How to Enhance Directors' Independence at Controlled Companies

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Directors' independence at controlled companies is an intriguing corporate governance conundrum. Recently, Bebchuk and Hamdani have shed new light on it by providing an analytical framework that seeks to make independent directors more effective in performing their oversight role. They convincingly argue that some independent directors should be accountable to public investors who, in order to achieve this aim, should have the power to influence the election or retention of several "enhanced-independence" directors. Starting from this persuasive outcome, and adopting a comparative and functional analysis, this Article will extend the Bebchuk and Hamdani framework in several directions, with the aim of rendering it more effective and adaptable to different jurisdictions around the world. First, reliance only on the initiative of activist hedge funds might raise some concerns with regard to the effectiveness of enhanced-independence directors as monitors as well as to the cohesiveness of the board. This Article will therefore argue that the involvement of non-activist institutional investors in the selection and election of enhanced-independence directors should be enhanced. It will further argue that the refinement of the election and retention process for independent directors might not be enough in order to tangibly enhance their independence, as the "human nature" of corporate boards must be taken into consideration as well. Pursuing this line of thought, it will develop an in-depth analysis of strategies available in order to limit the distorting effects of the board's relational dimension and to induce enhanced-independence directors to perform their oversight role in a truly independent way.

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I. INTRODUCTION

Director independence has become a common feature of issuer governance all around the world. In many legal systems, corporate governance rules and principles require a large part—often, the majority—of the board to be independent.[1] The role of independent directors was first enhanced with the rise of the monitoring board model—introduced by Eisenberg's seminal 1976 book "The Structure of the Corporation"[2]—according to which the main function of the board is to monitor the management of the company. Subsequently, the role of independent directors was further expanded following the financial scandals during the early 2000s, which prompted regulatory responses on both sides of the Atlantic that were heavily reliant on the monitoring function of independent

1. For a historical analysis of the rise of independent directors and the independent board model in the United States see generally 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 (2007); for a comparative overview see Klaus J. Hopt, *Comparative Corporate Governance: The State of the Art and International Regulation*, 59 AM. J. COMP. L. 1, 25–28 (2011); Harald Baum, *The Rise of the Independent Director in the West*, *in* INDEPENDENT DIRECTORS IN ASIA 33–55 (Harald Baum et al. eds., 2017) (describing the rise of independent directors in Asia).

2. MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS (1976).

directors. In the United States, the Sarbanes-Oxley Act of 2002 (SOX)[3] provided for the establishment of an audit committee comprised entirely of independent directors. In addition, the NYSE, NASDAQ, and AMEX listing standards introduced a requirement that the boards of public companies—with the notable exception of corporations with a controlling shareholder holding a stake of 50% or higher—must have a majority of independent directors.[4]

In Europe, building on the U.K. experience,[5] in 2005 the European Commission issued a non-binding recommendation on the role of non-executive or supervisory directors of listed companies and (supervisory) board committees,[6] prompting the presence in the board of a sufficient number of committed non-executive or supervisory directors "who play no role in the management of the company or its group and who are independent in that they are free of any material conflict of interest."[7] Subsequently, in line with the Commission's recommendation, almost all corporate governance codes adopted at EU Member State level recommend that the board include a minimum number or a ratio of independent directors.[8]

However, in the wake of the financial crisis, the independent monitoring board model has come under attack. It has been blamed for contributing to the crisis, since the independent monitoring board model is claimed to have made it difficult for financial institutions to find independent directors with an adequate level of expertise in their industry, thereby reducing the overall competence of the board.[9] In spite of these criticisms, directors' independence is still regarded as a key element within issuer corporate governance, and is widely acknowledged by corporate governance rules and principles, which continue to place their trust in board independence as a useful tool to limit the negative consequences of agency problems affecting corporations.[10]

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3. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 301, 116 Stat. 745 (2002) (codified in scattered sections of 11 U.S.C., 15 U.S.C., 18 U.S.C., and 28 U.S.C.).

4. STEPHEN M. BAINBRIDGE, CORPORATE GOVERNANCE AFTER THE FINANCIAL CRISIS 81–84 (2012); Eric M. Fogel & Andrew M. Geier, *Strangers in the House: Rethinking Sarbanes-Oxley and the Independent Board of Directors*, 32 DEL. J. CORP. L. 33, 41–47 (2007).

5. *See* Baum, *supra* note 1, at 45 (recalling that the Cadbury Report was the first to discuss the possibility of non-executive independent directors in Europe).

6. European Commission Recommendation of 15 February 2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board, 2005 O.J. (L 52) 51. [hereinafter Commission Recommendation on the role of non-executive directors].

7. *Id.* at 52.

8. For a comparative overview, see ORG. FOR ECON. CO-OPERATION & DEV., OECD CORPORATE GOVERNANCE FACTBOOK 108–10 (2017), http://www.oecd.org/daf/ca/Corporate-Governance-Factbook.pdf [hereinafter OECD FACTBOOK]. *See also* Paul Davies et al., *Boards in Law and Practice: A Cross-Country Analysis in Europe*, *in* CORPORATE BOARDS IN LAW AND PRACTICE 28–35 (Paul Davies et al. eds., 2013).

9. *See* BAINBRIDGE, *supra* note 4, at 103–04 (quoting Grant Kirkpatrick, *The Corporate Governance Lessons from the Financial Crisis*, 2009 OECD J. FIN. MKT. TRENDS 1 (2009)). *See also* Roberta S. Karmel, *Is the Independent Director Model Broken?*, 37 SEATTLE U. L. REV. 775, 777 (2014) (noting that director expertise may be more important than director independence); Theodore N. Mirvis & William Savitt, *The Dangers of Independent Directors*, 40 DEL. J. CORP. L. 481, 484 (2016) (stating that independent directors lacking expertise are not likely to check insider trading).

