⁷—similarly place the board at the center of the corporation. But business realities have caused all these models to founder: today's public corporation is dominated by outside directors, who have limited information about the corporation and little time to oversee its operations.

It didn't have to be this way. The board is an inherently protean body, capable of flexing and stretching to serve the needs of a broad spectrum of corporations. State corporate law by its nature necessitates such flexibility, given the fact that the same basic corporate code serves the needs of both tiny "mom and pop" corporations and Fortune 50 behemoths.⁸ As Bainbridge has pointed out, the literature identifies three functions for the public board: (1) monitoring and disciplining management, (2) providing advice and guidance to managers, and (3) providing a network of useful business contacts.⁹ Some boards will do more with one function, more with the other. The board mechanism, in state statutory construction at least, adapts to serve them all.

Enter the feds. As Mark Roe and others¹⁰ have elaborated, the states do not regulate in a vacuum, particularly where public corporations are concerned. A mixture of disclosure requirements that thinly veil substantive requirements, exchange rules, and best practices pressure have combined to effect a species of federal intervention into the composition of the public company board. This intervention has enshrined a monitoring model, one dependent on an independent board. As I have written elsewhere, the federal understanding of independence is status-driven, and far removed from the more functional definition of independence that Delaware applies.¹¹

5. See MELVIN ARON EISENBERG, *THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS* (1976) [hereinafter EISENBERG, *STRUCTURE*]; STEPHEN M. BAINBRIDGE, *CORPORATE GOVERNANCE AFTER THE FINANCIAL CRISIS* 53 (2012) [hereinafter BAINBRIDGE, *CORPORATE GOVERNANCE*] ("Although the modern understanding of the board's role and function has no single parent, if one were to insist on finding someone to whom to give the bulk of the credit—or blame—the leading candidate probably would be Professor Melvin Eisenberg.")

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

7. See Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547 (2003) [hereinafter Bainbridge, *Primacy*].

8. I put to one side the statutory close corporations, as they are relatively seldom used and hover on the periphery of corporate practice.

9. BAINBRIDGE, *CORPORATE GOVERNANCE*, *supra* note 5, at 49–50, 61.

10. See Marcel Kahan & Edward Rock, *Symbiotic Federalism and the Structure of Corporate Law*, 58 VAND. L. REV. 1573 (2005); Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588 (2003).

11. The Model Business Corporation Act uses the more specific term "qualified director" for the same purpose. See MODEL BUS. CORP. ACT § 1.43 (2011).

This federal intrusion has meant that some of the expectations the law and corporate reformers alike have for the board are now unrealistic. Accordingly, this Article suggests a way of reconstituting and reframing the board of directors to address the disconnect between the theoretical power and actual impotence of the public board. Today, because our law effectively requires that most public board members be independent, the quality of independence has become the defining feature of boards. Given this reality, this Article advocates disqualifying full-time employees from board membership altogether, thus relegating CEOs to an observer status that permits them to attend most meetings but not to vote. This fully independent board would focus solely on areas where management's interests conflict with those of the corporation as a whole: executive compensation, audit, takeovers, derivative suits, and related party transactions. Liberated from the foolish notion that it can effectively manage corporate strategy, the board could focus on those areas in which independence is an asset rather than a liability.

I pause to note that I confine my remarks to public companies only, and to those without a dominant shareholder. The private firm is a horse of a different color. It often has few independent directors, and frequently large shareholders serve both as board members and executives.¹² Insiders make up a considerable portion of the board and have the time, knowledge, and motivation to manage daily corporate affairs. The board in such corporations will presumably continue to play a vital managerial role. Likewise, in public corporations where a single shareholder or group possesses a "control block," that owner can assert control over the corporation by way of the board, and can generally expect that board to govern in accordance with his or her wishes.¹³ These two cases, then, I set to one side.

My argument proceeds as follows. Part II describes the accepted view of the board as the manager of the corporation. Part III describes how poorly today's boards are suited to manage. Part IV proposes a conflict primacy theory of the board of directors, describing how it would work and tying it to Melvin Eisenberg's original description of the monitoring board. Part V addresses some objections, and Part VI concludes.

II. THE CENTRALITY OF THE BOARD TO CORPORATE LAW IN THEORY

Boards are the crux of the corporation—at least in legal theory. Section 141(a) of the Delaware General Corporation Law requires that "[t]he business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of direc-

12. Mark K. Fiegener et al., *CEO Stakes and Board Composition in Small Private Firms*, *ENTREPRENEURSHIP: THEORY & PRAC.*, Summer 2000, at 5 (finding that small private firms are less likely to have independent board compositions).

13. See STEPHEN M. BAINBRIDGE, *THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE* (2008).

tors.”¹⁴ Similarly, the Model Business Corporation Act requires each corporation to have a board of directors.¹⁵ It provides: “All corporate powers shall be exercised by or under the authority of the board of directors of the corporation, and the business and affairs of the corporation shall be managed by or under the direction, and subject to the oversight, of its board of directors, subject to any limitation set forth in the articles of incorporation”¹⁶ As Stephen Bainbridge observes, “The key players in the statutory decision-making structure are the corporation’s directors.”¹⁷

Despite the central role the board plays in statutes, in practice the CEO and other executives have long dominated corporate life. In his landmark book, *The Structure of the Corporation*,¹⁸ published in 1976, Melvin Eisenberg challenged the insider-dominated boards of the day, positing that the modern board should serve as an independent monitor that works to safeguard shareholder interests.¹⁹ Cheek-by-jowl with the independent board, the shareholder primacy theory gained prominence, becoming the “dominant” view of the corporation.²⁰ Shareholder primacy holds that the purpose of the corporation is ultimately to serve the interests of its shareholders. As the corporation’s residual claimants, shareholders’ interests should be the focus of corporate decision makers, and shareholders’ power to vote for the board highlights this purpose.²¹ The independent board thus monitors managers to ensure that they run the corporation for the benefit of the shareholders.²²

Recent challenges to the shareholder-centric view of the corporation have come from Margaret Blair and Lynn Stout’s team production model and Stephen Bainbridge’s director primacy model, both of which likewise focus on the pivotal role played by boards of directors. Each model provides a calculated response to shareholder empowerment. Crucially, each model hinges on an active and powerful board of direc-

14. DEL. CODE ANN. tit. 8, § 141 (2013).

15. MODEL BUS. CORP. ACT § 8.01. The exception to section 8.01 is corporations governed by shareholders, which are covered in MODEL BUS. CORP. ACT § 7.32.

16. *Id.* § 8.01(b).

17. Bainbridge, *Primacy*, *supra* note 7, at 559.

18. EISENBERG, *STRUCTURE*, *supra* note 5.

19. William W. Bratton & Michael L. Wachter, *Shareholder Primacy’s Corporatist Origins: Adolf Berle and The Modern Corporation*, 34 J. CORP. L. 99, 145 (2008) (“Eisenberg’s monitoring model of the board of directors has ever since been the main focus of legal corporate governance.”).

20. *Id.* at 100 n.2 (citing Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 439 (2001) (“There is no longer any serious competitor to the view that corporate law should principally strive to increase long-term shareholder value.”)); Mark J. Roe, *The Shareholder Wealth Maximization Norm and Industrial Organization*, 149 U. PA. L. REV. 2063, 2065 (2001) (noting that “[s]hareholder wealth maximization is usually accepted as the appropriate goal in American business circles” without normatively endorsing the proposition).

21. Matthew T. Bodie, *AOL Time Warner and the False God of Shareholder Primacy*, 31 J. CORP. L. 975, 977 (2006).

22. Roberta S. Karmel, *Should a Duty to the Corporation Be Imposed on Institutional Shareholders?*, 60 BUS. LAW. 1, 17 (2004) (describing the ALI’s Corporate Governance Project).

tors. As Part III describes, the public boards of today in fact function very differently than these models envision.

With the director primacy theory, Bainbridge seeks to explain why the law places the board of directors at the center of the web of contracts that is the corporation. He views them “as a sort of Platonic guardian—a *sui generis* body serving as the nexus for the various contracts making up the corporation and whose powers flow not from shareholders alone, but from the complete set of contracts constituting the firm.”²³ While in his view the corporation is ultimately run for the shareholders, for Bainbridge corporate law statutes are justified in centering corporate decision making with the board, and moves to empower shareholders are thus wrongheaded and counterproductive.

The chief virtue of the public corporation, in Bainbridge’s view, is that “it provides a hierarchical decisionmaking structure well-suited to the problem of operating a large business enterprise with numerous employees, managers, shareholders, creditors, and other inputs.”²⁴ He further observes:

In such a firm, someone must be in charge: “Under conditions of widely dispersed information and the need for speed in decisions, authoritative control at the tactical level is essential for success.” In other words, someone must possess the right to make, by fiat, decisions binding on the whole firm.²⁵

Bainbridge concludes that the statutes are right to entrust power of fiat with the board.²⁶

Bainbridge’s *bête noire* is shareholder empowerment; he vociferously objects to those that would grant shareholders more robust voting rights or more voice in corporate governance.²⁷ Given this concern, it is in some sense logical for him to turn to the board of directors as a locus of power. What he objects to is not that the corporation be run for the shareholders—indeed, he embraces the desideratum of shareholder

23. Bainbridge, *Primacy*, *supra* note 7, at 560.

24. *Id.* at 572.

25. *Id.* (quoting another source).

26. Stephen M. Bainbridge, *The Board of Directors As Nexus of Contracts*, 88 IOWA L. REV. 1, 20 (2002) [hereinafter Bainbridge, *Nexus*] (“In the public corporation . . . fiat is essential. All organizations must have some mechanism for aggregating the preferences of the organization’s constituencies and converting them into collective decisions.”). Part III expresses skepticism as to whether the board, as opposed to the CEO, can actually exercise authority swiftly and effectively enough to fulfill the need for tactical control that Bainbridge describes.

27. Bainbridge accurately describes U.S. corporate law as being director-focused, rather than shareholder-focused:

Shareholders exercise virtually no control over either day-to-day operations or long-term policy. Instead, control is vested in the hands of the board of directors. . . . Under all corporation statutes, the vast majority of corporate decisions are assigned to the board of directors or their subordinates acting alone. Shareholders essentially have no power to initiate corporate action and are entitled to approve or disapprove only a very few board actions. . . . The statute thus recognizes that the board of directors hires capital, not vice-versa.

Bainbridge, *Primacy*, *supra* note 7, at 573–74.

wealth maximization.²⁸ But the shareholders themselves cannot be in charge of the corporation, or they lose the benefits of the separation of ownership and control. For him, the benefit of a board lies in having a group apart from the shareholders that can exercise authority for the corporation. This ability explains the existence and centrality of the board in the eyes of the law.

