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The Fetishization of Independence

Usha Rodrigues, University of Georgia School of Law

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The Fetishization of Independence

Usha Rodrigues*

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

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

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

* Assistant Professor, University of Georgia School of Law. I thank ______________.
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Introduction

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

This corporation, as it turns out, is not a hypothetical firm, but in fact is Hewlett-Packard, the eleventh largest corporation in the United States.\(^4\) Regardless of the blame that may ultimately be assigned to the various individuals on the board, the HP story illustrates the perils of relying on “best practices” corporate governance—such as a supermajority independent board—alone. Nevertheless, a student of corporate governance discourse over the past 40 years could easily conclude that independent boards are an

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essential—indeed, a natural—part of good corporate governance. It is now conventional wisdom that independent boards must run companies, so obvious that it does not even warrant discussion.

Even so, in some corners of academia, debate about the value of independent directors persists. Empirical studies have shown that a majority independent board does not improve firm performance—that is, firms with a majority of independent directors do not do better for shareholders than those with a minority of independents. Proponents in response urge ever-stricter definitions of independence. Surprisingly, however, participants in this debate have failed to examine the role of independence in Delaware, the preeminent source of corporate law in the

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5 Alan R. Palmiter, Reshaping the Corporate Fiduciary Model: A Director's Duty of Independence, 67 TEX. L. REV. 1351, 1438-39 (1989) (“The institution of outside directors has received voluminous attention. In the 1970s, advocates of corporate social responsibility, corporate regulators (such as the SEC and the stock exchanges), and corporate reformers focused attention on the subject.”); Kenneth B. Davis, Jr., Structural Bias, Special Litigation Committees, and the Vagaries of Director Independence, 90 IOWA L. REV. 1305, 1306 (2005) (“Since the beginning of the corporate governance movement in the mid-1970s, enhancing the independence of corporate directors and their function on the board has been at the center of corporate governance reform.”).

6 Note, Beyond “Independent” Directors: A Functional Approach to Board Independence, 119 HARV. L. REV. 1553 (2006); see also John H. Matheson and Peter D. Favorite, Multidisciplinary Practice and the Future of the Legal Profession: Considering a Role for Independent Directors, 32 LOY. U. CHI. L.J. 577, 609 (2001) (“Today, it is generally accepted by all concerned that independent directors may provide effective oversight of management and promote accountability. Over the past twenty years, independent directorship has evolved from being the subject of interesting speculation to an assumed “best practice” for the most successful corporations in the world.”).

7 Debate began in the 1970s with the ALI’s recommendation of the monitoring model and emphasis on the importance of the independent director. John H. Matheson & Brent A. Olson, Corporate Law and the Longterm Shareholder Model of Corporate Governance, 76 MINN. L. REV. 1313, 1363-64 (1992). The ALI reforms largely carried the day. See infra Part I.B. Nevertheless, a series of empirical studies has questioned the connection between firm performance and majority outside independent boards. See infra Part II.C. More recently, Jeffrey Gordon has suggested an alternate explanation for the value of independent directors. See infra n.XX.

8 See infra Part I.C.
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United States. This omission is particularly notable because Delaware’s theory of independence differs radically from the conventional approach. Although practitioners have parsed Delaware’s independence requirements in specific areas, there has been no systematic examination of the role that independent directors play in Delaware, nor any comparison of that role with the recommendations of independence-minded corporate governance activists.

This article uses Delaware’s approach to independence to question both the means and ends of director independence as currently conceived. By “means,” I refer to the way that independence is defined. The Sarbanes-Oxley Act of 2002 (SOX) and the self-regulatory organizations (SROs) such as the NASDAQ and the New York Stock Exchange (NYSE) define independence by way of status: “independence” means outsider status. The hallmark of the independent director, so conceived, is absence of ties to those in control of the corporation. SOX and the SROs gauge this lack of ties through the use of two metrics: (1) lack of financial ties to the corporation, and (2) lack of familial ties to the managers of the corporation. For example, under the NYSE rules, directors are not independent if they have received more than $100,000 in non-director fees, or are a close relative of executive management. Delaware, by contrast, takes a more contextual approach. Under Delaware law, one cannot determine independent status ex ante,


11 Or, in the terminology of Mitchell Berman, one might say that the article attempts to distinguish what he calls an “operative proposition” from a “decision rule.” See generally Mitchell N. Berman, Constitutional Decision Rules, 90 VA. L. REV. 1 (2004). Berman refers to “constitutional operative propositions” as “constitutional doctrines that reflect courts’ understanding of the proper meaning of a constitutional power, right, duty, or other sort of provision.” Id. at 9. “Constitutional decision rules” direct courts in how to implement constitutional operative propositions. Id. In this case, then, the article would argue that there are two dueling operative propositions regarding the proper function of the independent director, and two different decisional frameworks for courts (and corporate counsel) to use in determining whether a given director is independent.

before a conflict arises. Once a conflict triggers the need for an inquiry, Delaware looks to the specifics of the situation in order to determine independence. As a result, a person not related to an executive and who has never taken compensation from the corporation nonetheless may be deemed to lack independence for reasons of past obligation, or even friendship with key managerial personnel.

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

But it would be a mistake to extrapolate from Delaware’s concept of independence merely that the SRO’s definitions of independence must be tweaked. Delaware’s model provides the basis for a more trenchant critique of a conventional conception of independent directors. The SROs prescribe an independent board as the safeguard of shareholder interest, but this emphasis misconceives the ends of independence. Corporate governance advocates implicitly expect the director who lacks ties to the management of the corporation to be a positive good to the corporation. Delaware reminds us of what “ends” board independence is supposed to achieve: a mechanism for handling conflicting interest. Public corporations inevitably face conflict situations, in which the interests of management do not align with those of shareholders. It makes sense, for example, to place independents on audit

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14 Beam v. Stewart, 833 A.2d 961, 979 (“[S]ome professional or personal friendships, which may border on or even exceed familial loyalty and closeness, may raise a reasonable doubt whether a director can appropriately consider demand. This is particularly true when the allegations raise serious questions of either civil or criminal liability of such a close friend.”).

15 I will use the generic terms “corporate governance reformers,” “corporate governance activists,” and “corporate governance advocates” to denote scholars and institutional groups who focus on general corporate governance reform, almost always in the public corporation context. Thanks to the Conglomerate blog and commenters (http://www.theconglomerate.org/2006/10/terminology.html) for help with this terminology.
committees (in case management is cooking the books), compensation committees (so management does not set its own salary), and nominating committees (so management does not select the board that is tasked with overseeing it). It does not follow, however, that it makes sense to require independence from all or most board members, as the SEC has historically recommended. At the least, because empirical data has shown that majority independent boards do not improve firm performance, a close look at the value of the SEC approach is in order.

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

Fetishizing the independence proxy is not just misguided; it is also dangerous. A recent Wall Street Journal editorial proudly trumpeted the fact that 85% of the member companies of the Business Roundtable have boards with no less than 80% independent directors. The editorial used this statistic to argue against reforms that would enlarge the voting rights of shareholders. After all, the writer reasoned, shareholder interests were already well-protected by the best safeguard corporate governance offers to shareholders, majority independent boards. But recent corporate history teaches us that independent boards are cold comfort, indeed. Hewlett Packard hardly stands alone in illustrating that independent boards do not ensure proper corporate governance. Many corporations with supermajority independent boards have been tainted by scandal: Enron, WorldCom, Apple, Comverse, UnitedHealth, to name only a few.

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17 For example, a recent story shows that independent directors backdated their options as well as their insider counterparts. Steve Stecklow, Study Cites Role Outside Directors Had With Options, WALL ST. J., Dec. 18, 2006, at B3 (“The study is notable because it suggests that outside, or independent, directors -- who are supposed to play a special role safeguarding against cozy board relationships with management -- may have been co-opted in options backdating by receiving manipulated grants themselves.”).
Part I of this article describes the conventional conception of independence, that is, the idea that independence is a determinable status. It then describes how and to what extent a majority independent board has become “best practices” corporate governance. Part II explains why the question of the utility of independence warrants reexamination. First, it explains that qualified independent directors are scarce, and that the value of such board members has come under question, particularly in light of recent empirical scholarship. Part III describes independence under Delaware law, creating a kind of “taxonomy” of independence. Part IV then builds on the insights gained in Part III by offering conclusions for both how independence should be defined and the purposes for which it should be used—the means and ends of independence. Finally, Part V examines some potential objections to extrapolating from Delaware’s independence jurisprudence to the public companies with which corporate governance advocates are most concerned. Part VII concludes that, although there are some friction points, comparison between the two systems is fair and useful. The article concludes first that corporate governance needs to revisit the definition of independence, rendering it more context-specific. For example, to address the compensation committee problem, directors serving on that committee should be evaluated for financial independence from corporate executives, as well as from the corporation. Second, and more fundamentally, the article argues that corporate governance move from simple supermajority independent boards back to focusing on where outside independence truly matters: takeovers, related party transactions, compensation, and derivative suits.

I. The Hegemony of Independence

A. The Conventional Definition: Independence as Status

Corporate governance reformers generally presume (1) outside independent boards are better than non-independent boards, and (2) the more independent a board is, the better. These positions presume that independence is a status, something one can define ex ante and identify on a board without reference to the context of the transaction. Independence means independence from the corporation, period. Melvin Eisenberg is
probably most identified with this movement, which finds its current expression in SOX and the SRO rules.

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

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

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19 Ira M. Millstein, Holly J. Gregory and David Murgio, Practicing Law Institute, Corporate Law and Practice Course Handbook Series, PLI Order Number 3254, Ten Things That Every Director Should Know for 2004, 294-95 (2004). (“By definition, independent directors are outsiders who lack significant relationships to the company”); Olivier Diaz, Darrois Villey and Maillot Brochier, Practicing Law Institute, Counseling the European Board and Audit Committee, 271, 289, (“For the sake of simplicity, an independent director can be defined as follows: “A director is independent of the corporation's management when he or she has no relationship of any kind whatsoever with the corporation or its group which might risk coloring his or her judgment.”).

20 Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 301. SOX also disqualifies another class of individuals from being independent directors: affiliated persons of the corporation or any of its subsidiaries, i.e., large shareholders. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 301. Because only SOX classifies large stockholders as non-independent, and because it does so solely for the purposes of audit committee membership, this Article will not focus on the affiliate aspect of the SOX definition.

21 Compensation from the corporation to certain members of the director’s family or received by certain types of entities where the directors serves a specified role (for example, a director who is a partner at a law firm that receives legal fees from the corporation), counts as indirect compensation that would render a director non-
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The New York Stock Exchange (NYSE) and the NASDAQ elaborate on SOX, following the same underlying philosophy. As the NYSE Listed Company Manual states: “the concern is independence from management.” The NYSE adopts both a standards- and rules-based approach. The standard directs the board to determine affirmatively that the director has no "material relationship" with the company, either directly or as a partner, shareholder or officer of an organization that has a relationship with the company. Elaborate rules detail automatic exclusions from independence.

Unlike the rules of SROs such as the New York Stock Exchange (NYSE) and NASDAQ, however, there is no “look-back” period; once a director ceases to work for the corporation, for example, he may, depending on his stock holdings, immediately qualify as independent for SOX purposes.

22 NYSE Listed Company Manual, § 303A (2)(a) (commentary).

23 NYSE Listed Company Manual, § 303A (2)(a); Corporate Governance Proposals Reflecting Recommendations from the NYSE Corporate Accountability and Listing Standards Committee and Approved by the NYSE Board of Directors August 1, 2002. The NYSE has proposed a change that would require companies to “disclose affirmative reasons for its findings that its independent directors are, in fact, "independent."” This change was proposed to address the concern that some listing companies were using only the specific tests for independence and neglecting their obligation to make their own assessment of a director’s independence. Stock Exchanges: NYSE Seeks Rule Change on Director Independence, BNA’s Corporate Governance Report, International Developments, 9 BNA CGR 01 d11 (Jan. 2, 2006).

24 Material relationships include “commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships, among others.” NYSE Listed Company Manual, § 303A (2)(a) (commentary).

