Out of Sight, Out of Mind: The Case for Improving Director Independence Disclosure

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Director independence is a cornerstone of modern corporate law. Independent directors are entrusted with objectively and impartially monitoring management and ensuring that the interests of shareholders are well served. But translating the notion of independence into practice is far from a simple task, and while regulators and stock exchanges have tackled this elusive standard in different ways, for the most part their attempts have come up short. Currently, boards designate themselves as independent, and as this Article demonstrates empirically, they provide little information to investors regarding the considerations that supported their designation.

Regulating director independence is at heart a means of empowering investors to make informed decisions about where to invest and how to vote. The current regime of regulating director independence is blind to this function. It shuts investors out of the process, allowing boards to designate their own independence with virtually no transparency or investor oversight. This lack of information is particularly concerning considering the importance of effective disclosure on capital markets. To that end, the SEC has recently requested input on means to improve its current disclosure rules under regulation S-K. This Article is a response to that request. It argues that investor accountability is a core function of regulating director independence and uses a theoretical framework and empirical findings to assert that the current system fails to achieve this end. The Article then proposes regulatory reforms aimed at a shift towards an enhanced disclosure regime.

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I. INTRODUCTION 36
II. DIRECTOR INDEPENDENCE—WHAT'S AT STAKE 41
A. The Board of Directors' Role in the Governance of the Corporation 43
B. The Move Towards Independent Boards 44
III. THE CURRENT REGULATORY FRAMEWORK 46
A. State Law 46
B. Stock Exchange Listing Rules 47
1. The Sarbanes-Oxley Act 48
2. Dodd-Frank and the Expansion of Director Independence 49
3. The Definition of an Independent Director 50
IV. THE EMPTY NATURE OF THE CURRENT DIRECTOR INDEPENDENCE FRAMEWORK 52
A. Too Much: Companies Have Too Much Discretion 53
1. A Hand in the Cookie Jar? 53
2. Behavioral Bias 54
a. Social Ties & Structural Bias 54
b. Groupthink, Confirmation Bias, Social Conformity & Status Quo Bias 55
3. Director Tenure 56
4. The Result: Companies Blur the Lines 56
B. Too Little: Information is Lacking 57
1. Current Disclosure Requirements are Too Narrow and Lack Important Context 58
2. In Light of the General Emphasis on Disclosure—Director Independence Has Fallen Behind 60
C. Too Late: Director Independence is Indeed a Context Based Issue but it is Not Enough to Address It Ex-Post 61
D. Too Soft: Lack of Effective Enforcement 62
V. DIRECTOR INDEPENDENCE DISCLOSURES—EMPIRICAL SURVEY 63
A. Lack of Transparency 63
B. Companies Providing Useful Information Are the Minority 67
C. Companies That Have Regressed 68
VI. FIXING DIRECTOR INDEPENDENCE 69
A. Augmenting the Current Designation System with Stronger Disclosures 69
B. Independent Verification of Director Independence Determinations 71
C. Adjusting the "Bright-Line" Rules and Disclosure Requirements 72
D. Potential Objections 73
1. Unnecessarily Deterring Investors 73
2. Over-inclusiveness 74
3. Chilling Effect? 74
4. Questionable "Independent Directors" Will Persist 74
5. Increased Costs 75
VII. CONCLUSION 75

I. INTRODUCTION

In July 2016, a coalition of 13 CEOs and heads of major investment firms—which

included names like J.P.Morgan Chase CEO Jamie Dimon, Berkshire Hathaway CEO Warren Buffett, General Motors CEO Mary Barra, and BlackRock CEO Larry Fink, released the Commonsense Principles of Corporate Governance.[1] These principles emphasize the critical role of director independence in corporate America, stating that: "[t]ruly independent corporate boards are vital to effective governance, so no board should be beholden to the CEO or management"[2] and that "[d]irectors should be strong and steadfast, independent of mind and willing to challenge [management] constructively . . . ."[3] Indeed, this recent statement echoes the importance and emphasis that academics, investors, regulators, and companies alike, have placed on director independence.

Two months later, on September 7, 2016, Apple and Nike announced a new collaboration with one another regarding the Apple Watch. Within their announcement, the companies declared their new Apple Watch Nike+ to be "the latest result of a long-standing partnership" between the world-renowned brands.[4] Significantly, the announced initiative came on the heels of Nike appointing Mr. Tim Cook, Apple's CEO, as Nike's lead independent director.[5] Despite the new collaboration and its clear potential to impair Mr. Cook's ability to remain truly "independent," the companies did not refer to any potential conflicts of interest or to Mr. Cook's status as lead independent director within their press release.[6]

Mr. Cook's ability to continue serving as a lead independent director[7]—the most powerful independent director role on the board—despite Apple's business dealings with Nike, and without proper disclosure to shareholders, is not an outlier. It is one of many instances in which the ability of "independent directors" to act independently could be questioned, due to business, personal, or other ties with the companies, and the executives of the companies, in which they serve. These concerns are particularly heightened due to the lack of effective disclosure by companies to their investors regarding these connections and the potential impact they may have on the independence of these directors.

Apple itself has similarly straddled the line regarding the independence of its "independent" directors. Bob Iger, Disney's CEO, is one of Apple's five independent directors. This is despite the close and frequent business collaboration that Disney and Apple have with one another. Their collaboration dates back to 2006 when Steve Jobs, while serving as CEO for Apple and Pixar, sold Pixar to Disney for $7.4 billion.[8] More

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1. COMMONSENSE CORP. GOVERNANCE PRINCIPLES, http://www.governanceprinciples.org (last visited Oct. 31, 2017).

2. *Id.*

3. *Common Sense Principles of Corporate Governance,* COMMONSENSE CORP. GOVERNANCE PRINCIPLES, http://www.governanceprinciples.org/wp-content/uploads/2016/07/GovernancePrinciples_Principles.pdf (last visited Oct. 31, 2017).

4. Press Release, Apple, Apple & Nike Launch the Perfect Running Partner, Apple Watch Nike+ (Sept. 7, 2016), http://www.apple.com/newsroom/2016/09/apple-nike-launch-apple-watch-nike/.

5. John Kell & Jonathan Vanian, *Tim Cook Becomes Nike's Lead Independent Director*, FORTUNE (June 30, 2016), http://fortune.com/2016/06/30/apple-ceo-tim-cook-nike.

6. Press Release, Nike, Nike, Inc. and Phil Knight Complete Planned Chairman Succession (June 30, 2016), http://news.nike.com/news/nike-inc-and-phil-knight-complete-planned-chairman-succession.

7. Although the role is not universally defined, many see it as an alternative to having a separate, independent chairman and accordingly attribute most of those responsibilities to the lead-director position. In its most basic form, the lead director is charged with leading the board's independent directors to engagement and consensus, ensuring that independent consensus is heard and implemented.

8. Associated Press, *Disney to Buy Pixar for $7.4 Billion*, N.Y. TIMES (Jan. 24, 2006), http://www.nytimes.com/2006/01/24/business/disney-to-buy-pixar-for-74-billion.html.

recently, the companies negotiated a potential collaboration for a video streaming service produced by Apple.[9] Despite these frequent interactions with one another, Apple does nothing more than disclose that "in the ordinary course of its business, Apple enters into commercial dealings with Disney that it considers arms-length."[10] In regards to Mr. Iger's independence, Apple has stated that it "does not believe that Mr. Iger has a material direct or indirect interest in any of such commercial dealings."[11]

Indeed, in the current regulatory regime, public companies' boards self-designate their peer directors as "independent directors," and boards are only required to disclose very specific and very limited information regarding their designation of a director as an "independent director"—leaving shareholders with minimal knowledge regarding the true level of independence their elected directors actually have.

Apple's short statement concerning Mr. Iger's independence is indicative of a larger practice taken by public firms. Many public companies can, and do, satisfy their stock exchange's disclosure requirements by simply declaring that "the Board of Directors has determined that all non-employee Directors who served during [the fiscal year] are 'independent' under the listing standards of the NYSE."[12] Investors receive very little value from these unsubstantiated statements.

Giving self-interested boards the final say regarding their own independence, and the lack of full transparency regarding the designation of a director as independent, is particularly concerning considering two important trends. First, in recent years, effective disclosure has taken on an increasingly pivotal role in corporate law. The SEC has attempted to increase transparency for investors in many regulated areas and topics. Executive compensation, option grants, financial disclosures, and most recently share ownership and pay ratio have all seen continuous effort for effective disclosure. Reflective of that important role, in April 2016 the SEC chair stated that "[t]he SEC's disclosure regime is central to our mission to protect investors and the integrity of our capital markets. . .[g]ood disclosure benefits everyone—investors, companies, and the markets generally. And everyone has a strong interest in it."[13]

Second, the concept of director independence has also taken an increasingly central role in contemporary corporate America. Over the last few decades, the composition of U.S. public firms' boards of directors has seen a significant shift.[14] Boardrooms controlled by company executives have been replaced with boardrooms that are "independent," which in many cases consist of the CEO as the lone executive in the room.[15]

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9. Shalini Ramachandran & Daisuke Wakabayashi, *Apple's Hard-Charging Tactics Hurt TV Expansion*, WALL ST. J. (July 28, 2016), http://www.wsj.com/articles/apples-hard-charging-tactics-hurt-tv-expansion-1469721330.

10. Apple, Inc., Proxy Statement (Def. 14a) (Feb. 26, 2016).

11. *Id.*

12. *See, e.g.*, Johnson & Johnson, Proxy Statement (Def. 14a) (Mar. 16, 2016); Verizon Commc'ns, Proxy Statement (Def. 14a) (May 5, 2016).

13. Mary Jo White, Chair, SEC, Statement at an Open Meeting on Regulation S-K Concept Release (Apr. 13, 2016), https://www.sec.gov/news/statement/white-statement-1-041316.html.

14. *See* Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1473 (2007) (suggesting the shift to independent directors comes from U. S. political economy); *see also* Yaron Nili, *The "New Insiders": Rethinking Independent Directors' Tenure*, 68 HASTINGS L.J. 97, 108–14 (2016) (discussing the shift in board structure towards independence).

15. *See Spencer Stuart Board Index Survey*, SPENCER STUART (2014),

This ongoing shift, which has been aimed at ensuring that shareholders' interests in the corporation are properly represented and protected, has accelerated during the last decade.[16] Academic discourse, the trend towards the shareholder franchise approach, and corporate scandals that brought about regulatory reforms have all led to this push toward more, so-called, independent boards.[17]

If the purpose of independent boards is to ensure that directors are objective and free of conflicts that can impair their judgment when serving as monitors of management, then the definition and rules governing director independence must be properly crafted to achieve such goal. The example of Nike's designation of Tim Cook as lead independent director calls into question the efficacy of the current regulatory framework and whether all of the directors that companies designate as "independent" are in fact free of the conflicts that could cloud their ability to effectively and objectively serve as independent monitors of management. Moreover, it calls into question the ability of any definition of director independence that is not accompanied with a broad disclosure regime to successfully screen for all of the potential conflicts that might impede the independence of directors. This is particularly true in contemporary corporate America, where businesses and people are closely interconnected, often for the benefit of their shareholders.

This Article contends that this potentially problematic result stems from the intersection of (1) deficiencies in the definitions of director independence that govern publicly traded corporations; (2) lack of effective enforcement of these independence standards by regulators; and (3) lack of sufficient and meaningful disclosures by companies to their shareholders regarding their directors and the designations they made regarding their independence.

First, with respect to defining independence, Delaware law, federal regulations, and stock exchange rules have all tackled the issue of director independence with great variance. Delaware law, for instance, has treated the issue of independence as a factual issue to be determined on a case-by-case basis, after a challenge to the designation of independence has been made, examining "whether the director's decision is based on the corporate merits of the subject before the board, rather than extraneous considerations or influences."[18] The stock exchange rules following SOX and Dodd-Frank are widely perceived as "bright-line" rules.[19] They contain specific pre-requisites for independence—explicitly prohibiting some directors from being considered independent directors if they were employees of the company, received compensation that is not a director fee over a certain threshold, had ties to the company's auditor, or had business or compensation interlocks with the company above a certain threshold.[20]

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https://www.spencerstuart.com/~/media/pdf%20files/research%20and%20insight%20pdfs/ssbi2014web14nov2014.pdf%20target= (noting that in 59% of the S&P 500 companies the CEO is the only company employee in the boardroom).

16. *See* Gordon, *supra* note 14, at 1540 (discussing the shift to independent directors).

17. *Id.* at 1472–76.

18. Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1049 (Del. 2004); *see also* Maureen S. Brundage & Oliver C. Brahmst, *Director Independence: alive and well under Delaware law*, *in* THE GLOBAL CORPORATE GOVERNANCE GUIDE (2004) (supporting Delaware's approach).

19. *See infra* note 34 (explaining how the rules are considered by most to be "bright line"); *see also* the commentary by the NYSE to the rules themselves: N.Y.S.E. MANUAL (CCH) http://wallstreet.cch.com/LCMTools/PlatformViewer.asp?selectednode=chp_1_4_3&manual=%2Flcm%2Fsections%2Flcm-sections%2F.

20. For a more detailed commentary on each requirement, *see* N.Y.S.E. CORPORATE GOVERNANCE GUIDE,

However, while these prerequisites serve well to disqualify a director from being considered independent in instances where a conflict is clear, the mere fact that a director does not fall into one of the listed disqualifications in the listing rules does not automatically render him or her to be independent, even under the current stock exchanges definition of "independence." Regulators, recognizing the need to identify independent directors ex-ante, have sought a standard that would have both clear rules and the flexibility to address "gray zone" matters.[21] Therefore, the listing standards start with a general requirement that "[n]o director qualifies as 'independent' unless the board of directors affirmatively determines that the director has no material relationship with the listed company."[22] The question of what is a material relationship is left to the board to decide, thus, in practice, leaving a considerable gray zone as to the definition of such relationship and, in turn, as to the classification of a director as "independent" by the company.[23]

Second, the current regulatory approach has also lacked effective enforcement. Companies' self-designations of director independence are left uncontested and are done without proper vetting or auditing by the stock exchanges or the SEC,[24] as they have shown no effort to proactively enforce their own requirements.

Third, and most notably, companies do not provide detailed information to shareholders and prospective investors regarding the reasoning justifying the designation of a director as independent.[25] In essence, much of the information that boards are expected to consider when determining whether a director is independent is inputted into a "black box," to which shareholders have no access.

At its core, the failure of current regulatory standards to ensure an effective director independence regime stems from the fact that any independence definition is destined to suffer from ambiguity and interpretive freedom. Coupled with the fact that companies are required to provide little information on their internal independence assessment of directors, and due to self-interest and behavioral biases there is a question as to the efficacy of their designation. Moreover, the true value of director independence requirements is not only in that they strive to ensure actual independence, but also that they empower investors. Each investor may have a distinctive, subjective comfort level with the myriad independence questions that may arise, balanced against the benefits that these business and personal connections may provide. Information about their directors' ties and dealings

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https://www.nyse.com/publicdocs/nyse/listing/NYSE_Corporate_Governance_Guide.pdf (last visited Oct. 31, 2017). For futher description *see also infra* note 75 (explaining prerequisites for director independence).

21. *See* Self-Regulating Organizations, SEC Release No. 34-47672, File No. SR-NYSE-2002-33 (Apr. 11, 2003).