Margaret Blair and Lynn Stout likewise focus on the board of directors, which they characterize as “mediating hierarchs,” in developing their team production model of the corporation. They argue that the corporate form allows various corporate participants to give up rights in order to allow for combined investment and coordination.²⁹ The directors play the central role of coordinating the different corporate stakeholders.³⁰

The team production model, like Bainbridge’s, seeks to counter a theory of shareholder primacy. Thus, “boards exist not to protect shareholders *per se*, but to protect the enterprise-specific investments of *all* the members of the corporate ‘team,’ including shareholders, managers, rank and file employees, and possibly other groups, such as creditors.”³¹ Blair and Stout thus criticize the characterization of directors as merely the agents of the shareholders,³² pointing out that shareholders, unlike typical principals, do not—and cannot—tell directors what to do. They depict directors not as agents but rather as trustees, who “once elected, become the ultimate decisionmaking authority within the firm.”³³ Directors, in this view, have “tremendous discretion to sacrifice shareholders’ interests in favor of management, employees, and creditors, in deciding what is best for ‘the firm.’”³⁴

Bainbridge justifies the law’s anointing of the board as ultimate authority of the corporation, reasoning that, given that there must be an ultimate authority, it is better to entrust that function to a group.³⁵ Blair and Stout vest the board with power because it is a neutral collective entity, and therefore able to credibly mediate disagreements among various corporate constituencies.³⁶ Although different in approach, both Bainbridge and Blair and Stout, then, concur with the framework of our corporate statutes by conceptualizing corporate control as lodged with the board of directors. Whether directors serve as “mediating hierarchs” or as “Platonic guardians,” they are expected to serve as the corporation’s

28. *Id.* at 563.

29. Blair & Stout, *supra* note 6, at 249–51.

30. *Id.* at 251.

31. *Id.* at 253.

32. *Id.* at 290.

33. *Id.* at 291. Because directors have “free rein to consider and make trade-offs between the conflicting interests of different corporate constituencies,” they cannot fairly be described as mere agents of the shareholders. *Id.*

34. *Id.*

35. See Bainbridge, *Primacy*, *supra* note 7.

36. See Blair & Stout, *supra* note 6.

ultimate decision makers—in short, to run the firm. The next Part describes how ill-suited the modern public board is to serving this would-be role.

III. THE MARGINALIZATION OF THE MODERN BOARD IN PRACTICE

Public company boards today are supermajority independent, meaning that most directors are not company insiders. Indeed, increasing board independence has been the chief focus of corporate governance reform for the past thirty years. Ironically, this move toward independence has weakened boards by populating them with individuals who possess little information about the corporation, and who have little time to make use of what little information they have. This Part first describes the move toward increased board-member independence and then describes the problems independence reforms have created.

A. *Why More Independence*

Over the last thirty years, the boards of public corporations have undergone a gradual yet dramatic transformation. In the 1960s most boards had a majority of in-house, non-independent directors serving a largely functionary role.³⁷ The evolution of U.S. corporate boards from homogeneous, insider-dominated clubs to majority-independent institutions tracks the rise of the concept of the monitoring board. If a board's principal role is to monitor management, then "implicit in that role is a director's ability to exercise judgment independent from management."³⁸ Thanks to the widespread adoption of Eisenberg's monitoring board, most boards today have a supermajority of outside, independent directors.³⁹

Developments in the 1970s ranging from the Penn Central Railroad bankruptcy and Watergate scandal to the birth of the corporate social responsibility movement led to the support for empowering independent directors.⁴⁰ By the end of the 1970s, the ideal board became a "monitoring" board rather than a rubber-stamping, merely titular body.⁴¹ Note

37. 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, 1513–14 (2007) ("This conception fit with the idea of an advisory board that included many insiders and outsiders with important economic relationships with the firm, such as bankers, lawyers, and suppliers. Such knowledgeable parties could serve as a useful sounding board for the CEO, a kitchen cabinet, and could provide expertise in the face of increasing complexity. In an important sense, boards were an extension of management.").

38. Elizabeth Cosenza, *The Holy Grail of Corporate Governance Reform: Independence or Democracy?*, 2007 BYU L. REV. 1, 18–19.

39. Eisenberg served as reporter for the ALI's Corporate Governance Project, which focused on the monitoring role independent directors should play. John H. Matheson & Brent A. Olson, *Corporate Law and the Longterm Shareholder Model of Corporate Governance*, 76 MINN. L. REV. 1313, 1363–64 (1992).

40. Gordon, *supra* note 37, at 1514–18.

41. *Id.* at 1518.

that, as Part IV.F describes, from the beginning, board monitoring meant monitoring the CEO. The board was not meant to be some free-floating ombudsperson charged with fly-specking every little corporate matter as it arose. Instead, the core job of the board was to monitor the CEO's performance.⁴² Therefore a board free of conflicts of interest—that is, of ties to that CEO or to the CEO's management team—would best suit the task at hand.

Today's boards of directors are "independent": that is, they are made up of a majority of outside directors, who are not employed by the corporation on whose board they sit. Regulatory requirements explain much of the shift to the independent board. Reacting to the Enron and WorldCom scandals, the Sarbanes-Oxley Act of 2002 effectively required an independent audit committee,⁴³ and (at the SEC's behest) the New York Stock Exchange (NYSE) and NASDAQ each required listing firms to have a majority independent board, and independent nomination and compensation committees.⁴⁴ Even before Sarbanes-Oxley, however, best practices dictated that boards move toward ever-greater board independence.⁴⁵ Formalizing what was by then a de facto requirement, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 mandated that publicly traded companies have independent compensation committees.⁴⁶ In reality, today most public corporations have supermajority independent boards; indeed, often the CEO is the only employee-director.⁴⁷

B. *The Problem With Independence*

In theory, outside directors bring a fresh, unbiased, expert perspective to the task of corporate management. In practice, however, outside directors rely heavily on top management. The American Bar Association Task Force on Corporate Responsibility noted that many aspects of an outside director's role reflect a dependence on senior management: "Typically, senior management plays a significant part in the selection of directors, in proposing the compensation for directors, in selecting their

42. See *infra* Part IV.F.

43. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 303, 116 Stat. 745, 778 (codified at 15 U.S.C. § 7242).

44. Robert B. Thompson, *Collaborative Corporate Governance: Listing Standards, State Law, and Federal Regulation*, 38 WAKE FOREST L. REV. 961, 979–81 (2003); see NYSE LISTED COMPANY MANUAL, *supra* note 3, § 303A.06; *id.* § 303A.04 (nominating committee); NASD DEALERS MANUAL, *supra* note 3, § 4350(d) (audit committee); *id.* § 4350(e) (compensation and nominating committees); see also NYSE MKT LLC COMPANY GUIDE § 803 (2010), available at <http://wallstreet.cch.com/AMEX/CompanyGuide/> (audit committee); *id.* § 804 (requiring all nominating committee members to be independent); *id.* § 805 (requiring all compensation committee members to be independent).

45. Gordon, *supra* note 37, at 1481.

46. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 952, 124 Stat. 1376, 1900 (2010) (codified at 15 U.S.C. § 78j-3).

47. In 2007, the average board was made up of ten directors, eight of whom were outside directors. KORN/FERRY INST., 34TH ANNUAL BOARD OF DIRECTORS STUDY 6 (2008).

committee assignments, in setting agendas for their meetings, and in evaluating their performance.”⁴⁸

Even if directors are not hand-picked by the CEO, they inevitably rely heavily on officers in doing their work. As Kelli Alces has explained:

[D]irectors learn from officers why the officers recommend a particular course of action and officers are not perceived as inferior to directors when the board makes most of its business decisions. Rather, the officers present an idea to the board and advise directors and then the directors ask questions to determine if they agree with the officers’ judgment. . . . Directors have to rely heavily on officers for the judgment and information they use in performing their monitoring tasks.⁴⁹

Indeed, even if directors ask for additional information, that information will generally be created by or under the supervision of corporate officers.⁵⁰

No less importantly, part-time outside directors face information asymmetries relative to the managers of the companies they serve. As Stephen Bainbridge has pointed out, “Outsiders by definition need more information and are likely to take longer to persuade than are insiders.”⁵¹ Initial corporate governance reform focused on ensuring better information for the board, particularly through reports made by public accountants.⁵² Still, as Lisa Fairfax points out, these gatekeepers themselves rely on insiders for information. In addition, they may be subject to their own conflicts of interest. For example, the Arthur Andersen partner in charge of Enron’s audit and the Vinson & Elkins partner representing the firm relied on Enron for so much revenue that they functioned more as corporate ushers than as gatekeepers.⁵³ Professor Fairfax terms these asymmetries the “knowledge deficit.”⁵⁴

The ways in which board members receive information are also problematic. Directors typically obtain information shortly before board meetings and this material is often voluminous and poorly organized.⁵⁵ As Nicola Sharpe describes: “[D]irectors receive information packets prepared by the CEO or by the executives who work for her; directors rarely have channels outside of the CEO for information gathering. If

48. James H. Cheek, III et al., *Preliminary Report of the American Bar Association Task Force on Corporate Responsibility*, 54 MERCER L. REV. 789, 799 (2003).

49. Kelli A. Alces, *Beyond the Board of Directors*, 46 WAKE FOREST L. REV. 783, 795 (2011).

50. Lyman Johnson & Robert Ricca, *Reality Check on Officer Liability*, 67 BUS. LAW. 75, 82 (2011).

51. BAINBRIDGE, CORPORATE GOVERNANCE, *supra* note 5, at 87.

52. EISENBERG, STRUCTURE, *supra* note 5, at 186–211; Lisa M. Fairfax, *The Uneasy Case for the Inside Director*, 96 IOWA L. REV. 127, 161–62 (2010).

53. Fairfax, *supra* note 52, at 162–64.

54. *Id.* at 165.

55. Nicola Faith Sharpe, *The Cosmetic Independence of Corporate Boards*, 34 SEATTLE U. L. REV. 1435, 1454 (2011).

executive management's vision of the company is flawed, the board's information will share the same flaws."⁵⁶

The average director spends roughly twenty hours a month on the governance of his or her company.⁵⁷ One 2011 survey found that roughly half of North American CEOs believed their boards were well-prepared at meetings.⁵⁸ Only forty-six percent believed that boards "understand the factors that drive performance in each of the [firm's] main businesses."⁵⁹ It is no surprise, then, that board members lack the sort of expertise that company insiders possess.

Given the limitations on directors' time and the quality of the information they receive,⁶⁰ it is no wonder that empirical studies fail to indicate that adopting a majority independent board leads to improved financial performance. Sanjai Bhagat and Bernard Black, for example, found that

[f]irms with more independent boards (proxied by the fraction of independent directors minus the fraction of inside directors) do not achieve improved profitability, and there are hints in our data that they perform worse than other firms. This evidence suggests that the conventional wisdom on the importance of board independence lacks empirical support.⁶¹

Professor Jeffrey Gordon's response to these studies questioning the value of independent boards is to argue that the most significant positive effects of the independence movement have been systematic.⁶² In other words, while the individual gains to a particular firm from increasing independence might be negligible, overall independence has improved both the quality of disclosure and the market-wide level of legal compliance—both worthy benefits.⁶³ Furthermore, Gordon argues that as the SEC has required the disclosure of ever more and more detailed information, stock prices have become more informative, and thus inde-

56. *Id.*

57. Johnson & Ricca, *supra* note 50, at 80; MARTIN LIPTON ET AL., SOME THOUGHTS FOR BOARDS OF DIRECTORS IN 2012, at 5 (2011), available at <http://www.wlrk.com/files/2012/SomeThoughtsforBoardsOfDirectorsin2012.pdf> ("The 2011 Public Company Governance Survey of the National Association of Corporate Directors (NACD) suggests that public company directors spent an average of over 227 hours performing board-related activities in 2011.").