10. *See* Wolf-Georg Ringe, *Independent Directors: After the Crisis*, 14 EUR. BUS. ORG. L. REV. 401, 406–07 (2013) (noting continued importance of directors' independence). The favorable trend towards directors' independence is clearly confirmed, for example, by the G20/OECD Principles of Corporate Governance, which continues to support the view that "[i]ndependent board members can contribute significantly to the decision-making of the board" and "independent nonexecutive board members can provide additional assurance to market

Nevertheless, the inability of independent directors to play an active role in preventing a large number of financial scandals and related corporate failures has highlighted the limits of the formal approach to directors' independence "that takes into account only a corporate director's relationship with the corporation and not the tools a director needs to achieve substantive independence."[11] Those shortcomings prompted corporate governance experts to reconsider the very function and notion of directors' independence, and stimulated an intense debate about what directors' independence actually means, and how it can effectively improve issuer corporate governance.[12]

Although the debate is still ongoing and some are still skeptical about directors' independence as a regulatory tool,[13] a key point has been already made. Some divergences persist within the global convergence on independent directors.[14] In particular, the definition of independence and the role of independent directors are not universally defined, as they largely depend on ownership patterns, industry structure and regulatory goals.[15] While the main agency problem in diffusely owned firms is opportunism on the part of the management, and independent directors are required to protect the interests of the shareholders vis-à-vis the management, in controlled firms independent directors are mainly called upon to protect minority shareholders vis-à-vis the controlling shareholders. Therefore, in a context of concentrated ownership, independent directors are mainly involved in vetting operations involving conflicts of interest and preventing tunneling by

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participants that their interests are safeguarded."). *See* ORG. FOR ECON. CO-OPERATION & DEV., G20/OECD PRINCIPLES OF CORPORATE GOVERNANCE 52 (2015), http://www.oecd-ilibrary.org/governance/g20-oecd-principles-of-corporate-governance-2015_9789264236882-en (click on "PDF" link) [hereinafter G20/OECD PRINCIPLES].

11. *See, e.g.*, Nicole Faith Sharpe, *The Cosmetic Independence of Corporate Boards*, 34 SEATTLE U. L. REV. 1435, 1435 (2011) (stressing that "'cosmetic independence' is not enough to remedy the corporate failures of recent years"); Suzanne Le Mire & George Gilligan, *Independence and Independent Company Directors*, 13 J. CORP. L. STUD. 443 (2013) (Arguing that there is a "growing recognition that a reliance on formal independence, as it has been conceived in corporate governance regulation, is unsatisfactory").

12. *See* Stephen M. Bainbridge, *The Board of Directors*, *in* THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE 309–21 (Jeffrey Gordon & Wolf-Georg Ringe eds., 2015).

13. *See, e.g.*, Steven Davidoff Solomon, *The Case Against Too Much Independence on the Board*, N.Y. TIMES: DEALBOOK (Nov. 11, 2013), https://dealbook.nytimes.com/2013/11/11/the-case-against-too-much-independence-on-the-board/ (noting continued skepticism concerning regulatory function of directors' independence). Moreover, some scholars consider directors' independence to be an ineffective tool in avoiding the adoption of more vigorous regulation. *See* Urska Velikonja, *The Political Economy of Board Independence*, 92 N.C. L. REV. 855, 860 (2014) (arguing that "[i]nstitutional investors and corporate managers value director independence because it displaces more meaningful reform . . . that would reduce stock prices, even where such regulation would increase overall welfare"). However, an in-depth discussion of this line of argumentation falls outside the scope of this Article. For the purposes of this analysis, it is taken for granted that independent directors are—and will continue to be —a key element within issuers' corporate governance. After all, this underlying assumption seems to be in line with current corporate governance developments, which confirm the regulators and investors' trust in directors' independence. For survey update, which shows that a majority of independent directors is a common feature within boards in many countries see SPENCER STUART, BOARDROOM BEST PRACTICE 24–27 (2017), https://www.spencerstuart.com/research-and-insight/boardroom-best-practice (click on "download the PDF").

14. *See* Jeffrey N. Gordon, *Convergence and Persistence in Corporate Law and Governance* 5, 14 (Eur. Corp. Governance Inst. (ECGI), Law Working Paper No. 370/2017, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3038742 (showing divergences within convergence on independent directors).

15. *See infra* Part II.

controlling shareholders.[16]

Having been substantially ignored for a considerable period of time,[17] the distinction between controlled firms and widely owned firms is now accepted as fundamental within a large body of corporate governance scholarship.[18]

As far as controlled firms are concerned, in a recent groundbreaking article, Professors Lucian Bebchuk and Assaf Hamdani have shed new light on the role of independent directors, providing an analytical framework aimed at making independent directors more effective in overseeing decisions involving conflicts of interest and solving the basic agency problem affecting controlled firms.[19] According to Bebchuk and Hamdani, to incentivize independent directors to perform their oversight role effectively, they should be made accountable to public investors. Therefore, in firms with controlling shareholders, the main characteristic of directors who are expected to monitor transactions influenced by controlling shareholders should be accountability to minority (or public) shareholders rather than mere independence.[20] Specifically, to turn independent directors into enhanced-independence directors,[21] "public investors at controlled firms should have *at least veto* rights over enhanced-independence directors' initial appointment, reelection, and termination."[22] However, in line with jurisdictions that have already adopted reforms of this type, Bebchuk and Hamdani suggest that public investors should not have the "power to influence the election of *all* directors or even all independent directors."[23] Rather, they "believe that the election of some directors—*enhanced-independence directors*—should not be dictated by the controller."[24]

Starting from these relevant conclusions, this Article will focus on directors' independence within controlled companies and will seek to extend the Bebchuk and Hamdani framework further in several directions to render it more effective and adaptable to different jurisdictions. To be sure, allowing minority shareholders to play a role in the election and retention of a minority of directors is essential to enhancing the independence of these directors and to make them more accountable to public investors. Nevertheless, it remains doubtful whether providing public investors with influence over the election and

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16. *See, e.g.*, María Gutiérrez & Maribel Sáez Lacave, *Deconstructing Independent Directors*, 13 J. CORP. L. STUD. 63, 68–76 (2013) (explaining the primary tasks of independent directors).