22. *See* the commentary by the NYSE to the rules themselves: N.Y.S.E. MANUAL (CCH) http://wallstreet.cch.com/LCMTools/PlatformViewer.asp?selectednode=chp_1_4_3&manual=%2Flcm%2Fsections%2Flcm-sections%2F.

23. A nice illustration is the case of Penny Pritzker—one of America's richest and most powerful businesswomen—who was an independent director of Hyatt Hotels until her status changed. *See* John R. Emshwiller & Alexandra Berzon, *Hyatt Director Gets a Status Makeover*, WALL ST. J. (Aug. 24, 2010), http://online.wsj.com/article/SB10001424052748703649004575437713243128990.html. *See* Gary Larkin, *Just What is an Independent Director Anyway?*, THE CONF. BOARD GOVERNANCE CTR. BLOG (Sept. 10, 2010), http://tcbblogs.org/governance/2010/09/10/just-what-is-an-independent-director-anyway/ (offering a more detailed critique).

24. *See infra* Part IV (discussing the empty nature of the current director independence framework).

25. *See infra* Parts IV & V (showing that many companies do not provide detailed information to shareholders and investors).

gives investors a means of making informed decisions. As a result, effective director independence standards should facilitate an environment where companies are accountable to their investors regarding their choice of directors.

Therefore, this Article calls for a re-conceptualizing of the current approach to regulating company disclosures. This new approach will shift some of the focus from the definition and designation of a director as independent to a disclosure-based regime. Alongside the current designation regime, companies would have to disclose, for each "independent" director, the entirety of the information they considered when declaring a director as independent, including some mandatory information that is currently hard or costly to independently obtain or verify. This in turn will allow investors and regulators not only to confirm the judgment of the board on each director, but also to possess a more nuanced position concerning the true independence of each director in regards to each matter at hand.

Augmenting the current regime with such disclosures would educate investors on to what extent directors, such as Tim Cook and Bob Iger, satisfy the independence requirements despite their apparent business ties with other organizations. More importantly, it would allow them to individually consider the benefits and the concerns that these ties entail, and would allow them to better challenge their companies and boards when the information casts doubt on the independence of their actions.

The rest of this Article is organized as follows: Part II provides an overview of what is at stake—the importance of director independence to corporate governance and investor protection. Part III provides an overview of the current regulatory regime and the disclosure requirements imposed on public companies. Part IV underscores the issues and concerns surrounding the current disclosure requirements. Part V provides an empirical examination of the current disclosures made by public companies in their annual proxy statements, and the lessons that can be derived from it. Part VI offers a solution to the current problems surrounding director independence disclosures and addresses potential concerns and objections to the proposed solution, and Part VII concludes.

II. DIRECTOR INDEPENDENCE—WHAT'S AT STAKE

The dispersed ownership structure of U.S. publicly held corporations[26] presents a severe agency cost between management and shareholders.[27] Shareholders' lack of incentive to supervise management due to their dispersed ownership that is coupled with free riding concerns, effectively leads to a managerial controlled corporate structure. Having no significant monitoring or removal concerns, managers can divert corporate resources into their own hands, receive high compensation not correlated with their

26. ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 6 (1932).

27. Agency cost can be defined as the "costs of structuring, monitoring, and bonding a set of contracts among agents with conflicting interests." Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 304 (1983).

performance,[28] and engage in inefficient activities such as empire building.[29]

Thus, the dispersed ownership structure of the widely held U.S. corporation and the agency cost it creates, has become a principal concern of many academics, legislatures, and courts over the last several decades.[30] Efforts have ranged from improving market forces[31] to direct regulation,[32] and one of the first institutions asked to mitigate this agency issue was the board of directors.[33] In the United States, the board of directors serves a major role in the governance of the modern corporation.[34] The board, in the context of agency concerns, has been expected to represent shareholders interests' *vis-à-vis* management, curtailing management's ability to extract private benefits or act in a suboptimal way with

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28. *See* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 3 (2004) (arguing that executives' pay is not adequately correlated with their true performance, enabling them to benefit from industry success rather than their own work).

29. Empire building is the phenomenon of managers wishing to expand the corporate group under their control by mergers and acquisitions (M&A) or other methods, even when it is not to the benefit of shareholders. *See* David J. Denis et al., *Agency Problems, Equity Ownership, and Corporate Diversification*, 52 J. FIN. 135, 137 (1997); Paul A. Gompers et al., *Corporate Governance and Equity Prices,* 118 Q. J. ECON. 107, 144–45 (2003); Sharon Hannes, *Private Benefits of Control, Antitakeover Defenses, and the Perils of Federal Intervention,* 2 BERKELEY BUS. L. J. 263, 283 (2005).

30. *See* Ronald J. Gilson & Charles K. Whitehead, *Deconstructing Equity: Public Ownership, Agency Costs, and Complete Capital Markets*, 108 COLUM. L. REV. 231, 233–34 (2008) (showing several academics discussing the dispersed ownership structure of widely held U.S. corporations). Gilson and Whitehead refer to the seminal paper by Jensen and Meckling as the starting point of this ongoing academic debate. *See also* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Capital Structure*, 3 J. FIN. ECON. 305, 307 (1976).

31. For the market for corporate control, *see* Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112 (1965); Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1164 (1981). While the market for corporate control might have played an important role until the mid-eighties, it has weakened substantially after Delaware courts allowed the combined use of poison pills and staggered boards and the ability of the board to "just say no" (i.e. to reject offers of hostile bidders). It seems that increasing shareholders' involvement in the corporate life becomes even more of a crucial issue than it used to be due to the ineffectiveness of the hostile takeover market under the new antitakeover mechanisms. *See* Lucian A. Bebchuk & Alma Cohen, *The Costs of Entrenched Boards*, 78 J. FIN. ECON. 409, 410 (2005); Lucian A. Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 889 (2002). For market for new shares *see* Lucian A. Bebchuk, *The Myth of the Shareholder Franchise* , 93 VA. L. REV. 675, 715 (2007) [hereinafter Bebchuk, *The Myth of the Shareholder Franchise*]. For trading shares, *see* Kent Greenfield, *The Place of Workers in Corporate Law,* 39 B.C. L. REV. 283, 296–97 (1998). For a general review of the efficient capital market hypothesis, *see* RONALD J. GILSON ET AL., THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 135–81 (2d ed., 1995). Professor Bebchuk criticizes the validity of this argument. For the market for managers, *see* Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. L.J. 461 (1992); Arthur R. Pinto, *Corporate Governance: Monitoring the Board of Directors in American Corporations,* 46 AM. J. COMP. L. 317, 330 (1998). For product market, *see* Daniel R. Fischel, *The Corporate Governance Movement,* 35 VAND. L. REV. 1259, 1262 (1982) (noting that inability to compete in the product market will lead corporations to be pushed out of their business altogether). For debt, *see* Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance and Takeovers*, 76 AM. ECON. REV. 323, 325–27 (1986). Jensen took a step further, asserting that the leveraged buyouts of the eighties are the starting point of the eclipse of the public widely held corporation altogether. *See* Michael C. Jensen, *Eclipse of the Public Corporation*, HARV. BUS. REV. (1989), https://hbr.org/1989/09/eclipse-of-the-public-corporation.

32. Rafael La Porta et al., *Investor Protection and Corporate Governance*, 58 J. FIN. ECON. 3 (2000).

33. *See generally* Gordon, *supra* note 14 (discussing the shift in composition of public boards).

34. *See* STEPHEN BAINBRIDGE, THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE 155 (Oxford University Press, 2008) [hereinafter BAINBRIDGE, THE NEW CORPORATE GOVERNANCE] (detailing the role of the board and its importance in the governance of the firm).

respect to shareholder interests.[35] As this Part describes in detail, in order to fulfil these expectations, the board itself has gone through dramatic changes, both in the functions it is expected to serve as well as in its structure and the composition of its members. These changes lead to a shift towards the dominance and prominence of directors who are considered to be "independent."

A. The Board of Directors' Role in the Governance of the Corporation

The board of directors is one of the core organs of the modern corporation.[36] As such, it has been entrusted with several different important roles in the governance of the corporation. First, while most of the operational decision-making can be delegated to management, the board is still required to be an active participant in some of the more important managerial business decisions, such as mergers, stock issuance, and change of company governance documents.[37] Second, the board is a resource for management to utilize, providing insight and advice as well as networking benefits, and facilitating the firm's access to various resources.[38] Third, the board is charged with a monitoring role, making sure that shareholder interests are fully served, in an effort to constrain the agency costs associated with a managerial centric corporation model.[39] While each board serves all of these functions, the primary role and purpose of the board in the governance of the corporation has changed significantly over the years.

While in the early twentieth century the board's main function and expectation was to serve in an advisory role, providing insight and guidance to management along with networking benefits, the last few decades have seen the emergence of the "monitoring board structure."[40] This board structure, in which the board's primary role is monitoring management, has become the predominant model for boards in the United States.[41] The tipping of the scales, moving from a predominantly advisory role to a predominantly monitoring function, has also led to a rethinking of the proper composition of the board.[42] Because the different functions of the board also require different attributes from its

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35. *See* Michelle M. Harner, *Corporate Control and the Need for Meaningful Board Accountability*, 94 MINN. L. REV. 541, 583–84 (2010) (focusing on the boards' broader duties in the context of a controlling shareholder); *see also* Arthur B. Laby, *The Fiduciary Obligation as the Adoption of Ends*, 56 BUFF. L. REV. 99, 104 (2008) (describing directors' fiduciary duty to adopt shareholders' ends).

36. Melvin Aron Eisenberg, *Legal Models of Management Structure in the Modern Corporation: Officers, Directors, and Accountants*, 63 CALIF. L. REV. 375, 376 (1975).

37. *See* STEPHEN BAINBRIDGE, CORPORATE GOVERNANCE AFTER THE FINANCIAL CRISIS 45 (2012) [hereinafter BAINBRIDGE, CORPORATE GOVERNANCE] (discussing management's role in running a business).

38. *Id.* at 47.

39. *See* BAINBRIDGE, THE NEW CORPORATE GOVERNANCE, *supra* note 34, at 155 (detailing the role of the board monitoring management and the impact of Sarbanes-Oxley).

40. *See* MELVIN ARON EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS 139–41 (1976) (discussing the practices of the corporate board); *see also* BAINBRIDGE, THE NEW CORPORATE GOVERNANCE, *supra* note 34 (detailing the emergence of the monitoring structure over the last few decades).

41. *See* AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 3.03(a) (1984); Stephen M. Bainbridge, *Independent Directors and the ALI Corporate Governance Project*, 61 GEO. WASH. L. REV. 1034 (1993) (reviewing these principles in detail); BAINBRIDGE, THE NEW CORPORATE GOVERNANCE, *supra* note 34, at 161 (detailing the role of the board and management).

42. *See, e.g.*, Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921, 921–24 (1999) (discussing the role of the corporate board and management).

members, a corresponding change in the composition of the board has taken place.[43]

The ability to provide networking, business advice and other insight is no longer the most valued set of skills. Rather, the ability to, or at the very least the perception of an ability to, effectively scrutinize management has become increasingly important. As such, the presence of directors perceived by the corporation and the public to be "independent" has become essential.[44] Indeed, in a widely held public company, it has become increasingly important that directors be independent of those controlling the firm's day-to-day operations—the managers—who have interests that at times might be adverse to those of shareholders.[45]

B. The Move Towards Independent Boards

In reaction to this shift in the role and expectation of the board as a corporate institution, the composition of U.S. public firms' boards of directors has undergone a major change over the last few decades.[46] Directors designated to be independent began holding an increasingly larger portion of corporate board seats, replacing company employees commonly referred to as "insiders."[47]

The movement toward "independent" boards, which was mainly market driven until early 2000s,[48] has been further intensified by the corporate scandals that took place in the past decades and the regulatory reforms following it, including the Sarbanes-Oxley Act[49]

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43. *Id.*; *see also* Gordon, *supra* note 14 and accompanying text (discussing the composition of public company boards).

44. Indeed, calls for board independence were embraced in the American Law Institute Principles of Corporate Governance. For example, requiring that independent directors comprise a majority of the board, and that as a matter of good corporate practice, the independent directors should not have outside employment or other commitments that would interfere with the performance of their duties. The monitoring model required directors to take on an active role in the corporation, but one that was to monitor the performance of the senior executives of the company. BAINBRDIGE, *supra* note 34, Eisenberg, *supra* note 40. For a description of a competing approach, *see* Miriam Baer, *Corporate Policing and Corporate Governance: What Can We Learn from Hewlett-Packard's Pretexting Scandal*, 77 U. CIN. L. REV. 523, 540 (2008) (describing the cultural theory of corporate governance).

45. For the structure of the U.S. firm and the agency problem it entails *see* Adolf A. Berle & Gardiner C. Means, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932); Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301 (1983) (discussing the agency problem posed as a result of the structure of U.S. firms). For the role of the board in mitigating this issue, *see e.g.*, Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465; Melvin Eisenberg, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS 139–41 (Beard Books, 1976); *see also* BAINBRIDGE, THE NEW CORPORATE GOVERNANCE, *supra* note 34 (detailing the emergence of the monitoring structure over the last few decades).

46. *See* Gordon, *supra* note 14, at 1473–75.

47. "Insiders" will be used in this Article to mean company executives and employees.

48. State law has developed to require the approval of self-dealing transactions by disinterested directors, often independent directors. This requirement along with the need for special independent committees pushed companies to include more independent directors in their board room. *See* Gordon, *supra* note 14, at 1473 (showing a decrease in the percentage of inside directors from 49% in 1950 to 21% in 1995 and to 16% in 2000 well before the SOX requirements were put in place).

49. SOX directly regulated several aspects of the audit committee of the board, essentially requiring listing agencies, such as the NYSE and NASDAQ, to amend their listing standards so that a board have an audit committee, and that the audit committee be comprised entirely of independent directors. *See* 17 C.F.R. § 228, 229, 240, 249 & 274 (2012). Additionally, following SOX, listing agencies, such as the NYSE and NASDAQ, amended their listing requiring to mandate that a majority of the members of the board of directors of listed

and the Dodd-Frank Act.[50] Motivated by the belief that inside directors encounter greater difficulties in effectively monitoring corporate officers and that independent directors are better equipped to detect fraud, protect shareholders' interests, and monitor managerial abuse of authority, regulatory reforms forced U.S. exchanges to enhance their director independence requirements.[51] These subsequent amendments to listing standards require public firms to populate their boards and committees with independent directors.[52] The NYSE and NASDAQ listing standards mandate that a majority of the board members of public companies be independent of management and that the audit, compensation, and nominating committees be composed entirely of independent directors.[53]

Indeed, while in the 1950s, 49% of board members were company insiders, by 2005 only approximately 25% remained insiders.[54] Moreover, while only a majority of the board is required to be independent in order to comply with the regulatory requirements, independent directors, as currently defined, now make up 84% of all board members, the highest share ever,[55] and in the majority of the S&P 500 companies, the CEO is the lone company insider in the boardroom.[56] The percentage of companies with only the CEO as company employee, increased from 22% in 2000 and 39% in 2005 to nearly 59% of boards

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companies be independent of management and that each member of the nominating committee be independent. *See infra* notes 75–77 and accompanying text.