58. COLIN B. CARTER & JAY W. LORSCH, BACK TO THE DRAWING BOARD: DESIGNING CORPORATE BOARDS FOR A COMPLEX WORLD 26 (2004).

59. *Id.* at 24 tbl.2-1.

60. As Stephen Bainbridge rightly points out, the independence fetish has other costs, among them the need to incentivize outside directors to monitor and the loss of benefits of insider representation, including providing insight into situations where bad outcomes are outside managerial control, and providing a conduit of information and trust between management and the board. See BAINBRIDGE, CORPORATE GOVERNANCE, *supra* note 5, at 102-03. While such costs are real, for the purposes of this Article I take the position that the war of independence has already been lost. Insider board representation is unlikely to reemerge.

61. Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231, 233 (2002).

62. Gordon, *supra* note 37, at 1508-09.

63. *Id.*

pendent directors can rely more on outside performance signals to assess the performance of the CEO and the management team.⁶⁴

Certainly, at least up to a point, increasing the amount and quality of disclosure makes a corporation's stock price more accurately reflect the firm's performance, and thus lessens the information asymmetry described above. Yet a company's stock price performance is a crude and binary indicator. As discussed in Part IV.C below, it may serve as a valuable tool to evaluate CEO performance, allowing as it does benchmarking against industry peers. But if a firm's stock price is languishing, that fact only tells the board that something is amiss. It does not offer guidance as to which strategic path to take—that question is one of firm management. And yet, as the next Section will describe, many of the tasks public boards are exhorted to undertake involve just such managerial calls, which an independent board lacks the know-how to make. The blunt instrument of stock performance serves as a poor substitute for inside knowledge of the firm.

This Section first described the evolution of the modern independent board of directors. It next outlined the problems independence poses for the directors of today's public corporations: they come from outside the corporation, and, perhaps, outside the industry. They have limited channels through which to communicate with insiders and depend heavily on management for information.⁶⁵ They have limited time and attention to devote to conducting the business of the corporation.⁶⁶ Empirical studies show that independence does not positively correlate with firm performance in general.⁶⁷ Even if the rise in independent boards and concomitant increase in reliability of stock price as an indicator of firm performance has made it easier for boards to monitor the performance of the executives, these developments fail to provide the kind of working knowledge of firm or industry that could guide independent directors seeking to manage the firm. In other words, more accurate stock prices make it easier for independent directors to monitor managers' performance, but not for them to manage the firm itself. Yet there is little likelihood of reforms that will require or incentivize the creation of *less* independent boards—politically, a push to bring more insiders onto boards would be difficult to justify. The independent board is here to stay.⁶⁸

64. Gordon, *supra* note 37, at 1541–43.

65. See *supra* notes 49–54 and accompanying text.

66. See *supra* notes 55–59 and accompanying text.

67. See Bhagat & Black, *supra* note 61.

68. Reform usually happens only when a catalytic problem emerges—generally fraud. Putting more insiders on the board will never seem like the solution when managers loot or mismanage, which is the only time reform occurs. See Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521 (2005); Stephen M. Bainbridge, *Dodd-Frank: Quack Federal Corporate Governance Round II*, 95 MINN. L. REV. 1779 (2011).

C. *Where Theory Meets Practice: Boards Are Asked to Manage More with Less*

The modern public board's responsibilities lie in two areas: monitoring the activities of the corporate executives and managing the corporation's business affairs.⁶⁹ The board's monitoring responsibilities primarily involve appointing the CEO and evaluating the management team.⁷⁰ The board's management responsibilities essentially involve having the final say-so on major corporate issues, such as bringing suit on the corporation's behalf, pursuing mergers and acquisitions, issuing of dividends, and the like.⁷¹

Descriptions of what boards do alternate between these twin responsibilities of management and monitoring. Wachtell Lipton recently provided a long list of expectations for the board:

- Choose the CEO, monitor his or her performance, and have a detailed succession plan in case the CEO becomes unavailable or fails to meet performance expectations.
- Plan for and deal with crises, especially crises where the tenure of the CEO is in question, where there has been a major disaster, or where hard-earned reputation is threatened by product failure.
- Determine executive compensation, achieving the delicate balance of enabling the company to recruit, retain and incentivize the most talented executives, while avoiding media and populist criticism for "excessive" compensation.
- Interview and nominate director candidates, monitor and evaluate the board's own performance, and seek continuous improvement in board performance.
- Provide business and strategic advice to management and approve the company's budgets and long-term strategy.
- Determine the company's risk appetite (financial, safety, reputation, etc.), set state-of-the-art standards for managing risk, and monitor the management of those risks.
- Monitor the performance of the corporation and evaluate it against the economy as a whole and the performance of peer companies.
- Set state-of-the-art standards for compliance with legal and regulatory requirements, monitor compliance, and respond appropriately to "red flags."

69. See, e.g., Alces, *supra* note 49, at 790–805 (discussing the dual monitoring and management functions of the modern board).

70. See Jill E. Fisch, *Taking Boards Seriously*, 19 CARDOZO L. REV. 265, 269–71 (1997).

71. See Lynn A. Stout, *The Shareholder As Ulysses: Some Empirical Evidence on Why Investors in Public Corporations Tolerate Board Governance*, 152 U. PA. L. REV. 667, 668 (2003).

No. 3] A CONFLICT PRIMACY MODEL OF THE PUBLIC BOARD 1065

- Take center stage whenever there is a proposed transaction that creates a seeming conflict between the best interests of stockholders and those of management, including takeovers, mergers, and restructuring transactions.
- Set the standards of social responsibility of the company, including human rights, and monitor performance and compliance with those standards.
- Oversee government and community relations.
- Pay close attention to investor relations and interface with shareholders in appropriate situations.
- Adopt corporate governance guidelines and committee charters.⁷²

Whew! The sheer length of this list of responsibilities is overwhelming, especially when one considers that they will be performed by a group designedly composed of individuals who do not work full-time—or even nearly full-time—for the corporation. To be sure, some of these tasks entail the kind of work an outsider would be well placed to provide—such as monitoring the CEO, the performance of the corporation, and compliance regimes. Other tasks are more strategic in nature, requiring the kind of judgment calls an outsider would likely face considerable handicaps when making: overseeing government and community relations, determining the company’s risk appetite, setting standards of social responsibility, and approving budgets and long-term strategy. These are important questions, without a doubt. The current corporate governance structure cedes them to a body without the time or expertise to carry them out.

While this description of board responsibilities is notable for its detail, tasking the board with a direct managerial function is common.⁷³ In a perceptive article questioning the modern-day trend toward the super-independent board, Lisa Fairfax covers both managerial and monitoring functions, describing the independent directors’ responsibility to:

- guard against self-dealing by closely examining conflict-of-interest transactions to ensure that they benefit the corporation.
- detect and prevent fraud because their active oversight decreases managers’ ability to engage in wrongdoing.
- prevent managerial shirking and thus enhance corporate performance because they can proactively examine corporate affairs,

72. MARTIN LIPTON ET AL., THE FUTURE OF CORPORATE GOVERNANCE AND THE BOARD OF DIRECTORS 1–2 (2010), available at <http://www.wlrk.com/webdocs/wlrknew/WLRKMemos/WLRK/WLRK.18080.10.pdf>

73. This despite the fact that the relevant corporate statutes plainly allow for less direct board management, providing that the corporation is to be managed “by or *under the direction of* a board of directors.” See, e.g., DEL. CODE ANN. tit. 8, § 141(a) (2013).

not only to ensure that managers are productive, but also to ensure that managers make the most efficient and effective decisions.⁷⁴

Note how the first two functions deal overtly with managerial conflicts of interest: first, self-dealing, and second, fraud detection and prevention—loosely, the audit function, ensuring that managers and their underlings are not lying to the public or breaking the law. But the third function, which centers on ensuring that managers make the most efficient and effective decisions for the corporation, seems a herculean task for the typical public company board.⁷⁵ It envisions a sort of shadow management team made up of members whose only qualification is not the sort of context-specific expertise needed to manage, but instead the quality of independence, which inevitably carries with it a lack of firm-specific managerial know-how.

The managerial functions assigned to modern boards pose significant challenges for their members. As Part II showed, when it comes to managing the corporation, board members suffer from severe informational disadvantages because they have neither the time nor the competence to second-guess the managers upon whom they must rely for information. The evidence suggests that, for this reason, modern boards merely rubber-stamp managerial decisions when asked to evaluate them. Some commentators bemoan this state of affairs.⁷⁶ In contrast, I argue that such rubber-stamping is only natural, and the product of a misguided effort to make the part-time board do something it is constitutionally unfit to do: manage the corporation. Expecting the modern supermajority independent board to actively manage the corporation is like giving blind people reading glasses and exhorting them to focus more. Today we depend on independence to produce an ability to manage well. Yet independence does not guarantee a good manager, just a lack of ties to management.

74. Fairfax, *supra* note 52, at 138.

75. In a similar vein, the most recent edition of the *Corporate Director's Guidebook* describes as one of the board's "principal responsibilities"—"to provide general direction and guidance with respect to the corporation's strategy and management's conduct of the business." ABA Corporate Laws Comm., ABA Section of Bus. Law, *Corporate Director's Guidebook*, 66 BUS. LAW. 975, 986 (2011).

76. See, e.g., William T. Allen, *Independent Directors in MBO Transactions: Are They Fact or Fantasy?*, 45 BUS. LAW. 2055, 2056 (1990) (stating that outside boards rubber-stamp management actions); Michael C. Jensen, *The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems*, 48 J. FIN. 831, 862–64 (1993) (explaining that politeness and courtesy in board culture discourages candor in boardrooms, and thus lead to less active monitoring by a board); Laura Lin, *The Effectiveness of Outside Directors As a Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U. L. REV. 898, 914–16 (1996) (suggesting that a major constraint on outside directors' ability to monitor is that the directors "may see major issues confronting the corporation through management's eyes").

