IS THE INDEPENDENT DIRECTOR MODEL BROKEN?

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ABSTRACT

The common law concept of the disinterested director developed into the model of an independent director and was advocated by the Securities and Exchange Commission (SEC) as a general ideal and by court decisions in a variety of situations. The SEC has generally succeeded in imposing its corporate governance views concerning independent directors in the wake of scandals. Although the composition and behavior of securities markets and investors has changed drastically since the SEC was established in 1934, the SEC has persisted in its path dependent view that independent directors, ever more stringently defined, should dominate the boards of public companies. This article will critically address the question of what is the function and rationale for such directors.

The independent director ideal has not been embraced all over the world. Neither has shareholder primacy. In particular, in some countries the controlling shareholder is considered to be not independent because one of the goals of corporate governance is the protection of minority shareholders. Also, where the government is a major shareholder, the independent director model is problematic.

This Article will outline the evolution of the independent director model as championed by the SEC, and discuss criticisms of the independent director model. It also will set forth alternatives to the shareholder primacy theory of the firm because shareholder primacy is related to the independent director model. Finally, the article will discuss corporate governance models outside the United States.
I. INTRODUCTION

At common law, an interested director was barred from participating in corporate decisions in which he had an interest and therefore “disinterested” directors became desirable. This concept of the disinterested director developed into the model of an independent director and was advocated by the Securities and Exchange Commission (SEC) as a general ideal and by court decisions in a variety of situations. The SEC’s policy preference for independent directors was embodied in the Investment Company Act of 1940, and highlighted in some early cases. This SEC view should be understood in the context of Adolph Berle’s theory of the 1930s that shareholders had abdicated control of public corporations to corporate managers, and fiduciary duties needed to be imposed upon corporate boards in order to compensate for this loss of shareholder control. Berle’s writings laid the foundation for shareholder primacy as the theory of the firm, a theory embraced by the SEC, which viewed itself as a surrogate for investors.

The SEC has generally succeeded in imposing its corporate governance views in the wake of scandals. Following the sensitive payments enforcement program of the 1970s, the SEC embarked on an activist corporate governance reform program. During the merger and acquisition frenzy of the 1980s, the SEC used the Williams Act to foster the view that the market for corporate control constrained incompetent managers. After the bursting of the technology bubble in 2000, and the financial reporting scandals that ensued, the SEC was able to incorporate its views on independent directors into the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley). Following the financial crisis of 2008, the SEC further enforced its views on the requirements for independent directors in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).

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2 See text at notes infra.
3 AA. Berle, Jr., For Whom Corporate Managers are Trustees: A Note, 45 HARV. L. REV. 1365 (1932); AA. Berle, Jr., Corporate Powers as Powers in Trust, 44 HARV. L.REV. 1049, 1049-50.
The composition and behavior of securities markets and investors has changed drastically since the SEC was established in 1934. Yet the SEC has persisted in its path dependent view that independent directors, ever more stringently defined, should dominate the boards of public companies. What is the function and rationale for such directors? If it is to assure that corporations comply with laws and regulations imposed on public corporations, they become just another (probably ineffectual) gatekeeper. If it is to weaken the power of the CEO, there is some doubt independent directors can or should do so. If it is to be responsive to the needs and views of shareholders, which shareholders of an increasingly diverse body should be served? In recent years, and particularly in the aftermath of the 2008 financial crisis, academics and others have been questioning both the shareholder primacy model of the firm and the independent director model of board governance.

The independent director ideal has not been embraced all over the world. Neither has shareholder primacy. In particular, in some countries the controlling shareholder is considered to be not independent because one of the goals of corporate governance is the protection of minority shareholders. Also, where the government is a major shareholder, the independent director model is problematic.

I have never been entirely comfortable with the SEC’s view that the best public company boards are boards composed of directors whose only compensation for sitting on a board comes from directors’ fees and who have no potentially conflicting business interests, past or present, with the company. Since 2008, my doubts about this model have increased. This Article will explore those doubts and suggest that director competency may be more important that director independence. Further, directors should have an obligation to the long term viability of a corporation. Such an obligation would infringe upon the shareholder primacy theory of the firm. Furthermore, in an institutionalized marketplace, retail shareholders may need to be protected against institutional investors.  

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7 See Roberta S. Karmel, Should a Duty to the Corporation Be Imposed on Institutional Shareholders?, 60 Bus. LAWYER 1 (2004).
Part II of this Article will outline the evolution of the independent director model as championed by the SEC. Part III will discuss criticisms of the independent director model. Part IV will set forth alternatives to the shareholder primacy theory of the firm. Part V will discuss corporate governance models outside the United States. Part VI will conclude.

II. TWENTIETH CENTURY SEC VIEWS ON INDEPENDENT DIRECTORS

A. EARLY SEC VIEWS

The case that is generally cited as the first move by the SEC into the establishment of corporate governance standards is In the Matter of Franchard Corporation where the Commission held that the “integrity of management—its willingness to place its duty to public shareholders over personal interests” is a material disclosure item. The SEC staff had argued in this administrative stop order proceeding that “by identifying members of the board of directors, the registrant impliedly represented that they would provide oversight and direction to the registrant’s officers.” The Commission rejected this theory on the ground that it would “stretch disclosure beyond the limitations contemplated by the statutory scheme.” The Commission believed it was not equipped to evaluate the entire conduct of a board in the context of the whole business operations of a company.

Over time, this limited view of the SEC’s statutory authority and expertise gave way to a more activist approach to corporate governance. In its reports on the financial collapse of Penn Central lapses by the railroad’s board of directors were cited, including that “they failed to perceive the complexities of the company’s financial operations, problems, or the critical nature of the company’s financial situation,” and they “permitted management to operate without any effective review or control” since they “were uninformed of important developments and activities.”

