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## Article

# Government Governance and the Need to Reconcile Government Regulation with Board Fiduciary Duties

**Lisa M. Fairfax†**

*"As our nation works its way through this crisis, and we look for explanations as to how we reached this point and how to avoid another crisis in the future, let us keep in mind that a significant set of checks and balances—ultimately ending with the boards of directors—has failed."*

—John Schnatter[1]

*"It is a board's responsibility to oversee management and to ensure a company's long-term survival. . . . With the tumbling and collapse of dozens of major financial and other institutions, can we draw any conclusion other than that those directors utterly failed in this regard?"*

—Carl Icahn[2]

In light of corporate directors' clear responsibility to monitor the corporation and its managers, corporate governance scandals inevitably raise concerns about the extent to which directors may have failed in that responsibility.[3] Corporate statutes require that corporations be managed by or under the di-

† Leroy Sorenson Merrifield Professor of Law, George Washington University Law School. Special thanks to Brett McDonnell as well as the organizers and participants in the *Minnesota Law Review* conference on Government Ethics and Bailouts who provided invaluable feedback and commentary on earlier versions of this draft. All errors, of course, are mine. Copyright © 2011 by Lisa M. Fairfax.

1. John Schnatter, *Where Were the Boards?*, WALL ST. J., Oct. 25, 2008, at A11.

2. Carl C. Icahn, *Corporate Boards that Do Their Job*, WASH. POST, Feb. 16, 2009, at A15.

3. *See id.*; Schnatter, *supra* note 1, at A11.

rection of the board of directors.[4] Boards, therefore, have an obligation to monitor corporate affairs, ensuring that corporate managers act in the best interests of the corporation, and that such managers do not misbehave or otherwise shirk their duties.[5] When managers engage in fraud or other corporate misdeeds, that engagement raises questions regarding whether and to what extent directors failed to effectively exercise their monitoring obligation.[6]

Corporate governance reforms strive to shore up directors' roles, not only seeking to ensure that boards have sufficient incentives to engage in effective oversight, but also aiming to ensure that boards are held accountable for their oversight failures.[7] The newest wave of reforms is no exception. The current financial crisis not only ushered in an era of significant government entanglement in the financial system, it also generated significant government involvement in corporate governance matters.[8] That involvement ranged from the government becoming a shareholder of major corporations to the passage of a

4. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141 (Supp. 2010); MODEL BUS. CORP. ACT § 8.01(b) (2009).

5. *See* Stone *ex rel.* AmSouth Bancorp. v. Ritter, 911 A.2d 362, 369–70 (Del. 2006) (discussing oversight duty and liability); *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 968–70 (Del. Ch. 1996) (noting that directors' fiduciary duty encompasses a duty to monitor); MODEL BUS. CORP. ACT § 8.30(b) (2009) (noting that directors must devote attention to their oversight function).

6. *See* Icahn, *supra* note 2, at A15; Schnatter, *supra* note 1, at A11 ("Behind the CEO of every . . . Bear Stearns or Lehman Brothers who led their company down a path toward financial ruin, there was a board of directors that sat by silently and let it happen.").

7. *See* Lisa M. Fairfax, *Form Over Substance? Officer Certification and the Promise of Enhanced Personal Accountability Under the Sarbanes-Oxley Act*, 55 RUTGERS L. REV. 1, 2–3 (2002); Eric M. Fogel & Andrew Geier, *Strangers in the House: Rethinking Sarbanes-Oxley and the Independent Board of Directors*, 32 DEL. J. CORP. L. 33, 34 (2007); Brian Kim, *Sarbanes-Oxley Act*, 40 HARV. J. ON LEGIS. 235, 236–37 (2003); *G20 Statement on Strengthening Financial System*, REUTERS, Sept. 5, 2009, *available at* http://www.reuters.com/article/2009/09/05/g20-finance-financial-text-idUSL566412820090905 (noting a need for governance reforms that create better oversight and more appropriate levels of accountability).

8. *See* Cheryl D. Block, *Measuring the True Cost of Government Bailout*, 88 WASH. U. L. REV. 149, 156–60 (2010); Lawrence Cunningham & David Zaring, *The Three or Four Approaches to Financial Regulation: A Cautionary Analysis Against Exuberance in Crisis Response*, 78 GEO. WASH. L. REV. 39, 56–74 (2009); Lisa M. Fairfax, *The Legal Origins Theory in Crisis*, 2009 BYU L. REV. 1571, 1590–603.

host of regulatory initiatives.[9] Such involvement has clear implications for the board of directors, increasing their responsibilities in order to enhance the effectiveness of their oversight and thus meaningfully enhance board accountability and overall corporate performance.

However, this new wave of reforms appears to impose increased responsibilities on boards without reconciling those responsibilities with board functions and fiduciary law, at least as that law has been articulated by Delaware.[10] The lack of reconciliation not only represents a missed opportunity to reconsider boards' proper role and function within the modern public corporation, but also may undermine the effectiveness of reforms.

Part I of this Article pinpoints some of the key reforms that have implications for board fiduciary duties.[11] Part II and Part III then demonstrate what appears to be a fundamental disconnection between board reforms, on the one hand, and existing board structures and fiduciary law presumably necessary to support those reforms, on the other. Part II discusses this disconnection as it relates to existing board structures. First, Part II illustrates the manner in which the reforms may overburden boards in ways that not only may set them up for failure, but also may increase the likelihood that boards will engage in the sort of rubber stamping of managerial and agent decisions that reforms were aimed at counteracting. In this regard, Part II ar-

9. *See* Block, *supra* note 8, at 156–60; Cunningham & Zaring, *supra* note 8, at 56–74; Fairfax, *supra* note 8, at 1590–603; J.W. Verret, *Treasury, Inc.: How the Bailout Reshapes Corporate Theory and Practice*, 27 YALE J. ON REG. 283, 294–99 (2010).

10. *See infra* Parts II and III. This Article focuses on Delaware in light of its place of clear dominance in corporate law. *See* Brett McDonnell, *Two Cheers for Corporate Law Federalism*, 30 J. CORP. L. 99, 100 (2004) (noting the dominance of Delaware in corporate law); Mark J. Roe, *Delaware's Politics*, 118 HARV. L. REV. 2491, 2493 (2005) ("Delaware makes the state corporate law governing most large American corporations."); DEL. DIVISION CORP., http://corp.delaware.gov/ (last visited Apr. 10, 2011) (indicating that more than fifty percent of all public companies and sixty-three percent of Fortune 500 companies are chartered in Delaware).

11. As a result of the financial crisis, the government became a shareholder in many public companies, gaining the ability to select directors and otherwise directly intervene in boards and corporate affairs. *See* Verret, *supra* note 9, at 294–99. Although this direct intervention has clear implications for boards and their fiduciary duties, *see id.* at 304–07 (discussing potential conflicts of interest raised by government ownership in public companies as well as ways in which government may be pressuring corporations), this Article does not analyze those implications. Instead, this Article focuses on the manner in which government regulations impact boards and fiduciary duties.

gues that the reforms may reflect unrealistic expectations about boards and their capacity. Second, Part II illustrates how the reforms may raise serious concerns about whether we can expect directors to have the expertise to tackle their new responsibilities, undermining the potential effectiveness of those reforms and once again increasing the likelihood that boards will unduly rely on managers or outsiders in a manner that could undermine their effectiveness.

Part III demonstrates the manner in which reforms may be incompatible with fiduciary duty norms. Those norms, at least as articulated under Delaware law, currently impose a relatively low risk of any personal liability for directors who may run afoul of their new responsibilities, particularly with respect to risk oversight and compensation.[12] Part III, therefore, maintains that reforms raise questions about whether we can expect fiduciary duty law to hinder or support boards' enhanced obligations. Part IV offers some concluding assessments.

## I. THE GOVERNMENT'S ROLE IN GOVERNANCE REFORM

The financial crisis created the perception that the corporate governance apparatus had generated an environment whereby directors and officers felt free to engage in risky behavior without fear of repercussions from shareholders or other corporate constituents.[13] Federal reforms seek to alter this environment.[14] Specifically, those reforms seek to enhance boards' monitoring role as well as our ability to hold boards accountable for failing to fulfill that role.[15] This Part will discuss three areas in which the government has intruded on corporate governance matters in ways that have implications for boards and their fiduciary responsibilities. That discussion will explore executive compensation, risk oversight, and shareholder rights.

12. *See infra* Parts II and III.

13. *See* Charles E. Schumer, Press Release, Schumer, Cantwell Announce Shareholder Bill of Rights to Impose Greater Accountability on Corporate America (May 19, 2009), *in* 41ST ANNUAL INSTITUTE ON SECURITIES REGULATION 1093, 1095 (PLI Corporate Law & Practice, Course Handbook Ser. No. 1773, 2009).

14. *See id.*

15. *See id.*

A. EXECUTIVE COMPENSATION

In recent years, public outrage over large executive compensation packages, including bonuses and exit-pay arrangements, has increased.[16] That outrage appeared to reach a fever pitch in the midst of the financial crisis, particularly with respect to companies at which executive pay increased while profits and stock prices plummeted, or when companies paid executives significant salaries and bonuses while receiving government aid.[17] Disgruntled shareholders as well as the general public insisted that there needed to be a tighter connection between executive pay and corporate performance.[18] The public also expressed concern that executive compensation structures may have contributed to the financial crisis by incentivizing corporate managers to take unnecessary risk.[19]

In the face of this increased public outcry, the federal government has played a particularly aggressive role in regulating executive compensation.[20] That role has implicated a host of issues. This section will focus on four issues: say-on-pay, golden parachutes, incentive awards and clawbacks, and compensation committees. This section will conclude with a discussion regarding the impact of these issues on board responsibilities.

1. Say-on-Pay

Much of the efforts to curtail executive pay have coalesced around the campaign to secure "say-on-pay"—a nonbinding

16. *See, e.g.*, LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 1, 27–31 (2004); Michael B. Dorff, *Confident Uncertainty, Excessive Compensation and the Obama Plan*, 85 IND. L.J. 491, 492 (2010); *Polls Find Strong Populist Mood in Europe and to a Lesser Extent in the USA*, HARRIS INTERACTIVE, tbl.4 (July 25, 2007), http://www.harrisinteractive.com/vault/Harris-Interactive-Poll-Research-FT-Globalization-2007-07.pdf (revealing that seventy-seven percent of Americans believe that executives are overpaid). For the debate over the extent to which executive compensation can be classified as excessive, see Dorff, *supra*, at 493 n.7.

17. *See* Kenneth R. Davis, *Taking Stock—Salary and Options Too: The Looting of Corporate America*, 69 MD. L. REV. 419, 419–23 (2010).

18. *See* BEBCHUK & FRIED, *supra* note 16.

19. *See* Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247, 249 (2010); Frederick Tung, *Pay for Banker Performance: Structuring Executive Compensation for Risk Regulation* (Emory Pub. Law Working Paper Series, Paper No. 10-93, 2010), *available at* http://ssrn.com/abstract=1546229.