IV. A CONFLICT PRIMACY VIEW OF THE BOARD

A. *The Problem with Modern Boards*

Kelli Alces perceptively diagnosed the problem with the public company board in a recent article: “The board of directors has outlived its purpose. . . . [R]esponsibility for the success or failure of the firm lies with a group of professionals, the board of directors, who work part time to monitor the firm’s business, and management, who receive almost all of their information about the firm secondhand.”⁷⁷ She observes that corporate officers and investors (including creditors) are the “*real* corporate decision makers.”⁷⁸

Executives handle most corporate decisions. They launch advertising campaigns, roll out new products, handle hiring and firing, and make the purchasing, renting, and selling decisions that comprise a corporation’s everyday existence.⁷⁹ Even larger strategic decisions, like opening a new plant or launching a joint venture, are decisions for CEOs and their high-level advisors.⁸⁰ They live and breathe the corporation. As others have pointed out, part-time directors flown in to meet once a quarter—or even once a month—cannot hope to add much value to these decisions. For us to expect them to do so is absurd.

Alces’s solution is to do away with the board entirely.⁸¹ Acknowledging, however, that such a radical departure from current practice—and current law—would be difficult to effectuate, she suggests an intermediate “investor board,” made up of representatives from creditors, shareholders, and labor.⁸² Alces’s board reconfiguration—for her, just a stepping stone on the pathway to board elimination—appears to create a new style of governance, one involving an overt constant negotiation between various factions. In contrast, I still see a value to preserving the board as an institution—particularly given the fact that state corporate law applies to both public and private corporations. There are many different kinds of firms, and the beauty of the board mechanism as conceived by state statutes is that it can flex to reflect the different needs of the firm: a managerial board, an advisory board, or a conflicts board.⁸³ Federal intervention, by enshrining the independent board for the public corporation, has created an entity suitable for but one purpose, dealing

77. Alces, *supra* note 49, at 783.

78. *Id.* at 785.

79. Nicola Faith Sharpe, *Process Over Structure: An Organizational Behavior Approach to Improving Corporate Boards*, 85 S. CAL. L. REV. 261, 305 (2012) (“Specifically, overseeing the day-to-day operations of the company, setting strategy, ensuring firm profitability, and managing employees, are all tasks left to the CEO and her closest advisors.”).

80. *Id.*

81. She urges that the “now-vestigial board” should be allowed to “completely wither away.” Alces, *supra* note 49, at 786.

82. *Id.* at 808.

83. BAINBRIDGE, *CORPORATE GOVERNANCE*, *supra* note 5, at 65.

with managerial conflict. Yet this development does not logically entail eliminating the board, but merely acknowledging its limited utility—at least, in its public company supermajority independent incarnation.

While acknowledging that Alces has accurately diagnosed the problem of the modern public board, I prescribe a different course of treatment. Rather than repopulating the board to make it more knowledgeable about and invested in the corporation, I advocate embracing the very quality that prevents the modern board from serving as a viable day-to-day manager. The conflict primacy view of the board makes a virtue out of a vice by limiting the independent board's responsibilities to those areas where independence matters: problems of conflict of interest. Under my conflict primacy model, the board would monitor the CEO (including by setting compensation and planning for succession) and deal with managerial conflicts of interest as they arise.

B. No Executives Allowed; CEOs As ex Officio, Nonvoting Directors

In confining the board to these areas I suggest one further change to boards: the elimination of *any* inside directors from the board, excepting only the CEO in an *ex officio* role. This change would mean that public CEOs could no longer serve as voting members of the board of directors. While this change may seem drastic at first blush, my program of CEO-demotion and other-officer-removal is only the logical last step in the director-independence movement.⁸⁴

Today's supermajority boards rely unduly on the one or two managers in their midst.⁸⁵ Others have written about the harmful dynamic this situation creates, when board members thus become overly reliant on the CEO. Professor Lawrence Mitchell notes that the advent of independent boards has made boards overly dependent on the CEO for information and thus placed “the CEO in an enormously powerful position, with every incentive to present information to the board in a light that is most favorable to him.”⁸⁶ Further, because “[the CEO] has a mo-

84. A perennial corporate governance recommendation is to institute nonexecutive board chairs, that is, to split the roles of CEO and chairman. *See id.* at 104–05. For my purposes this move amounts to a half-measure, harmful because it fails adequately to signal the proper relationship between public company board and CEO. Proponents of splitting the roles argue that CEOs should not head the very organization tasked with evaluating them. *See id.* at 106. The conflict primacy model agrees with this view, and goes one step farther, arguing that the CEO should play no role—and have no vote—in situations of conflict.

85. *See* Marcel Kahan & Edward Rock, *Embattled CEOs*, 88 TEX. L. REV. 987, 1023 (2010).

86. Lawrence E. Mitchell, *Structural Holes, CEOs, and Informational Monopolies: The Missing Link in Corporate Governance*, 70 BROOK. L. REV. 1313, 1349 (2005) [hereinafter Mitchell, *Structural Holes*]. Mitchell offers a provocative solution: allowing shareholders, debtors, and employees to vote as separate classes for the CEO. Lawrence E. Mitchell, *On the Direct Election of CEOs*, 32 OHIO N.U. L. REV. 261, 283–84 (2006). Mitchell and I agree on the diagnosis of the problem, but his prescription seems problematic given the exigencies of corporate reality. Most notably, he suggests a standard seven-year contract for CEOs. *Id.* at 284. But poor performance or outside forces may demand CEO removal much earlier and more quickly than every seven years; a regular election seems a poor substitute for the kind of quick succession judgments the modern public corporation may require. And

nopoly over the information delivered to the [board],”⁸⁷ such information “can easily be manipulated or suppressed by the CEO because of his position as the sole source of information.”⁸⁸

As Mitchell points out, increasing the independence of the rest of the board paradoxically reduces its autonomy by reducing the number of its information channels and making the remaining few sources all the more important. Allowing CEOs to serve as an equal, voting member of the board both signals their importance to board operation and legitimizes their voice as the only board member with actual day-to-day knowledge of the corporation.

To be sure, CEOs’ knowledge can be invaluable to a board, and dismissing them entirely would be too drastic a step. The trick is to strike a balance that capitalizes on the valuable information benefits CEOs offer the board while minimizing the risk that the board will over-rely on them. Demoting the status of the CEO to that of an *ex officio*, nonvoting board member will encourage the board to weigh the CEO’s opinions and knowledge, but discount them when appropriate. At the same time, this move dovetails with my purpose of contraction of board authority, which removes from the board’s task list functions for which directors might be especially inclined to over-rely on the CEO. The CEO’s knowledge in the matters of CEO performance (including compensation, removal, and succession), audit, takeovers, and other matters is relatively irrelevant. CEOs can make their opinions and the pertinent facts known, and then be excused so that the voting board members can meet in executive succession.

Eliminating all insiders save the CEO from the board would be a reform that is structurally easy to implement. Because typically the CEO is the lone inside director (or one of two),⁸⁹ the change would not be disruptive. In many cases there would be no change in board membership at all. Professors Kahan and Rock paint a picture of a board already well-equipped to operate without the CEO.⁹⁰ Demoting CEOs to nonvoting member status and meeting in executive session to vote would strip them of much of their power, while retaining the benefits of having them on the board, and send a clear signal that the board should not—within its limited jurisdiction—serve as a mere validation of the executive

while CEO selection is an important role of the board, it is far from its only function in the corporation.

87. Mitchell, *Structural Holes*, *supra* note 86, at 1350.

88. *Id.*

89. Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921, 921–22 (1999) (noting that the number of firms whose only inside director is the CEO is increasing and that more than fifty percent of the firms in the S&P 500 have no more than two inside directors).

90. See Kahan & Rock, *supra* note 85, at 1044 (“Compared to outside directors fifteen years ago, outside directors today are likely to have more power, to enjoy a less collegial relationship to the insiders, to have a greater workload, to earn greater pay, to have occasional need to become confrontational, and to deal more often with vocal and restive shareholders.”).

team's decision. At the same time, removing all non-CEO executives from the board would solidify the separate and distinct identity of the board as the place to go when conflict with management arises. All senior executive officers would still have a fiduciary duty to keep the board informed of material information falling within its purview as further described below.

Having established the importance of a truly independent board, we can move to a consideration of those areas of conflict where the conflict primacy board would assume responsibility. Two of these, the CEO-related functions and the audit function, are regular tasks that would make up the bulk of the work of the board in a normal year. Three other areas, related party transactions, takeovers, and derivative suits, would be occasional events for the board to deal with as the need arose. Notably absent from the list of board responsibilities is the setting of overall corporate strategy on any level. Such a task lies beyond the scope of an independent board's competence and efficient use of decisional time; independence grants no advantage in the setting of strategy or making operational decisions.

C. Areas of Focus for the Conflict Primacy Board

1. CEO-Related Functions: The Monitoring of CEO Performance, Setting of Compensation, and Succession Planning

a. Executive Compensation

Executive compensation is a fraught topic,⁹¹ but most commentators agree that boards should be the ones that determine executive pay as part of their role as CEO-monitors.⁹² The conflicts associated with executives setting their own pay are clear. Tasking a group of outsiders with

91. See generally Lucian A. Bebchuk & Jesse M. Fried, *Pay Without Performance: Overview of the Issues*, 30 J. CORP. L. 647, 648–49 (2005) (describing the current state of executive compensation arrangements); Jeffrey N. Gordon, *Executive Compensation: If There's a Problem, What's the Remedy? The Case for "Compensation Discussion and Analysis,"* 30 J. CORP. L. 675 (2005) (advocating that the SEC require publicly traded companies to disclose a statement detailing the compensation elements for each senior executive); Stephen M. Bainbridge, *Executive Compensation: Who Decides?*, 83 TEX. L. REV. 1615 (2005) (reviewing LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (2004)); John E. Core et al., *Is U.S. CEO Compensation Inefficient Pay Without Performance?*, 103 MICH. L. REV. 1142 (2005) (reviewing BEBCHUK & FRIED, *supra*); Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 753 (2002) (finding that managerial power is significant in determining executive compensation).

92. Most commentators implicitly recognize that boards should determine executive compensation. See, e.g., Simone M. Sepe, *Making Sense of Executive Compensation*, 36 DEL. J. CORP. L. 189, 224 (2011) (recognizing that boards run corporations and thus make compensation decisions); William W. Bratton, *The Academic Tournament Over Executive Compensation*, 93 CAL. L. REV. 1557, 1561 (2005) (reviewing BEBCHUK & FRIED, *supra* note 91, and noting that boardroom practice in determining compensation "will never change absent robust criticism").

the job of assessing CEO performance and structuring a compensation scheme in light of that performance makes good sense.

So far so good. Indeed, every publicly traded corporation has a compensation committee made up solely of independent directors. What I advocate is a shift in emphasis and focus. The task of CEO monitoring and compensation should be a focus of every independent member of the board—that is (according to my model), every member of the board. The completely independent board will admittedly lose the insider perspective of the CEO and any other management board members—but this perspective is of little legitimate use on the question of setting pay.

Some might object that the same information asymmetries that prevent the current board from managing effectively also hinder it from performing the pay-setting monitoring role. One response to this objection is the same one rightly made to critics of democratic self-rule: it is a terrible system of governance, but it is still better than the alternatives. No less important, three distinctive factors help to ameliorate the information asymmetry problem in the executive-review context: first, Dodd-Frank's emphasis on empowering the compensation committee; second, the conflict primacy board has a narrower scope of responsibility and can thus focus its attention more effectively; and third, the stock market provides an initial indicator of performance.