50. Section 952 of the Dodd-Frank Act and Rule 10C-1 of the Securities Exchange Act of 1934 direct the national securities exchanges to adopt new listing standards applicable to compensation committees. *See* 17 C.F.R. § 240.10C-1 (2012). The SEC rules and the proposed listing requirements of the stock exchanges require boards to take into consideration the following when assessing the independence of compensation committee members: (1) the source of compensation of the director, including any consulting, advisory, or other compensatory fee paid by the issuer to the director; and (2) whether the director is affiliated with the issuer, its subsidiaries or their affiliates.

51. *See* Gordon, *supra* note 14, at 1540. *See also* William W. Bratton & Michael L. Wachter, *Tracking Berle's Footsteps: The Trail of the Modern Corporation's Last Chapter*, 33 SEATTLE U. L. REV. 849, 866 (2010).

52. For example, SOX mandated the creation of an audit committee of the board that has greater powers and many more responsibilities than ever before, such as working with external auditors of internal controls. *See Considering Director Independence*, COVINGTON & BURLING LLP (July 12, 2007), https://www.cov.com/~/media/files/corporate/publications/2007/07/823.pdf [hereinafter *Considering Director Independence*].

53. N.Y.S.E. MANUAL (CCH), § 303A.01, 303A.04-06; NASDAQ STOCK MKT. RULES (CCH) 5605(b)(1), 5605(c)(2), 5605(d)(2), and 5605(e). *See also Developments in the Law—Corporations and Society*, 117 HARV. L. REV. 2187, 2194 (2004) ("the revised listing standards of both the NYSE [New York Stock Exchange] and NASDAQ . . . require (with few exceptions) that listed-company boards have a majority of independent directors").

54. *See* Gordon, *supra* note 14, at 1473–75; Urska Velikonja, *The Political Economy of Board Independence*, 92 N.C. L. REV. 855 (2014) (discussing board members as insiders).

55. Data used in this part was collated from several reports. *See, e.g.*, *Spencer Stuart Board Index Survey* , SPENCER STUART (2016), https://www.spencerstuart.com/~/media/pdf%20files/research%20and%20insight%20pdfs/spencer-stuart-us-board-index-2016_july2017.pdf [hereinafter *Stuart Survey*]; *Corporate Governance & Executive Compensation* 2016, SHEARMAN & STERLING LLP (2016), http://legalexecutiveinstitute.com/wp-content/uploads/2016/09/49.-Shearman-2016-Corporate-Governance-Survey.pdf; *Insights from the Boardroom 2012*, PRICEWATERHOUSECOOPERS (2012), http://www.pwc.com/us/en/financial-services/events/assets/pwc-annual-corporate-directors-survey.pdf; *2015 Annual Corporate Governance Review*, GEORGESON (2015), http://www.georgeson.com/us/Documents/acgr/acgr2015.pdf; *33rd Annual Board of Directors Study*, KORN FERRY INST. (2008), https://www.kornferry.com/institute/231-33rd-annual-board-of-directors-study.

56. *See Stuart Survey*, *supra* note 55 (noting that in 59% of the S&P 500 companies the CEO is the only company employee in the boardroom).

nowadays.[57] This percentage reflects an ongoing increase in the ratio of independent directors to non-independent directors from 3.6:1 a decade ago to 5.4:1 today.[58] Relatedly, 47% of S&P 500 boards had separate CEO and chair roles, up from 23% in 2000, and 28% of chairs were independent, versus just 9% in 2005.[59]

The emphasis on director independence is also manifest in the renewed attention to director elections, as board members' dependency on shareholders' confidence and approval has dramatically risen in the last decade due to the increased rate of majority voting requirements and declassification of boards: currently 84% of the companies in the S&P 500 have a majority voting/resignation policy in place, up from 79% in 2011, 65% in 2009 and 56% in 2008. The percentage of boards serving one-year terms has also risen every year and currently stands at 97%, more than double what it was a decade ago (40%). Equally important is the rise in restrictions on other corporate directorships placed by companies. In light of the time and commitment required for effective service, 75% of S&P 500 companies now limit other corporate directorships, versus 27% in 2006. Finally, the financial literacy of the board has improved. In 2003, only 21% of boards reported having a financial expert while today every S&P 500 board reports having at least one financial expert, and the percentage of chief financial officers, treasurers, or other financial executives serving as audit committee chair increased from 4% in 2002 to 37% in 2014.[60]

Finally, investors deeply care about director independence when deciding how to vote. In a 2015 survey of leading institutional investors, 62% of the surveyed investors indicated that they read the director independence section of the proxy statement and rely on it to make voting decisions which was the second highest mark after the pay for performance section which was at 64%.[61] In addition, 59% of the investors indicated that they read the Director nominee descriptions, their quality, qualifications and skills section of the proxy statement and rely on it to make voting decisions.[62]

In sum, public expectation, the role of the board as a monitor, and regulatory intervention have all led to the rise in the prominence of the concept of independent directors, accompanied by different standards, and regulatory definitions for director independence. The next Part provides an overview of the current regulatory framework against which director independence is established.

III. The Current Regulatory Framework

A. State Law

As further detailed below, federal law and listings rules have developed to require the presence of independent directors on several of the board committees as well as to require that a majority of directors will be independent. However, federal legislation and stock exchange listing rules were not the first to require board independence in certain instances,

57. *Id.*

58. *Id.*

59. *Id.*

60. *See* Kobi Katiel & Yaron Nili, *"Captured Board": The Rise of "Super Directors" and the Case for a Board Suite*, 2017 WISC. L. REV. 19 (discussing the Spencer Stuart Board Index Survey).

61. RR Donnelley et al., *2015 Investor Survey: Deconstructing Proxy Statements—What Matters to Investors*, STAN. BUS. (2015), https://www.gsb.stanford.edu/sites/gsb/files/publication-pdf/cgri-survyey-2015-deconstructing-proxy-statements_0.pdf.

62. *Id.*

as the term "independent directors" arose against a larger backdrop of existing state law requiring director independence for numerous issues, such as the approval of interested transactions and in the context of derivative suits and litigation committees.

Delaware law, for instance, has treated the issue of independence as an ad-hoc factual issue. Examining "whether the director's decision is based on the corporate merits of the subject before the board, rather than extraneous considerations or influences,"[63] or "whether a director is, for any substantial reason, incapable of making a decision with only the best interests of the corporation in mind."[64] This in turn, has led to different outcomes in particular cases, depending on procedural issues such as the burden of proof, the specifics of the case and the availability of admissible facts.[65] Most importantly, due to its ad-hoc ex-post nature, Delaware law suggests that while a director could be independent as to some issues, she might not be for others.

B. Stock Exchange Listing Rules

While the movement toward "independent" boards was mainly[66] "market driven" until the early 2000s,[67] and to that point was not mandated by the regulator or by self-regulating bodies, this shift was further driven by the corporate scandals of the early 2000s. The backlash from the Enron and WorldCom scandals led to the enactment of the Sarbanes-Oxley Act of 2002 (SOX)[68] and subsequent stock exchange listing standards. The 2008 financial crisis led to similar reactive legislation in the form of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).[69] These legislative acts and listings standards have not only transformed the voluntary shift in board composition into a mandatory one, but have also laid increasing responsibilities at the board's feet, further

63. Beam ex. rel Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1049 (Del. 2004) (discussing the definition of director independence); *see* Brundage & Brahmst, *supra* note 18 (discussing the definition of director independence); Usha Rodrigues, *The Fetishization of Independence*, 33 J. CORP. L. 447, 469 (2008).

64. *In re* Oracle Corp. Derivative Litig., 824 A.2d 917, 938 (Del. Ch. 2003) (defining independence such "that 'a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences.'") (quoting Aronson v. Lewis, 473 A.2d 805, 816 (Del. 1984)).

65. For instance, in *Oracle*, it was determined that personal connections rose to the level of impeding independence, while in *Beam* the opposite was held. *See id.* at 938. Similarly, the court in *MFW* stated that "Even in the context of personal, rather than financial relationships, the materiality requirement does not mean that the test cannot be met. *In re* MFW S'Holders Litig., 67 A.3d 496, 509 n.37 (Del. Ch. 2013). For example, it is sometimes blithely written that 'mere allegations of personal friendship' do not cut it. More properly, this statement would read 'mere allegations of mere friendship' do not qualify. If the friendship was one where the parties had served as each other's maids of honor, had been each other's college roommates, shared a beach house with their families each summer for a decade, and are as thick as blood relations, that context would be different from parties who occasionally had dinner over the years, go to some of the same parties and gatherings annually, and call themselves "friends." *Id.*

66. State law has developed to require the approval of self-dealing transactions by disinterested directors, often independent directors. This requirement, along with the need for special independent committees, pushed companies to include more independent directors in their board room.

67. *See* Gordon, *supra* note 14, at 1473 (showing a decrease in the percentage of inside directors from 49% in 1950 to 21% percent in 1995, and to 16% percent in 2000, well before the SOX requirements were put in place).

68. Sarbanes-Oxley Act of 2002, 15 U.S.C. § 7201 *et seq.* (2010) [hereinafter "*SOX*"].

69. *See* 17 C.F.R. § 240.10C-1 (2012) (discussing regulations governing the financial industry in America).

cementing its primary role as a monitor and not as an adviser.[70] While many corporations have introduced director independence requirements even before regulators specifically required it, publicly traded companies are now required to have a majority of their board members be "independent." Regulators also specifically targeted the independence of specific committees of the board, most notably the audit committee and the compensation committee.

1. The Sarbanes-Oxley Act

In the aftermath of the Enron scandal, the regulatory requirements for public corporations were overhauled by comprehensive legislation, SOX.[71] The empowerment of the board and the need to ensure its effectiveness as a monitor were an important part of the reform.[72]

SOX directly regulated several aspects of the audit committee of the board,[73] mandating independent audit committees that are comprised of independent directors, and prohibiting members of such committees from accepting any "consulting, advisory, or other compensatory fee" from the company except for directors' fees.[74]

In addition, all major exchanges, including the New York Stock Exchange (NYSE) and NASDAQ, were mandated to amend their listing requirements to require that a majority of members of the board of directors of listed companies be independent[75] to expand the duties and powers of the independent directors, in particular in the context of the audit committee, and to reformulate their definition of independence.[76]

Accordingly, in its post-SOX listing standards, the NYSE mandated that all listed companies "must have a majority of independent directors"[77] with a specific definition of

70. For example, *SOX* mandated the creation of an audit committee of the board that has greater powers and many more responsibilities than ever before, such as working with external auditors of internal controls. *See Considering Director Independence*, *supra* note 52 (discussing the impact of *SOX* regulations).

71. *See* John C. Coates IV, *The Goals and Promise of the Sarbanes–Oxley Act*, 21 J. ECON. PERSPS. 91, 91–92 (2007) (discussing why *SOX* was created); Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 11–18 (2002); Roberta Romano, *Does the Sarbanes-Oxley Act Have a Future?*, 26 YALE J. REG. 229, 235–39 (2009); Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1523–42 (2005); *see also* Dana Brakman Reiser, *Director Independence in the Independent Sector*, 76 FORDHAM L. REV. 795 (2007) (discussing impact of increasing director independence).

72. *See* Stephen M. Bainbridge, *A Critique of the NYSE's Director Independence Listing Standards* (UCLA Sch. of Law, Working Paper No. 02–15, 2002) (quoting Editorial, *The Capitalist Cavalry*, WALL ST. J., June 7, 2002, at A10 (regarding the corporate governance proposals by the New York Stock Exchange, stating that they "anointed boards of directors, especially 'independent' directors as the capitalist cavalry")).

73. *See* 17 C.F.R. §§ 228, 229, 240, 249 & 274 (discussing SEC provisions); Annemarie K. Keinath & Judith C. Walo, *Audit Committee Responsibilities: Focusing on Oversight, Open Communication, and Best Practices,* 74 CPA J. 22 (2004); Ganesh M. Pandit et al., *Audit Committee Reports Before and After Sarbanes-Oxley: A Study of Companies Listed on the NYSE*, 75 CPA J. 42 (2005).

74. For a detailed analysis of the stock exchange rules prior to and after the SOX, *see* BAINBRIDGE, THE NEW CORPORATE GOVERNANCE, *supra* note 34, at 161 (detailing the role of the board and its importance in the governance of the firm).

75. This is true unless a company is a "controlled company," a limited partnership, is in bankruptcy proceedings, or lists only preferred or debt securities. *See SEC Approves NYSE and NASDAQ Proposals Relating to Director Independence,* FINDLAW (June 21, 2008, 12:19 PM), http://corporate.findlaw.com/finance/sec-approves-nyse-and-nasdaq-proposals-relating-to-director.html (discussing impact of SEC approval).

76. *See* 17 C.F.R. §§ 228, 229, 240, 249 & 274 (discussing SEC provisions).

77. *See* N.Y.S.E. MANUAL (CCH) § 303A.01 (noting the requirement of a majority of independent

independence as discussed below. In addition, listed companies are required to have an audit committee comprised solely of independent directors.[78] The committee has to have at least three members, all of whom are to be "financially literate" and at least one of whom has to have expertise in accounting or financial management.[79] Finally, the NYSE requires that "[t]o empower non-management directors to serve as a more effective check on management, the non-management directors of each listed company must meet at regularly scheduled executive sessions without management."[80]

Finally, while post-SOX all listed companies were required to have an audit committee,[81] the NYSE also mandated the establishment of a nominating and corporate governance committee[82] and a compensation committee.[83]

2. Dodd-Frank and the Expansion of Director Independence

In the wake of the collapse of the financial industry in 2008, Congress reacted with the Dodd-Frank Act. Some might call the Act a "catch-all" legislative reform dealing with various, and seemingly unrelated, issues: from the regulation of the financial industry and the shadow banking system to derivative trading and whistleblowing.[84]

Part of the reform addressed the issues of compensation committee independence, its authority to retain and be directly responsible for the consultants and advisers it retains, its analysis of the independence of compensation consultants and advisers, and the disclosure of any conflicts of interest concerning compensation consultants.[85] Accordingly, the stock exchanges have filed with the SEC suggested listing rules[86] that comply with the new

members).

78. *Id.* § 303A.07.

79. *Id.*

80. *Id.* § 303A.03. While no mandatory number of meetings is required, in practice such meetings take place regularly. *See* BAINBRIDGE, CORPORATE GOVERNANCE, *supra* note 37 (referring to an 1996 Korn/Ferry survey that found that the boards of 62% of respondents met in executive session at least once a year and that, by 2005, that figure had risen to 94%).

81. While state law allows the board to set up committees, it does not mandate formation of any specific one. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(c)(2) (2016).

82. The nominating committee is in charge of nominating director candidates, and often also selects new CEOs and peer directors to the other board committees. While some treat the formation of an independent nominating committee as a weakening of the power management has on director election, in reality, company management still holds significant power over the board nomination process. *See* Bebchuk, *The Myth of the Shareholder Franchise*, *supra* note 31; Joseph V. Carcello et al., *CEO Involvement in Selecting Board Members, Audit Committee Effectiveness, and Restatements*, 28 CONTEMP. ACCT. RES. 396, 401 (2011).

83. The compensation committee is tasked with setting the compensation of senior executives and generally oversees the corporation's compensation policies. Under NYSE Listing Rules the committee must be comprised solely of independent directors. *See* N.Y.S.E. MANUAL (CCH) § 303A.05.