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9 Ralph Ferrara & Mark Goldfus, EVERYTHING YOU EVER WANTED TO KNOW ABOUT THE FUTURE OF FEDERAL INFLUENCE IN CORPORATE GOVERNANCE 28 (1979).
The SEC staff’s view of the need for corporate governance reform generally has been aired in the context of corporate scandals. In the early 1970s a number of influential voices cried out for federal corporate chartering in order to curtail the deleterious influence of giant corporations. The SEC then embarked on an activist corporate governance reform program in the context of a general post-Watergate hysteria, an effort to blame business for a prevailing climate of corruption, a stagflation economy and a long bear market. The immediate spur to this program was the questionable foreign payments cases, in which approximately 400 public companies consented injunctions to cease paying commercial bribes for foreign government agents in order to obtain business. Some of these consents included the restructuring of a company’s corporate board.

In response to the sensitive payments cases, Congress passed the Foreign Corrupt Practices Act, which criminalized the paying of bribes to foreign officials, and also added a provision requiring companies registered with the SEC to maintain accurate books and records and develop a system of internal accounting controls. This was the first statute in which the SEC was given a direct power to regulate the internal affairs of public corporations. Ironically, the statute was passed almost simultaneously with a Supreme Court decision prohibiting the use of Section 10(b) and Rule 10b-5 from being used to regulate directorial breaches of fiduciary duty. According to the Court, such an extension of the securities laws would over-lap and interfere with state corporation law. “Absent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities.”

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11 See SEC & EXCH. COMM’N REPORT ON QUESTIONABLE AND ILLEGAL CORPORATE PAYMENTS AND PRACTICES, 94TH CONG., REPORT OF THE SEC & EXCH. COMM’N ON QUESTIONABLE AND ILLEGAL CORPORATE PAYMENTS AND PRACTICES (Comm. Print 1976) [hereinafter SEC REPORT ON QUESTIONABLE PAYMENTS].
15 Id. at 478-79.
Nevertheless, in a general atmosphere of criticism of business leaders, the corporate governance debate turned to questions of board composition and director independence and the SEC embarked on a program to influence board structure, at a time when the SEC had a new chairman who believed in independent board directors. In April of 1977, the SEC announced that it would hold public hearings concerning shareholder communications, shareholder participation in the corporate electoral process, and corporate governance in general.\(^\text{17}\) After these hearings the SEC proposed rules to encourage boards to become independent of management by restructuring so as to have persons not in any way affiliated with the corporation.

At the very least, in the view of Harold Williams, then SEC Chairman, a board’s nominating, compensation and audit committees should be composed of independent directors.\(^\text{18}\) He also advocated that the CEO should not serve as chairman of the board. It is interesting that Chairman Williams was not a fan of shareholder primacy. He criticized shareholders who purchased stock to hold for a short period of time to sell at a profit, by stating: “They do not perceive themselves as owners of the company, but rather as investors—or speculators—in its income stream and the stock market assessment of its securities.”\(^\text{19}\) Although he believed that a board of independent directors could be a countervailing force to CEO power, necessary to make corporations more accountable, his concept of accountability went far beyond corporate accountability to shareholders. “As a society, we depend on private enterprise to serve as the instrument through which to accomplish a wide variety of goals—full employment, equal economic opportunity, environmental protection, energy independence, and others. When viewed in light of these social implications, corporations must be seen, as to a degree, more than purely private institutions, and corporate profits as not entirely an end in themselves, but also as one of the resources which corporations require in order to discharge

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\(^{18}\) Harold M. Williams, Chairman, Sec. and Exch. Comm’n, Address on Corporate Accountability—One Year Later at the Sixth Annual Securities Regulation Institute, San Diego, Cal. (Jan. 18, 1979).

\(^{19}\) Harold M. Williams, Chairman, Sec. and Exch. Comm’n, Address on Corporate Accountability at the Fifth Annual Securities Regulation Institute, San Diego, (Jan. 18, 1978), at 12.
their responsibilities. The view that corporations are quasi-public institutions that should be held accountable to a number of constituencies has a long history, but the independent director movement did not usher in an era of corporate accountability to employees, customers or the public.

At the time of the SEC’s corporate governance program of the 1970s, the only mechanism the SEC had for effecting boardroom reform was disclosure regulation. Accordingly, the SEC proposed to require all corporations subject to the SEC’s proxy rules to label their directors as “independent” or “affiliated.” These rules aroused a storm of protest and the SEC’s final rules required only a brief description of “significant economic and personal relationships . . . between the director and the issuer.” Although the SEC has generally managed to utilize disclosure requirements as a prophylactic device to achieve some modification of corporate conduct, the agency chafed at being unable to directly regulate corporate behavior. It viewed the absence of any SEC authority to regulate corporate board structure as a policy error to be corrected.

In the 1980s an active merger and acquisition market led to the demise of many established industrial companies. In administering the Williams Act, the SEC generally sided with bidders, or the interests of Wall Street, in opposition to target companies, or the interests of Main Street. In retrospect, the takeovers of this period were part of the deindustrialization of the United States, and may not have been entirely positive. Although it can be argued that the U.S. economy became more efficient and competitive, the manufacturing of goods and many types of jobs were outsourced or exported. Finance overtook industry and income inequality markedly increased. Some of these issues were debated during the November 2012 elections with a hindsight view of the financial crisis of 2008. In my opinion, however, the asset bubble of the early years of this century and its bursting in 2008 was the culmination of economic and financial regulation problems that should have been apparent in the 1980s. The SEC was

20 Id. at 8.
focused on defending the market for corporate control when perhaps it should have been focusing on the questionable behavior of financial investors who were dismantling public corporations for short term shareholder gain.

The merger mania of the 1980s was financed to a significant extent with junk bonds emanating from Drexel Burnham Lambert (Drexel). The role of that firm in using leverage to take over major industrial companies continues to be controversial, even after Michael Milken, Drexel’s maestro, went to jail for insider trading. More recently, the spotlight has focused on Bain Capital, a Drexel client, which engaged in a number of highly leveraged private equity deals in the 1980s that resulted in the export of U.S. manufacturing and jobs.

