BEYOND THE BOARD OF DIRECTORS

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INTRODUCTION

The board of directors has outlived its purpose. The board is theoretically responsible for directing the management of a corporation, for monitoring its senior officers, and for making significant business decisions. The typical directors of the largest multinational corporations devote about seventeen hours per month to the governance of the corporation.[1] So responsibility for the success or failure of the firm lies with a group of professionals, the board of directors, who work part time to monitor the firm's business, and management, who receive almost all of their information about the firm secondhand.

Certainly the board of directors monitors corporate officers, particularly the CEO, and makes significant business decisions for the firm. But it is the senior corporate officers who are responsible for the day-to-day operation of the company and who are most involved in its business decisions. When the board must vote on a particular matter of corporate business, officers and experts selected by the officers brief it on the subject.[2] Despite being the focus of corporate law's accountability for corporate decision making, the board of directors relies heavily on the senior corporate officers it is supposed to monitor and lacks the time and expertise to challenge those officers in order to contribute valuable independent business judgment.[3]

There are a number of other groups that exercise oversight over the firm. Creditors, for example, reserve oversight power in their

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1. KORN/FERRY INT'L, 33RD ANNUAL BOARD OF DIRECTORS STUDY 23 (2006).
2. *See* DEL. CODE ANN. tit. 8, §141(e) (2010).
3. Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 872 (1991).

contracts with the firm. Those contracts often give creditors a veto over some corporate decisions if the company is in a poor financial condition, and creditors often use the declaration of default threat to influence officers' and directors' decisions.[4] Shareholders may exert control over the company through their ability to elect directors and enforce officers' and directors' obligations to the firm. Also, shareholder estimation of managerial performance is one component of stock price, which is a significant component of executive compensation.[5] In firms with unionized labor forces, union representatives are able to influence corporate decision making through their ability to threaten a strike.[6] Among these corporate monitors, directors are often the ones paying the least attention to the firm on a regular basis, even though they are ultimately responsible for the success of the firm. The board of directors, as an institution, has failed the modern public corporation with widely dispersed share ownership.[7]

The inability of the board of directors to adequately perform its intended functions exacts serious costs. A system that relies so heavily on one governance structure is left vulnerable when that structure fails.[8] Further, placing a strong emphasis on board accountability when boards cannot be meaningfully responsible for corporate decision making leaves those harmed by corporate scandal without recourse. Money spent on pursuing litigation against corporate directors is wasted, by and large, as directors are shielded from personal liability and yet the law still looks to directors for accountability for corporate decisions.[9] Our expectations for boards of directors of large public companies far outweigh what such boards can realistically accomplish.[10]

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4. Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1226–28 (2006) [hereinafter Baird & Rasmussen, *Private Debt*].

5. Lucian Ayre Bebchuk, Jesse M. Fried & David I. Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751 (2002).

6. Abigail Evans, *Cooperation or Co-Optation: When Does a Union Become Employer-Dominated Under Section 8(A)(2) of the National Labor Relations Act?*, 100 COLUM. L. REV. 1022, 1048–49 (2000).

7. Throughout this Article, when I refer to "public corporations," I mean public firms with widely dispersed share ownership. There are many public firms dominated by single shareholders or small groups of shareholders, but this Article's proposal is aimed at those with widely held ownership.

8. JONATHAN R. MACEY, CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN 56 (2008).

9. *See* DEL. CODE ANN. tit. 8, § 141(e) (2010); MACEY, *supra* note 8 at 51–52.

10. MACEY, *supra* note 8, at 56 ("A crucial, but wholly unexamined, assumption underlying this foundational theory of corporate governance is that boards of directors can reasonably be expected to do what is required of them. This assumption cannot withstand scrutiny.").

Numerous corporate law scholars have critically examined the structure and functions of the board of directors[11] and have evaluated the relative success of various board compositions.[12] These commentators have alternatively praised and criticized the board for its ability to monitor management and maximize shareholder wealth.[13] The academic and business communities have failed to reach a consensus about how exactly the board should fit into the corporate governance structure, what its role and level of influence should be, how it is supposed to work toward the goal of shareholder wealth maximization, and to what extent the board should be responsible for a failure to meet those ends. Although the members of the corporate law community have reached a variety of conclusions, they all rest on the assumption that a board of directors is both necessary and desirable.

This Article challenges that basic assumption. It argues that the board of directors in a large public corporation is ineffective to perform the functions assigned to it and should thus be eliminated in favor of a governance system that more accurately reflects corporate decision making. Corporate officers and the investors and parties in interest that are essential to the firm's daily operation and capital structure—the *real* corporate decision makers—should

11. *See, e.g.*, Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999); Lisa M. Fairfax, *The Uneasy Case for the Inside Director*, 96 IOWA L. REV. 127 (2010); Jill E. Fisch, *Taking Boards Seriously*, 19 CARDOZO L. REV. 265 (1997) (warning that reforms calling for uniform standards for boards of directors may not improve corporate governance); Gilson & Kraakman, *supra* note 3; Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797 (2001).

12. *See, e.g.*, Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921 (1999); Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, (1982); Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U. L. REV. 898 (1996).

13. Compare, for example, the perspective of Professor Stephen Bainbridge with those of his critics. Bainbridge strongly supports boards, arguing consistently that a board of directors exercising unfettered discretion should serve at the top of the corporate decision-making structure. *See, e.g.*, Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735 (2006); Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547 (2003) [hereinafter Bainbridge, *Director Primacy*]; Stephen M. Bainbridge, *Why A Board? Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1 (2002) [hereinafter Bainbridge, *Why a Board?*] (explaining why a group, rather than an individual CEO, should dominate the corporate governance structure). By contrast, other distinguished corporate law scholars challenge these views, emphasizing improvements in shareholder power, among other options. *See, e.g.*, MACEY, *supra* note 7; Gilson & Kraakman, *supra* note 3; Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005).

perform the functions assigned to the board, so that the now-vestigial board of directors can completely wither away.

Abolishing a formal board of directors would not spell the end of corporate governance. In the absence of a board, corporate constituents would be permitted to enforce their rights against the corporation and management directly. Their contracts with the firm could evolve to fill gaps in corporate decision making. Because these constituents already exercise significant oversight of the firm, they are well equipped to perform the monitoring and management functions of the board. Because a post-board firm is so different from what we have had to date, this Article suggests a path that could lead to the gradual elimination of the board governance structure. This Article is meant to be the first step on a path toward the evolution of the corporate form away from the use of a board of directors and highlights regulations it might be prudent to remove.

Because current legal and regulatory regimes do not appear to permit the wholesale abandonment of the board of directors immediately, this Article also proposes a less radical change to the corporate governance structure—one that would allow it to more accurately reflect corporate decision making within extant legal regimes. In particular, the Article suggests implementing a board dominated by representatives of the firm's investors—at least the firm's creditors and shareholders. Major bank lenders would be represented on this "investor board," indenture trustees would represent bondholders, and an equity trustee[14] could represent the shareholders. Such a board would monitor senior officers directly and also make major corporate business decisions (according to the powers reserved to the board and the investors sitting on it through their respective contracts). The diversity of the board members' individual interests assures that they are less likely to settle into too close of a relationship with management, but instead will actively protect their investments, and thereby, best protect the corporation.

14. An equity trustee is selected by a committee of the corporation's seven largest shareholders and represents the entire common shareholder class to management in performing the shareholder role in corporate governance. For further explanation and discussion of the concept of an "equity trustee," see Kelli A. Alces, *The Equity Trustee*, 42 ARIZ. ST. L.J. 717 (2010) [hereinafter Alces, *Equity Trustee*] (developing in detail the innovation of the equity trustee and explaining what it is, how it could be implemented, and what its role in corporate governance would be); Kelli A. Alces, *Debunking the Corporate Fiduciary Myth,* 35 J. CORP. L. 239 (2009) [hereinafter Alces, *Debunking*] (arguing that corporate officers and directors do not truly stand in fiduciary relation to shareholders and the firm, and that equity representation could facilitate meaningful contracting to develop and enforce more effective corporate governance relationships); Kelli A. Alces, *Strategic Governance,* 50 ARIZ. L. REV. 1053 (2008) [hereinafter Alces, *Strategic Governance*] (suggesting that an equity trustee could help balance against strong creditor power over corporate management in times of financial distress to provide continuity in equity representation during times of differing financial success).

The divergence of interests will provide a check on overreaching.

This Article proceeds in three Parts. Part I explains the conventional justifications given for the current board structure. It reviews the evolution of the board to its present form and considers the purpose of the modern board of directors. Modern corporate law favors a board primarily intended to monitor corporate officers. A board of directors is also expected to perform a more limited management function by advising senior officers about significant corporate decisions. Part I explains that the current board structure suboptimally allocates authority and oversight in public corporations.

Part II proposes significant changes to the board of directors. It sketches a post-board firm, suggesting how to monitor corporate managers in different, more direct ways. Recognizing the hurdles to completely and immediately abolishing the board of directors, Part II suggests how an evolution toward a post-board firm might begin with a board of directors made up of investor representatives. Such a board would more accurately reflect the balance of power in corporate decision making and would set the stage for an evolution away from the use of a formal board of directors. A more accurate understanding of corporate decision making will lead to more direct accountability for those responsible for the firm's financial success.

Part III considers various obstacles to the Article's proposals. Corporate and securities laws confine the structure of the board and prevent some kinds of market evolution. Though several problematic aspects of board governance are the products of market forces, it is the law, not the market, that prevents corporate governance from evolving past its current form and away from the use of a vestigial board of directors. The market has chosen to render the board of directors weak and relatively meaningless and to empower corporate constituents and officers to dominate corporate decision making. Part III proposes relaxing or removing laws that prevent the governance structure from expanding upon and formalizing the reality of corporate decision making.

I. WHY A BOARD OF DIRECTORS?

Surely, there are reasons, perhaps good ones, for choosing a governance structure in which a board of directors bears primary responsibility for the direction of the management of "[t]he business and affairs of every corporation."[15] The fact that the board has evolved to its present form reveals market preferences against a strong board in the extant legal framework. It is important to understand that evolution before criticizing the board's diminished role. Insights from organizational theory also shed light on our

15. DEL. CODE ANN. tit. 8, § 141(a) (2010).

current board structure.[16] This Part will examine each of those observations in order to better understand why the modern corporate board of directors looks and acts as it does. It will also explain why the current formulation of the board prevents it from effectively performing its assigned tasks.

A. History and Evolution of Board Structure and Purpose

American corporations have always had boards of directors.[17] This tradition emerged from English trading companies, which used governing boards to represent business owners in joint stock companies.[18] The board was to sit at the top of a parliamentary system of corporate governance.[19] Originally, boards managed the day-to-day business of the firm.[20] This was because they were made up primarily of controlling shareholders and managers selected by those shareholders.[21] Particularly in family-run firms, the founders and their closest friends and relatives were the owners and managers of the firm and so constituted the board of directors.

Even into the early 1900s, when corporations were just beginning to grow and move past the realm of family-run local businesses, corporate boards were chosen by dominant majority shareholders and were often composed of firms' managers.[22] As corporations grew through the 1970s and shareholding was divided among more widely dispersed shareholders, CEOs, rather than shareholders, began to choose the board members.[23] Shareholders elect directors, but once an increasing number of firms failed to have a controlling shareholder in place, the CEO was able to run the daily operations of the firm and could handpick nominees to the board. The result of that change was that the board was effectively inferior

16. *See, e.g.*, Bainbridge, *Why a Board?*, *supra* note 13, at 53.

17. Franklin A. Gevurtz, *The Historical and Political Origins of the Corporate Board of Directors*, 33 HOFSTRA L. REV. 89, 108 (2004).

18. *Id.* at 110.

19. *Id.*

20. Franklin A. Gevurtz, *The Function of "Dysfunctional" Boards*, 77 U. CIN. L. REV. 391, 395 (2008).

21. *See* Elizabeth Cosenza, *The Holy Grail of Corporate Governance Reform: Independence or Democracy?*, 2007 BYU L. REV. 1, 18 ("Whereas in the 1960s most boards had a majority of in-house, non-independent directors, most boards today have a majority of outside, independent directors."); Tamar Frankel, *Corporate Boards of Directors: Advisors or Supervisors?*, 77 U. CIN. L. REV. 501, 504 (2008).

22. Cosenza, *supra* note 21, at 18–19.

23. Frankel, *supra* note 21, at 505 (stating that, over time, CEOs began choosing the board members, rather than the board choosing CEOs, and the board's role became advisory, rather than supervisory). *See also*, JAY W. LORSCH & ELIZABETH MACIVER, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARD 20 (1989) [hereinafter PAWNS OR POTENTATES] (explaining that traditionally, nominating and selecting board members was the "exclusive responsibility of the CEO").

to the CEO it was supposed to supervise. The board's role "became advisory rather than supervisory."[24]

That state of affairs persists and continues to shape board composition and effectiveness. Because shareholders cannot coordinate to exercise control over the firm and its management,[25] the CEO and senior officers have an advantage when it comes to choosing directors. So chosen, and without intimate knowledge of the firm, the board of directors cannot exert control over the daily business of the firm and cannot easily monitor management. Directors owe their positions to the officers they are supposed to supervise, and they rely upon those same officers for the information they use in supervising them.[26] Social pressures also define the relationship between the board and management[27]—"board traditions in the United States make outsiders invited guests, not policy makers."[28]

Still, there must be some role for the board. It is, after all, where legal accountability for corporate decision making lies. The board of directors may not be particularly effective, but it is not yet dismissed as a mere figurehead. Modern corporate law has settled on a notion of a "monitoring" board.[29] A monitoring board is composed mostly of independent directors, those not having close personal or financial ties to the firm.[30] It is supposed to pay attention to management to the extent it can, to discover bad faith or incompetence, and replace officers as necessary.[31] Board independence is supposed to be optimal for performance of the monitoring function. An independent board, theoretically, will not have strong ties to individual managers and thus will be comfortable challenging and removing them.[32] It will force senior officers to defend their choices and will make them notice irregularities or improprieties in management's conduct of corporate business.[33] The

24. Frankel, *supra* note 21, at 505.

25. *Id.* at 504–06.

26. MELVIN ARON EISENBERG, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS 204 (8th ed. 2000); Frankel, *supra* note 21, at 503–04.

27. Frankel, *supra* note 21, at 508.

28. *Id.* at 507 (quoting Edward S. Herman, *The Limits of the Market as a Discipline in Corporate Governance*, 9 DEL. J. CORP. L. 530, 533 (1984)).

29. Fisch, *supra* note 10, at 269.

30. Frankel, *supra* note 21, at 506–07. For the SEC's definition of independent director, see 15 U.S.C. § 80a-2(a)(19) (2006). *See also*, *Developments in the Law—Corporations and Society*, 117 HARV. L. REV. 2181, 2187–94 (2004) (explaining both the NYSE and NASDAQ definitions of independent director).