25 If the director: (1) is an employee of the company, or has an immediate family member who is an executive officer of the company; (2) receives, or has an immediate family member who receives, more than $100,000 per year in direct compensation from the company (other than director and committee fees or certain forms of deferred compensation for prior service that is not contingent on continued service); (3) is affiliated with or employed by, or has an immediate family member who is affiliated with or employed in a professional capacity by, the company’s present or former internal or external auditor; (4) is employed, or has an immediate family member who is employed, as an executive officer of another company whose compensation committee includes an executive officer of the listed company; or (5) is employed by, or has an immediate family member who is an executive officer of, a company that makes payments to, or receives payments from, the listed company in an amount which, in any single fiscal year, exceeds the greater of $1 million or 2% of such other company’s consolidated gross revenues. In addition, unlike SOX, the NYSE contains a “look-back”
The NASDAQ rules, while similar in spirit, differ in the details. Both the NYSE and NASDAQ go two steps beyond SOX by (1) requiring that a majority of the board be independent and (2) considering not only current, but also prior, relationships in assessing the independence of directors.

The cumulative effect of these requirements shows the thought and attention paid to ensuring that independent directors have absolutely no ties to the corporation. Legislators, SEC staff, and NYSE and NASDAQ rulemakers have constructed a labyrinth of rules to prohibit all conceivable categories of ties: not only must the independent directors receive no money from the corporation, but neither can members of their family nor the firm where they are partners or directors. Even if that firm is a non-profit.

 provision, so that in each case, once the affiliation that tainted the director has ended (i.e., the director ceases to be an executive officer or her husband ceases to be an auditor of the corporation), 3 years must elapse before that director’s ties with the corporation have “cooled off” sufficiently to qualify her as independent. NYSE Listed Company Manual, § 303A (2)(b)(i)-(v).

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

NYSE Listed Company Manual, § 303A(1); NASDAQ Manual, Rule 4350(c)(1).


SOX § 301.
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Behind all of these rules lurks the belief that, by closing off all conceivable connections to management, rulemakers can create the ideal board.\textsuperscript{33} As discussed in Part I.B., this presumption has led to the modern ascendancy of the supermajority independent board, one free from ties to the corporation. I will argue that this move fetishizes independence, by viewing outsider status as a proxy for excellence as a corporate agent. I will also argue that this approach is both wrong and counterproductive.


\textsuperscript{31} Rule 10A-3(e)(8), 17 C.F.R. § 240.10A-3(e)(8).

\textsuperscript{32} NASDAQ Manual, Rule 4200(a)(15)(D).

\textsuperscript{33} Status-defined “independent” directors also play a role in asset securitization. When an entity seeks to securitize certain assets to raise financing, it can create a “special purpose vehicle” (“SPV”) that receives the assets. Steven L. Schwarcz, \textit{The Alchemy of Asset Securitization}, 1 STAN. J.L. BUS. & FIN. 133, 135 (1994). In order to protect SPV investors from the danger that the originating company will become insolvent and voluntarily petition for bankruptcy, SPVs commonly have independent directors and require the vote of these directors in order to file a voluntary petition, thus rendering the SPV “bankruptcy remote.” Steven L. Schwarcz, \textit{Structured Finance: A Guide to the Principles of Asset Securitization}, 3d ed., § 3:2.1 (2006). Definitions of the “independent” directors tend to be status-based. Standard and Poor’s, for example, describes a “generally acceptable definition of “independent director” to be: “A duly appointed member of the board of directors of the relevant entity who shall not have been, at the time of such appointment or at any time while serving as a director or manager of the relevant entity and may not have been at any time in the preceding five years, any of the following: A direct or indirect legal or beneficial owner in such entity or any of its affiliates; A creditor, supplier, employee, officer, director, family member, manager, or contractor of such entity or any of its affiliates; or A person who controls (whether directly, indirectly, or otherwise) such entity or any of its affiliates, or any creditor, supplier, employee, officer, director, manager, or contractor of such entity or its affiliates.” Standard & Poor’s, U.S. CMBS Legal and Structured Finance Criteria, May 1, 2003, available at: http://beta.standardandpoors.com/spf/pdf/fixedincome/040103_cmbslegalcriteria14.pdf. Other common status-based definitions of independent SPV directors include “a person who is not a director (other than being a director of the SPV), officer, employee, or holder of 5% or more of the voting securities of the originator or of any of the originator’s affiliates.” Steven L. Schwarcz, \textit{Structured Finance: A Guide to the Principles of Asset Securitization}, 3d ed., § 3:2.1 (2006). But see In re Kingston Square Assoc., 214 B.R. 713 (Bankr. 1997), for one bankruptcy court’s critical examination of a supposedly “independent” director’s behavior, and refusal to respect independent status alone.
B. The State of the Independence Debate

The current emphasis on independent boards has been building for many years. Early drafts of the American Law Institute’s (ALI) Principles of Corporate Governance stressed the importance of independent directors, requiring that they comprise a majority of the board of directors of large publicly held corporations.\(^{34}\) In the 1980s Delaware courts issued opinions that privileged the decisions of an independent board, adding fuel to the independence fire.\(^{35}\)

These reforms arose from the perception that corporate boardrooms were clubby and insider-dominated.\(^{36}\) Instead of offering any real check on managers, boards were self-perpetuating institutions made up mostly of insiders handpicked by the CEO.\(^{37}\) The danger of such a set-up is self-evident: management plays the starring role in a morality play featuring unmonitored, and therefore faithless, agents.\(^{38}\)

The arguments of independence proponents have largely triumphed.\(^{39}\) Even before Enron’s precipitous demise, most boards of directors of public

\(^{34}\) Stephen M. Bainbridge, *Independent Directors and the ALI Corporate Governance Project*, 61 GEO. WASH. L. REV. 1034, 1037 (1993). Early iterations of the Principles required a majority independent board and completely independent nominating and compensation committees. *Id.* at 1037. In response to criticism, the mandatory independence requirement became a recommendation, but also suggested increased deference by the courts to independent directors’ decisions. *Id.* at 1043.

\(^{35}\) See infra __________. See also Lawrence E. Mitchell, *Structural Holes, CEOs, and Informational Monopolies: The Missing Link in Corporate Governance*, 70 BROOK. L. REV. 1313, 1345 (2005).


\(^{38}\) As Bainbridge asks and answers the rhetorical question: “Why . . . do independent directors have any corporate governance role? Because management is not perfectly faithful.” Bainbridge, *supra* n.XX, at 1057.

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companies had a majority, or supermajority, of independent directors. Indeed, as of 2001, approximately 75% of NYSE-listed companies had independent board majorities and 65% of directors of S&P 1500 companies were independent. By the time of the enactment of the Sarbanes-Oxley Act in 2002, most public corporations had a supermajority independent board, with only one or two inside directors.

The agency cost argument seems almost too natural to require proof from commentators: “An active and independent board of directors working for shareholders clearly would seem to benefit the corporation by reducing the losses from misdirected ‘agency’ inherent in the separation of ownership from control that is fundamental to the modern corporation.” Scholars trumpet the need for an “independent watchdog.” The governance industry and Rock’s narrative, the movement towards independent directors occurred at least in part because of board initiative: “Boards became increasingly independent with the acquiescence of incumbent board members; confrontational election contests designed to increase the number of independent directors are practically unheard of. In the latter case, shareholders were cheering while their board was acting.” It is worth asking why boards were so willing to bring in a watchdog of their own volition. They suggest that it is because independent directors are the lesser of 2 evils; by adopting more independent boards, directors are spared the “less forgiving” discipline of the takeover market.

40 Palmiter, supra n. XX, at 1357. (“The public corporation landscape, since the 1960s, has come to be characterized by boards composed of a significant number, and often a majority, of outside directors.”).


42 Pub. L. No. 107-204.

43 Bhagat & Black, Non-Correlation, supra n.XX, at 232 (“By 1997, the mean number of inside directors at S&P 500 firms (which should be comparable to our sample) had dropped from three to two, and 56% of the S&P 500 firms had only one or two inside directors.”).


45 “Independent directors have proven their value to corporation’s shareholders by serving as watchdogs over their investment.” Matheson and Favorite, supra n.XX, at 577.
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(Institutional Shareholder Services, Standard & Poors, etc.) grades corporations on the independence of their boards via scorecards and ratings systems.\(^{46}\) To oppose the institution of the independent director almost amounts to heresy.\(^{47}\)

Today, scholars speak of the “norm” of a supermajority independent board,\(^{48}\) while corporate governance activists clamor for boards on which independent directors make up a “substantial majority.”\(^{49}\) Chancellors Chandler and Strine of the Delaware Chancery Court have gone so far as to predict that SOX and related reforms will lead to a world in which the CEO is the board’s *only* non-independent director.\(^{50}\)

Especially against this backdrop, it is clear that recent SOX and related stock-exchange reforms represent only the cresting of a wave of independence that had been growing for some time. At the same time, they legitimized the independence movement. As outlined in Part I.A., SOX itself mandated only the creation of a wholly independent audit committee\(^{51}\) (although the law had the effect of significantly increasing both the size of


\(^{47}\) Kahan and Rock, supra n.XX, at 892 (remarking on the claim to legitimacy of increasing independent directors and observing: “it is hard to oppose more independent directors.”).


\(^{51}\) Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 Yale L.J. 1521, 1588 (2005), citing a study by James Linck et al.
boards and the proportion of independent directors).\textsuperscript{52} The NYSE and NASDAQ went beyond SOX: each exchange required that listing companies have (1) wholly independent nominating/corporate governance and compensation committees and (2) a majority independent board.\textsuperscript{53} In short, while independence was the norm for large public companies even before the new rules went into effect, SOX and the exchange reforms reflect a renewed emphasis on the importance of using independent directors, at the expense of managerial control of the corporation.\textsuperscript{54}

II. Why Revisit Independence?

If the consensus is that more outside independent directors are better, why focus on independence at all? First, anecdotal evidence suggests that the heavy demands placed on independent directors and the concomitant threat of increased liability discourage people from agreeing to serve, thus creating a scarcity of well-qualified independent candidates; it makes sense to consider how many independent directors we actually need and what their appropriate role should be. Second, and more fundamentally, there is reason to question whether—even assuming there is an ample supply of independent directors—they provide the sort of unadulterated benefit that conventional wisdom suggests.\textsuperscript{55}

\textsuperscript{52} More precisely, the Exchange Act provides that if the board has no audit committee, the whole board is to be treated as audit committee. Release Nos. 33-8220; 34-47654; Standards Relating to Listed Company Audit Committees.


\textsuperscript{55} One flashpoint of controversy has been the SEC’s rule that required the increase in the required number of independent directors on mutual fund boards from a majority to 75%. Mutual funds are outside the scope of this paper, but it is worth questioning what role independents have on a mutual fund board, and whether that role differs from that of a corporate board.
A. Lack of Candidates

The renewed focus on and increased expectations of independent directors may be discouraging them from service. Additionally, the demands on the time of an independent director have increased significantly, with commitments now averaging around 180 hours per year. Because directors often have demanding full-time jobs, these increases in hours make serving as an independent director less appealing. Well-publicized out-of-pocket settlements by Enron and WorldCom independent directors have reinforced fears of personal liability, not to mention the reputational costs of being at the helm of a scandal-plagued company.

This perceived increase in liability exposure means higher costs, including higher director fees. Director and officer (D&O) insurance premiums have risen as risk has increased. Candidates for outside independent director positions may require increased insurance coverage or more robust

56 Symposium on Corporate Elections, supra n.XX, at 14, 26-27 (quoting both Michael Price, managing partner at MFP Investments, and attorney Martin Lipton as saying that companies were already having a much more difficult time finding and recruiting independent directors under the shadow of the then-proposed corporate governance listing standard reforms). Bainbridge, A Critique of the NYSE’s Director Independence Listing Standards, n. 27, available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=317121, (“Public corporations are finding it increasingly difficult to recruit and retain qualified independent directors.”); See, e.g., Michael T. Burr, Securing the Boardroom, CORP. LEGAL TIMES, June 5, 2005, at 53; Anne Fisher, Board Seats Are Going Begging, FORTUNE, May 16, 2005, at 204; Suzanne McGee, The Great American Corporate Director Hunt, INSTITUTIONAL INVESTOR, Apr. 1, 2005, at 32.

57 Sung Hui Kim, The Banality of Fraud: Re-Situating the Inside Counsel as Gatekeeper, 74 FORDHAM L. REV. 983, n. 475 (citing Melvin Aron Eisenberg, Corporations and Other Business Organizations 156 for the proposition that outside directors spend about 180 hours per year on board work, including preparation and travel time).