The directors of target companies who attempted to fend off unwelcome hostile takeovers during this period were frequently criticized for their failure to act independently of management. But with hindsight, it is possible to inquire whether the financial interests that fueled the takeover boom of the 1980s acted in the public interest, or only in the interest of stock market speculators.

B. INVESTMENT COMPANY GOVERNANCE

Investment company corporations are organized under state law, often the state of Maryland. Under the Investment Company Act of 1940, at least 40% of the board must be composed of “independent” or “disinterested” directors. The rationale for this provision was to eliminate conflicts of interest and abuses rampant in the investment trusts of the 1920s. This principle may have originated at the New York Stock Exchange, Inc. (NYSE), which made independent representation on the boards of investment trusts a requirement for listing in 1931 on the theory that investor “protection could be most readily obtained by independent

24 See, e.g., Smith v. Van Gorkam, 488 A.2d 858 (Del. 1985)
directors under whose scrutiny and friendly criticism [of] contemplated transactions would pass for review.”

Initially the directors of an investment company could not be “affiliates” of the investment company, but in 1970, the statute was changed to the stricter standard that directors must be “disinterested.” The SEC did not remain satisfied with this amendment, however, and pushed for further director independence. In 2001, the SEC determined that investment companies that rely on certain exemptions by rule were required to have a board of a majority of disinterested directors and independent legal counsel for the independent directors. This rule was not challenged.

In 2004, the SEC amended 10 widely relied upon exemptive rules to enhance the effectiveness of independent directors. Funds using these exemptions were required to have 75% disinterested directors and an independent chairman. Other provisions with regard to governance were: (1) fund directors must perform an evaluation, at least once annually, of the effectiveness of the board and its committees, and among other things, decide if they are serving on too many fund boards; (2) independent directors need to be authorized to hire their own employees; and (3) funds need to retain the written materials directors consider in approving an advisory contract. Two Commissioners dissented from the adoption of these rules and the case went to the D.C. Circuit Court, which held, in Chamber of Commerce v. SEC, that the SEC had the authority to pass the rule mandating a 75% board of independent directors, but did not appropriately consider costs and benefits with regard to the separation of the CEO and Chairman. Therefore, the court vacated the independent chairman rule. Nevertheless, most funds now have at least a majority and usually 75% independent directors. Some have independent chairmen, but many have a lead director instead.

27 Id. at 36.
30 412 F.3d 133 (D.C. Cir. 2005). The case was remanded to the SEC and a revised rule was also stricken. 443 F.3d 890, 896 (D.C. Cir. 2006).
The SEC is happy to experiment with its corporate governance ideas in the context of investment company regulation, but investment companies are merely a pool of assets, without employees or products. The role of the board is to manage the relationships between the company and its service providers, particularly its advisers and underwriters. In many respects, the board serves a compliance function and is not involved with strategy or the development of new products or services. Despite the SEC’s belief that the organization of an investment company board is a good model for all corporations, investment companies are highly regulated financial vehicles and their use as a model for other corporate boards is questionable.

C. SARBANES-OXLEY REFORMS

After the bursting of the technology stock market bubble of the 1990s and the implosion of Enron and WorldCom, the Congress passed Sarbanes-Oxley Act in 2002, in an effort to reform the corporate governance of public companies under the direction and supervision of the SEC. Immediately prior to the passage of the Sarbanes-Oxley Act, in June 2002, at the urging of the SEC, a committee of the NYSE issued a report with recommended changes to the NYSE listing standards. This report had a variety of recommendations for changes in NYSE listing standards that went beyond Sarbanes-Oxley, including (i) requiring listed companies to have a majority of independent directors, with a stringent definition of the term “independent”; (ii) a provision for regularly scheduled executive sessions of boards chaired by a lead director or independent chairman; (iii) requiring listed companies to have nominating and compensation committees composed entirely of independent directors; and (iv) requiring shareholder votes on equity-compensation plans. These recommendations were then transmitted to the NYSE board of directors and several of them were filed with the SEC as proposed new listing standards.

Sarbanes-Oxley gave the SEC the authority it had long wanted to restructure aspects of corporate governance, but it did so primarily by authorizing the SEC to direct self-regulatory organizations (SROs) to change their listing rules to meet certain standards. The law mandated that the SEC put into place requirements pertaining to the independence and

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33 REPORT OF THE NEW YORK STOCK EXCHANGE CORPORATE ACCOUNTABILITY AND LISTING STANDARDS COMMITTEE (June 6, 2002) [hereinafter NYSE Corporate Accountability Report], available at: http://www.iasplus.com/resource/nysegovf.pdf. This project was requested by the Chairman of the SEC.
functioning of public company boards—audit committee members, in particular—by ordering the New York Stock Exchange, Inc. (NYSE) and other SROs to make such requirements part of their listing standards. In addition to regulating the manner in which audit committees are structured and function in a way that was not previously done, the Sarbanes-Oxley Act made these regulations a matter of federal, rather than state, law.

Because Sarbanes-Oxley greatly enlarged the scope of the Securities Exchange Act of 1934 as to specific matters of corporate governance, the SEC acquired greater freedom to utilize SRO listing standards to accomplish corporate governance reform. In implementing Sarbanes-Oxley it has made ample use of this new authority, raising the interesting question of where the line in the sand between federal and state law with respect to a corporation’s internal affairs should be drawn.

In addition to proposals that relate to audit committees, the NYSE proposed that non-management directors must meet at regularly scheduled executive sessions and that nominating and compensation committees be composed entirely of independent directors. Similar, although slightly different, listing proposals were filed with the SEC by Nasdaq. The final SRO listing rules as approved by the SEC implementing Sarbanes-Oxley include provisions for independent board members for key committees, mandate executive sessions of non-management directors, define committee independence for audit and nominating committee members, define audit committee financial experts, set forth specific size requirements and obligations of the audit committee, and require companies to have codes of business conduct and ethics. Continuing education for directors is also suggested.