31. Fisch, *supra* note 11, at 271.

32. *Id.* at 268–72.

33. Mark S. Beasley, *An Empirical Analysis of the Relation between the Board of Director Composition and Financial Statement Fraud*, 71 ACCT. REV. 443, 460 (1996) (finding that firms with larger proportions of outside directors were less likely to commit financial statement fraud).

independent monitoring board has been criticized, however, for being ineffective at performing even the most basic monitoring function.[34] The next Subparts consider the monitoring and management functions of the modern monitoring board and evaluate the board's effectiveness in performing those functions.

B. Monitoring

Directors are supposed to appoint the CEO, perhaps advise the CEO on the selection of other senior officers, and evaluate the work done by the senior management team.[35] To the extent corporate governance law and practice now favor a monitoring board, the board functions are supposed to be separate from senior management, and the board is supposed to be a largely independent supervisory body.[36] Rather than holding senior officers directly responsible for corporate well-being, even though officers control the day-to-day business of the company, Delaware law has long placed primary responsibility with directors, providing that directors are responsible for monitoring officers and so are ultimately responsible for whatever corporate decisions the officers make.[37] The board, then, is conceived of as an independent, relatively distant body charged with overseeing the very highest levels of corporate decision making.

1. Board Independence

In designing a monitoring board for the public corporation, federal and state law as well as public listing exchanges have required that only "independent" board members be allowed to perform certain functions in public companies.[38] For example, mandatory audit and compensation committees must be made up of independent directors.[39] Indeed, firms appear to have better and more accurate financial reporting when independent directors with

34. Fisch, *supra* note 11, at 270–71.
35. *Id.*
36. Frankel, *supra* note 21, at 506–07.
37. This focus on directors may explain why Congress addressed officer accountability directly in the Sarbanes-Oxley Act of 2002. Pub. L No. 107–204, 116 Stat. 745. Sarbanes-Oxley ("SOX") was the congressional response to the corporate scandals of the early 2000s. A jurisdictional glitch in Delaware law that made it impossible to get personal jurisdiction over corporate officers sitting in other states has been corrected, so we may begin to see more suits against officers for breach of fiduciary duty. Of course, liability for poor decision making is exceptionally rare for directors, as they receive generous protection from the business judgment rule and Delaware General Corporation Law section 102(b)(7).
38. For a general discussion of board independence, see STEPHEN M. BAINBRIDGE, CORPORATE LAW 80–84 (2d ed. 2009).
39. 15 U.S.C. §§ 78j-1, 78j-3 (2010); Fairfax, *supra* note 11, at 136.

accounting expertise sit on their audit committees.[40] The majority of board members must be independent.[41] Independent directors are those having little or no personal or financial relationship with the firm.[42] The rationale for using independent directors is the expectation that they will not be sympathetic to management, will feel free to challenge managers as necessary, and will remove them without compunction if senior officers are not performing optimally. For instance, independent directors may not "have a personal financial stake in retaining management."[43] If the directors do not have a personal stake in keeping management on board or can keep a certain distance and remove themselves from the company's business, they will be able to respond dispassionately to problems that arise, prioritizing shareholder wealth maximization.

This definition of "independence" is not clear and guarantees only a certain kind of autonomy from other corporate operations.[44] Independent directors are neither necessarily socially independent from management nor unsympathetic to the concerns of senior officers.[45] Professors Gilson and Kraakman note that in trying to find an appropriately independent outside director, shareholders may have succeeded in finding directors who are more independent from shareholders than they are from management.[46] This is

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40. Lawrence A. Cunningham, *Rediscovering Board Expertise: Legal Implications of the Empirical Literature*, 77 U. CIN. L. REV. 465, 478 (2008).

41. NASDAQ Rules 5600–5640: Corporate Governance Requirements, *available at* http://nasdaq.cchwallstreet.com/NASDAQTools/bookmark.asp?id=nasdaq-rule_5600&manual=/nasdaq/main/nasdaq-equityrules/ (last visited Sept. 16, 2011) (outlining qualitative rules relating to boards of directors, including audit committees, independent oversight of executive compensation, director nomination, related party transactions, and shareholder voting rights); NYSE Amex PART 8 Corporate Governance Requirements (2010), *available at* http://wallstreet.cch.com/AMEXTools/bookmark.asp?id=sx-policymanual-amex-acg_8&manual=/AMEX/CompanyGuide/amex-company-guide/ (last visited Sept. 16, 2011) (specifying corporate governance listing requirements).

42. Daniele Marchesani, *The Concept of Autonomy and the Independent Director of Public Corporations*, 2 BERKELEY BUS. L.J. 315, 322 (2005) (observing that Delaware corporate law permits transactions where a director has a personal financial interest, so long as a majority of independent directors—those without a personal interest at stake—approve the transaction).

43. Gilson & Kraakman, *supra* note 3, at 873.

44. Brudney, *supra* note 12, at 613 ("No definition of independence yet offered precludes an independent director from being a social friend of, or a member of the same clubs, associations, or charitable efforts as, the persons whose compensation or self-dealing transaction he is asked to assess.").

45. Fairfax, *supra* note 11, at 146–49; Gilson & Kraakman, *supra* note 3, at 875 (observing that no definition of independence prohibits outside directors from befriending officers, and outside directors are often the officers of other companies and therefore will not monitor any more vigorously than they believe they themselves should be monitored). For an in-depth discussion of the social dynamics of corporate boards, see generally Rakesh Khurana & Katharina Pick, *The Social Nature of Boards*, 70 BROOK. L. REV. 1259 (2005).

46. Gilson & Kraakman, *supra* note 3, at 875 (describing the various

because independent directors are still primarily senior officers of other corporations, making them unlikely to monitor senior officers of the companies on whose boards they serve more than they want to be monitored themselves.[47]

Further, it is difficult, if not impossible, to give independent directors strong incentives to monitor carefully.[48] Any sort of compensation that tracks corporate or management performance would undermine the very independence required.[49] If the board is supposed to be a truly independent, distant monitor, then giving directors personal ties to the firm's finances might make them too much like the managers they are supposed to monitor. It would truly duplicate the role of officers except that the supervisors, the directors, would only work part-time. To the extent we rely on reputation to constrain outside directors or to give them incentives to monitor conscientiously, we must remember that those directors are essentially chosen by the CEO. The directors' reputations, then, must have more currency with the CEOs that they are supposed to monitor than with the shareholders who passively, and perhaps inattentively, elect them.[50] Independence for the purpose of monitoring management is, therefore, difficult to achieve. And even if it were possible, it might not be ideal.

Board members are at a disadvantage when it comes to monitoring officers because they rely on those officers for the information they use to monitor.[51] If the employee tells her employer why she is doing a great job and gives the employer the information needed to assess the job she is doing, the boss cannot really make an independent judgment about the employee's performance because all of the information comes from the employee.[52] This problem with the monitoring structure became

institutional, social, and financial mechanisms that draw outside directors towards officers, rather than shareholders).

47. *Id.* (noting that "[sixty-three] percent of outside directors of public companies are chief executive officers of other public companies"); *see, e.g.*, PAWNS OR POTENTATES, *supra* note 23, at 18–19 (discussing the benefits and detriments of board members holding multiple positions as CEO in other public corporations).

48. Gilson & Kraakman, *supra* note 3, at 875 (arguing that "in addition to these dependency, ideological, and social obstacles to monitoring, outside directors typically lack an affirmative incentive to monitor effectively").

49. *Id.*

50. Rachel A. Fink, *Social Ties in the Boardroom: Changing the Definition of Director Independence to Eliminate "Rubber-Stamping" Boards*, 79 S. CAL. L. REV. 455, 464 (2006).

51. The American Bar Association has made this observation. *Report of the American Bar Association Task Force on Corporate Responsibility*, 59 BUS. LAW. 145, 158 (2003) ("Outside directors too often have relied almost exclusively upon senior executive officers, and advisers selected by such officers, for information and guidance about corporate affairs.").

52. As Jonathan Macey points out:

manifest during the recent financial crisis.[53] Independent monitoring boards were not able to discover the serious problems with decisions officers were making and were unable to prevent the collapse of financial firms.[54] Still, we regulate with an eye toward more independence in board composition,[55] even as it becomes clear that truly independent boards lack the knowledge of the firm that might be necessary to assess managerial performance.

In an article written twenty years ago, Gilson and Kraakman suggest that the market should develop a pool of professional directors to respond to these problems.[56] They propose that academics and other outside consultants make themselves available to serve on corporate boards and that these "professional directors" devote themselves full time to service on the boards of a handful of companies.[57] These directors would be beholden only to the shareholders, primarily institutional shareholders, who elect them.[58] Such a system could create real independence from management in the board and could also result in board members who could invest more time in learning about the companies they supervise. Unfortunately, the market has not yet evolved toward such a system. As regulators continue to press for independent, outside directors and those directors are no less likely to be sympathetic to or chosen by management, it is difficult to see how the monitoring board is likely to change.

> [M]anagers have extremely high-powered incentives to present themselves, and their work, to directors in the most favorable light possible. This, in turn, strongly suggests that the flow of information from management to the board will be biased in ways that put management in the most favorable light possible and undermine the effectiveness of dissident or uncooperative directors.

MACEY, *supra* note 8, at 60.

53. *See generally* Lisa Fairfax, *Government Governance and the Need to Reconcile Government Regulation with Board Fiduciary Duties*, 95 MINN. L. REV. 1692 (2011).

54. *Id.*; *see also In re* Am. Int'l Group, Inc. Consol. Derivative Litig., 965 A.2d 763 (Del. Ch. 2009); *In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106 (Del. Ch. 2009).

55. SOX is a prime example of this. Pub. L. No. 111–203, § 10C, 124 Stat. 1900, 1900–04 (2002) (codified as amended at 15 U.S.C. § 78j-3 (2010)). SOX requires board committees that focus on director selection, compensation, and auditing to be composed of independent directors. Public listing standards promulgated at the same time require public firms to have majority independent boards. The Dodd-Frank Act also requires some level of independence for various boards of directors. Pub. L. No. 111–203, § 932(t), 124 Stat. 1872, 1882–83 (2010). *See id.* at § 10C (outlining various requirements for the compensation committees for the board of directors of an issuer); *see also id.* at § 932(t)(2) (requiring one half of a nationally recognized statistical rating organization's board of directors to be composed of independent members).

56. Gilson & Kraakman, *supra* note 3, at 884–86.

57. *Id.* at 885–86.

58. *Id.* at 885.

2. How the Board Monitors

Determining board composition is only one part of designing a board that is able to monitor management. It is also important to understand how the board is supposed to monitor management and what expectations we have about the board's monitoring. We must then try to appreciate how well-suited the board of directors is to performing that level of monitoring. Understanding the hierarchical, collegial, and probabilistic monitoring described by organizational theory can be useful here. Hierarchical monitoring contemplates a situation in which the supervisor has the same information as the subordinate actor and can make superior, independent decisions based on more sophisticated knowledge, understanding, or expertise.[59] This occurs in standard employer/employee relationships and throughout the corporate hierarchy.[60] Collegial monitoring occurs when the monitor does not "have superior information, or less bias when evaluating the available information."[61] In a system of collegial monitoring, managers do not stand as inferiors to their monitors.[62] Finally, probabilistic monitoring is relatively passive. Probabilistic monitors respond only when a problem has occurred and try to discern whether the party they are monitoring is responsible for the problem.[63]

The corporate governance monitoring structure is, at various times, hierarchical, collegial, and probabilistic, with directors often acting as more detached, irregular monitors than one would expect given their position at the top of the corporate hierarchy.[64] For instance, director monitoring is hierarchical when directors decide whether to retain a CEO or which CEO to appoint because they may have sufficient information to make a better decision and obviously lack some of the strong biases the CEO or other senior officers would bring to the decision. In that situation, the directors' decision supersedes the preferences of others and their decision is final.[65] However, directors lack the time and attention hierarchical monitors usually devote to their task. Directors usually receive

59. *See* Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 56 (1991).

60. *See* Bainbridge, *Why a Board?*, *supra* note 13, at 7 (explaining that creating a hierarchical monitoring scheme in M-form corporations "addresses the problems of uncertainty, bounded rationality, and shirking faced by monitors . . .").

61. Roe, *supra* note 59, at 56.

62. *Id.*

63. *Id.*

64. Bainbridge, *Why a Board?*, *supra* note 13, at 7 (explaining that the board of directors is at the top of the hierarchical organization of the corporation).

65. *Id.* at 4 (describing "authority-based decision making").

their information from officers[66] and so cannot be regular hierarchical monitors because the information the directors have is not as good, let alone superior to, the information officers use to make decisions on a daily basis. Directors are just not as informed about the day-to-day business of the firm—and they are not expected to be.

Most director monitoring of management is collegial. That is, directors learn from officers why the officers recommend a particular course of action and officers are not perceived as inferior to directors when the board makes most of its business decisions.[67] Rather, the officers present an idea to the board and advise directors and then the directors ask questions to determine if they agree with the officers' judgment.[68] Directors may consult outside experts (perhaps the same experts officers consulted) to reach as clear an understanding as officers have—not a clearer one. Directors have to rely heavily on officers for the judgment and information they use in performing their monitoring tasks. The collegiality between the monitors and the monitored is not metaphorical, but real. As mentioned above, directors are usually officers of other companies; directors and officers are colleagues and kindred spirits.[69] Their professional and personal relationships establish a collegial norm for their interaction in governing a corporation.[70]

Directors also engage in some probabilistic monitoring. Because directors are not always informed about the daily operations of the firm, they cannot know exactly what officers do every day and arguably have little or nothing to do with most decisions officers make. Directors could not possibly anticipate every problem that may arise and may not know what has caused the difficulties the company faces. While we expect them to catch big problems and to head off serious financial disasters, directors are not always able to do so. This occurs, in part, because the board's oversight responsibility is limited. The board is only required by law to ensure that reporting mechanisms are in place so that it will hear about serious violations of corporate policy or the law, but the board is not expected to press beyond those systems to discover potential malfeasance.[71] Also, board members only meet occasionally and are not regularly at the firm observing standard practices. Because the

66. *See id.* at 5.
67. *See id.* at 45.
68. *Id.* at 45–47.
69. *See* Gilson & Kraakman, *supra* note 3, at 875.
70. Edward B. Rock & Michael L. Wachter, *Symposium: Norms and Corporate Law: Introduction*, 149 U. PA. L. REV. 1607, 1609 (2001).
71. *See, e.g.*, Stone v. Ritter, 911 A.2d 362, 364–65 (Del. 2006) (dismissing shareholders' complaint because there was no proof that the board knew of the inadequacy of the corporation's internal controls); *In re* Caremark Int'l, 698 A.2d 959, 970–72 (Del. Ch. 1996).

board only works for the corporation part-time, its members cannot know most of what happens at the highest levels of management. When a serious problem arises or the company's value falls precipitously, the board has often been unaware of the potential problem and thus unable to do anything to prevent the crisis.[72] After the dust has cleared, the board must act as an ex post, probabilistic monitor and must try to determine whether the problem occurred because of the incompetence or dishonesty of the senior officers, or whether it was the result of blameless market- or industry-wide difficulties.