20. *See* Dorff, *supra* note 16, at 529–51; David I. Walker, *The Challenge of Improving the Long-Term Focus of Executive Pay*, 51 B.C. L. REV. 435, 455–56 (2010).

vote on executives' compensation packages.[21] Shareholders have actively encouraged corporations to adopt say-on-pay, and several corporations have voluntarily done so.[22] Then too, although they were never implemented, several federal bills incorporated say-on-pay requirements.[23]

Say-on-pay advocates argue that shareholders' advisory vote will curb excessive compensation, increasing the likelihood that corporations will more closely align such compensation with corporate performance.[24] In the United Kingdom, where such votes have been required since 2002, say-on-pay appears to have created such an alignment, at least with respect to more closely linking pay to performance at poorly performing companies.[25]

Critics of say-on-pay contend that these results will not be replicated in the United States[26] Critics also argue that the United Kingdom experience reveals troubling pay trends.[27] Such trends include an undue reliance on best practices, which may lead to ineffective compensation policies,[28] as well as the failure of say-on-pay to significantly curtail the overall growth

21. In 2009, say-on-pay was the most prevalent shareholder proposal submitted. *See 2009 Proxy Season Scorecard,* RISKMETRICS GROUP (Dec. 15, 2009), http://www.riskmetrics.com/knowledge/proxy_season_watchlist_2009; *see also* Jeffrey N. Gordon, *"Say on Pay": Cautionary Notes on the U.K. Experience and the Case for Shareholder Opt-In*, 46 HARV. J. ON LEGIS. 323, 339–40 (2009) (describing shareholder efforts to advance say-on-pay proposals).

22. *See* Andrew C.W. Lund, *Say on Pay's Bundling Problems*, 99 KY. L.J. 119, 122 (2010).

23. As early as 2007, bills in the House and Senate sought mandatory say-on-pay. *See, e.g.*, Shareholder Vote on Executive Compensation Act, H.R. 1257, 110th Cong. (2007), *available at* http://financialservices.house.gov/pdf/HR1257BillText.pdf; Shareholder Vote on Executive Compensation Act, S. 1181, 110th Cong. (2007), *available at* http://www.govtrack.us/congress/billtext.xpd?bill=s110-1181. Similarly, in 2009 there were House and Senate bills incorporating say-on-pay proposals. *See, e.g.*, Shareholder Bill of Rights Act of 2009, S. 1074, 111th Cong. (2009), *available at* http://law.du.edu/documents/corporate-governance/legislation/bill-text-shareholders-bill-of-rights-act-of-2009.pdf; Shareholder Empowerment Act of 2009, H.R. 2861, 111th Cong. (2009), *available at* http://www.govtrack.us/congress/bill.xpd?bill=h111-2861.

24. *See* Gordon, *supra* note 21, at 336–40.

25. *See* Fabrizio Ferri & David Maber, Say on Pay Votes and CEO Compensation: Evidence from the United Kingdom (Oct. 15, 2010) (unpublished manuscript), *available at* http://ssrn.com/abstract=1420394.

26. *See* Gordon, *supra* note 21, at 352–53.

27. *See infra* notes 28–29.

28. *See* Stephen Davis, *Does 'Say on Pay' Work? Lessons on Making CEO Compensation Accountable*, *in* DIRECTORS' INSTITUTE ON CORPORATE GOVERNANCE 37, 55 (PLI Corporate Law & Practice, Course Handbook Ser. No. B-1622, 2007); Gordon, *supra* note 21, at 351–52.

in compensation.[29] Empirical evidence from the United Kingdom also indicates that say-on-pay has not increased the connection between pay and performance at well-performing companies.[30] In this regard, critics question whether say-on-pay will have a positive impact on executive compensation, while insisting that the complexity of compensation decisions are better left to the board.[31]

Despite these concerns, there has been considerable momentum behind say-on-pay, which has translated into implementation of say-on-pay at the federal level. The first such implementation occurred in connection with the federal government's program to provide federal assistance to troubled companies.[32] In October 2008 the federal government enacted the Emergency Economic Stabilization Act (EESA), which created a program for financially distressed companies to receive federal funds known as the Troubled Asset Relief Program (TARP).[33] In February 2009 the American Recovery and Reinvestment Act (ARRA)[34] amended and extended the EESA. In addition to providing federal aid to troubled companies, the Reinvestment Act requires that companies receiving TARP funds comply with certain executive compensation and corporate governance standards during the period in which they are receiving these funds.[35] Pursuant to those standards, the ARRA requires that companies receiving TARP funding provide shareholders with an annual say-on-pay vote throughout the period during which such companies receive funds.[36]

29. *See* Davis, *supra* note 28, at 49; Ferri & Maber, *supra* note 25, at 20; Gordon, *supra* note 21, at 344.

30. *See* Ferri & Maber, *supra* note 25, at 52; Lund, *supra* note 22, at 127–28.

31. *See* Gordon, *supra* note 21, at 352–53; Lund, *supra* note 22, at 129–30.

32. *See* Dennis J. Block, *Public Company M&A: Directors' Fiduciary Duties and Recent Developments in Corporate Control Transactions*, *in* CONTESTS FOR CORPORATE CONTROL 2010: CURRENT OFFENSIVE & DEFENSIVE STRATEGIES IN M&A TRANSACTIONS 39, 190 (PLI Corporate Law & Policy, Course Handbook Ser. No. B-1786, 2010).

33. *See* Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765.

34. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115.

35. *See id.* § 7001.

36. *See id.*; Press Release, U.S. Dep't of the Treasury, Treasury Announces New Restrictions on Executive Compensation (Feb. 4, 2009), *available at* http://www.treasury.gov/press-center/press-releases/Pages/tg15.aspx.

In July 2010 President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), which among other things included a host of provisions aimed at regulating executive compensation.[37] Dodd-Frank extended the say-on-pay requirement to all public companies.[38] Dodd-Frank not only requires public companies to provide their shareholders with a say-on-pay vote at least once every three years, but also requires such companies to provide shareholders with a nonbinding vote on whether the company should hold a say-on-pay vote every one, two, or three years.[39]

2. Golden Parachutes

Public concern over executive compensation encompassed concerns regarding golden parachute payments.[40] Golden parachutes refer to compensation paid at an executive's departure, particularly when the executive's departure results from a change of control at the company.[41] One package that especially fueled public outcry was the $210 million exit payment received by Home Depot's chief executive officer (CEO) during a time when the company had its smallest increase in net income in nine years.[42] Critics pointed to this payment not only as an example of an excessive golden parachute, but also as an example of the failure to link pay with performance.[43] This kind of severance package heightened public anger over the seeming inappropriateness of many golden parachutes.[44]

Such severance arrangements also prompted reforms aimed at regulating and even prohibiting such payments. TARP companies are required to prohibit golden parachute payments to senior executive officers (defined as the top five most highly compensated officers) and the next five most highly

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37. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 951, 971, 124 Stat. 1376, 1899–900, 1915 (2010).

38. *See id.* § 951(a)(1).

39. *See id.* § 951(a)(1)–(2).

40. *See* Miriam A. Cherry & Jarrod Wong, *Clawbacks: Prospective Contract Measures in an Era of Excessive Executive Compensation and Ponzi Schemes*, 94 MINN. L. REV. 368, 374 (2009); Josh Fineman, *Nardelli Exit Package Called 'Outrage,' May Heighten Pay Debate*, BLOOMBERG, Jan. 3, 2007, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aI7fAyAMAi2A.

41. *See* Richard P. Bress, *Golden Parachutes: Untangling the Ripcords*, 39 STAN. L. REV. 955, 955–56 (1987); Cherry & Wong, *supra* note 40, at 374.

42. *See* Fineman, *supra* note 40.

43. *See id.*

44. *See id.*

compensated officers.[45] Under Dodd-Frank, public companies must provide shareholders with disclosure on golden parachute arrangements made in connection with mergers and similar transactions, and must provide shareholders with a nonbinding vote on such compensation arrangements.[46]

### 3. Incentive Awards and Clawbacks

Public outrage over bonuses and other incentive-based payments also encouraged the federal government to focus on incentive-based compensation in a variety of ways.[47] When it was reported that Wall Street bonuses for 2008 would exceed $20 billion, President Obama referred to such bonuses as "shameful."[48] Public ire over such bonuses spurred legislative reforms aimed at curtailing them. Thus, TARP companies must prohibit the payment of all bonuses, other than long-term restricted stock.[49] However, TARP exempts bonuses required to be paid pursuant to contracts enacted prior to federal legislation.[50] Moreover, the number of employees subject to the prohibition depends on the amount of financial assistance the employer received.[51]

Regulations also require companies to recover bonuses inappropriately paid to executives. Thus, companies receiving TARP funding must provide for a "clawback" or recovery of bonuses or other incentive-based compensation paid based on earnings or other criteria later proven to be materially inaccurate.[52] The clawback applies to senior executive officers and the

45. *See* American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 7001, 123 Stat. 123, 517–18.

46. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951, 124 Stat. 1376, 1899–900 (2010).

47. *See* President Barack Obama, Remarks Following a Meeting with Economic Advisers and an Exchange with Reporters, 2009 Daily Comp. Pres. Doc. 34, at 1 (Jan. 29, 2009), *available at* http://www.gpo.gov/fdsys/pkg/DCPD-200900034/pdf/DCPD-200900034.pdf.

48. *See id.*

49. *See* American Recovery and Reinvestment Act § 7001.

50. *See id.*

51. *See id.* The SEC also implemented disclosure rules that alter the manner in which corporations must disclose stock and option awards. *See* Proxy Disclosure Enhancements, 74 Fed. Reg. 68,334, 68,338 (Dec. 23, 2009) (to be codified at 17 C.F.R. pts. 229, 239–40, 249, 279).

52. *See* American Recovery and Reinvestment Act § 7001. Section 304 of the Sarbanes-Oxley Act of 2002 (SOX) also has a clawback provision, but it is more limited because it applies only to the CEO or CFO, and only has a twelve-month look-back and recovery period. Pub. L. No. 107-204, § 304, 116 Stat. 745, 778. As of January 2009, the SEC had not recommended any actions

top twenty most highly compensated executives.[53] Dodd-Frank extended clawback provisions to all public companies, requiring them to implement policies to recover compensation when it is later shown that the compensation was based on erroneous financial results.[54] Dodd-Frank permits recovery from any current or former executive officer who received incentive-based compensation during the three-year period preceding the date of a company's restated financials.[55]

4. Compensation Committees

Dodd-Frank requires each public company to establish a compensation committee responsible for evaluating the company's compensation practices and policies.[56] The committee must be comprised solely of independent directors.[57] To be sure, the New York Stock Exchange (NYSE) and NASDAQ already require public company compensation committees to be comprised of independent directors.[58] In this regard, Dodd-Frank may be viewed as codifying preexisting listing requirements in this area. However, the new rules reflect concern that stock exchange independence standards did not go far enough and, hence, such rules seek to increase the criteria for determining independence.[59] Dodd-Frank also specifically enables compensation committees to hire their own counsel and an independent compensation consultant.[60]

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to require repayment pursuant to section 304, and SOX does not provide for a private right of action. *See* Linda E. Rappaport, *Hot Issues in Executive Compensation and Corporate Governance*, *in* PREPARATION OF ANNUAL DISCLOSURE DOCUMENTS 2009, at 717, 731 (PLI Corporate Law & Practice, Course Handbook Ser. No. B-1710, 2010). For an intriguing discussion of how clawbacks can be used to more closely align compensation with shareholders' long-term interests, see Cherry & Wong, *supra* note 40, at 410–22.

53. *See* American Recovery and Reinvestment Act § 7001.

54. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 954, 124 Stat. 1376, 1904 (2010).

55. *See id.*

56. *See id.* § 952.