17. *See* Karl Hofstetter, *One Size Does Not Fit All: Corporate Governance for Controlled Companies*, 31 N.C. J. INT'L L. & COM. REG. 597, 600–02 (2005) (noting tendency in U.S. for corporate governance discussions to ignore controlled companies).

18. *See, e.g.*, G20/OECD PRINCIPLES, *supra* note 10, at 51 ("The variety of board structures, ownership patterns and practices in different countries will thus require different approaches to the issue of board objectivity.").

19. *See* Lucian A. Bebchuk & Assaf Hamdani, *Independent Directors and Controlling Shareholders*, 165 U. PA. L. REV. 1271, 1273 (2017) [hereinafter Bebchuk & Hamdani, *Independent*].

20. *Id.* at 1290–92. *See also* Ringe, *supra* note 10, at 420–24; Gutiérrez & Sáez Lacave, *supra* note 16, at 93–94.

21. Bebchuk and Hamdani use the term "enhanced-independence directors" to identify directors elected in ways that would make them at least somewhat accountable to public investors and to distinguish them from "independent directors" whose elections fully depend on the controlling shareholders. Bebchuk & Hamdani, *Independent*, *supra* note 19, at 1272. Hereafter, "enhanced-independence directors" and "directors appointed by minority shareholders" are used as synonyms. When the distinction between independent directors and enhanced-independence directors will be relevant, it will be specified.

22. *Id.*

23. *Id.* at 1290.

24. *Id.*

retention of some directors will be enough to promote truly independent and objective conduct by these board members.

First, especially when minority shareholders are allowed to appoint some independent directors, potential apathy on the part of minority shareholders could lead to their failure to participate in directors' elections and consequently limit the practical relevance of enhanced-independence directors. In addition, it seems that the effectiveness of the Bebchuk and Hamdani proposal may depend also on the type of public investors supporting the election of enhanced-independence directors. In particular, since a purely activist-driven approach could present some drawbacks and can barely be adapted to jurisdictions where activist campaigns are rare, alternatives aimed at stimulating and favoring the involvement of institutional investors in the election of enhanced-independence directors should be developed.

Second, and more generally, to induce these directors to perform their oversight function in a truly independent way, the formal approach to independence currently adopted internationally should be replaced with a more effective regulatory strategy aimed at providing directors with incentives to stimulate their independent conduct. Obviously, to turn independent directors into enhanced-independence directors by reducing controlling shareholders' influence over them, it is necessary to prevent possible distorting incentives resulting from personal and business ties to the controlling shareholders. However, enhancing the independence of directors at controlled companies requires closer consideration to be given to the "human nature" of corporate boards.[25] Therefore, given that the social dimension of the board can impact directors' conduct regardless of the firm's ownership structure,[26] incentives aimed at preventing the decisions of enhanced-independence directors from being distorted by behavioral biases—including groupthink—should be introduced. In particular, within a context of concentrated ownership, legislators should consider measures that promote unbiased decisions by independent directors concerning transactions that are influenced by controlling shareholders and, more broadly, related-party transactions.

Against this backdrop, and with a view to developing an extended analytical framework for enhancing directors' independence in controlled firms, this Article proceeds as follows: Part II defines the role of independent directors in firms with controlling shareholders and provides a brief overview of the approach currently adopted in the U.S. and in other countries for the purpose of establishing a director's independence in controlled companies; and Part III examines why a formal approach to directors' independence is not adequate. Part III illustrates the fundamental distinction between independence in appearance and independence in mind and, building on this distinction, shows that setting independence criteria alone is not sufficient to promote truly independent conduct by the director. Moreover, Part III lays the basis for the following analysis by concluding that, to enhance directors' independence within firms with controlling shareholders, rules and corporate governance principles aimed at both limiting the influence of controlling shareholders over independent directors and inducing directors to engage in unbiased oversight over transactions involving controlling shareholders and

25. Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 800 (2001).

26. *See generally* Rakesh Khurana & Katharina Pick, *The Social Nature of Boards*, 70 BROOK. L. REV. 1259, 1262 (2005).

related parties are necessary. After recognizing that the appointment and termination regime for independent directors designed by Bebchuk and Hamdani is a key factor in enhancing directors' independence, Part IV contends that the reliance only on activist hedge funds may raise some concerns about both the effectiveness of enhanced-independence directors as monitors, as well as board cohesiveness. Therefore, Part IV argues that there is a case for stimulating the involvement of institutional investors in the selection and the election of the enhanced-independence directors, and, with reference to the Italian system, shows that the Italian institutional investor-driven model for the election of enhanced-independence directors may make the Bebchuk and Hamdani proposal more effective and adaptable to different jurisdictions. Part V extends the Bebchuk and Hamdani framework even further by providing solutions designed to curb the risk of the oversight role of enhanced-independence directors being undermined by cognitive biases deriving from intra-board dynamics. It focuses specifically on how to induce these directors to maintain truly independent conduct within the context of transactions influenced by controlling shareholders or involving related-parties. Part VI sets out some concluding remarks.

II. Independent Directors at Controlled Companies

This Part illustrates how the monitoring role of independent directors varies depending on a firm's ownership structure. It also recognizes that the definition of independence itself necessarily depends on companies' ownership patterns and provides an overview of how different legislation regulates—if at all—directors' independence at controlled companies.

A. Supervising Related-Party Transactions and Preventing Tunneling

Observers have broadly acknowledged that patterns of corporate ownership are probably the force that, more than any other, shapes corporate law, and determines the differences between legal systems.[27] Hence, diverging ownership structures characterizing public companies all around the world make the quest for internationally accepted governance standards elusive.[28] This is true also in regard to independent directors, since the monitoring role they are asked to perform, as well as the definition of independence itself, varies significantly depending on a company's ownership structure.