First, the Dodd-Frank Act emphasizes the importance of independent directors, advised by independent consultants, when setting executive pay. Dodd-Frank directs the SEC to ensure the independence of the compensation committee and its advisors.⁹³ Congress directed the SEC to ensure that each compensation committee has authority, in its sole discretion, to retain or obtain the advice of compensation consultants, independent legal counsel and other advisers.⁹⁴ The Act further requires that “[t]he compensation committee of an issuer shall be directly responsible for the appointment, compensation, and oversight of the work of a compensation consultant” and have “appropriate funding” to the com-

93. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 952, 124 Stat. 1376, 1900 (2010) (codified at 15 U.S.C. § 78j-3).

94. *Id.* In Rule 10C-1, the SEC defined the listing standards for compensation committees. The factors that a compensation committee must consider in selecting a compensation adviser include:

- Provision of other services to the issuer by the employer of the consultant, legal counsel or other advisor;
- What percentage fees received from the issuer represent of total revenue of the employer of the consultant, legal counsel or other advisor;
- Policies of the employer of the consultant, legal counsel or other advisor to prevent conflicts of interest;
- Any business or personal relationship of the consultant, legal counsel or other advisor with any member of the compensation committee;
- Any stock of the issuer owned by the consultant, legal counsel or other advisor (but not stock owned by his or her employer, or by its other employees); and
- Any business or personal relationships between the executive officers of the issuer and the compensation adviser or the person employing the compensation adviser.

Listing Standards for Compensation Committees, 77 Fed. Reg. 38,422, 38,430–33 (June 27, 2012) (to be codified at 17 C.F.R. § 229.407).

pensation advisors.⁹⁵ The compensation committee must disclose whether it retained a compensation consultant and if the consultant's work raised any conflict of interest.⁹⁶ Outside consultants have their drawbacks; Lucian Bebchuk and Jesse Fried have described how the predisposition for boards to view their CEOs as above average and compensate them accordingly has led to "an ever-increasing average and a continuous escalation of executive pay."⁹⁷ Still, using them in conjunction with relegating the CEO to a less prominent role might foster more frank evaluations of a particular CEO's worth.

The conflict primacy model envisions the entire board fulfilling the role of the compensation committee, but Dodd-Frank's insistence on the need for independent compensation advisors remains quite useful. Armed with its own counsel and consultants, the board would have the tools and the time to perform the limited task of evaluating high-level executives' performance and pay. Freed from the expectation that it would opine on matters of corporate policy or management, it could focus on the one part of corporate management where independence is truly an asset: evaluating the managers' performance.

Second, as Part II described, corporate directors face an array of tasks. The managerial functions amount to second-guessing (more often, rubber-stamping) managerial decisions. As Alces observes, "[t]he board can only do so much, in addition to what senior managers have already done, and it really only serves as a backstop, or a final quality check, before a major decision is finalized."⁹⁸ Taking tasks off the plate of the time-pressed board will enable it to focus on areas where its independence actually serves a useful purpose.

Finally, as discussed above in Part III.B, Professor Jeffrey Gordon has suggested another factor ameliorating the information asymmetries facing the outside director: as the SEC has required the disclosure of ever more and more detailed information, stock prices have become more informative, and thus independent directors can rely more on outside performance signals to assess the performance of the CEO and the management team.⁹⁹ While stock performance is not the sole indicator of a CEO's contribution to the corporation, at least it provides a benchmark. Boards can consider how the stock prices of competitors and other firms have fared, and the publicly disclosed levels at which those other CEOs have been compensated.

I do not advocate a slavish short-termism when monitoring the CEO's performance. Recurring managerial complaints about being forced to manage earnings for the short term have validity, and CEOs

95. § 952, 124 Stat. at 1902.

96. *Id.*

97. Bebchuk & Fried, *supra* note 91, at 657.

98. Alces, *supra* note 49, at 800.

99. Gordon, *supra* note 37, at 1541–43.

should be able to make contrarian bets by funding unpopular research and development, or launching a product to which conventional wisdom has turned a skeptical eye. But if a corporation's stock consistently underperforms that of its peers, the board should be more attuned to the issues of compensation and of succession.

Equipped with these tools—compensation consultants, a narrower focus, and the information the public market affords—boards can begin to address the information asymmetries from which they suffer. Additionally, a lack of on-the-ground information may be less of a problem in compensation than in other areas. While CEOs have a firmer grasp on the costs and benefits of a particular corporate decision, they may not have a realistic notion of their worth to the corporation. Most people probably think they are underpaid, and although each individual may have in some sense the most “informed” view on the subject, an outsider's perspective may generate the most accurate and fair result.

b. Removal and Succession

Removing a CEO is the ultimate exercise of the board's monitoring power. The power to fire and replace the CEO necessarily must reside with the board. Coordination and collective action problems keep shareholders from fulfilling this role. And because “[n]o man is allowed to be a judge in his own cause,”¹⁰⁰ it is a decision that cannot reside with CEOs themselves. Encouragingly, in the recent past boards have appeared more willing to replace CEOs.¹⁰¹ Professors Kahan and Rock argue that this increase in CEO turnover signals greater “substantive independence” among boards.¹⁰²

To credibly exercise its power to fire, a board must have a succession plan in place. CEO succession is a crucial area for the board, whether or not its CEO is underperforming.¹⁰³ The first job of the king is to produce an heir; similarly, boards should prioritize the identification of likely replacements for the CEO should death, disability, or public scandal require an unexpected departure from office. CEO tenures are decreasing, and emergencies arise quickly.¹⁰⁴ The SEC considers succes-

100. THE FEDERALIST NO. 10, at 59 (James Madison) (Jacob E. Cooke ed., 1961).

101. Kahan & Rock, *supra* note 85, at 1031.

102. *Id.* at 1030–32.

103. DENNIS C. CAREY & DAYTON OGDEN, CEO SUCCESSION 3 (2000) (noting “that succession has become a front-burner issue for directors”).

104. ABA Corporate Law Comm., *supra* note 75, at 986. The *Corporate Director's Guidebook*, a product of the ABA's Committee on Corporate Laws, has shaped the development of corporate governance since its first edition in 1978. See Marshall L. Small, *The 1970s: The Committee on Corporate Laws Joins the Corporate Governance Debate*, LAW & CONTEMP. PROBS., Winter 2011, at 129. Now in its sixth edition, it recommends that the board as a whole or a separate succession committee pay attention to this task:

[T]he board should take an active role in assessing on an ongoing basis whether the current senior management team is appropriate for the needs of the organization, as well as in implementing and periodically reviewing management development and succession plans. Through this pro-

sion planning “a significant policy [and governance] issue” “so that [a] company is not adversely affected by a vacancy in leadership.”¹⁰⁵

CEOs often take for granted their right to anoint a successor,¹⁰⁶ and if the presumptive heir is an internal candidate then the line of succession is often well defined. Still, it is the board’s fundamental responsibility to be informed about this process and to have at its fingertips a short list of external and internal candidates should the need arise.¹⁰⁷ Particularly if the board removes the CEO, it will not want to be tied to her choice of heirs. Her flaws may extend to her choice of successor, who might favor the same policies and practices that led to the ousting.

In succession planning, the board’s first responsibility is to identify the traits it considers most important in a CEO—a determination that is highly subjective, time consuming, and company-specific. The board may consider insiders, outsiders, outsiders brought in for the purpose of replacing the CEO (“inside outsiders”), or even appoint existing directors to be the CEO. Studies suggest that existing directors can be effective CEOs, while companies led by inside outsiders tend to underperform expectations.¹⁰⁸ Insiders tend to be effective hires when taking over companies that are already well managed, and outsiders tend to be most effective in taking over companies that have problems, or need a change of direction.¹⁰⁹

No matter what the situation, the board must be able to identify credible candidates to replace the CEO well before a replacement is needed. Therefore, the company should have a credible long-term talent development program in place to develop, assess, and groom potential leaders inside the company; indeed, some experts suggest planning on having a replacement identified up to four years ahead of the current CEO’s likely departure date.¹¹⁰ Managing such a process requires that boards have direct and regular contact with promising candidates, both on a formal and an informal basis, so that when the time comes, the board has enough information to make a wise decision as to whom the

cess, boards gain the knowledge required to develop judgment about the corporation’s potential future leaders.

ABA Corporate Law Comm., *supra* note 75, at 986.

105. SEC Staff Legal Bulletin No. 14E (CF) (Oct. 27, 2009).

106. See CAREY & OGDEN, *supra* note 103, at 8–9 (noting that in the past CEOs chose their successors, and that CEOs often keep succession plans secret).

107. For a discussion of the CEO succession process and the board’s role in it, see Jay W. Lorsch & Rakesh Khurana, *Changing Leaders: The Board’s Role in CEO Succession*, HARV. BUS. REV., May-June 1999, at 96 (a roundtable of corporate directors suggesting good practices for boards to follow in succession planning); see also Kenneth A. Borokhovich et al., *Outside Directors and CEO Selection*, 31 J. FIN. & QUANTITATIVE ANALYSIS 337 (1996) (evaluating the empirical impact of outside directors on CEO selection).

108. James M. Citrin & Dayton Ogden, *Succeeding at Succession*, HARV. BUS. REV., Nov. 2010, at 29, 29–30.

109. *Id.* at 30.

110. Ram Charan, *Ending the CEO Succession Crisis*, HARV. BUS. REV., Feb. 2005, at 72, 78 (suggesting that management candidates should be recruited four years ahead of time).

next CEO should be.¹¹¹ Boards should also work to identify “gaps” in management ranks that can be filled by proactively recruiting new talent via executive search firms.

This is not to say that the board should shut the CEO out of the process of identifying possible successors. Indeed, the board should obtain the CEO’s feedback both when the CEO is retiring (as the CEO’s recommendation carries great weight in such a situation) and as an emergency plan is developed in case a new CEO has to be appointed immediately.¹¹² Finally, it is critical that the board review the succession plan periodically and make sure that the process of grooming future leaders is working. Appointing a CEO, after all, is likely the most important decision a board will ever make.

One study suggests that firm performance may improve because of the removal threat an outside board presents. Tod Perry and Anil Shivdasani compare outcomes for poorly performing firms with outside boards to similar firms without outside boards. They hypothesize that after a drop in performance the CEO’s bargaining power diminishes and the CEO becomes more vulnerable, and is therefore more likely to initiate restructuring activities.¹¹³ They find that firms with a majority of outside directors are twice as likely to initiate restructuring activities to respond to the corporate crisis.¹¹⁴

Finally, it is worth noting that, as Stephen Bainbridge has pointed out, a board’s evaluation of a CEO’s performance, and ultimately the removal decision, can have a decidedly managerial cast. Bainbridge critiques Eisenberg’s monitoring board model for unrealistically characterizing the board’s role as monitor as distinct from that of the managers, and for not acknowledging the “fuzzy” line between monitoring executive performance and managing the corporation itself.¹¹⁵ For example, if a board seeks to identify new candidates whose policy preferences match its own, then the board is clearly by its very choice recalibrating corporate policy—i.e., managing.¹¹⁶ Bainbridge is quite correct on this score; my response is that in certain cases management by nonmanagers is required and the best one can do is narrowly circumscribe the limits of circumstances where outsiders must make manager-like decisions.