57. *See id.*

58. *See* NYSE, INC., NYSE LISTED COMPANY MANUAL § 303A.03 (compensation committee); NASDAQ, INC., NASD MANUAL RULES § 4350(c) (compensation and nominating committees).

59. *See* Press Release, U.S. Dep't of the Treasury, Fact Sheet: Administration's Regulatory Reform Agenda Moves Forward: New Independence for Compensation Committees (July 16, 2009), *available at* http://www.treasury.gov/press-center/press-releases/Pages/tg218.aspx.

60. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act § 952(c)–(d).

5. Impact on Board Responsibilities

The combination of reforms focused on executive compensation enhances directors' duties by requiring them to more closely monitor and implement corporate compensation practices. Of note, Dodd-Frank states that say-on-pay votes may not be construed to create or imply any change or addition to the board's fiduciary duties.[61] Notwithstanding this statement, reforms focused on say-on-pay encourage boards to pay greater attention to executive compensation matters and shareholders' preferences with respect to those matters, or risk rejection of the pay packages approved by the compensation committee.[62] Reforms that require disclosure of golden parachute arrangements along with an advisory vote covering such arrangements appear to have a similar impact.[63] Presumably any disclosure requires boards to gain a better understanding of the arrangements being disclosed. Then too, the fact that the federal government now mandates the existence of compensation committees is likely to enhance their prominence and their responsibilities. Indeed, corporate governance reforms under the Sarbanes-Oxley Act of 2002 (SOX)[64] essentially required public companies to maintain independent audit committees, which enhanced that committee's role in the corporate governance landscape.[65] It is likely that the focus on compensation committees will have a similar impact. Moreover, the compensation committee bears responsibility for overseeing the implementation of compensation policies.[66] Thus, regulations related to prohibitions on certain forms of compensation arrangements, or otherwise providing for the creation of compensation policies, require greater involvement by the board with respect to such matters.

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61. *Id.* § 951(c)(2).

62. *See* Rebecca A. Crawford, *Corporate Governance Reform: How to Promote the Long-Term Health and Value of U.S. Corporations*, 5 N.Y.U. J.L. & BUS. 905, 926 (2009).

63. *See, e.g.*, Jeremy R. Delman, *Structuring Say-on-Pay: A Comparative Look at Global Variations in Shareholder Voting on Executive Compensation*, 2010 COLUM. BUS. L. REV. 583, 590.

64. Pub. L. No. 107-294, 116 Stat. 745.

65. *See* Bryan A. McGrane, *The Audit Committee: Director Liability in the Wake of the Sarbanes-Oxley Act and* Tello v. Dean Witter Reynolds, 18 CORNELL J.L. & PUB. POL'Y 575, 575 (2009).

66. John D. Shipman, *The Future of Backdating Equity Options in the Wake of SEC Executive Compensation Disclosure Rules*, 85 N.C. L. REV. 1194, 1194 n.3 (2007).

### B. RISK OVERSIGHT

Legislators and academics alike have argued that company policies encouraging or rewarding imprudent risk taking contributed to, if not caused, the financial meltdown.[67] Importantly, such policies include compensation structures that may have enhanced excessive managerial risk taking.[68] In light of the concern related to risk taking, a number of reforms focus on risk, particularly risk associated with compensation structures.

#### 1. Risk Evaluation and Limits

TARP addresses risk in at least two ways. TARP recipients are required to impose limits on compensation to exclude incentives for senior executives to take "unnecessary and excessive risks."[69] TARP also requires recipients to have compensation committees comprised solely of independent directors with responsibility for evaluating employee compensation plans to assess the risk posed by such plans.[70] Most public companies already had compensation committees composed of independent directors.[71] However, TARP requirements mark the first time the federal government specifically directed such committees to focus on risk.[72] These requirements mark the first time the fed-

67. *See* Bebchuk & Spamann, *supra* note 19, at 249; Karl S. Okamoto, *After the Bailout: Regulating Systemic Moral Hazard*, 57 UCLA L. REV. 183, 185 (2009); Karl S. Okamoto & Douglas O. Edwards, *Risk Taking*, 32 CARDOZO L. REV. 159, 159 (2010); Press Release, U.S. Dep't of the Treasury, Statement by Treasury Secretary Tim Geithner on Compensation (June 10, 2009), *available at* http://www.treasury.gov/press-center/press-releases/Pages/tg163.aspx ("At many firms, compensation design unintentionally encouraged excessive risk-taking, providing incentives that ultimately put the health of the company in danger."); Martin Lipton et al., *Risk Management and the Board of Directors*, HARVARD L. SCH. F. ON CORP. GOV. & FIN. REG. (Dec. 17, 2009, 9:33 AM), http://blogs.law.harvard.edu/corpgov/2009/12/17/risk-management-and-the-board-of-directors-2/ ("[The] public and political perception [is] that undue risk-taking was central to the breakdown of the financial and credit markets.").

68. *See* Bebchuk & Spamann, *supra* note 19, at 249; Tung, *supra* note 19, at 2 n.2.

69. *See* Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 111, 122 Stat. 3765, 3777.

70. *See id.*

71. *See supra* notes 57–59 and accompanying text.

72. *See The Economic Crisis: Broader Executive Compensation Reforms Coming Soon*, K&L GATES LLP, http://www.klgates.com/newsstand/detail.aspx?publication=5777 (last visited Apr. 10, 2011) (noting that historically risk and compensation issues were managed separately by boards).

eral government demanded that such committees evaluate the compensation arrangements of all employees.[73]

2. Risk Disclosure and Oversight

The Securities and Exchange Commission (SEC) also implemented enhanced risk-disclosure requirements.[74] Corporations now must provide a narrative discourse about the compensation policies of all employees as they relate to risk management and risk taking incentives if such policies create risks that are "reasonably likely to have a material adverse effect" on the corporation.[75] The SEC's disclosure rule not only includes a nonexhaustive list of examples that may trigger disclosure by suggesting that compensation policies may be risky, but also includes issues that must be addressed to the extent a company determines that disclosure is warranted.[76] In crafting the rule, the SEC noted that a company may appropriately conclude that "its compensation policies are not reasonably likely to have a material adverse effect on the company" and, hence, do not require disclosure.[77] Indeed, because the SEC only requires companies to disclose policies that have a material "adverse" effect, companies avoid having to discuss arrangements that would serve to mitigate inappropriate risk taking.[78] For companies that conclude disclosure is not necessary, the SEC rule does not require them to affirmatively state that they have determined the risks arising from their compensation policies are not reasonably expected to materially impact the corporation.[79]

In addition to this risk assessment, the SEC requires corporations to describe the board's role in risk oversight.[80] The

73. *See* CLEARY GOTTLIEB STEEN & HAMILTON LLP, COMPENSATION AND RISK: COMPENSATION COMMITTEE ACTIONS UNDER NEW SEC RULES 1 (2009) [hereinafter COMPENSATION AND RISK], *available at* http://www.cgsh.com/files/News/763d0ecc-7c1c-4174-aefa-fc354f40f67e/Presentation/NewsAttachment/472aa234-4cfe-48dc-bd3f-0067d4f99847/CGSH%20Alert%20-%20Compensation%20and%20Risk.pdf (noting that, prior to the reforms, most compensation committees did not review the compensation arrangements of all rank-and-file employees).

74. *See* Proxy Disclosure Enhancements, 74 Fed. Reg. 68,334 (Dec. 23, 2009) (to be codified at 17 C.F.R. pts. 229, 239–40, 249, 274).

75. *See id.* at 68,334.

76. *See id.* at 68,337.

77. *See id.*

78. *See id.*

79. *See id.* at 68,338.

80. *See id.* at 68,345.

new rule not only seeks to assess how the board administers its risk oversight function, but also how the board receives information from those responsible for day-to-day risk assessment.[81]

3. Impact on Board Responsibilities

Collectively, these reforms focus boards' attention on risk and risk assessment, broadening their responsibility for monitoring risk, particularly as it relates to compensation matters. Indeed, most compensation committees currently do not routinely review the compensation arrangements for all employees.[82] As a result, requirements to evaluate compensation arrangements extending beyond the CEO and top executives represent a significant expansion of the committee's duties. Then too, compensation committees did not necessarily review compensation arrangements with an eye towards evaluating their impact on risks.[83] Hence, reforms ensure that compensation committees have a heightened level of involvement in risk assessment. Moreover, by mandating disclosure on board involvement in risk oversight, the reforms increase the likelihood that boards will play a more comprehensive role in risk assessment.

C. SHAREHOLDER RIGHTS

In the past few years, shareholder activism has increased as shareholders have sought to enhance their authority over director elections and corporate governance.[84] Advocates of increased shareholder power argue that augmenting shareholder rights not only will positively impact corporate performance, but also will enhance board and managerial accountability, thereby reducing incidences of misconduct and shirking.[85] Op-

81. *See id.*

82. *See* COMPENSATION AND RISK, *supra* note 73, at 1.

83. *See* Lipton et al., *supra* note 67 (noting that most boards delegate the risk management function to the audit committee).

84. *See* Lisa M. Fairfax, *Making the Corporation Safe for Shareholder Democracy*, 69 OHIO ST. L.J. 54, 61–78 (2008).

85. *See* Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56,668, 56,669 (Sept. 16, 2010) (to be codified at 17 C.F.R. pts. 200, 232, 240, 249) (noting that new proxy access rules were aimed at responding to serious concerns about the accountability and responsiveness of some companies and their boards, as well as the need to ensure that they exercise effective oversight); Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 835, 836 (2005); Luis A. Aguilar, SEC Comm'r, Increasing Accountability and Transparency to Investors, Remarks at "The SEC Speaksin 2009" (Feb. 6, 2009), *available at* http://www.sec.gov/news/speech/2009/spch020609laa.htm

ponents raise considerable objections to increased power, ranging from its potential to undermine board discretion necessary to ensure the efficient management of corporations, to concerns that shareholders will use their increased power to advance special interests or issues antithetical to the best interests of the corporation and the broader shareholder class.[86] Despite these concerns, many federal reforms focus on enhancing shareholder power; such reforms necessarily implicate boards. This section will analyze three such reforms—say-on-pay, broker discretionary voting, and proxy access—and their impact on board responsibilities.

1. Say-on-Pay

As noted in Part I.A, Dodd-Frank entitles shareholders of public companies to have a say on executive compensation and golden parachutes in connection with mergers, acquisitions, or similar transactions.[87] Say-on-pay is designed to provide shareholders with a voice in executive compensation decisions and to hold directors accountable to shareholders for the compensation decisions they make.[88]

2. Broker Discretionary Voting

In July 2009 the SEC adopted a rule that eliminated broker discretionary voting for uncontested director elections.[89] Under NYSE Rule 452, if the beneficial holders of shares failed to provide brokers with voting instructions by the tenth day before a shareholder meeting, brokers could vote any such uninstructed shares for "routine matters."[90] The SEC decided to eliminate uncontested elections from those matters classified as "routine," thereby prohibiting brokers from voting uninstructed

("[S]hareholders can do a lot to align company management's incentives with the public interest.").

86. *See* Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 577 (2006); Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1746 (2005); William Bratton & Michael Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 653 (2010).

87. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951, 124 Stat. 1376, 1899–900 (2010).

88. *See* Gordon, *supra* note 21, at 337–40.