Diffusely-owned companies and companies with controlling shareholders present different agency problems and, consequently, pose fundamentally divergent corporate governance challenges. When a company's ownership is dispersed, the main agency conflict results from the separation of ownership and control, since managers have the de facto power to control the company and there is a higher risk that they act opportunistically

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27. *See generally* John Armour et al., *What Is Corporate Law?*, *in* THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 25–28 (John Armour et al. eds., 3d ed. 2017).

28. *See* Lucian A. Bebchuk & Assaf Hamdani, *The Elusive Quest for Global Governance Standards*, 157 U. PA. L. REV. 1263, 1268 (2009) [hereinafter Bebchuk & Hamdani, *The Elusive Quest*] (arguing the task of establishing global governance standards should be replaced by an effort to develop separate methods for assessment in companies with and without a controlling shareholder). *See also* Klaus J. Hopt, *Response, American Corporate Governance Indices as Seen from a European Perspective*, 158 U. PA. L. REV. PENNUMBRA 27 (2009), http://www.pennlawreview.com/online/158-U-Pa-L-Rev-PENNumbra-27.pdf (explaining the differences between shareholder structures internationally).

at the cost of the shareholders.[29] By contrast, within the context of concentrated ownership,[30] controlling shareholders are incentivized to monitor the management and have the power to do so.[31] However, controlling shareholders can, in turn, abuse their power and divert value through tunneling, or related-party transactions, at the expenses of minority shareholders.[32] Hence, the basic agency conflict here is between controlling shareholders and outside shareholders.[33] Consequently, at controlled companies, independent directors are not required to monitor managers—who are already monitored by controlling shareholders—and their surveillance role is mainly aimed at preventing controlling shareholder tunneling and related-party transactions intended to divert value at the expenses of minority shareholders.[34] Within concentrated ownership systems, independent directors are therefore understood as one tool within the larger set for dealing with conflicts between controlling and minority shareholders.[35] In keeping with this conceptual background, a number of legal regimes from around the world assign independent directors the task of monitoring transactions that are influenced by controlling shareholders or involving related-parties, where the risk of a conflict of interest is greater.[36]

29. Bebchuk & Hamdani, *The Elusive Quest*, *supra* note 28, at 1281.

30. For the sake of simplicity, in the following analysis I shall assume that controlling shareholders are only shareholders who hold a majority of voting rights. However, this is a simplification, since, in practice, there are many mixed situations or variants. *See* Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. REV. 1641, 1643–45 (2006); Hopt, *supra* note 28, at 30–31 (noting that European legislation accepts a broader concept of control that takes account of the low attendance rates at general meetings of public companies, where ad hoc majorities are often reached with far less than 50% control).

31. *See* Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE L. J. 560, 565 (2016) (noting that "control allows entrepreneurs to pursue business strategies that they believe will produce above-market returns by securing the ability to implement their vision in the manner they see fit"); Gutiérrez & Sáez Lacave, *supra* note 16, at 71–76.

32. Gutiérrez & Sáez Lacave, *supra* note 16, at 71.

33. *See* Luca Enriques & Paolo Volpin, *Corporate Governance Reforms in Continental Europe*, 21 J. ECON. PERSP. 117, 122–25 (2007) (discussing management strategy differences between outside shareholders and controlling shareholders); Goshen & Hamdani, *supra* note 31, at 591 (highlighting that "[t]he higher the controller's share of cash-flow rights, the lower her incentive to expropriate the minority").

34. *See, e.g.*, G20/OECD PRINCIPLES, *supra* note 10, at 25–26 (explaining remuneration and nomination committee differences globally); Bebchuk & Hamdani, *Independent*, *supra* note 19, at 1279–80 (differentiating between controlled companies' and widely held companies' governance challenges); Guido Ferrarini & Marilena Filippelli, *Independent Directors and Controlling Shareholders Around the World* 10–15 (Eur. Corp. Governance Inst. (ECGI), Law Working Paper No. 258/2014, 2014), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2443786 (noting corporate ownership and agency costs of different shareholder structures).

35. *See* Ringe, *supra* note 10, at 413; Paul L. Davies & Klaus J. Hopt, *Corporate Boards in Europe—Accountability and Convergence*, 61 AM. J. COMP. L. 301, 323–26 (2013) (defining independent directors as "protectors of non-controlling shareholders"). For an overview of the legal strategies available for reducing agency costs see John Armour et al., *Agency Problems and Legal Strategies*, *in* THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 31–39 (John Armour et al. eds., 3d ed. 2017).

36. *See generally* Ferrarini & Filippelli, *supra* note 34, at 22–25. However, there is some skepticism regarding the ability of independent directors to act as tool for constraining opportunism on the part of controlling shareholders. *See generally* Luca Enriques et al., *Related-Party Transactions*, *in* THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 153 (John Armour et al. eds., 3d ed. 2017). Nevertheless, I shall assume that many jurisdictions rely on independent directors in order to deal with transactions that are influenced by controlling shareholders. Moreover, like Bebchuk and Hamdani, I shall focus only on the role of independent directors without considering (i) when other tools (namely, a majority-of-the-minority vote) should be used in conjunction with or instead of enhanced-independence directors; (ii) how to define self-dealing and

In the U.S.—where, contrary to conventional wisdom, a considerable proportion of listed companies are controlled by a dominant shareholder[37]—stock exchange listing standards[38] set a somewhat lax federal framework for independent directors at controlled companies.[39] In contrast to the position for companies with dispersed ownership, controlled companies are not required to appoint a majority of independent directors, are exempted from the independent compensation and nomination committee requirements, and remain subject only to the independent audit committee requirements.[40] Moreover, the various sets of corporate governance principles by both the corporate community and institutional investors promoted in 2016 fail to consider the role of independent directors in tunneling and related-party transactions.[41] On the other hand, state corporate law encourages controlled companies to assign independent directors a significant role in vetting transactions influenced by controlling shareholders.[42] In particular, Delaware law requires evidence of the active involvement of an effective special negotiation committee comprised solely of independent directors in transactions involving controlling shareholders to alleviate the burden on the defendant company of proving that the transaction was entirely fair,[43] or to provide business judgment rule protection.[44]

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other cases of controller conflicts; and (iii) when a company should be deemed to be controlled. *See* Bebchuk & Hamdani, *Independent*, *supra* note 19, at 1276 n. 8.

