The Multiple Roles of Corporate Boards of Directors

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I. INTRODUCTION

As corporations have increased in size and complexity, so have the demands on their operations, requiring more complex organizational structures, such as departments and divisions, a more diverse workforce possessing various levels and areas of expertise, and a more formalized accountability system that provides, for example, for formal disclosure reports and the hiring of independent auditors. The demands on corporate boards of directors have also changed. These demands require boards to perform a multitude of functions that call for attention to the structure of boards and to their composition and practices. Insufficient changes have been made, however, to accommodate these multiple roles of corporate boards.

This Article discusses the multiple roles of corporate boards, including the manager-monitoring, relational, and strategic management roles. The main focus for legal reform of corporate boards has been on the manager-monitoring role, which is commonly called the supervisory role. To better perform this function, corporations have made a number of changes in the structure, composition, and practices of their boards. For instance, corporations have changed their boards' structure by creating specialized board committees. They have also given attention to the composition of their boards to ensure the necessary expertise for these committees and the independence of board members from management. In addition, boards are increasingly adopting the practice of requiring outside directors to meet separately from executive officers in certain situations. The second role of boards, the relational role, is less well understood. The relational role refers to the use of board memberships to facilitate the sharing of information and perspectives among corporations and their various stakeholders, such as shareholders, consumers, and the legal and financial community, and to ensure the corporations of the continued support of these stakeholders.

Traditionally, approximately twenty-six percent of board members have been selected to perform relational functions.[1] In recent years, the interest of the business community in forming more diverse boards illustrates the continued importance of the relational role of boards. Diversity in terms of the presence of women, minority, and foreign directors on boards is intended to enable corporations to better relate to their domestic and foreign consumers and employees. The third role of boards, the strategic role, is generally subsumed within the manager-monitoring and relational roles. A separate strategic role of boards is indicated, however, to the extent that boards engage in strategic management, which refers to the development and implementation of corporate strategy at the board level. This Article explains how these roles more accurately describe board functions than the description of board functions as control, service, and strategy.

The multiple roles of boards often come into conflict with each other. The relational role of boards can conflict with the manager-monitoring role when board members selected to perform relational functions have business relationships with the corporation and therefore are not independent of management, as is desirable for manager monitoring. Similarly, the emergence of a strategic management role for boards, to the extent that it is occurring, is not necessarily a positive development because the performance of this role may detract from the time boards spend on manager monitoring. Also, if insiders are best at this strategic management function, this may dictate a more insider (executive officer)-dominated board at the expense of independent directors who are advisable for effective manager monitoring.

A recent meta-analysis has found that both insider-dominated and outsider-dominated boards are associated with more successful corporations in terms of return on assets.[2] This Article explores a number of alternative explanations for these findings. It proposes an interpretation based on the perception that boards perform multiple roles. Insider-dominated boards perform some roles more effectively than outsider-dominated boards, particularly strategic management. Outsider-

1. Barry D. Baysinger & Henry N. Butler, *Corporate Governance and the Board of Directors: Performance Effects of Changes in Board Composition*, 1 J.L. ECON. & ORG. 101, 113 (1985).

2. *See generally* John A. Wagner III et al., *Board Composition and Organizational Performance: Two Studies of Insider/Outsider Effects*, 35 J. MGMT. STUD. 655 (1998) (presenting two studies that examine the association between the inside/outside director composition of boards and organization performance).

dominated boards perform other functions better than insider-dominated boards, particularly manager-monitoring functions, to the extent that the outside directors are truly independent of management—unlike many outside directors of Enron Corporation prior to its collapse.[3] Both boards perform relational and some monitoring functions. This analysis suggests a number of corporate board reforms that will enable boards to perform their multiple functions more effectively.

The findings of the meta-analysis suggest that the potential exists for enhancing board performance by the use of a dual board structure. This structure would consist of (1) an insider-dominated board, composed of insiders and outside (relational) board members who would not necessarily be independent of management—a "business review" board, and (2) an outsider-dominated board, composed solely of independent directors—a "conflicts" board.[4] First, a conflicts board is designed to decrease the pressures that inside directors place on independent directors to conform to management wishes in areas where management has conflicts of interest. The organization of a conflicts board is a logical step in the process of board reform, which began with increasing the number of outside directors on corporate boards and their committees, and has extended more recently to having outside directors meet separately from the full board. The formation of a conflicts board takes the social dynamics of groups seriously and insists on the independence of outside directors. A related proposal, although one also applicable to single board systems, is one in which independent directors appoint a corporate ombudsperson who would have access to all corporate meetings and information concerning the corporation.[5] The corporate ombudsperson would serve the independent directors full-time for a three-year period and would report to both independent directors and shareholders in the corporation's annual report. Improving the flow of

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3. *See infra* note 61. Prior to Enron's collapse, it was listed as the seventh largest publicly traded company in the United States, with over $100 billion in gross revenues. Enron was widely admired for its transformation of an old-line energy company into a high tech global company. It filed for bankruptcy on December 2, 2001. As a result of its aggressive accounting and off-book activities, its assets had to be written down by as much as $24 billion. Its stock plummeted from ninety dollars per share in August 2000 to forty cents per share in December 2001. Many Enron employees lost their jobs and significant retirement savings that were heavily invested in Enron stock. PERMANENT SUBCOMM. ON INVESTIGATIONS OF THE COMM. ON GOVERNMENTAL AFFAIRS, THE ROLE OF THE BOARD OF DIRECTORS IN ENRON'S COLLAPSE, S. REP. NO. 107-70, at 1, 6 (2002). *See generally* William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275 (2002) (addressing the implications that the Enron collapse holds out for a self-regulatory system of corporate governance).

4. For a detailed exploration of this proposal, see generally Lynne L. Dallas, *Proposals for Reform of Corporate Boards of Directors: The Dual Board and Board Ombudsperson*, 54 WASH. & LEE L. REV. 91 (1997).

5. *Id.* at 130–36.

information is important for a board with outside directors and can be accomplished by the appointment of a board ombudsperson by outside directors and also by establishing a strategic planning committee which provides a forum for outside directors to meet with management. Query whether the Enron debacle would have occurred had Enron utilized a separate conflicts board composed of truly independent directors and sought to improve the flow of information to these independent directors as suggested by this proposal.

Second, the business review board would consist of inside directors and outside directors, who may or may not be independent of management. This Article suggests that the performance of the insider-dominated board reported in the meta-analysis may indicate the advantage of group decisionmaking by peers (fellow executives), which decreases corporate politics and the chance that a dominant CEO will become convinced of his invincibility, as appeared to have been the case with Enron CEO Jeffrey Skilling.[6] In addition, the quality of decisions is enhanced in ambiguous and uncertain situations when diverse perspectives are shared, and this sharing is encouraged when persons are in similar social positions (for example, all are directors of the corporation). The business review board would make business decisions not within the jurisdiction of the conflicts board and would have various advantages in performing relational, strategic management, and some monitoring functions.

To avoid confusion, it is important to point out that the dual board structure proposed here is not the same as the two-tiered board structure found in Germany.[7] The division of functions in the two-tiered German board system is of supervision and management. Both boards in the dual board structure perform supervision: The conflicts board performs mainly manager monitoring, and the business review board performs mainly relational monitoring.[8] In addition, neither board in the German system is composed solely of independent outside directors, unlike the recommendation for the conflicts board in the dual board system. In

6. *See infra* text accompanying notes 184–92.
7. Dallas, *supra* note 4, at 96.
8. As explained later in this Article, the relational role of boards involves a two-way relationship. *See infra* text accompanying notes 130–31. The relational director serves the corporation and enhances its ability to perform. *Id.* At the same time, the relational director is in a position to monitor the corporation to ensure the corporation's consideration of the relational director's interests, whether those interests are to comply with legal regulations or to consider the advancement of its female employees. *Id.*

Germany, supervisory boards include employees and persons who have business relationships with the corporation. In addition, the dual monitoring boards are not restricted in the way German supervisory boards are in conducting the business and affairs of the corporation. One feature of the German system that U.S. corporations may wish to consider is having employee representatives on their boards, or in the dual board system, on business review boards. Employee directors not only would likely protect the employees' stake in the corporation, which was substantially impacted by Enron's governance, but also would bring diverse perspectives onto corporate boards.[9]

This Article first discusses recent developments in board structure, composition, and practices that accommodate the manager-monitoring and relational roles of U.S. boards of directors. It then explores the multiple roles of corporate boards, theoretically and empirically, and addresses issues relating to the strategic role of boards. Finally, this Article turns to interpretations of recent empirical literature on corporate boards and proposals for reforming U.S. boards of directors.

II. DEVELOPMENTS IN THE MANAGER MONITORING BY U.S. BOARDS OF DIRECTORS

More effective board supervision of managers is the objective of various reforms in recent years in the structure, composition, and practices of boards of directors of U.S. public corporations. These reforms are encouraged by developments in fiduciary duty law, whereby courts apply a more deferential standard of review when reviewing corporate decisions made by independent directors.[10] Thus, reforms to change the composition of boards to include more independent directors are supported by these decisions. In addition, shareholders in the 1980s experienced board approvals of defensive tactics that effectively defeated takeovers that shareholders favored; this highlighted the managerial dominance of corporate boards. This experience also had the effect of spurring board reform, particularly because institutional

9. *See* Lynne L. Dallas, *The New Managerialism and Diversity on Corporate Boards of Directors*, 76 TUL. L. REV. 1363, 1403–05 (2002) ("[T]he evolving importance placed on diverse boards may indicate that it is time for U.S. corporations to consider stakeholder representation (e.g., employee-elected directors on U.S. corporate boards."); *see also* Howard Fineman & Michael Isikoff, *Lights Out: Enron's Failed Power Play*, NEWSWEEK, Jan. 21, 2002, at 14 (noting the impact of Enron's failure on employees).

10. State courts in the United States apply deferential standards to corporate decisions that are approved by independent directors. *See* Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) (applying the deferential business judgment rule); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (excusing the demand requirement); Auerbach v. Bennett, 393 N.E.2d 994, 1002 (N.Y. 1979) (deferring to an independent litigation committee in dismissing a shareholder derivative action).

ownership has increased.[11] These institutional investors have become increasingly active in corporate governance because exit has become a less viable option and norms have changed concerning the appropriateness of their participation in corporate governance.[12]

A. Trends Towards Outside Directors on U.S. Corporate Boards

Probably the most significant trend in board governance in the United States in the last twenty years has been the increase in the number and proportion of outside directors on corporate boards of directors.[13] This increase has naturally coincided with a decrease in the number and proportion of corporate insiders on boards. Proxy statement data for 1998 shows that corporate boards of public corporations in the United States average eleven directors, with two inside directors.[14] This represents a decrease in the number of inside directors from 1993, when boards averaged three inside directors, and from 1973, when boards averaged five inside directors.[15] In a study comparing the composition of boards of directors in 1970 and 1980, the decrease in inside directors was offset by independent directors.[16] Independent directors included public and professional directors, private investors, and directors

11. Institutional ownership in the United States increased from 15.8% in 1970 to 38% in 1981, 44.8% in 1986, and 53.3% in 1990. James P. Hawley, *Political Voice, Fiduciary Activism, and the Institutional Ownership of U.S. Corporations: The Role of Public and Noncorporate Pension Funds*, 38 SOC. PERSP. 415, 417 (1995). Large institutional investors doubled their share of the common stock market from 1980 to 1996 and controlled over one-half of that market by 1996. Paul A. Gompers & Andrew Metrick, *Institutional Investors and Equity Prices*, 116 Q.J. ECON. 229, 229 (2001).