89. *See* Order Approving NYSE Proposed Rule Changes to Eliminate Broker Discretion Voting for the Election of Directors, 74 Fed. Reg. 33,293, 33,305 (July 10, 2009).

90. *See id.* at 33,293 n.7.

shares in such elections.[91] This rule change took effect in January 2010.[92] Dodd-Frank codified this change and extended it to all national securities exchanges.[93] Dodd-Frank also required that the SEC eliminate broker discretionary voting on compensation matters and any other matter the SEC determined was "significant."[94]

The broker voting change could have a significant impact on shareholders' voting authority. Empirical evidence reveals that broker discretionary voting almost always followed the advice of managers and incumbent directors, potentially distorting votes in their favor.[95] This evidence suggests that eliminating such voting is likely to increase shareholders' role in election matters.

3. Proxy Access

Proxy access—the ability of shareholders to access the corporation's proxy statement for purposes of nominating their own candidates—is the subject of contentious debate in the corporate arena.[96] Proponents of proxy access insist that such access will enhance shareholder voice and corporate accountability by ensuring that shareholders have a meaningful voice in board elections and, by extension, corporate affairs.[97] Opponents contend that such access could have a deleterious impact on the corporation.[98] Some argue that such access could enhance the number of proxy contests, thereby creating unnecessary costs and distraction for corporations and their boards.[99] Others contend that proxy access will enable shareholders with

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91. *See id.* at 33,298.

92. *See id.* at 33,293 n.6.

93. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 957, 124 Stat. 1376, 1906 (2010).

94. *See id.*

95. *See* PROXY WORKING GRP. TO THE N.Y. STOCK EXCH., REPORT AND RECOMMENDATIONS OF THE PROXY WORKING GROUP TO THE NEW YORK STOCK EXCHANGE 14 (2006), *available at* http://www.nyse.com/pdfs/PWG_REPORT.pdf.

96. *Compare* Bebchuk, *supra* note 85, at 836, *with* Bainbridge, *supra* note 86, at 1746.

97. *See* Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56,668, 56,761 (Sept. 16, 2010) (to be codified at 17 C.F.R. pts. 200, 232, 240, 249). (noting the potential of proxy access to lead to "greater accountability on the part of incumbent directors to the extent they see a close link between their performance and the prospect of removal"); Bebchuk, *supra* note 85, at 836.

98. *See* Facilitating Shareholder Director Nominations, 75 Fed. Reg. at 56,765–66 (discussing concerns).

99. *See id.* at 56,765 (discussing concerns).

special interests to gain unwarranted influence over the company and its policies.[100] Given the strength of views on both sides of this issue, shareholders have found it difficult to obtain proxy access.[101]

The federal government has played a vital role in the proxy access debate. As an initial matter, in an effort to pave the way for a proxy access rule, Dodd-Frank specifically authorized the SEC to create a proxy access rule.[102] This authorization reflected a direct response to those who insisted that the SEC lacked the authority to mandate proxy access.[103]

Shortly after this authorization, the SEC approved a proxy access regime for the first time in its history.[104] That regime not only requires every public company to grant proxy access to its shareholders, but also allows shareholders to propose additional mechanisms for gaining access to the company's proxy statement.[105] Under the new rules, shareholder nominees may be included on a corporation's proxy statement if they (1) own at least three percent of the voting power of the company's securities, (2) have held such securities continuously for at least three years, and (3) are not holding the securities in order to change control of the company or gain board seats exceeding the maximum number required to be included under the SEC's rule.[106] Under the new regime, a company is not required to include more than one nominee, or the number of nominees that would represent up to twenty-five percent of the company's board, whichever is greater.[107]

In addition to mandating proxy access, the new rules amend the federal shareholder proposal rule to enable shareholder proposals regarding the company's nomination proce-

100. *See* Bainbridge, *supra* note 86; Bratton & Wachter, *supra* note 86.

101. *See* Lisa M. Fairfax, *The Future of Shareholder Democracy*, 84 IND. L.J. 1259, 1273–79 (2009).

102. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 971(a)–(b), 124 Stat. 1376, 1915 (2010).

103. *See* Facilitating Shareholder Director Nominations, 75 Fed. Reg. at 56,674.

104. *See* Neal Lipschutz, *'Proxy Access' Era Begins; Welcome to the Unknown*, WALL ST. J., Aug. 25, 2010, http://online.wsj.com/article/SB10001424052748703632304575451892123490472.html.

105. *See* Facilitating Shareholder Director Nominations, 75 Fed. Reg. at 56,670.

106. *See id.* at 56,674–75.

107. *See id.* at 56,675.

dures to appear on the company's proxy statement.[108] The SEC made clear that if shareholders approve any such proposals, they will not supplant the mandated access rule.[109] Instead, such proposals would represent an additional route through which shareholders could access the corporation's proxy statement in order to nominate candidates of their choice.[110]

The proxy access rules were scheduled to take effect on November 15, 2010, and apply to public companies (other than small issuers) that had mailed their proxy statements on or after March 15, 2010.[111] However, the U.S. Chamber of Commerce and the Business Roundtable challenged the SEC's authority to implement such rules.[112] As a result, the SEC announced that it would delay implementation of the rules until a court ruling on the suit, which is not expected until late spring of 2011 at the earliest.[113]

Proxy access is aimed at enhancing shareholders' nomination right and, hence, their ability to influence board elections and, by extension, corporate governance.[114] Because of the dispersed nature of public shareholders, such shareholders typically vote by proxy—that is, they do not attend the shareholder meeting in person, but rather designate a representative to cast a vote on their behalf.[115] Proxy rules require that any solicitation of shareholders' proxy be accompanied by a proxy statement filed with the SEC and distributed to shareholders entitled to vote.[116] Thus, when shareholders vote on board

108. *See id.* at 56,676–77. This new provision reverses a provision adopted by the SEC in 2007. *See* 17 C.F.R. § 240.14a-8(i)(8) (2010).

109. *See* Facilitating Shareholder Director Nominations, 75 Fed. Reg. at 56,730–31.

110. *See id.*

111. *See* Memorandum from Wilson Sonsini Goodrich & Rosati to clients of Wilson Sonsini Goodrich & Rosati, Effective Date of Proxy Access Rules Announced (Sept. 16, 2010), *available at* http://www.wsgr.com/publications/pdfsearch/wsgralert_proxy_rules_effective_date.pdf.

112. *See* Jessica Holzer, *Lawsuit Aims to Overturn Proxy Rule in Overhaul*, WALL ST. J., Sept. 30, 2010, at C3, *available at* http://online.wsj.com/article/SB10001424052748704116004575522151605541266.html.

113. *See* Jesse Westbrook, *SEC Delays Proxy-Access Rules Amid Legal Challenge*, BLOOMBERG BUSINESSWEEK (Oct. 4, 2010, 5:34 PM), http://www.businessweek.com/news/2010-10-04/sec-delays-proxy-access-rules-amid-legal-challenge.html.

114. *See* Facilitating Shareholder Director Nominations, 75 Fed. Reg. at 56,669–70.

115. *See id.* at 9.

116. *See* 17 C.F.R. § 240.14a-4(a)(2) (2010) (distribution to shareholders); 17 C.F.R. § 240.14a-6 (2010) (filing with the SEC).

candidates, corporations distribute a proxy statement identifying the names of director-candidates.[117] Currently, only management-supported candidates appear on the corporate proxy statement.[118] As a general matter, shareholders seeking to nominate candidates of their choice must engage in a proxy contest pursuant to which they prepare and distribute their own separate proxy statement.[119] Evidence suggests that the costs and other logistical hurdles associated with waging a proxy contest makes it prohibitive for all but a small percentage of shareholders.[120] As a result, very few shareholders have the opportunity to nominate candidates of their choice.[121] Thus, in most director elections, shareholders only vote on candidates supported by management and the incumbent board. Proxy access appears to change this dynamic, ensuring that boards are not simply nominating themselves, thereby increasing the likelihood that boards feel more accountable to shareholders.[122]

4. Impact on Board Responsibilities

Increasing shareholders rights implicates directors' responsibilities. Reforms in this area are designed to increase the likelihood that directors will pay closer attention to, and be better informed about, shareholder concerns.[123] Hence, law firms have begun encouraging corporations to become better informed about their shareholder base in the wake of proxy access and broker voting changes.[124] Moreover, reforms that in-

117. *See id.* § 240.14a-3 (2010).

118. *See id.* § 240.14a-8(i)(8) (2010).

119. Facilitating Shareholder Director Nominations, 75 Fed. Reg. at 56,755.

120. *See id.* at 56,755–57.

121. *See* Bebchuk, *supra* note 85, at 856 (discussing the relatively small number of proxy contests waged each year).

122. *See* Facilitating Shareholder Director Nominations, 75 Fed. Reg. at 56,761.

123. *See* CLEARY GOTTLEIB STEEN & HAMILTON LLP, ALERT MEMO: RESPONDING TO THE ELIMINATION OF BROKER DISCRETIONARY VOTING IN ELECTIONS OF DIRECTORS 3–5 (2009) [hereinafter RESPONDING TO BROKER VOTING], *available at* http://www.cgsh.com/files/News/0463ffec-4df5-4fe7-ad00-23897d70b313/Presentation/NewsAttachment/be81ee82-fd96-4837-a7d0-74b4d2d8a359/CGSH%20Alert%20-%20Responding%20to%20Elimination%20of%20Broker%20Discretionary%20Voting%20in%20Elections%20of%20Directors.pdf (emphasizing the need for enhanced responsiveness to shareholder concerns).

124. *See id.* at 3 (noting the need to refocus on shareholder outreach); *SEC Adopts Shareholder Proxy Access Rules*, DORSEY & WHITNEY LLP, (Aug. 30, 2010), http://www.dorsey.com/eu_proxy_access_0830/ (noting that in the face of increased shareholder power, outreach and attention to shareholder relations "will be more important than ever"); *Proxy Access Litigation and Next*

crease shareholder power also increase the likelihood that directors will enhance their engagement with shareholders on a more routine basis. Anecdotal evidence from the United Kingdom reveals that say-on-pay has increased communications between boards and shareholders with respect to compensation.[125] A similar pattern may emerge in the United States Additionally, anecdotal evidence in the United States suggests that increased shareholder activism has prompted corporations to meet more frequently with some of their large shareholders.[126] Although directors did not historically view engagement with shareholders as part of their job, increased shareholder activism coupled with reforms aimed at giving shareholders greater voice, have prompted corporations to facilitate director-shareholder communication.[127] In this respect, reforms aimed at enhancing shareholder power may lead to a climate of more active engagement between shareholders and directors.[128] While such a climate may be beneficial, it certainly expands boards' responsibilities.[129]

*Steps*, GIBSON DUNN & CRUTCHER LLP, (Oct. 8, 2010), http://www.gibsondunn.com/publications/pages/ProxyAccessLitigationAndNextSteps.aspx (recommending that companies reach out to their significant shareholders, keep directors informed about shareholder concerns, and reach out to their entire shareholder base); *SEC Adopts Proxy Access Rules to Facilitate Shareholder Nominations of Directors*, GOODWIN PROCTER LLP, (Sept. 1, 2010), http://www.goodwinprocter.com/Publications/Newsletters/Client-Alert/2010/SEC-Adopts-Proxy-Access-Rules-to-Facilitate-Shareholder-Nominations-of-Directors.aspx (advising corporations to get to know their large shareholders); *SEC Eliminates Discretionary Broker Voting for Uncontested Director Elections*, WILSON SONSINI GOODRICH & ROSATI (July 15, 2009), http://www.wsgr.com/wsgr/Display.aspx?SectionName=publications/PDFSearch/wsgralert_rule452_amendment.htm (advising companies to get a better understanding of their shareholder base and potential changes to that base, and "[t]ake a more comprehensive, year-round" approach to director elections).