59 Romano, supra n.XX, at 1588.

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indemnification rights, and more intangible costs lurk below the surface, such as excessive caution by independent directors fearful of litigation.61

B. The Value of Outside Independent Directors

Beyond the fact that outside independent directors are an expensive, scarce resource, some observers have raised fundamental questions about their utility. Critics suggest that outsiders lack the time, information, and motivation to manage the corporation effectively.62 Independents are by definition individuals from outside the corporation, who generally have demanding day jobs that keep them from devoting much time to board affairs.63 For this reason, they rely on corporate officers and other employees for information and tend to defer to insiders’ management recommendations.64

As for incentives, two problems can emerge: a disinclination to criticize fellow executives, and a lack of motivation to do so. With respect to inclination, independent directors traditionally were nominated by insiders and, in any event, generally are selected from the business community to ensure that they will have adequate expertise. Because of structural bias, it


63 Id.; Bainbridge, supra n.XX, at 1058.

64 For an excellent treatment of the extent to which outside directors rely on inside directors for information about the corporation, and the potential negative repercussions of this reliance when there are only a few insiders on the board, see generally Mitchell, supra n.XX, at 1345 (“[If the only insider is the CEO, then] as the sole bridge between corporate management and the board the CEO is put in an enormously powerful position. He has a monopoly over the information delivered to the body ultimately responsible for the integrity of corporate management and information.”). See also Ribstein, supra n.XX, at 26 (“The so-called outsiders moreover are often friends of the insiders. And since they spend only part of their time on the affairs of the corporation, their knowledge of those affairs is much less than that of the insiders, to whom they are likely therefore to defer.”); Dynamics Corp. of America v. CTS Corp, 794 F.2d 250 (7th Cir. 1986), rev’d on other grounds, 481 U.S. 69 (1987) (Posner, J.) (“the board is generally dependent on the information management chooses and presents to it.”).
may be difficult for them to criticize either their fellow directors or the officers of the corporation. Therefore, they are often unwilling to second-guess managers. Reforms that made the nominating committee independent were designed to avoid the old sense of beholdenness to insiders for board seats, and the trend toward granting directors stock options or restricted stock was designed to align outside directors with shareholders. The success of these measures is debatable, at best.

C. Empirical Evidence That Independence Does Not Matter

These structural concerns about the value of independence are supported by recent empirical research. Professor Roberta Romano and Professors Sanjai Bhagat and Bernard Black have surveyed a number of studies regarding the relationship between independence and both firm performance and particular managerial tasks. The data indicate that independence does not lead to improved firm performance and may even be associated with suboptimal performance. Likewise, independence fails to correlate with

65 Julian Velasco, Structural Bias and the Need for Substantive Review, 82 WASH. U. L.Q. 821, 824 (2004) (“The term "structural bias" generally refers to the prejudice that members of the board of directors may have in favor of one another and of management. It is said to be the result of the "common cultural bond" and "natural empathy and collegiality" shared by most directors, the "economic [] or psychological [] dependen[cy] upon or tie[s] to the corporation's executives, particularly its chief executive," and the "process of director selection and socialization, which incumbent management dominates.") (citations omitted).

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

67 Bhagat & Black, Uncertain Relationship, supra n. XX, at 923-24, 924-33, 940-44; Romano, supra n.XX, at 1521.

68 Romano, supra n.XX, at 1530. Romano conducts a survey of the literature, and draws these conclusions. Still, some competing data does exist that suggests that independence may be beneficial, after all. Corporate governance activists may argue that the earlier, studies were flawed because they relied on earlier incarnations of board “independence,” that did not truly capture the more modern notion of independence. Ira Millstein and Paul MacAvoy found a positive relationship between independent boards in the newer era of more “active” governance. The Active Board of Directors and Performance of the Large Publicly Traded Corporation, 98 COLUM. L. REV. 1283, 1318 (1998). See also Laura Lin, The
improved performance in specific areas. Studies on the performance of independent audit committees, for example, found no relation between committee independence and performance.69

Furthermore, although supermajority outside independent boards have become the norm, empirical research suggests that their benefits remain unproven. As Bhagat and Black observe: “No study asks whether there are behavior differences between, for instance, a board with six independent directors out of nine (67%), and a board with seven out of nine (78%) or eight out of nine (88%) independent directors. Yet current conventional wisdom calls for supermajority-independent boards, with only one or two inside directors on a typical nine- or eleven-member board.”70 This conventional wisdom survives despite empirical indications that more independence is not necessarily better.71

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

70 Bhagat & Black, Non-Correlation, supra n.XX at 235.

71 “[T]he addition of independent directors to a corporate board is subject to both diminishing marginal increases and absolute declines in relative performance. If this were not true, then the boards of all profit-maximizing firms would be totally independent. Our inquiry into optimal board composition revealed that the optimal percentage of independent directors is well below the majority requirement championed...
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Advocates for independence have a ready answer: existing studies are flawed because they do not measure “true” independence. That is, many of the so-called “independent” directors of the 1980s and 1990s were only nominally independent: they were outside legal counsel or investment bankers, for the company, suppliers, or other so-called “grey” directors. In defense of independence, in the face of the empirical evidence, Professor Donald Langevoort observes: “If we could identify truly independent directors more precisely, perhaps we would find the expected correlation” on which reformers rely.

D. Resisting the Fetishization of Independence

Even as corporate governance reformers champion independence, some admit to misgivings. Professor Langevoort, for example, believes that the word “independence” should connote not just a lack of financial ties to management, but also “a willingness to bring a high degree of rigor and skeptical objectivity to the evaluation of company management and its plans and proposals.” The imprecision inherent in the word “independence” by the reformers.” Barry D. Baysinger & Henry N. Butler, Revolution Versus Evolution in Corporation Law: The ALI’s Project and the Independent Director, 52 GEO. WASH. L. REV. 557, 574-75 (1984).

72 “Yet none of these studies speaks to whether a board implementing the current panoply of structural and procedural reforms would perform better than a prereform "independent" board. .... Read in this light, such studies point toward a narrower conclusion than the one that their authors seem to reach: putting independent directors on a board is unlikely to have much effect on financial performance if not accompanied by the implementation of structures and procedures to counteract the social and psychological constraints that paralyze many facially independent boards.” And Now, the Independent Director! Have Congress, the NYSE, And NASDAQ Finally Figured Out How to Make the Independent Director Actually Work?, 117 HARV. L. REV. 2181, 2200 (2004).

73 Bainbridge, supra n.XX, at 1059.

74 Bhagat & Black, Non-Correlation, supra n.XX, at 239.

75 Langevoort, supra n.XX, at 799 (emphasis added). See also Charles M. Elson, Enron and the Necessity of the Objective Proximate Monitor, 89 CORNELL L. REV. 496, 502 (2004) (“Had [the directors] been both truly independent of management and significant equity holders in the company, the Enron tale might have had a less dramatic and devastating conclusion.”).
means that the empirical studies necessarily must use “rough proxies for independence”: “the simple absence of a job with the company, a lack of a close family connection, or (perhaps) the absence of a regular stream of income from the company apart from directors’ fees and dividends are all that it takes to qualify.” Langevoort observes that “[u]nder these restrictive definitions, many directors who lack any real desire to take their monitoring role seriously—who are on the board for reasons of status-seeking, sociability, or the perquisites that come with board membership—fall into the ‘independent’ category, thereby muddying the data.”76 His conclusion is that independence, defined in terms of non-management status alone, does not guarantee a good monitor.

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

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

76 Langevoort, supra n.XX, at 798-99.
III. “Independence” under Delaware Law

It makes sense to seek guidance in Delaware law for two reasons. First, Delaware is the dominant source for corporate law in the United States.\textsuperscript{77} Delaware’s preeminence in the field makes it a logical place to start in addressing a key question of corporate law.\textsuperscript{78} Second, even if one rejects the

\textsuperscript{77} Jill E. Fisch, Institutional Competition to Regulate Corporations: A Comment on Macey, 55 CASE W. RES. L. REV. 617, 619 (2005). This is not the place to revisit the old race to the top/race to the bottom debates, but if one believes that federalism has a positive effect on corporate law, with states competing to develop the best form of corporate law, then Delaware’s status as the leading source of state corporate law makes it the most value-maximizing, therefore the source of the best rules for defining independence. The classic positions are articulated in William L. Cary, Federalism and Corporate Law: Reflections upon Delaware, 88 YALE L. J. 663 (1974) and Ralph K. Winter, State Law, Shareholder Protection, and the Theory of the Corporation, 6 J. LEGAL STUD. 251 (1977). See generally Roberta Romano, THE GENIUS OF AMERICAN CORPORATE LAW (1993).

\textsuperscript{78} As it turns out, almost all states follow Delaware’s approach. Some states do discuss independence in their codes, but they do not define independence as status. Instead, they adopt a contextual definition. For example, a corporation’s independent directors may move to dismiss a derivative suit. “Independent” for this purpose, is defined contextually, as a director who does not have an interest in the proceeding. See the most version of the MBCA, which defines “qualified” directors as those who do not have “(i) a material interest in the outcome of the proceeding, or (ii) a material relationship with a person who has such an interest.” § 1.43(a)(1); see also prior commentary to § 7.44 stating that “The concept of an independent directors is not intended to be limited to nonofficer or “outside” directors but may in appropriate circumstances include directors who are also officers.” States that follow the MBCA’s use of independence in derivative suits are: Florida (F.S.A 607.07401), Georgia (O.C.G.A. 14-2-744), Hawaii (H.R.S. 414-175), Idaho (I.C. 30-1-744), Iowa (I.C.A. 504.635), Maine (13-C M.R.S.A. 755), Massachusetts (M.G.L.A. 156D § 7.44), South Dakota (SDCL 47-1A-744); Utah (U.C.A. 1953 16-10a-740).

Tracking Delaware, additionally in Arizona, Hawaii, Iowa, Minnesota, Nebraska, New Hampshire, North Carolina, Rhode Island mere nomination or election of the director by defendants, and the naming the director as defendants is not enough to render a director non-independent. H.R.S. 414-175; I.C.A 504.635; MCA 31-1-545; Neb. Rev. St. 21-2074; N.H. Rev. Stat. 293-A:7:44; N.C.G.S.A. 55-7-44; RI General Laws 1956, 7-1.2-711; Wisconsin (W.S.A. 181.0744).

Finally, Iowa, Minnesota, North Dakota, and Wisconsin provide that the board may establish a special litigation committee consisting of one or more independent directors, and that all committees except the SLCs are “subject at all times to the direction and
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idea of Delaware as necessarily the “best” corporate law, when searching for an alternative to the national corporate governance model, it makes sense to look to the states. The focused attention that Delaware gives to its corporate code and case law, coupled with the high volume of corporate law cases that the Delaware courts considers, means that Delaware’s law can be taken as a fair representative of state law, at least if a state were to prioritize corporate law.

In contrast to the standard corporate-governance definition of independence, which equates independence with outsider status, Delaware courts conduct a more nuanced inquiry into independence in two ways. First, Delaware courts examine a director’s behavior as an indicator of independence, creating a contextual approach—rather than looking only to rigid proxies like lack of a familiar or financial relationship—in gauging the lack of improper influence or conflicts of interest. Second, Delaware examines each conflict, looking at a mix of factors rather than a preprogrammed set. SOX, the NASDAQ, and the NYSE all make the control of the board.” I.C.A. 501A.711; M.S.A. 302A.241; NDCC 10-19.1-48; W.S.A. 193.451. M.C.L.A. 450.1495.

For the two states that deviate from Delaware and take an outsider-status approach to defining independence, see infra n. XX.

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


Of course, corporate governance advocates, with their prospective perspective (i.e., they are providing guidelines for companies searching for suitable future directors), do not have the luxury of pointing to specific behavior in particular cases. This distinction will be dealt with infra in Part V.A.

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blanket assumption that outsider status—that is, lack of financial or familial ties to the company—is the best indicator for independence. Delaware courts, in contrast, first focus on the reason for the independence inquiry. This focus makes their analysis less “status” driven, in the sense that it is not based on the status of independence from the corporation. Instead, Delaware courts can examine the independence of a director from a majority stockholder, from a potential acquirer, or from the current CEO. Conflicts associated with these individuals are not entirely captured by SOX’s prohibitions on ties to the corporation.