D. DODD-FRANK REFORMS

The restructured public company board as mandated by Sarbanes-Oxley did little to prevent the financial meltdown of 2008. There was insufficient focus on, or understanding of,

risk management and insufficient understanding of risk by independent directors.\(^3\) Instead of questioning whether the independent director model is defective, the SEC pushed forward with its ideological preference for independent directors and so added provisions to this effect into the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).\(^4\)

Dodd-Frank further tightened the independence requirements for compensation committees by requiring that each member of compensation committees be independent and clarifying the standards by which committee members are determined to be independent.\(^5\) Additionally, Dodd-Frank requires compensation committees to consider certain enumerated factors in selecting compensation consultants, legal counsel, or other advisors to the committee, such as “the policies and procedures of the person that employs the compensation consultant, legal counsel, or other adviser that are designed to prevent conflicts of interest.”\(^6\)

Dodd-Frank also directed the Board of Governors of the Federal Reserve Board to issue regulations requiring each bank holding company with consolidated assets of greater than $10 billion, as well as each nonbank financial company supervised by the Board of Governors, to establish a risk committee.\(^7\) The risk committee is responsible for the oversight of enterprise-wide risk management practices of the supervised company or bank holding company and is to include such number of independent directors as the Board of Governors may determine appropriate.\(^8\) Additionally, the risk committees are to include at least one risk management expert having experience in identifying, assessing, and managing risk exposures of large, complex firms.\(^9\)

Misguided ratings for structured products were widely blamed for the 2008 financial crisis. In response to this problem, Dodd-Frank put into place new requirements for Nationally Recognized Statistical Rating Organizations (“NRSROs”).\(^10\) At least half of the board of an NRSRO

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\(^5\) § 952(a).

\(^6\) §§ 952(b), (b)(2)(C).

\(^7\) § 165(h)(2).

\(^8\) §§ 165(h)(3)(A), (B).

\(^9\) § 165(h)(3)(C).

\(^10\) § 932.
must be comprised of independent directors. Further, a portion of the independent directors must include users of NRSRO ratings.

In order to be considered independent, a member of the board of an NRSRO may not, other than as a board member, accept any consulting, advisory, or other compensatory fee from the NRSRO or be associated with any affiliated company of the NRSRO. Additionally, a board member must be disqualified from any deliberation involving a specific rating in which the independent board member has a financial interest in the outcome of the rating. Finally, the compensation of such independent board members may not be linked to the business performance of the NRSRO, and the term of office of such a director is limited to 5 years.

Despite affirming the independent director model for compensation committees, Dodd-Frank therefore addressed capital market failures that led to the 2008 financial crisis, in ways that go beyond or even contradict the usual SEC solution of mandating more independence for corporate board members. First, the statute and the financial regulators are focused on the ability of directors to assess risk. Second, in the case of NRSROs, the concept of independence is geared to directorial responsibility for the quality of a company’s products. Also, Dodd-Frank suggests a distinction in the shareholder primacy model between Main Street business corporations and financial institutions.

III. PROBLEMS WITH THE INDEPENDENT DIRECTOR MODEL AND SHAREHOLDER PRIMACY

A. THE THEORY OF INDEPENDENT DIRECTORS

The installation of independent directors on the boards of public corporations is “grounded in the belief that outside directors are more effective than inside directors in monitoring management conduct.” This is because “independent directors’ incentives would be more closely aligned with shareholders’ incentives, which would lead the board to keep a closer eye on executive management and ensure that shareholder value was maximized.” Independent directors are to be elected by shareholders and are “not beholden to the CEO.”

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47 § 932(a)(8)(t)(2)(A).
48 Id.
49 § 932(a)(8)(t)(2)(B).
50 Id.
51 § 932(a)(8)(t)(2)(C).
52 Thuy-Nga T. Vo, To Be or Not to Be Both Ceo and Board Chair, 76 BROOK. L. REV. 65, 70 (2010).
54 Id.
The conventional wisdom is that independent directors will “reduce executive mismanagement, and decrease the likelihood of future corporate failure.”

The primary function of the independent director is to “monitor the corporation and its officers with an eye towards ensuring that managers do not abuse their authority by engaging in self-dealing or fraud, or otherwise shirking their responsibilities.” Through oversight of management, independent directors are supposed to “detect and prevent fraud . . . and managerial shirking of responsibilities.” This in turn should “enhance corporate performance because they can proactively examine corporate affairs, not only to ensure that managers are productive, but also to ensure that managers make the most efficient and effective decisions.”

Nevertheless, “companies have continued to fail despite the ubiquity of the majority independent board and related committee structures.” Some studies have shown that independent directors actually negatively affect corporations “because the outside directors are more likely to support management prerogatives than shareholder interests, that increasing outsider representation reduces research and development spending, and that an outsider-dominated board is more likely to award ‘golden parachutes’ to the company’s executives.” A 2009 study by David Erkens, et al., points to “the inadequacy of measures to make boards more accountable to shareholders and to increase the independence of boards.” The study examined 296 financial institutions in 30 different countries that were at the heart of the 2008 financial crisis. The results showed that firms with more independent directors on their boards and a higher level of institutional ownership, “experienced worse stock returns during the crisis period.”

Independent directors are part-time participants in a corporation’s affairs. By definition they are outsiders. However intelligent, hardworking or strong minded they may be, they do not have the time or the mandate to challenge management’s judgments except as to a discrete number of issues. If they spend all of their time trying to audit the auditors and assure

55 Id. at 277.
57 Id.
58 Id.
60 “Golden parachutes” are compensation arrangements “that allow covered managers to voluntarily resign and collect substantial remuneration--in some cases several million dollars--after a triggering event, usually a hostile takeover.” Philip L. Cochran, Robert A. Wood & Thomas B. Jones, The Composition of Boards of Directors and Incidence of Golden Parachutes, 28 ACAD. MGMT. J. 664, 664-65 (1985).
61 Thuy-Nga T. Vo, To Be or Not to Be Both Ceo and Board Chair, 76 BROOK. L. REV. 65, 70 (2010).
63 Id.
that executive compensation is reasonable, they will have no time for focusing on important business and strategy matters. If they become essentially full time directors they will no longer be independent.