84. For a critique of the Dodd-Frank Act, *see generally* BAINBRIDGE, CORPORATE GOVERNANCE*, supra* note 37. For a more general critique of legislation in the wake of a crisis, *see* Roberta Romano, *Regulating in the Dark, in* REGULATORY BREAKDOWN: THE CRISIS OF CONFIDENCE IN U.S. REGULATION (2012) (discussing how the legislative reform dealt with various issues that were unrelated to one another).

85. Section 952 of the Dodd-Frank Act and Rule 10C-1 of the Securities Exchange Act of 1934 direct the national securities exchanges to adopt new listing standards applicable to compensation committees and compensation advisers. *See* 17 C.F.R. 240 § 10C-1 (2012).

86. NASDAQ required executive compensation decisions to be determined either by (1) a compensation committee comprised of independent directors; or (2) independent directors constituting a majority of the board's independent directors. NASDAQ's Proposed Standards provided that listed companies be required to have a compensation committee comprised of two or more independent directors. *See* NASDAQ, *Summary of NASDAQ*

requirements without going beyond them.[87]

The SEC rules and the proposed listing requirements of the stock exchanges require boards to take into consideration the following when assessing the independence of compensation committee members: (1) the source of compensation of the director, including any consulting, advisory, or other compensatory fee paid by the issuer to the director; and (2) whether the director is affiliated with the issuer, its subsidiaries or their affiliates.[88] These requirements are specific to the compensation committee and are added to the general rules as to director independence described above.[89]

3. The Definition of an Independent Director

As detailed above, state corporations law has traditionally used a fairly ambiguous standard to decide if a given director is independent of management, inquiring whether "through personal or other relationships the directors are beholden to [management]."[90] In contrast, the NYSE and NASDAQ listing requirements adopt rules for deciding whether a director is adequately independent to count toward the requisite majority that include both specific requirements[91] as well as a determination by the board that a nominee has no material direct or indirect relationship with the listed company.[92]

First, companies must follow objective standards when making director independence determinations.[93] The objective requirements address past employment with the company, for both the director and immediate family member,[94] compensation received from the

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Corporate Governance Proposals, CORP. COMPLIANCE (Oct. 10, 2002), http://www.corporatecompliance.org/Portals/1/Users/169/29/60329/Nasdaq_Corporate_Governance_Proposals.pdf.

87. 17 C.F.R. § 240.10C-1 (2012) directs the SEC to require the national securities exchanges and associations to adopt listing rules that implement the requirements of Rule 10C-1. On September 25, 2012, NYSE and NASDAQ each filed proposed listing rules with the SEC (collectively referred to throughout this commentary as the "Proposed Standards") to implement the requirements of Rule 10C-1. In general, the Proposed Standards closely track Section 952 and do not contain major changes or heightened requirements to the SEC's Rule 10C-1.

88. These two factors are specific to the compensation committee members and are in addition to the so called "bright-line" independence tests currently required by the respective exchanges. NYSE's Standards require that the two above factors be "considered" with all other relevant factors in determining "whether a director has a relationship to the Company which is material to that director's ability to be independent from management in connection with the duties of a compensation committee member." NASDAQ's Standards prohibit a compensation committee member from accepting directly or indirectly any consulting, advising or compensatory fee from the issuer (subject to certain limited exemptions). NASDAQ's Standards further provide that the board must also consider whether the director is affiliated with the company and "whether such affiliation would impair the director's ability to make independent judgments about the Company's executive compensation." *See* NASDAQ LISTING RULES (CCH) § 5605(d)(2)(A).

89. *See supra* notes 66–81 and accompanying text (discussing the general rules of director independence).

90. *See* EDWARD P. WELCH ET AL., FOLK ON THE DELAWARE GENERAL CORPORATION LAW 254 (5th ed. 2006) (citing the Delaware court in the matter of Odyssey Partners, LP. v. Fleming Cos., 735 A.2d 386, 407 (Del. Ch. 1999)).

91. Among the specific requirements are that directors are not allowed to be an employee of the listed company or an immediate family member of an individual who has been an executive officer within the last three years or is to receive more than $120,000 in direct compensation from the listed company, other than in director and committee fees. *See supra* text accompanying note 68.

92. *See* N.Y.S.E. MANUAL (CCH) § 303A.02(a)(i); NASDAQ STOCK MKT. RULES (CCH) 4200(a)(15).

93. *Considering Director Independence*, *supra* note 52.

94. N.Y.S.E. MANUAL (CCH) § 303A.02(b)(i) ("a director is not independent if . . . [t]he director is, or has

company,[95] as well as certain business affiliations.[96] In regards to business affiliations, the NYSE prohibits a director from being classified as independent if he or she, or an immediate family member, is affiliated with an organization that has derived the greater of $1 million or 2% of the organization's consolidated gross revenues from the company hoping to classify the director as independent.[97] The restrictions apply to any of the last three fiscal years.[98] NASDAQ's requirement is similar, only it applies to directors affiliated with organizations that received the greater of $200,000, or 5% of its annual gross revenues from the company.[99] Collectively, these objective requirements establish bright line rules for boards to utilize when considering director independence.

However, even if a director clears the objective threshold, the board must determine that the director has no "material relationship with the listed company."[100] The NYSE encourages boards to consider all relevant facts and circumstances when making this determination.[101] NASDAQ has similar subjective requirements, prohibiting individuals who have "a relationship which, in the opinion of the [c]ompany's board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director."[102]

In addition, the Securities and Exchange Commission ("SEC"), imposes disclosure requirements on publicly traded companies in regard to their independent directors. Item 407 of Regulation S-K establishes the following requirements: First, companies must disclose which directors have been determined to be independent by the board of directors.[103] Second, companies must disclose any members of the compensation, nominating, or audit committee that are non-independent.[104] Lastly, if any company has adopted its own director independence standards, in addition to their stock exchange rules, the company must disclose whether its own definition is available online.[105] If the internal standards are available online, a hyperlink must be included for shareholders to access.[106] Companies must satisfy the Item 407 requirements by including the disclosures within their annual proxy statement or annual 10-K.[107]

Operating in conjunction with the independence disclosure requirements are "specific transactions" disclosure requirements. Item 407(a)(3) requires companies to disclose "any transactions, relationships or arrangements. . .that were considered by the board of directors under the applicable independence definitions in determining that the director is

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been within the last three years, an employee of the listed company").

95. *Id.* § 303A.02 (b)(ii) (a director is not independent if . . . "[t]he director has received . . . during any twelve-month period within the last three years, more than $120,000 in direct compensation from the listed company").

96. *Id.* § 303A.02 (b)(iii)(A), (b)(iv) (discussing various employment positions that disqualify a director from being independent).

97. *Id.* § 303A.02 (b)(v).

98. *Id.*

99. NASDAQ STOCK MKT. RULES (CCH) 5605(a)(2).

100. N.Y.S.E. MANUAL (CCH) § 303A.02.

101. N.Y.S.E. MANUAL (CCH), *General Commentary to Section 303A.02(b)*.

102. NASDAQ STOCK MKT. RULES (CCH) 5605(a)(2).

103. 17 C.F.R. § 229.407(a) (2012).

104. *Id.*

105. *Id.* § 229.407(a)(2).

106. *Id.*

107. *Id.*; *see also* NYSE and NASDAQ rules that effectively defer to Item 407 for disclosure. N.Y.S.E. MANUAL (CCH) § 303A.02(b)(i); NASDAQ STOCK MKT. RULES (CCH) 5605(b)(1).

independent."[108] This is in connection to disclosures made under Item 404, which requires companies to disclose any "related party transactions" over $120,000 where a "related person" has a direct or indirect material interest.[109] "Related person" includes directors, executive officers, and five percent shareholders, as well as any immediate family members.[110] Item 407 clarifies that any company transaction over the past year that may have resulted in a direct or indirect conflicting interest for the independent director must be disclosed.[111]

Item 404 and 407 collectively require companies to disclose which directors are considered "independent," as well as any transactions that were considered in making that determination. As will be illustrated in Part IV, companies typically satisfy these disclosure requirements in their annual proxy statements.[112] As will also be illustrated in Part IV, large cap sized companies typically adopt their own director independence standards in accordance with Item 404(a)(3). The company's website then publishes the standards.[113]

Before addressing the problems with current disclosure requirements, it is worth noting that publicly traded companies have no issues with meeting their majority requirements. As noted above, 85% of the directors in the S&P 500 were independent and 60% of boards had only one non-independent director—the company CEO.[114] However, despite the high percentage of directors designated as independent, questions remain regarding individual determinations and the level of information provided to concerned shareholders. These problems are addressed next.

IV. THE EMPTY NATURE OF THE CURRENT DIRECTOR INDEPENDENCE FRAMEWORK

While the notion of director independence as an important corporate governance institution has been widely accepted and lauded,[115] it is the translation of the ideal into implementation that is paramount to achieving the desired goal of director independence. Unfortunately, as detailed below, the current definitions of director independence miss the mark in providing shareholders with an effective system for ensuring the true independence of their "independent" directors. Equally important, by allowing companies to declare directors as independent without effectively ensuring or enforcing their independence, regulators may be doing a disservice to shareholders by cultivating a false notion of trust

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108. 17 C.F.R. § 229.407(a)(3) (2012).

109. Transactions with Related Persons, Promoters and Certain Control Persons, 17 C.F.R. § 229.404(a) (2008); *see* Geeyoung Min, T*he SEC and the Courts' Cooperative Policing of Related Party Transactions* COLUM. BUS. L. REV. 663 (2014) [hereinafter Min, *The SEC and the Courts*] (detailing the differences between the requirements of sections 404 and 407).

110. *Id.* at "Instructions to Item 404(a)" (describing what "related person" means).

111. Corporate Governance, 17 C.F.R. § 229.407(a)(3) (2012) (requiring the company to disclose any transactions, relationships or arrangements considered by the board in determining the director's independence).

112. *Infra* Part IV (showing that companies typically satisfy disclosure requirements in their proxy statements).

113. *E.g.*, Walt Disney Co., Proxy Statement (Def. 14a) (Jan. 15, 2016); Procter & Gamble, Proxy Statement (Def. 14a) (Aug. 26, 2016).

114. Harold Baum, *The Rise of the Independent Director: A Historical and Comparative Perspective* (Max Planck Inst. for Comparative and Int'l Private Law, Research Paper, 2016) (citing Urska Velikonja, *The Political Economy of Board Independence*, 92 N.C. L. REV. 855, 857 (2014)).

115. *See generally* Theo Francis & Joann S. Lublin, *Boards Get More Independent, But Ties Endure*, WALL ST. J. (Jan. 19, 2016), https://www.wsj.com/articles/boards-get-more-independent-but-ties-endure-1453234607 (stating that "shareholders like their corporate boards stocked with independent directors").

in the independence of their directors.

The opaque nature of director independence is not easy to overcome. However, the current approach to director independence—one that is focused on a set of criteria and subsequent certification by the board of directors—is an approach that this Article argues to be of an empty nature. The current framework can be summed as being *too much, too little, too late, and too soft*. It provides companies with *too much* discretion, as boards retain too much power to assert the independence of their peer directors, and they may suffer from behavioral bias in doing so. It provides investors with *too little* information regarding the factual context against which a director is considered to be independent. Further, even when a director's independence designation is scrutinized through state law, it is often *too late*, as these assessments are done post-hoc when it is too late to address many of the issues that director independence is meant to protect against. Finally, it is *too soft*, as companies' self-designations of director independence are left uncontested and without proper vetting by the stock exchanges or the SEC, as they have shown no effort to proactively enforce their own requirements.

A. Too Much: Companies Have Too Much Discretion

As mentioned above, current stock exchange rules are comprised of a two-step process when certifying a director as independent. First, the company must ensure that the director meets the basic threshold requirements for his or her independence. From work relationship to blood relationships, clear cases of non-independence are ruled out. However, the second step requires the board to consider any *material* information that may affect the director's independence. This second step, while being praised for allowing companies flexibility in deciding whether to disqualify a director from being considered independent, goes too far in vesting the board with the ultimate, and unchecked, discretion in making such determination. What is material for one board can be considered non-material to others. Indeed, the ability of different boards to arrive at different outcomes when faced with similar facts is problematic in and of itself.

But the concern with entrusting the board with the authority to determine director independence is also structural. Expecting directors to effectively police director independence fails to account for the board dynamics and behavioral biases that call into question the true effectiveness of their designation. Below, the Article outlines the main conceptual concerns with the reliance on board judgment in the determination of director independence.

1. A Hand in the Cookie Jar?

Boards of directors are empowered with making final determinations regarding director independence. This subjective aspect of board authority is problematic in multiple ways. First, a potential conflict of interest arises as boards are empowered to determine whether they themselves are independent. This concern is further heightened due to the requirement that a majority of board members be independent. Since companies are expected to have a supermajority of independent directors, and at the very least are obligated to have a simple majority, boards are therefore incentivized to continue to classify themselves individually as independent, to avoid having to be replaced with truly independent directors. While current rules do include objective components that carve out some of the common ways a director can lose his or her independence, the inherent conflicts of interest they face may incentivize the board to push the subjective requirements

as far as possible.

2. Behavioral Bias

In addition to the explicit interest board members may have in maintaining one's independence, or approving the independence of a sought-after newcomer, boards suffer from a myriad of behavioral biases that could reduce their ability to objectively assess the independence of their fellow board members.

a. Social Ties & Structural Bias

Social ties are already considered a potential disqualifying factor under Delaware state law, but are missing from the "bright-line" prerequisites for independence in stock exchange rules, which instead focus on directors' financial ties to the corporation.[116] However, as directors spend more time on the board, they not only gain experience and knowledge, but also foster social interaction with their peers on the board and with upper management. As their tenure increases, these ties are likely to grow stronger, leading to a "structural bias:" the bias resulting from board members' interactions with one another after joining the board.[117] This bias could potentially compromise directors' ability to act independently of their social ties, or at the very least, such close ties might cloud directors' ability to properly assess the independence of their peers.

Granted, social science[118] and corporate governance[119] literature has pointed out that a close-knit board can be beneficial for board performance by increasing trust and openness between board members. However, the same social science literature has also acknowledged that these benefits do come with a price tag of decreased independence and increased difficulty in impartially assessing another director's work.[120] Perhaps more importantly, a close-knit board can tend to avoid conflict if and when action would undermine the friendship one has formed.[121]

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116. *See* Lisa M. Fairfax, *Sarbanes-Oxley, Corporate Federalism, and the Declining Significance of Federal Reforms on State Director Independence Standards*, 31 OHIO N.U. L. REV. 381, 399 (2005) (discussing the *Oracle* and *Beam* cases in the context of Delaware courts' willingness to consider social and professional ties in the independence inquiry); *see also* Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040 (Del. 2004) (focusing on social and professional ties); *In re* Oracle Corp. Derivative Litig., 824 A.2d 917, 938 (Del. Ch. 2003) (holding that the independence analysis should pay heed to personal and social relationships among directors, and finding that such relationships negated directors' independence).

117. *See* Julian Velasco, *Structural Bias and the Need for Substantive Review*, 82 WASH. U. L.Q. 821, 851–65 (2004) (discussing the existence of structural bias in a variety of business situations).

118. *See* James D. Westphal & Edward J. Zajac, *Defections from the Inner Circle: Social Exchange, Reciprocity, and the Diffusion of Board Independence in U.S. Corporations*, 42 ADMIN. SCI. Q. 161, 163–64 (1997) (noting that group cohesion and solidarity can improve cooperation among group members).