A. Distinguishing Between Independence and Interest

Given the current emphasis on the importance of independent directors, it may be surprising to note that the Delaware General Corporation Law (DGCL) does not contain a single reference to independent directors. Instead, the DGCL speaks only of the narrower concept of “interested directors.” Directorial independence is an important part of Delaware law, but it is all judge-made. As two prominent Delaware jurists have explained, awareness of the difference between interest and independence is “vital.” A director is interested in a given transaction if she stands to gain monetarily from it in a way that other shareholders do not. If a director is interested

83 Interestingly, the Delaware Lawyers’ Rules of Professional Conduct do contain a reference to independent directors, not in the Rules themselves, but in the comments. When discussing Rule 1.13, “Organization as Client,” the commentary states that “The organization’s highest authority to whom a matter may be referred ordinarily will be the board of directors or similar governing body. However, applicable law may prescribe that under certain conditions the highest authority reposes elsewhere, for example, in the independent directors of a corporation.” Delaware law or, at least, Delaware’s statutory law, never prescribes that the highest authority of a corporation reposes with the independent directors.

84 Chandler and Strine, supra n.XX, at, 997-98.

85 Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (“directors can neither appear on both sides of a transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally”); Robert Clark, CORPORATE LAW, § 4.1 (“conflict of interest” means a transaction between the corporation and another person where the allegedly interested individual has decision making power with the corporation and “has a greater personal interest in the welfare of the other person involved in the transaction, or in certain collateral consequences of the transaction, that in the welfare of the …corporation.”).
and the transaction is challenged, it will be subject to the rigorous “entire fairness” test.86

In contrast, the concept of “independence,” as developed by the Delaware courts, is broader than that of simple financial interest; it examines whether a director, although lacking in a financial self-interest, is somehow “beholden” to an individual who is interested, or whose decisions are not based on the corporate merits, but rather are influenced by “personal or extraneous considerations.”87 The focus is therefore not always on strict financial ties; that is the ambit of “interest.” Instead, for “independence” Delaware courts broaden the inquiry into more amorphous ties that can generate a sense of “beholdenness.” Common membership in a university,88 charitable giving,89 and friendships90 can all factor into the equation.

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

In contrast to the conventional account of “independence” in the corporate governance literature, the concepts of “interest” and “independence” in Delaware law are both transaction-specific and have what I been call a “situational” or “contextual” character. Any application of the definitions will necessarily involve looking at the challenged transaction for guidance. In Delaware, unlike under SOX, the NYSE, or NASDAQ, one cannot determine independence or interest ex ante. One must instead ask:

88 In re Oracle Corp Deriv. Litig., 824 A.2d 917, 942 (Del. Ch. 2003).
90 Beam v. Stewart, 833 A.2d 961, 979 (“[S]ome professional or personal friendships, which may border on or even exceed familial loyalty and closeness, may raise a reasonable doubt whether a director can appropriately consider demand. This is particularly true when the allegations raise serious questions of either civil or criminal liability of such a close friend.”).
“Independent for what purpose? Independence from whom?”

Defining independence in isolation is impossible because the challenged transaction holds the key. Therefore as we go through paradigmatic situations where Delaware courts have analyzed interest and independence, we can arrive at a better understanding of what the terms actually mean.

B. Conflicting Interest Transactions and Self-Dealing

1. Delaware’s Exploration of the Nuances of “Interest”

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

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93 Cinerama, 663 A.2d at 1169.

94 Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (1971). A large number of cases deal with a subset of these transactions, where a merger is contemplated between the director, officer, or controlling shareholder, and the corporation (and thus potentially will receive a benefit—a lucrative job at the new company, for example—not shared by shareholders generally). These cases will be dealt with separately in Part II.D.1.
On the other hand, Delaware courts have gradually acknowledged that conflicting interest transactions can arise even when a party does not stand on both sides of the transaction and there is therefore no “self-dealing,” as traditionally understood. For example, if a corporation is considering the purchase of a building, and the CEO’s wife is the realtor, who will make a $1,000,000 commission if the sale goes through, then the CEO may have a financial interest in the transaction, even though he has no direct financial interest in party on the other side, the seller of the building. So, despite the lack of self-dealing, the CEO may be interested.95

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

Conflicting interest transactions are vulnerable to attack in two different ways under Delaware law: first, such transactions may be void or voidable, and second, conflicting transactions do not receive the protection of the business judgment rule, and thus are subject to the more rigorous “entire fairness” review.96 Section 144 deals with the issue of whether an interested

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95 What if the wife’s commission was $1,000? In Cede v. Technicolor, Inc., 624 A.2d 345 (1994), and Cinerama v. Technicolor, Inc., 663 A.2d 1156 (1995), the Delaware Supreme Court dealt somewhat painfully with this question. It concluded that, in the absence of self-dealing, the personal financial benefit that the director receives must be substantial in order to render that director interested. Cede, 634 A.2d at 363. The court applies a “subjective ‘actual person’ standard” in its analysis, that is, it decides whether the financial interest was material enough to affect the judgment of the particular director at issue. Cinerama, 663 A.2d at 1167.

96 The business judgment rule is a principle of judicial deference to the decisions of the board of directors. Plaintiffs can attack the business judgment rule by alleging a conflict of interest or lack of independence in the board of directors. Robert B. Thompson & D. Gordon Smith, Toward a New Theory of the Shareholder Role: "Sacred Space" in Corporate Takeovers, 80 TEX. L. REV. 261, 279 (2001). Compliance with the requirements of § 144 is not enough to restore to defendants the protection of the business judgment rule, although it shifts the burden to the plaintiffs to prove that the transaction was unfair. For an excellent discussion of DGCL § 144, see In re Cox Communication Shareholders Litigation, 879 A.2d 604, 614-15 (2005). See also Cinerama, 663 A.2d at 1169. In theory, litigation over the applicability of the business judgment rule would be a fruitful context in which to learn more about what independence and interest mean to Delaware courts. In fact, because of the demand requirement, in-depth discussions of interest arise most frequently in derivative suits. Students of corporate law will remember that Aronson’s second prong asks whether the challenged transaction is protected by the business judgment rule, thus re-injecting the business judgment rule analysis in the derivative suit.
transaction is void. Early corporate law held that any transaction between a corporation and its director or officers was voidable at the prompting of the corporation or its shareholders, whether or not it was fair.\textsuperscript{97} Again, modern Delaware law has a more flexible approach, articulating exceptions to the old blanket rule that conflicting transactions are automatically void, perhaps because of a recognition that self-dealing is not necessarily harmful to the corporation.\textsuperscript{98} To take an example from Robert Clark, a board of a large public company might look askance at a proposal from a director who wishes to make a loan of $1 million to the corporation at market interest rate. After all, the corporation can get such a loan from myriad other sources. But if the corporation is the “small, young, closely held Jones Mattress Company of Podunk, Alaska,” then the self-dealing loan, while still by its nature self-dealing, might represent an advantage that the corporation cannot obtain elsewhere.\textsuperscript{99}

Lengthy articles have been written on the modern rule of conflicting interest transactions,\textsuperscript{100} but for our purposes the salient points are simple enough: a contract is not void or voidable simply because it involves a conflicting interest if (1) a majority of the disinterested directors approve the transaction\textsuperscript{101} (2) in good faith (3) with all the material facts of the transaction having been disclosed.\textsuperscript{102} If a corporation offers ratification under § 144 as a defense, courts look to the nature of the transaction, and then determine context. Delaware courts seem to focus more on Aronson’s first prong when discussing interest and independence, so for simplicity’s sake, I will do the same.

\textsuperscript{97} Robert Clark, \textit{CORPORATE LAW}, § 5.1. An exception is the context of a merger, where dissenting shareholders have a direct, rather than derivative, cause of action. Mergers are discussed in Part III.D.

\textsuperscript{98} Grover C. Brown, Michael J. Maimone, Joseph C. Schoell, \textit{supra} n. xx, at 1163 (citing comment to § 8.60 of Model Bus. Corp. Act).

\textsuperscript{99} Robert Clark, \textit{CORPORATE LAW}, § 5.1.


\textsuperscript{101} A vote of the shareholders can also sanitize the transaction, but that is outside the scope of this paper.

\textsuperscript{102} 8 DGCL § 144.
whether the ratifying directors had an interest in the transaction, in order to
determine whether the transaction is void for reasons of interest.

3. Interest Summarized

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

C. Derivative Suits

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

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

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103 Aronson, 473 A.2d at 811.

104 DGCL § 141.

105 Aronson, 473 A.2d at 811-12.
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Plaintiffs may avoid the near-fatal\textsuperscript{106} demand requirement if they successfully allege that demand would be futile—that is, that the board in place at the time the complaint was filed (when demand would have been made) was either interested or not independent.\textsuperscript{107} Thus, most plaintiffs wind up alleging demand futility, triggering an examination of board interest and/or independence.\textsuperscript{108} We need first to focus on interest, but there are ramifications for independence, as well.

2. Interest

The general rules against self-dealing and conflicting interest transactions still apply in derivative suits. If a director stands on both sides of the underlying transaction or will “derive any personal financial benefit from it in the sense of self-dealing,” rather than a benefit shared proportionately with all other shareholders, then she is counted as an interested director.\textsuperscript{109}

Beyond this classic understanding, because of derivative suits’ peculiar procedural posture, they have the unique potential to taint almost all directors. For example, say in 2001 Director X approves a CEO severance package that amounts to $140 million. In 2002, while Director X is still on the board, shareholders file suit, alleging that the directors breached their fiduciary duties of care and loyalty in approving such a grossly excessive payout—i.e., they allege that Director X was grossly negligent and/or dominated and controlled by the CEO when she approved the payout.

\textsuperscript{106} If a demand is made, then directors are free to decline to pursue the litigation, even if it is meritorious, if they judge that it is in the best interests of the corporation. Telxon Corp. v. Bogomolny, 792 A.2d 964, 973 n.11 (Del. Ch. 2001). Reasons abound why lawsuits may not be in the best interests of the corporation: most obviously, the distractions to the executives caused by the suit, coupled with the associated negative publicity, could outweigh the benefits of any potential recovery. The decision not to sue is an ordinary board decision and therefore is protected by the business judgment rule. Aronson v. Lewis, 473 A.2d 805, 812; Grimes v. Donald, 673 A.2d 1207, 1220 (Del. 1996). It can only be attacked by showing that the board’s refusal to sue on the underlying claims was “wrongful.” Grimes v. Donald, 673 A.2d 1207, 1220 (Del. 1996).

\textsuperscript{107} Beam v. Stewart, 833 A.2d 961, 977 (Del. 2003).


\textsuperscript{109} Aronson, 473 A.2d 805, 812.
Under the demand requirement, the plaintiffs are obliged to ask Director X in 2002, when the suit is filed, to decide whether the corporation should pursue these claims against Director X for her own actions taken in 2001. This pattern is repeated time and again in derivative suits which, in effect, require demands on directors to name themselves as defendants in high-stakes litigation.

For this reason, in a real sense, the directors in a derivative suit are on both sides of the “transaction”—that is, on both sides of the potential lawsuit. Nevertheless, Delaware courts have firmly held that being asked to sue themselves is not enough by itself to cast doubt on directors’ disinterestedness. It might appear counterintuitive, but after a few moments’ thought, the reasons for this conclusion become clear. The demand requirement would be meaningless if plaintiffs could evade it merely by alleging that directors are interested simply by virtue of being directors. Delaware courts have refused to permit plaintiffs to “abrogate” the demand requirement entirely by allowing plaintiffs to “bootstrap” their way out of any demand requirement merely by asserting that the suit would require directors to “sue themselves.”

Another seemingly contradictory result flows from the derivative suit’s nature. Merely alleging that directors have an interest in retaining their board seats (the loss of which would be threatened if the derivative suit were successful) cannot, without more, show demand futility. At first blush, this might seem unjustifiable. After all, average annual director compensation is now $136,000, and few will willingly give up such a lucrative position and the perquisites that accompany it. Nevertheless, in Beam v. Stewart, the Delaware Supreme Court rejected a bright-line rules that conclusively

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110 Aronson, 473 A.2d 805, 815 (“However, the mere threat of personal liability for approving a questioned transaction, standing alone, is insufficient to challenge either the independence or disinterestedness of directors”).