37. For an overview of statistics see Bebchuk & Hamdani, *Independent*, *supra* note 19, at 1279; Deborah A. DeMott, *Guests at the Table: Independent Directors in Family-Influenced Public Companies*, 33 J. CORP. L. 819, 821 (2008). For a summary of the ownership patterns that are characteristic of listed companies in 42 OECD Countries see OECD FACTBOOK, *supra* note 8, at 11–14 (highlighting the growing dominance of concentrated ownership structures in global equity markets).

38. *See* NYSE, INC., LISTED COMPANY MANUAL, § 303A.00 (2018), http://wallstreet.cch.com/LCM/ [hereinafter NYSE LISTED COMPANY MANUAL]; NASDAQ, STOCK MKT. INC., LISTING RULES, R. 5615(c) (2018), http://nasdaq.cchwallstreet.com [hereinafter NASDAQ LISTING RULES]. *See also* Fogel & Geier, *supra* note 4, at 42 (describing support and opposition for the NYSE listing standards); Yaron Nili, *The New Insiders: Rethinking Independent Directors' Tenure*, 68 HASTINGS L.J. 97, 108 (2016) (explaining the impact of the NYSE listing standards on board composition and responsibilities).

39. The Sarbanes-Oxley Act of 2002 (SOX) does not include specific provisions concerning controlled companies and only deals with the independence of the audit committee members stating that "[i]n order to be considered to be independent for purposes of this paragraph, a member of an audit committee of an issuer may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee—(i) accept any consulting, advisory, or other compensatory fee from the issuer; or (ii) be an affiliated person of the issuer or any subsidiary thereof." 15 U.S.C.A. § 78j-l(m)(3)(B) (West Supp. 2003). On the interplay between SOX and stock exchange listing standards see Bainbridge, *supra* note 12, at 311–12.

40. Bebchuk & Hamdani, *Independent*, *supra* note 19, at 1281.

41. *See* COMMONSENSE PRINCIPLES OF CORPORATE GOVERNANCE (2016), http://www.governanceprinciples.org/; *Principles of Corporate Governance*, BUSINESS ROUNDTABLE, http://businessroundtable.org/corporate-governance (last visited Sept. 25, 2018); *Corporate Governance Principles For US Listed Companies*, INVESTOR STEWARDSHIP GROUP, https://www.isgframework.org/corporate-governance-principles/ (last visited Sept. 25, 2018).

42. *See* Bebchuk & Hamdani, *Independent*, *supra* note 19, at 1282 (providing a special negotiation committee as an example).

43. *See, e.g.*, Weinberger v. UOP, Inc., 457 A.2d 701, 709 (Del. 1983); Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1116–21 (Del. 1994). *See also* Guhan Subramanian, *Fixing Freezeouts*, 115 YALE L. J. 2, 13–15 (2005) (analyzing the rulings in *Weinberger* and *Kahn*).

44. The Delaware Supreme Court has held that freezeout mergers should be reviewed under the more lax business judgment standard when the defendants show that the transaction was both (i) negotiated by an adequately empowered special committee of independent directors and (ii) approved by the majority of the minority shareholders. Kahn v. M&F Worldwide Corp., 88 A.3d 635, 642–44 (Del. 2014); *In re* Martha Stewart Living Omnimedia, Inc. S'holder Litig., No. CV 11202-VCS, 2017 WL3568089 (Del. Ch. Aug. 18, 2017)

Given that scrutiny of tunneling and related-party transactions is regarded as an essential function of independent directors in controlled companies, many legal systems characterized by a high degree of ownership concentration require independent directors—whether explicitly or implicitly—to perform a monitoring role in this area, though a variety of approaches persist.[45]

In Europe, the Directive 2017/828[46] states that "Member States shall ensure that material transactions with related parties are approved by the general meeting or by the administrative or supervisory body of the company."[47] However, initial commentaries recognized that this rule cannot achieve the effective harmonization of Member States' related-party transactions regime, and found the alternative board approval mechanism to be a weak safeguard, as it neither excludes representatives of the related party from the voting process nor assigns independent directors a pivotal role.[48] Hence, because of the vagueness of the provisions of Directive 2017/828, it is likely that the role of independent directors in vetting related-party transactions will continue to be partially blurred.[49]

The Belgian and Italian regimes represent two notable exceptions as they explicitly require the involvement of independent directors in the decision-making process for related-party transactions. According to Article 524 of the Belgian Companies Code, certain related-party transactions must be reviewed by a committee of three independent directors—assisted by one or more independent experts—before the board can decide on them. The full board is free to pass over the committee's recommendation—although it is required to state the reasons for doing so.[50] Italy follows a similar approach, where Article

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(applying the two-part test). *See also* James D. Cox & Randall S. Thomas, *Delaware's Retreat: Exploring Developing Fissures and Tectonic Shifts in Delaware Corporate Law*, 42 DEL. J. CORP. L. 324, 345–49 (2018); Bernard S. Sharfman, *Kahn v. M&F Worldwide Corporation: A Small but Significant Step Forward in the War against Frivolous Shareholder Lawsuits*, 40 J. CORP. L. 197, 204–09 (2014); Scott V. Simpson & Katherine Brody, *The Evolving Role of Special Committees in M&A Transactions: Seeking Business Judgment Rule Protection in the Context of Controlling Shareholder Transactions and Other Corporate Transactions Involving Conflicts of Interest*, 69 BUS. LAW. 1117, 1127–28 (2014).