3. How the Board Should Monitor

Given that we expect shareholders to engage in probabilistic monitoring of directors—the best shareholders can do because of collective action problems and their relative lack of information[73]—it seems that the board should be designed to perform closer, more direct monitoring of senior officers. Collegial monitoring of management by the board is probably the norm. Both directors and officers are supposed to be working toward the goal of shareholder wealth maximization. Directors may be somewhat less biased than officers in certain matters, whether because of directors' "independence" or because they were not part of the decision making up to that point. Otherwise—because of the problems with board independence mentioned above—board members are no less biased than officers, and so, in the interests of "getting along," they are most likely to try to reach a consensus with officers over major corporate decisions requiring director approval.[74]

The legislative and regulatory emphasis on board independence might suggest that legislators want directors to engage in hierarchical monitoring. If the board of directors is supposed to be in charge and the proverbial "buck" is supposed to stop with them, it seems as though corporate governance law favors more hierarchical monitoring of management. To the extent we ask directors to engage in hierarchical monitoring, we are really asking them to make management decisions because we want them to replace officers' judgment with their own. Management is a separate and

72. *In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 129–32 (Del. Ch. 2009) (holding that while Citigroup officers and board members may not have adequately understood the riskiness of the investments that constituted a large part of the company's profit, and caused the company's eventual collapse, their actions were covered by the business judgment rule).

73. Roe, *supra* note 59, at 14 (stating that scattered shareholders do not intervene in the decision making of management until something dramatic, such as a hostile takeover or leveraged buyout, occurs).

74. MACEY, *supra* note 8, at 62 ("Where a CEO makes a proposal to a group of board members, the first board member to raise questions or to disagree with management bears the greatest risk of being branded uncooperative or non-collegial.").

quite limited role of directors.[75] Expanding monitoring responsibility and authority too far turns monitoring into an affirmative management obligation. That is not consistent with the policy choice to limit the board's management responsibility to a very few significant decisions, and to leave officers with primary responsibility for the day-to-day operation of the firm. This tension suggests that a board of directors is not actually designed to be an effective hierarchical monitor—and we may not want it to be.

If hierarchical monitoring of senior officers by part-time directors is not possible in most situations, then we must consider collegial and probabilistic monitoring sufficient. Because shareholders and financial institutions (the latter functioning as both shareholders and creditors) perform probabilistic monitoring of directors[76] and, in some ways, of officers, it seems redundant to have so many layers of "watchers," unless each additional layer adds something essential. The board of directors, as currently constituted, is not better suited to hierarchical monitoring than attentive shareholders, creditors, or even labor representatives would be. As a collegial monitor, the board is not independent enough or knowledgeable enough to exercise distinct decision-making authority in a meaningful way. The board may be able to challenge the senior officers by asking difficult questions of them about decisions they propose, but it still relies on senior officers for information and guidance about the most efficacious course of action for the corporation. At best, the board provides a skeptical body to which senior officers must justify their decisions. This function, while valuable, could just as easily be performed by other parties in interest such as shareholders or creditors. In fact, in some situations, the senior officers may have to justify decisions to other constituents more often than they have to answer to the board, because those constituents, or their representatives, closely monitor the day-to-day business of the firm in order to protect their contractual rights against it. As currently constituted, it is hard to see how the board is uniquely qualified to monitor senior officers or corporate business.

C. Management

The board of directors is also supposed to perform a management function. While not in charge of managing the day-to-day business of the firm, the board is supposed to have the ultimate say on various major corporate issues, such as whether to bring certain lawsuits on the company's behalf, whether to sell the

75. *But see id.* at 54 (stating that the role of directors has recently expanded to include greater participation in management decision making, in addition to its monitoring function).

76. Roe, *supra* note 59 (describing probabilistic monitoring).

corporation or to buy another firm, whether to issue dividends to shareholders, and what the corporation's capital structure should be.[77] While we have moved more toward a monitoring board over the last forty years or so,[78] the management function of the board cannot be ignored. The board is expected to make significant management decisions, albeit with the advice of the senior officers and other experts. Perhaps more importantly, the board performs an advisory function, offering advice and opinions to management about general business concerns.[79] This advisory function has come to dominate the board's role when the corporation is healthy.[80] This Subpart will consider what the board's management function is, what we may want it to be, and how well suited the current board structure is to making important decisions about the management of the firm.

While most boards of public corporations are now made up of a majority of independent directors, some inside directors sit on all boards.[81] These inside directors help to set the agenda and help to advise outside board members about the business's proper course of action.[82] For many years now, it has been commonplace for the CEO to serve as the chairman of the board of directors.[83] That means the CEO sets the board's agenda and calls meetings.[84] In most instances, inside directors' work is most important to the board's management function.[85] The inside directors know more about the firm's day-to-day business as well as its relationship with the various parties with whom it contracts.

77. Bainbridge, *Why a Board?*, *supra* note 13, at 49–54 (discussing the formal structure of the corporate governance system); Lynn A. Stout, *The Shareholder as Ulysses: Some Empirical Evidence on Why Investors in Public Corporations Tolerate Board Governance*, 152 U. PA. L. REV. 667, 668 (2003) (stating that directors decide "how the firm shall be run, whom it shall hire, . . . in what it shall invest [and] . . . whether corporate earnings will be used to pay dividends—or used instead to build empires, raise salaries, and support charities").

78. *See* Frankel, *supra* note 21, at 504–07.

79. Donald C. Langevoort, *Commentary: Puzzles About Corporate Boards and Board Diversity*, 89 N.C. L. REV. 841, 843 (2011) [hereinafter Langevoort, *Commentary*].

80. *Id.* ("[S]urvey data indicate that this is the function board members think they are performing most of the time.") (citing Renee Adams et al., *The Role of Boards of Directors in Corporate Governance: A Conceptual Framework & Survey*, 48 J. ECON. LIT. 58, 64–66 (2010)).

81. Bhagat & Black, *supra* note 12, at 921.

82. Nicholas Johnson, *Open Meeting and Closed Minds: Another Road to the Mountaintop*, 53 DRAKE L. REV. 11, 42 (2004).

83. *See* Robert W. Hamilton, *Corporate Governance in America 1950–2000: Major Changes But Uncertain Benefits*, 25 J. CORP. L. 349, 351 (2000).

84. Johnson, *supra* note 82.

85. Lynne L. Dallas, *The Relational Board: Three Theories of Corporate Boards of Directors*, 22 J. CORP. L. 1, 5 (1996) (discussing managerial dominance of the board).

The board's very independence may, paradoxically, hinder its ability to make independent business decisions. As noted above, the board has to rely heavily on inside directors for information and judgment to reach what ends up being a consensus with management. Professors Gilson and Kraakman point out that outside directors "rarely exercise their judgment today, except during crises, not only because they lack the time and the incentives to do so, but also because board meetings are dominated by a management ethos of forced collegiality and agreement."[86] Independent directors are ill equipped to second-guess the decisions of management in a meaningful way. Not only are they dependent on inside directors for information, but they are kept from "posing hard questions and framing strategic alternatives" which could allow them to "be drawn into real discussions of company policy and might well reject management's views when warranted" by social and professional norms and personal sympathy with the positions of the company's officers.[87]

One circumstance stands out as an exception to the general inability of independent directors to exercise meaningful and independent business judgment.[88] When an acquirer approaches a corporation, the judgment of independent directors becomes vitally important.[89] Because inside directors have their careers at stake in a potential sale of the company and it is their management of the firm that is being challenged, the "omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders"[90] taints any decisions they may make about the takeover bid, and courts will conduct a review of the decision before affording it the benefits of the business judgment rule.[91] Outside directors are granted more deference when decisions about mergers are reviewed by courts.[92] In the

86. Gilson & Kraakman, *supra* note 3, at 889.

87. *Id.*

88. Delaware courts often defer to the judgment of independent directors when those directors, or a special litigation made up of independent directors, refuse to bring a suit demanded by shareholders or move to have a derivative suit dismissed. *See* Cunningham, *supra* note 40, at 469.

89. Cunningham notes the progression of this deference to the judgment of independent directors in the takeover context by tracking the jurisprudence during the takeover boom of the 1980s.

> Delaware courts, continuing a pattern dating at least to the bribery scandal litigation, strengthened the appeal of independent directors by increasingly deferring to their decisions. Using independent directors insulated from judicial review, self-interested transactions, cash-out mergers, adoption of poison pills, resisting hostile takeover threats, and simply "saying no" to them.

Id. at 470.

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

91. *Id.*

92. *Id.* at 955.

takeover context, outside directors play an important role and are expected to make judgments about the future, or demise, of the company mostly independent of insiders.[93] This is one area where the expertise of a board of directors without close personal or financial ties to the firm may be useful, particularly to the extent that that board may represent the shareholders' interests in maximizing the value received for their shares.[94]

Because of the heavy reliance on inside directors and other officers to perform the board's management function outside of the takeover context, a board of directors does not clearly constitute a separate, additional decision-making body. The board can only do so much, in addition to what senior managers have already done, and it really only serves as a backstop, or a final quality check, before a major decision is finalized.[95] In order for a board of directors to be worth the time, expense, and effort it represents, it should perform a function that is both valuable and distinct from the work others are already doing. Some would argue that this special function is the work the board performs by mediating among the various parties that have claims against the corporation's assets.[96]

If the firm is a nexus of contracts,[97] or a nexus of relationships

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93. *Id.* Even so, boards are allowed wide discretion to block takeover attempts, and corporate law has evolved to allow executives to make hostile takeovers virtually impossible. MACEY, *supra* note 8, at 123. Because insiders are so thoroughly protected by antitakeover laws and a judiciary that is traditionally sympathetic to their interests in the takeover context, the threat of a takeover or a merger offer does not threaten their position in the firm as much as it otherwise might.

94. Curiously, a board's decision to choose a course that is designed to enhance long-term shareholder or corporate value over short-term value was upheld in the takeover context. The Delaware Supreme Court's decision in *Paramount Commc'ns, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1989), is the oft-cited example of a court allowing the board to make such a judgment over the objection of shareholders who would have preferred to take a higher cash value for their shares in a tender offer. *See also* Stout, *supra* note 77, at 696 ("Change of control transactions consequently provide some of the best illustrations of the remarkable degree of discretion corporate law grants directors to favor nonshareholder interests at the shareholders' expense.").

95. Langevoort, *Commentary*, *supra* note 79, at 847.

96. *See* Blair & Stout, *supra* note 11, at 280–81; Stout, *supra* note 77, at 686–88.

97. Stephen M. Bainbridge, *The Board of Directors as Nexus of Contracts*, 88 IOWA L. REV. 1, 9–10 (2002) (describing the "nexus of contracts" theory as the dominant model of the corporation among legal scholars, and placing its origins in Ronald Coase's article, *The Nature of the Firm*, 4 ECONOMICA (n.s.) 386 (1937)); Antony Page, *Has Corporate Law Failed? Addressing Proposals for Reform*, 107 MICH. L. REV. 979, 984 (2009) (explaining that in the "nexus of contracts" theory, the state supplies a standard contract in the form of default rules, which parties may negotiate to modify). Note that there is some dispute about this characterization of the firm, with some scholars arguing that the modern corporation is a heavily regulated, formalized structure that lacks the flexibility in form that a "nexus of contracts" would contemplate. *See generally*,

among people and entities, then managing those relationships is an important responsibility of the board. The board must balance the requirements of loan covenants against shareholder expectations for profit maximization and dividend payments, all while honoring other contracts into which the firm has entered. The board must determine how to advance the shareholder interest in profit maximization in the face of relevant laws and regulations that constrain the firm's business activity and its ability to take investment risks. A working corporation has a number of moving pieces, and those managing the corporation must take care that those pieces do not collide in a way that will do harm to the firm.

Mediating between corporate constituents requires a solid working knowledge of the rights each party has against the corporation and the corporation's reciprocal obligations. The board must understand which parties can enforce which rights in what circumstances and how each set of rights fits—or possibly conflicts—with others. Because senior officers often negotiate the firm's contracts on its behalf,[98] they have more intimate knowledge of the deals than the board and may have to explain the interactions of the different relationships to the board. Again, the board must rely heavily on the senior officers it is supposed to independently monitor in order to do its job. When the board is asked to make big decisions that involve mediating among various interests, it is simultaneously supposed to be supervising officers' work in setting up the various contracts in the first place and in making the decisions that have led to the firm's current position.

Meanwhile, corporate constituents do not sit idly by when significant corporate decisions are at stake. They work to influence board and officer decision making by threatening to stand on their rights or to use their powers to remove or replace officers or directors.[99] Institutional creditors are a helpful example. Major

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LARRY E. RIBSTEIN, THE RISE OF THE UNCORPORATION (2010). Still others argue that the firm cannot really be a "nexus of contracts" because shareholders are unable to actually negotiate contract terms with the firm or its management. *See, e.g.*, Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403, 1415–16 (1985) ("[T]o impute to investors knowledge of either the terms of the law when they first enter the 'contract' or the changes in the law while stock is held is pure fiction in the case of most individual investors. In the case of institutional investors or market professionals who advise individuals about investments, it is hardly less."). *See generally* Robert C. Clark, *Agency Costs Versus Fiduciary Duties*, *in* PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 55 (John W. Pratt & Richard Zeckhauser eds., 1985).

98. *See, e.g.*, Anne Tucket Nees, *Who's the Boss? Unmasking Oversight Liability Within the Corporate Puzzle*, 35 DEL. J. CORP. L. 199, 251 (2010).