Independent directors are completely beholden to management for information. This dependence on insiders may give a CEO more power than was the case when a board included insiders. Moreover, the most informed outsiders may not be able to sit on a board due to anti-trust or competitive constraints.

If independent directors repeatedly challenge the judgments of a CEO, the CEO will lose his authority and be forced to resign. Corporations are essentially hierarchical and need a strong leader. The SEC has not necessarily respected the celebrity CEO, and activist shareholders today are doing their best to diminish the CEO’s authority. Indeed, in the struggle between management and shareholders, it appears that CEO power is being diminished. But some of the most highly regarded U.S. corporations have had authoritarian CEOs who have rewarded shareholders over a long period of time.64

This does not mean that independent directors are a bad idea, but corporations should have greater freedom to experiment with board structures than they now have under federal law. Further, since the independent director board simply cannot carry the freight the SEC has placed upon it, it is bound to disappoint and cause investor and public dissatisfaction and loss of confidence. The collegial board has its flaws and there are times when management deserves to be challenged and even thrown out of office, but the model of mixed inside and outside directors actually served the U.S. economy well over a long period of time. The consequences of changing this model to one of giving investors control of the public corporation and giving control of board structure to a federal government agency are problematic and did not prevent the 2008 financial meltdown.

The tweaking of the independent director model for NRSROs is an interesting development. In the case of rating agencies, the purpose of the independent director no longer seems to be acting on behalf of the shareholders as a check on management, but rather acting to insure the quality of the corporation’s product—ratings. The NRSRO independent director would appear to be a director who can put a brake on the quest for corporate profits if that is necessary for improved ratings quality. This not only confuses the independent director model, but makes one wonder whether the entire independent director concept needs rethinking.

64 The corporations run by Warren Buffet (Bershire Hathaway), Jack Welch (General Electric), and Bill Gates (Microsoft) come to mind as examples. See Helen Stock, Buffet Admonishes Fund Directors, WASHINGTON POST, Mar. 7, 2004, at A15.
The SEC does not have general authority to regulate internal corporate affairs. Yet, state law does not have regulatory requirements dictating particular board structures, including whether or not any independent directors are required on boards or particular committees, such as the audit committee. Rather, legislators have been silent on this issue so that corporations could deal with it flexibly and good corporate practices could develop over time. Courts have dealt with issues of board structure and independent directors in cases enforcing fiduciary duties or in certain specific contexts such as whether demand needs to be made in a derivative case. Very generally, the courts have encouraged boards to have independent directors by scrutinizing the actions of non-independent directors with greater skepticism. In some cases, state law has been more flexible than stock exchange definitions of independence, but in other situations, state law has held relationships that would not fit within those definitions to demonstrate a lack of independence. If the SEC prevents the development of state law with regard to independent directors, state law is likely to atrophy.

IV. SHAREHOLDER PRIMACY AND OTHER MODELS

Shareholder primacy has been the dominant corporate governance theory since Berle and Dodd first debated it in the 1930’s. However, the theory has recently begun to fall out of favor for several reasons. First, the theory is premised on the idea of shareholder homogeneity, the existence of which is becoming increasingly rare. Second, the theory, with its emphasis on shareholder value, gives managers a short-term focus, rather than a focus on the long-term development of the corporation. In addition, shareholder primacy is thought to have resulted in increased risk-taking by financial corporations, which led to the 2008 financial crisis. Scholars continue to debate whether other theories of corporate governance are a better model than the dominant shareholder primacy approach.

A. SHAREHOLDER PRIMACY

The independent director model for boards is entwined with the shareholder primacy model. The shareholder primacy theory “derives from the concept that the shareholders are the owners of the corporation and, as such, are entitled to control it, determine its

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70 E.g., In re Oracle Corp. Derivative Litigation, 824 A.2d 917 (Del. Ch. 2003).
fundamental policies, and decide whether to make fundamental shifts in corporate policy and practice.”

Under this theory, officers and directors are considered agents of the shareholders. They have a duty to maximize the financial value of the corporation in order to increase the value of the shareholder’s interest. Essentially, shareholder primacy means that corporations exist to serve the interests of shareholders.

In addition to the ownership rationale that supports the shareholder primacy theory, proponents also cite the fact that shareholders are the sole residual claimants of the corporation and as such “are in the best position to exercise control for the good of all corporate constituents.” Because shareholders are not paid until after all other stakeholders receive their entitlements, shareholders must “exercise discretion in a way that maximizes value for the entire corporation.”

At one time, director fiduciary duties were to the corporation and the body of shareholders as a whole. Because the SEC views its mandate as the protection of investors, it has changed this duty, for public companies, to a direct duty by directors to shareholders. But the SEC’s mantra that it is the investors’ advocate is too narrow. Since 1996, an amendment to the securities laws requires the SEC to consider, in addition to the protection of investors, efficiency, competition and capital formation.

One problem with the shareholder primacy theory is that it assumes the existence of shareholder preference homogeneity” – that all shareholders “have a single-minded interest in wealth maximization.” However, in recent years, it has become evident that not all shareholders share this common goal. Rather, “their interests diverge along a number of dimensions.” For example, some shareholders are in the control group, while others are not. Non-employee shareholders often have different interests than employee and pension-holding shareholders. In addition, “time horizons” for wealth maximization vary among shareholders. “Short-term and long-term shareholders often have strongly divergent goals, which is particularly relevant given the increasing role of activist short-term investors such as hedge

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75 Grant Hayden and Matthew T. Bodie, Shareholder Democracy and the Curious Turn Toward Board Primacy, 51 WM. & MARY L. REV. 2071, 2076 (2013).
76 Id. at 2083.
78 Id. at 2085.
funds." And while shareholder interests may sometimes be aligned in that they can agree on the definition of wealth maximization, “they may differ as to the best way to achieve that goal.”