111 Aronson, 473 A.2d 805, 818.

112 A desire to retain the benefits of board membership seems to me to go to the issue of interest, particularly when considering whether demand is excused. However, the Disney court treated this as a question of independence.

excused the demand requirement on these grounds, and instead required plaintiffs to show that any compensation would be enough to “entice” the outside director to ignore her fiduciary duty.\textsuperscript{114} Delaware courts have pointedly refused to find such enticement in many cases, including (for example) when the director is a person of modest means.\textsuperscript{115}

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

3. Independence

Delaware courts focus a great deal of attention on independence in derivative suits for two reasons. First, as we have seen, the demand futility inquiry turns on the independence and disinterestedness of the board upon which demand must be made unless it is excused. Because the courts’ interpretation of interest forecloses analysis of the most obvious examples of interest—threat of liability and loss of directorial office—dependence

\textsuperscript{114} Beam, 833 A.2d at 978.

\textsuperscript{115} So Reveta Bowers, the principal of the elementary school that Disney CEO Michael Eisner’s children once attended, was not judged to be nonindependent simply because of receipt of director’s fees. In re Walt Disney Co. Deriv. Litig., 731 A.2d 342, 359 (Del. Ch. 1998). The court observed that to hold otherwise would be “to discourage the membership on corporate boards of people of less-than extraordinary means. Such "regular folks" would face allegations of being dominated by other board members, merely because of the relatively substantial compensation provided by the board membership compared to their outside salaries.” In re Walt Disney Co. Deriv. Litig., 731 A.2d 342, 360 (Del. Ch. 1998). For more on the court’s treatment of Reveta Bowers, see Larry Catá Backer, Director Independence and the Duty of Loyalty: Race, Gender, Class, and the Disney-Ovitz Litigation, 79 St. John’s L. Rev. 1011 (2005).
becomes crucial. Second, an interested or non-independent board can create a committee of independent directors who are empowered to act on the board’s behalf to move to dismiss the suit. The fight then turns on whether the putatively “independent” committee really is independent.

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

Under these authorities, a tainting beholdenness must involve more than mere debt to the alleged controller for directorial office. Inquiry focuses more

116 In Zapata Corp. v. Maldonado, 430 A.2d 779 (1981), the Delaware Supreme Court held that even a compromised board (comprised of less than a majority of independent or disinterested directors) may form an independent special litigation committee (SLC) to evaluate the derivative suit. Id. at 785. The board must delegate its full powers to act to the special committee pursuant to DGCL § 141(c). Id. If this committee recommends that the suit be dismissed, the court must inquire into the independence of the committee and the thoroughness of its investigation. Id. at 788. If the court is satisfied on these two fronts, then it may honor the SLC’s recommendation and dismiss the suit. The court may also, at its discretion, exercise its own independent business judgment in evaluating whether the motion to dismiss should be granted. Id. at 789.


118 Aronson, 473 A.2d at 815.

119 Id. at 816.
on a director’s behavior than on the circumstances of her appointment: “It is the care, attention and sense of individual responsibility to the performance of one’s duties, not the method of election, that generally touches on independence.” For actionable interestedness to be shown, plaintiffs must point to a pattern of directors’ acting “in such a way as to comport with the wishes or interests of the corporation (or persons) doing the controlling.”

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

Delaware skeptics at this point might assert that Delaware’s law is typically director-protective. Not even being nominated by a shareholder or receiving money from the corporation is enough, on its own, to imply that a director lacks independence. Still, later Chancery Court opinions have construed the notion of “beholdenness” more broadly, beyond simple financial indebtedness. Because each opinion involved a fact-intensive analysis, and because the analysis is so contextual, these cases sometimes seem in tension with each other, as Vice Chancellor Strine has candidly

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120 Aronson, 473 A.2d 805, 816. This behavior-centered language is commonly cited, but it may be a standard more honored in the breach than in the observance. I am pressed to find any derivative suit actually analyzing a director’s behavior to discern beholdenness or independence, perhaps because it is difficult for plaintiffs to muster evidence of specific acts demonstrating beholdenness. See n.XX for a discussion of behavior-centered language in the takeover context.

121 Aronson, 473 A.2d 805, 816.

122 See, e.g., In re The Limited, Inc. S’holder Litig., 2002 WL 537692, *5 (employment as an officer of the corporation or of a wholly-owned subsidiary of the corporation raises reasonable doubt as to independence).

123 See, e.g., In re The Limited, Inc. S’holder Litig., 2002 WL 537692, *5-6 (a director who is principal of a company that receives $400,000 in revenue from the company in question may be independent; further showing is needed as to whether the revenue was “material” to the business; a director who was a university official who received $150,000 in consulting fees was not independent).
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observed.\textsuperscript{124} Still, patterns appear to be emerging. Proof of friendship alone is not enough.\textsuperscript{125} But “beholdenness” (or “owingness” as the courts have also termed it) means more than simple financial interest.\textsuperscript{126}

For instance, familial relationships, as in the corporate governance model,\textsuperscript{127} can taint a director’s independence for the purposes of asserting demand futility.\textsuperscript{128} The parent-child relationship appears to be an easy case,\textsuperscript{129} but other familial relationships can prove problematic, as well. In one case, for example, Vice Chancellor Strine observed that (wholly apart from significant financial ties), he was “incredulous” about the independence of a director who was the CEO’s brother-in-law on the question whether the corporation should sue the CEO.\textsuperscript{130} Nevertheless, Delaware courts do not always find bare familial relationships suffice to prove a lack of independence. In \textit{Seibert v. Harper & Row, Publishers, Inc.}, the Chancery Court found that the mere fact that a director is cousin of an interested director, “without more,” was not enough to show domination or control.\textsuperscript{131}

\textsuperscript{124} \textit{In re Oracle Corp. Deriv. Litig.}, 824 A.2d 917, 939 (2003) (“[I]t would be less than candid if I did not admit that Delaware courts have applied these general standards in a manner that has been less than wholly consistent. Different decisions take a different view about the bias-producing potential of family relationships, not all of which can be explained by mere degrees of consanguinity. Likewise, there is admittedly case law that gives little weight to ties of friendship in the independence inquiry.”).

\textsuperscript{125} \textit{Beam v. Stewart}, 833 A.2d at 979.

\textsuperscript{126} \textit{Id.} at 938 (“Delaware law should not be based on a reductionist view of human nature that simplifies human motivations on the lines of the least sophisticated notions of the law and economics movement. \textit{Homo sapiens} is not merely \textit{homo economicus}.”).

\textsuperscript{127} \textit{Supra} ____.

\textsuperscript{128} \textit{Grimes v. Donald}, 673 A.2d 1207, 1216 (Del. 1996).

\textsuperscript{129} \textit{Chaffin v. GNI Group, Inc.}, 1999 WL 721569, *5 (observing, in the merger context, that “most parents would find it highly difficult, if not impossible, to maintain a completely neutral, disinterested position on an issue, where his or her own child would benefit substantially if the parent decides the issue a certain way.”).


\textsuperscript{131} 1984 WL 21874, at *3 (Del. Ch. Dec. 5, 1984)
Delaware’s approach to familial relationships is thus more flexible than an ex ante status-based approach. In *Mizel v. Connelly*, Vice Chancellor Strine found that a grandson was not independent for the purpose of deciding whether the corporation should sue his grandfather for rescission of an interested transaction,132 calling the grandfather/grandson relationship “of great consequence.” Interestingly, in a footnote the Vice Chancellor noted that the ALI’s Principles of Corporate Governance: Analysis and Recommendations “do not include grandparents in their definitions of related persons that trigger a label of interestedness.”133 Thus, Delaware’s transaction-specific, contextual inquiry can produce a more textured and probing analysis than the corporate governance model into what having an interest (and thus lacking independence) actually means. As Vice Chancellor Strine observed, a grandchild’s relationship with his grandfather can be a close one: “I could not consider impartially such a demand as to my own grandfather.”134

A number of key cases involving what constitutes beholdenness involve academics. Professors seem a natural choice for independent directors: they are (we can all agree) intelligent, sophisticated and, when tenured, enjoy enviable job security that would seem to render them largely impervious to financial influences from the corporation, as long as they are not relatives of the CEO or other defendants. But even they are not immune. A Duke University president was found potentially lacking in independence because he had served on several boards (including Duke’s own board) with the defendant who allegedly dominated and controlled the board, who had a history of donating to Duke, and with whom he had shared “numerous political and financial dealings.”135 Even a university president’s past successful solicitation of $25 million at a former institution from an alleged controller could create “a sense of ‘owingness’” in that director.136

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

134 Id.


In contrast, in *Disney*, the court found that the president of Georgetown University, Father Leo O’Donovan, was independent despite a donation of $1 million from the alleged controller, and the fact that the alleged controller’s son had attended the school.\(^\text{137}\) These searching inquiries stand in stark contrast to the mechanical tests used by SOX and the exchanges’ blunt tools: as long as a director does not receive money from the corporation, does not have a family relationship with a corporate executive or employee, or is not employed by another company whose compensation committee includes an executive of the corporation, then the director is safe. Under this calculus, Duke’s president would clearly qualify as independent.

*In re Oracle Corp. Deriv. Litig.*\(^\text{138}\) contains the most searching analysis of academics’ independence to date. In it, Chancellor Strine gave weight to various financial connections between Stanford—where both Special Litigation Committee members were tenured professors—and the *Oracle* defendants. He dutifully examined, among other financial connections, that one defendant had given $300,000 to Stanford and was reported to be considering an additional gift of $170 million, and that another had given nearly $600,000 to Stanford, including by donating money directly to a Stanford institute of which both SLC directors were members.\(^\text{139}\) These facts were not dispositive, in part because the professors were tenured and were well-respected in their fields. Because these circumstances clearly rendered the professors able to obtain employment elsewhere, the court concluded they qualified as independent.\(^\text{140}\)

Beyond questions of financial independence, Strine has suggested that social ties between SLC directors and defendants might play a role in a court’s analysis. As he explained: “[C]orporate directors are generally the sort of people deeply enmeshed in social institutions. Such institutions have norms, expectations that, explicitly and implicitly, influence and channel the behavior of those who participate in their operation.” In such a close-knit atmosphere, “[s]ome things are ‘just not done,’ or only at a cost, which might not be so severe as a loss of position, but may involve a loss of standing in the


\(^{138}\) *In re Oracle Corp. Deriv. Litig.,* 824 A.2d 917 (Del Ch. 2003).

\(^{139}\) *Id.* at 931-33.

\(^{140}\) *Id.* at 930.
institution.” The fact that one of the defendant directors was a fellow Stanford professor who had formerly taught one of the SLC members raised further questions of bias.

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

*Oracle’s* influence remains unclear. One could argue that *Oracle’s* searching inquiry is reserved for members of a special litigation committee which, because it is formed when the board as a whole is tainted by interest and non-independence, must be held to a higher standard. Moreover, despite *Oracle’s* musings on the importance of community ties, Delaware has hastened to make clear that friendship alone is not enough to show non-independence. Before *Oracle*, Delaware courts had found that a fifteen-year professional and personal relationship between a CEO and a director was not enough to taint a director’s independence. Post-*Oracle*, the Supreme Court has reiterated that mere claims of friendship, without specific allegations that of an exceedingly close relationship, are not enough.

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141 *Id.* at 938.

142 *Id.* at 942-43.

143 The standard quotation is that the SLC committee members must, like Caesar’s wife, be “above reproach.” The Delaware Chancery Court first used this phrase to make the point that a committee composed of a single member is held to an extremely high standard. Lewis v. Fuqua, 502 A.2d 962, 967 (Del. Ch. 1985). The Supreme Court later used this language to mean that the entire committee has the burden of proving independence by a yardstick that is “above reproach.” Beam v. Stewart, 845 A.2d 1040, 1055 (Del. 2004). Gesoff v. IIC Industries Inc., 902 A.2d 1130, 1146 n.101, (Del. Ch. 2006)., explains the derivation of the quotation as follows: “Julius Caesar was asked why he chose to divorce his wife after a false accusation of adultery, Caesar’s laconic answer is said to have been that ‘Caesar’s wife must be above suspicion,’ or as it is usually rendered, ‘Caesar’s wife must be above reproach.’”


145 Beam, 833 A.2d at 979.
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Still, the Supreme Court did not reject Oracle’s emphasis on social ties, suggesting that “more detailed allegations about the closeness or nature of the friendship, details of the business and social interactions” between the director in question and the alleged controller, may have been enough to make a showing of a lack of independence. The very ability of Delaware to reserve the power to examine these other facets of human relationships gives it bite. Delaware is not bound by ex ante proscriptions against conflicts with the corporation as a whole. Instead, it can look deeply into particular conflicts.