12. *See* Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 570–75 (1990); *see also* Alfred F. Conard, *Beyond Managerialism: Investor Capitalism?*, 22 U. MICH. J.L. REFORM 117, 143–44 (1988); Patrick J. Ryan, *Rule 14a-8, Institutional Shareholder Proposals, and Corporate Democracy*, 23 GA. L. REV. 97, 157–63 (1988). *See generally* THE CAL. PUB. EMPLOYEES' RET. SYS., CORPORATE GOVERNANCE PRINCIPLES & GUIDELINES 3 (1988) (providing core principles that represent "the foundation for accountability between a corporation's management and its owners" and guidelines that represent, in CalPERS's view, "additional features that may further advance this relationship of accountability"), *available at* http://www.calpers-governance.org/principles/domestic/us/downloads/us-corpgov-principles.pdf [hereinafter CALPERS, CORPORATE GOVERNANCE].

13. KORN/FERRY INT'L, 26TH ANNUAL BOARD OF DIRECTORS STUDY 11 (1999).

14. *Id.* at 10–11.

15. *Id.* at 11.

16. Baysinger & Butler, *supra* note 1, at 113.

employed by nonrelated business organizations.[17] The proportion of relational outside directors consisting of financiers, consultants, legal counsel, and directors employed by related businesses did not change significantly during this period.[18]

This trend towards fewer inside directors was fueled by the objective of making boards more independent from management. As early as 1975, Melvin Eisenberg made a persuasive case for having boards composed of a majority of outside directors who are independent of management in his foundational book, *The Structure of the Corporation*.[19] Psychological studies confirm the considerable pressures on directors to conform to the wishes of corporate insiders and thus the importance of true independence.[20]

Today, numerous codes of best practices proposed and adopted in the United States and abroad by national stock exchanges, professional organizations, blue-ribbon committees of academicians, legal practitioners, and business leaders recommend independent outside directors on corporate boards of directors for more effective manager monitoring.[21]

B. Developments in U.S. Board Committees

Attempts to improve manager monitoring have also been made in

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17. *Id.*

18. *Id.* at 112–14.

19. MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION 170–77 (1976); *see* KORN/FERRY INT'L, *supra* note 13, at 5 (finding that it was generally accepted among U.S. public corporations that "[b]oards are composed primarily of independent directors who have no significant ties or conflicts of interest with the company").

20. *See, e.g.*, James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, LAW & CONTEMP. PROBS., Summer 1985, at 83, 84–85; *see* Dallas, *supra* note 4, at 104–11.

21. *See, e.g.*, 1 AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 3A.01 (1994); CORPORATE ACCOUNTABILITY AND LISTING STANDARDS COMM., N.Y. STOCK EXCH., JUNE 6, 2002 REPORT 25 (2002), *available at* http://www.nyse.com/pdfs/corp_govreport.pdf [hereinafter JUNE 6, 2002 REPORT]; F.F. Du Plessis, *Corporate Governance: Some Reflections on the South African Law and the German Two-Tier Board System*, *in* 2 PERSPECTIVES IN COMPANY LAW 131, 136–37 (Fiona Macmillan Patfield ed., 1997). Numerous definitions are offered for "independent directors." Basically, directors will be considered independent if they (1) have never been an employee of the corporation or any of its subsidiaries, (2) are not a relative of an employee of the company, (3) provide no services to the company, (3) are not employed by any firm providing major services to the company, and (4) receive no compensation from the company, other than director fees. NAT'L ASS'N OF CORPORATE DIRS., REPORT OF THE NACD BLUE RIBBON COMMISSION ON PERFORMANCE OF CHIEF EXECUTIVE OFFICERS, BOARDS, AND DIRECTORS 13–35 (1994). Definitions of independence are found in the Investment Company Act of 1940, the Securities and Exchange Act of 1934, and the Internal Revenue Code. They have also been developed by the Federal Deposit Insurance Company (FDIC), American Law Institute, Business Roundtable, National Association of Securities Dealers, New York Stock Exchange, and Council of Institutional Investors. *See* CALPERS, CORPORATE GOVERNANCE, *supra* note 12, at 104–11.

recent years by changing board structure through the use of committees. Management literature supports the use of committees for effective board functioning.[22] Committees enhance board effectiveness by permitting directors both to use and develop expertise in specialized areas and to focus their energies on a subset of issues confronting the corporation. The number of public corporations that now have audit committees composed of outside directors (although not necessarily independent directors) is a dramatic example of the increasing focus on manager monitoring by U.S. boards. Board audit committees are intended to implement and support the boards' manager-monitoring functions by periodically reviewing the corporations' processes for compiling financial data, their internal controls, and the independence of the corporations' external auditors.[23] According to 1998 proxy statements, all public corporations have audit committees with an average of zero insiders on these committees.[24] These committees have widespread support from a variety of sources, including national stock exchanges, professional organizations, and blue-ribbon committees formed in the United States and abroad.[25]

Another board committee considered important to effective board manager monitoring is the compensation committee, which is responsible for setting and reviewing executive compensation.[26] There is a consensus in the United States that good board practice requires a compensation committee composed of independent directors.[27] According to a 1999 survey, ninety-six percent of the corporations surveyed have compensation committees composed solely of outside directors,

22. Diana Bilimoria & Sandy Kristin Piderit, *Board Committee Membership: Effects of Sex-Based Bias*, 37 ACAD. MGMT. J. 1453, 1454 (1994).

23. 1 AM. LAW INST., *supra* note 21, § 3A.03.

24. KORN/FERRY INT'L, *supra* note 13, at 14.

25. BLUE RIBBON COMM. ON IMPROVING THE EFFECTIVENESS OF CORPORATE AUDIT COMMS., N.Y. STOCK EXCH., REPORT AND RECOMMENDATIONS 7 (1999), *available at* http://www.nyse.com/pdfs/blueribb.pdf [hereinafter BLUE RIBBON COMM.]; COMM. ON THE FIN. ASPECTS OF CORPORATE GOVERNANCE, DECEMBER 1992 REPORT §§ 4.30–4.39 (1992), *available at* http://www.ecgi.org/codes/country_documents/uk/cadbury.pdf; NASDAQ, LISTING REQUIREMENTS AND FEES: THE NASDAQ STOCK MARKET 9 (2003), *available at* http://www.nasdaq.com/about/nasdaq_ listing_req_fees.pdf; SEC. AND EXCH. BD. OF INDIA, REPORT OF THE KUMAR MANGALAM BIRLA COMMITTEE ON CORPORATE GOVERNANCE § 9.1 (2002), *available at* http://www.sebi.gov.in/commreport/corpgov.jsp.

26. KORN/FERRY INT'L, *supra* note 13, at 13.

27. CONFERENCE BD., BOARD DIVERSITY IN U.S. CORPORATIONS: BEST PRACTICES FOR BROADENING THE PROFILE OF CORPORATE BOARDS 20, 22 (1999).

although these directors are not necessarily independent directors.[28] This study chastised boards that have insiders on their compensation committees, explaining that outside directors are necessary for boards "to properly oversee their fiduciary responsibilities and operate independently of management."[29]

The third, most popular board manager-monitoring committee is the nominating committee, which is responsible for recommending board members to shareholders.[30] Having a nominating committee consisting of independent directors is considered good board practice.[31] According to 1998 proxy statements, seventy five percent of public corporations have nominating committees composed, on average, entirely of outside directors.[32]

Of course, having audit, compensation, and nominating committees does not guarantee effective manager monitoring. Recently, there has been substantial attention paid to the decline in the quality of financial reporting by U.S. corporations. In 1998, Arthur Levitt, the former chairperson of the Securities and Exchange Commission (SEC), cautioned corporations against the manipulation of numbers, referred to as "earnings management," which may assist corporations in attaining a short-term competitive advantage, but in the long run will undermine confidence in U.S. capital markets.[33] The actual functioning of audit committees has varied among corporations, from being thorough to perfunctory, from having expert, professional committee members to having members who do not understand the basic principles of financial reporting.[34] Proposals to address this situation have been made by the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, which was sponsored by the New York Stock Exchange (NYSE), and the National Association of Securities Dealers, whose 1999 report focused on the important role of the board audit committee in providing active and independent oversight.[35] In 2000, the SEC adopted new rules and amendments based in large measure on the recommendations of this committee.[36] Further reforms are receiving

28. SPENCER STUART, SPENCER STUART BOARD INDEX 9 (1999). According to the 1998 proxy statements, ninety-nine percent of U.S. public corporations had compensation committees composed, on average, of only outside directors. KORN/FERRY INT'L, *supra* note 13, at 13–14.

29. SPENCER STUART, *supra* note 28, at 9.

30. KORN/FERRY INT'L, *supra* note 13, at 13.

31. CONFERENCE BD., *supra* note 27, at 22.

32. KORN/FERRY INT'L, *supra* note 13, at 13.

33. SEC Chairman Arthur Levitt, Remarks at the N.Y.U. Center for Law and Business (Sept. 28, 1998), *available at* http://www.sec.gov/news/speech/speecharchive/1998/spch220.txt. For a discussion of earnings management, see Dallas, *supra* note 9, at 1380–82.

34. SEC Chairman Arthur Levitt, *supra* note 33.

35. BLUE RIBBON COMM., *supra* note 25, at 6.

36. Audit Committee Disclosure, Exchange Act Release No. 34-42266, 64 Fed.

considerable national attention as a result of accounting irregularities at Enron and other corporations.[37] The Sarbanes-Oxley Act of 2002, which was passed in the wake of Enron, requires public corporations to have audit committees composed solely of independent directors and to disclose whether at least one member is a "financial expert."[38] The SEC has promulgated regulations on these subjects.[39] In addition, the NYSE has proposed rules to the SEC dealing with the independence, authority, and responsibilities of audit committees.[40] Compensation committees may have difficulty in monitoring executive compensation. This difficulty is arguably reflected in the dramatic recent rise in executive compensation,[41] the increasing use of stock options that may create inappropriate managerial incentives,[42] and the growing differences in levels of compensation of U.S. executives when compared with the compensation of the average employee and corporate executives in other nations.[43] Board nominating committees often do not consider shareholder nominees, which is a serious failing.[44] In its proposed rules, the NYSE requires listed companies to have compensation and nominating board committees, which are to consist solely of

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Reg. 73389, 73390 (Dec. 30, 1999).

37. *See, e.g.*, Fineman & Isikoff, *supra* note 9, at 24.

38. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §§ 301(m)(3)(A), 407(a)–(b), 116 Stat. 745, 775–76, 790 (2002). The Sarbanes-Oxley Act further places responsibilities on corporate officers for financial reports and internal controls for financial reporting. *Id.* §§ 302, 404.

39. *See generally* Standards Relating to Listed Company Audit Committees, Release No. 34-47654, 68 Fed. Reg. 18,788 (Apr. 16, 2003) (to be codified at 17 C.F.R. pts. 228, 229, 240, 249, 274); Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Release No. 34-47235, 68 Fed. Reg. 5110 (Jan. 31, 2003) (to be codified at 17 C.F.R. pts. 228, 229, 249).