One response to the lack of shareholder homogeneity is to move away from the shareholder primacy theory, and move towards one of the board primacy theories. Since shareholder preferences are as diverse as those of the corporation’s other constituents, it is arguable that “corporate boards should be less responsive to shareholder interests and more power and discretion should be accorded to these boards.” But, while shareholder heterogeneity may provide some support for a board primacy approach, “it is relevant to almost any feature of corporate governance that makes the system more or less responsive to the shareholders.”

Another criticism of the shareholder primacy theory is that it causes management to focus too much on short-term goals, like stock price, and to pay less attention to the long-term development of the corporation. The 2008 financial crisis “added more fuel to the debate about shareholder empowerment.” Although recent legislation and rulemaking by the SEC has pushed “the trend toward more shareholder influence, we cannot rule out that the increased shareholder orientation of the past two decades is partly to blame for the [2008] events, given that pressure to produce more shareholder value may have led to more risk-taking, particularly in financial institutions.”

In Hurly-Berle-Corporate Governance, Commercial Profits, and Democratic Deficits, Allan C. Hutchison argues that there was “a failure on the part of regulators to appreciate that it was the single-minded focus on maximizing shareholder value that was at the heart of the [financial crisis].” According to Hutchison, “the corporation’s demise was fueled by the single-minded and irresponsible efforts by the management and board to inflate and maintain share prices and stock values.” Thus, it was the “continuing attachment to shareholder primacy [that] was

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82 Grant Hayden and Matthew T. Bodie, Shareholder Democracy and the Curious Turn Toward Board Primacy, 51 WM. & MARY L. REV. 2071, 2096 (2013).
83 Id. at 2097.
85 Id. at 660.
86 Id. at 660.
87 Id. at 1238.
88 Id.
as much the problem as the solution." While Hutchison does not propose that any particular theory of corporate governance replace the shareholder primacy norm, he does recommend the creation of a more democratic corporate governance approach through “limits on limited liability; a broadening of directors’ fiduciary duties; the increased representativeness of the board; and the enactment of substantive regulatory standards.”

B. BOARD PRIMACY

Proponents of this theory are sometimes referred to as “board primacists” and “instead of advocating for greater shareholder involvement, they advocate for greater board independence.” According to Grant Hayden and Matthew T. Bodie, there are four primary board primacy theories: the director primacy theory, the team production theory, the self-perpetuating board theory and the quinquennial election model.

Under the director primacy theory of corporate law, directors must manage “the corporation according to their best judgment.” According to one proponent of this theory, Stephen M. Bainbridge, “[t]he chief economic virtue of the public corporation is ... that it provides a hierarchical decision-making structure well-suited to the problem of operating a large business enterprise with numerous employees, managers, shareholders, creditors, and other constituencies.” Bainbridge and other director primacy advocates believe that this view of director conduct actually supports a “shareholder wealth maximization norm.” This view of director conduct supports a view of directors as “neutral mediating hierarchs.” Under this theory, directors “make sure that each corporate constituent receives adequate returns in light of their participation in the corporate endeavor.” Thus, “shareholder wealth maximization is no longer a mandate.”

According to Margaret Blair and Lynn Stout, the corporation is comprised of “a series of relationships” that “result in the joint production of goods or services that in turn create

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89 Id.
90 Id. at 1250.
91 Grant Hayden and Matthew T. Bodie, Shareholder Democracy and the Curious Turn Toward Board Primacy, 51 WM. & MARY L. REV. 2071, 2076 (2013).
92 Id. at 2089.
96 Id.
97 Id.
98 Id.
Directors must be insulated and independent because they “serve as the ultimate authority when it comes to assigning responsibilities, mediating disputes, and divvying up the profits.” If the Board were to favor one group over another, those in the unfavored group “would be less willing to make the proper investments of capital and labor to make the firm function.” Unlike proponents of the director primacy theory, Blair and Stout do not argue for shareholder wealth maximization. Instead, they argue that directors “owe a duty to the corporation and that the corporation consists of all of the stakeholders who are responsible for the business of the enterprise.”

This approach, which is chiefly supported by Lawrence Mitchell, argues that boards of public corporations should be self perpetual and that the directors themselves should “fill the periodic vacancies resulting from death, resignation, and increases in board size by selecting the people to fill those vacancies.” While admitting that this is a radical approach, Mitchell argues it “would best free managers to manage the firm.” Mitchell advocates against any control by shareholders, because such control causes directors to only focus on share price. By contrast, granting directors “complete freedom from shareholder oversight would ‘enable them to manage responsibly and for the long term.’”

Proponents of the quinquennial election model of the corporation “deplore the short-term focus that shareholder primacy brings to the corporation” and instead establish a new framework that revolves around lengthening the terms of directors to five years. During their five-year terms, directors could only be fired for illegal conduct or “willful malfeasance.” Although directors would have the authority to approve mergers, acquisitions and the like, these changes could only occur “at the time of the directors’ election.” In addition, directors would be required to present a detailed five-year corporate plan that would be critiqued by independent advisors prior to the election. The director’s compensation would also be directly tied to the success or failure of the plan.

C. STAKEHOLDER THEORY

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100 Id.
101 Id.
102 Id.
103 Id.
104 Id. at 2093.
105 Id.
106 Id.
107 Id. (quoting Lawrence E. Mitchell, CORPORATE IRRESPONSIBILITY: AMERICA’S NEWEST EXPORT 101 (2001)).
108 Id.
109 Id.
110 Id.
111 Id. at 2093-94.
Under the stakeholder theory, which is similar to the team-production theory, officers and director’s fiduciary obligations flow not only to the shareholders of the corporation, but also to “nonshareholder constituents whose interests are affected by corporate action.”  