99. While "[s]hareholders nominally have the right to elect directors . . . , the dispersion of shares . . . [makes] the board . . . effectively self-perpetuating." Baird & Rasmussen, *Private Debt*, *supra* note 4, at 1214; *see also* Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751,

loans from banks include detailed covenants that dictate the firm's capital requirements and its ability to distribute dividends in certain financial conditions, and that give lenders certain powers over corporate decision making.[100] If the corporation violates a covenant, the lender may declare a default[101]—a declaration that can have serious consequences. A default on one loan can, by itself, constitute a default on others[102] and cause a number of obligations to become due and payable immediately, which might lead to the firm's bankruptcy. Lenders do not want to declare a default any more than the corporation wants them to, but a creditor can use the threat or at least the right to declare a default as leverage to convince management that it should make certain decisions the creditor would prefer.[103] A creditor might threaten to declare a

779 (2002) [hereinafter Baird & Rasmussen, *Bankruptcy*] ("The board can be replaced by the shareholders."). By contrast, creditors influence board and officer decision making in a more substantive way, particularly during times of financial distress. *See* Baird & Rasmussen, *Private Debt*, *supra* note 4, at 1242–45. For example, unlike shareholders, creditors—through elaborate loan covenants—have the ability to replace the CEO of the distressed borrower-corporation. *Id.* at 1211. Also, shareholders, because of their wide dispersal, "cannot often galvanize quickly when misfortune strikes." *Id.* at 1242. Thus, not only do creditors exert more power, they actually provide a more efficient method of oversight. *Id.* Finally, labor unions similarly exert substantial influence over decision making through their stockholdings as pension funds. *See, e.g.*, Stewart J. Schwab & Randall S. Thomas, *Realigning Corporate Governance: Shareholder Activism by Labor Unions*, 96 MICH. L. REV. 1018 (1998). One way unions have exerted influence is through the heavy use of Rule 14a-8 to place proposals on the company's ballot. *Id.* at 1045. Such union-sponsored proposals usually "involve standard corporate-governance issues designed to maximize the value of the corporation by improving the efficiency of the market for corporate control and aligning manager incentives with shareholder interests." *Id.*

100. For example, Visteon Corporation entered into a loan agreement with five banks following a negotiated bailout with Ford Motor Company. The agreement contained various affirmative and negative covenants, including granting the bank group priority on after-acquired property and a prohibition on certain debt ratios. *See* Visteon Corp., Amended and Restated Five-Year Revolving Loan Credit Agreement (Form 8-K) exhibit 10.4, §§ 7.9(a), 7A.1 (June 30, 2005). For additional examples, see Delphi Corp., $2,825,000,000 Five-Year Third Amended and Restated Credit Agreement (Form 8-K) (June 15, 2005); Gen. Motors Corp., 364-Day Revolving Credit Agreement (Form 10-Q) (Aug. 7, 2007).

101. *See* Visteon Corp., Amended and Restated Five-Year Revolving Loan Credit Agreement (Form 8-K) exhibit 10.4, § 8, (June 30, 2005).

102. Heinrich Harries, *Co-Financing Between Public and Private Institutions for Development Financing*, 32 AM. U. L. REV. 111, 117 n.15 (1982) ("A cross-default clause in a loan agreement that a default on any one loan by the borrower entitles the lender(s) to declare the borrower in default of its other loan obligations."); *see also* Laura Lin, *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Director's Duty to Creditors*, 46 VAND. L. REV. 1485, 1507 (1993).

103. One way creditors may have leverage over management is through debt

default unless a corporate restructuring officer of its choosing is appointed or unless the CEO is replaced with someone the lender trusts and prefers.[104] At the same time, shareholders can enforce their preferences by electing a new board or selling their shares.[105] Shareholders might prefer that the board pursue a different course of action or may prefer that the board issue a dividend, while creditors, through the power reserved in their covenants, may be able to block the decisions shareholders would prefer. The necessary mediation among various corporate constituents can be a significant component of the board's management of the firm, particularly when considering decisions that may affect the firm's capitalization or capital structure.[106]

The board's role in these situations is, ideally, to favor the management decisions that are most likely to maximize profits without violating the law or running afoul of the firm's contractual obligations. The business judgment rule protects the board from liability for the manner in which it decides to strike that balance.[107] The board's role here might serve an important purpose when, for example, creditors and labor unions are both lobbying for particular positions that might compromise shareholder interests and shareholders are not otherwise adequately represented. To the extent the board can juggle the claims and interests of various corporate constituents while working toward maximizing the firm's wealth, it can serve an indispensable function for the corporation.

The board's management, however, is not the best or the most direct way to perform the mediation function. Because it must be brought up to speed about the relationships at issue before it can even begin to deliberate,[108] the board is not particularly well-

contracts which give the creditors the power to place handpicked persons on the board of directors in times of financial distress. Baird & Rasmussen, *Bankruptcy*, *supra* note 99, at 779.

104. Baird & Rasmussen, *Private Debt*, *supra* note 4, at 1233.

105. Shareholders may also allege a breach of fiduciary duty to the extent the board seems to prefer creditors' interests or preferred courses of action to their own but are likely to find that the business judgment rule precludes relief. *See* Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., No. 12150, 1991 WL 277613, at *36 n.22 (Del. Ch. 1991).

106. Labor unions can be powerful influences on officers and directors and may have interests adverse to those of shareholders and lenders. The struggle between General Motors and the United Auto Workers for years while GM crept slowly toward insolvency illustrates the point. *See* Steven Greenhouse, *G.M.'s New Owners, U.S. and Labor, Adjust to Roles*, N.Y. TIMES, June 1, 2009, http://www.nytimes.com/2009/06/02/business/02uaw.html (discussing the UAW's use of the threat of a strike to extract concessions from GM management, a move which ultimately contributed heavily to GM's bankruptcy).

107. *Credit Lyonnais Bank*, 1991 WL 277613, at *36 n.22.

108. *See* Fisch, *supra* note 11, at 274 (explaining that the board must have detailed knowledge of the corporation prior to making decisions over corporate

situated to make a final decision and must rely heavily on the judgment of others more involved in the day-to-day business of the firm. There is no reason to believe that the board's judgment would be superior under those circumstances. Further, the board does not directly manage most of the firm's relationships with and among various constituents on a regular basis. It only weighs in on particularly significant decisions.

When the firm is doing well, the board's management role is very limited and it defers much more to the judgment of officers.[109] In reality, the board's most useful role may be as a group of experienced, collegial consultants available to advise officers about various business matters.[110] Board members might provide useful connections to the business community or to particular groups with interests in the corporation or its business.[111] They might have connections to government regulatory bodies that affect the company's business. These functions may be useful, but they do not make up a management role responsible for operating a business. These advisory, or "relational," functions could be performed by hired professionals or consultants and need not be contained in the body legally responsible for operating the corporation's business.[112] To the extent the firm relies on connections with governmental offices or agencies, there may also be ways to maintain connections by retaining certain people as consultants or counsel to the firm without placing those symbolic ornaments on the firm's governing body.

The firm's senior officers and managers work with various parties in interest to manage the firm's relationships with its investors and the outside world.[113] It is not outside board members,

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matters).

109. *See* Benjamin E. Hermalin & Michael S. Weisbach, *Endogenously Chosen Boards of Directors and Their Monitoring of the CEO*, 88 AM. ECON. REV. 96 (1998) (putting forth a model that demonstrates that boards become less independent and thus engage in less monitoring of a CEO the longer the CEO has been in office); Langevoort, *Commentary*, *supra* note 79, at 846–47.

110. Langevoort, *supra* note 11, at 802–03.

111. Lynne Dallas, *The Multiple Roles of Corporate Boards of Directors*, 40 SAN DIEGO L. REV. 781, 805 (2003); Langevoort, *Commentary*, *supra* note 79, at 843. Professor Dallas explains that the relational role of outside directors allows the corporation to: "(1) coordinate with its external environment, (2) obtain advice and access to information from directors with differing backgrounds, skills, and networks, (3) enhance the support, status, and legitimacy of the corporation in the eyes of relevant audiences, and (4) effectuate monitoring of the strategic direction of the corporation." Dallas, *supra*.

112. Langevoort, *Commentary*, *supra* note 79, at 843 (noting that the advisory function could be performed by consultants while acknowledging that directors with important political or government connections can be valuable to some firms).

113. *See* Lin, *supra* note 12, at 914–16 (discussing ways the board of

but officers, midlevel managers, and in-house counsel who work most directly with corporate constituents and perform the mediation function. The board plays only a very limited role in mediating among the corporation's constituents. Those constituents take an active role in protecting their own interests and are able to influence management decisions that are important to them. The day-to-day business of the firm—and so the state of affairs that leads to any decisions the board is asked to make—is largely determined by the interaction of corporate constituents with the firm's managers. The board does not perform a meaningfully independent role in the bulk of very important corporate decision-making situations.

Ronald Coase would predict that if we could simply allow corporate constituents to talk with one another when their interests conflict and allow managers to balance the various contracts with the firm between points of conflict, we might reach better outcomes than if we involve a relatively ill-informed third party.[114] That does not mean transaction costs would be zero, of course, only that a number of transaction costs would be eliminated so direct bargaining could produce better outcomes. For that reason, it may be appropriate to ask whether the board is in a particularly good position to perform the mediation function: is the board better suited to the task than others, and is a board-centric governance structure justified by the rather insignificant role we see for the board in practice? The governance structure this Article ultimately proposes contemplates just that kind of communication between the corporation's parties in interest while allowing the vestigial board to wither away.

II. MOVING TOWARD THE ELIMINATION OF THE BOARD OF DIRECTORS

Maybe the board structure is not all that many hope it could be, or intend for it to be, but that might not matter if it is still a useful second-best alternative.[115] The problems with the existing board structure are significant, however, and matter very much to the extent they impede the ability of corporate investors to constrain the agency costs inherent in the corporate form. The goal of reducing those agency costs has been the preoccupation of corporate law and

directors' ability to monitor management is restricted by managements' control of information and expertise).

114. The Coase Theorem, developed by Ronald Coase in his famous article *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960), dictates that if transaction costs are zero, then parties will reach an efficient distribution of wealth between them, regardless of their relative bargaining power or strength.

115. Benjamin E. Hermalin & Michael S. Weisbach, *Boards of Directors as an Endogenously Determined Institution: A Survey of the Economic Literature*, FED. RES. BANK N.Y. ECON. POL'Y REV., Apr. 2003, at 7, 7.

scholarship for at least the last eighty years.[116] Corporate monitoring boards are advisory at best and are not designed to bear the weight of responsibility placed on their shoulders by corporate law. If enough people care about corporate accountability, it should be vitally important to find a way to meaningfully identify and respond to the behavior of the parties actually making decisions for the firm. By erroneously believing that the board is in that decision-making position, our efforts to improve corporate law and practice are essentially impotent. The failure of more independent boards to adequately control agency costs is an example of the difficulty the market and reforms have found in trying to fix corporate governance problems by tweaking the monitoring board.[117] Understanding the reality of corporate decision making and developing a governance structure that openly acknowledges it is essential to providing more efficient, effective corporate management and to ensuring that various forms of effective accountability will be available for investors interested in corporate wealth.

I propose a corporate governance paradigm shift that would result in the eventual elimination of the board of directors. Because eliminating the board of directors would be a dramatic change in the corporate governance structure—and one that is arguably not possible under extant law[118]—I offer a description of an intermediate step, a so-called "investor board." An investor board would be a board of directors made up of representatives of various corporate constituents, including shareholders, creditors, and senior managers. The makeup of a particular investor board would correspond with the needs and true decision-making structure of each individual company. Scholars have criticized some corporate governance reforms as requiring a one-size-fits-all board structure despite the fact that different companies have different needs.[119]

116. Adolf Berle and Gardiner Means are widely credited with describing the separation of ownership from control that defines the modern public corporation in their book THE MODERN CORPORATION AND PRIVATE PROPERTY, first published almost eighty years ago. ADOLF A. BERLE & GARDINER M. MEANS, THE MODERN CORPORATION & PRIVATE PROPERTY (Transaction Publishers 2009) (1932). Since the publication of THE MODERN CORPORATION & PRIVATE PROPERTY, corporate governance law and scholarship has focused primarily on reducing the agency costs Berle and Means illuminated. In another seminal work, Jensen and Meckling explained how various capital structures could work to constrain agency costs within the firm. *See generally* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

117. *See* Bhagat & Black, *supra* note 12.

118. *See* DEL. CODE ANN. tit. 8, § 141(a) (2010) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . . .").

119. *See* Langevoort, *supra* note 11, at 814 ("[T]he ideal board structure may be firm-specific . . . ."); Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1529 (2005).

The suggestion of an investor board responds to those concerns by providing a blueprint various public corporations can use to design a board of directors that responds to their particular capital structures and the needs of their dominant constituents. Such a board would accurately reflect the negotiations and relationships the board is expected to mediate. It would be able to resolve conflicts among corporate constituents directly and knowledgeably. Most importantly, an investor board moves us further toward an evolution of corporate governance that discards the vestigial monitoring board of directors in favor of a fluid, dynamic governance structure that accurately reflects decision-making power and authority within the modern large public corporation.

Path dependence may have taken us too far down the board of directors road without considering whether the board is necessary and whether the same objectives could be achieved without a board. As I develop a framework for an investor board in this Part, I will explain at each stage how a component or advantage of the investor board can serve as a valuable step toward the elimination of the board. I will then explain why progress down this evolutionary path would represent a significant improvement in corporate governance and decision making.

A. Accurately Reflecting Corporate Decision Making

Part I detailed corporate law's expectations for the corporate board of directors and explored reasons why those expectations may not be met by the current composition of corporate boards. The contemporary board does not effectively achieve its stated purposes because it is both too independent to be an effective management body and not independent enough to be an effective monitor.[120] In coming to terms with the realities of corporate decision making, we may appreciate that certain parties in interest are able to exercise more authority over corporate decision making than others. Corporate managers, for instance, have much more influence over corporate business than directors can,[121] and creditors may be in a better position to directly influence managers' choices than shareholders.[122] By striking or threatening to strike, labor unions may be able to hold up the entire enterprise regardless of what business choices may be best for corporate wealth. Allowing these parties to interact directly with each other when their interests conflict, and otherwise acknowledging their influence over corporate management in enforcing their contracts with the firm, may lead to

120. See *supra* Part I.B.
121. *See* Alces, *Debunking*, *supra* note 14, at 249 (explaining that managers will permit their own self interests to direct their business decisions, resulting in greater monitoring of the corporation than any other form of loyalty or fiduciary duty would produce).
122. *See* Alces, *Strategic Governance*, *supra* note 14, at 1053–54.

a more accurate understanding of corporate decision making and may result in the more effective performance of the tasks currently assigned to the board of directors. An important first step to eliminating the board is acknowledging that reality and putting those parties in formal monitoring positions with an understanding of their rights and responsibilities that corresponds to their relationships with the firm.