40. *See* BLUE RIBBON COMM., *supra* note 25, at 13–14; Self-Regulatory Organizations, Exchange Act Release No. 34-47672, 68 Fed. Reg. 19051 (Apr. 17, 2003) [hereinafter Exchange Act Release No. 34-47672].

41. The mean salaries and bonuses of CEOs rose by 97% between 1980 and 1994, and the mean value of stock options rose by 683%. Brian J. Hall & Jeffrey B. Liebman, *Are CEOs Really Paid Like Bureaucrats?*, 113 Q.J. ECON. 653, 661–62 (1998); *see* KORN/FERRY INT'L, *supra* note 13, at 7 ("Twenty-six percent [of U.S. directors surveyed] feel that CEO compensation is too high, but 50 percent think it is just right and 23 percent think it is generally in line with economic conditions.").

42. Dallas, *supra* note 9, at 1377–83; *see infra* text accompanying notes 65–69.

43. *See* LAWRENCE MISHEL ET AL., THE STATE OF WORKING AMERICA 2002/2003, at 213–15 (2003) (showing that, by 2000, CEOs in major companies earned 310 times more than the average worker and that U.S. CEOs earn more than three times the average of the thirteen other advanced countries studied).

44. CONFERENCE BD., *supra* note 27, at 23.

independent directors, and these rules specify the committees' duties and responsibilities.[45]

C. Other Recent Developments in Board Practices

Increasing sophistication in monitoring is exhibited in recent board developments. A number of public corporations are establishing standing board committees to review corporate governance processes.[46] One survey found that fifty-six percent of responding companies have corporate governance committees.[47] Another study notes: "Increasingly, the corporate governance committee or the full board is appointing the committee chairman and members of the committees of the board with the concurrence of the chairman/CEO, instead of having these appointments made by the CEO alone."[48] A number of boards are also evaluating their own performances and, to a lesser extent, the performances of individual board members.[49] Twenty percent of corporations surveyed evaluate individual directors formally and, as evidence of this emerging norm, seventy-three percent believe that this is a good corporate practice.[50] Independent directors are also meeting separately from the boards to consider matters.[51] This practice goes some distance to counter the social dynamics of boards that can stymie independent decisionmaking.[52]

U.S. corporations have not taken steps to adopt certain proposals for

45. *See* JUNE 6, 2002 REPORT, *supra* note 21, at 9–11; Exchange Act Release No. 34-47672, *supra* note 40.

46. KORN/FERRY INT'L, *supra* note 13, at 6.

47. *Id.* (explaining that the corporate governance committee usually assumes the functions of the nominating committee); *see* CONFERENCE BD., *supra* note 27, at 21.

48. KORN/FERRY INT'L, *supra* note 13, at 6.

49. *Id.* A 1998 survey of U.S. corporate directors showed "139 companies (23 percent of sample) had a formal board evaluation process. However, only 58 companies (9 percent) had an evaluation process for individual board members." CONFERENCE BD., *supra* note 27, at 28.

50. KORN/FERRY INT'L, *supra* note 13, at 8.

51. *Id.* at 24–25. Concerning U.S. corporations:

> [Sixty-nine] percent of the respondents report that their outside directors meet in executive session, other than for compensation matters, without the CEO present. However, this does vary according to type and size of company. While only 56 percent of insurance companies meet in executive session, 75 percent of the largest companies ($20 billion and over) do. Respondents report that such meetings take place three times a year on average.

Id. at 25. The NYSE in its proposed rules proposes that nonmanagement directors meet at "regularly scheduled executive sessions without management." Exchange Act Release No. 34-47672, *supra* note 40, at 19053. The nonmanagement directors include directors who are not independent.
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52. *See* Dallas, *supra* note 4, at 104–11 (discussing the social dynamics that limit outside board members' independence).

improving manager monitoring. They have not appointed independent directors as board chairpersons or as lead directors.[53] Board leadership by independent directors could have a positive effect on the social dynamics of boards.[54] But a 1999 survey of public corporations found that only nine percent of responding corporations had independent director chairpersons, thirty percent had lead directors, and the remaining corporations had no plans to implement either of these reforms.[55]

Another proposal is to limit the number of directorships that a single director may hold.[56] This proposal is designed to ensure that directors have sufficient time to attend to the affairs of the corporation. Few corporations have adopted this proposal,[57] although corporations are increasingly limiting the number of directorships their executive officers may hold.[58] This proposal is problematic to some because it does not guarantee that a director will spend any length of time on corporate affairs and does not take into account that some individuals may prefer to spend their time on board affairs rather than on other pursuits.

A primary responsibility of the board of directors is to appoint the successor to the current CEO. Directors of U.S. corporations believe that improvements are needed in this area. A survey of public directors reveals that "many are critical of the management succession process."[59] But based on 1998 proxy statements, only thirty-two percent of public corporations have management succession committees.[60]

In conclusion, a number of changes have occurred in corporate structures, composition, and practices that are designed to improve the

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53. KORN/FERRY INT'L, *supra* note 13, at 7–8.

54. *See, e.g.*, ROBERT S. BARON ET AL., GROUP PROCESS, GROUP DECISION, GROUP ACTION 73 (1992). *See generally* Susan E. Jackson, *Consequences of Group Composition for the Interpersonal Dynamics of Strategic Issues Processing*, 8 ADVANCES IN STRATEGIC MGMT. 345, 370–71 (1992) (discussing the importance of leadership to group behavior).

55. KORN/FERRY INT'L, *supra* note 13, at 8 (defining independent director chairmen as nonexecutive chairmen who are also not former employees of the corporation).

56. *Id.* at 26–27; *see* NAT'L ASS'N OF CORPORATE DIRS., REPORT OF THE NACD BLUE RIBBON COMMISSION ON DIRECTOR PROFESSIONALISM 12 (1996) (noting the commission's awareness that "CEOs and directors themselves may have concerns about director over-commitment").

57. KORN/FERRY INT'L, *supra* note 13, at 7–8 (listing this proposal as a "lost cause"); CONFERENCE BD., *supra* note 27, at 12.

58. KORN/FERRY INT'L, *supra* note 13, at 26.

59. *Id.* at 7 ("Twenty-three percent [of directors surveyed] say most companies do a poor job, 27 percent say the CEO dominates the process and 30 percent say the board gets involved too late.").

60. *Id.* at 13.

manager-monitoring functions of boards. These reforms include the following: increasing the percentage of outside directors on corporate boards, creating committees composed predominantly of outside directors that specialize in important subjects requiring objective assessments, having outside directors meet separately from the entire board, decreasing the CEO's control over the appointment of board and committee members, and encouraging the review of board and board members' performance. But more attention needs to be focused on the subject of whether outside directors are truly independent. For example, as the facts are coming to light about Enron, it appears that many outside directors were not independent, but were benefiting from various kinds of financial relationships with Enron.[61] In addition, attention needs to be given to board leadership through independent chairpersons or independent lead directors and to the methods by which independent directors are kept informed of important issues concerning the corporation. For example, Enron directors claim that they were unaware of Enron's accounting problems.[62] This claim would be much harder to maintain had independent directors appointed a corporate ombudsperson to keep them informed.

III. DEVELOPMENTS IN THE RELATIONAL MONITORING BY U.S. BOARDS OF DIRECTORS

United States boards of directors are not limited to performing manager monitoring; they also perform relational monitoring. Relational monitoring addresses the corporation's substantial environmental uncertainties. The corporation obtains access to information, advice, support, and legitimacy by furthering relationships with stakeholders through board memberships.

A. Shareholders

An important relationship to the corporation is its relationship with its shareholders. A 1999 study reports a "cultural change" in the last few years within the United States with respect to the relationship between shareholders and the boards of directors of public corporations, which "correspond[s] to a growing awareness by board members of their duty to properly represent the shareholders who elected them as directors."[63]

61. *See* Christopher H. Schmitt et al., *One Cozy Bunch*, U.S. NEWS & WORLD REP., Feb. 11, 2002, at 28.
62. Mark Babineck, *Enron Debacle Exposes Board Conflicts*, NORTH COUNTY TIMES, Feb. 17, 2002, *available at* http://www.nctimes.net/news/2002/20020217/60100.html.
63. KORN/FERRY INT'L, *supra* note 13, at 5.

Given that the prevailing legal theory provides that directors should operate corporations to benefit shareholders, this change in culture may seem mysterious. Managerialism has predominated, however, as the mode of governance of U.S. public corporations. Although substantial attention has been given in the past to ensuring the professionalism of managers, the operative goals of the corporation have been largely undefined. The increasing power of institutional shareholders has changed the culture in which corporations operate today.[64] Armed with the formal legal doctrine of shareholder primacy, institutional shareholders are currently pressuring directors to specify how the directors' decisions serve the shareholders' interests.

In this vein, attempts are being made to align the interests of directors with those of shareholders. A recent trend is to compensate outside directors, in whole or in part, with stock or stock options in order to align the outside directors' financial interests with those of shareholders.[65] One study shows that eighty-eight percent of companies offered stock compensation in 1998, compared with only thirty-three percent in 1990.[66] Unfortunately, it is becoming increasingly apparent that stock options do not align the interests of directors and shareholders. Because accounting rules do not require stock options to be recognized as expenses, corporate profits reported to shareholders are inflated.[67] These accounting rules also encourage the issuance of large amounts of options. Eventually, corporate resources are diverted from real investments to share repurchases in order to satisfy the options once they are exercised.[68] In addition, compensation with stock options encourages "earnings management," or the manipulation of reported financial results to affect stock prices; Enron is an example of the damage that earnings management can cause.[69]

64. *See* Dallas, *supra* note 9, at 1373–76.

65. KORN/FERRY INT'L, *supra* note 13, at 5.

66. CONFERENCE BD., *supra* note 27, at 32. Based on 1998 proxy statement data, 84% of U.S. public corporations compensated directors with some form of stock, as compared to 78% in 1997 and 62% in 1995. KORN/FERRY INT'L, *supra* note 13, at 18.

67. *See* Matthias Benz et al., Are Stock Options the Managers' Blessing? Stock Option Compensation and Institutional Controls 5–6 (rev. version 2001) (unpublished Ph.D. dissertation, Inst. for Empirical Research in Econ., Univ. of Zurich), *available at* http://papers.ssrn.com; Dallas, *supra* note 9, at 1379–80; Daniel Murray, *Employee Stock Options: The Fed Joins In*, Report No. 142, at 1, 13 (2000), *available at* http://www.smithers.co.uk/aboutreports.shtml.

68. Daniel A. Bens et al., *Real Investment Implications of Employee Stock Option Exercises*, 40 J. ACCT. RES. 359, 360 (2002), *available at* http://papers.ssrn.com; Dallas, *supra* note 9, at 1380.