111. *Id.*

112. Many boards require the CEO to put together a “hit by a bus” plan, i.e., CEOs have to have a plan in place to make sure the company can be effectively run in the event they are incapacitated or otherwise unavailable. See, e.g., Lorsch & Khurana, *supra* note 107, at 102 (suggesting that CEOs should leave instructions detailing what should happen if they “suddenly get[] hit by a trolley car”).

113. Tod Perry & Anil Shivdasani, *Do Boards Affect Performance? Evidence from Corporate Restructuring*, 78 J. BUS. 1403, 1404 (2005).

114. *Id.* at 1430.

115. BAINBRIDGE, CORPORATE GOVERNANCE, *supra* note 5, at 61.

116. *Id.* at 61–62.

2. *Audit Function*

The worst-case scenario for corporate governance is the unscrupulous manager intent on fleecing the corporation and defrauding its shareholders. Such rent-seeking represents the paradigmatic example of conflict of interest: shareholders clearly have conflicting interests with managers who are intent on lining their own pockets at the shareholders' expense. In the United States, disclosure is the regulatory tool of choice for combating fraud.¹¹⁷ In order for disclosure to be effective, however, it must be accurate. Thus, to guard against fraud or inaccuracies born of managerial scheming or wishful thinking, the independent board should be entrusted with responsibility for the audit function.

The Sarbanes-Oxley Act of 2002 reinforced the independent directors' critical role in the audit function, much as Dodd-Frank has strengthened that role with regard to executive compensation.¹¹⁸ As a result, basic legal structures are already in place that operationalize this element of the conflict primacy model. Under my model, the entire board would be tasked with ensuring that the information reported to the SEC was accurate and fully complied with all applicable regulations. Of course, the board would rely upon its independent counsel and external auditors in fulfilling this role, much as the audit committee does now. The conflict primacy model simply underscores the centrality of the board's auditing task.

Empirical support exists for the benefits of board independence in the auditing function. It is true that Part III described that empirical studies have found no reliable relationship between board independence and overall performance.¹¹⁹ Given the part-time character of the typical U.S. board, this lack of correlation should come as no surprise. Intriguingly, however, Professor Fairfax observes that "the strongest and most robust evidence indicating that directors have a positive impact on reducing fraud has emerged in the context of such directors' role on the audit committee."¹²⁰ Studies have found that making audit committees more independent reduces internal control problems and reduces earnings management.¹²¹ Studies have also correlated independent audit committees with smaller incidences of fraud and earnings restatements,

117. See, e.g., Paula J. Dalley, *The Use and Misuse of Disclosure As a Regulatory System*, 34 FLA. ST. U. L. REV. 1089, 1093–94 (2007) (noting that the fundamental regulatory tool of the securities acts is disclosure). Commentators frequently refer to Justice Brandeis's famous quote: "[S]unlight is . . . the best of disinfectants." *Id.* at 1096 (omission in original).

118. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §§ 201–09, 301, 116 Stat. 745, 771–77 (codified as amended at 15 U.S.C. §§ 78c, j–l).

119. See *supra* note 61 and accompanying text.

120. Fairfax, *supra* note 52, at 188 (citing Robert A. Prentice & David B. Spence, *Sarbanes-Oxley As Quack Corporate Governance: How Wise Is the Received Wisdom?*, 95 GEO. L.J. 1843, 1873–74 (2007)).

121. Prentice & Spence, *supra* note 120, at 1873–74.

and with a lowered triggering of SEC enforcement actions.¹²² Professors Robert Prentice and David Spence conclude: “Overall, more independent audit committees tend to translate into better auditing, more informative and credible earnings disclosure, and other benefits.”¹²³

The reliability of a corporation’s public numbers serves another important role for the conflict primacy board: accurate disclosures lead to more reliable stock prices, which aid in the board’s evaluation of executive performance. The day-to-day monitoring of the CEO of a public corporation comes chiefly from the shareholders, expressed in the company’s market performance. Shareholders constantly buy and sell according to their perceptions based on the wealth of publicly available information.¹²⁴ To ensure that the market is receiving accurate information, so that it can correctly price the company’s prospects, the board should control the auditing function, ensuring that it has independent lines of communication in place with both internal and external auditors.

The audit function encompasses more than simply monitoring CEO performance; it functions as a corrective to any insider malfeasance. Corporate employees have a natural tendency to bend or break the law in order to raise corporate profits and thus advance their own interests.¹²⁵ The law accordingly imposes sanctions to incentivize corporations to obey governing rules.¹²⁶ Indeed, the oversight function of the board with respect to compliance with applicable laws and regulations has grown in importance in the modern era as corporate fines and settlements with regulators have become more draconian. Both federal¹²⁷ and state law (most notably the *Caremark* case¹²⁸) create incentives for corporations to have effective compliance programs in place. If a violation occurs, the presence of adequate internal training, prevention, and reporting systems are a key factor in assessing liability.¹²⁹ The board should ultimately supervise and monitor such systems, since insiders have incentives to risk illegal activities in order to pad the corporation’s bottom line.

CEO evaluation, succession planning, and the audit function are routine functions that will likely occupy the bulk of the conflict primacy

122. *Id.* at 1874.

123. *Id.* at 1874–75.

124. Jeffrey Gordon argues that the board should carefully monitor market performance in order to evaluate CEO performance. Gordon, *supra* note 37, at 1563.

125. See, e.g., Jean McGuire et al., *CEO Incentives and Corporate Social Performance*, 45 J. BUS. ETHICS 341, 342 (2003) (“Recent cases such as the Enron and WorldCom bankruptcies suggest that stock-based incentives may encourage executives to disregard social performance in pursuit of market price increases.” (citation omitted)).

126. See *infra* notes 144–46.

127. U.S. SENTENCING GUIDELINES MANUAL § 8C2.5(f) (2011) (reducing potential liability if the organization has an effective compliance program in place at the time of the offense).

128. *In re Caremark Int’l Inc. Derivative Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996).

129. *Id.*; *id.* § 8B2.1 cmt. background (2011) (“The prior diligence of an organization in seeking to prevent and detect criminal conduct has a direct bearing on the appropriate penalties and probation terms for the organization if it is convicted and sentenced for a criminal offense.”).

board's limited time. The next three Sections delineate occasional conflicts that the board should deal with if and when they arise.

3. *Related Party Transactions*

If any executive wishes to engage in a transaction with the corporation, the board should evaluate the transaction for fairness and negotiate vigorously on behalf of the corporation. Related-party transactions occur occasionally and are reported in a corporation's 10-K.¹³⁰ Such transactions may be innocent or even beneficial to the corporation. For example, a CEO might agree to allow the corporation to rent space in a family-owned facility at below-market rates. The corporation may wish to use the CFO's family business as a supplier because it produces the best product at the cheapest price. Transactions of this kind, however, inevitably raise the specter of conflict of interest. Traditionally such transactions were void or voidable.¹³¹ Delaware's section 144 and the Model Act's sections 8.60–63, however, insulate them from shareholder attack if independent directors approve them.¹³² These transactions should not arise often, but when they do, the independent board should evaluate them with special care. Reminding the board of the centrality of its role might help to prevent situations such as Enron's board green-lighting the special-purpose entities that its CFO Andrew Fastow used to move liabilities off Enron's balance sheet—and to make millions of dollars for himself in the process.¹³³

The corporate opportunity doctrine also highlights the modern board's special role in policing conflicts. If insiders are presented with a business opportunity that might also interest the corporation,¹³⁴ the safest course is for them to present the opportunity to an independent board for approval.¹³⁵ If the board elects not to pursue the opportunity, the insider is free to do so. As with insider self-dealing, however, evaluation of these sorts of corporate decisions requires an especially watchful role by the independent board.

130. 17 C.F.R. § 229.404 (2011).

131. *Marciano v. Nakash*, 535 A.2d 400, 403 (Del. 1987) (recognizing a *per se* common-law rule that self-interested transactions were voidable).

132. DEL. CODE ANN. tit. 8, § 144 (2013); MODEL BUS. CORP. ACT §§ 8.60–63 (2011). While these sections contain other circumstances under which related party transactions are permitted (notably, when the shareholders ratify the transaction or when it is fair to the corporation), our concern is the cleansing director vote.

133. John R. Emshwiller & John M. Biers, *Fastow Gets Six Years As Judge Calls for Mercy; Plea Deal Had Envisioned a Decade of Imprisonment; Ebbers Also Begins His Time*, WALL ST. J., Sep. 27, 2006, at A3.

134. Usha Rodrigues, *From Loyalty to Conflict: Addressing Fiduciary Duty at the Officer Level*, 61 FLA. L. REV. 1, 16 n.68 (2009).

135. ABA Corporate Law Comm., *supra* note 75, at 995 (“If a director has reason to believe that a contemplated transaction might be a corporate opportunity, the director should bring it to the attention of the board and disclose the material information that the director knows about the opportunity. If the board, acting through its disinterested directors, disclaims interest in the opportunity on behalf of the corporation, then the director is free to pursue it.”).

4. Takeovers: Hostile and Friendly

Perhaps the paramount case of shareholder/management conflict is that of a takeover bid, that is, when an offer is made to buy the shares or assets of the target corporation. With a hostile bid the concern is that management intent on keeping their jobs might resist a sale desirable to shareholders.¹³⁶ With a friendly bid the concern is that the managers will sell out shareholders at an unduly low price because of “sweetheart” deals that benefit them alone.¹³⁷ Delaware law embraces the role of the independent special committee for the target in evaluating takeovers because takeovers typically involve these conflicts of interest.¹³⁸ The conflict primacy model proposed here merely builds on Delaware law by replacing the special committee with the whole board.

In a friendly merger (including situations as varied as parent/subsidiary mergers, cash outs by majority shareholders forcing minority shareholders out of the business, and management buyouts), the conflict arises because directors have a duty to get a fair price for the shareholders, but insiders or friendly parties want to pay as little as possible. In *Weinberger v. UOP, Inc.*,¹³⁹ the Delaware Supreme Court suggested that “an independent negotiating committee of . . . outside directors” could eliminate conflict and shift the burden during litigation.¹⁴⁰ Delaware courts have additionally held that when “a well functioning committee of independent directors”¹⁴¹ approves a merger with a controlling shareholder, the plaintiff has the burden of proving that the transaction is unfair.¹⁴²

As I have argued elsewhere, Delaware’s definition of independence is “situational,” meaning it cannot be determined *ex ante*. Because Delaware courts evaluate both the relationship of directors with the acquirer¹⁴³ and the directors’ actions to find out if the committee is independ-

136. John H. Matheson & Brent A. Olsen, *Shareholder Rights and Legislative Wrongs: Toward Balanced Takeover Legislation*, 59 GEO. WASH. L. REV. 1425, 1484–85 (1991) (“Facing the real possibility of losing both their jobs and their ability to determine the corporate fate upon becoming a target, management often seeks to wield corporate governance machinery to assure continued control.”).