“The heart of stakeholder theory is that corporations affect a variety of individuals and groups who have a ‘stake’ in the firm.”  

Because the corporation “benefits from the fruits of those individuals and groups,” management has a “reciprocal duty to them.”  

Thus, managers have a “broader obligations to balance the interests of shareholders with the interests and concerns of [stakeholders].”  

Stakeholders, unlike shareholders, are those people with whom corporate managers regularly deal with: “employees, regarding work performance and working conditions; suppliers, concerning the quality of the goods delivered and non-delivery of goods; customers, who complain about the goods that the corporation markets; and local communities, concerning what the corporation is doing or not doing as a corporate citizen.”  

By taking into account all stakeholders’ interests, “managers gain respect and trust in the eyes of stakeholders; and, importantly for the corporation, they can do their job better and more efficiently.”  

The stakeholder theory competes with shareholder primacy because shareholder primacy “pushes managers to exploit non-shareholders in pursuit of shareholder gains.”  

For example, “directors can put downward pressure on wages and benefits for corporate employees” in order to increase shareholder wealth. In addition, “unlike shareholder primacy, no grouping has prima facie priority over another, and no group warrants priority over any other groups.”  

Some commentators have argued that, “for a corporation to be truly sustainable, it will have to adopt a stakeholder, rather than a shareholder, value approach.”  

Robert Sprague argues that shareholder wealth maximization occurs in the long run when “managers act in the best interests of those who also have a stake in the success of the corporation--such as

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113 Id.
114 Id.
115 Id.
117 Id.
119 Id.
employees, suppliers, customers, and society. If corporate activities promote a healthy society, that society, in return, can support an environment of business growth.”

The anti-takeover statutes passed by many states in response to the takeover mania of the 1980s were based on a stakeholder theory. Some of these statutes allow directors to consider constituencies other than shareholders when confronted with a hostile takeover. Other statutes allow such considerations for any and all directorial decisions. These statutes have been upheld as not pre-empted by the federal securities laws, which expressed a principle of neutrality as between bidders and target companies. Although these other constituency statutes were passed at the behest of labor interests because of the large scale firings that generally followed takeovers, they could be utilized more generally to protect employee and other interests against shareholder interests.

Recently, many states have made provision for the incorporation of benefit and flexible purpose corporations, which straddle a space between for-profit and non-profit corporations. The benefit corporation commits its owners to pursue social or philanthropic objectives, although shareholder profits may also be pursued. However, there is no obligation to give shareholders priority. Flexible purpose corporations similarly would allow customers, the community or society to trump shareholder interests. These statutes are an updated version of the other constituency statutes, and their increasing use is an indication that at least some entrepreneurs eschew the shareholder primacy model.

D. MANAGERIAL THEORY

In Questioning Authority: The Critical Link Between Board Power and Process, the author discusses an additional theory of corporate control - managerialism. Under this theory lies the assumption that managers “run the firm free from any significant influence of the boards.” Advocates of this theory are called managerialists and they “place the ultimate right of corporate control in the hands of managers, not directors or shareholders.” While discussions about this approach have diminished in modern corporate governance scholarship, there is practical evidence that the theory is in use. Indeed, it can be seen in the fact that CEOs have control over the selection of directors, over the board meeting agendas, and, because of

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122 Id. at 80-81.
126 Id.
127 Id.
information asymmetry, the CEOs also control the amount and nature of the directors’ knowledge and information about the corporation.\(^{128}\)

E. BANK BOARDS

After the 2008 financial crisis regulators in the United States and Europe gave greater attention to the corporate governance of banks. Dodd-Frank required large bank holding companies to establish a risk committee. Similarly, the EU draft Capital Requirements Directive mandates that banks establish a risk committee composed of members of the management body who do not perform any executive functions at the bank.\(^{129}\) The management body is defined as the governing body of a corporation, comprising the supervisory and the managerial functions, with ultimate decision making authority.\(^{130}\)

Under the corporate law of the United States, directors do not generally owe a duty to creditors, with the possible exception of when the corporation is on the verge of insolvency. This proposition was tested during the takeover battles of the 1980s and was maintained in several cases. Yet, at one time bank directors were held to have duties to depositors of the bank and bank deposits in the United States are insured by the FDIC. The concern after the 2008 financial crisis is, rightly, to prevent future bank insolvencies. Although risk committees are one response, explicitly charging directors with a duty to depositors would be another appropriate response.

F. FURTHER PROBLEMS WHEN THE GOVERNMENT IS A SHAREHOLDER OR STAKEHOLDER

In emerging economies, especially the BRIC (Brazil, Russian, India, China) countries, former state owned enterprises (SOES) that have been fully or partially privatized have listed on national or foreign stock exchanges and have become subject to independent director requirements. Nevertheless, where the government remains a major stockholder, there is a question as to how independent a director can be, and what independence means in this context.

A similar issue has arisen with regard to public companies in which the U.S. government took a major stake as a stockholder, or otherwise, during the 2008 financial crisis. In this context, independence should mean not only independence from the management of the company, but also independence from the majority stockholder. Yet, when the government appoints, or at least approves, the directors, the directors are not necessarily independent of

\(^{128}\) Id.


\(^{130}\) Id.
government control.  

Although the government generally took a hand-off attitude with regard to corporate governance after the bailout, when it became a major shareholder in various financial institutions and General Motors, it did interfere with some key corporate decisions, such as the payment of bonuses, and, in the case of GM, termination of dealerships. Further, the government had at least an indirect influence on the appointment of managers and directors of some firms.