69. SEC Chairman Arthur Levitt, *supra* note 33 (discussing earnings management).

B. Diversity on Corporate Boards

The role of the board in providing an avenue for shareholders to influence the corporation is consistent with the formal view of the corporation as intended to further shareholder interests.[70] However, competing views of the corporation are found in both case law and commentary. For example, Adolph Berle and E. Merrick Dodd, in their famous debate in the 1930s, considered the significance of the separation of control from ownership that results from the ownership of shares by dispersed, public shareholders.[71] Berle and Dodd ultimately agreed that the corporation was not only a profit-making entity, but also an institution with social responsibilities.[72] Dodd claimed that "business is permitted and encouraged by the law primarily because it is of service to the community rather than because it is a source of profit to its owners."[73] Case law supports the existence of a fiduciary duty of directors to the corporate entity as distinct from its shareholders.[74] Under this conception of fiduciary duty, directors are trustees for the corporation and arguably for the stakeholders who comprise it. In more recent years, this view has been codified in a number of constituency (stakeholder) statutes enacted in over one-half of the states in the United States. These statutes permit directors to take into account in their decisionmaking the interests of stakeholders, at least in tender offer situations.[75] Moreover, in the important corporate law state of Delaware, which does not have a constituency statute, the Delaware Supreme Court has stated that directors may take into account the interests of

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See generally Dallas, *supra* note 9, at 1380–82.

70. Lynne L. Dallas, *Two Models of Corporate Governance: Beyond Berle and Means*, 22 U. MICH. J.L. REFORM 19, 95–96 (1988) (describing the relationship between the corporation and shareholders as one of informal or formal cooptation).

71. *Compare* A.A. Berle, Jr., *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365 (1932), *with* E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932) [hereinafter Dodd, *Corporate Managers*], *and* E. Merrick Dodd, Jr., *Is Effective Enforcement of the Fiduciary Duties of Corporate Managers Practicable?*, 2 U. CHI. L. REV. 194 (1934).

72. *See* ADOLF A. BERLE, JR., THE 20TH CENTURY CAPITALIST REVOLUTION 166–69 (1954); *see also* Adolf A. Berle, *Corporate Decision-Making and Social Control*, 24 BUS. LAW. 149, 150 (1968).

73. Dodd, *Corporate Managers*, *supra* note 71, at 1149.

74. *See* Jackson v. Hooper, 75 A. 568, 571 (N.J. 1910) (stating that "the corporation itself is an entity wholly separate and distinct from the individuals who compose and control it"); McQuade v. Stoneham, 189 N.E. 234, 238 (N.Y. 1934) (Lehman, J., concurring); *see also* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 293–94 (1999); Thomas A. Smith, *The Efficient Norm for Corporate Law: A Neotraditional Interpretation of Fiduciary Duty*, 98 MICH. L. REV. 214, 243 & n.70 (1999).

75. *See* James J. Hanks, Jr., *Playing with Fire: Nonshareholder Constituency Statutes in the 1990s*, 21 STETSON L. REV. 97, 97 (1991).

employees, consumers, and other stakeholders in making decisions as long as these decisions have a mere rational relationship to furthering a shareholder interest.[76]

In addition, there is increasing interest by U.S. public corporations in having corporate boards represent the interests of a diverse society.[77] This development arguably represents recognition of the value of stakeholder capitalism, although the discussion among directors and other businesspersons proceeds emphatically in the traditionally acceptable context of enhancing shareholder value. One study of board best practices, which is based on the opinions of working groups of corporate executives, investors, and directors throughout the United States, found that "diversity is [considered] a key part of good governance."[78] Diversity was defined to include diversity in terms of gender, race, and cultural diversity as companies become international.[79] The study reports considerable consensus among the working groups that there are substantial economic arguments in favor of diversity on corporate boards as "companies broaden the scope of what they consider relevant to creating shareholder value to include things like workplace practices and customer satisfaction."[80]

A substantial number of directors, particularly of the largest corporations, consider it important to have minority representation on the board. The reason is "to better reflect the changing marketplace and the growth in minority market segments."[81] Service industries, such as

76. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985).

77. For an extended discussion of the significance of this development, see Dallas, *supra* note 9, at 1383–85.

78. CONFERENCE BD., *supra* note 27, at 3 (stating that the diversity focus does not change the board's obligations as fiduciaries to represent all shareholders, "but rather helps a board fulfill its duties and mission").

79. *Id.* at 7.

80. *Id.* The report states that "[s]hareholder value is strengthened when intangibles such as diversity, workplace practices, and customer satisfaction permeate a company." *Id.* at 3.

81. KORN/FERRY INT'L, *supra* note 13, at 13. According to 1998 proxy statements, 60% of public corporations have ethnic minorities on their boards: 39% of the companies have African Americans on their boards, 12% have Latino directors, and 9% have Asian directors. *Id.* at 11–12; *see also* SPENCER STUART, *supra* note 28, at 6. Ethnic minorities account, however, for only 6% of Fortune 500 company directors. KORN/FERRY INT'L, *supra* note 13, at 11. Based on a survey of directors, 29% of U.S. companies plan to increase the numbers of African American directors, 14% plan to increase the number of Latino directors, and 10% plan to increase the number of Asian directors. *Id.* at 12–13. Minorities are also underrepresented in the executive suite. Dan R. Dalton & Catherine M. Daily, *The Other Ceiling*, ACROSS THE BOARD, Nov./Dec. 1998, at 19. Moreover,

the motel, restaurant, telephone, and airline industries, which have substantial minority employees, are found to have more minority representation on boards, indicating a labor stakeholder orientation.[82] In addition, there is substantial support for having women on corporate boards to perform relational functions.[83] James Preston, retired CEO of Avon Products, stated that because "60% of all purchases in this country are made by women, having women on the board just makes good business sense."[84] Having women on boards also permits the corporation to send important signals to current female managers and potential recruits.[85]

The fact that minorities and women on boards contribute to the performance of all board roles should not be overlooked. For example, the consideration of women and minorities permits the corporation to take advantage of the full range of intellectual capital available to it.[86] As one CEO of a Fortune 1000 company said of women: "When you open positions to both sexes, you double the number of people in the top 10, or in the top 1% of ability in the marketplace."[87] Moreover, one study found that women are not "token" directors, but are on the boards because of their business expertise and access to information and

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minority women of color are underrepresented in the managerial labor force when compared with their participation in the total labor force. Margaret Blackburn White & Joseph Potts, *Just the Facts: Women of Color in U.S. Corporations*, DIVERSITY FACTOR, Spring 1999, at 8.

82. Gerald E. Fryxell & Linda D. Lerner, *Contrasting Corporate Profiles: Women and Minority Representation in Top Management Positions*, 8 J. BUS. ETHICS 341, 345 (1989).

83. Unlike the glass ceiling women have reached in seeking to enter the executive suite, *see* CONFERENCE BD., *supra* note 27, at 26, women have made slow, yet steady progress in the boardroom. The number of Fortune 500 companies with one or more women on their boards increased from 69% in 1993 to 86% in 1998. *Id.* at 16–17. This represents an increase in the percentage of total board seats held by women from 8.3% in 1993 to 11.1% in 1998 (percentages vary by industry). *Id.* at 17; *see also* KORN/FERRY INT'L, *supra* note 13, at 11; SPENCER STUART, *supra* note 28, at 6. Larger companies tend to have more women on their boards. CONFERENCE BD., *supra* note 27, at 18 (showing that corporations located in the U.S. Northeast also tend to have more women on their boards). The percentage of Fortune 500 companies with more than one woman director increased from 29.2% in 1993 to 37.6% in 1998, with 6.8% of such companies in 1998 having three or more women directors. *Id.* at 17. Bilimoria says, "Although 85 percent of the CEOs considered it important to have female directors, 48 percent found female candidates 'difficult to identify,' and cited this as a reason for current low levels of female directorships." Diana Bilimoria, *Women Directors: The Quiet Discrimination*, CORPORATE BOARD, July/Aug. 1995, at 10. There currently is no consensus on whether qualified women are available to increase the number of women on corporate boards. *See* Donna Dillon Manning, *Women Directors: A CEO Priority*, DIRECTORS & BOARDS, Spring 1995, at 19, 21.

84. Catherine M. Daily et al., *A Decade of Corporate Women: Some Progress in the Boardroom, None in the Executive Suite*, 20 STRATEGIC MGMT. J. 93, 94 (1999).

85. *Id.* at 94–98.

86. *Id.* at 96–97.

87. Manning, *supra* note 83, at 20.

resources the corporation requires.[88] The percentage of female outside directors with corporate backgrounds rose from 13.3% in 1987 to 37.6% in 1996, twelve years later.[89] Moreover, the percentage of women serving as outside directors who represent organizations that provide services to the corporation rose from 13.3% in 1987 to 32.6% in 1996.[90]

Some studies have examined whether there are sex-based biases in the appointment of women directors to board committees. A study based on 1983 data found sex-based biases in committee assignments, even after controlling for experience-based characteristics.[91] This study observed that female directors were as qualified as, if not better qualified than, their male counterparts on most characteristics examined. Women were favored over men for public affairs committee memberships, and men were favored over women for the more powerful compensation and executive committees.[92] But this data is outdated, and the small number of female directors makes reliance on this study, as well as on studies attempting to link the presence of female or minority directors to corporate performance, problematic.

A survey of corporate directors found that twenty percent of directors expressed the desire to add foreign directors to their boards "to enhance their global perspective."[93] Although time and distance barriers exist to having non-U.S. directors on corporate boards, these barriers are being overcome by fewer, but possibly longer, board meetings and video teleconferencing.[94] A study of global corporations found that the corporations that added foreign directors to their boards did so to acquire an in-depth understanding of new markets, to comprehend a new customer base, to deal with the demands of international investors, and to gain credibility in certain capital markets or political environments.[95]

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88. Daily et al., *supra* note 84, at 96–97.
89. *Id.* at 96.
90. *Id.*
91. Bilimoria & Piderit, *supra* note 22, at 1469–70. *But see* Idalene F. Kesner, *Directors' Characteristics and Committee Membership: An Investigation of Type, Occupation, Tenure, and Gender*, 31 ACAD. MGMT. J. 66, 70 (1988).
92. Bilimoria & Piderit, *supra* note 22, at 1464–65. Women directors of U.S. companies are most likely to be on audit and social/corporate responsibility committees (14% and 15%, respectively) and are least likely to be on executive committees (6%). They are most likely to chair social or corporate responsibility committees (21%). CONFERENCE BD., *supra* note 27, at 30.
93. SPENCER STUART, *supra* note 28, at 5.
94. *Id.* at 7.
95. CONFERENCE BD., GLOBALIZING THE BOARD OF DIRECTORS: TRENDS AND STRATEGIES 15 (1999).

The discussion concerning board diversity in the United States takes place in the context of improving corporate returns for shareholders. Shareholders, including institutional investors, have been active in using the corporate proxy machinery to further diversity within the company, including on boards. Shareholder board diversity proposals at Cypress Semiconductor and American Power Conversion have received supporting votes as high as 43.8% and 30.1%, respectively.[96] Although business leaders indicate little support for having constituency or special interest directors on boards,[97] the issues focused on for improving returns to shareholders include stakeholder concerns, such as workplace practices and customer satisfaction.[98] Corporations with diverse boards are expected to have greater sensitivity to these stakeholder issues;[99] thus, diverse boards enable these corporations to more effectively relate to their socioeconomic environment. Boards also perform other relational roles that facilitate the corporations' interactions with their environment. Corporations benefit from understanding their legal and financial environment and supplier markets. Between 1970 and 1980, twenty-six percent of board members were financiers, consultants, legal counsel, and directors employed by related businesses.[100]

In summary, boards perform various relational roles by having persons on their boards who assist the corporations in dealing with environmental uncertainties. These persons lend legitimacy to the corporations and help the corporations in their operations by, among other things, assisting the corporation in effectively relating to shareholders and various other corporate stakeholders.