D. Takeovers

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

1. Freezeout mergers

Freezeout mergers raise conflict-of-interest problems because they result from an insider’s effort to gain control of a corporation. Examples include parent/subsidiary mergers, other transactions involving majority stockholder, transactions involving directors, and management buyouts.

In all such cases, the directors are duty-bound to get a fair price for the shareholders, but the insiders want to pay as little as possible for the corporation. In the seminal case Weinberger v. UOP, the Delaware Supreme

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146 *Id.* at 980.

147 “A freezeout is a transaction in which a controlling shareholder buys out the minority shareholders in a publicly traded corporation, for cash or the controller's stock. Freezeouts are also known, with some occasional loss of precision, as "going private mergers," "squeeze-outs," "parent-subsidiary mergers," "minority buyouts," "take outs," or "cash-out mergers."” Guhan Subramanian, *Fixing Freezeouts*, 115 YALE L.J. 2, 5 n.1 (2005).

148 457 A.2d 701, 710 (Del. 1983).
Court suggested that one way to reduce the potential liability associated with this conflict was to employ independent directors.149

In Weinberger, the Court lamented the absence of “an independent negotiating structure.”150 Without such an independent body—or the interested directors’ completely abstaining from participation—any directors on both sides of the transaction must exercise their fiduciary duties “in light of what is best for both companies.”151 In a footnote, the Court offered more detailed guidance for companies faced with this situation: “Although perfection is not possible, or expected, the result here could have been entirely different if UOP had appointed an independent negotiating committee of its outside directors to deal with Signal at arm’s length. Since fairness in this context can be equated to conduct by a theoretical, wholly independent, board of directors acting upon the matter before them, it is unfortunate that this course apparently was neither considered nor pursued.”152 Later Delaware courts have held that the use of “a well functioning committee of independent directors” 153 shifts the burden of proof in the context of mergers.

149 In Weinberger, Signal was the controlling shareholder of UOP, owning 50.5% of the company. Id. at 704. Signal sought to acquire complete control of UOP. Because this was a conflicting interest transaction, the defendants needed to prove the entire fairness of the transaction. Gottlieb v. Heyden Chemical Corp., Del. Supr., 91 A.2d 57, 57-58 (1952). “The requirement of fairness is unflinching in its demand that where one stands on both sides of a transaction, he has the burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts.” 457 A.2d at 710. Two UOP directors were also Signal directors, but they prepared a feasibility study for “the exclusive use and benefit of Signal,” which they did not share with the UOP outside directors. Id. at 708. The fact that these directors stood on both sides of the transaction, and favored the parent corporation over the subsidiary, raised the possibility of a breach of fiduciary duties existed. The defendants did not meet their burden of proving the entire fairness of the transaction. Id. at 712.

150 Weinberger, 457 A.2d at 710-11.

151 Id. at 710-11.

152 Id. at 709 n.7 (emphasis added).

153 Kahn v. Tremont Corp., 694 A.2d 422, 428 (Del. 1997). A special committee is not necessary for a merger, especially when a majority of the board is disinterested and independent. Rosenblatt v. Getty Oil CO., 493 A.2d 929, 938 n.7 (Del. 1985). See also Alidina v. Internet.com Corp, 2002 WL 31584292 *7 (“There is no automatic requirement that the board employ a special committee...especially when a majority of the board is disinterested and independent.”).
with a controlling shareholder.\textsuperscript{154} Although not fully able to claim the protection of the business judgment rule, defendants in such cases nonetheless benefit gain an advantage because it falls to the plaintiff to prove the transaction was unfair.\textsuperscript{155}

Here for the first time we see Delaware implicating \textit{outside} directors in its discussion of independence. Delaware is nevertheless true to its philosophy of context-specific definition: corporations need outside directors in conflicting interest transactions only where the conflict is with insiders, and focus is on independence from the particular insider that is causing the conflict.\textsuperscript{156}

There are two reasons why, despite the “outside negotiating committee” language, this is not independence as defined by corporate governance—that is, it is not independence as outsider status alone. First, the independence tested is independence from \textit{the acquirer}, not the corporation. Prior financial relationships with the acquirer can cause a showing of nonindependence.\textsuperscript{157}

\textsuperscript{154} Companies have taken the cue from these decisions, and established independent negotiating committees in a variety of conflict transactions. Gregory V. Varallo, William M. McErlean, Russell C. Silberglied, \textit{From Kahn to Carlton: Recent Developments in Special Committee Practice}, 53 BUS. LAW. 397, 397-98. \textit{See also} Gesoff v. IIC Industries Inc., 2006 WL 1458218 *10 (Del. Ch.); \textit{see also} \textit{In re Cox Comm’n S’holders Litig.}, 879 A.2d 604, 618-19 (2005) (describing incentive effect created by Kahn v. Lynch for corporations to establish independent negotiating committees). As Vice Chancellor Strine observed, “In the main, the experience with such committees has been a positive one. Independent directors have increasingly understood and aggressively undertaken the burdens of acting as a guarantor of the minority’s interest, by undertaking a deep examination of the economics of the transactions they confront and developing effective negotiation strategies to extract value for the minority from the controller.” \textit{Cox}, 879 A.2d at 618. Strine concluded: “When it works well, the combination of a special committee, with general business acumen and a fair amount of company specific knowledge, with wily advisors who know how to pull the levers in merger transactions in order to extract economic advantage, is a potent one of large benefit to minority stockholders.” \textit{Cox}, 879 A.2d at 618.

\textsuperscript{155} Kahn v. Lynch Communication Sys., 638 A.2d 1110, 1117 (Del. 1994).

\textsuperscript{156} \textit{See} Orman v. Cullman, 794 A.2d 5, (Del. Ch. 2002).

\textsuperscript{157} In \textit{Kahn v. Tremont}, the Delaware Supreme Court found that a committee was not independent where “[a]ll three directors had previous affiliations with [the alleged controller] or companies which he controlled and, as a result, received significant financial compensation or influential positions on the boards of Simmons’ controlled companies.” 694 A.2d at 429-30. One director was paid $10,000 as a consultant to one of the controlling shareholder’s affiliates, and also received over $325,000 in bonuses from
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Second, the independence of directors is evaluated not just in terms of their lack of ties with the acquirer, but also in terms of their behavior. Delaware courts conduct a fact-intensive ex post inquiry into the special committee’s actions. The key point is that courts assessing the situational interestedness of directors do not focus solely on relationships; they also inquire whether the directors’ actions demonstrate “true” independence.158

In Kahn v. Tremont Corp., the court cited Aronson’s derivative suit language to justify this scrutiny of director conduct.159 What is more, the Court’s analysis of the negotiating committee’s actions seemed to range even further than in derivative suits.160 In this case and others, courts have reviewed the negotiating history of the independent committee to ensure that the committee is independent “in fact and not merely on paper.”161

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158 In re MAXXAM, Inc./Federated Development Shareholders Litigation, the court refused to allow use of a special committee to shift the burden of proving entire fairness at trial, in part because each member of the special committee had "significant financial and/or business ties" with the controlling shareholder. Nos. CIV.A. 12111, 12353, 1997 WL 187317 (Del. Ch. Apr. 4, 1997).

159 “As this Court has previously stated in defining director independence: "[i]t is the care, attention and sense of individual responsibility to the performance of one's duties ... that generally touches on independence."” Tremont, 694 A.2d at 430.

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

161 Varallo, McErlean, and Silberglied, supra n.XX, at, 400.
committee hire advisors who are also truly independent? Did they “aggressively seek to promote and protect minority interests?” Chancellor Allen has said that special committees must be willing to do more than just negotiate; they must be willing to exercise the “critical power…to ‘say no.’” The goal for the corporation is to try to simulate arm’s-length bargaining as closely as possible. Delaware’s context-specific model allows more room for the notion of “true” independence, probing the process by which an independent committee reached its decision and carefully assessing whether particular instances in the negotiation demonstrate independence, or a lack thereof.

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

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162 In re Cox Comm’n S’holders Litig., 879 A.2d 604, 618 (2005) (“Critical to the effectiveness of the special committee process has been the selection of experienced financial and legal advisors, who can help the special committee overcome the lack of managerial expertise at their disposal.”).


164 In re First Boston, Inc. S’holders Litig., 1990 WL 78836, at *7 (Del. Ch.).

165 Gesoff v. IIC Industries Inc., 2006 WL 1458218, at *10 (Del. Ch.)

166 *Tremont*, 694 A.2d at 430. There, the other two, arguably more independent members of the committee, seemed to abdicate most responsibilities to the most compromised committee member. Furthermore, the advisors to the committee also had ties to the controlling shareholder. *Id.*

167 In re Cox Comm’n S’holders Litig., 879 A.2d 604, 610.

168 493 A.2d 929, 937 (Del. 1985). For example, directors that stood on both sides of the transaction resigned before negotiations got underway, both companies had a third party
Delaware courts seem loath to trust outside independent status alone. Chancellor Allen, author of many influential takeover decisions, has voiced ambivalence about independent director committees. Although he called himself “open to the possibility” that such committees could protect shareholder interests, he admitted to “a painful awareness of the ways in which the device may be subverted and rendered less than useful.”

The Supreme Court has pointedly emphasized that corporations must do more than create a “perfunctory special committee of outside directors.”

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

value their reserves, and the subsidiary engaged in such hard bargaining that it “nearly caused the collapse of negotiations on at least two occasions.” Id. at 938.

**Legal Citations**


171 Kahn v. Tremont Corp., 694 A.2d 422, 429 (Del. 1997).


173 Rock, *supra* n.XX, at 1026.

174 The inquiry of Delaware courts has focused on particular facts in assessing committee’s performance. Good facts include: the committee hiring an independent law firm and investment bank, and repeated rejection of management’s offers. Freedman v. Restaurant Assoc. Indus., 1987 WL 14323 (Del. Ch. 1987), at *3-4. Bad facts include: “precipitous” Employee Stock Option Program issuances with the goal of entrenching management, EAC Industries v. Franz Manufacturing, 1985 WL 3200 (Del. Ch. 1985), at *9; or one member of the committee being a company-paid consultant who did not resign until after the committee had recommended the merger; Greenfield v. National Medical Care, 1986 WL 6505 (Del. Ch. 1986), at *4. Possibly the most famous, and still the largest (failed) management buyout to date was RJR Nabisco. There the independent negotiating committee functioned robustly; in fact, they gave the ultimate demonstration
2. Defensive Measures Against Hostile Takeovers

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

In Unocal Corp. v. Mesa Petroleum Co., the Supreme Court dealt with the problem of management’s response to a threat of hostile takeover, where the risk of management (and board) entrenchment is clear.\footnote{175 Palmiter, supra n. XX, at 1412.} If a takeover bid is successful, directors may lose their directorships, with their accompanying “power, prestige and prominence, not to mention their increasingly handsome directors’ fees and perquisites; they face the embarrassment of losing a fight; and they face breaking their tacit promise of fealty to management.”\footnote{176 Id. at 1413. In a noteworthy dissent, Judge Cudahy observed: “Directors of a New York Stock Exchange-listed company are, at the very least, ‘interested’ in their own positions of power, prestige and prominence (and in their not inconsequential perquisites). They are “interested” in defending against outside attack the management which they have, in fact, installed or maintained in power ‘their’ management (to which, in many cases, they owe their directorships). And they are “interested” in maintaining the public reputation of their own leadership and stewardship against the claims of ‘raiders’ who say that they can do better. Thus, regardless of their technical ‘independence,’ directors of a target corporation are in a very special position, where the slavish application of the majority’s version of the good faith presumption is particularly disturbing.” Panter v. Marshall Field & Co., 646 F.2d 271, 300-01 (7th Cir. 1981) (Cudahy, J., dissenting).} As the court worded this risk in oft-quoted language, takeover defenses raise “the omnipresent specter that a board may be acting

primarily in its own interests, rather than those of the corporation and its shareholders.” 177

Given this potential conflict for the entire board, the Delaware Supreme Court announced in *Unocal* an enhanced scrutiny for takeover defense measures. The board must have “reasonable grounds to believe that a danger to corporate policy and effectiveness” exists, a burden it satisfies by showing “good faith and reasonable investigation.” 178 The directors bear the burden of proof in this area of “inherent conflict”—no protection of the business judgment rule applies—but if the board is comprised of a “majority of outside independent directors,” the burden of proof is “materially enhanced.” 179 The second part of the *Unocal* inquiry requires that “the defensive measure must be “reasonable in relation to the threat posed.” 180 Building on *Unocal*, the court in *Moran v. Household International, Inc.* 181 held that, in the absence of a specific takeover threat, adoption of a pill by a board consisting of a majority of outside independent directors shifts the burden of proof to the plaintiffs to show a breach of fiduciary duties.