45. For a comparative overview of related-party transaction regimes adopted in more than 30 jurisdictions see OECD FACTBOOK, *supra* note 8, at 65–77; Enriques et al., *supra* note 36, at 154; for Israel, Amir Licht, *Be Careful What You Wish For: How Progress Engendered Regression in Related Party Transaction Regulation in Israel* (Eur. Corp. Governance Inst. (ECGI), Law Working Paper No. 382, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3104062; for Asia, Dan W. Puchniak & Kon Sik Kim, *Varieties of Independent Directors in Asia: A Taxonomy*, *in* INDEPENDENT DIRECTORS IN ASIA, *supra* note 1, at 110–14.

46. *See* Directive 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC in regards to the encouragement of long-term shareholder engagement, 2017 O.J. (L 132) 1 [hereinafter SHRD II].

47. *Id.* art. 9c.

48. *See* Andreas Tarde, *Related Party Transactions in the Revised Shareholder Rights Directive*, OXFORD BUS. L. BLOG (Feb. 8, 2017), https://www.law.ox.ac.uk/business-law-blog/blog/2017/02/related-party-transactions-revised-shareholder-rights-directive; Christoph Van der Elst, *Empowering the Audit Committee and the Auditor in Related Party Transactions* 18–19 (Eur. Corp. Governance Inst. (ECGI), Law Working Paper No. 318/2016, 2016), http://www.ecgi.org/wp/wp_id.php?id=788 (suggesting that the independent audit committee can serve as the body that approves the related-party transaction).

49. *See* Ferrarini & Filippelli, *supra* note 34, at 28–29 (recalling that most Member States do not assign a specific role to independent directors in vetting related-party transactions).

50. *See* Koen Geens, *Corporate Boards in Belgium*, *in* CORPORATE BOARDS IN LAW AND PRACTICE, *supra* note 8, at 142–44 (noting that, due to the duty to substantiate publicly its reason for doing so, the board rarely deviates from the opinion of the committee).

8 of the Regulation on Related-Party Transactions issued by the Italian Financial Markets Authority[51] gives independent directors a key role in vetting material related-party transactions.[52] First, a committee comprised entirely of independent directors must be involved in the negotiation phase and receive full and timely information from the executive directors and managers with responsibility for conducting such negotiations. Second, the committee must state its opinion concerning the transaction. However, the committee's opinion cannot be definitively binding on the board. In fact, the procedures adopted by the company according to Article 4 of the Regulation on Related-Party Transactions[53] may allow the board to approve the transaction even if the committee has delivered a negative opinion, provided that a shareholders' meeting is convened and that a majority of unrelated shareholders ratify the transaction.[54]

B. Why Directors' Independence at Controlled Companies Is Different

Different ownership patterns shape not only the role of independent directors but also the definition of independence itself.[55] In fact, as is clearly summarized by Bebchuk and Hamdani:

> In [non-controlled] companies, the principal concern is managerial opportunism, so it is important to ensure directors' independence from the company and its management. Indeed, a director affiliated with a significant outside blockholder may be especially likely to act independently of management, because such a director may have stronger incentives to enhance share value by monitoring management effectively and constraining insider opportunism. In contrast, the principal concern in [controlled] companies is controller opportunism, so assessment of their governance should focus on director independence from the controller. Ties between directors and the controller (or entities affiliated with it) may make the directors less effective in limiting controller opportunism.[56]

Consequently, it is impossible to define a universal definition of independence.[57] The

51. Commissione nazionale per le società e la borsa (Consob), Resolution no. 17221 (Mar. 12, 2010), http://www.consob.it/web/consob-and-its-activities/laws-and-regulations [hereinafter Consob Resolution no. 17221] (regulations containing provisions relating to transactions with related parties). *See generally* Marcello Bianchi et al., *Regulation and Self-Regulation of Related Party Transactions in Italy: An Empirical Analysis* (Eur. Corp. Governance Inst. (ECGI), Finance Working Paper No. 415/2014, 2014), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2383237; Guido Ferrarini et al., *Corporate Boards in Italy*, *in* CORPORATE BOARDS IN LAW AND PRACTICE, *supra* note 8, at 400.

52. For non-material transactions, a simplified procedure is laid down by Consob Resolution no. 17221, according to which the committee must include a majority of independent directors. *See* Consob Resolution no. 17221, *supra* note 51, at art. 7 (discussing "[p]rocedures for transactions of lesser importance in companies adopting traditional or single-tier management and control systems").

53. *See id.* art. 4 ("The boards of directors or management board of the company shall adopt, as specified in this regulation, the necessary procedures to ensure transparency and substantial and procedural fairness of related party transactions.").

54. *Id.* arts. 8(3), 11(3).

55. *See* Ringe, *supra* note 10, at 414.

56. Bebchuk & Hamdani, *The Elusive Quest*, *supra* note 28, at 68–76. *See also* Gordon, *supra* note 14, at 15; Puchniak & Kim, *supra* note 45, at 102–10.

57. *See* Gordon, *supra* note 14, at 17 (noting that "[a]doption of a transplant, particularly under pressure of foreign investors or global governance institutions, does not determine how the new institution will function. That emerges over time, as the transplant is contextualized within the local ecology, and can lead to significant

independent director regime, designed to address agency problems arising from managerial opportunism cannot be adapted to companies with concentrated ownership since a director who is independent from management but has ties with a controlling shareholder will lack the incentive to monitor tunneling and conflicted transactions in the interest of public investors.[58]

Ownership structure also influences the composition of the board as a whole, specifically the number of independent directors. As the OECD's comparative survey shows, jurisdictions that link board independence requirements or recommendations with the ownership structure generally require that only a minority of the board must be independent.[59] Unsurprisingly, this regulatory trend is consistent with the theoretical assumption that controlling shareholders are incentivized to monitor management and should have the right to set the firm's future direction and make all management decisions.[60]

C. Definition of Directors' Independence at Controlled Companies

Local approaches to defining independence vary considerably with regard to independence from controlling—and significant—shareholders. However, a comparative analysis shows that independence from controlling shareholders is also required—though in disparate ways—in countries where the ownership of listed companies is mostly dispersed.[61]

1. Dispersed Ownership Countries

In the U.S. and the U.K., listed companies are characterized by a similar pattern of ownership presenting a prevalence of dispersed ownership, albeit there is a not insignificant number of controlled companies.[62]

In the U.S., both the SOX and exchange listing standards do not extensively regulate directors' independence from controlling shareholders. Section 301 of the SOX only states that a member of the audit committee cannot be qualified as independent when they are

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divergence in practice.").