96. Susan Williams, 2001 Background Report E, Board Diversity 2–3 (Feb. 12, 2001) (unpublished manuscript, on file with author).

97. *Id.* at 9–10; NAT'L ASS'N OF CORPORATE DIRS., *supra* note 56, at 11–12.

98. CONFERENCE BD., *supra* note 27, at 9; *see also* Manning, *supra* note 83, at 19, 21 (noting that in a survey of over one-third of the CEOs of Fortune 1000 companies, the following percentages of CEOs sought to have women directors to (1) "exemplify commitment to diversity to shareholders" (60%), (2) "exemplify commitment to advancing women" (59%), (3) "enhance the ability to recruit and retain women" (46%), (4) "initiate discussions about issues that affect female employees" (29%), (5) "reflect female consumers' perspectives" (26%), and (6) "contribute a perspective different from those of male directors" (49%)).

99. For example, one report observes that issues like family life and flexible work arrangements are given greater prominence in companies that attract both female executives and female board members. CONFERENCE BD., *supra* note 27, at 8, 27 (stating that the Executive Leadership Council proposes that companies conduct a self-audit, which would include making "key stakeholder evaluations").

100. Baysinger & Butler, *supra* note 1, at 113.

IV. ROLES OF CORPORATE BOARDS: THEORIES AND EMPIRICAL STUDIES

The board of directors is expected to perform a number of functions. This has confounded the empirical literature on corporate boards and has made it difficult to find definitive answers concerning principles of board composition, structure, and process. This Section explores board theories and empirical findings on corporate board functioning.

A. Manager Monitoring and the Shareholder-Relational Role of Corporate Boards

Agency cost theory, originating in research in finance and economics, explains that corporate boards are used to reduce agency costs, which are "costs imposed on the principal [shareholders] when an agent with discretionary authority [management] takes actions to help himself, rather than the principal."[101] Boards of directors are intended to ensure that managers act in the interests of shareholders rather than in their own personal interests.[102] This theory embraces the manager-monitoring and the shareholder-relational roles of boards. Manager monitoring is intended to curtail managerial self-dealing, negligence, and the lack of professionalism on the part of management in attending to the affairs of the corporation. Boards mediate the relationship between corporate shareholders and management by providing the appropriate oversight and incentives for management to protect the interests of shareholders.

Three agency cost theories are offered that are relevant to board composition. The first theory focuses on the importance of outside directors to effective manager monitoring. According to this theory, the board performs manager monitoring primarily by providing a forum for competition among top managers for the top management position.[103] The outside directors on the board "act as arbiters in disagreements

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101. LARRY RIBSTEIN & PETER V. LETSOU, BUSINESS ASSOCIATIONS § 1.02, at 4 (3d ed. 1996).

102. *See* Rita D. Kosnik, *Greenmail: A Study of Board Performance in Corporate Governance*, 32 ADMIN. SCI. Q. 163, 167–68 (1987); Shaker A. Zahra & John A. Pearce II, *Boards of Directors and Corporate Financial Performance: A Review and Integrative Model*, 15 J. MGMT. 291, 301 (1989).

103. Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 293 (1980); *see also* Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 314–15 (1983) (describing the board as a "top-level court of appeals of the internal agent [labor] market").

among internal managers,"[104] rank internal managers,[105] and provide appropriate incentives for managers to act in the interests of shareholders.[106] This agency cost theory relies on outside directors to evaluate competing executives and suggests that a mix of both inside and outside directors on boards enhances board performance.

The second, more recent agency cost theory focuses on the role of inside directors in monitoring the CEO directly, without the outside directors playing a role.[107] This agency cost theory, referred to in this Article as the "managerial-incentive theory," claims that inside directors are superior to outside directors in evaluating CEOs. According to this theory, because of their superior access to information concerning strategic decisionmaking by CEOs, inside directors are better at evaluating CEOs and providing them with appropriate incentives to engage in strategic risk taking.[108] This theory recommends an insider-dominated board for more effective manager monitoring.

The third agency cost theory is called the "substitute" hypothesis. This theory claims that manager monitoring by corporate boards may, in certain situations, be less cost-effective than other forms of corporate monitoring, in which case these other forms of monitoring will substitute for corporate board manager monitoring.[109] For example, it is argued that, in certain industries, stock ownership by managers,[110] increased corporate leverage,[111] and increased dividend payouts[112] will provide

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104. Fama & Jensen, *supra* note 103, at 315.
105. *Id.* at 314.
106. *Id.*; *see also* Fama, *supra* note 103, at 293.
107. Barry Baysinger & Robert E. Hoskisson, *The Composition of Boards of Directors and Strategic Control: Effects on Corporate Strategy*, 15 ACAD. MGMT. REV. 72, 73–74 (1990).
108. *See infra* text accompanying notes 154–57.
109. See Chenchuramaiah T. Bathala & Ramesh P. Rao, *The Determinants of Board Composition: An Agency Theory Perspective*, 16 MANAGERIAL & DECISION ECON. 59, 59–60 (1995); James A. Brickley & Christopher M. James, *The Takeover Market, Corporate Board Composition, and Ownership Structure: The Case of Banking*, 30 J.L. & ECON. 161, 162 (1987).
110. Bathala & Rao, *supra* note 109, at 62, 63, 66. *But see* Benjamin E. Hermalin & Michael S. Weisbach, *The Determinants of Board Composition*, 19 RAND J. ECON. 589, 594 (1988) (containing findings that contradict the predictions of the substitute hypothesis when family directors are considered).
111. Bathala & Rao, *supra* note 109, at 62, 63, 66. *But see* John A. Pearce II & Shaker A. Zahra, *Board Composition from a Strategic Contingency Perspective*, 29 J. MGMT. STUD. 411, 421 (1992) (discussing the findings of a positive relationship between increased proportions of outside directors on corporate boards and increased leverage); Jeffrey Pfeffer, *Size and Composition of Corporate Boards of Directors: The Organization and Its Environment*, 17 ADMIN. SCI. Q. 218, 224 (1972) (finding an inverse relationship between higher debt/equity ratios and the proportion of inside directors on corporate boards).
112. Bathala & Rao, *supra* note 109, at 62, 63, 66. *But see* Michael H. Schellenger et al., *Board of Director Composition, Shareholder Wealth, and Dividend Policy*, 15 J.

managers with appropriate incentives, thus negating the need for manager monitoring by corporate boards of directors. Thus, according to the substitute hypothesis, no general recommendation applicable to all corporations is appropriate concerning the composition of corporate boards.

The first agency cost theory, which predicts a reduction of agency costs by the presence of outside directors on corporate boards, has been tested in studies examining situations where managers have conflicts of interest with shareholders.[113] These studies try to test the ability of outside directors to engage in effective manager monitoring, although the studies do not determine whether this monitoring occurs through the outside directors' observation of competition among inside directors.[114] Empirical studies test the relationship between the proportion of outside directors on corporate boards and the adoption of antitakeover devices, which are presumed to be harmful to shareholders but beneficial to managers.[115] These studies report mixed results.[116] These results are not surprising, however, because whether these antitakeover devices operate to benefit or harm shareholders depends on the context in which they are used. In addition, studies on the relationship of the proportion of outside directors on corporate boards and the level of executive compensation report inconsistent findings.[117] Levels of executive compensation, however, are arguably more a reflection of industrial norms and market constraints than the manager-monitoring capability of individual boards.[118] Studies on executive turnover may be more reflective of the benefits of outside directors on corporate boards. These studies have

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MGMT. 457, 465 (1989) (giving support that the substitution hypothesis is not confirmed regarding the relationship between the proportion of outside directors on the board and dividend payouts).

113. *See* studies cited *infra* notes 116, 117, 119.

114. *Id*.

115. *See* studies cited *infra* note 116.

116. Kosnik, *supra* note 102, at 167; *see* Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U. L. REV. 898, 932–36, 962 (1996); Paul Mallette & Karen L. Fowler, *Effects of Board Composition and Stock Ownership on the Adoption of "Poison Pills*,*"* 35 ACAD. MGMT. J. 1010, 1010, 1023–25, 1028–30 (1992); Paula L. Rechner et al., *Corporate Governance Predictors of Adoption of Anti-Takeover Amendments: An Empirical Analysis*, 12 J. BUS. ETHICS 371, 371 (1993).

117. Brickley & James, *supra* note 109, 163, 177–80; *see* Hamid Mehran, *Executive Compensation Structure, Ownership, and Firm Performance*, 38 J. FIN. ECON. 163, 180 (1995).

118. *See generally* John M. Bizjak et al., Has the Use of Peer Groups Contributed to Higher Levels of Executive Compensation? (Dec. 11, 2000) (unpublished manuscript), http://ssrn.com/abstract=252544.

more consistently found a positive relationship between the proportion of outside directors on corporate boards and executive turnover.[119] But a problem with many of these studies is that they fail to differentiate between independent and nonindependent outside directors. The outside directors studied often include directors who have business relationships with the corporation and directors who may have significant social relationships with the CEO.

In addition, the independence of outside directors is diminished when outside directors serve on boards with inside directors. Psychological studies on group behavior indicate that members of groups operate under social pressures that encourage conformity to the group, or lack of objectivity.[120] Studies also show "a correlation between the capacity to exert influence and one's position in a hierarchical social structure."[121] CEOs often assume the leadership positions on boards. CEOs, particularly as board chairpersons, exert considerable influence over outside board members. Thus, the structure of corporate boards does not support independence on the part of outside directors. Therefore, it is not surprising that studies often do not find differences in boards when additional outside directors are added. Some outside directors do exercise more independence than others, and the dominance of these directors on important board committees may have positive effects. However, the socialization process of board group memberships often robs these directors of much-needed independence. It is also important to point out that empirical literature is further confounded by those situations where nonindependent outside directors have interests that are negatively affected by managerial self-dealing or negligence. In those situations, nonindependent directors have incentives to effectively monitor management.

The second agency cost theory, the managerial-incentive theory, is discussed later in this Article.[122] The third theory, the substitute hypothesis, which predicts that agency cost reduction methods may substitute for having outside directors on corporate boards, has received, at most, moderate empirical support.[123] There are inconsistent findings relating to the proposition that increased leverage, high dividend payouts, and stock ownership substitute for outside directors on corporate boards.[124]

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119. *E.g.*, Lin, *supra* note 116, at 962; Michael S. Weisbach, *Outside Directors and CEO Turnover*, 20 J. FIN. ECON. 431 *passim* (1988).

120. Dallas, *supra* note 4, at 108–11.

121. JOHN C. TURNER, SOCIAL INFLUENCE 131, 136–41 (1991).

122. *See infra* Part V.B.

123. *See supra* notes 109–12.