These anti-takeover cases reveal two key differences in analysis vis-à-vis Delaware’s general approach to issues of board-member independence. First, the court’s approach to derivative suits’ special litigation committees, conflicting-interest transactions under § 144, and squeezeouts focuses on the make-up of special board committees. In dealing with anti-takeover measures, however, the court creates an incentive for the majority of the *board itself*—rather than a committee thereof—to be outside independent directors. Presumably this difference in approach has taken hold because of the “inherent conflict”—all directors, non-employee as well as employee, are susceptible to the temptation to cling to the “powers and perquisites” associated with board membership. 182 As we will see in the next section, the incentive structure set up by Delaware has had its effect. 183

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

178 *Id.*

179 *Id.*

180 *Id.* at 955.


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

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184 Perhaps at the time of Unocal, a majority of independent directors seemed like enough of a protection, given that courts still reserved the right to review whether there were reasonable grounds to believe a danger to corporate policy existed, and that any defensive measure was reasonable in relation to the threat posed. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954-55 (Del. 1985). However, subsequent cases showed that almost any threat would do, including the risk that shareholders would accept an acquirer’s non-coercive offer “in ignorance or a mistaken belief of the strategic benefit which a business combination.” Paramount Commc’ns, Inc. v. Time Inc., 571 A.2d 1140, 1153 (Del. 1989). More generally, this danger is known as substantive coercion, has “the risk that shareholders will mistakenly accept an underpriced offer because they disbelieve management’s representations of intrinsic value.” Id. n.17; Unitrin, Inc. v. American General Corp., 651 A.2d 1361, 1384 (Del. 1995). Recognizing this rationale as a threat adequate to justify defensive measures virtually guaranteed that directors would be able to survive Unocal’s first prong. Thompson & Smith, supra n.XX, at 291. Courts also appear to have been reluctant to prevent defensive measures as unreasonable in relation to potential threats perhaps because it puts them in the position of engaging in a form of substantive analysis. Id. at, 293. Thus, defensive tactics are rarely overturned. Id. at 326.

185 Sometimes Delaware courts’ review of the independence of boards in the Unocal setting is quite cursory: the courts dutifully add up the numbers of outside independents, cite the Unocal language regarding the ability of an outside independent board to enhance the burden of proof, and proceed with the analysis. They do not delve into the question of whether the outside directors are “truly” independent. See Carmody v. Toll Bros., Inc., 723 A.2d 1180 (Del. Ch. 1998) (where five of nine directors were outside directors, although one was an outside attorney who had received $128,000 in fees from the company in 1996, the court did not reach the independence question); Unitrin, Inc. v. American General Corp., 651 A.2d 1361, 1375 & n.15 (Del. 1995) (outlining the tests for outside directors and independent directors, acknowledging that the chancery court had found that the directors were independent, explaining that these issues are usually settled at trial, and then turning to the second part of the test). Mentor Graphics Corp. v. Quickturn Design Systems, Inc., 728 A.2d 25 (Del. Ch. 1988), addresses the subject in greater depth than most, but it reduces the definition of independence to “in any
Still, students of hostile takeover jurisprudence know that Delaware courts will inquire into the behavior of a board composed of outside independent directors in the hostile takeover context. In *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,¹⁸⁶ the court declined to find that the board consisted of “truly outside independent directors” where six board members held senior management positions, two were major stockholders, and four had relationships with various companies that had done business with Revlon in the past.¹⁸⁷ In *Paramount Communications, Inc. v. Time Inc.*,¹⁸⁸ the court seemed to consider a majority of outside independent directors to be an important factor, but not a dispositive one. The opinion first considered the board’s “zealousness” in seeking to preserve Time’s corporate culture. Not only was this an important corporate policy worthy of defense, but Time’s “lengthy” prior investigation of merger candidates, including Paramount, the eventual hostile suitor, meant that Time was exercising an informed judgment in rejecting that suitor’s overtures. The court concluded that the board had met its fiduciary burdens as articulated in *Unocal*—that is, it had acted reasonably. After citing these factors the court did, it is true, cite *Unocal* for the proposition that having twelve of sixteen outside independent directors materially enhanced the finding, but the court then went on to inquire into the reasonableness of the board response. Board independence was only one factor the court considered.

Furthermore, in some of the cases where Delaware courts have given only cursory consideration to analysis of independence in *Unocal’s* first step—the requirement that the board show it had reasonable grounds for believing that a danger to corporate policy existed—the same courts have invalidated some defenses as not reasonable in relation to the threat posed, the second step of the *Unocal* analysis.¹⁸⁹ In short, the deference accorded to outside independent directors does not necessarily carry the day; indeed, one feels

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¹⁸⁷ Id. at 177 n.3.


that the courts rush through the independence analysis in order to reach the question whether so-called “dead hand”\textsuperscript{190} or “no hand”\textsuperscript{191} poison pills were permissible under Delaware law.

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

E. Independence Summarized

Delaware rejects corporate governance advocates’ attempts to reduce independence to status. Chancellor Allen wrote that the protection of the business judgment rule is not available to a fiduciary who could be shown to have caused a transaction to be effectuated (even one in which he had no financial interest) for a reason unrelated to a pursuit of the corporation's best interests. Greed is not the only human emotion that can pull one from the path of propriety; so might hatred, lust, envy, revenge, or, as is here alleged, shame or pride. Indeed any human emotion may cause a director to place his own interests, preferences or appetites before the welfare of the corporation.\textsuperscript{192}

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

I have asserted that articulating a simple, non-contextual definition of Delaware’s independence is impossible. Nevertheless, patterns emerge. In areas like derivative litigation and freezeout mergers, courts have examined the extent of a director’s relationships, personal as well as financial and

\textsuperscript{190} Carmody v. Toll Bros., Inc., 723 A.2d 1180 (Del. Ch. 1998).


familial, in order to determine whether the director is capable of a truly independent assessment. In the freezeout merger context, they have examined the specific behavior of independent directors. Delaware courts do not rely on status alone to ascertain independence; indeed, they are suspicious of nominally independent committees that fail to show sufficient determination to safeguard shareholders’ interests. Mindful of the specific conflict at issue, they focus the independence inquiry in order to determine whether a relevant form of bias exists.

This fact-intensive definition-as-process approach is one that Delaware jurists have steadfastly defended. Vice-Chancellor Strine lauded the “contextual approach” as “a strength of our law,” observing that “even the best minds have yet to devise across-the-board definitions that capture all the circumstances in which the independence of directors might reasonably be questioned. By taking into account all circumstances, the Delaware approach undoubtedly results in some level of indeterminacy, but with the compensating benefit that independence determinations are tailored to the precise situation at issue.”193 In fact, when the Council of Institutional Investors asked the Delaware Supreme Court to adopt a definition of independence, the Supreme Court resisted.194 Proposals for Delaware to require independent directors on the board have also failed.195

IV. Lessons Learned

What can be learned from Delaware’s independence jurisprudence? Our focus, as set out in the Introduction, is two-fold. First, we consider the “means” of independence, i.e., how it should be defined. Generally, corporate governance has it right: there are three main areas of obvious potential conflict with outsiders: audit committee, compensation committee, and nominating committee. But we need to focus more precisely on the nature of the relevant conflict. For the audit committee, an independent director must be independent of the auditors as well as the managers of the company. For nominating committee purposes, independents should not

194 Veasey, supra n.XX, at 2182-83.
have ties to other directors or nominees. And for the compensation committee, not only should the independents not have ties to the corporation, but they should not have ties to the executives whose pay they are setting. The next section will take executive compensation as a case study.

A. Refining the Definition: The Executive Compensation Case Study

The NYSE and NASDAQ both require an outside independent compensation committee for what should be self-evident reasons. Taking CEO compensation as an example, a corporation would not want anyone dependent on the corporation to set executive pay, because of the danger that there would be threats of retribution for lowering pay with pay, even if being stingy was in the shareholders’ best interest. Even when outside directors are used, however, they may not help much. Some commentators believe that outside directors are biased towards excessive executive compensation. Outside directors are often CEOs or high-placed executives at other large public corporations, and therefore have an interest in reinforcing a generally high level of executive compensation.196 The group dynamics of the board further reinforce the unlikelihood that directors will challenge a CEO’s compensation.197

Delaware’s approach to independence provides clues on how compensation committees might be reformed. For example, UnitedHealth’s CEO, William McGuire, recently resigned because of a backdating scandal.198 The head of the compensation committee and the “ad hoc” committee that negotiated McGuire’s back-dated-option-laden 1999 employment contract was William G. Spears, who served as trustee for two trusts benefiting the CEO’s children and managed between $15 and $55 million of the CEO’s family fortune. In June 1999, only months before the employment contract

196 Lucian Bebchuk and Jesse Friedman, Pay Without Performance, Harvard University Press, 33 (2004). The authors refer to “cognitive dissonance”, the idea that executives and former executives will have pre-conceived ideas that large salaries are “desirable and serve shareholders.”


198 Backdating involves granting stock options not at current market price (as tax laws require), but at an earlier, more favorable date when the stock exercise price is cheaper.
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was renegotiated, McGuire also invested $500,000 “to help Spears repurchase his money management firm from a financial conglomerate.” 199 Spears was an “independent” director by SOX and SRO standards, because he was financially independent of UnitedHealth and he was not a relative of an executive officer. But he lacked sufficient independence from the CEO, particularly when, as chair, he should have been the most independent compensation committee member.

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

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

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

199 Alan Murray, How UnitedHealth Spotlights Gap in Reform, WALL ST. J. A2, Oct. 18, 2006. William G. Spears, the “independent” director, served as trustee for two trusts benefiting the CEO’s children and managed between $15 and $55 million of the CEO’s family fortune. “In June 19999, just months before the employment agreement was renegotiated, [the CEO] also invested $500,000 to help Spears repurchase his money management firm from a financial conglomerate.” The employment agreement authorized backdated options, which arguably result in a windfall to the CEO.
outside independent director—is crucial only in the specific situations where a conflict exists between the interests of management and those of the shareholder.

I am not the first to point to the perils of supermajority independence. As Jill Fisch has convincingly argued, focusing on board independence means a board full of outsiders who lack the internal knowledge of the company to manage effectively. The supermajority independent board thus necessarily must focus on the monitoring role of the board, at the expense of the board’s management role.\(^{200}\) Lawrence Mitchell has argued that supermajority independent boards paradoxically give CEOs more power and make it less likely that the board can fulfill its monitoring role. With so few insiders on the board, CEOs become practically the only avenue for providing internal information about the corporation to the outside board members. This reliance on the CEO makes fraud more likely.\(^{201}\)

This article offers another argument against supermajority independent boards. Independence matters for a reason: to deal with conflict. Governance advocates want independent directors to take a more active role in the corporation, but they ask too much. Outside independent directors need only be front and center in areas of conflict with management. Take the case of Enron, where the independent directors received requests from the company that the board approve waivers of the ethics code to allow Andrew Fastow, the corporation’s CFO, to enter into transactions with the corporation. The board-approved transactions allowed the creation and functioning of the special purpose entities that helped lead to Enron’s undoing.\(^{202}\) Fastow’s SPE transactions with the corporation constituted classic self-dealing. Because they involved a corporate insider doing business with the corporation, they should have triggered intense scrutiny from the independent directors. Instead, approval was viewed as a mere formality.\(^{203}\)

If a more Delaware-like conception reigned, those outside directors would have realized that their role lay precisely in this area of conflict. In cases of

\(^{200}\) Jill E. Fisch, \textit{supra} n. xx, at 267.