137. David D. Haddock et al., *Property Rights in Assets and Resistance to Tender Offers*, 73 VA. L. REV. 701, 738 (1987).

138. See Rodrigues, *supra* note 2, at 476–83 (2008) (describing the role of the special committee in evaluating mergers under Delaware law).

139. 457 A.2d 701 (Del. 1983). *Weinberger* involved the buyout of UOP by Signal, which owned 50.5% of UOP. *Id.* at 704. Two UOP directors who were also Signal directors proposed a report on the price Signal could pay, and the court found that they withheld information that should have been provided to the independent directors. *Id.* at 708–09. For this reason, the court held the transaction had not been approved by a majority of disinterested directors, and so the parent buyout would have to pass the intrinsic fairness test. *Id.* at 710–14. The court found that the requirements of fair price and fair dealing had not been met. *Id.*

140. *Id.* at 709 n.7.

141. *Kahn v. Tremont Corp.*, 694 A.2d 422, 428 (Del. 1997).

142. *Id.*

143. *Id.* at 429–30 (finding the committee was not independent where all three directors were previously affiliated with the alleged controller and received significant financial compensation or were on the board of the alleged controller’s companies); *In re MAXXAM, Inc.*, No. 12111 & 12353, 1997

ent, it may well be that board members that the NYSE would call “independent” would not qualify as independent for the purposes of a particular transaction under Delaware law. For example, even if a board member has no ties to management, he or she may own the potential acquirer. Thus when a takeover looms the board should first determine who will qualify as independent for the purpose of evaluating that particular transaction. The key policy goal of having a special committee is to ensure that there is “a truly independent, well informed and properly motivated bargaining representative.”¹⁴⁴ Thus, Delaware courts look to see if the “special committee was sufficiently independent, informed, and able and willing to bargain effectively with the interested party.”¹⁴⁵ It may be that the whole board can fulfill this role, or it may need to form a separate committee.

In the case of hostile takeovers, the main potential conflict is management entrenchment: shareholders rightly fear that managers will reject even an advantageous offer in order to keep their jobs. In terms of adopting takeover defenses (most notably the poison pill) prospectively, Delaware law encourages approval by a supermajority of outside directors.¹⁴⁶ Once a hostile offer is launched, Delaware law also requires a situational independence analysis.¹⁴⁷ As with the friendly takeover, then, a conflict primacy board should enquire into any ties between each director and the bidder and, if necessary, create a special committee to handle any negotiations.¹⁴⁸

5. *Derivative Suits*

Finally, derivative suits are tailor-made for a conflict primacy board. The derivative suit is a mechanism whereby shareholders unhappy with corporate actions may file a suit on the corporation’s behalf. The corporate form requires a neutral arbiter to determine whether a lawsuit is indeed a desirable course of action or would be a waste of corporate resources, and the executives who make the daily management decisions that are likely the subject of the shareholders’ lawsuit clearly cannot

WL 187317, at *20–22 (Del. Ch. Apr. 4, 1997) (finding that the special committee did not shift the burden of proving fairness at trial because each member of the special committee had significant ties to the controlling shareholder).

144. *MAXXAM*, 1997 WL 187317, at *22.

145. *Id.*

146. In *Unocal* the Delaware Supreme Court held that having a board that consists of a “majority of outside independent directors” materially enhances the burden of proof of showing that there were “reasonable grounds for believing that a danger to corporate policy and effectiveness existed.” *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985).

147. Rodrigues, *supra* note 2, at 482–83 (discussing Delaware’s inquiry into the independence of each board member from management and from the potential acquirer, and the reasonableness of its response).

148. When a firm’s breakup becomes inevitable, then the board’s role shifts to auctioneers, tasked with getting the best price for the company’s stockholders. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986).

serve this role. The statutory mechanics vary,¹⁴⁹ but the result is similar: the shareholders must prove that the board or committee deciding whether to sue is made up of independent directors.¹⁵⁰

Derivative suits come in two flavors: some alleging breach of the duty of care, and others breach of the duty of loyalty (involving self-dealing, misappropriation of corporate opportunity, and the like). A conflict primacy board offers the clear advantage of providing “untainted” directors in deciding whether to pursue claims that insiders have breached their duty of loyalty. Duty of care claims are trickier, in that they generally involve challenges to the level of care taken in a particular action by the board. Of course often the very board that authorized a certain action—for example, Michael Ovitz’s no-fault termination that cost Disney \$140 million¹⁵¹—will be the one whose independence is evaluated, and that prior authorization is not enough to disqualify the board members (otherwise plaintiffs could merely “bootstrap” their way to control of a lawsuit).¹⁵² And a conflict primacy board will be managing less, and so likely there will be less involvement with the decisions over which shareholders choose to sue.

D. Why a Board?

The reader may be left wondering whether, given the problems modern boards confront, boards will be any better suited to handling managerial conflicts of interest than they are to managing the corporation. If the modern board is so dysfunctional, it should not be entrusted with this important task.

The first response to such an objection is that boards are better suited to the task than any other corporate player. Stephen Bainbridge has defended locating a group, rather than an individual, at the top of the corporate hierarchy, because of the “clear advantages” that groups enjoy.¹⁵³ The work of experimental psychologists suggests that group decision making can outperform individual decision making,¹⁵⁴ and collective action can counteract individual biases such as herding and overconfidence.¹⁵⁵ He concludes that “[c]orporate law’s strong emphasis on collective decisionmaking by the board thus seems to have a compelling efficiency rationale.”¹⁵⁶

149. Delaware recognizes situations of demand futility, DEL. CODE ANN. tit. 8, § 327 (2013), while states adopting the Model Act framework have a “universal” demand requirement. MODEL BUS. CORP. ACT § 7.42 (2011).

150. “Qualified” in the parlance of the Model Act. MODEL BUS. CORP. ACT § 1.43.

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

152. *Aronson v. Lewis*, 473 A.2d 805, 818 (Del. 1984).

153. Stephen M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1, 54 (2002).

154. *Id.* at 18.

155. *Id.* at 27–30.

156. *Id.* at 19.

Nevertheless, boards are not perfect: as Bainbridge himself acknowledges, boards are subject to unique cognitive biases, such as groupthink, and unique sources of agency costs.¹⁵⁷ Yet boards need not function perfectly for the conflict primacy model to work: they need only be the corporate constituency best suited to the task. Managers self-evidently cannot deal with managerial conflicts of interest effectively. Marshaling the shareholders to sanitize each and every conflict would be procedurally unwieldy: imagine having to identify a group of shareholders to pass judgment on each takeover offer or related party transaction that arose. Issues of confidentiality and the dangers of extortionate behavior would also arise, particularly if the group of shareholders was large. Given the board's unique status as an embedded body of outsiders, it is only logical to task it with dealing with managerial conflicts.

E. Harmonizing Theory with Practice

Eisenberg observed in 1976 that it was not the board, but the executives, who actually managed the corporation.¹⁵⁸ His monitoring board was an attempt to change that reality. Since 1976 there has certainly been a shift in rhetoric, but the reality of board detachment remains. Despite the move to supermajority independent boards, the CEO continues to be the decision maker of the modern public corporation. Corporate theory generally ignores this reality. The director primacy model and the team production model center authority with the board in the face of calls for greater focus on the shareholder. Yet both theories describe a board that does not exist—at least not for public corporations.

The team production model envisions directors who are actively and constantly mediating between the various interests of labor, shareholder, management, and perhaps the larger community. The modern part-time board simply cannot take such an active role in management. As Alces points out, “Mediating between corporate constituents requires a solid working knowledge of the rights each party has against the corporation and the corporation’s reciprocal obligations.”¹⁵⁹ But senior management knows much more about these issues than does the board, and the board will rely on the corporate officers to explain and contextualize the different claims of different constituencies that are vying for corporate resources.¹⁶⁰ The board may of course hire outside advisors, but as outsiders these advisors will face the same informational difficulties. While the board lacks the same vested interests that management has, the constraints on its time and attention limit its ability to gather information and mediate effectively. In short, independent directors are ill-

157. *Id.* at 54.

158. EISENBERG, *STRUCTURE*, *supra* note 5, at 140.

159. Alces, *supra* note 49, at 801.

160. *Id.*

equipped to serve as mediators of diverse and conflicting corporate-constituency interests.

The director primacy model, put forward by Professor Bainbridge, likewise asks too much of the modern board. Bainbridge views the board as both the ultimate monitor and fiat-exerciser of the corporation.¹⁶¹ According to the conflict primacy model, neither of these roles fits the modern public board well. First, Bainbridge relies on the board to monitor both the executives and itself.¹⁶² He lauds the ability of a group to provide better monitoring—indeed, to self-monitor and to constrain agency costs, while being less prone to capture than would be any single individual.¹⁶³ In contrast, the conflict primacy model focuses the board's monitoring solely on areas of conflict: setting the pay of the CEO and other high-level officers, monitoring their performance (and having a succession plan ready), and springing into action should another conflict arise, such as a takeover offer. Other than that, the board should do very little.

Bainbridge's conception of the fiat-wielding power emphasizes the need for speed and authoritative control at the tactical level as a reason for rejecting shareholder primacy in favor of board authority.¹⁶⁴ This analysis, however, involves a false choice because there is a third way for assigning the fiat-wielding power—that is, to assign it to the corporation's officers. Indeed, the capacity for speed and control is far removed from the modern-day realities of the part-time board. In other words, someone *does* have to be in charge of the corporation—but the right person is the CEO. To be sure, CEOs cannot monitor themselves. That has to be the job of the board. And the good news is that a conflict primacy board with focused responsibilities that center on CEO monitoring and succession can be expected to move quickly and decisively in this area, in part because it has little else to do.

To be fair, Bainbridge readily acknowledges that CEOs, not boards, run modern-day corporations, and that “statutory theory has long failed to translate into real world practice.”¹⁶⁵ In one sense he can afford to be indifferent to the inadequacy of corporate law theory in practice, since

161. Bainbridge, *Primacy*, *supra* note 7, at 567, 569.

162. *Id.*

163. Bainbridge, *Nexus*, *supra* note 26, at 29 (“The board solves that problem by creating a self-monitoring hierarchy whose internal governance structures provide incentives for optimal monitoring of its subordinates. Mutual monitoring and social norms, enforced through peer pressure and reputational sanctions, provide important constraints on behavior. In addition, a multi-member board is inherently harder for misbehaving subordinates to suborn than would be a single autocrat. Instead of having to bribe or otherwise co-opt a single individual, the wrongdoers now must effect a conspiracy amongst a number of monitors. Consequently, we vest corporate power in boards rather than individuals so as to create an institutional constraint on agency costs.”).