124. *Id.*

B. The Broad Relational Roles of Corporate Boards

This Section introduces the resource dependence theory, which explains the relational role of corporate boards. This theory, grounded in sociology and organizational behavior theory, explains that corporations seek to decrease uncertainty by gaining access to needed resources, tangible and intangible, through board memberships.[125] Outside board members permit the corporation to do the following: (1) coordinate with its external environment, (2) obtain advice and access to information from directors with differing backgrounds, skills, and networks, (3) enhance the support, status, and legitimacy of the corporation in the eyes of relevant audiences, and (4) effectuate monitoring of the strategic direction of the corporation.[126] Inside directors perform similar functions for the corporation by reflecting the views and diverse interests of various departments and functional units within the corporation itself. Thus the board, according to resource dependence theory, is used as a "bridging strategy"[127] or "boundary scanning"[128] device that enables the corporation to mediate its relationships with various stakeholders and others who comprise its external and internal environment. According to the resource dependence perspective, women, minority, and foreign directors provide advice, support, enhanced status, and legitimacy to the corporation's operations. These functions may also be provided by having bankers, environmentalists, major suppliers, and customers on corporate boards. Thus, "because of their prestige in their professions and communities, directors are able to extract resources for successful company operations. . . . [T]hese activities are believed to enhance the firm's legitimacy in society and to help it achieve goals of efficiency and improved performance."[129]

125. Catherine M. Daily & Charles Schwenk, *Chief Executive Officers, Top Management Teams, and Boards of Directors: Congruent or Countervailing Forces?*, 22 J. MGMT. 185, 191–94 (1996); Dallas, *supra* note 70, at 91–94; Pearce & Zahra, *supra* note 111, at 417–18; Zahra & Pearce, *supra* note 102, at 297–99.

126. Daily & Schwenk, *supra* note 125, at 190–91, 194, 196; Dallas, *supra* note 4, at 102; Lynne L. Dallas, *The Relational Board: Three Theories of Corporate Boards of Directors*, 22 J. CORP. L. 1, 12–13 (1996); Zahra & Pearce, *supra* note 102, at 297–99.

127. Dallas, *supra* note 70, at 91–94; Zahra & Pearce, *supra* note 102, at 297.

128. Daily et al., *supra* note 84, at 95.

129. Zahra & Pearce, *supra* note 102, at 297. The singular focus on the managerial-monitoring function of corporate boards in the U.S. legal academy has tended to downplay the important relational roles that boards perform. Professor Eisenberg has argued that corporations may gain access to resources, such as advice, information, and

Resource dependence theory also explains the two-way relationship represented by board memberships.[130] The corporation benefits from the abilities of relational board members. Internal and external interests also benefit because relational directors are able to influence the corporation. For example, a woman on the board may influence the corporation to consider human resource issues of particular concern to women. A banker or lawyer may influence the amount of corporate attention directed to financial or regulatory concerns. Inside directors employed by foreign divisions or sales divisions of the corporation may gain attention for the needs of their divisions. An important factor in determining the ability of these board members to influence corporations is the perceived dependence of the corporations on the resources provided by these members, which perception in turn is influenced by the board members themselves.[131]

Related to the resource dependence theory is the strategic contingency perspective, which explains that a corporation's environment, strategy, and past performance are strategic contingencies facing the corporation. Board composition reflects these strategic contingencies, which are important to the corporation's effectiveness and survival.[132] Studies have shown that corporations that utilize board memberships to acquire resources for the corporation enhance their performance.[133] For example, in the nonprofit sector, positive associations have been found between board composition and the ability of nonprofit agencies to raise

legitimacy, by means other than board memberships. *See* EISENBERG, *supra* note 19, at 157–58. But board members provide the corporation with relevant advice and information on a continuing basis due to their membership on the board, thus providing the corporations with assistance as their circumstances change. Moreover, the information is provided in a setting where joint deliberation is possible and where all members possess fiduciary duties to act in the best interest of the corporation. Furthermore, many outside board members are CEOs of other corporations and would not provide resources to the corporation if they were not board members. CEOs' acceptance of board memberships as opposed to independent consulting contracts is a socially acceptable way for CEOs to interact with corporations other than their own. Also, the lure of board memberships to CEOs is not the opportunity to provide independent advice, but more the experience of interacting with other knowledgeable individuals on business problems and the prestige associated with board memberships. KORN/FERRY INT'L, 22ND ANNUAL BOARD OF DIRECTORS STUDY 31 (1995); *see also* JAY W. LORSCH & ELIZABETH MACIVER, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS 23–30 (1989); Cox & Munsinger, *supra* note 20, at 96–97.

130. *See* Dallas, *supra* note 70, at 92–97.

131. *See* JEFFREY PFEFFER & GERALD R. SALANCIK, THE EXTERNAL CONTROL OF ORGANIZATIONS: A RESOURCE DEPENDENCE PERSPECTIVE 43, 53 (1978); JAMES D. THOMPSON, ORGANIZATIONS IN ACTION 31 (1967); Richard M. Emerson, *Power-Dependence Relations*, 27 AM. SOC. REV. 31, 32 (1962); David J. Hickson et al., *Organization as Power*, *in* 3 RESEARCH IN ORGANIZATIONAL BEHAVIOR 151, 159–60 (L.L. Cummings & Barry M. Staw eds., 1981).

132. Pearce & Zahra, *supra* note 111, at 415.

133. *See* Zahra & Pearce, *supra* note 102, at 297–99.

funds.[134] In a study of eighty corporations, deviations from an optimal ratio of inside to outside directors were related to poor performance.[135] Moreover, in a survey of the CEOs of 119 Fortune 500 corporations, environmental uncertainty was found to be related to the proportion of outside directors on corporate boards.[136] Uncertainties respecting a corporation's customers, competitors, suppliers, technology, as well as the corporation's economic and political circumstances, were considered.[137] The authors concluded that having higher proportions of outside directors on corporate boards was a viable way of "co-opting the environment and reducing uncertainty surrounding strategy development and execution."[138]

C. The Strategic Roles of Corporate Boards

A board of directors' manager-monitoring and relational functions concerning corporate strategy include the following: (1) involvement in setting the corporation's overall goals or missions, (2) overseeing and setting guidelines for the development and implementation of corporate strategy, (3) pointing out strategic opportunities and issuing warnings about environmental threats, and (4) evaluating senior executives with regard to their choices of strategic initiatives and implementation of strategic choices.[139] These manager-monitoring and relational functions concerning corporate strategy are more specifically referred to as "strategic monitoring." More controversial is whether the board should also engage in "strategic management," that is, in the actual development and implementation of corporate strategy.[140] Although particular situations may warrant a board's involvement in strategic management, such involvement at the very least duplicates corporate management's responsibilities, with all the attendant problems that duplication entails. There are advantages in having management perform strategic management functions because of the amount of time that management has to devote

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134. *See* Keith G. Provan, *Board Power and Organizational Effectiveness Among Human Service Agencies*, 23 ACAD. MGMT. J. 221, 226–27 (1980); Mayer N. Zald, *Urban Differentiation, Characteristics of Boards of Directors, and Organizational Effectiveness*, 73 AM. J. SOC. 261, 268 (1967).
135. Pfeffer, *supra* note 111, at 226.
136. Pearce & Zahra, *supra* note 111, at 418, 423.
137. *Id.* at 425.
138. *Id.* at 432.
139. Zahra & Pearce, *supra* note 102, at 301–02.
140. Kenneth R. Andrews, *Directors' Responsibility for Corporate Strategy*, HARV. BUS. REV., Nov.–Dec. 1980, at 30.

to such efforts and because of managerial expertise. Moreover, separating strategic management and monitoring functions creates a structure designed to enhance accountability.

According to the resource dependence theory, directors are boundary scanning agents who have access to important information that enables them to assist corporations in setting goals, embracing opportunities, and avoiding threats.[141] Moreover, as agency cost theory points out, the monitoring of managerial performance requires attention to corporate strategy, including overseeing and evaluating the development and implementation of corporate strategy by executive officers. Thus, the manager-monitoring and relational board functions involve corporate strategy. Boards also perform a third role when they perform strategic management functions.

A recent survey of over one thousand directors of large U.S. corporations indicates that corporate boards are becoming increasingly active in strategic monitoring and possibly in strategic management.[142] This survey found that:

> Over 40 percent of our respondents say their boards spend considerable time on strategy and over 60 percent contend that they are deeply involved in the strategy-setting process. Surprisingly, 54 percent say they participate in an annual retreat or special planning session. And a very strong 80 percent believe that their boards have sufficient and relevant expertise to evaluate strategic options. Again, we recognize that there are many companies that leave the strategic planning function almost exclusively to the CEO as part of the management process, but our respondents strongly suggest that it is the board's responsibility to become involved in both the setting and the review of strategic goals.[143]

The answer to a specific question by these respondents indicates that boards mainly perform strategic monitoring functions. In this question, the respondents were asked to choose the statement that best describes their board's role concerning corporate strategy: (1) "Reviews strategy after it is developed," (2) "Helps develop the strategy," or (3) "Plays no role." Over sixty percent of the respondents chose the first answer, indicating that their boards review strategy after it is developed, which means that their boards perform strategic monitoring rather than strategic management functions.[144]

D. Rejection of Service, Strategy, and Control as Descriptions of Board Roles

While this Article describes board roles as manager-monitoring, relational,

141. *See supra* text accompanying notes 125–29.
142. KORN/FERRY INT'L, *supra* note 13, at 6–7.
143. *Id.*
144. *Id.* at 41 tbl.36.

and possibly strategic management, some organizational literature refers to board roles as service, strategy, and control.[145] However, the latter categorization of board roles is problematic. For example, the service role of boards is defined as "enhancing company reputation, establishing contacts with the external environment, and giving counsel and advice to executives."[146] These functions are explained by the resource dependence perspective on corporate boards, but the service depiction of these functions neglects the two-way nature of the resource dependence perspective. The service depiction does not consider the fact that board members not only provide services, but also obtain opportunities to influence the corporation through board memberships. These service and influence functions are more appropriately referred to as the relational role rather than the service role of boards.

In addition, the control role is subsumed within manager-monitoring and relational functions and is a misleading description of board functions. Although the board has the legal power to control the corporation, at most it monitors the corporation and influences corporate policy; control is primarily in the hands of management. This reality is reflected in provisions of state statutes on board responsibilities and in the more recent recommendations of the American Law Institute's Principles of Corporate Governance, which separately specify the control functions of management and the monitoring functions of boards.[147] Finally, the strategy role of boards is potentially quite broad and may encompass strategic monitoring and strategic management. While the manager-monitoring and relational roles cover the former function, they do not necessarily cover the latter. Thus, if boards perform or ought to perform strategic management functions, there is a third role of boards, which is more accurately called the strategic management role. Categorizing the board roles as monitoring, relational, and possibly strategic management is, therefore, more accurate and helpful than describing board roles as service, control, and strategy.

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145. *E.g.*, Zahra & Pearce, *supra* note 102, at 298.

146. *Id.* at 292. These functions have also been referred to as "institutional" functions, whereby "boards help to link the organization to its external environment and secure critical resources, including prestige and legitimacy." Jerry Goodstein et al., *The Effects of Board Size and Diversity on Strategic Change*, 15 STRATEGIC MGMT. J. 241, 241 (1994).

147. *E.g.*, DEL. CODE ANN. tit. 8, § 141(a) (2001) (providing that the business of every corporation "shall be managed by *or under the direction of* a board" (emphasis added)); 1 AM. LAW INST., *supra* note 21, §§ 3.01, 3.02 (1994).