58. *See, e.g.*, Bebchuk & Hamdani, *Independent*, *supra* note 19, at 1289 (noting several instances where social ties caused courts to determine that a director was not completely independent).

59. OECD FACTBOOK, *supra* note 8, at 95–97. In Italy, a stricter requirement for a majority of independent directors is imposed for listed subsidiary companies that are subject to management and coordination—and not merely control—by other companies whose shares, in turn, are listed on regulated markets. *See* Commissione nazionale per le società e la borsa (Consob), Resolution no. 20249 of December 28, 2017, art. 16 (regulation laying down implementation rules of Legislative Decree no. 58 of February 24, 1998 on markets).

60. *See* Goshen & Hamdani, *supra* note 31, at 600–01 (stressing that "the need to balance controller rights and minority protection should also shape board reforms at firms with controlling shareholders"). *See also* NASDAQ LISTING RULES, *supra* note 38, at R. 5615(c) (stating that the controlled companies' exemption from the obligation to appoint a majority of independent directors "recognizes that majority Shareholders, including parent companies, have the right to select directors and control certain key decisions, such as executive officer compensation, by virtue of their ownership rights").

61. *See generally* OECD FACTBOOK, *supra* note 8, at 97 (surveying the board independence requirements of some nations relative to their ownership status).

62. *See* DeMott, *supra* note 37 (noting that "[p]ublic companies that are either controlled by individual founders or members of the founder's family or, more loosely, influenced by them . . . are often said to account for about one third of the Fortune 500"). *See also* María Gutiérrez & Maribel Sáez Lacave, *Strong Shareholders, Weak Outside Investors*, 18 J. CORP. L. STUD. 280 (2018).

"an affiliated person of the issuer or any subsidiary thereof."[63] Rule 10A-3 of the Securities Exchange Act of 1934 specifies that the "term affiliate of, or a person affiliated with, a specified person, means a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified," and that a person will be deemed not to be in control of a specified person for purposes of this section if the person "[i]s not the beneficial owner, directly or indirectly, of more than 10% of any class of voting equity securities."[64] Therefore, while excluding that controlling shareholders and shareholders holding more than 10% of the voting shares must be considered independent, Section 301 of the SOX does not take financial and family ties between directors and controlling shareholders into account.

A different approach characterizes U.S. exchange rules. NYSE and NASDAQ listing standards provide a list of certain relationships precluding independence which, though modelled mostly on companies with dispersed ownership, do consider the incidence of relationships between controlling shareholders and directors.[65] NYSE listing standards state 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," and clarify that "references to 'listed company' would include any parent or subsidiary in a consolidated group with the listed company."[66] Along the same lines, NASDAQ listing standards provide that only "a person other than an Executive Officer or employee of the Company or any other individual having a relationship which, in the opinion of the Company's board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director"[67] can qualify as an independent director, and further explain that "reference to the 'Company' includes any parent or subsidiary of the Company."[68]

Adopting a different approach, the definition of independence provided by the U.K. Corporate Governance Code explicitly includes relationships with significant shareholders among the circumstances the board is required to weigh when assessing non-executive directors' independence.[69] More specifically, according to the Code, independence can be excluded when a director "has been an employee of the company or group within the last five years," or "represents a significant shareholder."[70] In conclusion, regardless of the

63. Sarbanes-Oxley Act of 2002 § 301, 15 U.S.C. § 78j–l(m)(3)(B) (2010).

64. 17 C.F.R. § 240.10A–-3(e)(1) (2008). *See also* Donald C. Clarke, *Three Concepts of the Independent Director*, 32 DEL. J. CORP. L. 73, 86 (2007) (explaining the statute).

65. *See Requirements for Public Company Boards: Including IPO Transition Rules*, WEIL, GOTSHAL & MANGES LLP: GOVERNANCE & SECS. WATCH (Nov. 17, 2016), https://governance.weil.com/whats-new/requirements-for-public-company-boards-including-ipo-transition-rules/ (displaying the sources of regulations).

66. NYSE LISTED COMPANY MANUAL, *supra* note 38, section 303A.02

67. NASDAQ LISTING RULES, *supra* note 38, R. 5605(a)(2).

68. NASDAQ LISTING RULES, *supra* note 38, IM-5605.

69. FIN. REPORTING COUNCIL, UK CORPORATE GOVERNANCE CODE § E (2016), https://www.frc.org.uk/directors/corporate-governance-and-stewardship/uk-corporate-governance-code (click link on "The UK Corporate Governance Code 2016) [hereinafter UK CORPORATE GOVERNANCE CODE 2016]. In July 2018, a new version of the UK Corporate Governance Code was adopted which will take effect on January 1, 2019. *See* FIN. REPORTING COUNCIL, UK CORPORATE GOVERNANCE CODE § 2 (2018), https://www.frc.org.uk/directors/corporate-governance-and-stewardship/uk-corporate-governance-code (click on link to "2018 version"). As directors' independence related provisions are unchanged, reference is made in this Article to the 2016 version of the Code currently in force.

70. UK CORPORATE GOVERNANCE CODE 2016, *supra* note 69, section B.1.1. *See also* Paul Davies,

prevalence of dispersed ownership among listed companies, both in the U.S. and the U.K. corporate governance rules and principles include links with significant and controlling shareholders among the factors that can negatively affect or preclude directors' independence.