119. *See* John F. Olson & Michael T. Adams, *Composing a Balanced and Effective Board To Meet New Governance Mandates*, 59 BUS. LAW. 421, 445–46 (2004) (noting that close personal relationships can promote honesty and trust).

120. *See* Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 598–99, 612–13 (1982); *see also* Marleen A. O'Connor, *The Enron Board: The Perils of Groupthink*, 71 U. CIN. L. REV. 1233 (2003) (discussing the closer personal connections of the Enron board of directors).

121. *See* Karen A. Jehn & Priti Pradhan Shah, *Interpersonal Relationships and Task Performance: An Examination of Mediating Processes in Friendship and Acquaintance Groups*, 72 J. PERSONALITY & SOC. PSYCHOL. 775, 778 (1997) (discussing the differences between how friends and non-friends solve conflicts); Janine Nahapiet & Sumantra Ghoshal, *Social Capital, Intellectual Capital, and the Organizational Advantage*,

While critics of current definitions of director independence have already voiced concern over the impact social interaction might have on independence—and while Delaware law has acknowledged the potential effect it might have on independence (although in a very limited fashion)[122]—stock exchange rules have not addressed the issue.

b. Groupthink, Confirmation Bias, Social Conformity & Status Quo Bias

Similarly, boards tend to suffer from groupthink,[123] the practice of thinking or making decisions as a group in a way that discourages creativity or individual responsibility,[124] where it is less likely that a wide array of opinions would be expressed or considered regarding "gray-zone" information that may impact a director's independence.

Equally important is the concern that board members will suffer from confirmation bias, the tendency to search for, interpret, focus on, and remember information in a way that confirms one's preconceptions.[125] In this regard, directors may be seeking to corroborate their internal belief in their peers, and validate their own background as sufficiently independent, by selectively interpreting and "coloring" the information before them.

Boards may also suffer from social conformity, which is a type of social influence that results in a change of behavior or belief in order to fit in with a group, preventing directors from challenging long-lasting traditions in the boardroom regarding acceptable practices that are not to be factored into director independence consideration. Finally, boards may suffer from a status quo bias, i.e. a preference for the current state of affairs. Boards therefore take the status quo as a reference point, and any change from that baseline is

23 ACAD. MGMT. REV. 242, 245 (1998) (analyzing the interaction between social capital and intellectual capital and how that interaction affects relationships); Reed E. Nelson, *The Strength of Strong Ties: Social Networks and Intergroup Conflict in Organizations*, 32 ACAD. MGMT. J. 377, 380 (1989) (considering the impact of social ties on conflict); Jerry Goodstein & Warren Boeker, *Turbulence at the Top: A New Perspective on Governance Structure Changes and Strategic Change*, 34 ACAD. MGMT. J. 306 (1991) (finding that the longer the members of a board of directors have worked together, the more likely they are to resist change); STANLEY C. VANCE, CORPORATE LEADERSHIP: BOARDS, DIRECTORS, AND STRATEGY (1983) (finding that the longer the members of a board of directors have worked together, the more likely they are to tolerate poor performance on the part of senior management); Rita D. Kosnik, *Effects of Board Demography and Directors' Incentives on Corporate Greenmail Decisions*, 33 ACAD. MGMT. J. 129 (1990) (examining how demographics of boards of directors impact greenmail transactions).

122. *See* Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040 (Del. 2004) (emphasizing that evidence regarding social, professional, or business relationships would normally be insufficient to discredit a director's independence); *see also* Litt v. Wycoff, No. 19083-NC, 2003 WL 1794724 (Del. Ch. Mar. 28, 2003) (noting that even longstanding personal friendships would not impede a director's independence); Crescent/Mach I Partners, L.P. v. Turner, 846 A.2d 963, 980–81 (Del. Ch. 2000) (stating that a fifteen-year personal relationship is insufficient to impact an independence inquiry); *In re* Walt Disney Co. Derivative Litig., 731 A.2d 342, 352 (Del. Ch. 1998) (establishing that Ovitz and Michael Eisner, the CEO of Walt Disney, had been friends for twenty-five years before Eisner recruited Ovitz to serve as president and director, but reasoning that such friendship did not impact Eisner's ability to be deemed independent for purposes of assessing the derivative action against Ovitz).

123. James McRitchie, *Groupthink in the Boardroom Context*, CORPGOV (Feb. 2, 2015), http://www.corpgov.net/2015/02/groupthink-boardroom-context/.

124. *See* Einer Elhauge, *Are Term Limits Undemocratic?*, 64 U. CHI. L. REV. 83 (1997) (describing the impact tenure has on power, clout, and influence in the political sphere).

125. Margit E. Oswald & Stefan Grosjean, *Confirmation Bias*, *in* COGNITIVE ILLUSIONS: A HANDBOOK ON FALLACIES AND BIASES IN THINKING, JUDGEMENT AND MEMORY 79–96 (Rudiger F. Pohl ed., Psychology Press 2004).

perceived as a loss, leading to a disincentive in declaring a director as non-independent.

3. Director Tenure

Director tenure, which has been on the rise,[126] may further exacerbate the aforementioned concerns with entrusting the board with the discretion to establish and declare director independence. As I have pointed out elsewhere,[127] director tenure may not only jeopardize director independence in itself—a concern many in the investor community now share—but may also worsen the behavioral biases and the group dynamics of the boardroom; and in the context of defining independence, it may lead to an overly lax view of what may disqualify a peer director from being independent.

A recent Wall Street Journal article[128] highlighted the board member longevity problem, both as it pertains to the actual independence of directors as well as to the ability of the board to properly assess its independence and effectiveness. Chipotle, who has suffered from revenue declines in recent years,[129] stated that it would be reconsidering its current board members and structure.[130] This is in response to both revenue declines and the reality that many members of the nine-person board have remained in their positions throughout the company's 23-year history.[131] Five of the board members have remained with the company for over 15 years.[132] Additionally, several members have close ties to Mr. Steve Ells, the company's co-CEO and Chairman.[133] Nevertheless, the Chipotle board determined that seven of its nine members (with the other two being the co-CEOs) are independent in the company's annual proxy statement.[134]

4. The Result: Companies Blur the Lines

With companies having an implicit and explicit interest in maintaining the independence of directors, it is not surprising that they elect to apply a soft prism to examining director independence. As exemplified above, despite the existence of strong social, financial, and charitable ties between directors and their companies, many are still designated as independent directors. These questionable designations are not exclusive to Chipotle, Apple, and Nike. Similar issues have arisen with many other companies.[135] Google, for example, has designated Mr. John Hennessy, president of Stanford University

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126. Nili, *supra* note 14.

127. *Id.*

128. David Benoit & Julie Jargon, *Chipotle, Ackman Near Settlement*, WALL ST. J. (Nov. 18, 2016), http://www.wsj.com/articles/chipotle-ackman-near-settlement-1479470401; *see also* Francis & Lublin, *supra* note 115 (discussing the independence of board members).

129. *See* Hadley Malcolm & Charisse Jones, *Chipotle Sales and Revenue Plummet in the Second Quarter*, USA TODAY (July 21, 2016), http://www.usatoday.com/story/money/2016/07/21/chipotle-second-quarter-earnings/87381760/; *see also* Timothy Green, *Why Chipotle Stock Tumbled 21% in 2016*, NASDAQ (Jan. 11, 2017), http://m.nasdaq.com/article/why-chipotle-stock-tumbled-21-in-2016-cm732494 (showing Chipotle's revenue decline in recent years).

130. Benoit & Jargon, *supra* note 128.

131. *Id.*

132. *Id.*

133. *Id.*

134. Chipotle Mexican Grill, Inc., Proxy Statement (Def. 14a) (Mar. 24, 2016).

135. *See also* Francis & Lublin, *supra* note 115 (showing examples of questionable designations in other companies).

as one of its independent directors.[136] This is despite the $24.9 million in donations, scholarships, and payments for research services and patent licenses Google has paid Stanford during Mr. Hennessy's 12-year term as an independent director.[137] Mr. Andrew McKenna has been an independent director with McDonalds for 25 years.[138] This is despite his former involvement with a family-owned paper-goods company that sold a combined $71 million of french-fry bags and other goods to McDonald's over a 22-year period.[139]

Similarly, a Wall Street Journal study[140] found that nearly a dozen large companies had directors "on important board committees [who] were also lobbyists paid either by the company or by a group at which the company's CEO had influence."[141] For example, one of Boeing's independent directors, Mr. Kenneth Duberstein, owns a lobbying firm, Duberstein Group Inc.[142] The firm has been paid millions of dollars by Business Roundtable, an association whose executive committee has featured Boeing's chairman or CEO in 12 of the past 18 years.[143] The study noted that "there is no evidence these ties influenced decisions by either the CEOs or the board members."[144] However, the study is another example of directors being classified as independent despite prima facie evidence to the contrary.

It is not surprising then, that the same survey that found that institutional investors consider director independence information as important to their voting decisions[145] and also found that only 40% of the surveyed investors found the information in the director independence section to be clear and effective, while 60% found it to be somewhat or not at all effective.[146]

B. Too Little: Information is Lacking

The concern highlighted in this Part is not limited only to the fact that boards are endowed with the authority to decide these "gray zone" cases, i.e. instances where a director clears the basic "bright-line" thresholds set by the stock exchanges but may have other factual circumstances that cast doubt on her independence. The empowerment of the board is coupled with a deficiency in transparency, which further exacerbates the efficacy of the director independence determination.

As detailed below, the current regulatory framework is fundamentally lacking in providing investors with sufficient information regarding the board's director independence designations. Boards do not have to disclose the steps taken to reach director independence decisions. Instead, simple disclosure statements are made regarding which

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136. *Id.*

137. *Id.*

138. Press Release, McDonalds, Andrew J. McKenna to Retire from McDonald's Board of Directors (Apr. 6, 2016), http://news.mcdonalds.com/press-releases/andrew-j-mckenna-to-retire-from-mcdonald-s-board-of-directors-nyse-mcd-1252620.

139. *See also* Francis & Lublin, *supra* note 115 (showing McKenna's involvement with a company that sold french fry bags to McDonalds).

140. Theo Francis & Brody Mullins, *Lobbyists as Directors Test Rules for Corporate Boards,* WALL ST. J. (Oct. 4, 2016), https://www.wsj.com/articles/lobbyists-as-directors-test-rules-for-corporate-boards-1475608483.

141. *Id.*

142. *Id.*

143. *Id.*

144. *Id.*

145. *See* RR Donnelley et al., *supra* note 61 (sharing the results of a 2015 survey).

146. *Id.*

directors are independent and which ones are not. There are some related-party transactions that must also be disclosed, but the vast majority of considerations that are made, with respect to director independence, are kept outside of the public's eye.[147] Simply put, investors have no easy way of knowing how or why a director was determined to be independent. Not surprisingly, investors are concerned and have voiced displeasure regarding the lack of effectiveness and completeness of these disclosures.[148]

1. Current Disclosure Requirements are Too Narrow and Lack Important Context

In connection with a board's independence determinations, Item 407 of Regulation S-K requires that a company disclose, by specific category or type, any transaction, relationship or arrangement with any of the company's independent directors that was (i) not disclosed under the related party transactions disclosure, but was (ii) considered by the board in determining the independence of the director.[149]

However, the related party disclosure under item 404 *and* the seemingly "catch all" disclosure under item 407 are subject to materiality qualifiers that afford the company with discretion regarding the decision of what transactions or relationships should be disclosed to investors. Item 404 specifically calls for "a direct or indirect material interest" and item 407 refers to the definition of director independence, which in turn refers to "material relationship with the listed company." In other words, both under item 404 and 407 the board can decide that a transaction was not material, and therefore refrain from disclosing it.[150]

Therefore, and as further detailed in Part V below, the current system of disclosures fails to achieve its desired goal. Companies are disclosing information in piecemeal form, the information provided is highly selective, lacks context and is non-verifiable. This, in turn, leaves investors without a complete understanding of the steps taken to determine director independence.

Since it is hard to uncover what companies should have disclosed but have not, this Article examined a series of Delaware state law cases where the independence of directors was challenged after the fact and contrasted the information revealed during discovery and trial with the information provided to shareholders in the company proxy filings before litigation arose.

The findings are striking. There are numerous examples of shareholders not being privy to relevant information, although such information was available to the board when determining director independence. For example, cases have illustrated that past employment may have jeopardized a director's independence, but disclosure was not made.[151] Such information is material to assessing a director's independence, but is typically not disclosed in annual proxy statements. In *In re KKR Financial Holdings LLC Shareholder Litigation*, for example, a director's independence was challenged on grounds that he previously worked with one of the directors of the company that was buying out

147. *See* Min, *The SEC and the Courts*, supra note 109 (finding that companies show great variance in their approach to sections 404 and 407 and in their conception of the materiality requirement of section 404).
148. *Id.*
149. 17 C.F.R. § 229.407 (2012).
150. Min, *The SEC and the Courts*, *supra* note 109.
151. *In re* KKR Fin. Holdings LLC S'holder Litig., 101 A.3d 980, 997–98 (Del. Ch. 2014).

KKR Financial.[152] The relationship was not disclosed, despite the two directors holding high ranking positions at Wells Fargo for an extended period of time.[153]

Another category of information that is not fully disclosed is charitable affiliations.[154] A director's relationship to charitable organizations is factored into the NYSE[155] and NASDAQ independence tests,[156] but because of the subjective nature of director independence disclosures, cases have illustrated instances where companies determined charitable affiliations to be immaterial, making disclosure unnecessary.[157] For example, in a case concerning one of J.P. Morgan Chase's independent directors, the plaintiffs alleged that the director, who was President and CEO of the United Negro College Fund ("UNCF"), could not be independent because William Harrison, Jr., J.P. Morgan's CEO, served as trustee of UNCF.[158] This connection between the independent director and Mr. Harrison was not disclosed in the company proxy statement.[159]

Relatedly, only some companies provide current outside employment of their directors, including concurrent board positions and even fewer disclose past directorships, even when such facts may potential impact a director's independence.[160]

Lastly, companies have failed to disclose personal relationships,[161] previous business transactions that did not occur over the past calendar year—but are relevant to assessing a director's independence[162]—and current business interests that are determined to be

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152. *Id.*

153. KKR, Proxy Statement, (Def. 14a) (Mar. 24, 2014). The KKR director was previously Wells Fargo's CFO from 1998 to 2001. *In re KKR Fin. Holdings*, 101 A.3d at 997. The buying out director was Chairman and CEO from 1995 to 1998, and Chairman from 1998 to 2001. *Id.*

154. Donating over $120,000 to a charity affiliated with an independent director is required to be disclosed under Item 404, if the director has or will have a direct or indirect material interest. Despite this, cases have highlighted charitable contributions that were not disclosed. In *Bader v. Blankfein*, it was revealed that Goldman Sachs had previously made a "substantial contribution" to a campaign chaired by one of its independent directors to renovate the Chicago Lyric Opera House and Orchestra Hall. No. 07-CV-1130, 2008 U.S. Dist. LEXIS 102698, at *29 (E.D.N.Y. Dec. 18, 2008). The court disagreed with the plaintiff's argument because the "substantial contribution" in question was completed prior to the company's 2006 proxy statement disclosure, and because there was no evidence that the Goldman Sachs Foundation, Inc. (the foundation that made the donation) had "unilateral power . . . to decide whether the challenged director continues to receive a benefit." *Id.* at 26–27.