1. *The Basic Structure of an Investor Board*

An investor board would be made up of representatives of major corporate creditors, a shareholder representative, and, perhaps, labor representatives or others significant to the corporation's business.[123] Members of that board would be determined by the significance of their role in the corporation's life or capital structure. For example, significant senior creditors and indenture trustees of significant bond issuances would be granted board positions in their loan documents. The notion of an investor board assumes a shareholder representative like the equity trustee, but, absent a single representative, the company's largest shareholders could assume positions on the board or get together to select a representative. A board so composed would be a more effective monitor of senior officers because its members would be less sympathetic to those officers, as well as less socially or professionally entangled with them. Such a board would also know more about the decisions those officers may make on a daily basis, particularly as those decisions may affect the interests of the various member constituents in the corporation. Because these parties already serve as effective monitors to a large degree, moving them to the position envisioned for the board could allow the corporation's governance structure to more accurately reflect the

123. This investor board structure is similar to corporate governance in other countries. In Japan, for instance, corporations are owned and dominated by large banks. German corporations have two boards—one that supervises and one that manages. The supervisory board is selected by shareholders and labor unions and monitors the management board. German banks dominate corporate shareholding, as in Japan, and shares in both countries are held in large blocks. Franklin Allen & Mengxin Zhao, *The Corporate Governance Model of Japan: Shareholders are Not Rulers*, 36 PKU BUS. REV. 98 (2007), *translated in* BEIJING BUS. REV. (May 13, 2007) (working paper), *available at* http://finance.wharton.upenn.edu/~allenf/download/Vita/Japan-Corporate-Governance.pdf. *See generally* Thomas J. Andre, Jr., *Some Reflections on German Corporate Governance: A Glimpse at German Supervisory Boards*, 70 TUL. L. REV. 1819 (1996). These economies are different from ours, however, and the dominance of banks on both the lending and shareholding side is very different from the American system. The American system is intentionally diffuse relative to the other systems and no one bank is as able to completely dominate an American corporation. Roe, *supra* note 54. Therefore, the investor board and post-board firm suggested here is very different from the practical realities of foreign systems.

reality of accountability on the ground. While the investor board would start as a formal replacement for the monitoring board of directors, we may find that in time, the dynamic of the investor board is such that it need only meet to consider certain significant issues. Over time, we may also find that a governance structure that assigns key constituents different but interlocking and complementary rights no longer resembles a formal board of directors at all.

Without a formal board of directors, the focus of the firm's decision making would shift to senior officers. An investor board could capture the important role of senior officers while also balancing their control over decision making against the monitoring powers of significant corporate investors. For example, senior officers could sit on the investor board and hold voting power for the purpose of reaching important business decisions confronting the firm. Senior officers make the big decisions about a corporation's business, and lower-ranking managers make the day-to-day decisions that allow the company to realize the business plan and strategy promulgated by senior officers. Those business decisions and policies are carried out and prioritized under the influence of the corporate constituents who would exercise oversight on an investor board. A board composed of senior officers and influential parties in interest may do a better job of reaching management decisions because its members would have more intimate, first-hand knowledge of the corporation's business than the current monitoring board.

2. Balancing Interests

The key to successfully redesigning the board in this manner is to make sure that the powers of all of the participating parties are equitably and appropriately balanced. It must be clear what the goal of corporate decision making is supposed to be and how decisions will be reached to that end. The corporation must also clearly decide what decisions require the input of which parties and who will have what degrees of control in particular situations. A lot of these issues are already settled in investors' agreements with the firm. It will be important that no members of a board composed of corporate constituents are able to exercise more power than they would under their contracts with the firm, and that they will not be able to extract rents from the corporation at the expense of corporate wealth or the protected rights of other constituents. Senior officers will be responsible for making most business decisions, with the investor board coming together only infrequently to make game-changing decisions such as whether to file bankruptcy or how to respond to a takeover attempt. For instance, one creditor may already be able to veto a decision to hypothecate more corporate assets or take on additional debt, but its decision to do so may be checked by strong preferences of other, more powerful creditors, or the extent to which the corporation needs the new loan to stay afloat or pursue an important business opportunity. Shareholders may be able to exert pressure by threatening to avail themselves of their rights to change management personnel or by signaling problems to the capital markets (and so the credit markets) by devaluing the stock through exit.

To some extent, the relevant parties have reached a balance considered optimal because they have negotiated rights and powers with the corporation and each has negotiated knowing the extant and possible rights of others. Creditors have already reserved the power over the corporation they deem necessary. They understand how the powers assigned other creditors, shareholders, or significant parties in interest may conflict with theirs or how those other parties may be able to exercise more power in some situations. Similarly, shareholders understand that they have certain powers over corporate management and have the ability to vote on some corporate decisions, but that they have little control over the activities of officers. Shareholders also realize that creditors may have more influence over corporate decision making during times of financial distress because those enhanced powers are expressly reserved in loan covenants.[124]

The contracts defining these investors' rights in and powers over the corporation already fix an important part of the corporate governance structure. Through the implementation of an investor board, those contracts could evolve to account for their enhanced authority and so eventually fill remaining gaps in corporate decision-making authority. Eventually, those agreements could so completely define the interaction of particular parties at important moments in the corporation's operation that a formal board of directors will be unnecessary. The parties may exercise influence over various decisions, or those with particular concerns can confer as necessary and otherwise monitor management through the enforcement of their agreements with the firm.

3. Adjusting Shareholder Power

Indeed, it is the role and powers of shareholders that would require the biggest change to current corporate governance practice if an investor board were adopted. Perhaps shareholders' greatest power over corporate decision making is their ability to elect the members of the board of directors.[125] If the board becomes a group

124. Alces, *Strategic Governance*, *supra* note 14, at 1073–78; Baird & Rasmussen, *Private Debt*, *supra* note 4, at 1231–32.

125. Julian Velasco, *The Fundamental Rights of the Shareholder*, 40 U.C. DAVIS L. REV. 407, 409 (2006) (arguing that shareholders' rights to elect directors and to sell their shares are more important than other shareholder rights).

composed of investor representatives and senior officers, then the shareholder power to elect board members is certainly diminished if not eliminated. Two important shareholder protections must remain: shareholders must be able to choose an important part of the board and shareholder interests must be specifically represented as effectively as those of other corporate investors. As to the first point, shareholders should be able to elect the senior officers to the investor board. As mentioned above, a few senior officers could sit on the board for the purpose of advising and voting on business decisions. Shareholders could select those officers and perhaps even elect the CEO. That way, shareholders would maintain some power over corporate personnel. Upon the elimination of a formal board of directors, shareholders could maintain this authority over the choice of senior corporate managers. On the second point, particular shareholder representation—to counter creditor representation—would be required. Some may argue that this shareholder representation is what the board is supposed to do now. The shareholder representation envisioned by an equity-trustee structure is different because shareholders are not responsible for balancing corporate business concerns or making ultimate business decisions. The shareholder representation on an investor board would focus on doing the shareholder job as it is assigned to shareholders, not running the corporate business. The equity trustee can be a zealous advocate for shareholder interests, with a voice that will be appropriately balanced with other interests. That scheme leads to better and more direct representation of the shareholder interest than the current board provides while still allowing corporate officers to make the business decisions for the firm.

In prior work, I have suggested a way for shareholders to find meaningful, sophisticated representation: an equity committee, made up of the corporation's largest shareholders, that supervises and works in concert with an equity trustee who is responsible for representing shareholder interests to management.[126] The equity trustee could sit on the board and represent the shareholder interest in wealth maximization to management and other corporate decision makers. It could negotiate with other board members on behalf of shareholders and represent the shareholder role in the corporation's power and capital structure. Further, the equity trustee could recommend CEO candidates who could then be approved by shareholder vote. The equity trustee would monitor the CEO with the help of the other board members. The shareholders' ability to remove or replace the CEO could have a significant effect on corporate governance. The shareholders' power would have to be balanced against the rest of the board's role in monitoring

126. Alces, *Equity Trustee*, *supra* note 14, at 747–50.

management.

While significantly different in structure from the current regime, this change in the exercise of shareholder authority would not represent a revolutionary departure from current practices. The choice of a corporation's CEO is not free from investor influence now. Creditors are able to pressure boards to remove and replace CEOs when corporations are in trouble.[127] The creditors play an active role in monitoring the CEO.[128] Giving shareholders power over who serves as CEO seems fitting given the power over corporate managers shareholders currently enjoy. When the corporation is healthy, shareholders are responsible for monitoring the board, and the board is supposed to monitor and hire or replace the CEO with the shareholders' interests in corporate wealth maximization in mind.[129] It makes sense, then, to give shareholders more power over who serves as the CEO as a replacement for their power to choose board members if the current board structure is removed or replaced.

One possible way to balance the relevant interests and provide for some stability in management is to allow shareholders to elect the CEO at particular intervals, but to only allow removal of a CEO with a vote by the rest of the board or on account of defined "cause." If a CEO is doing a bad job, then the board should agree that his performance is subpar and a vote for removal should be successful. Removal for specifically defined cause can protect a company from a particularly harmful CEO. Even if other investors want to remove a CEO and are able to vote to remove or are able to pressure the shareholders to move for a change, the shareholders would choose the replacement—thus the shareholders retain primary control over that part of corporate management.

This exercise of authority replaces the power shareholders now have to elect the board of directors. In fact, the power they exercise could have a more direct bearing on corporate management and decision making than they now have—shareholders would be able to exercise that power more effectively and directly through a sophisticated, informed representative. Of course, the parties could reach one of any number of agreements about how to balance the power each constituent can wield over management personnel. One of this Article's objectives is to encourage such negotiation so that the constituents of each corporation find the right arrangements for

127. In fact, the power of the lender to appoint new management may be an event of default under a loan covenant or a condition of a loan itself. *See* Baird & Rasmussen, *Private Debt*, *supra* note 4, at 1233; Frederick Tung, *Leverage in the Board Room: The Unsung Influence of Private Lenders in Corporate Governance*, 57 UCLA L. REV. 115, 156–58 (2009).

128. Baird & Rasmussen, *Private Debt*, *supra* note 4, at 1233; *see* Tung, *supra* note 115, at 156–58.

129. *See* Tung, *supra* note 127, at 119, 133.

their firm.

While the proposed regime would change some of the process of corporate decision making, the reality of power relationships would remain largely the same. The CEO is already beholden to various investors and serves at the pleasure of the board, which purports to represent shareholder interests. With an investor board, the board of directors replicates the monitoring relationships already extant in the modern corporation: creditors monitor through their loan covenants, labor unions enforce their collective bargaining agreements, and both groups have the ability to seek removal of the CEO if their rights are particularly compromised. Still, a replacement CEO cannot be appointed without the approval of shareholder "representatives"—the modern board.[130] In the new scheme, the replacement CEO would be chosen by more direct shareholder representatives responsible only for pursuing the interests of shareholder wealth maximization—without the current boards' sympathy for management and with the advantages of a better understanding of the company. This understanding would come from the closer monitoring a shareholder representative could provide because an equity trustee would devote more time and resources to representing shareholders in its portfolio of companies.

B. Why a Post-Board Firm is an Improvement

An advantage of using a collection of active investors at the top of the corporate hierarchy is that it approximates the way corporate decisions are made and so provides a structure for more direct and meaningful accountability for corporate decision making. Corporate law places such an emphasis on the role of the board of directors, and places so much responsibility and accountability on the board's shoulders, that it may divert resources from understanding relationships that have more of a bearing on corporate decision making. Bringing together the most effective board-monitoring parties should decrease the costs of corporate monitoring and decision making and should also highlight the parties responsible for particular decisions so that they can be held accountable for the jobs they are supposed to do.

An investor board would be better at monitoring than the traditional board because investors are not as sympathetic to management and so have the necessary distance from management to monitor more effectively.[131] An investor board would also better perform the board's management function because investors who

130. *See id.* at 118.

131. *See* Fairfax, *supra* note 11, at 130 (explaining that there is an "overwhelming consensus that boards should be dominated by 'independent' directors . . . [because they are] better equipped to monitor the corporation, detect fraud, and protect shareholders' interests").

closely monitor the corporation must understand the state of the corporation's affairs to protect their own interests. Additionally, investors already form opinions about the major decisions that should be made on the corporation's behalf. Of course, these opinions may diverge because of individual interests the board members have that conflict with those of the corporation. For this reason, an investor board would represent a significant departure from the laws and norms underlying the structure of the modern corporate board and thus would require changes to the legal framework governing corporate management. Nevertheless, because the recommended structure more accurately approximates actual decision making, it can provide for more predictable, meaningful accountability and do a better job of performing the limited functions of the modern board.

1. Better at Monitoring

An investor board would do a better job of monitoring management than the modern board of directors because the investor representatives would be more socially and, for the most part, professionally independent from management than current board members. An investor board could, therefore, provide the kind of hierarchical monitoring that second-guesses the subject's judgment that the board of directors is ideally supposed to provide for the corporation's management team. The professionals serving on the investor board would not be officers at other companies. Rather, they would be responsible for representing the interests of those seeking to protect the expectations of certain investments. Therefore, they do better professionally if there is more rigorous monitoring of corporate managers, rather than less, because the investors choosing them for their positions will evaluate them based on the job they do protecting those investors. Most important, unlike current officers or directors,[132] they would not be setting a reciprocal precedent for the monitoring to which they would be subject themselves.

One caveat applies to the claim that investor representatives would be professionally independent from management. In some instances, the corporation chooses which banks it borrows money from or may hire institutional shareholders to manage firm retirement funds[133] and so, in those circumstances, the corporation would be choosing the investors who would sit on the board. When parties serving on the investor board depend on the corporation for business, they rely on good relationships with corporate managers.

132. *See* MACEY, *supra* note 8, at 54.
133. *See* Jennifer S. Taub, *Able But Not Willing: The Failure of Mutual Fund Advisors to Advocate for Shareholders' Rights*, 34 J. CORP. L. 843, 849–51 (2009).

In those instances, the investors themselves may want to curry favor with management so that they will continue to be selected by the firm. Such conflicts have proven problematic for auditors in the past—auditors were responsible for independently reviewing corporate financial records, but relied on the managers whose work they were reviewing for business.[134]

Additional protections should be available in a post-board firm to prevent those conflicts from presenting a problem. For example, the selection of creditors, at least private lenders, should be dominated by the terms of the loan. Other corporate monitors can ensure that that this takes place and can also provide a check against the conflicted interests of any one investor. Investor representative sympathies for managers would only be a serious problem if management selected a significant portion of the investors represented on the board. In those instances, the selection of private lenders could be done with the advice and consent of other board members. That way, allegiance to management would not be an effective way to maintain the relationship with the firm and the company may proceed on the merits of service offered by the investor or investor representative in question.

These potential conflicts of interest are easier to see and thus easier to guard against than those arising from the empathies plaguing the current board structure. Investor representatives, by the very nature of their job descriptions (as zealous representatives of reasonably attentive investors[135]), would be less likely to feel sympathetic to management. Investor representatives already monitor management on their clients' behalf,[136] by enforcing loan covenants, for example, and do so without problematic allegiance to management.[137] The dynamics of those relationships between investor representatives and managers should not change by simply elevating the monitoring the representatives do to a more formally recognized place in the corporate governance structure.

Investor representatives would also enjoy an informational advantage over the directors on a modern monitoring board. Recall that board positions are not full-time jobs. Most directors have very demanding careers apart from their service on corporate boards.[138]

134. John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. Rev. 301, 326 (2004).

135. The equity committee structure would make shareholders a more attentive group in monitoring the equity trustee than current beneficial owners are in monitoring the institutions managing their investments. While the structure adds a layer of agents to agents watching agents watching agents, the focus of shareholder power in fewer, more sophisticated hands makes shareholder activity easier to observe and thus more accountable to the larger class of shareholders. Alces, *Equity Trustee*, *supra* note 14, at 748–50.

136. *See id.* at 720.