V. Research on Outside Directors and the Multiple Roles of Corporate Boards

The empirical literature has been mixed on whether there is a positive, a negative, or no relationship between inside/outside board member composition and corporate performance.[148] However, one meta-analysis of such studies found a curvilinear relationship between inside/outside board member composition and return on assets (ROA), although not return on equity.[149] That is, boards more dominated either by outside or by inside directors were found to have a positive effect on ROA. The following Subsections explore alternative explanations of these findings.

A. Different Strategies

Assuming the findings of this study are replicated in future studies, the authors of the meta-analysis suggest that a board predominantly composed of outside or inside directors may support alternative business strategies, with each set of strategies providing avenues for improved corporate performance.[150] The choice of strategies may follow from the inside directors' greater firm-specific knowledge and the outside directors' access to information and connections external to the corporation. The researchers speculate as follows:

> [N]ote that insiders' greater knowledge of company affairs and internal operations is compatible with a focus on asset allocation strategies and attainment of related efficiencies, therefore, with movement toward stronger ROA through control of working assets. In contrast, outsiders' greater knowledge about and experience with external affairs seems more consistent with the formulation of environmental strategies, leading to strengthened ROA though the enhancement of income sources and streams.[151]

Similarly, another researcher suggests that differences in information

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148. *See* Baysinger & Butler, *supra* note 1, at 104; Rajeswararao S. Chaganti et al., *Corporate Board Size, Composition and Corporate Failures in Retailing Industry*, 22 J. MGMT. STUDIES 400, 406–07, 411–12 (1985); William Q. Judge, Jr., *Correlates of Organizational Effectiveness: A Multilevel Analysis of a Multidimensional Outcome*, 13 J. BUS. ETHICS 1, 7 (1994); Hamid Mehran, *Executive Compensation Structure, Ownership, and Firm Performance*, 38 J. FIN. ECON. 163, 180 (1995); Pearce & Zahra, *supra* note 111, at 433; Stuart Rosenstein & Jeffrey G. Wyatt, *Outside Directors, Board Independence, and Shareholder Wealth*, 26 J. FIN. ECON. 175, 190 (1990); Schellenger et al., *supra* note 112, at 465; Zahra & Pearce, *supra* note 102, at 316. A recent meta-analysis found little evidence of a linear relationship between board composition measured by the proportion of outside or inside board members and corporate performance. Dan R. Dalton et al., *Meta-Analytic Reviews of Board Composition, Leadership Structure, and Financial Performance*, 19 STRATEGIC MGMT. J. 269, 269 (1998).

149. Wagner et al., *supra* note 2.

150. *Id.*

151. *Id.* at 671.

may cause outside directors to focus on new market entry through venturing and acquisition activities and inside directors to focus on internal business and product development. [152]

Thus, boards composed predominantly of either inside or outside directors may pursue different strategies that positively affect corporate performance. Note that the "different strategies" interpretation of the findings of the meta-analysis suggests a strategic management role for boards. It does not ascribe less risk taking to outsider-dominated boards though, as does the agency cost managerial-incentive theory[153] described in the next Subsection.

B. Different Managerial Incentives

The agency cost managerial-incentive theory has been offered to explain the advantages of insider-dominated boards,[154] although it does not explain the advantages of outsider-dominated boards that were also found by the meta-analysis. Like the different strategies explanation for the performance implications of board composition, this explanation focuses on the different informational sources of inside and outside directors. But rather than informational differences that affect a board member's preferences for strategies, these differences are claimed to affect a board's method of evaluating managers, which in turn supposedly impacts the corporation by affecting the managers' choices

152. Shaker A. Zahra, *Governance, Ownership, and Corporate Entrepreneurship: The Moderating Impact of Industry Technological Opportunities*, 39 ACAD. MGMT. J. 1713, 1729 (1996) (discussing outside directors who own large blocks of stock); *see also* Pearce & Zahra, *supra* note 111, at 420–21 (finding that boards with larger proportions of outside directors tend to pursue strategies of external growth and diversification). The outside or inside director board classification scheme has been criticized for failing to capture the external or internal orientation of board members. Using an attitudinal survey of directors of nine publicly held banks, the outsider or insider director classification did not reflect the external or internal orientation of board members. *See* John A. Pearce II, *The Relationship of Internal Versus External Orientations to Financial Measures of Strategic Performance*, 4 STRATEGIC MGMT. J. 297, 302–03 (1983). In addition, the study found a positive association between bank profitability and a high internal or low external orientation. The definitions of internal and external orientation used in this study, however, are problematic. The definitions, for example, bear no relationship to the manager-monitoring or relational roles of the board described in this Article and fail to capture the wide variety of functions that board members may perform. *Id.* at 301–03.

153. *See supra* text accompanying notes 107–08.

154. Baysinger & Hoskisson, *supra* note 107, at 73–74; *see supra* text accompanying notes 107–08.

between more or less risky strategies.[155] The argument is that outside directors are at a disadvantage relative to insiders in evaluating the CEO, that is, in discriminating between corporate financial outcomes that are the result of bad decisionmaking by the CEO and outcomes that are due to factors beyond the CEO's control. This explanation maintains that inside directors with firm-specific knowledge are better at evaluating the CEO and, therefore, they can enhance the CEO's commitment and willingness to pursue risky strategies through investments and research and development.[156]

In the terminology of this managerial-incentive theory, outside directors are said to rely on "outcome" or "financial" controls, whereas inside directors are claimed to rely on "behavioral" or "strategic" controls through observation of the actual behavior of the CEO.[157] The managerial-incentive theory predicts that the choice of controls impacts strategic decisionmaking by the CEO by affecting his or her incentives. Outcome controls are claimed to shift the risk of poor results from shareholders to the CEO and cause the CEO to adopt more risk-averse strategies. Thus, in corporations with more outside directors who are expected to utilize outcome controls, corporations are predicted to pursue more risk-averse strategies such as unrelated diversification and less expenditure on capital investments and research and development than if their boards were composed of more inside directors.

Some studies have suggested that insider boards are more successful than outsider boards at supporting corporate risk taking activities. One study of entrepreneurship activity found that corporations with more inside directors engaged in more entrepreneurial activities.[158] Another study found a positive relationship between the percentage of inside directors on boards of Fortune 500 corporations and research and development spending.[159] However, research and development spending may not reflect risk taking activities, but rather may reflect internal inefficiencies when corporations decide to keep funds rather than distribute them to shareholders.[160] Moreover, without relating the entrepreneurial activities in the former study to corporate performance, it

155. Baysinger & Hoskisson, *supra* note 107, at 76–77, 80.

156. *Id.* at 80–81.

157. *Id.* at 78–79.

158. Zahra, *supra* note 152, at 1714–15 (including such activities as innovation, expansion of operations to enter new businesses, and strategic renewal in revitalizing the corporation's operations by changing the scope of its business or competitive approach).

159. Barry D. Baysinger et al., *Effects of Board and Ownership Structure on Corporate R&D Strategy*, 34 ACAD. MGMT. J. 205, 205, 207 (1991).

160. Zahra, *supra* note 152, at 1715. Research and development expenses may also serve a relational role by signaling to shareholders the corporation's commitment to innovation. *Id.* at 1717.

is difficult to judge whether these activities are advantageous to corporations. One study of small and large airlines "found that both small and large airlines performed better to the degree that their competitive behaviors resembled those of the average, or typical, small and large airline."[161] This study suggests benefits to competitive conformity. It may be that "small (or large) firms that are doing badly are inclined to engage in extreme, deviant behavior but that those performing well tend to engage in risk-averse conformist behavior."[162] This explanation is consistent with prospect theory, which suggests that persons become more risk-seeking when faced with returns below target.[163] More extreme strategic behaviors are observed by corporations that are in a downward spiral toward bankruptcy.[164]

In a study of California general hospitals, the relationship between a board dominated by outside directors and the use of either outcome or behavioral controls was tested directly by surveying board members on their actual criteria for evaluating CEOs.[165] This study found that boards consisting of higher percentages of outside directors were not associated with an emphasis on outcome controls.[166] It also found mixed support for the relationship between outcome controls and risk-averse strategies.[167] A negative relationship was found between the use of outcome controls and capital expenditures, but no relationship was found between outcome controls and unrelated diversification.[168]

This study also found a negative relationship between the use of outcome controls for evaluating CEOs and both the frequency of board meetings and the existence of board-level strategic planning committees.[169] Thus, interactions between CEOs and boards diminish the use of outcome controls. The authors of this study explain:

161. Ming-Jer Chen & Donald C. Hambrick, *Speed, Stealth, and Selective Attack: How Small Firms Differ from Large Firms in Competitive Behavior*, 38 ACAD. MGMT. J. 453, 475 (1995).
162. *Id.* at 475–76.
163. Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CAL. L. REV. 1051, 1104 (2000).
164. Donald C. Hambrick & Richard A. D'Aveni, *Large Corporate Failures as Downward Spirals*, 33 ADMIN. SCI. Q. 1, 1 (1988).
165. Rafik I. Beekun et al., *Board Characteristics, Managerial Controls and Corporate Strategy: A Study of U.S. Hospitals*, 24 J. MGMT. 3, 14–15 (1998).
166. *Id.* at 15.
167. *Id.* at 14.
168. *Id.* at 15.
169. *Id.* at 16.

> The results of this study suggest that board composition may not be the sole factor influencing the board's access to information about the CEO's performance-related behavior. In fact, we showed that outsiders may have better access to information about the quality of the top manager's decision making than suggested by the management [managerial-incentive] literature. Besides tighter board-CEO linkage through more frequent board meetings and the presence of a strategic planning committee, outsiders may successfully develop informal communication with "inside" management officials whose opinions they trust and respect.[170]

This study suggests that, especially in corporations with outside directors, considerable attention should be given to the flow of information within the corporation and to the establishment of a board-level strategic planning committee.[171] Note that a corporate ombudsperson would also improve the flow of information to outside directors.

C. Homogeneous and Heterogeneous Groups

Although the heterogeneity and homogeneity group research has mainly focused on management teams rather than boards, it is suggested that the reason corporations with either insider- or outsider-dominated boards have higher ROAs is because these boards are more homogeneous than those consisting of more equal numbers of inside and outside directors.[172] In fact, insider- and outsider-dominated boards are not more homogeneous and are unlikely to have the same degree of heterogeneity. Moreover, homogeneous groups are not necessarily superior.[173] As group theory has shown, heterogeneous groups tend to make higher quality decisions in matters involving creative and judgmental decisionmaking.[174] Heterogeneous groups also have an advantage in solving problems having verifiably correct answers when "heterogeneity increases the probability of the group containing some members who are capable of determining the correct answer to the problems being solved"[175] or when diversity increases "the amount of attention and discussion paid to each group member's individual solution."[176] In regard to manager monitoring, "diversity 'may promote the airing of different perspectives and reduce the probability of

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170. *Id.*

171. *Id.*; *see* Daily & Schwenk, *supra* note 125, at 191 (noting that outside directors can easily acquire the information needed by "requesting this information" from top management team members, "regardless of their service on the board").

172. Wagner et al., *supra* note 2.

173. For a discussion of the advantages and disadvantages of homogeneous and heterogeneous groups, see Dallas, *supra* note 9, at 1388–1405.

174. *Id.* at 1392.

175. *See* Jackson, *supra* note 54, at 359.