155. N.Y.S.E. MANUAL (CCH) § 303A.02.

156. NASDAQ STOCK MKT. RULES (CCH) 5605.

157. *See Bader*, No. 07-CV-1130, 2008 U.S. Dist. Lexis 102698 at *29 (holding that the "substantial contribution" that was previously made was immaterial); *See also In re KKR Fin. Holdings*, 101 A.3d 980 (holding that the charitable contributions were immaterial to assessing the director's independence).

158. *In re* J.P. Morgan Chase & Co. Shareholder Litigation, 906 A.2d 808, 823–24 (Del. Ch. 2005).

159. J.P. Morgan Chase & Co, Proxy Statement (Def. 14a) (2004).

160. In Part V, I discuss my research observations of 100 publicly traded companies' proxy statement disclosures from 2000 to 2016. One of my observations was that many companies did not disclose past board positions. Of the 100 companies, 32 did not reference past board positions anywhere within their annual proxy statements.

161. In *United Here v. Cintas Corp.*, it was revealed that a company received legal services from a law firm where one of the partners was related to two independent directors. D.C. 2006 U.S. Dist. LEXIS 72936, at 10 (S.D.N.Y. 2006). The court stated that "it does not appear that Cintas had a duty to disclose its payments . . . under Item 404(a)." *Id.* at *26. In *In re* Orchard Enters., Inc., a director's independence was challenged on past business and social connection grounds. 88 A.3d 1, 25 (Del. Ch. 2014). The case revealed that the independent director of Orchard Enterprises frequently socialized with a family that was buying out Orchard. *Id.* at 9. Additionally, the director was hired as a consultant after the merger was completed. *Id.* The close social ties were not disclosed in the company's 2010 proxy statement.

162. *In re* MFW S'holders Litig., 67 A.3d 496 (Del. Ch. 2013). A director's independence was challenged

immaterial by the company board.[163]

Collectively, these cases illustrate that important information regarding director independence is omitted from company filings, and is only discovered after the fact, when challenged by shareholders. Rethinking Item 407's current disclosure methodology would create more transparency regarding these independence determinations.

2. In Light of the General Emphasis on Disclosure—Director Independence Has Fallen Behind

As highlighted above, current independent director disclosures are fairly limited and suffer from ambiguity. However, the inadequacy of the current disclosure regime with respect to director independence is even more striking when contrasted against the general emphasis on effective disclosure in other realms of securities laws and investor protection.

In response to Enron, the Great Recession, and other recent events that have disrupted investor confidence, the SEC has placed a greater emphasis on company disclosures.[164] Companies are now required to disclose additional information regarding finances,[165] environmental-rated matters,[166] and relationships with foreign governments,[167] but no such changes have been made to director independence requirements. Instead, the SEC sticks to the disclosure amendments that were made in 2006.[168] In 2006, the SEC required

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because of a large investment made nine years prior to the director obtaining a seat on the company board. *Id.* at 514. The investment was made to Ronald Perelman, who owns 43% of M&F Worldwide, the company in question. *Id.* at 499. The business transaction in question involved selling several companies to Citigroup for $5 billion. *Id.* at 513. MFW did not disclose the prior transaction between the company owner and independent director.

163. In *J.P. Morgan*, the plaintiffs argued that an independent director's transactions with the Trade Bank of Iraq, totaling $2 billion, harmed the director's independence designation because Trade Bank of Iraq is managed by J.P. Morgan Chase. 906 A.2d at 814. The transaction was not disclosed in J.P. Morgan's 2004 proxy statement. J.P. Morgan Chase, Proxy Statement (Def. 14a) (2004). In *In re MFW S'holders Litig.*, an independence designation was challenged on grounds that the director's teaching position at Georgetown University created a conflict with the company, because the company CEO was also affiliated with the University. 67 A.3d at 512–13. The CEO and independent director's connection was not disclosed in the company's proxy statement. *Id.* Additionally, the independent director in question also had another potential conflict by virtue of serving on another separate company's board. *Id.* at 512. The director obtained a seat on the board by virtue of the MFW's CEO recommendation. *Id.* The two directors' ties at Georgetown and the separate board were not disclosed to shareholders.

164. *Disclosure Effectiveness*, EY (Nov. 2014), http://www.ey.com/Publication/vwLUAssets/EY-disclosure-effectiveness-november-2014/$FILE/EY-disclosure-effectiveness-november-2014.pdf.

165. *ASC 606 (revenue recognition) transition: The role of internal control over financial reporting (ICFR) and auditor expectations*, BAKER TILLY (Jan. 31, 2017), http://bakertilly.com/insights/asc-606-revenue-recognition-transition-the-role-of-internal-control-over-fi/.

166. Suzanne Beaudette Murray & Phong Tran, *Companies Facing Increasing Scrutiny over Environmental-Related Disclosures*, HAYNESBOONE (Apr. 20, 2016), http://www.haynesboone.com/alerts/companies-facing-increasing-scrutiny-over-environmental; E. Lynn Grayson & Patricia L. Boye-Williams, *SEC Disclosure Obligations: Increasing Scrutiny on Environmental Liabilities and Climate Change Impacts*, JENNER & BLOCK LLP, https://jenner.com/system/assets/publications/1696/original/Environmental_Issues_in_Bus_Trans_Chapter_15_SEC_Disclosure.pdf?1319628667 (last visited Oct. 31, 2017).

167. Lincoln Brown, *SEC Ruling: Oil and Gas Companies to Increase Disclosure*, OILPRICE (June 28, 2016), http://oilprice.com/Latest-Energy-News/World-News/SEC-Ruling-Oil-And-Gas-Companies-To-Increase-Disclosure.html.

168. Press Release, SEC, SEC Votes to Adopt Changes to Disclosure Requirements Concerning Executive Compensation and Related Matters (July 26, 2006), https://www.sec.gov/news/press/2006/2006-123.htm.

disclosure as to whether each director was independent, the related-party transactions that were taken between the company and independent director, as well as the process and procedure of determining director compensation.[169] These changes provided positive momentum.

However, despite additional disclosure movements, director independence disclosures have remained unchanged for the past decade. This is particularly concerning because director independence has become a vital concern for investors.[170] Recent years have highlighted that in addition to ensuring the independence of directors,[171] investors are seeking greater corporate governance transparency.[172] Transparency enables shareholders to hold corporate decision-makers accountable for their missteps, but can also force directors to apply better judgment ex-ante.[173]

The SEC has recently recognized the need for greater transparency by actively seeking comment on the effectiveness of current company disclosures.[174] The SEC Chair Mary Jo White stated that

> The SEC's disclosure regime is central to our mission to protect investors and the integrity of our capital markets . . . [b]ecause of its critical importance to investors and issuers, optimizing Regulation S-K, and our disclosure regime more broadly, is a crucial ongoing responsibility of the Commission and the staff. . . [g]ood disclosure benefits everyone—investors, companies, and the markets generally. And everyone has a strong interest in it.[175]

Indeed, within its request for comment, the SEC stated that one of its goals is to assess "whether additional disclosures . . . are necessary or appropriate to facilitate investor protection."[176] This Article underscores the need for such additional steps in the context of director independence.

C. Too Late: Director Independence is Indeed a Context Based Issue but it is Not Enough to Address It Ex-Post

As developed above, determining one's independence is not an easy task. Bright line

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169. *Id.*

170. *Importance of Independent Directors*, LESLIE DASHEW, http://www.lesliedashew.com/_assets/pdf/articles/importance-of-independent-directors.pdf (last visited Oct. 31, 2017).

171. Francis & Lublin, *supra* note 115 and accompanying text.

172. John Wilcox, *Directors Should Communicate with Shareholders*, HARV. L. SCH. F. ON CORP. GOVERNANCE AND FIN. REG. (Oct. 16, 2014), https://corpgov.law.harvard.edu/2014/10/16/directors-should-communicate-with-shareholders/.

173. Luis A. Aguilar, *Looking at Corporate Governance from the Investor's Perspective*, HARV. L. SCH. F. ON CORP. GOVERNANCE AND FIN. REG. (Apr. 24, 2014), https://corpgov.law.harvard.edu/2014/04/24/looking-at-corporate-governance-from-the-investors-perspective/. Having an independent board provides comfort to investors that decisions are made in an unbiased manner. This includes executive officer commissions, conflict of interests, and decisions being made independent of management's interests, which isn't always the same as shareholders. *See generally* LESLIE DASHEW, *supra* note 170 (examining the importance of independent directors).

174. *SEC Seeks Public Comment for Next Phase of Disclosure Effectiveness Initiative*, SIMPSON THACHER (Sept. 1, 2016), http://www.stblaw.com/docs/default-source/memos/firmmemo_09_01_16.pdf?sfvrsn=2.

175. White, *supra* note 13.

176. Request for Comment on Subpart 400 of Regulation S-K Disclosure Requirements, Exchange Act Release No. 33-10198 (Oct. 31, 2016).

rules not only set a low threshold and may fail to account for many factual components that may impact independence, they also fall short of capturing the nuanced and context based nature of a director's background. Specifically, while a specific set of facts may be considered as irrelevant to a director's independence at time X, the same factual backdrop may become material at time X+1, due to the importance of the context against which one's independence is assessed. For example, a director who has served for many years as a CEO of company A, may be deemed independent when elected to the board of company B. However, if the COO of company A is now to become the CEO of company B, would such a director still be considered independent?

State law, and in particular Delaware law, is particularly attuned to this context based conundrum of director independence, and thus courts have applied a factual ad-hoc determination of director independence, contrasting the factual background of each director with the matter at hand.

However, while arguably more effective,[177] Delaware's approach suffers from one fundamental and significant limitation—the determination of independence is done only through litigation, most often after the fact, when the damage is already done.

The ex-post nature of state law, having courts affirm whether a director was independent in regard to a specific transaction, renders it extremely limited. It only applies in the few cases where litigation arises in front of courts, the facts are made known months and years after litigation started, and most importantly it is *too late*. If director independence is meant to safeguard shareholder interests in the company, waiting for a court ruling after the damage has already been done is rendering it futile.

D. Too Soft: Lack of Effective Enforcement

The concerns regarding the true effectiveness of the designations of independence made by boards regarding their peers are magnified due to lack of an effective enforcement mechanism.

First, state law enforcement is limited to litigation, and while shareholders can challenge the independence of directors in Delaware courts, these challenges must be made in connection with a shareholder challenge to a specific board action, and must cross procedural and substantive thresholds before discovery.

Second, in the context of the stock exchange listing rules, the designation of directors as independent is designed to be difficult to enforce, and in practice is rarely enforced. Specifically, since the definition of director independence places much weight on the discretion of the board, it would be hard and costly to directly challenge a determination that was made by the board. Similarly, because there is no private right of action for the violation of exchange rules,[178] and due to the lack of access to the information the board considered, there is also no private enforcement mechanism at the disposal of shareholders.

Of course, providing incorrect information in a proxy statement or periodic report, or omitting such information, will violate the securities laws, which would subject the

177. Although courts have shown that the application of the standard may not be consistent. *See* Nili, *supra* note 14 (discussing the different result courts achieve when examining friendships in the context of director independence).

178. *See, e.g.*, NASDAQ OMX Grp, Inc. v. UBS, Sec., LLC, 770 F.3d 1010, 1046 (2d. Cir. 2014) (Straub, J., dissenting) ("It is undisputed that the Exchange Act does not provide for a private cause of action for violations of stock exchange rules.").

company to SEC enforcement. In reality, the SEC has shown no apparent interest in vigilantly ensuring, however, that Items 404 and 407 are properly followed, only acting when such violations have a greater impact than the independence of directors.[179]

V. DIRECTOR INDEPENDENCE DISCLOSURES—EMPIRICAL SURVEY

As discussed above, the current designation system of directors as independent may suffer from structural concerns, and there are numerous anecdotal examples demonstrating the deficiencies and lack of proper disclosure by companies.

This Part seeks to augment the theoretical discussion and the anecdotal observations with a more robust empirical survey, exploring the state of director independence designations and disclosure in practice. To do so, using a hand collected data set, I analyzed the disclosure statements of 100 public companies from the year 2000 up until today. To account for both large, high profile companies as well as smaller, less visible public companies, 50 of the companies make up the Fortune 50 and the remaining 50 are Fortune 2000 small-cap companies.

All 100 companies choose to satisfy their disclosure requirements in their annual proxy statements instead of their annual 10-Ks. Therefore, for each company, the company's proxy statements in the years 2000, 2004, 2008, 2012 and their most recent filing, either in 2015 or 2016, were analyzed and coded.

The results can be grouped under three broad observations. First, the majority of companies provide very little information in regards to their director independence designations. It is instead the bare minimum required by the governing stock exchange rules that is provided—with no means to ascertain the grounds for the company's designation. Indeed, in a related study, Min found that this practice of companies was also prevalent in the specific issue of related party transaction disclosures.[180] Second, some companies do provide very helpful information to an interested investor—exemplifying the ability to improve disclosures. These are the vast minority, however, as most companies do not provide information beyond what is absolutely necessary. Third, when examining how director independence disclosures have evolved over time, several companies are in fact regressing in regards to the level of transparency they are providing to investors, further underscoring the need for a reform.

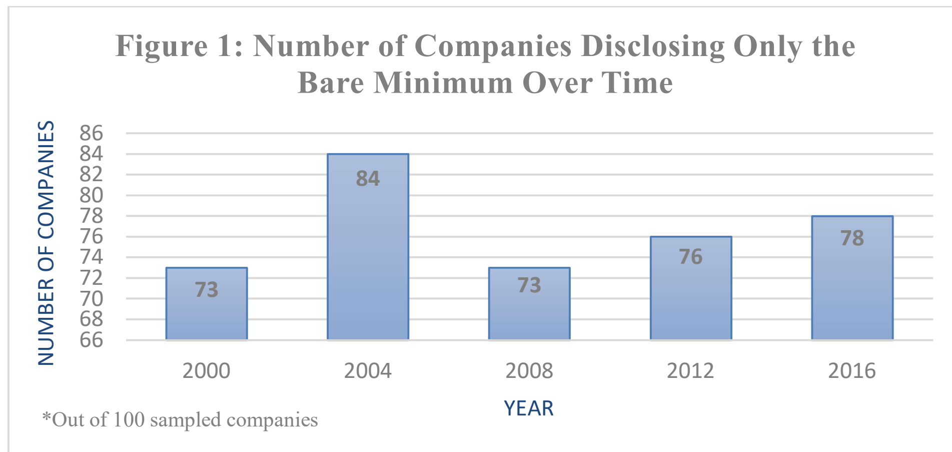
A. Lack of Transparency

As noted, the vast majority of sampled companies provide the bare minimum of what is required under Item 407 and the stock exchange standards. Of the one hundred companies analyzed, 78 satisfied their stock exchange disclosure requirements, without providing any additional information. As Figure 1 shows, that number has been steadily

179. An example is the action against Mark Thompson. In effect, the Commission sanctioned Thompson for not being independent. The agency did it by finding that the failure to disclose his relationship with E&Y resulted in disclosure violations under the proxy rules and periodic reporting requirements. J. Robert Brown, *Director Independence and SEC Enforcement (Part 2)*, RACE TO THE BOTTOM (Aug. 11, 2008, 12:00PM) http://prosoxblog.squarespace.com/the-sec-governance/director-independence-and-sec-enforcement-part-2.html.