\(^{201}\) See Mitchell, \textit{supra} n.xx, at 1345.


conflict, outsiders’ negative quality—their lack of ties to the corporation and management—does indeed become a positive good. But the board does much more than just handle conflict: it makes high level strategic decisions for the corporation. In making decisions as to product line-up, acquisitions, or marketing strategy, outside directors should have at most an advisory role. These are areas for management, the full-time agents of the corporation. Independents, defined as outsiders, should ensure that none of the managers have a special interest in a given transaction or connection to those on the other side. Beyond that, their lack of ties to the corporation or management gives them no particular insights or expertise.

V. Potential Objections to Generalizing From Delaware’s Independence to Corporate Governance

A. Apples and Oranges

But wait, you’ve been thinking. This whole argument erroneously presupposes that one can fruitfully draw lessons from Delaware’s case law for federal-law and exchange-created corporate governance rules. Corporate governance activists are concerned with proscriptive solutions, about making things better for shareholders in general. Delaware courts are courts: they are in the businesses of deciding particular disputes. They necessarily only discuss independence ex post, on a case by case basis, and have the luxury of being able to craft fine-tuned independence standards that work for particular situations, such as the behavior of independent negotiating committees in a management buyout, for example. It makes no sense, then, to compare Delaware’s approach with that of the corporate governance reformers. They address two completely different situations.

This objection draws a false line between the effect of statutory and common law rules. Delaware’s case law, like all case law, is prospective in nature. Delaware courts attempt to craft rules for future litigants and for future boards who would like to avoid litigation and liability. In fact, Delaware, by virtue of its calculated desire to compete with other states in corporate law, is deeply invested in crafting the best rules for future corporate actors so as to make itself attractive to corporations. If Delaware’s law is competing to be the best, then if independence-as-status really was a benefit, a prospective prescription for it (e.g., “each board shall be composed of a majority of independent directors”) should have made it into the
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Delaware code or case law. Delaware would then have the benefit of ex ante outside directors, and also be able to apply ex post independence analysis as the need arose. Against this backdrop, Delaware’s refusal to rely on independence defined as outside status should give corporate reformers pause.

B. The Interest Group Objection

John Macey and Geoffrey Miller’s interest group theory of Delaware law offers a more provocative reason to conclude that Delaware’s approach to board-member independence offers little of value to rulemakers outside the

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204 Two states take the independence-as-outside-status approach, but only in a limited form. The Michigan Business Corporation Act, which defines independent directors in terms of their financial and familial relationships with the corporation, financial, business, or legal expertise, and length of board service. M.C.L.A. 450.1107. However, Michigan does not require that a corporation have an independent director, but merely provides that any director designated as independent may receive additional compensation, and may communicate with shareholders at the corporation’s expense. The Act also provides that an independent director does not have any greater duties or liabilities than any other director. M.C.L.A. 450.1505. Independent directors can also approve interested transactions. M.C.L.A. 450.1545a. Independent directors not party to the proceeding also approve indemnification. M.C.L.A. 450.1564a.

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

205 Conversely, if Delaware is engaged in a race to the bottom, pandering to company management, one might expect to find that other states that have not sunk so low would adopt the status-based approach. However, only two states have done so, and then only to a limited extent. See supra n.XX.
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These commentators argue that Delaware is captured by lawyers; both plaintiffs’ attorneys and defense attorneys have an interest in keeping legal rules unclear. Delaware’s highly contextual independence jurisprudence fits this pattern. A clear, ex ante standard like that of the NYSE or SOX presents little to consult or advise over. (One either has or hasn’t received $60,000 in fees from the corporation in the past three years.) Plaintiffs’ attorneys can expend a lot of ink, and garner a proportionate amount of fees, making arguments that an SLC member’s relationship with a defendant CEO is more like the Oracle SLC members than it is like the defendant director’s friendship with Martha Stewart in Beam. Although this indeterminacy creates a cost to defendant corporations, who often settle claims of unclear worth, it also creates a benefit for corporate counsel who can bill hours upon hours advising clients on how their board should be structured in light of this uncertainty. Within the corporation, clients generally defer to their lawyers as to choice of state of incorporation. Because lawyers have a great deal of power over changes to the Delaware corporate code, their interest wins out.

The interest group theory is only one explanation of Delaware’s legal indeterminacy: Ehud Kamar has suggested the uncertainty associated with Delaware law aids in its competition with other states by “stymieing their compatibility with Delaware law.” Delaware competes not on its laws alone, but also with a specialized and expert judiciary and a wide array of cases.

But even assuming for the sake of argument that lawyers drive the uncertainties underlying Delaware’s contextual approach, compelling

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207 Id. at 504.


210 Id. at 1911 (“This allows Delaware judges both to utilize their superior skills and to sharpen them. If another state adopted Delaware's indeterminate law, the relative inexperience of its judiciary would become apparent, and it still could not ensure compatibility of outcomes with Delaware. If it adopted clear law, it would explicitly forgo compatibility with Delaware.”)
reasons nevertheless remain for assessing the value of Delaware’s approach and its potential applicability in other settings. First, the empirical data suggests that a rules-based definition of independence seems to be inadequate, at least when coupled with the requirement of a majority independent board. The logical alternative to a rule-governed regime is a standard, and standards necessarily involve uncertainty. The fact that uncertainly also benefits lawyers should not be enough, alone, to condemn it.

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

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

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

Private corporations are very different creatures from public corporations. Public corporations, by definition, are traded on a national exchange.

211 See generally the rules v. standards debate, supra n.XX.

212 Supra, n.XX.

213 C.G.S.A. 33-753.

214 Of course, all fifty states face a similar issue in that the corporate codes cover public and private corporations. The contrast is simply starker in Delaware because so much of the statute’s revenue comes from corporate law. See nn. XX and XX for further discussion of other states’ treatment of independence.
single corporation can have thousands of shareholders, in different countries, all trading in their shares. In contrast, private corporations often have relatively few shareholders,\textsuperscript{215} who are frequently family members.\textsuperscript{216} Shareholders often have direct representation on the board, and serve as the officers of the corporation, as well.\textsuperscript{217}

The DGCL, then, is framed for multiple audiences, and so faces a bit of a dilemma. In terms of sheer volume, close corporations dominate the corporate world.\textsuperscript{218} To the extent that theorists have postulated that Delaware is motivated by franchise fees to create a corporate law that is either efficient or management-friendly in order to attract revenue in the form of incorporation and corporate franchise fees, then it must take into account the interests of close corporations. Still, public corporation law creates a national reputation for a state—if Delaware is to claim proudly that “more than 50% of all U.S. publicly-traded companies and 60% of the Fortune 500” incorporate in Delaware,\textsuperscript{219} then it must also cultivate laws that work for public corporations.\textsuperscript{220}

\textsuperscript{215} American Law Institute, Principles of Corporate Governance: Analysis and Recommendations § 1.06 (Proposed Final Draft 1994) (“Closely held corporation means a corporation the equity securities of which are owned by a small number of persons, and for which no active trading market exists.”) Although many close corporations are small, not all are. O’Neal and Thompson’s Close Corporations and LLCs: Law and Practice, §1.3 (citing, among others, Milliken & Co., Inc., a textile operating and holding company; Mars, Inc., producer of various candies and other foods; and Hallmark Cards, Inc., and discussing the rise of “going private” transactions affecting many large, formerly public, companies.).


\textsuperscript{218} Robert A. Ragazzo & Douglas K. Moll, CLOSELY HELD BUSINESS ORGANIZATIONS 1 (2006) (“the number of closely held businesses in this country vastly exceeds the number of publicly held businesses”).

\textsuperscript{219} http://www.state.de.us/corp/.

\textsuperscript{220} Generally, of course, all state corporate codes address private and public corporations—Delaware is not unique in this respect. Because Delaware is, for well-rehearsed reasons, one of the few states to seriously compete on the basis of corporate charters. Delaware is a small state, and corporate franchise fees make up 15-20% of its revenue. Wells M. Engledow, Handicapping the Corporate Law Race, 28 J. CORP. L. 143, 146.
Generally there is little difference between the laws of public and private corporations. Basic corporate law concepts like fiduciary relationships, duties of care and loyalty, and the business judgment rule all translate from the public realm to the private realm, and back again with little loss of utility. In contrast, in the intimate environment of the close corporation, independence must mean something very different than it does in the harsh spotlight of the public corporation.

In public corporations, agency costs pose a problem—perhaps the central problem of corporate law. Widely dispersed shareholder-owners cannot control their agents, the officers of the corporation. They lack both the power and the incentive to monitor them effectively, because any gain from increased monitoring is usually only a fraction of their total wealth. Finding “outsiders” to monitor their inside agents is thus enormously appealing: the outsider (at least in theory) will ensure that the agents remain faithful to the owners. Much of corporate governance—public corporate governance, at least—is focused on making sure that these watchers indeed do their jobs. But the tools that the law uses are ex ante, status-based definitions: financial independence and lack of familial relationships are proxies for faithful monitoring.

In a private corporation, in contrast, there is often near identity between large shareholders, officers, and directors. To introduce an outsider into this mix would be enormously intrusive. Close corporations forge delicate equilibriums that balance who will sit on the board, and which directors and

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(2002). When corporate service organizations, Delaware bar interests are factored in, one can argue that a uniquely large percentage of the state economy depends on making Delaware an attractive site for incorporation. Macey & Miller, supra n.XX, at 503-05. Because it has achieved such dominance, it is the most fruitful code to compare with general corporate governance practices. Two states—Michigan and Connecticut, that define independence in an ex ante manner. See n.XX supra. For our purposes, given the dominance of Delaware corporate law, it is relatively insignificant that two states not known for their competition for corporate charters, define independent status in their codes—although it is significant that the only state to require independent directors does so only for corporations with over 100 shareholders—corporations that start to look more like public corporations. C.G.S.A. 33-753.


222 Elson, supra n.XX, at 499 (arguing that proper monitoring requires objectivity, and that independence creates this objectivity).
which shareholders must approve certain actions, and who will receive a salary. These careful contractual arrangements would be thrown into disarray by a requirement that the board be composed of a majority of outsiders. For close corporations, Delaware’s situational definition of independence makes much more sense. “Independence” only matters when it is needed, and the court’s analysis is flexible enough to adjust to various contexts.

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

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

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223 See supra Part III.D.2.

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

225 See generally DGCL §§ 341-356. Corporations can elect statutory close corporation status in their certificate of incorporation. They may not have more than 30 shareholders, their shares must be subject to restrictions on transfer, and they must not make a “public offering” of shares under the Securities Act of 1933. §342. But only a very small percentage of Delaware corporations actually become statutory close corporations because the form offers few advantages not obtainable under the general corporation law. O’NEAL AND THOMPSON’S CLOSE CORPORATIONS AND LLCS: LAW AND PRACTICE, §1.20 (“The evidence suggests that the great majority of corporations eligible for statutory
governed by one statute, and public corporations by another. Default rules are provided by the general corporation law, which applies to both public and private corporations. Furthermore, most of the Delaware cases dealing with independence are public company cases.226

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

D. Administrability

SOX’s rules-based approach at least has the virtue of certainty. Corporate attorneys can clearly identify directorial candidates that fulfill the requirements of the NYSE. The uncertainties of Delaware’s standards-based approach are not fatal, however, for several reasons. First, as Jill Fisch points out, indeterminacy has benefits: most obviously, because it permits results that are carefully tailored to the particular situation.227 Secondly, fuzzier standards force parties to the bargaining table, encouraging parties to negotiate rather than litigate.228

Perhaps most important, Delaware’s general-standard approach does not leave corporate planners completely in the dark. Delaware jurisprudence offers clear guiding principles for corporate planners: focus on the transaction. Determine if a board member as a conflict. If so, then that board

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228 Id. at 1083.
member should not participate. Even if the board member lacks a conflict of interest, delve deeper to see if anyone who might be seen to dominate or control that board member—an employer, a major supplier, a former donor, even a close friend, has a conflict of interest that would taint the director’s independence. This analysis of independence places us in the realm of uncertainty, it is true. But by forcing the board, and corporate counsel to examine conflicts as they occur, Delaware encourages decisionmakers to assess conflict in an active, reflective way. In this function of guiding the decisions of corporate planners, Delaware’s jurisprudence is just as “ex ante” as SOX’s. The difference is that evaluation of independence is made at the time of the conflict, and it is made with an understanding of the particular interests at stake. The insidiousness of the rules-based approach is that it removes responsibility from the board members at the critical point, the time a conflict arises; if one qualifies as independent initially by virtue of lack of ties to the corporation and management, one is independent.229

VI. Conclusion

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

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