137. *Id.* at 739.

138. Mark J. Loewenstein, *The Quiet Transformation of Corporate Law*, 57

They simply cannot stay informed about corporate business on a regular basis and must be brought up to speed quickly when it is time to make significant decisions. Because they are already monitoring the management of relevant companies, investor representatives are paying attention to important information affecting their clients' investments in a number of firms. In this way, investor representatives could resemble the professional outside directors suggested by Professors Gilson and Kraakman.[139] Each new board member would have a portfolio of companies on whose board she sits, and she could devote most of her professional energy to reviewing the information necessary to monitor those companies.

Investor board members would not focus solely on the information necessary to make management decisions or monitor managers. Most important would be the information the investor must have to enforce its contracts with the corporation. It is the enforcement of those contracts with the firm that constitutes most of the monitoring of management and most of the new corporate governance structure suggested here. Monitoring that is driven by individual contracts with the firm can be more predictable for the managers being monitored, making the parameters of their jobs clearer. The scope of investment contracts and the powers assigned under them also make the powers of monitors over management and the firm more transparent.

This contract-driven scheme resembles governance through "'Big Boy' letters" described by Professors Baird and Henderson.[140] Baird and Henderson suggest that corporate governance by fiduciary duties owed to shareholders is an outdated notion and that sophisticated parties should be able to negotiate ex ante about the responsibilities they want to enforce against the firm's managers.[141] They then argue that courts should honor those agreements and that those agreements should in turn shape managers' duties.[142] In a corporate governance system dominated by contracts, those with an interest in how the corporation is performing and with interests to protect are paying close attention to corporate management with

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SMU L. REV. 353, 376 (2004) ("American corporate governance is wedded to the notion of directors who serve only part time and who have substantial, often overwhelming, responsibilities outside of the corporation(s) on whose board(s) they serve."). Twelve of Enron's fourteen board members were outside directors with other demanding jobs. The Chairman of the Audit Committee, for example, also worked at Stanford's School of Business. *See* Lisa M. Fairfax, *The Sarbanes-Oxley Act as Confirmation of Recent Trends in Director and Officer Fiduciary Obligations*, 76 ST. JOHN'S L. REV. 953, 957 n.20 (2002).

139. Gilson & Kraakman, *supra* note 3, at 884–92.

140. Douglas G. Baird & M. Todd Henderson, *Other People's Money*, 60 STAN. L. REV. 1309, 1339 (2008).

141. *Id.* at 1315–56.

142. *Id.* at 1342–43.

some, but not too many, means of responding to managerial decision making. They are able to monitor one another, and each party's rights, responsibilities, and powers are known to the others. The enforcement of these contracts yields the most meaningful monitoring in corporate governance.[143] That is why I propose bringing those relationships to the forefront of corporate governance and why I think that kind of monitoring is superior to the monitoring provided by an independent board of directors. Bringing the focus more accurately to the parties doing the real governance work should improve our ability to hold the responsible parties accountable for corporate decision making and should make the decision-making structure more transparent and accessible. It illuminates an important part of the corporate decision-making structure.

2. Better at Management

Because investors are often better informed than members of an independent monitoring board, and because investor representatives already play an important role in corporate decision making, an investor board, or a less formal group of investors, would also do a better job of performing the management function assigned to the board. Investor representatives often know much more about the day-to-day operation of the business and the state of its capital structure than do monitoring boards, so they are in a better position to make major decisions.[144] If asked to perform the board's functions, investors would come into a decision with their own opinions about information acquired from officers as part of the monitoring and enforcement of their contractual relationships, so much of the information on which they would base decisions would not be presented to them immediately before deliberations on a particular question. Further, the presentation of the information would not necessarily be shaded toward whatever outcome management preferred.[145]

One potential problem with giving investors control over corporate decision making is that they may have interests or other investments that conflict with the "best" course of action for the corporation. Various investors may have differing risk preferences and may want to influence corporate management to honor their preferences in making business decisions for the company.[146] A group of creditors could conspire to vote together to exercise control

143. *See id.*
144. *See* Alces, *Strategic Governance*, *supra* note 14, at 1098 ("[T]he equity trustee would monitor the corporation and remain informed as to its financial condition and important business decisions and capital structure, ready to spring into action when its agreement with the corporation requires it.").
145. Langevoort, *supra* note 11, at 813–14.
146. Alces, *Strategic Governance*, *supra* note 13, at 1061–63.

over the company to try to force it to take actions consistent with their creditors' selfish interests. This concern arises any time parties with potentially conflicted interests have decision-making authority. This problem is considered in more detail below.[147] For now, it is worthwhile to point out that there are several reasons it need not be an intractable problem and that those interested relationships may actually provide important advantages.

The board's decision-making authority is extremely limited, so to the extent we are finding an alternative way to make those decisions, we are talking about a very limited universe of corporate decision making. Combine the limits of the board's decision-making authority with the ability of these investor representatives to influence daily decision making in more direct ways, and it is difficult to see how imputing current board responsibilities to the investor representatives would create a new problem or exacerbate an old one. To the extent the board's "independence" and lack of conflicted interest helps it represent shareholders, the shareholders of a company with an investor board would be more effectively and directly represented and have a greater ability to negotiate with the other investors who may compromise their current interests. Replacing the monitoring board with one that more closely represents the corporate decision-making process serves largely to remove a vestigial middleman of sorts from the appropriate balancing of the financial interests that make up the modern corporation.

3. Contractual Accountability

Transitioning to an investor board would also enhance accountability for corporate decision making. For instance, enforcement of investment contracts may be a better way to hold managers accountable to investors of all kinds than reliance on fiduciary duties has proved to be.[148] Baird and Henderson suggest enforcing disclosure requirements against managers through ex ante provisions in investment contracts.[149] That way, managers are responsible for making sure the corporation abides by disclosure requirements to various parties in interest. Having received the required disclosures, the investors or corporate constituents in question could protect their other rights against the corporation.[150] They need managers to make the proper disclosures to enforce their contracts, so it makes sense to hold managers personally responsible for faithfully providing important information about the business.[151]

147. *See infra* Part II.D.
148. Baird & Henderson, *supra* note 140, at 1338–41.
149. *Id.*
150. *Id.*
151. *Id.*

Further, disclosure is a discreet and specific task that is relatively transparent thus investors will be able to reliably determine whether managers have complied.

Similar terms may be effective beyond disclosure requirements. To the extent there are specific tasks managers can perform, investors can require them to do so and enforce those requirements contractually. If managers cause breaches—with a certain predetermined degree of malfeasance—they can be subject to personal penalties or consequences as provided in investor agreements with the firm. This would allow all corporate constituents to enforce their agreements with the firm and to hold managers personally responsible only for certain, specific obligations. This prevents uncertainty for managers by delineating their responsibilities and limits the power of individual constituents over the firm and its management in ways other parties in interest can count on.

For instance, shareholders know exactly what power creditors would have over management under particular circumstances and could account for that power in deciding the best course of action. As suggested above, the power to remove the CEO would belong to an investor board, or to a group of qualified investors, only under certain circumstances. But if the CEO is removed, all shareholders would have the power to choose a replacement, keeping in mind that their choice should not be completely inimical to the preferences of creditors and other investors. If shareholders do too much to compromise the interests of other investors, those investors may be unwilling to cooperate when deciding how to avail themselves of their rights against the corporation.

The success of a post-board governance structure relies upon carefully balanced rights and responsibilities among the parties in power, with full disclosure and knowledge of what those rights and powers are and how they may be exercised. Its strength lies in the ability of the relevant parties to openly discuss what actions they might take to direct the course of the corporation's business and what decisions each may make when confronted with important choices. It brings the balancing act that current directors and officers must perform in their heads out into the open and allows for direct bargaining among the parties in interest.

The notion of managerial accountability under an investor board is very different from the traditional norm of relying upon fiduciary duties in corporate governance. Currently, corporate governance relies heavily upon a fiduciary rhetoric that emphasizes an obligation for directors to run the corporation according to shareholders' best interests.[152] The rhetoric is often hollow and

152. Lawrence A. Cunningham, *Commonalities and Prescriptions in the Vertical Dimension of Global Corporate Governance*, 84 CORNELL L. REV. 1133,

rarely leads to serious liability, basically eviscerating any threat of personal liability officers and directors might face.[153] The choice Delaware courts have made—to not enforce fiduciary duties with personal liability—shows a wariness of using liability as a means to discipline corporate decision makers.[154] Holding managers accountable through specific contract terms allows more predictable, meaningful liability. This makes particular sense in the context of an investor board. There, board members would only be accountable directly to the investors they represent. Board members want to ensure that managers uphold the bargains the investors have made with the corporation, but only want other investors to be able to exercise clearly-defined powers over management. In maintaining the proper balance among investors, it is crucial that all board members understand the powers of others as well as when and how those powers may be exercised. Precise contract terms help to provide that certainty.

4. *Leaving Fiduciary Duties Behind*

Delaware corporate law relies heavily on fiduciary duties to address agency costs in the large, public corporation.[155] What is lost in a purely contractual—as opposed to fiduciary—corporate governance regime is the ability to apply more flexible standards and decide ex post what constitutes a breach of the obligation to manage the corporation in the interests of corporate wealth maximization, or, more specifically, to avoid conflicts of interest that compromise a director or officer's ability to decide what is in the corporation's best interests.[156] That loss would not be so great once

1165–66 (1999) (explaining that fiduciary rhetoric performs socializing, educational, and proselytizing functions in corporate governance).

153. Alces, *Debunking*, *supra* note 14, at 256 ("The current system relies on a clumsy combination of smoke and mirrors to discourage bad behavior through stern threats of possible liability while only punishing truly egregious behavior, often ineffectively and after it is too late.").

154. *Id.* at 243 (stating that "fiduciary duties are not relied upon to discipline managers, and they are not enforced very often"). The Delaware Legislature has similarly reflected this desire to punish directors without imposing personal liability. DEL. CODE ANN. tit. 8, § 102(b)(7) (2008). *See* Alces, *Debunking*, *supra* note 14, at 251 ("[T]he Delaware corporation statute allows directors . . . to opt out of personal liability for breaches of the duty of care. [Therefore,] [o]fficers and directors must be punished for incompetence in other ways.").

155. Baird & Henderson, *supra* note 140, at 1309–10.

156. Some scholars question whether the same duty of loyalty applies to officers as applies to directors. Lyman P.Q. Johnson & David Millon, *Recalling Why Corporate Officers are Fiduciaries*, 46 WM. & MARY L. REV. 1597, 1600–08 (2005) (arguing that because officers are appointed, rather than elected, officers should be held to stricter fiduciary standards than directors, with agency law serving as the basis for imposing liability). Still, a contractual system that does not rely on fiduciary duties would mean that officers would not be held to a

one considers the fact that the protection afforded by fiduciary duties, outside the social-norm-creating benefits of the rhetoric, is not substantial and the costs associated with misunderstanding the extent of the legal protection provided by fiduciary duties may be significant.[157] Those norms can arise without the pretense of supposed liability that results in significant wasted time, litigation expense, and legislative angst. Vague liability rules do not have a place in corporate governance.

One concern about using vague liability rules has been the potential chilling effect of unpredictable personal monetary liability for officers and directors.[158] We rely on corporate decision makers to exercise business judgment and hope that they will cause the corporation to make investment decisions reflecting a desirable level of risk.[159] If those decision makers are afraid of being held personally liable for decisions deemed bad in hindsight, then they will likely not take profitable risks.[160] The business judgment rule protects corporate decision makers from liability for what turn out to be bad business decisions, leaving conflicts of interest as the only reliable basis for personal liability under Delaware corporate law.[161]

That does not mean that corporate investors are powerless in the face of bad decision makers. Bad decision makers are supposed to be replaced or punished (i.e., paid less than good decision makers). The current corporate governance model provides officers

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fiduciary standard.

157. Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619, 1640–45 (2001).

158. Geoffrey P. Miller, *A Modest Proposal for Fixing Delaware's Broken Duty of Care*, 2010 COLUM. BUS. L. REV. 319, 332–33 (2010) ("Fear of overwhelming judgments against directors for a good decision gone wrong might deter people from serving on boards, or might discourage them from undertaking risky but desirable ventures if they do serve.").

159. David Rosenberg, *Supplying the Adverb: The Future of Corporate Risk-Taking and the Business Judgment Rule*, 6 BERKELEY BUS. L.J. 216, 221 (2009) (discussing arguments in favor of risk taking and the importance of allowing managers to exercise their business judgment in taking risks).

160. Miller, *supra* note 158.

161. Breach of the duty to act in good faith can also lead to liability, but the meaning of that term has been debated. Most recently, bad faith has been characterized as malicious, willful behavior or behavior that evinces a complete disregard for the director or officer's duties to the corporation. *See* Andrew S. Gold, *The New Concept of Loyalty in Corporate Law*, 43 U.C. DAVIS L. REV. 457, 469 (2009) (describing the Delaware Supreme Court's decision in Disney V as defining a violation of good faith as acting with "an intent to do harm," or actions "reflect[ing] a conscious disregard of a director's duties"). For unincorporated entities, Gold describes good faith as "contractual gap-fillers: they are a means of filling in implied terms when contracts are silent as to specific contingencies." Andrew S. Gold, *On the Elimination of Fiduciary Duties: A Theory of Good Faith for Unincorporated Firms*, 41 WAKE FOREST L. REV. 123, 127 (2006).

and directors a great deal of job security. Directors are generally only removed when they are not reelected in annual elections.[162] Officers generally have to be removed by directors who tend to be sympathetic to the officers they have chosen because they do not want to admit that they have done a poor job of appointing or monitoring senior managers.[163] Creditors have enjoyed some success in causing senior officers to be replaced but are only able to do so in the most dire of financial circumstances.[164] In fact, a great deal of officer turnover occurs when a firm is experiencing severe financial difficulty,[165] but officer positions tend to be secure most of the time and are often otherwise protected by lucrative golden parachutes.[166]

In a post-board firm, officers may enjoy fewer protections and key decision makers may be easier to remove. For one, investor representatives are directly accountable to those with interests in the firm and those who are actively monitoring their performance. The officers who make the day-to-day decisions must report regularly to investor representatives in a manner prescribed by the investor contracts with the firm. The CEO may be removed by the board, but is chosen at regular intervals by shareholder representatives. This would allow investors to weigh in if they think the CEO is doing a bad job, but leaves the residual claimant the ultimate authority to choose the CEO. Furthermore, reduced dependence on vague liability rules should mean that investors will remove officers who are performing poorly and officers will, in turn, work to build strong reputations for making profitable, wise decisions for their firms. The enhanced monitoring provided by the investor board, and the ability investors will have to enforce

162. The Delaware Code was amended in 2006 to specifically allow for this type of removal process. *See* William K. Sjostrom, Jr. & Young Sang Kim, *Majority Voting for the Election of Directors*, 40 CONN. L. REV. 459, 474–75 (2007).