180. *See* Min, *The SEC and the Courts*, *supra* note 109 (conducting a study of 50 companies' disclosures and finding that they keep investors in the dark in respect to related party transactions).

rising since the current disclosure requirements took effect in 2006.[181]

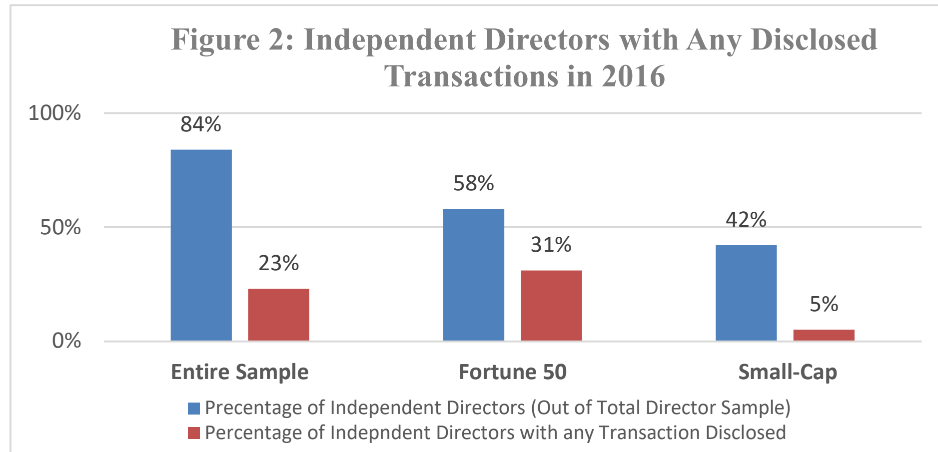


Importantly, the problem is much more notable when assessing company disclosures regarding individual independent directors. In 2016, the surveyed companies had a combined 1,062 directors serving on their boards. 896, or 84% of these directors were declared independent. Beyond being declared independent, only 23% of the independent directors had material transactions that were disclosed by their company. 19% of these disclosures were under item 407, an additional 4% had related party transactions under Item 404.

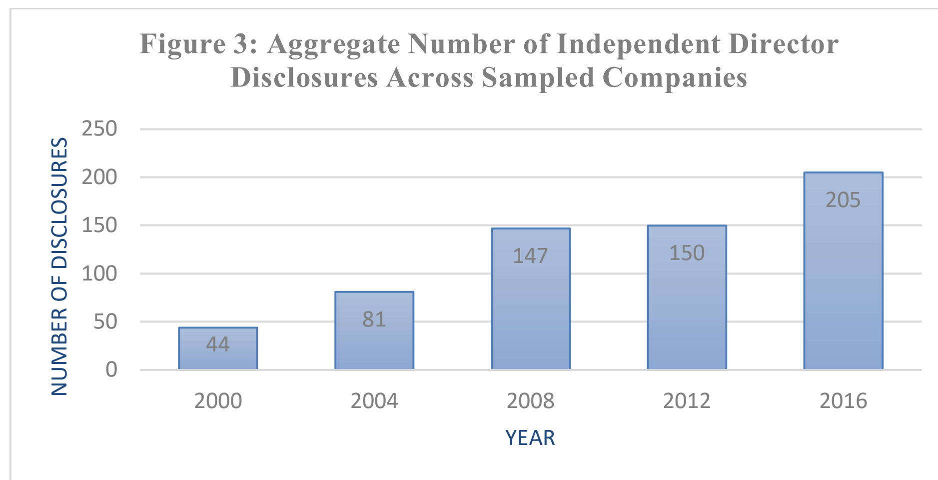
The lack of disclosures is particularly notable in small-cap companies. Only 3% of the 380 independent directors had material transactions that were disclosed. An additional 2% had transactions disclosed under Item 404, bringing the total to 5%. This is far less than the Fortune 50 companies, where 31% of the independent directors had material transactions disclosed under Item 407 or Item 404.[182]

181. The data was derived manually from a sample of 100 companies. This sample contains 50 Fortune 50 companies and 50 Fortune 2000 small-cap companies. For each company, the company's proxy statements in the years 2000, 2004, 2008, 2012, and their most recent filing in 2016 were analyzed and coded. The complete data file is with the Author.

182. *Id.*



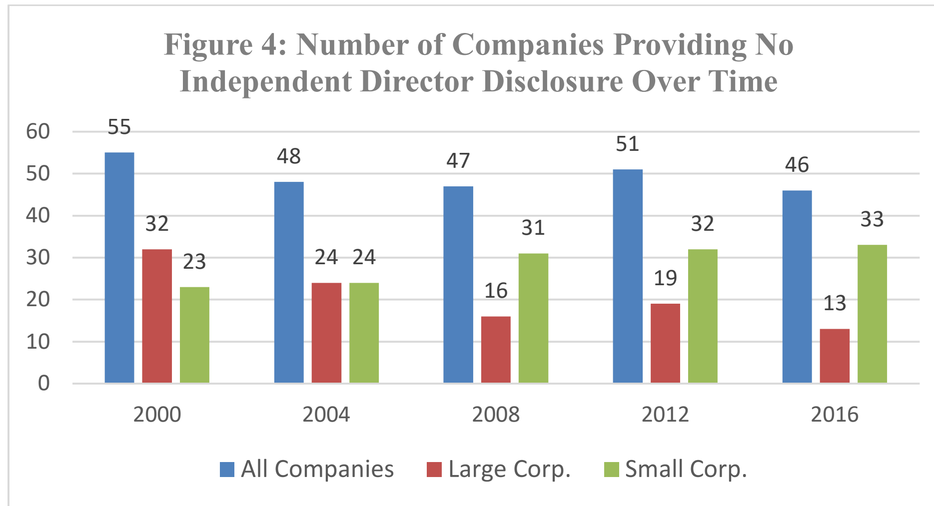
However, even in the Fortune 50 sub-sample, many independent directors are being declared independent without any substantiating information concerning the steps taken to determine their independence. As Figure 3 below shows, while there is a slight upward trend in the number of absolute disclosures made, the number is still relatively low and is concentrated within the companies that do include specific disclosures.[183]



Particularly alarming is the number of companies that did not disclose *any* material transactions considered by the board in assessing all of their directors' independence. As Figure 4 below details, in 2016, 46 of the 100 companies did not disclose any material transactions, either under Item 407 or Item 404.[184]

183. *Id*.

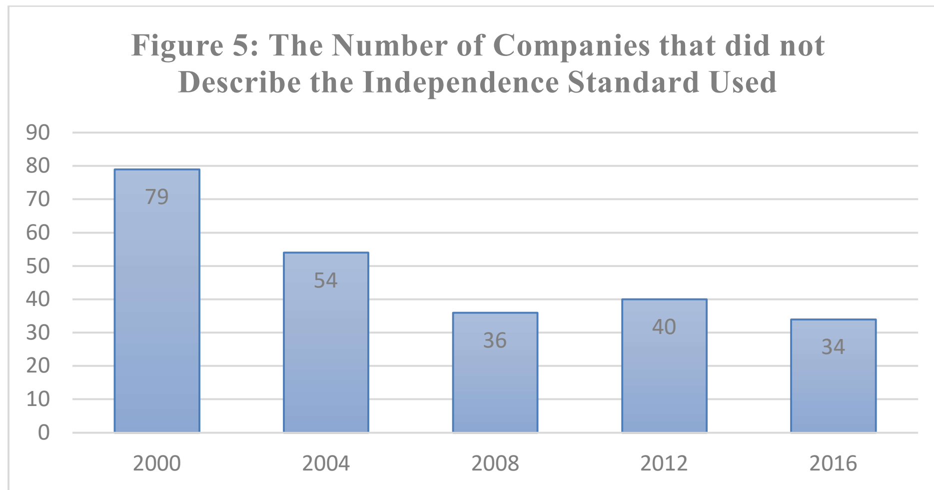
184. While it is plausible that some companies would have many directors that would not have material transactions, it is extremely unlikely that the entire board is free of such transactions, particularly since similarly sized companies did have such disclosures.



These findings were more noticeable in small cap companies, where 66% of the 50 companies did not disclose any material transactions. In contrast, only 26% of the Fortune 50 companies did not include any material transactions. These figures have stayed constant from 2008 to 2016. In 2008, 47% of the 100 companies did not disclose any material transactions.

A significant number of companies also refrain from providing shareholders with important information regarding the directors' other board positions. 29% of the companies in the sample did not provide information on other current directorships of their director nominees. Of these 29 companies, 11 were Fortune 50 companies and 18 were small cap size companies. Similarly, 32% of the companies did not provide information on past directorships. Of these 32 companies, 18 were Fortune 50 companies and 14 were small cap size companies.

Finally, the number of companies that are not disclosing the substance of the independence tests they are using within their proxy statements is also significant. As Figure 5 below shows, 34 companies did not include the definition of "independent director" within their proxy statement. Instead the company casually referenced the NYSE or NASDAQ listing requirements (i.e. "Under the NYSE, the following directors are independent"). Of the remaining 66 companies, only 32% developed their own independence standards, which exceeded the listing requirements under its stock exchange. More importantly, it provided a clear outline of what their independence standards are. This is particularly important for less sophisticated investors who are unfamiliar with the director independence standards under the NYSE or NASDAQ. Notably, before the enactment of the stock exchanges rules, companies actually provided more information regarding the standard they use, with 79 companies providing the definition of independence they used in their proxy statements.



The lack of transparency forces investors to rely on inadequate amounts of information in regards to director independence determinations. This is especially problematic because investors may and do assume that the designations made by companies truly reflect the independence of their directors.[185] However, since the information being provided in the company filings is inadequate, then sharp backlashes could occur when suspect transactions are reported between an 'independent director' and the company which they serve.[186] Providing more information will combat this inadequacy.

B. Companies Providing Useful Information Are the Minority

Despite the broad observation that a large portion of the surveyed companies do not provide enough information to investors, a select few companies are actually providing very helpful information to investors. The additional information can be divided into three main dimensions. The first dimension is whether the company is describing both the reason why certain directors are not independent and the reason why directors who seemingly lack independence, due to their business or charitable affiliations, are in fact independent. The second dimension is whether the company is disclosing financial data regarding the independent directors' business or charitable affiliations. Lastly, the third dimension is whether the company is providing their director independence information in an organized, easy to read manner, such as a table or bullet point lists.

The most notable observation is that few companies are providing information beyond what is required by their stock exchanges. Of the 100 companies, only 20 met at least one of the three dimensions. This means that 80 companies did not provide explanations for either their independent or non-independent directors. Instead, the companies disclosed who their independent and non-independent directors were, without detailed explanations. Of the 20 companies that did meet one of the three dimensions, 13 satisfied multiple dimensions.

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185. Francis & Lublin, *supra* note 115 and accompanying text.

186. For example, the Nike and Apple transactions discussed in *supra* notes 4–6; as well as the Apple-Disney transactions, *supra* note 9.

An example of one company providing very useful director independence disclosures is Johnson & Johnson. Within its 2015 proxy statement, the company has an easy to read table that organizes each director's organizations, the director's relationship to the organization, and the amount of business conducted between Johnson & Johnson and the director's organization.[187] The chart is extremely helpful for understanding the considerations the board had in determining that each of its non-employee directors are independent.[188]

A second company providing a great deal of transparency to investors is General Electric. Similar to Johnson & Johnson, General Electric provides an easy to read table that illustrates all of the transactions considered when making director independence determinations.[189] The table notifies investors of organizations that certain directors affiliate with, their relationship to the organization, and the level of business the director's organization conducts with General Electric.[190] While the company eventually determined that all of its non-employee directors are independent, shareholders are now able to choose the extent to which they adopt these determinations.[191]

Both Johnson & Johnson and General Electric are large companies, which illustrates a second observation. Not surprisingly, large cap companies disclose additional information at a much more frequent rate than small-cap companies. Of the 20 companies whose disclosures exceeded their stock exchange's requirements, 16 were a part of the Fortune 50 companies, compared to four belonging in the bottom half of the Fortune 2000. This is unsurprising, given the amount of resources available to larger organizations but may also be credited to the greater amounts of scrutiny larger companies receive.[192]

C. Companies That Have Regressed

Finally, a few companies in the sample have actually provided less and less helpful information to investors. These companies illustrate the problems surrounding the current state of director independence disclosures. Of the 100 companies analyzed, three met one of the criteria used to identify companies providing information beyond what is required by their stock exchanges during a previous disclosure, only to fail to meet the same tests in later disclosures.

To illustrate this observation, one can look at Wells Fargo's 2016 proxy statement.[193] In 2016, Wells Fargo determined that 14 of their 15 board members were independent.[194] The lone exception being John G. Stumpf, the company CEO.[195] In doing so, Wells Fargo explicitly stated that all applicable NYSE regulations guided them in making their determinations.[196]

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187. Johnson & Johnson, Proxy Statement (Def. 14a) (Mar. 11, 2015).

188. *Id.*

189. Gen. Elec., Proxy Statement (Def. 14a) (Apr. 22, 2015).

190. *Id.*

191. *Id.*

192. It is also worth noting that the number of companies providing additional information, beyond what is required by its stock exchange, has stayed constant between 2000 and 2016. In 2016, there were 20 companies that met one of the three criteria I established. For comparison, in 2008, 21 companies met one of the three criteria.

193. Wells Fargo & Co., Proxy Statement (Def. 14a) (Mar. 16, 2016).

194. *Id.*

195. *Id.*

196. *Id.*

Wells Fargo's 2016 proxy statement provided a stark contrast to their 2010 proxy statement. In 2010, the company provided a bullet point list of certain transactions that were considered in making their independence determinations.[197] This is in addition to their related-party disclosures under Item 404. Eight of their fifteen independent directors were listed in the company's bullet point list.[198] Transactions covered included outside employment, family member affiliations, and charitable contributions.[199] By 2016, these disclosures were not included in the company's proxy statement.

Taking these findings as a whole, it is clear that in many instances the current disclosure requirements are providing investors with little information. The vast majority of companies have been providing the bare minimum ever since the disclosure requirement's enactment, some companies are regressing to provide even less than what they used to, and the companies that are providing extremely useful disclosures represent a small minority. Of course, one can argue that the lack of disclosure is merely a function of the lack of relevant information to share. However, as demonstrated above, there are ample cases where relevant information was not shared with shareholders, only to be revealed through litigation.

Moreover, the notable differences between companies regarding disclosure practices and the glaring differences in the type and volume of information provided by similarly sized companies casts serious doubt that the lack of any disclosure is due to a lack of relevant information to disclose. Finally, as noted above, the current rules do not require companies to provide information that is not material, and what the board may consider as non-material may be viewed differently by shareholders. Collectively, these observations illustrate the problems surrounding current disclosure practices.

VI. FIXING DIRECTOR INDEPENDENCE

As illustrated in Part IV, the current state of director independence disclosures suffers from numerous concerns that could limit its effectiveness. As further illustrated in Part V,[200] and against the backdrop of these structural concerns, the empirical findings confirm these concerns, showing that many companies disclose the bare minimum that is required under applicable stock exchange regulations, while providing little insight into their independence designations. This Part proposes a solution to this problem—in the form of a heightened disclosure regime and addresses potential objections to the proposed proposal.