125. *See* Davis, *supra* note 28, at 50; Gordon, *supra* note 21, at 342 (noting the much higher level of shareholder engagement); Lund, *supra* note 22, at 126–27.

126. *See* LATHAM & WATKINS LLP, DANGEROUS TALK? WHEN/HOW SHOULD DIRECTORS COMMUNICATE WITH SHAREHOLDERS? 2, *available at* http://www.directorsforum.org/resources/pdf/cdf_dangerous_talk_program_outline_3-18.pdf?ID=3.362 (describing companies' increased engagement with shareholders).

127. *See id.* at 2–3.

128. *See id.*

129. *See infra* Part II.A.

## II. THE DISCONNECT BETWEEN BOARD REFORMS AND BOARD REALITIES

The governmental reforms pinpointed in Part I appear to lose sight of at least two realities of current board structure that not only undermine the potential effectiveness of those reforms, but also highlight the need for reconsideration of the board's role. This section examines three areas. First, reforms appear to have an unrealistic expectation about board capacity, potentially overburdening boards in ways that may undermine their ability to be effective. Second, reforms not only impose a myriad of new responsibilities on boards without sufficient consideration of whether board members have sufficient expertise to effectively tackle those responsibilities, but also impose criteria on directors that may undermine their expertise, increasing the likelihood that boards will feel ill equipped to adequately perform their duties. Reforms also increase the likelihood that boards will inappropriately rely on third-party advisors and managers, engaging in the kind of rubber-stamping of their decisions reforms were aimed at combating. This section addresses each of these issues.

### A. PART-TIME JOB, FULL-TIME RESPONSIBILITIES?

Reforms impose increasing amounts of responsibility on board members. Some reforms even pinpoint the number of meetings to be held by directors.[130] For example, companies receiving TARP funding must ensure that their compensation committees meet at least semiannually to discuss and evaluate any risks associated with the company's employee compensation plans.[131] Proxy data reveals that directors spend considerably more time on board matters as compared to ten or twenty years ago.[132] Moreover, the time commitment associated with board service grew significantly in the wake of governance reforms passed under SOX.[133] It seems likely that the current set

130. *See* American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 7001, 123 Stat. 115, 518.

131. *Id.*

132. *See* KORN/FERRY INST., 34TH ANNUAL BOARD OF DIRECTORS STUDY 10 (2007), *available at* http://www.kornferryinstitute.com/files/pdf1/Board_Study07_LoRez_FINAL.pdf; SPENCER STUART, 2009 SPENCER STUART BOARD INDEX 8–9 (2009), *available at* http://content.spencerstuart.com/sswebsite/pdf/lib/SSBI2009.pdf.

133. *See* KORN/FERRY INST., *supra* note 132, at 10.

of reforms will generate a similar increase in the amount of time directors must devote to board matters.

However, reforms fail to reconcile this increased time commitment with the limited nature of board service.[134] As an initial matter, reforms appear to lose sight of the fact that board membership represents a part-time position. Many reforms, such as those involving the compensation committee, impose duties on directors who are required to be independent.[135] However, even when reforms do not embody such a requirement, empirical data demonstrates that the vast majority of public company directors are independent.[136] By definition, independent directors are people who have no employment relationship with the company, which means that such directors often have outside engagements, including other full-time jobs.[137] One 2007 study revealed that seventy-eight percent of companies have at least one active CEO or chief operating officer (COO) on the board.[138] A 2009 study further revealed that although active CEOs, COOs, and presidents no longer dominate the board, they still account for twenty-six percent of all new directors.[139] Moreover, sixty-one percent of new directors are active executives or professionals.[140] These statistics confirm that most directors have significant outside obligations, requiring them to balance their board responsibilities with these obligations. Reforms only exacerbate this difficult balancing act.

Second, reforms do not appear to sufficiently appreciate the fact that boards consist of a relatively small group of people. The average public company board consists of ten directors, a number that has been virtually unchanged for at least a decade.[141] However, board size has decreased significantly from its historical levels in which the average board contained between sixteen and twenty-five directors.[142] In this respect, we have

134. *Id.* at 14.

135. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 952, 124 Stat. 1376, 1900–03 (2010).

136. *See* KORN/FERRY INST., *supra* note 132, at 4.

137. *See* Donald C. Clarke, *Three Concepts of the Independent Director*, 32 DEL. J. CORP. L. 73, 84, 99–100 (2007); Usha Rodrigues, *The Fetishization of Independence*, 33 J. CORP. L. 447, 464 (2008).

138. KORN/FERRY INST., *supra* note 132, at 18 tbl.B.

139. SPENCER STUART, *supra* note 132, at 12.

140. *See id.* at 13.

141. *See* KORN/FERRY INST., *supra* note 132, at 4, 17 tbl.A.

142. *See id.* at 6.

come to expect that a smaller group of directors can carry out increasingly greater responsibilities.

Third, often director responsibilities disproportionately fall on a particular board committee, rather than the board as a whole.[143] In the last set of reforms, the committee experiencing the greatest level of enhanced responsibilities was the audit committee.[144] Reflecting these increased responsibilities, audit committees saw the greatest rise in the frequency of their meetings as well as the greatest rise in the time devoted to board matters.[145] Current reforms focus significantly on the compensation committee,[146] which has on average three members.[147] A 2009 study revealed that compensation committees were already meeting more frequently, likely due to the increased focus on compensation matters.[148] These new reforms demand an even greater time commitment from such committee members. This means that the enhanced work required of directors is actually being imposed on a small subset of the board, a subset already burdened with additional meetings and workloads.

Finally, it is possible that reforms augmenting shareholder rights exacerbate this overburdening problem. If proxy access and other election related reforms increase the potential for election contests, they could prove distracting in ways that undermine boards' ability to fully carry out their other responsibilities.[149] Indeed, election contests are time-consuming and, thus, any spike in those contests could ensure that directors turn their attention away from other issues. Of course it is possible that legal challenges will hinder implementation of proxy access and, thus, the distractions associated with proxy access may never materialize.[150] However, even without such access, rules aimed at increasing shareholder power inevitably increase board responsibilities with respect to shareholders, ensuring that they devote time and resources toward under-

143. *Cf. id.* at 18 tbl.B ("[R]esponsibilities of boards specifically identified in the proxies and assigned to a particular committee.").

144. *See* Lawrence Cunningham, *Rediscovering Board Expertise: Legal Implications of the Empirical Literature*, 77 U. CIN. L. REV. 465, 475–76 (2008).

145. *See* KORN/FERRY INST., *supra* note 132, at 18–19 tbls.C–E.

146. *See supra* Part I.A.4.

147. *See* KORN/FERRY INST., *supra* note 132, at 19 tbl.D.

148. *See* SPENCER STUART, *supra* note 132, at 7, 9.

149. *See* Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56,668, 56,765 (Sept. 16, 2010) (to be codified at 17 C.F.R. pts. 200, 232, 240, 249).

150. *See* Holzer, *supra* note 112, at C3.

standing issues of concern to the shareholder base.[151] Thus, reforms like changes to broker discretionary voting and the increased implementation of majority voting heighten the corporation's need to identify and interact with investors.[152] Indeed, in adopting its final proxy access rule, the SEC identified concerns that "the board may incur costs in attempting to institute policies and procedures it believes will address shareholder concerns."[153]

To be sure, the observation that enhanced shareholder rights may involve an increased time commitment from directors does not necessarily mean that such an enhancement is not legitimate or otherwise worthwhile. As the SEC noted, the costs associated with new shareholder rights may be offset by the new rules themselves as well as the benefits associated with those rules.[154]

Nonetheless, the combination of the time commitment associated with increased shareholder rights coupled with the time necessary to tackle directors' new responsibilities in other areas does raise serious questions about board capacity. Importantly, are we asking too much of the relatively small pool of part-time directors tasked with these new responsibilities? New reforms do not answer that question, thereby failing to fully reconcile the duties imposed on boards with the realities of board life.

### B. INDEPENDENCE VS. EXPERTISE?

Reforms also impose responsibilities on the board without a careful consideration of how, and to what extent, directors will have the expertise to carry out those duties. Only one reform references director expertise.[155] The new SEC disclosure rules now require companies to disclose the "experience, qualifications, attributes or skills" of all board nominees and directors every year.[156] However, other rules are not only silent on this issue,[157] but may potentially undermine director expertise.

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151. *See supra* Part I.A.4.

152. *See supra* note 127 and accompanying text (discussing the notion that shareholders' enhanced rights require enhanced interaction between the board and its shareholders).

153. Facilitating Shareholder Director Nominations, 75 Fed. Reg. at 56,765.

154. *See id.*

155. *See* Proxy Disclosure Enhancements, 74 Fed. Reg. 68,334, 68,342 (Dec. 23, 2009).

156. *Id.*

157. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act,

In particular, reforms that focus on director independence could prove counterproductive. Indeed, all public company compensation committees must now consist entirely of independent directors.[158] On the one hand, this new mandate may appear unremarkable. Indeed, this mandate parallels the one encompassed in SOX for audit committees.[159] Moreover, this mandate appears to codify existing listing standards which require compensation, audit, and nominating committees to consist of independent directors.[160] In the vast majority of public companies, not only are most board committees comprised solely of independent directors, but almost all board members are independent.[161] In 2007 the average board only had two directors who were not independent.[162] As a result, reforms in this area do not appear to break any new ground.

On the other hand, such reforms further legitimize the presumption in favor of board independence without a full appreciation of the potential drawbacks associated with that independence.[163] Evidence on the benefits of independence both with respect to the entire board and with respect to certain committees is equivocal. Some empirical studies support the notion that independent directors improve corporate perfor-

Pub. L. No. 111-203, § 952, 124 Stat. 1376, 1900–03 (2010).

158. *Id.*

159. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 301, 116 Stat. 745, 775–77.

160. *See* NASDAQ, INC., NASDAQ LISTING RULES, rs. 5605(c) (audit committee), 5605(d) (compensation committee), 5605(e) (nominating committees) (2009), *available at* http://nasdaq.cchwallstreet.com/NASDAQ/pdf/new_listing_rules.pdf; NYSE, INC., NYSE LISTED COMPANY MANUAL §§ 303A.07 (audit committee), 303A.05 (compensation committee), 303A.04 (nominating committee) (2009), *available at* http://nysemanual.nyse.com/LCMTools/PlatformViewer.asp?selectednode=chp_1_4_3&manual=%2Flcm%2Fsections%2Flcm-sections%2F; *see also* NYSE AMEX, INC., NYSE AMEX L.L.C. COMPANY GUIDE §§ 803 (audit committee), 804 (nominating committee), 805 (compensation committee) (2008), *available at* http://wallstreet.cch.com/AMEXtools/PlatformViewer.asp?SelectedNode=chp_1_1_8&manual=/AMEX/CompanyGuide/amex-company-guide/.

161. *See* Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231, 239 (2002) [hereinafter Bhagat & Black, *Long-Term Performance*]; Jeffrey Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1476 (2007); KORN/FERRY INST., *supra* note 132, at 6, 19 tbl.D.