163. MACEY, *supra* note 8, at 58–60.

164. Baird & Rasmussen, *Private Debt*, *supra* note 4, at 1242–45.

165. A. Mechele Dickerson, *Privatizing Ethics in Corporate Reorganizations*, 93 MINN. L. REV. 875, 915 (2009) (stating that "[e]mpirical studies have found that officers are replaced in roughly half of the firms who are in financial distress"); Tung, *supra* note 127, at 157 (explaining that the likelihood of CEO turnover is especially related to financial difficulties for firms with private debt).

166. David V. Maurer, *Golden Parachutes—Executive Compensation or Executive Overreaching?*, 9 J. CORP. L. 346, 351–52 (1984); Mary Siegel, *Tender Offer Defensive Tactics: A Proposal for Reform*, 36 HASTINGS L.J. 377, 377 n.4 (1985) (explaining that the justification for golden parachutes is that management, knowing it will be financially secure regardless of who is the victor in a takeover battle, will be able to accept or reject the tender offer in an objective fashion); Randall S. Thomas & Harwell Wells, *Executive Compensation in the Courts: Board Capture, Optimal Contracting, and Officers' Fiduciary Duties*, 95 MINN. L. REV. 846, 854 (2011).

particular contract terms, will mean that officers' decisions are more carefully monitored and so can be more accurately evaluated.

Of course, any monitoring and accountability provided should not exceed efficient levels. Stephen Bainbridge adopts Kenneth Arrow's view of the relationship between authority and accountability in defending board primacy.[167] Bainbridge points out that accountability cannot be so great that it overwhelms the authority the board is given to make business decisions for the firm.[168] Second-guessing every board decision essentially robs the board of its authority and gives it to the parties that can hold the board accountable.[169] The same concern would arise in a post-board firm to the extent officers may be held accountable for the business decisions they make or other corporate constituents could be held accountable for exceeding the bounds of their authority in making decisions for the firm. Someone has to have authority to make business decisions and that authority cannot be second-guessed or overturned constantly. Nothing about a post-board firm's governance structure, as described here, undermines the business judgment rule or a deference to business decisions made by officers with technical knowledge of the firm's business. The accountability this Article encourages focuses on responding to existing violations of governance rules and norms rather than concentrating on defining new ones. The idea is to hold managers who defraud investors directly accountable, not to limit the activities or discretion of honest managers.

5. Summary

A post-board firm would be run by its managers and representatives of major corporate investors and constituents according to a well-balanced system of contracts. The investor representatives would fulfill the board's monitoring role, while the officers would make management decisions subject to the rights and powers of significant parties in interest. Investors thus empowered would be better at performing both board functions. They have the independence necessary to be good monitors and the intimate knowledge of the corporation to be capable corporate decision makers. Problems with conflicts of interest would be different, but not greater than, those faced by current monitoring boards and could be overcome through carefully negotiated and enforced contracts. Investors would be able to strike a sensible balance of power directly by negotiating various rights and powers with the corporation and enforcing those as necessary, then negotiating with each other when the time comes for concerted decision making.

167. Bainbridge, *Shareholder Disempowerment*, *supra* note 13, at 1747.
168. *Id.*
169. *Id.*

D. Problematic Relationships in a Post-Board Firm

The most apparent potential problem with using an investor board as the dominant monitoring and decision-making body for a corporation involves managing the negotiation dynamics of the various parties. How would various investor representatives interact? Would they behave strategically to form coalitions to take power from other investors? Would we allow creditors to exercise too much control over a healthy company? How do we really moderate shareholder views, particularly as the views of various shareholders may differ? Might more than one shareholder representative be necessary? What do we do with divergent views and risk preferences? Who wins? What if the "wrong" party wins? We have long counted on the board of directors to mediate these disputes, break these ties, and fill these gaps.

Despite having a board to referee these interactions, these very questions have long plagued corporate governance. Tomes have been devoted to determining whose interests should drive corporate decision making at different points in the corporation's life.[170] How the interests of corporate constituents should be balanced is an important question that dominates the board's decision making under the current system.[171] Allowing investors to assume the board's role would not necessarily end these inquiries about the struggle for corporate control, but there is also little reason to believe that an investor board should make it more difficult to reach satisfactory answers or to find the right balance of power over corporate governance. In fact, a post-board governance structure would allow each corporation to decide its optimal balance of power according to who its significant investors are and what interests motivate its business decisions.

In thinking about how dominant investors in a post-board firm would interact with each other, it is important to acknowledge that the board has limited power. The board of directors is only charged with making a few significant decisions for the firm and is mostly concerned with monitoring the CEO and other senior managers.[172] By shifting those roles to investors, we would simply be

170. *See, e.g.*, Bainbridge, *Director Primacy*, *supra* note 13; Baird & Rasmussen, *Private Debt*, *supra* note 4; Bebchuk, *supra* note 13; Dallas, *supra* note 82; Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733 (2005); Frederick Tung, *The New Death of Contract: Creeping Corporate Fiduciary Duties for Creditors*, 57 EMORY L.J. 809 (2008).

171. *See* Bainbridge, *Director Primacy*, *supra* note 13 (arguing that balancing the various interests of corporate constituents is a matter that should be left to the discretion of the board of directors); Blair & Stout, *supra* note 11 (explaining the mediating function of a board of directors).

172. Bainbridge, *Why a Board?*, *supra* note 13, at 9; James P. Holdcroft, Jr. & Jonathan R. Macey, *Flexibility in Determining the Role of the Board of Directors in the Age of Information*, 19 CARDOZO L. REV. 291, 291–92 (1997).

acknowledging more directly the monitoring and managing investors already do. It does not add much to that authority to ask those investors to participate in decisions currently reserved for the board of directors. Instead of giving the keys to the corporation to investors in a new way, we would be bringing investors' power over the board's limited decision-making authority out into the open. The power investors can exercise over management outside of the board decision-making structure dwarfs the ability of the board to make business decisions for the firm. Giving the board's power to investors should not be cause for too much concern.

In the same vein, to the extent we worry that improvident alliances among various corporate constituents, to the exclusion of others, would undermine corporate priorities and the ability to reach decisions that are in the best interest of corporate wealth maximization, we should already be worried about such alliances. Currently, creditors can form coalitions or coordinate with each other in the enforcement of their covenants.[173] In fact, that is exactly what the bankruptcy system encourages. The basic rules and structures of that system often bleed into pre-bankruptcy times of financial distress as creditors work with the debtor firm to arrive at accommodations that will allow the company to stay afloat.[174] All of that work and negotiation is done to the practical exclusion of shareholders[175] and may or may not involve the concerns of other corporate constituents, depending on how vital those constituents are to the firm's survival. It is hard to see why creditors would take such an interest in the management of the firm if the firm is not either financially distressed or at risk of becoming so. Enhanced powers over management when the firm is healthy are not reserved to creditors in the creditors' contracts.

One may argue that by including creditors in post-board governance we allow them to cast meaningful votes about corporate decisions even when the firm is healthy. That is not necessarily true if we define creditors' roles in similar terms as we do now—that is, empowering them to influence corporate management only when the firm is experiencing financial distress. To the extent a post-board firm does give creditors some power during times of financial health, creditors' preferences should not diverge so widely from those of other investors in those instances. It may be true that creditors disfavor riskier corporate business strategies and that their preferences differ from shareholders' in that regard.[176] However, it makes sense to limit creditors' voting power during times of financial health and enhance it during times of financial

173. Tung, *supra* note 127, at 125.
174. Baird & Rasmussen, *Bankruptcy*, *supra* note 99.
175. Tung, *supra* note 127, at 178–80 (discussing the impact that lenders can independently have on the governance of corporations).
176. *Id.* at 178.

distress, just as we currently do with creditor power provided in loan agreements. Nothing about a post-board governance structure prevents such an accommodation—rather, the proposed structure encourages just that sort of balance.

Furthermore, we must think carefully about the possible effects of inappropriate collusion before we believe it is a significant problem. Why would a creditor want to take time to run the company in a way the creditor sees fit unless the company is in serious financial trouble? Using too heavy a hand when it could cause a corporation to be less profitable might cause corporations to disfavor a particular creditor in the future, which, in turn, might cause those creditors to lose business. Additionally, excessive control by investors that hinders effective or profitable management of the firm may cause a corporation to lose good managers. Similar problems could arise with shareholders who decide to use whatever authority they have to pursue short-term gain. No one shareholder has absolute authority over the shareholder position and shareholders still have to assert their will through the decisions of officers and are still checked to some extent by the firm's contracts with other investors and the power creditors have over corporate governance. If shareholders push a management agenda that is too risky or that is ineffective, creditors stand ready to assert the considerable authority they would have in times of financial distress.

In a post-board governance regime, it would be easier to see collusive or potentially troublesome activities of corporate investors, bringing their management and monitoring activities into the open. That would allow the firm to balance its contracts as necessary and would allow constituents with differing interests to check each other. For now, it is important to set up the necessary safety nets to ensure that no one party has the power to dominate the firm (without buying that kind of control) and that no one investor can usurp corporate authority to the detriment of the firm or other investors. It will take time to figure out what those agreements and relationships should look like and how they should be structured.

In the meantime, we should do what we can to remove obstacles to what may be a very beneficial and effective evolution of the board of directors. If we remove legal obstacles that are not essential to useful functioning of the board and put in their place appropriate protective rules that provide more flexibility, then we may realize a deliberate evolution of the corporate governance structure to one that more accurately reflects the realities of corporate decision making.[177] This strategy should lead to better monitoring and

177. This is exactly what state regulation of corporate governance is designed to allow. State corporate law is made up of enabling statutes with many default provisions designed to let incorporating parties design the best

management and also a more effective way to hold those in charge accountable for performing their jobs faithfully and as expected.

The proposal set forth in this Article is intentionally nonspecific. My intention is not to present a "new board in a box" to which one could add water and have a fully formed new corporate governance system. I only intend to suggest a path toward what may be natural evolution for corporate governance so that we can see what agreements the relevant parties reach. I think, in many important ways, the market has already begun work on this by changing the power structure of corporate decision making so as to render the monitoring board very weak. The next step may be to remove corporate law's focus on the independent monitoring board so that better governance structures may emerge in its place. The next Part explains how to begin to do that so that the natural evolution of corporate governance may continue.

III. POTENTIAL OBSTACLES

Any time someone suggests an innovation in corporate law, the first question posed to challenge the innovation is bound to be, "If it's such a good idea, why hasn't it happened already?" Market forces have been at work on the best way to run a business for hundreds of years and the corporation has grown and changed dramatically in its history.[178] We have reasons for the corporate governance structures we have chosen, and disturbing those carefully considered choices should be done cautiously and must be justified thoroughly. If the current board structure is a product of rational market forces and wise choices over the course of generations, then those in favor of changing it drastically may face an uphill battle.

I argue that the changes to the current structure of the board of directors proposed by this Article *reflect* rather than upend the work market choices have done on corporate governance. Corporate governance has evolved to the point that corporate constituents and officers exercise more power over the firm than the board, and to the point where the board of directors performs only the most superficial monitoring and is called upon to make few business decisions under the strong influence of the corporation's officers whom they are charged with monitoring. The weak position of the board in its very limited role is a product of market evolution, as is the strength of the influence of significant corporate creditors and the influence parties like proxy advisors and some institutional shareholders can have over corporate governance. The law, not the market, preserves

governance regime for their business. Romano, *supra* note 119.

178. *See, e.g.*, Harwell Wells, *The Birth of Corporate Governance*, 33 SEATTLE U. L. REV. 1247 (2010) (discussing the changes, over time, of the corporation, and corporate governance's reaction to those changes).

the place of the board of directors in corporate governance.

Market evolution has led us to a corporate governance structure that resembles the investor board suggested here. To move formally to such a board, several intermediate steps are necessary. First, legal impediments to the evolution of boards in this direction will have to be removed. Then, we might find an intermediate step with an advisory board of investor representatives. That might be a way to gather investor representatives in the same place so they can begin conferring with each other and pooling their monitoring abilities and information. If they come together to advise and monitor the board, albeit in a nonbinding way, then the relationships may begin to evolve such that the "advisory" board replaces the traditional board of directors. My goal in this Article is to set the stage for a new (and, I think better) way of constituting a corporate board and to argue that we should clear the way for corporate governance to evolve toward such a change.

Allowing corporate governance to evolve toward an investor board, and, eventually, the elimination of the board of directors, would require removing legal impediments to that evolution. Rules mandating board independence would have to be relaxed, as would interpretations of prohibited conflicts of interest. For instance, the investors dominating a post-board governance structure will necessarily be buying and selling the corporation's securities while they or their representatives have access to material, nonpublic information. Such conflicts would have to determine the extent to which certain parties could participate in corporate decision making and may result in additional requirements for pre-trading disclosures.

Certain laws relating to corporate governance would have to change to lower the barriers to this kind of evolution. Lowering those barriers could result in some unintended consequences, and we should be careful not to remove the protections we have against opportunistic or self-interested behavior on the part of officers and directors that could harm the firm. The emphasis here should be on removing or relaxing regulations that are not actually helpful or that constrain the evolution of corporate governance in unhelpful ways. From there, any changes to that structure would have to develop slowly and carefully and perhaps reflect the needs of individual firms. This last Part highlights ways those paths to evolution may be cleared and to suggest possible forms that evolution could take.

A. Mandatory Board Structure

We might not have yet fully evolved to the governance structure suggested by this Article because state and federal law mandate some aspects of corporate governance. Right now, the vast majority of corporations cannot dispense with the board of directors entirely because, under Delaware law, the corporation must be operated under the direction and supervision of a board of directors.[179] Investors and their direct representatives cannot make up a majority of a corporation's board because public companies must have majority independent boards: a majority of board members cannot have personal or financial ties to the firm.[180] None of the members of an investor board would satisfy this definition of independence because officers would work for the company and the investor representatives would be working to directly represent the interests of those having financial ties to the corporation. The Sarbanes-Oxley Act requires the boards of public companies to form audit and compensation committees made up of independent board members.[181] These statutory and regulatory provisions mandate a corporate governance structure for public companies that an investor board would violate.

The application of common law principles of corporate governance would also have to be adjusted to accommodate the lack of board independence. For instance, the application of the duty of loyalty to the corporate board would have to be tweaked to accommodate directors representing those with financial interests in the firm and interests that might diverge with those of the corporation. The investor representatives would have to disclose their trading activities and interests they have that may be adverse to the corporation so that their decision-making authority can be altered accordingly. Allowing investor board members to continue to trade in the corporation's securities (trading that defines their board membership in many instances) would also require accommodations in the application of insider trading laws. This Part addresses these regulatory obstacles and argues that some should be removed while others could be supplemented by special rules regulating the conflicts of interest affecting investor board members.