A. Augmenting the Current Designation System with Stronger Disclosures

At its core, the failure of current regulatory standards to ensure effective director independence regime stems from the fundamental approach that was taken regarding director independence. Regulators, recognizing the need to identify independent directors ex-ante have sought a standard that would have both clear rules but also flexibility to address "gray zone" matters. The combination of limited objective thresholds and a process led by the board to certify a director as independent has strived to strike that balance. However, as developed above, the current regulatory landscape has missed the mark. Companies are providing little information on their internal independence assessment of

197. Wells Fargo & Co., Proxy Statement (Def. 14a) (Mar. 18, 2010).
198. *Id.*
199. *Id.*
200. *Supra* Parts IV and V.

directors, there is a question as to the efficacy of their designation, and there is a lack of verification and enforcement mechanisms.

Equally important, the choice of a standard-based approach also leads to a binary designation of a director as independent/non-independent, a designation that shareholders then rely on when making decisions based on board recommendations. However, since director independence is a context based issue, changing over time and in regard to the matter at hand, trying to capture it with the current regulatory process is a task that is destined to fail.

Therefore, we need to re-conceptualize the current approach from focusing merely on the provision of a designation regarding each director to an approach that equally focuses on the provision of effective and detailed company disclosures to shareholders, who can then make individual determination as to the level of comfort and reliance they may have with the board.

Under the suggested shift, companies will have to disclose, for each "independent" director the entire set of information they considered when declaring a director as independent. This in turn will allow investors and regulators not to only confirm the judgment of the board on each director but also to possess better sensitivity concerning the true independence of each director in regards to each matter at hand. The improved information will enable investors to make an informed decision regarding the validity of company assertions. Shareholders may decide to oppose the election of such director, and even if elected, they can decide to treat further recommendations of the board with increased doubt. It will also empower companies to tailor each disclosure to a given director's unique circumstances.

As already illustrated in Part V, many companies simply state that "the board has determined all non-employee directors are independent."[201] This may comply with the applicable NYSE and NASDAQ rules, but does not illustrate how a company went about their determination. Disclosing steps taken by the board to reach their ultimate determination will create more transparency for investors, force companies to become more vigilant in their designations and will allow shareholders to place different weights on these designations based on the matter at hand. Investors will then be able to determine for themselves whether a director is truly independent.

While the SEC already requests companies to provide some information regarding their independence designations, the current framework is severely lacking. First, companies are only required to disclose what they considered as potentially material information. Second, companies can escape the need to provide detailed information by adopting categorical standards to assist them in making determinations of independence and then may make only a general disclosure if a director meets these standards. Third, currently a company can report different information about the director in various locations in its filing—making it harder for shareholders to easily review the information. Finally, as Part V demonstrated, many companies provide no information to shareholders, potentially violating the current disclosure regime, but these practices are not enforced by the SEC.

Therefore, in order to ensure effective disclosure by companies, the SEC should make various changes to its current rules. While the idea of complete disclosure is straightforward, the design of such system is far from simple and involves different choices and considerations that regulators will have to take into account. Below, the Article provides several points-of-emphasis that should be a part of the suggested reform.

201. *Supra* Part V.

First, the Article does not call for the elimination of the independence designation by companies. Companies will still be required to make a determination regarding independence in order to comply with mandatory director independence ratios and board committee's rules. However, these designations will now benefit from greater depth, allowing shareholders and regulators better sensitivity to the potential conflicts each director may have on any given issue.

Second, the SEC should create a non-exclusive list of types of information that should be obtained by the board and then disclosed to shareholders. Currently, companies are free to decide what information to request from the director nominee, and that may allow some to manipulate the process. By creating a non-exclusive but detailed list, the SEC will ensure that these factors are indeed considered and disclosed to investors. For example, many companies do not view past directorship as a matter that needs to be disclosed, despite the clear relevance it may have on the independence of directors in some instances.

Third, in order to prevent boards from ignoring information altogether, or selectively disclosing only some, the rules should clearly require the disclosure of all information obtained by the company regarding the director.

Fourth, the SEC should standardize the way information is provided to shareholders, ensuring that the presentation is both user-friendly and centralized. As discussed above, there are already companies that provide their information in such a manner, and the SEC should make it the norm rather than the exception.

Finally, and critically, the SEC must make companies and directors accountable for their disclosures. Therefore, the SEC should ensure effective enforcement of these rules. This can be done by selectively auditing companies or by requiring the filing of the questionnaires that directors provide the company with the SEC.

B. Independent Verification of Director Independence Determinations

As part of the greater reform suggested above, or independently, the SEC should make sure that all regulatory demands with respect to director independence are fulfilled accurately. Therefore, a second, more limited solution to the current problems facing director independent disclosures is to require independent verification of board determinations by an outside gatekeeper; possibly the company's outside independent auditor. As discussed above, stock exchanges and the SEC, are ill-equipped to enforce these rules. Because of this, investors must rely on these board determinations at their face value. However, as made evident by Nike, Apple, and other examples contained within, a lack of trust has rightfully arisen.[202] Requiring boards to obtain independent verification of their final determinations will correct this problem.

Companies already have many public disclosures verified by independent auditors, so requiring verification of director independence decisions should not add significant additional strain to a publicly traded company's operations. Independent auditors must review and verify financial statements before publicly traded companies publish their financial performances.[203] It would be extremely easy for independent auditors to also review director independence determinations, which also includes financial information.

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202. *Supra* notes 4–6.
203. *See generally* 17 C.F.R. § 210.2-01(b) (2005) (requiring accounts to be independent).

C. Adjusting the "Bright-Line" Rules and Disclosure Requirements

Finally, at a minimum, regulators should strive to tighten the "bright-line" rules governing director independence. This will ensure that the objective standards will become a key component of the definition rather than a mere basic threshold. It will also ensure conformity across companies in their interpretation of independence and will reduce the impact the inherent conflict of interests they possess may have on their determination.

While establishing how and where adjustments to the rules are needed requires detailed regulatory work, below are some key areas that would need to be addressed.

First, as discussed in Part III, directors are non-independent if they are affiliated with organizations that conduct a certain amount of business with the company they serve on.[204] This is one of the "bright-line" rules used for determining director independence. Directors may be under the applicable threshold, but nevertheless above the $120,000 disclosure requirement.[205] Both of these rules are in need of adjustment.

The problem with the current "bright-line" rules is that large cap companies are able to easily circumvent their intended effect, due to the company's annual revenues. The NYSE eliminates directors who are affiliated with a company that has made payments to the listed company in any of the last three fiscal years, that "exceeds the greater of $1 million, or 2% of [the] . . . company's consolidated gross revenues."[206] NASDAQ eliminates directors from independence consideration who are affiliated with organizations that conducted business with the company that "exceed[s] 5% of the recipient's consolidated gross revenues for that year, or $200,000, whichever is more."[207]

For a company the size of Apple, who reported over $215 billion in annual revenue last year,[208] many transactions are outside the scope of the current stock exchange regulations. Apple, with its reported revenue, would only be prohibited from labeling directors as independent when the director's transactions with Apple exceed roughly $10 million under NASDAQ's requirements. If Apple was traded on the NYSE, the applicable amount would be $4.3 million.

The same problem lies with Nike. In 2016, Nike reported $30 billion in annual revenue.[209] Under the NYSE, Nike may not classify directors as independent if the director's transactions with Nike exceed $600,000. If Nike were traded on NASDAQ, the applicable amount would be $1.5 million. These numbers illustrate why Tim Cook is able to remain lead independent director of Nike, despite Apple's business ties with the company. The Apple numbers also explain why Bob Iger is able to remain an independent director under current regulations.

To counteract this problem, stock exchanges should adjust their current regulations to cast a wider net for their "bright-line" rules. Instead of opting for allowing a higher threshold based on a percentage of revenue, the exchanges should focus on a monetary

204. *Supra* Part III.

205. Transactions with Related Persons, Promoters, and Certain Control Persons, 17 C.F.R. § 229.404(a) (2008).

206. N.Y.S.E. MANUAL (CCH), § 303A.02.

207. *Equity Rules*, NASDAQ STOCK MKT. RULES (CCH), http://nasdaq.cchwallstreet.com/NASDAQTools/PlatformViewer.asp?selectednode=chp%5F1%5F1%5F4%5F3&manual=%2Fnasdaq%2Fmain%2Fnasdaq%2Dequityrules%2F (last visited Oct. 31, 2017).

208. *Apple Company Financials*, NASDAQ, http://www.nasdaq.com/symbol/aapl/financials?query=income-statement (last visited Oct. 31, 2017).

209. Press Release, Nike, Nike, Inc. Reports Fiscal 2015 Fourth Quarter and Full Year Results (June 25, 2015), http://news.nike.com/news/nike-inc-reports-fiscal-2015-fourth-quarter-and-full-year-results.

threshold already codified in the regulations—using the percentage based threshold only when it is *lower* than the monetary threshold. This means that any transactions above $1 million will eliminate a director from independence considerations under the NYSE.[210] For NASDAQ-traded companies, the applicable threshold is $200,000.[211]

Adjusting the "bright-line" stock exchange rules will eliminate some of the questionable independent designations issued by companies. The SEC should also assist in this problem by increasing the level of transparency for investors interested in director transactions with their company. Under Item 404, companies are required to disclose related-party transactions between directors, executives, and other high-ranking members that exceed $120,000.[212] Under the disclosure requirements, companies must disclose the name of the high ranking member, their interest in the transaction, the approximate dollar value of the amount involved in the transaction, the approximate dollar value of the amount of the related person's interest in the transaction, as well as "[a]ny other information . . . that is material to investors in light of the circumstances of the particular transaction."[213] The disclosure requirements already provide a great deal of useful information to investors, but the requirements can go a step further by requiring a description of the actual transaction. For example, Apple should be required to describe the actual transactions it undergoes with Disney, so that investors can assess the validity of Bob Iger's independence.

Commentators may argue that by requiring disclosure of "any other information . . . that is material to investors,"[214] regulators already require a description of the actual transaction by companies. However, in practice, companies are not describing the transaction in a manner that is useful to investors.[215] Perhaps investors do not view describing the transaction as "material," at least from the companies' perspective. Regardless, providing a brief description of the related-party transaction will increase transparency for investors and enable them to track the company's interactions with one another more easily. This adds a great deal of value to interested investors and provides grounds for an adjustment to the Item 404 disclosure requirements.

D. Potential Objections

This Part considers and responds to a variety of possible objections to the proposed disclosure reforms.

1. Unnecessarily Deterring Investors

Companies may argue that by increasing the amount of disclosures, investors may view insignificant transactions that a director had as a reason not to invest in a given company. Alternatively, investors may continue investing in a company, but lose confidence in the decisions that are being made by the board. There are several responses warranted to this potential objection. First, director independence is one of many factors

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210. N.Y.S.E. MANUAL (CCH) § 303A.02.

211. *Equity Rules*, *supra* note 207.

212. Transactions with Related Persons, Promoters and Certain Control Persons, 17 C.F.R. § 229.404(a) (2008).

213. *Id.*

214. *Id.*

215. *Supra* Part V.

investors consider before investing in a company.[216] There is no guarantee that increasing the amount of disclosure will deter investors from a given company. Second, even if an investor does decide to avoid a certain company, they will be doing so on a more informed basis. This is a socially desirable outcome.

Importantly, to avoid potential investor fears, companies may alter their board member compositions in an effort to continue complying with their stock exchange requirements—leading to stronger and more accurate board structure.

2. Over-inclusiveness

Some critics may argue that the current disclosure requirements are sufficient and that any additional disclosures would lead to over-inclusiveness and to overloading investors with information. In an effort to avoid liability, companies may provide information that is clearly immaterial, placing unnecessary costs on the company and for investors who would need to comb through this information, the argument goes.

However, this argument is also lacking in several aspects. First, since boards are expected to collect and analyze this information with or without disclosure, companies will not incur added costs of collecting information. Second, the exact concern underscored in this Article is that it is hard to assess what information is material or immaterial to establishing independence, and in any event the board is not the correct organ to filter it. By forcing the board to be over-inclusive, a light is shined on each director's attributes—allowing for a better assessment of their independence. Finally, shareholders are more than capable to properly factor this information, with the help of sophisticated investors and proxy advisers, and the general trend, as noted above, is for more information rather than less. There is no reason to deviate from this approach when it comes to director independence.

3. Chilling Effect?

Some may argue that forcing companies to provide more information regarding each independent director may lead directors to refuse serving on public companies' boards, in order to protect their privacy. I believe that this chilling effect argument, while appealing on its face, falls short. First, directorship is a highly desired position and it is unlikely that directors will refuse to serve just because they would rather keep some information private. Second, one can argue that we should welcome this chilling effect if directors have something to hide. Third, nothing prevents the company from continuing to retain directors that refuse to disclose their information to the public in a non-independent director role if the company and the director so chooses.

4. Questionable "Independent Directors" Will Persist

A fourth potential objection is that changing disclosure requirements will not cure the problem of questionable independent director designations. For example, even under the proposed changes, Tim Cook will nevertheless remain Nike's lead independent director. This is despite Nike and Apple's close business relationship.

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216. *Evaluating the Board of Directors*, INVESTOPEDIA (Sept. 18, 2014), http://www.investopedia.com/articles/analyst/03/111903.asp (discussing the various factors investors should consider while evaluating the board of directors. The article specifically references director independence as a criteria investors should desire.).

However, the proposed changes are designed to increase investor transparency, rather than restrict "independent" designations. Tim Cook will remain an independent director for Nike and Bob Iger will remain an independent director for Apple, but investors will be better educated of their company's decision makers under the proposed changes. Under the proposal, investors will know that subjective decisions made by boards, in accordance with stock exchange requirements, are not an abuse of power. Investors will also know a great deal more about their independent directors' business arrangements. All of these outcomes are desirable. They are also necessary for increasing the amount of trust and transparency investors have in their companies.

5. Increased Costs

A final objection is in regards to added costs. Requiring companies to hire outsiders to verify their independence determinations will add financial strains to a company's operations. However, for the reasons already discussed, the added financial strains are worthwhile in light of the value added to investors. There is a growing demand for U.S. boardrooms to be composed of independent directors. Stock exchanges have catered to this demand by requiring a majority of board members to be independent. Under the proposed rule changes, investors will now understand why directors are independent, increasing shareholder confidence in a company's operations.

It will also take additional time for boardrooms to complete independence determinations. This is due to outside verification, as well as increased documentation requirements. The proposed solutions will certainly take *some* additional time to complete, but this will be outweighed by the increased amount of confidence investors will have in their company's independent director determinations. Moreover, the additional time costs will not be significant, especially for mid to large sized publicly traded companies.

VII. CONCLUSION

There has been an ongoing push towards independent boards over the past few decades. Regulators and stock exchanges recognized this desire and mandated an independence requirement for a majority of directors in publicly traded companies. However, the regulatory approach to defining director independence has not lived up to the notion it is meant to protect. It is lacking in both treating director independence as a binary designation and in entrusting a self-interested board to decide its own independence, with few checks on the process it engages in to make its decision. It is also lacking by ignoring the need to provide investors with detailed and effective information.

This Article addresses this problem by proposing a regulatory solution that is both pragmatic and effective. By shifting the focus of director independence from a designation of independence to both designation and disclosure, investors will better understand the steps boards take in making their independence determinations, but importantly, will also be allowed to assign a different weight to the factors behind the designation of the board. If we truly care about director independence, regulators should ensure that the regulatory framework accounts for its elusive nature.