164. Bainbridge, *Primacy*, *supra* note 7, at 569.

165. BAINBRIDGE, *supra* note 13, at 19 (“Neither shareholders nor directors run the corporation; CEOs do. Managerialism may have fallen out of favor as a normative theory of corporate governance, but it remains the work-a-day world reality.”).

the goal of Bainbridge's director primacy project is to understand and justify the existing architecture of statutory corporate law.¹⁶⁶

As should by now be evident, I think there is much to recommend in Bainbridge's notion of director primacy. It is largely successful in its explanation of why corporate law statutes center power in a board of directors. But corporate law statutes by necessity address both public and private corporations. Federal intervention has ossified the public board into one specific incarnation: supermajority independent boards. This subspecies of board, I argue, is constitutionally ill-suited for the generalized monitoring and fiat-wielding expected of it by the director primacy model. Thus, the conflict primacy model best fits the realities of the modern public corporation.

F. Back to Basics: Eisenberg's Monitoring Board Revisited

In many ways the conflict primacy board looks much like Eisenberg's original monitoring board. Indeed, Eisenberg's argument made in 1976 tracks in significant ways my own description of the board in 2013. After observing that "under the received legal model" the board manages the corporation, Eisenberg added that, "in practice the board rarely performs either the management or the policymaking functions."¹⁶⁷ He went on to enumerate the constraints on time and information that impede directors in their work. He lamented that the board of the day was composed of people "economically or psychologically dependent upon or tied to the corporation's executives, particularly its chief executive."¹⁶⁸

Eisenberg next described the four functions of the board: "[P]roviding advice and counsel to the office of the chief executive; authorizing major corporate actions; providing a modality by which persons other than executives can be formally represented in corporate decisionmaking; and selecting and dismissing the members of the chief executive's office and monitoring that office's performance."¹⁶⁹ It is the fourth function that he termed the monitoring function. And, anticipating the analysis I offer here, Eisenberg emphasized that this function is "both of critical importance to the corporation and uniquely suited for performance by the board."¹⁷⁰

Part-timers, he continued, will never be as good at "managing the corporation's business" or making corporate policy as full-time employees.¹⁷¹ It was absurd to think that they might. Eisenberg observed, how-

166. Yet Bainbridge does suggest that the balance of power is moving from "imperial CEOs" to boards. *Id.*

167. EISENBERG, *STRUCTURE*, *supra* note 5, at 139.

168. *Id.* at 145.

169. *Id.* at 157–68.

170. *Id.* at 162.

171. Melvin Aron Eisenberg, *Legal Models of Management Structure in the Modern Corporation: Officers, Directors, and Accountants*, 63 Calif. L. Rev. 375, 387 (1975) [hereinafter Eisenberg, *Legal Models*].

ever, that there is one function the board can perform, and perform better than any other corporate group: “[S]electing, monitoring, and removing the members of the chief executive’s office.”¹⁷²

Somehow over time, this specialized, CEO-centered focus on the monitoring function of the board lost its sharpness of definition. Loose translations of “monitoring” that embraced the corporation’s operations more generally, crept into this reconception of the core board role. The conflict primacy board attempts to bring us back to Eisenberg’s central insight as to what a board is best suited to do. But the conflict primacy board, while encompassing Eisenberg’s originally conceived monitoring board, has broader authority than Eisenberg envisioned. The conflict primacy board is the place for the resolution of *any* conflict that pits shareholder against top management. The independent board thus must supervise the audit function because the auditor certifies that the financial information provided to the shareholders is accurate. And the board has a role to play if the CEO, or any officer, seeks to transact business with the corporation. In contrast, Eisenberg wrote that “[i]n duty-of-loyalty cases the courts have often given disproportionate weight to the fact that outside directors have approved a transaction in which executives are interested.”¹⁷³ What he missed in this line of thought is that the chief function of the board of directors—at least if composed of outside directors—is to provide a mechanism for resolving managerial conflicts of interest of any flavor. That is, the independent board’s role should not be limited to the selection, monitoring, and removal of the CEO. Whenever a conflict arises, the independent public board has a role to play.

Interestingly, Eisenberg himself raised the possibility of a wholly independent board, stating that its advantages were “obvious”: “Since the board’s principal function is to monitor management’s performance, and since a director who is not independent can scarcely be trusted to perform that function, board membership for such persons seems counter-productive.”¹⁷⁴ In the end, he concluded that the law should favor a majority independent board. The wholly independent board, he reasoned, would involve an “unacceptably sharp break with tradition.”¹⁷⁵ In addition, because many public firms already had several outside directors, he worried that a more aggressive change would be too disruptive.¹⁷⁶ Finally, Eisenberg argued that allowing a “structural overlap” between management and the board could encourage management to take important issues to the board on “at least a pro forma basis.”¹⁷⁷ With the benefit of thirty-five years’ experience, I argue that these “pro forma” gestures have clouded the monitoring board’s essential purpose, while eating up

172. EISENBERG, STRUCTURE, *supra* note 5, at 170.

173. Eisenberg, *Legal Models*, *supra* note 171, at 384.

174. EISENBERG, STRUCTURE, *supra* note 5, at 172.

175. *Id.* at 174.

176. *Id.* at 174–75.

177. *Id.* at 175.

scarce director time. Based on Eisenberg's own core reasoning, laid out more than thirty years ago, it is high time to demote the CEO to the position of nonvoting *ex officio* board member and to remove all other insiders from the board.

The conflict primacy board directly addresses the concerns articulated in Part III regarding the time constraints and lack of information possessed by an independent board. The board need not be updated about the ins and outs of the corporation's business. Its focus on the chief executive's performance and the audit function is its strength. The beauty of the conflict primacy model is that it turns the independent director's chief liability into an asset. The conflict primacy board member need not have an intimate or even general knowledge of the industry or the corporation itself, only good judgment and an eye on its narrow mandate.

V. OBJECTIONS

A. *Statutory Difficulties*

As Part II described, the major corporate statutes require that the corporation's affairs be managed by or under the direction of the board of directors. One might argue that the conflict primacy board impermissibly delegates the managerial function to the executive.

I argue that these statutory provisions mesh well with the conflict primacy board. In the 1970s corporate codes were amended to add that the corporation is managed by "or under the direction of" the board of directors—a nod to the changed reality of corporate America.¹⁷⁸ Residual control, the ultimate control over the corporation, lies with the board: it delegates its power to CEOs, but it retains the power to remove them, and thus ultimate control over the corporation. Corporate management in the conflict primacy model remains "under the direction of" the board of directors. As discussed in the introduction, I defer more detailed questions of implementation for the present time.

178. The phrase was added to the Delaware General Corporation Law by the Delaware Legislature on July 11, 1974, taking effect on July 1, 1974. The Committee on General Corporation Law stated that the amendment "makes explicit the present law that the duty of directors to 'manage' the corporation may be carried out by officers and employees under the direction of the board. Thus, the directors' role usually is formulating policy and directing officers to conduct the day-to-day operations." GEN. CORP. LAW COMM., DEL. STATE BAR ASS'N, COMMENTARY ON LEGISLATIVE PROPOSALS FOR THE 127TH GENERAL ASSEMBLY, SECOND SESSION, 1974 § 2 (1974), available at <http://law.widener.edu/LawLibrary/Research/OnlineResources/DelawareResources/DelawareCorporationLawDocuments.aspx>.

B. Shouldn't We Expect More from Directors? Opting into a More Robust Board

Perhaps the biggest problem with the conflict primacy board is also its primary strength: it declines to ask much of the board. This Article argues thus far that, given the way independence is defined and corporate boards are constituted, requiring anything more than dealing with areas of conflict would be foolhardy. While every corporation would like to have an intelligent, active, engaged board—the Platonic Ideal board—none of those qualities are, or indeed can be, required by law.¹⁷⁹

Boards can contribute much more to the life of a corporation than merely handling conflict. Indeed, a PricewaterhouseCoopers survey found that most directors would like to spend more time on areas such as strategic planning and risk management.¹⁸⁰ Engaged board members, drawn from the corporation's industry or related ones, or those who have taken the enormous amount of time required to familiarize themselves with areas of corporate strategy or market trends, have much to offer the corporation lucky enough to have them.¹⁸¹ I am deferring the implementation question for another day, but, in general terms, corporations would be free under the conflict primacy board to give their boards a greater role, either by way of their organizational documents (i.e., adopting an amendment to the articles of incorporation or a bylaw approved by the shareholders that tasks the board with substantive managerial duties) or simply by promoting the fact of their knowledgeable, active, and engaged board membership. Such corporations would be free to tout their more robust boards as a distinguishing feature of corporate governance that enhances shareholder value. The conflict primacy board sets the minimum that we require of boards, but in individual corporations they could take on a more substantive role.

VI. CONCLUSION

Boards play a pivotal role in corporate law theory, yet this Article has shown that they do not and cannot sustain this role in practice. Modern public boards, composed almost entirely of outsiders with only incomplete knowledge of the corporation's inner workings and limited

179. The only substantive positive requirement is that Sarbanes-Oxley's de facto requirement that the audit committee have one financial expert. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 407, 116 Stat. 745, 790 (codified at 15 U.S.C. § 7265).

180. Pricewaterhouse Coopers, *The 2011 Proxy Season: Say on Pay*, PWC TO THE POINT: CURRENT ISSUES FOR BOARDS OF DIRECTORS, Winter 2011, at 1, 3, available at <http://pwc.com/us/en/corporate-governance/assets/to-the-point-current-issues-for-boards-of-directors-winter-2011.pdf>.

181. Lynne Dallas's suggestion of dual boards, one focused on conflicts and one focused on relational functions, may serve as one avenue for a corporation to enjoy the benefits of both kinds of boards. Lynne L. Dallas, *Proposals for Reform of Corporate Boards of Directors: The Dual Board and Board Ombudsperson*, 54 WASH. & LEE L. REV. 91 (1997). My suggestion parts company from Dallas's by emphasizing the centrality and primary necessity of the conflict primacy board.

time in which to manage the corporation, simply cannot effectively fulfill the myriad tasks expected of them. The dominant monitoring board model has enlarged to the point where boards are expected to make strategic choices they are ill-equipped to handle. The leading competing models of the corporation, Blair and Stout's team production model and Bainbridge's director primacy model, likewise expect unrealistically engaged behavior from the modern independent board.

This Article proposes embracing the modern public board's independence by employing it where it will be most useful: in areas where management faces a conflict of interest. Circumscribing the board's role in this manner will enable it to focus on areas—CEO evaluation, compensation, and succession, audit, related party transactions, takeovers, and derivative suits—where outside status serves as a strength, not a weakness. To underline the conflict primacy function of the board, I advocate removing all inside directors, retaining only the CEO as an *ex officio*, nonvoting board member. Thus reconstituted and refocused, the board in the conflict primacy model of the public corporation will serve a vital function: managing the corporation where—and only where—the managers cannot.