1. The Board "Requirement"

Delaware corporate law provides that:

> The business and affairs of every corporation organized under this chapter *shall* be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation. If such a provision is made in the certificate of incorporation, the powers

179. DEL. CODE ANN. tit. 8, § 141(a) (2010).
180. NYSE AMEX SECTION § 802, CORPORATE GOVERNANCE REQUIREMENTS (2010), *available at* http://wallstreet.cch.com/AMEXTools/PlatformViewer.asp?searched=1&selectednode=chp_1_1_8_1&CiRestriction=governance&manual=%2Famex%2Fcompanyguide%2Famex-company-guide%2F.
181. 15 U.S.C. § 78j-1 (2006).

> and duties conferred or imposed upon the board of directors in this chapter shall be exercised or performed to such extent and by such persons as shall be provided in the certificate of incorporation.[182]

The common understanding of this provision is that it requires that each corporation organized under Delaware law have a board of directors.[183] To the extent the language in section 141(a) allows a firm to provide for a different governance structure, it has generally been interpreted to refer to the power of boards to delegate their authority to committees[184] or officers[185] in certain circumstances. Nevertheless, section 141(a) is, strictly speaking, a default rule that corporations can contract around in their articles of incorporation.[186]

Thinking of section 141(a) as a default rule might provide an avenue through which corporations could evolve to post-board governance without overturning state incorporation statutes.[187] Lynn Stout points out that corporations are free to adopt any number of governance structures at the outset, yet public companies have failed to do so.[188] In fact, public firms and those preparing for IPOs have adopted provisions that strengthen board power vis-á-vis shareholders and hostile bidders.[189] It is easy to see that the reasons for preferring a strong board of directors have little to do with regard for board decision making and are more likely driven by the fact that the choice is framed as one between giving dispersed, rationally apathetic, and unsophisticated shareholders power over corporate decision making or leaving that power vested in a board.[190] If that is the choice, indeed board authority is the prudent

182. DEL. CODE ANN. tit. 8, § 141(a) (2010) (emphasis added).

183. If one were to use an online service to establish a corporation in Delaware, one would find a notation requiring that a board of directors be formed. *See, e.g.*, *Incorporating 101*, HARV. BUS. SERVS., INC., http://www.delawareinc.com/101/index.cfm?pageid=10068 (last visited Sept. 16, 2011) (stating that, as a formality, the formation of a board of directors is required to establish a corporation in Delaware).

184. DEL. CODE ANN. tit. 8, § 141(c)(2) (2010) (allowing the board to designate a committee and stating that such committees "shall have and may exercise all the powers and authority of the board of directors in the management of the business and affairs of the corporation"); *see also* Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981) (considering the business judgment of the corporation's directors as delegated to a special litigation committee).

185. Grimes v. Donald, 673 A.2d 1207 (Del. 1996) (holding, in part, that a board of directors is permitted to delegate its decision-making authority to the firm's CEO provided it has the power to do so).

186. Stout, *supra* note 77, at 669.

187. *Id.* at 698.

188. *Id.* at 669.

189. *Id.*

190. *Id.* at 698–701 (arguing that a mediating board should be favored as opposed to an independent monitoring one but preferring board decision making to shareholder authority); Bainbridge, *Director Primacy*, *supra* note 12

course of action. It is not realistic to frame the market choice as one between corporations with boards of directors and those without, because all public corporations have a board of directors.[191] The infrastructure necessary to allow the elimination of the board in a large, public corporation is not yet in place.

That is why this Article suggests how we could allow the market to slowly move toward a post-board governance structure and does not propose that corporations eliminate boards of directors immediately. Before the board of directors can be responsibly eliminated, better mechanisms for shareholder representation would have to be in place. The governance structure of public corporations would have to change slowly. Perhaps significant investors could begin by forming an advisory committee to more directly communicate with each other while monitoring management and influencing significant corporate decisions. Then, perhaps that advisory board could take over for the monitoring board of directors. Finally, the formal board structure could give way to a strong system of investor contracts. Too abrupt a change would not be beneficial for corporations or investors, so it is inappropriate to take a measure of market preferences in the current regime as a signal of what may happen if market evolution is allowed to take its natural course. There are still significant obstacles to the evolution away from the board and those legal obstacles must be removed to allow corporations to design the governance structure that best suits their needs.

That freedom is contemplated by state incorporation statutes that provide default terms around which organizing corporations can contract. Where state law allows freedom to design firm-specific governance structures, the laws governing public companies place far more onerous requirements forcing firms to adopt more uniform governance regimes. Where state law allows corporations to opt out of a governance structure dominated by a board of directors, federal law seems to prohibit that choice. That is not to suggest that there is no role for federal regulation of public companies, only that state law has the right idea—adopt default rules that provide certain minimum protections from abuse, and let the parties design the form that works best for their company.

2. Regulations Requiring Independence

The New York Stock Exchange Listed Company Manual requires that listed companies have a board composed of a majority

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(maintaining that boards should be able to exercise discretion over corporate business without regard to preferred shareholder means because shareholders lack knowledge of corporate affairs and the necessary sophistication to make profit-maximizing business decisions).

191. Stout, *supra* note 77, at 669.

of independent directors.[192] This would seem to rule out a listed company's not having a board of directors at all and further defines what the composition of that board should be. The listing requirements define an independent director as one having a "material relationship" with the listed company.[193] A comment to the apposite section explains that "material relationship" is to be interpreted broadly and cannot be specifically defined, but would include "commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships, among others."[194] This would seem to pose a problem for an investor board as all members would either be managers or investors in the firm. Creditors would have "commercial" or "banking" relationships with the listed company.

However, the comment clarifies that it means "independence from management," thus holding a large amount of stock would not necessarily make a board member "not independent."[195] That would seem to solve the problem and emphasize that the NYSE intended for boards to exercise their judgment—that as long as the investor did not have ties to managers, it might qualify as "independent." The regulation does not say "no material relationship with the listed company's managers," however, so it seems that those doing business with the firm or investing with the firm would not be considered independent board members. A board made up entirely of those investors having "commercial" and "banking" relationships "with the company" and senior managers would not pass the independence requirement. Because the comment explaining the requirement leaves the door to "independent" board members with financial interests in the firm, and the rule is framed broadly and in a way designed to allow discretion, it may not be difficult to adjust the rule to more clearly allow significant investor representation on the board of directors of a listed company.

Sarbanes-Oxley[196] requires that public companies have independent audit[197] and compensation committees.[198] The committees are to be made up of members of the company's board of directors who are "independent."[199] Again, these regulations so

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192. NYSE LISTED COMPANY MANUAL § 303A.01, *available at* http://nysemanual.nyse.com/LCMTools/PlatformViewer.asp?searched=1&selectednode=chp%5F1%5F4%5F3%5F2&CiRestriction=independent+AND+director&manual=%2Flcm%2Fsections%2Flcm%2Dsections%2F (last visited Sept. 16, 2011).

193. *Id.* § 303A.02(a).

194. *Id.*

195. *Id.*

196. Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in scattered sections of 15 and 18 U.S.C.).

197. 15 U.S.C. § 78j-1(i) (2010).

198. *Id.* § 78j-3.

199. *Id.* § 78j-1(m)(3); *id.* § 78j-3(a).

strongly assume that public corporations have a board of directors that they practically require that public companies have a board even though state law does not. Furthermore, independence is not specifically defined, but contemplates members who would not be personally interested in the decisions assigned to the committee[200]—decisions relating to executive compensation and reviewing the work of the firm's outside auditors. Many investor representatives would be able to satisfy the independence requirements for the compensation and audit committees even if they would not qualify as independent directors for the purposes of satisfying the listing requirements. Thus, part of the evolution proposed by this Article could take place under current Sarbanes-Oxley rules, thereby maintaining the protections those federal regulations provide, while the governance structure moves slowly away from the board-centric model. Then, as firms evolve beyond the use of a board of directors, federal law may have to be tweaked to accommodate the change.

Congress cannot be accused of inventing corporate governance reforms that were out of step with corporate practice at the time they were adopted. As described above, the market had evolved to favor the use of independent monitoring boards.[201] The problem is that the regulations requiring the use of increasingly independent monitoring boards of directors artificially stalls that evolution. The problems with the independent monitoring board have become apparent and each new regulation makes it harder for corporate governance to continue to evolve past the current ineffective board structure. To the extent regulations force corporate governance to maintain ineffective or meaningless structures, they impose costs and prevent the market from correcting problems it discovers.[202] Corporate governance has long been considered the province of the states because state law allows firms to adjust their governance structures to suit their particular needs and allows those structures to evolve over time.[203]

B. Laws Governing Conflicts of Interest

Because directors are supposed to exercise independent judgment about which business decisions are in the best interests of the firm, corporate law focuses on ensuring that they do not place personal interest ahead of firm interest in their work for the corporation. The fiduciary duty of loyalty prohibits conflicts of interest and self-dealing that compromise the corporation's wealth.[204] The federal prohibition of insider trading builds on the

200. *Id.* § 78j-1(m)(3).

201. *See supra* Part I.A; *see also* Langevoort, *supra* note 10, at 800; Romano, *supra* note 108, at 1526.

202. *See* Romano, *supra* note 108, at 1523.

203. *Id.* at 1529.

204. R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, DELAWARE LAW OF

fiduciary duty of loyalty imposed by state law.[205] It prohibits an officer or director's trading of a corporation's securities while in possession of material, nonpublic corporate information.[206] The rationale for the insider trading prohibition is that corporate executives are supposed to use corporate information for the benefit of the firm, not for personal profit.[207] They breach their duty of loyalty by trading on that information without first disclosing it to the market.[208]

In a post-board firm whose governance is dominated by investor representatives, it will be more difficult to separate investors' individual interests from the work they do for the firm. Their individual interests define their role with the firm and place them in their positions of relative power. In fact, the representation of those individual interests makes investor representatives effective monitors and gives them the incentives to invest in the information necessary to make business judgments for the firm. Conflicts of interest may pose a different sort of problem in a post-board firm that is regulated by contractual relationships rather than broad fiduciary duties.

The key to overcoming the difficulties associated with moving investors representing individual interests into the firm's dominant decision-making roles is to understand that a post-board firm contemplates a different governance structure in significant ways. First, the powers various investors exercise would vary depending on their contracts with the firm. Different investors would have the power to influence different decisions to varying degrees. This is in stark contrast to the current board structure that assumes that directors exercise equal authority when making corporate decision as a collective body. An investment board, and eventually, a post-board governance structure, would make major corporate decisions by consulting the various parties in interest who have the power to influence a particular decision. Again, that may be drawing on the fact of individual interests that may conflict with the best interests of the firm. But, with just a few parties in interest at the table, the potentially conflicting interests of each will be more transparent. Those conflicts can be managed the way director conflicts are now: with disclosure and appropriate modification of the relevant party's

CORPORATION AND BUSINESS ORGANIZATION § 4.16 (2008); *see also* Anadarko Petroleum Corp. v. Panhandle E. Corp., 545 A.2d 1171, 1174 (Del. 1988) ("It is a basic principle of Delaware General Corporation Law that directors are subject to the fundamental fiduciary duties of loyalty and disinterestedness. Specifically, directors cannot stand on both sides of the transaction nor derive any personal benefit through self-dealing.").

205. STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 519 (2002).

206. *Id.*

207. *Id.* at 520.

208. *Id.* at 531–37.

decision-making power.

Regulating insider trading among investors whose trading defines their management authority within the firm and who will have access to substantial, perhaps nonpublic, information about the firm could present challenges. Insider trading by investors represented in a post-board firm's governance regime could be addressed in a number of ways. In regulating insider trading in a post-board firm, we may draw on insights from the regulation of officer and director trading now. Officers and directors are currently prohibited from trading on material nonpublic information and firms often set certain blackout dates defined by the release of certain corporate information during which officers and directors cannot trade in the corporation's securities.[209] In a post-board firm, certain investors may be banned from trading in the corporation's securities, or derivatives based on the value of the corporation's securities, while charged with authority to make corporate decisions. Furthermore, regulations prohibiting investor representatives from sharing certain nonpublic information with their clients may be justified. To the extent investor rights in a post-board firm mirror the rights influential investors have now, their trading should not present new problems. If investors have access to more information in a post-board firm, securities law can adapt to address the insider trading risks those investors pose in the same ways it responded to the threat of officer and director trading.

CONCLUSION

The board of directors has become a vestigial entity that is structurally unable to achieve its intended purposes. Many reforms have tried to tweak its structure to improve it, but those very reforms have made it even less meaningful and less effective. Boards are both too independent to be good managers and not independent enough to be good monitors. In the face of a weak board of directors, other corporate actors have taken a more active role in monitoring management and influencing important business decisions. A firm's investors and other influential constituents use their contract rights against the firm to influence management and monitor management more carefully than the board can to protect their interests and investments in the firm.

Because these corporate constituents can do the board's job more effectively than can the current board, the formal corporate governance structure must evolve to reflect the realities of corporate decision making. The corporate board of directors should be comprised of investor representatives and, for some purposes, corporate officers so that the parties that do the most to monitor

209. *See generally* M. Todd Henderson, *Insider Trading and CEO Pay*, 64 VAND. L. REV. 505 (2011).

management and decide the course of the corporation's business can negotiate openly about how to balance and exercise their power over corporate decision making. Changing the formal structure this way would focus attention and accountability on the actors responsible for corporate decision making. Transparency that reveals how corporate decisions are really made—and who makes them—should improve that decision making by increasing accountability for those decisions. We would be able to see who exercises what authority and so would not waste time, money, and energy trying to hold independent board members responsible for decisions they did not know about and could not have controlled. In time, firms may move away from a formal board structure entirely, allowing the network of investor contracts and the interaction of those parties with management to perform the functions once delegated to the board of directors.

This Article does not offer a detailed description of what post-board firm should look like or what the investors' contracts should provide. Rather, it suggests that we allow corporate governance to evolve further down the path it has chosen. The realities of corporate decision making reflect important choices by knowledgeable market participants. We should remove obstacles that keep us from formalizing that reality. A post-board governance structure would reflect a real change in corporate governance and the way we think about and implement management authority over a corporation. It is impossible to say now exactly how that change should happen or what exactly it should look like because it should be the product of a careful and slow development informed by an appreciation of what structures best serve the needs of companies. To suppose that the world of corporate investment has changed drastically in the last one hundred years[210] and that the governance structure of the firm has not or should not change at all is nonsensical. Though we do not yet know what path market actors will choose, evolution away from board governance seems sensible and likely and the path for that evolution should be cleared of legal and regulatory obstacles.

210. Jill E. Fisch, *Securities Intermediaries and the Separation of Ownership from Control*, 33 SEATTLE U. L. REV. 877, 877–88 (2010); Tamar Frankel, *The New Financial Assets: Separating Ownership from Control*, 33 SEATTLE U. L. REV. 931, 933 (2010) ("[D]uring the past thirty years, fundamental financial concepts and designs have been warped or eliminated.").