162. *See* KORN/FERRY INST., *supra* note 132, at 6.

163. *See* Cunningham, *supra* note 144, at 494–97 (2008) (discussing the "curious" pattern of rewarding independence over expertise).

mance.[164] Moreover, some studies find that boards comprised of independent directors perform better at particular tasks such as firing a poorly performing CEO[165] and detecting fraud.[166] Other studies reveal that greater independence on the audit committee improves financial reporting,[167] while reducing the incidence of abusive accounting practices.[168]

By contrast, some studies find no significant correlation between enhanced director independence and corporate performance.[169] In addition, a study of nominating, audit, and compensation committees found little evidence that complete independence on those committees positively impacted a company's performance.[170] Studies also indicate that independent directors may not be more effective at discrete tasks such as monitoring companies in financial distress.[171] More importantly for purposes of the current reforms, studies indicate that independent directors may not have an impact on curtailing CEO compensation.[172] Then too, no study supports the proposition that a supermajority of independent directors will produce better corporate performance.[173]

While scholars disagree with respect to the weight that should be given to various studies, even proponents of enhanced director independence acknowledge that the empirical evidence on the benefits associated with independent directors

164. *See, e.g.*, Robert A. Prentice & David Spence, *Sarbanes-Oxley as Quack Corporate Governance: How Wise Is the Received Wisdom?*, 95 GEO. L.J. 1843, 1866 (2007); Sanjai Bhagat & Brian Bolton, Sarbanes-Oxley, Governance and Performance 17 (Mar. 17, 2009) (unpublished manuscript), *available at* http://ssrn.com/abstract=1361815.

165. *See* Michael S. Weisbach, *Outside Directors and CEO Turnover*, 20 J. FIN. ECON. 431, 444, 452–54 (1988).

166. *See* Hatice Uzun et al., *Board Composition and Corporate Fraud*, 60 FIN. ANALYSTS J. 33, 39 (2004).

167. Prentice & Spence, *supra* note 164, at 1872–73.

168. *See* Bhagat & Bolton, *supra* note 164, at 19 (finding financial expert directors are not busier and thus not associated with weaker corporate governance).

169. *E.g.*, Bhagat & Black, *Long-Term Performance, supra* note 161, at 231, 263.

170. *See* April Klein, *Firm Performance and Board Committee Structure*, 41 J.L. & ECON. 275, 300–01 (1998).

171. *E.g.*, Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921, 932–33 (1999) [hereinafter Bhagat & Black, *Uncertain Relationship*].

172. *See* Bhagat & Black, *Long-Term Performance*, *supra* note 161, at 235.

173. *See id.*; Bhagat & Black, *Uncertain Relationship*, *supra* note 171, at 922–23.

is mixed, if not "weak at best."[174] Moreover, studies indicate that factors beyond director independence may explain the positive relationship between such independence and improved corporate performance.[175]

Even if independent directors produce some benefits for the corporation, such benefits must be weighed against costs that may undermine reform goals. Indeed, independent directors by their very nature are not employed by the company and, hence, have no first-hand knowledge of the day-to-day affairs of the corporation.[176] Moreover, currently there is no requirement that directors have any industry-specific knowledge about the company on whose boards they serve.[177] Thus, while many directors may have knowledge about business matters more generally, there is nothing to ensure that they have knowledge regarding the particular industry or the specific company on whose board they sit.[178] This suggests that even as we impose additional responsibilities on directors, those directors may not have the expertise necessary to effectively grapple with those responsibilities.

In addition, it is possible that shareholder reforms exacerbate this expertise problem in at least three respects. First, by enabling shareholders to determine who is nominated to the board, proxy access creates the possibility that shareholders will elect directors without the skill-set to tackle important problems, or that the overall board will not have the appropri-

174. Gordon, *supra* note 161, at 1500; *see also* Prentice & Spence, *supra* note 164, at 1864, 1867 ("[The evidence is] decidedly mixed, [and thus] one cannot claim the empirical evidence clearly indicates that more independent boards will produce better financial results.").

175. Bhagat & Bolton, *supra* note 164, at 4.

176. *See* Clarke, *supra* note 137, at 79; Rodrigues, *supra* note 137, at 460 n.66.

177. Statutes give boards the discretion to determine director qualifications. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141 (Supp. 2010) (same); MODEL BUS. CORP. ACT § 8.02 (2009) (enabling director qualifications to be set forth in the bylaws or charter). While SOX requires that at least one member of the audit committee be a "financial expert," *see* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 407(a), 116 Stat. 745, 790, the new rules do not dictate any further director qualifications. *See also* Laurie B. Smilan, *The New Enhanced Disclosure Rules—Ready, Set, Change and Now*, *in* AUDIT COMMITTEE WORKSHOP 2010, at 611, 630 (PLI Corporate Law & Practice, Course Handbook Ser. No 23,982, 2010), *available at* WL 1820 PLI/Corp 611.

178. *See* Margaret A. Bancroft, *Knowledge is Power: What Went Wrong in the Mutual Fund Industry*, 1 J. BUS. & TECH. L. 145, 154–55 (2006) (noting that independent directors do not even have experience relevant to the industry, let alone specific experience related to the company on whose board they serve).

ate mix of skills necessary to perform its responsibility.[179] Second, by potentially increasing the number of contested elections or otherwise increasing directors' election vulnerability, enhanced shareholder rights may discourage qualified candidates from serving on boards, thereby reducing the overall pool of qualified candidates available for board service.[180] Third, campaigns aimed at increasing majority voting and decreasing classified boards increase the possibility that directors will serve for shorter terms,[181] making it more difficult to create a group of board members with a long-term knowledge of the company and the industry.

To be sure, these possibilities are not an inevitable byproduct of increased shareholder power. Instead, it is possible that the new rules may have relatively little impact on directors' willingness to serve. Moreover, such rules may enhance the overall quality of boards by increasing the diversity of board candidates.[182]

Nonetheless, like the overburdening problem, the possibility that boards will not have the expertise to carry out their functions could undermine their ability to sufficiently fulfill those functions. Indeed, new reforms not only require directors to fulfill an increased amount of responsibilities, but also require them to attend to different types of issues ranging from shareholder-related concerns to those involving risk assessments. Such requirements certainly raise the possibility that directors may not be equipped to sufficiently address the complete range of issues on which they are now being asked to focus.

### C. IMPLICATIONS ASSOCIATED WITH OUTSIDE ADVISORS

Reforms also increase the possibility that boards will unduly rely on management, advisors, and outside consultants in a manner that could have significant negative repercussions. This possibility could emerge in a variety of ways. First, the mere fact that boards may feel overburdened could prompt them to rely more heavily on outsiders and management in or-

179. *See* Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56,668, 56,765–66 (Sept. 16, 2010) (to be codified at 17 C.F.R. pts. 200, 232, 240, 249) (detailing concerns).

180. *Id.* at 56,765.

181. *See* Fairfax, *supra* note 84, at 61–71 (discussing trends related to majority voting and classified boards).

182. Facilitating Shareholder Director Nominations, 75 Fed. Reg. at 56,766.

der to alleviate that burden. Second, anecdotal and other evidence suggest that when directors believe that they lack the necessary expertise to grapple with particular issues, they tend to rely more heavily on managers and other advisors perceived to have such expertise.[183] From this perspective, it is no surprise that the growing influence of compensation consultants[184] coincides with the increased emphasis on independent directors who often may feel ill equipped to tackle the complexities of compensation matters. Finally, increasing shareholders' power also may increase the potential for enhanced reliance on outside consultants such as proxy and advisory firms. Shareholders tend to rely on such firms for voting and other advice because the firms are perceived to have more resources and to be better informed about issues on which shareholders must cast their vote.[185] Shareholders' reliance on these firms impacts boards because boards look to such firms for cues regarding shareholder preferences.[186] In this manner, increased shareholder voice increases the likelihood that these firms will play a more central role in board decisionmaking.[187]

To be sure, reliance on managers and outside advisors may be beneficial. Indeed, one should expect that directors would rely on outsiders to help educate them on particular issues, or to fill the gap in their own knowledge base.[188] Importantly, reforms expect and even encourage such reliance.[189]

183. *See* Susan J. Stabile, *Viewing Corporate Executive Compensation Through a Partnership Lens: A Tool to Focus Reform*, 35 WAKE FOREST L. REV. 153, 175–76 (2000); Randall S. Thomas, *Explaining the International CEO Pay Gap: Board Capture or Market Driven?*, 57 VAND. L. REV. 1171, 1191–92 (2004) (noting that compensation committees hire expert compensation consultants to assist with its tasks).

184. *See* Lucian Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 768 (2002); Fogel & Geier, *supra* note 7, at 62 n.125; Mary-Hunter Morris, *The Price of Advice*, 86 U. DET. MERCY L. REV. 153, 176–77 (2009); Randall S. Thomas, *Should Directors Reduce Executive Pay*?, 54 HASTINGS L.J. 437, 466–67 (2003).

185. *See* Stephen Choi et al., *Director Elections and the Role of Proxy Advisors*, 82 S. CAL. L. REV. 649, 655 (2009) (noting the tendency of shareholders to rely on proxy services who are perceived to have more specialized expertise with respect to voting issues); Gordon, *supra* note 21, at 351–52.

186. *See* Choi et al., *supra* note 185, at 653.

187. *See* Gordon, *supra* note 21, at 352 ("The propensity of many U.S. institutional investors to delegate such decisions could well give power to a handful of proxy service firms to make substantively very important decisions with potentially economy-wide ramifications.").

188. *See* Choi et al., *supra* note 185, at 655.

189. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 952, 124 Stat. 1376, 1900–03 (2010) (providing for di-

However, significant reliance on management and advisors raises its own set of problems. First, there always exists the potential that directors may inappropriately defer to such decisions.[190] Such deference could mean that directors fail to sufficiently criticize or probe decisions made by third parties.[191] In this way, directors' reliance could lead to the kind of rubber stamping of critical decisions that reforms are aimed at preventing.

Second, directors' increased reliance on advisors could negatively impact the performance of board duties because such advisors may have conflicts of interests that undermine reform goals. Indeed, studies reveal that advisors can have conflicts of interest resulting from their dual role of both establishing guidelines in a given area while also providing advice with respect to particular decisions in that same area.[192] Reflecting such conflicts, a 2007 report commissioned by the House of Representatives revealed a pervasive level of conflicts of interests among compensation consultants.[193] Such conflicts raise transparency issues. Indeed, according to the report, not only did companies fail to disclose the extent of such conflicts, but often companies identified consultants as independent even when other information suggested the existence of conflicts.[194] Furthermore, the report indicated that conflicted consultants worsen problems associated with excessive or inappropriate executive compensation.[195] Thus, companies with highly conflicted consultants paid their CEOs a median salary sixty-seven percent higher than the median salary of companies that had

rector engagement of compensation consultants, independent legal counsel, and other advisors).

190. *See* Fogel & Grier, *supra* note 7, at 62; Morris, *supra* note 184, at 176–77; Stabile, *supra* note 183, at 175–76; Thomas, *supra* note 184, at 467.

191. *See* Choi et al., *supra* note 185, at 650.

192. *See id.* at 657–58; Gordon, *supra* note 21, at 352–53.