176. John P. Wanous & Margaret A. Youtz, *Solution Diversity and the Quality of Group Decisions*, 29 ACAD. MGMT. J. 149, 157 (1986).

complacency and narrow-mindedness in a board's evaluation of executive proposals.'"[177] Such a board can produce a wider range of solutions for problems and decision criteria for evaluating corporate options. Heterogeneity also mitigates various cognitive biases in decisionmaking.[178] Thus, even if insider- and outsider-dominated boards were more homogeneous, this homogeneity would not necessarily explain better performance.

D. Conflicting Multiple Roles of Corporate Boards

There is another interpretation of the findings of the meta-analysis: This interpretation recognizes that boards are expected to perform multiple roles, with the effective performance of these roles requiring different types of directors. Some boards perform some roles better than others, depending on their composition. An outsider-dominated board that consists of mainly independent directors may achieve a group dynamic necessary for effective manager monitoring. Another kind of outsider-dominated board, composed of both independent and nonindependent outside directors, may more successfully assist the corporation in relating to its external environment. An insider-dominated board arguably may enable more insiders to communicate effectively with outside directors on the board, who provide advice and counsel. The insider-dominated board may also reap the advantages of peer group decisionmaking when inside directors confer among themselves on strategic management issues.

As previously noted, the manager-monitoring role of boards conflicts with the relational role of boards to the extent that the presence of inside and nonindependent outside directors on corporate boards prevents independent outside directors from objectively monitoring management. Although a structure that has important monitoring committees consisting of predominantly independent directors, such as the auditing, compensation, and nominating committees,[179] may mitigate conformity pressures, a board dominated by independent directors is expected to be more successful at resisting these pressures.[180] In addition, the manager-monitoring role of boards conflicts with the strategic management role to the

177. Dallas, *supra* note 9, at 1400 (quoting Goodstein et al., *supra* note 146, at 243).
178. *See id.* at 1401–02.
179. *See* discussion *supra* Part II.B.
180. Dallas, *supra* note 9, at 1400–01.

extent that the latter role requires that more inside directors serve on boards.

If conflict exists between board roles, and if the advantages of different kinds of boards are better understood, it may be possible to modify the board's structure to enhance the performance of multiple board roles. For example, if insider boards engage in more strategic management and are more successful at these functions than outsider boards, it may be due to the benefits of group decisionmaking on issues involving some complexity and ambiguity. That is, the main benefit of an insider board may be that it levels the hierarchy among executive officers by creating a more peer-like structure. For example, consider the German two-tiered board structure, with a supervisory and management board.[181] The two-tiered board structure permits collegial monitoring of management by the management board. The management board of a German corporation usually consists of the corporation's "top seven or so operating executives."[182] This flattening of the executive hierarchy means that the chairman of the management board in Germany is "the first among equals rather than the first among lessers usually associated with U.S. chief executive officers."[183] Of course, corporations can vary, with some having very strong chairmen. Nevertheless, this structure has a number of advantages. The leveling of the hierarchy can result in greater accountability. There is less of a chance that a dominant individual will become convinced of his invincibility. As one observer notes: "The trouble with dominant figures is their increased propensity as time goes on to listen less, believe their own hyperbole, and as a consequence to make bad mistakes."[184] There are fewer instances of this occurring in German corporations than in U.S. corporations.[185]

The danger of placing too much power in the hands of CEOs is confirmed by an Enron officer's description of Enron CEO Jeffrey Skilling:

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181. *See generally* GOV'T COMM'N, GERMAN CORPORATE GOVERNANCE CODE (convenience trans., 2002) (presenting "essential statutory regulations for the management and supervision (governance) of German listed companies" and containing "internationally and nationally recognized standards for good and responsible governance"), *available at* http://www.muhlbauer.com (last modified Aug. 22, 2003); *see also* Russian Institute of Directors, *Code of Best Practices for German Corporate Governance* (2000) (discussing the German Stock Corporation Act), http://www.rid.ru/ (last visited Aug. 20, 2003).

182. SPENCER STUART, EUROPEAN BOARD INDEX: CURRENT BOARD TRENDS AND PRACTICES AT MAJOR EUROPEAN CORPORATIONS 12 (1999); Steven N. Kaplan, *Top Executives, Turnover, and Firm Performance in Germany*, 10 J.L. ECON. & ORG. 142, 143 (1994).

183. Kaplan, *supra* note 182, at 147.

184. JONATHAN P. CHARKHAM, KEEPING GOOD COMPANY: A STUDY OF CORPORATE GOVERNANCE IN FIVE COUNTRIES 361 (1994).

185. *Id.*

> Over the years, Jeff changed. He became more of a creature of his own creation. His hubris came to outweigh some of the more attractive parts of his personality. He became more intolerant, more opinionated, more bombastic. Jeff was always right, and that got worse. He had a little bit of a God syndrome.[186]

One knowledgeable observer of corporate practice notes that "a committee is actually a more efficient way of running a large and complex modern corporation than relying on a powerful and charismatic leader."[187] This is not only due to the cult of personality. There is support for this view in psychological studies, which indicate that decisionmaking in ambiguous or uncertain situations is best made by groups rather than by individuals.[188] Moreover, persons in more proximate social positions are more likely than those in disparate positions to bring disagreements and opposing perspectives into the open for discussion.[189] Less political behavior can also be expected for a top management team in which members are also peers.[190] A study of top management teams in the microcomputer industry found less evidence of politics in teams when power was not centralized in the CEO.[191] Politics is characterized by behind-the-scenes coalition formation, office lobbying, cooptative attempts, withholding information, and the controlling of agendas.[192] Thus, the advantages of insider-dominated boards found by the meta-analysis may reflect the advantages of group decisionmaking on strategic management issues by executive officers serving in proximate social positions on these boards.

A restructuring proposal that is consistent with this Article's interpretation of the meta-analysis on the multiple roles of corporate boards and that takes advantage of group decisionmaking among top corporate officers is the dual board structure. This structure consists of a manager-monitoring board composed only of independent directors, the conflicts board, and a relational board consisting of a mix of different

186. Evan Thomas et al., *Every Man for Himself*, NEWSWEEK, Feb. 18, 2002, at 22.
187. CHARKHAM, *supra* note 184, at 361.
188. DON HELLRIEGEL ET AL., ORGANIZATIONAL BEHAVIOR 228–30 (3d ed. 1983); Robert J. Haft, *Business Decisions by the New Board: Behavioral Science and Corporate Law*, 80 MICH. L. REV. 1, 9–12 (1982).
189. Kathleen M. Eisenhardt & L.J. Bourgeois III, *Politics of Strategic Decision Making in High-Velocity Environments: Toward A Midrange Theory*, 31 ACAD. MGMT. J. 737, 749–53, 763–65 (1988).
190. *Id.* at 756–59.
191. *Id.* at 743.
192. *Id.* at 737–38.

types of directors—the business review board.[193] The business review board would perform various relational and strategic management functions, and some monitoring functions, and would be composed of a mix of inside directors and relational outside directors. This board would have the advantages of group decisionmaking among top executives, but would also perform important relational functions and some monitoring functions through the presence of relational outside directors. The conflicts board would have group dynamics more consistent with objective manager monitoring by being composed solely of independent outside directors. Attention should also be given to the flow of information to these independent directors. The appointment by independent directors of a corporate ombudsperson, who would have access to all meetings and information concerning the corporation and would report to these directors, would enhance the directors' ability to engage in effective manager monitoring.[194] The formation of board-level strategic planning committees would also facilitate important communication between outside directors and management.

The dual board structure would have the effect of allowing boards to perform potentially conflicting functions through persons best able to perform each function. As the corporation has created divisions and departments to specialize in the many tasks required of it as its operations have become more complex, so must the board of directors give attention to the many roles it is expected to perform and to the characteristics of persons best suited to perform those functions. The dual board structure also draws on the benefits of group decisionmaking. In ambiguous and uncertain situations, group decisionmaking can prove beneficial. This insight also provides support for restructuring the U.S. system to provide for employee directors who would further enhance the manager-monitoring and relational functions of corporate boards by, among other things, bringing diverse perspectives and information to the attention of boards.[195]

VI. CONCLUSION

This Article has explored developments in board structure, composition, and practices that are designed to improve the manager-monitoring capability of corporate boards of directors. These developments have included an increase in the percentage of outside directors on corporate boards and board committees. In addition, board

193. Dallas, *supra* note 4, at 114.
194. *Id.* at 130–36.
195. *See* Dallas, *supra* note 9, at 1407.

committees have been formed to specialize in areas where managerial oversight is particularly important. Attention has also been given to decreasing the role of the CEO in the appointment of board chairpersons and committee members. These functions are increasingly being performed by full boards or by corporate governance committees. Board practices have also developed to enhance the objectivity and effectiveness of boards. Outside directors often meet separately from the full boards, and boards have put in place methods for reviewing the performances of the full board and individual board members. Few corporations have adopted other proposals for improving the performance of their boards; such proposals include appointing a lead director or chairperson who is an independent director, limiting the number of directorships that board members may simultaneously fill, and forming management succession committees despite substantial criticism of the management succession process by many directors. Perhaps more important, too little attention has been given to whether the outside directors are truly independent of management, as the Enron debacle has demonstrated. In addition to the manager-monitoring role of boards, this Article also discussed the relational role of boards. Corporations relate to their shareholders through the presence of shareholder representatives on their boards. In addition, a portion of board memberships is held by various persons who assist corporations in relating to their nonshareholder stakeholders. More recently, the diversity movement on corporate boards has exemplified the importance of the relational functions of corporate boards. Diverse directors are intended to relate corporations to their consumers and employees, both domestic and foreign. Diversity also has an additional benefit in uncertain and ambiguous environments in which diverse perspectives have the potential to improve the quality of decisionmaking. These reasons also support the giving of additional attention to providing employee representation on corporate boards.

Finally, boards also perform functions relating to corporate strategy. This Article has delineated the various strategy-related functions that boards may perform. Although most of these functions are subsumed within the manager-monitoring and relational roles of corporate boards, a third role, which this Article refers to as strategic management, may be emerging. Strategic management functions are usually performed by management, and there are good reasons for this allocation of functions. There are advantages to peer group decisionmaking on strategic management subjects that suggest advantages to the restructuring of boards to provide for a business review board in a dual board system.

Considerable theoretical and empirical literature supports the importance of outside directors to the board's performance of relational and manager-monitoring functions. A recent meta-analysis of board studies finds that both insider- and outsider-dominated boards are associated with corporations with higher ROAs. These findings may indicate that both insider- and outsider-dominated boards have advantages that offset their disadvantages. The potential for improving board effectiveness lies in maximizing the advantages of both kinds of boards through a dual board structure. As previously explained, the structure proposed in this Article is not the German two-tiered board structure, but a structure that is specially suited to the performance of the multiple roles of corporate boards. The dual board consists of a conflicts board, composed solely of independent directors, and a business review board, consisting of a mix of different types of directors who need not be independent.

Without attention to board structure, the multiple roles of boards will conflict because the persons ideally suited to perform some board functions are not ideally suited to perform others. In addition to the dual board structure, this Article recommends the appointment of corporate ombudspersons by independent directors and the formation of strategic management committees to improve the flow of information to outside directors. Also recommended are employee directors who have incentives to protect their stakes in the corporations and who are able to provide diverse perspectives and information to improve the quality of board decisionmaking. As corporate organizations change to accommodate the needs of a more complex, changing environment, so must the structure, composition, and practices of corporate boards.