V. CORPORATE GOVERNANCE OUTSIDE THE UNITED STATES

A. EUROPE

Europe has had different corporate governance models; with the United Kingdom having boards of directors and directorial fiduciary duties similar to the United States, and Germany having two-tier boards, with employee representation on the second tier. The influence of European Union directives and white papers, and events in the capital markets are tending to make European boards more similar, however. Although the independent director ideal has spread to Europe to some extent, the recent push in the direction of requiring female board directors may change the emphasis on independence. Also, the financial crisis of 2008, the subsequent sovereign debt crisis in Europe and the LIBOR scandal may orient boards and regulators in the direction of demanding more director competence, especially with regard to risk.

The issue of independence is generally covered by “comply or explain” corporate governance codes. There are few mandatory requirements, although under an EU directive, at least one member of the audit committee must be independent.  

In Germany, supervisory board members are non-executive by definition, but they are not necessarily independent. An important issue is the definition of independence. An EU Green Paper defines independent as “free of any business, family or other relationship, with the company, its controlling shareholder or the management of either, that creates a conflict of interest such as to impair his judgement.”

The question of whether a representative of a controlling shareholder is independent is important in Europe and in other countries, although it has not been focused on in the United

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133 P.L. Davies & K.J. Hopt, Boards in Europe—Accountability and Convergence, http://ssrn.com/abstract=2212272 (Feb. 2, 2013), at 16. In the Italian two-tier model, if the management board has more than four members, at least one should be independent. Id.
States. In several countries of Europe a representative of a 10 per cent shareholder is not considered independent.\textsuperscript{135}

The possible problem with the independent director is a downplaying of competence. Recently, debates about board composition focus on expertise and diversity as much as independence.\textsuperscript{136} Especially for financial firms, there is a need for expertise so the board can effectively discharge its responsibilities.\textsuperscript{137} The debates about diversity are a push for more women on corporate boards in Europe. In some countries, such diversity has been mandated, but other countries have rejected required diversity.\textsuperscript{138} These new desired attributes for board members—expertise and diversity—are likely to reduce independence as a priority. Furthermore, independence may actually contribute to the lack of meaningful involvement by non-executive directors, and accordingly the knowledge and experience of insiders may be required for effective board participation in the decision making of firms, especially financial firms.\textsuperscript{139}

B. CHINA

In China, where laws may require directors to be members of the Communist Party, and they are under an obligation to consider the general welfare, and not only the welfare of minority or public shareholders, independence does not have the same meaning as in the United States.\textsuperscript{140} In addition, that state owns 30% or more of nearly two-thirds of listed companies and therefore controls them. Although the Code of Corporate Governance for Listed Companies in China requires listed companies to be operated “in an independent manner,” it is likely this means independent of government interference with corporate governance.\textsuperscript{141} In addition, state owned enterprises have social responsibilities and are viewed as vehicles for state control over certain industries, and optimal profits cannot trump these stakeholder values.

The Company Law of China was passed in the 1990s and adopted a two-tier board structure similar to the German corporate governance model, with a board of directors and a board of supervisors. Employee representatives may sit on both boards. In addition to this law, the Code of Corporate Governance for Listed Companies in China and the Securities Law of the

\textsuperscript{135} Davies & Hopt, at 17-18.
\textsuperscript{136} Id. at 22.
\textsuperscript{137} See id. at 23.
\textsuperscript{138} Id. at 23-25.
\textsuperscript{139} See Jaap, at 7.
PRC regulate corporate governance. State owned enterprises are regulated by the State-owned Assets Supervision and Administration Commission of the State Council (SASAC). In addition, various financial regulators also regulate public companies.

In addition to PRC state owned enterprises, there are non-state owned companies in China and Hong Kong. Many if not most of these are controlled by a family or small group. Some of these corporations are listed on the Hong Kong stock exchange which has corporate governance listing rules. Hong Kong has a “comply or explain” corporate governance code based to some extent on the U.K. Code. With regard to independent, non-executive directors (INEDs), the Hong Kong rules, as well as the PRC rules, require that at least one-third of the board of an issuer should be INEDs. But the Hong Kong exchange rejected the proposition that INEDs should be elected by minority shareholders only. Nevertheless, the directors are required to act in the best interest of the company and shareholders as a whole.

VI. CONCLUSION

The independent director model has been accepted in many jurisdictions, either as a mandatory requirement for public companies or a recommended structure. Yet, boards of independent directors did not prevent the scandals of Enron, WorldCom and other companies in the United States and in Europe after the bursting of the technology bubble of the 1990s. Neither did such boards prevent the financial institution meltdowns of 2008. A rethinking of this model is therefore in order.

Although inside or executive directors may have conflicts of interest, they are more knowledgeable than outsiders and more involved in making business decisions for the corporation, both short-term and long-term. Their most serious conflict of interest decisions relate to compensation, but where directors and officers are both compensated, in whole or in part, on the basis of contingent stock awards, insiders and outsiders have similar conflicts. Further, such compensation has resulted in shareholder primacy run amuck. It also encouraged the risk taking that resulted in the 2008 financial crisis. Accordingly, shareholder primacy also needs to be re-examined.

Since 2008, director diligence and expertise have been focused upon. But a board of independent directors remains dependent on a corporation’s management for information. Regulation cannot compel those personal qualities that make a director excellent—intelligence, integrity, experience, competence and a willingness to question herd decision-making. Further, a public corporation should not be some battle ground where executives, directors and shareholders are adversaries.
In my opinion, public corporations should have a mix of independent and non-independent directors, and directors should be held to a duty to the corporation as a whole. The interests of employees, customers and creditors should be balanced against a duty to shareholders, especially when those shareholder interests are short-term. Although such complicated duties may prove more difficult to enforce, shareholder primacy has brought business to a sorry pass, especially in the United States, where our industrial base had been seriously impaired and speculation in the financial markets has wrecked havoc on the real economy. Only a fully informed board can possibly help to steer a forward course for public corporations in our global, complex world. The board needs to be informed by experienced and responsible insiders with a stake in the future of the corporation as well as independent outsiders who have the expertise and ability to both question and advise management.