193. *See* STAFF OF H. COMM. ON OVERSIGHT AND GOV'T REFORM, 110TH CONG., EXECUTIVE PAY: CONFLICTS OF INTEREST AMONG COMPENSATION CONSULTANTS, at i, 4 (Comm. Print 2007), *available at* http://www.erieri.com/PDF/Executive-Consultant-Conflicts.pdf (noting that over one hundred Fortune 250 firms hired compensation consultants that have been hired by corporate management to provide other services to the company, and that often the amount the consultants earned for these other services far outstripped the amount earned for compensation advice).

194. *See id.* at 5.

195. *See id.* at 6.

hired consultants without such conflicts.[196] Then too, the median CEO salary increased at a higher pace in companies with conflicted compensation consultants.[197] To be sure, reforms aim to reduce conflicts related to compensation consultants by enhancing the independence criteria associated with such consultants.[198] However, it is not clear if such criteria will have their desired effect. In addition, no such criteria exist for proxy firms and similar advisors, despite concerns about their potential conflicts of interest.[199] Thus, it remains possible that consultants can pose conflicts that prevent reforms from achieving their goal. As a result, undue reliance on such consultants is especially troubling.

Third, reliance on such advisors may increase the potential for one-size-fits-all solutions that could negatively impact corporations and undermine the effectiveness of reforms. Several commentators have expressed concern that overreliance on compensation consultants could lead corporations to "homogenize" compensation practices.[200] Studies associated with the United Kingdom reveal that such homogenization has occurred.[201] While there may be some practices that are applicable across companies, it is likely that standardizing certain practices would lead to suboptimal compensation practices at some companies.[202] Such a possibility suggests that an undue reliance on outside advisors could have unintended and negative consequences for reform goals.

Finally, a heightened reliance on outside advisors may raise accountability concerns. Indeed, in the context of proxy advisors, several commentators have expressed fear that such advisors have an inordinate amount of power without sufficient accountability for how they wield that power.[203] While this fear

196. *See id.* The median salary of CEOs with highly conflicted consultants was $12.5 million as opposed to $7.5 million for CEOs with nonconflicted consultants. *Id.*

197. *See id.* at 7 (demonstrating that the median CEO salary increase of the most highly conflicted consultants rose by 226 percent over a five-year period, as compared to 105 percent amongst nonconflicted CEOs).

198. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 952, 124 Stat. 1376, 1900–03 (2010).

199. *See* Choi et al., *supra* note 185, at 657–58.

200. *See* Gordon, *supra* note 21, at 347–48; Lund, *supra* note 22, at 130–31.

201. *See* Davis, *supra* note 28, at 51.

202. *See* Lund, *supra* note 22, at 130–32.

203. *See* Choi et al., *supra* note 185, at 657–58 (pinpointing concerns).

may be exaggerated,[204] it nevertheless underscores the fact that outside advisors are not accountable to shareholders or other corporate constituents. In this respect, reliance on those advisors creates the potential for an environment of reduced accountability at odds with reform goals.

### D. Concluding Assessments

This Part demonstrates that reforms may have overestimated directors' ability to grapple with the variety of new responsibilities imposed upon them. Indeed, the board is composed of a small group of people with significant outside obligations. Reforms enhance those obligations without assessing whether directors have the ability to effectively perform them. Moreover, reforms require directors to tackle increasingly complex issues without any discussion regarding whether they have the necessary expertise. As a result, reforms may encourage directors to unduly rely on management and outside advisors. This Part reveals that reforms raise legitimate concerns regarding whether we can expect directors to carry out their new roles with the kind of diligence and rigor needed to avoid the next calamity, or if we have simply set boards up for failure in this regard.

## III. THE FIDUCIARY DUTY MISMATCH

This Part focuses on the fiduciary duty concerns raised by increasing directors' responsibilities with respect to compensation and risk. As this Part will demonstrate, directors' liability risk appears to be at odds with reform goals, particularly to the extent those goals seek to enhance director accountability or otherwise incentivize directors to more effectively fulfill their monitoring role.

### A. Director Duties and the Rarity of Liability

Under Delaware law, the risk that directors will be held personally liable for breaching their fiduciary duty in connection with compensation-related decisions is exceedingly low.[205] Importantly, the leading and most comprehensive empirical study on outside director liability makes clear that, as a general matter, directors' risk of personal liability with respect to

204. *See id.* at 696.

205. *See* Bernard Black et al., *Outside Director Liability*, 58 STAN. L. REV. 1055, 1062 (2006).

paying legal expenses or damages either in connection with judgments following a shareholder suit or a settlement agreement is relatively low, making such liability a "rare occurrence."[206]

This observation is especially apropos with respect to compensation matters. Indeed, in light of directors' express authority to determine the compensation of officers and agents,[207] courts grant them wide discretion in this area.[208] That discretion protects director decisions even if they can be characterized as ill-advised or poorly timed.[209] Thus, a board or compensation committee decision will be protected even if it falls "far short of corporate governance 'best practices.'"[210] In fact, unless such decisions can be defined as fraudulent or unconscionable, directors will not be held liable for them.[211] Boards' discretion in this area extends to their ability to rely on others who may have expertise in compensation matters.[212] Reasonable reliance on compensation consultants or other experts often insulates boards from seemingly ill-advised compensation decisions.[213] In light of these realities, it is extremely difficult to hold directors liable for compensation decisions.

A similar pattern emerges with respect to allegations involving breach of directors' duty to oversee risk. As an initial matter, Delaware courts have made clear that seeking to hold

206. *See id.*

207. *See* DEL. CODE ANN. tit. 8, § 122(5) (2001).

208. *See* White v. Panic, 783 A.2d 543, 553 (Del. 2001); Brehm v. Eisner, 746 A.2d 244, 262 (Del. 2000); Grimes v. Donald, 673 A.2d 1207, 1214–15 (Del. 1996); Litt v. Wycoff, No. Civ.A. 19083-NC, 2003 WL 1794724, at *6 (Del. Ch. Mar. 28, 2003).

209. *See, e.g.*, *White*, 783 A.2d at 553 (holding that strike-suit settlements were within the confines of the business judgment rule, without examining the merits of the allegations); *Brehm*, 746 A.2d at 262 (declaring that the burden was on plaintiff to rebut the presumption of validity of board action under the business judgment rule, where the board has followed expert advice); *Grimes*, 673 A.2d at 1215 (declaring that the business judgment rule extends to the awarding of large severance packages to senior management); *Litt*, 2003 WL 1794724, at *6 n.39 (deeming the distribution of bonuses well within the discretion of the board).

210. *See In re* Walt Disney Derivative Litig., 906 A.2d 27, 55 (Del. 2006).

211. *See White*, 783 A.2d at 553; *Brehm*, 746 A.2d at 262; *Grimes*, 673 A.2d at 1215; *Litt*, 2003 WL 1794724, at *6 n.39.

212. *See* DEL. CODE ANN. tit. 8, § 141(e) (Supp. 2010) ("A member of the board of directors . . . shall . . . be fully protected in relying in good faith upon . . . opinions . . . the member reasonably believes are within such other person's professional or expert competence . . . .").

213. *See Walt Disney*, 906 A.2d at 60.

directors liable for breaching their oversight duty represents "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."[214] This difficulty appears to be exacerbated when oversight claims involve allegations of improper risk assessments.[215] Courts begin from the premise that directors have significant discretion to evaluate and determine their company's risk appetite. As one Delaware court noted, "[T]he essence of the business judgment of managers and directors is deciding how the company will evaluate the trade-off between risk and return."[216] That court then insisted that fiduciary duty law was "designed to allow corporate managers and directors to pursue risky transactions without the specter of being held personally liable if those decisions turn out poorly."[217]

Based on this understanding of directors' personal liability exposure in this area, the court expressed considerable doubt about the appropriateness of oversight cases alleging directors' failure to properly manage risk, noting that it is "almost impossible" for a court to determine whether directors had properly evaluated risk.[218] Thus, even if such a case could be brought, there would be an extremely high burden on plaintiffs "seeking to state a claim for personal director liability for a failure to see the extent of a company's business risk."[219] Moreover, if a corporation has an audit or risk management committee in place designed to report information with respect to risk, the existence of such a committee goes a long way toward shielding directors from liability.[220] As a result, Delaware courts have indicated that cases in this area would be almost impossible to win.[221] As this suggests, under current law, directors' liability exposure for breaches of their oversight responsibilities associated with risk appears to be almost nonexistent.

Directors' relatively low risk of liability related to compensation and risk seems at odds with federal reforms. In particu-

214. *See* Stone *ex rel.* AmSouth Bancorp. v. Ritter, 911 A.2d 362, 371 (Del. 2006) (citing *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967 (Del. Ch. 1996)).

215. *See In re* Citigroup S'holder Litig., 964 A.2d 106, 106 (Del. Ch. 2009) (noting the high burden for claims related to oversight).

216. *Id.* at 126.

217. *Id.* at 125.

218. *Id.* at 126.

219. *Id.* at 125.

220. *Id.* at 127.

221. *See id.*

lar, it seems in tension with the apparent desire to hold directors more accountable for their actions in these areas. Indeed, many reforms appear to reflect a desire to increase the accountability of directors, especially for compensation and risk decisions.[222] In adopting proxy access rules, the SEC specifically noted that the financial crisis had generated serious concerns about the accountability of some companies and boards, "and whether boards need to be more accountable for their decisions regarding issues such as compensation structures and risk management."[223] Yet this section's analysis of state fiduciary law makes clear that such law imposes no significant risk of personal liability for director duties related to such issues. As a result, one can be concerned about whether Delaware fiduciary law appropriately incentivizes directors to effectively perform their responsibilities related to risk monitoring or related to establishing appropriate compensation policies and practices.[224] In this regard, the lack of personal accountability inherent in Delaware fiduciary law seems to run counter to the expressed intent of reforms, reflecting an apparent disconnection between reform goals and that law.

### B. ALTERNATIVE ACCOUNTABILITY MECHANISM

Of course, this appearance may be deceiving for at least three reasons. First, reforms may embody their own accountability mechanism, making reliance on state fiduciary law un-

222. *See* Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56,668, 56,669 (Sept. 16, 2010) (to be codified at 17 C.F.R. pts. 200, 232, 240, 249); Proxy Disclosure Enhancements, 74 Fed. Reg. 68,334, 68,334 (Dec. 23, 2009) (emphasizing the focus on corporate accountability in adopting rules related to compensation and risk oversight); Richard Hall & John White, *A New Emphasis on Director Accountability*, WHO'S WHO LEGAL (June 2010), http://www.whoswholegal.com/news/features/article/28396/a-new-emphasis-director-accountability/ (discussing the focus on accountability throughout reforms); Sheppard Mullin, *New TARP Executive Compensation Guidance and a Call for Further Reform in Compensation Practices*, CORP. & SEC. L. BLOG (June 18, 2009), http://www.corporatesecuritieslawblog.com/tax-new-tarp-executive-compensation-guidance-and-a-call-for-further-reform-in-executive-compensation-practices.html (noting that the Treasury Department aimed to promote accountability through say-on-pay legislation and enhancements related to compensation committees).

223. *See* Facilitating Shareholder Director Nominations, 75 Fed. Reg. at 56,669.

224. *See, e.g.*, Eric J. Pan, *A Board's Duty to Monitor*, 54 N.Y.L. SCH. L. REV. 717, 718 (2010) (arguing that by failing to hold boards of directors responsible for "harmful outcomes that do not involve wrongful or illegal acts . . . Delaware courts have encouraged boards to be uninformed of aggressive risk-taking by officers").

necessary. Second, reforms may look beyond personal liability as a means for ensuring effective director accountability. Third, reforms may be relying on fiduciary duty law to adapt to the altered environment. This section will evaluate these possibilities and demonstrate the manner in which each appears unconvincing.

1. Shareholder Power as Accountability

It is possible that reforms themselves serve to enhance directors' accountability. In particular, it is clear that reforms aimed at increasing shareholder power also aim to enhance director accountability.[225] This is especially true with respect to proxy access.[226] Say-on-pay is also aimed at making directors more accountable for their compensation decisions.[227] Similarly, changes in broker voting rules have the goal of increasing director accountability.[228] In this regard, it is possible that reforms sought to rely on increasing shareholder power as a means for ensuring director accountability.

However, this possibility is problematic for several reasons. One, proxy access may never materialize, thereby undermining any expected increase in shareholders' ability to hold directors accountable stemming from such access.[229] Two, while there are other reforms aimed at increasing shareholder power, several commentators have argued that those reforms may be flawed and hence may not meaningfully enhance shareholder rights.[230] Indeed, some mechanisms continue to leave directors with significant discretion over voting matters, prompting the conclusion that any apparent grant of shareholder power is il-

225. *See* Fairfax, *supra* note 7, at 2–3.

226. *See* Facilitating Shareholder Director Nominations, 75 Fed. Reg. at 56,669–70 (noting that proxy access was critical to holding boards accountable).

227. *E.g.*, Elisse B. Walter, SEC Comm'r, Restoring Investor Trust Through Corporate Governance, Remarks Before the Practising Law Institute (Feb. 18, 2009), *available at* http://www.sec.gov/news/speech/2009/spch021809ebw.htm (noting that say-on-pay promotes increased accountability of board members and corporate management).

228. *See* Order Approving Proposed Rule Change to Amend NYSE Rule 452, Exchange Act Release No. 34-60215, 12 n.34, 14 (July 1, 2009), *available at* http://www.sec.gov/rules/sro/nyse/2009/34-60215.pdf (noting that broker-voting rule changes were important for ensuring director accountability in the election process).

229. *See* Fairfax, *supra* note 101, at 1268–69.

230. *See, e.g.*, *id.* at 1261; William K. Sjostrom & Young Sang Kim, *Majority Voting for the Election of Directors*, 40 CONN. L. REV. 459, 461–63 (2007).

lusory.[231] This means that any increase in director accountability associated with those mechanisms may also be illusory. Even the SEC has recognized that these other mechanisms fall short of enhancing shareholders rights and thus fall short of effectively bolstering director accountability.[232] Three, relying solely on increased shareholder power to increase board accountability seems ill-advised for several reasons, including the tendency of shareholders to be apathetic as well as the potential that shareholders will advance concerns at odds with the best interests of the corporation.[233] These reasons may blunt the ability of shareholders to exercise their power adequately or effectively. In this regard, an exclusive reliance on increased shareholder power as a means for holding directors accountable seems troubling.

2. Extralegal Sanctions and Accountability

It is also possible that reforms seek to depend upon mechanisms beyond personal liability to ensure accountability. Many argue that personal liability is not the only, nor the most effective, means of holding directors accountable for their actions.[234] Instead, they argue that extralegal devices such as the market and directors' concern for their reputations do a better job of ensuring that directors pay heed to their duties.[235] The existence of these devices suggests that reforms may not pose an accountability conundrum.

However, such a suggestion is unconvincing given that reforms reflected clear dissatisfaction with the status quo as it

231. *See* Sjostrom & Kim, *supra* note 230, at 463 (referring to majority voting as "smoke and mirrors").

232. *See* Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56,668, 56,670–72 (Sept. 16, 2010) (to be codified at 17 C.F.R. pts. 200, 232, 240, 249).

233. *See, e.g.*, Anabtawi, *supra* note 86, at 577; Bratton & Wacthter, *supra* note 86, at 653.

234. *See* Black et al., *supra* note 205, at 1140 (noting the importance of market incentives and reputation in supplementing the limited deterrence of out-of-pocket liability for directors); Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1265–68 (1999) (noting that directors adhere to their duties based on reputational threats); David M. Phillips, *Principles of Corporate Governance: A Critique of Part IV*, 52 GEO. WASH. L. REV. 653, 673 (1984) (noting the importance of extra-legal sanctions in regulating director conduct, and the undesirability of legal regulations); Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 47–48 (2002) (defending a preference for market-based solutions).

235. *See, e.g.*, Eisenberg, *supra* note 234, at 1265–68.

pertained to accountability.[236] To the extent these other measures reflected that status quo, it seems curious that reforms would rely solely on them for accountability purposes. Moreover, even proponents of extralegal accountability measures acknowledge that they may be insufficient on their own to promote director accountability.[237] Instead, they must supplement some level of personal liability risk.[238] Most importantly, while there may be disagreement about the optimal level of personal liability risk necessary to effectively promote director accountability, it seems relatively clear that reforms viewed the current level as suboptimal.[239] Reform's failure to alter that level, therefore, appears to be in tension with reform goals.

3. State Law Deference?

It is also possible that reforms seek to rely on states to craft appropriate accountability mechanism that account for directors' increased responsibilities. Most would agree that Delaware's judiciary has developed an expertise in corporate affairs that makes Delaware judges uniquely adept at responding to governance issues quickly and effectively.[240] Moreover, some insist that the tasks of crafting appropriate responses to the crisis—including crafting appropriate accountability mechanism—should be left to Delaware and other states, as opposed to the federal government.[241] From this perspective, it is arguable that reforms appropriately left the fiduciary duty question open

236. *Accord G20 Statement on Strengthening the Financial System*, REUTERS, Sept. 5, 2009, *available at* http://www.reuters.com/assets/print?aid=USL566412820090905 (envisioning governance reforms that increase oversight and accountability).

237. *See* Black et al., *supra* note 205, at 1140 (noting that market, reputation, and other soft incentives supplement personal liability).

238. *Id.*

239. *See id.* at 1062.

240. *E.g.*, Steven J. Cleveland, *Process Innovation in the Production of Corporate Law*, 41 U.C. DAVIS L. REV. 1829, 1836 (2008) (describing the structural attributes of the Delaware judiciary that allow it to be viewed as impartial by the business community); Randy J. Holland, *Delaware's Business Courts: Litigation Leadership*, 34 J. CORP. L. 771 *passim* (2009); Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN L. REV. 679, 725–26 (2002) (explaining how the reputation of the Delaware judiciary's corporate law expertise attracts corporations).

241. *See* Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56,668, 56,670–72 (Sept. 16, 2010) (to be codified at 17 C.F.R. pts. 200, 232, 240, 249) (summarizing the comments submitted by those insisting that a federal rule is not necessary).

so that states could grapple with the task of altering fiduciary duty norms to take account of the new regulatory environment.

However, the probability that Delaware courts will alter or otherwise expand their conception of fiduciary duty as applied to risk and compensation seems extremely low. Delaware's most recent pronouncement regarding directors' risk of oversight liability occurred in the context of a case arising out of the financial crisis.[242] Similarly, its analysis of director liability in the context of compensation arrangements occurred in the context of a heightened concern about excessive executive compensation.[243] In both cases, the court appeared to resoundingly endorse the status quo with respect to directors' duties and liability risk in these areas despite a seemingly altered environment related to these issues.[244] Hence, the likelihood that Delaware will reconsider its longstanding fiduciary duty principles seems remote.

### C. IMPLICATIONS

What does this relatively low risk of personal liability mean? On the one hand, many have articulated why it makes sense for fiduciary duty law to ensure that shareholders must meet a relatively high threshold in order to hold directors liable for breaching their fiduciary duty.[245] Indeed, imposing such liability involves a hindsight judgment that could be inappropriate and could undermine directors' ability to make the kinds of risky decisions we might actually favor.[246] Moreover, there are thorny issues involved with setting appropriate pay as well as divergent views about the appropriateness of particular pay structures. Thus, significantly enhancing directors' risk of personal liability with respect to these decisions also involves hindsight judgments that may be inappropriate and counterproductive.[247]

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242. *In re* Citigroup S'holder Litig., 964 A.2d 106, 112–13 (Del. Ch. 2009) (detailing Citigroup's exposure to the subprime crisis).

243. *In re* Walt Disney Derivative Litig., 906 A.2d 27, 33 (Del. 2006).

244. *See id.* (approving a $130 million severance package for president fired without cause); *Citigroup*, 964 A.2d at 123 (upholding bad faith as the standard for oversight liability).

245. *E.g.*, Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 108 (2004) (identifying why the authority to make corporate decisions should lie somewhere, whether it be with the boards or with the courts).

246. *See id.*

247. *See, e.g.*, Andrew S. Gold, *A Decision Theory Approach to the Business*

On the other hand, the pendulum may have swung too far with respect to liability risk, resulting in a fiduciary duty regime that does not incentivize directors to make efficient decisions or otherwise hold them accountable for their failure to do so.[248] Indeed, to the extent some threat of personal liability is necessary to supplement other forms of accountability mechanisms, it could be that the current threat level is simply too low.

Ultimately, however, the lack of personal liability associated with current fiduciary duty law diverges from reform expectations about accountability. Indeed, such reforms expressed frustration with the current accountability regime and, thus, clearly embody a desire to enhance directors' accountability beyond its current state. Fiduciary duty law fails to satisfy this desire, and it seems unlikely that the law will significantly change in the future. This suggests a need to reconcile the apparent expectation of reforms with the limits embedded in laws necessary to support those reforms.

Reforms do not seem to acknowledge or otherwise recognize this limit. This lack of recognition raises questions about the ability of the reforms to achieve their goals, while challenging us to think critically about directors and effective measures for ensuring that they pay heed to their new duties. Indeed, we likely need to engage in a closer examination of fiduciary duty rules, including procedural roadblocks associated with bringing challenges under those rules. In addition, it could be that we need to expand the number of directors who serve on boards so that we can have more confidence about the board's capacity to tackle their increased responsibilities and, hence, less concern that they will not have sufficient time for their new duties. In fact, it could be time to more seriously consider the notion of a professional director. Unfortunately, reforms did not grapple with any of these considerations. Instead, reforms continued the troubling shift, which began with SOX, of expanding the board's role without meaningfully expanding the support and even incentives the board may need to carry out that role effectively.

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*Judgment Rule: Reflections on* Disney*, Good Faith, and Judicial Uncertainty*, 66 MD. L. REV. 398, 443 (2007) (exploring the reality of "hindsight bias" that courts are stricken with when attempting to analyze business decisions).

248. *See* Pan, *supra* note 224, at 718.

## CONCLUSION

The financial crisis ushered in a wave of governmental reforms that intruded on board functions and responsibilities. As a result of those reforms, it is relatively clear that board duties have been dramatically enhanced. Hence, current and future boards will be charged with performing many more tasks because of the financial crisis and reform effort.

However, because existing reforms failed to fully acknowledge or grapple with the limitations associated with board functions and fiduciary duty, the board's ability to effectively fulfill those tasks may be hampered. Moreover, there may exist no effective mechanism for ensuring that boards are held accountable for failing to perform their new tasks.

Ultimately, what is necessary is a more robust discussion of boards and their role in the modern corporation. To be sure, the federal government may not be in the position to fully engage that discussion. However, at the very least, reforms may reflect the need for others to begin that engagement.