2. Concentrated Ownership Countries

The predominantly concentrated ownership structure of European listed companies largely influences the regulation of directors' independence in continental Europe. At the E.U. level, the Commission's non-binding Recommendation on the role of non-executive or supervisory directors provides a definition of independence: the recommendation seeks to provide a common understanding of what independence precisely entails and to promote a harmonized regulation of directors' independence at the E.U. level. According to the recommendation, "[a] director should be considered to be independent only if he is free of any business, family or other relationship, with the company, its controlling shareholder or the management of either, that creates a conflict of interest such as to impair his judgement."[71] Moreover, Annex II of the recommendation includes relationships with controlling or relevant shareholders among the circumstances that should be considered when assessing the independence of directors.[72]

Within continental European jurisdictions, the definition of directors' independence is generally set out by corporate governance codes adopted at the national level—which are applicable on the basis of the "comply or explain" approach.[73] Hence, also due to the considerable leeway granted by the Commission's recommendation, a uniform notion of independence is lacking.[74] In particular, while business and personal ties with the corporation and its managers are considered as impediments on independence in all E.U. jurisdictions, differences persist about independence from the controlling shareholder.[75]

Corporate Boards in the United Kingdom, *in* CORPORATE BOARDS IN LAW AND PRACTICE, *supra* note 8, at 740 (highlighting that "[t]he approach of the CGC to the definition of 'independence' is to put that task in the hands of the board itself, which must state in its annual report which of the non-executive directors it has determined to be independent").

71. Commission Recommendation on the role of non-executive directors, *supra* note 6, ¶ 13.1.

72. *Id.* Annex II.1d (stating that an independent director must "not . . . be or . . . represent in any way the controlling shareholder").

73. *See* Armour et al., *supra* note 35, at 31–39; Davies & Hopt, *supra* note 35, at 318 ("The issue of independence is normally treated in corporate governance codes and is a matter of 'comply or explain' recommendations, though there are some mandatory (if minimal) requirements, such as the E.U. requirement that at least one member of the audit committee be independent."). For a comparative overview of governance codes adopted in 10 European countries see AUTORITÉ DES MARCHÉS FINANCIERS (AMF), COMPARATIVE STUDY: CORPORATE GOVERNANCE CODES IN 10 EUROPEAN COUNTRIES (2016), http://www.amf-france.org/en_US/Publications/Rapports-etudes-et-analyses/Gouvernement-d-entreprise (click on the "Comparative Study" link and download the report) [hereinafter AMF COMPARATIVE STUDY].

74. *See* AMF COMPARATIVE STUDY, *supra* note 73, at 31–32 (noting that "[t]he definition of independence varies significantly among the different European countries. While many codes rely on the independence criteria defined in Annex II of the European Commission's recommendation, authors of the codes have also taken specific local characteristics into account and have added and/or removed certain criteria").

75. *See* Davies & Hopt, *supra* note 35, at 320. Interestingly, in some E.U. jurisdictions the absence of business and personal relationships with significant shareholders is required only for some independent directors. In Sweden, for instance, at least two members must also be independent of the company's major shareholders, which means that it is possible for major shareholders—defined as those controlling ten per cent or more of the shares or votes in the company—of Swedish companies to appoint a majority of members with whom they have

In the Netherlands, the Corporate Governance Code provides that any director with a shareholding in the company of 10% or more will not be regarded as independent, but does not consider any personal and business links with controlling shareholders.[76] According to the German Corporate Governance Code, a supervisory board member is considered non-independent if he has a personal or business relationship with a controlling shareholder that may cause a substantial, and not merely temporary, conflict of interest.[77] Similarly, the French Corporate Governance Code states that "[d]irectors representing major shareholders of the corporation or its parent company may be considered independent, provided these shareholders do not take part in the control of the corporation."[78] A stricter recommendation—adhering to the principle of substance over form—is provided by the Italian Corporate Governance Code, according to which a director will usually not be considered as independent if they (i) "ha[ve], or had in the preceding fiscal year, directly or indirectly . . . a significant commercial, financial or professional relationship . . . with a subject who, also jointly with others through a shareholders' agreement, controls the issuer, or—in case of a company or an entity—with the relevant significant representatives"; (ii) "is, or has been in the preceding three fiscal years, an employee of the above-mentioned subjects. . . ."[79]

Ties with controlling shareholders can lead to the conclusion that a director is not

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close ties. SWEDISH CORP. GOVERNANCE BD., THE SWEDISH CORPORATE GOVERNANCE CODE ⁋ III.4.5. (2016), http://www.corporategovernanceboard.se/the-code [hereinafter SWEDISH CORPORATE GOVERNANCE CODE]. *See also* Ferrarini & Filippelli, *supra* note 34, at 16 (pointing out that the same recommendation is provided by the Finnish and Norwegian codes).

76. CORP. GOVERNANCE CODE MONITORING COMM., DUTCH CORPORATE GOVERNANCE CODE ⁋ 2.1.8 (2016), https://www.mccg.nl/download/?id=3364. Similar criteria are accepted also in Denmark, where according to the applicable corporate governance principles code "[t]he fact that a member of the board of directors was elected by votes of the controlling shareholder does not in itself influence the assessment of that member's independence. Other factors determine the question of independence, including whether the person in question is member of the executive management or has close ties to the company's controlling shareholder." However, "If the board of directors determines that several members of the board of directors are associated with shareholders with significant influence, the board of directors should consider whether its composition is sound in relation to independence. It is the opinion of the Committee that an indication of significant influence is when a shareholder holds more than 20% of the voting rights." *See* COMM. ON CORP. GOVERNANCE, DANISH RECOMMENDATIONS ON CORP. GOVERNANCE ⁋ 3.2 (2017), https://corporategovernance.dk/sites/default/files/180927_clean_recommendations_version260918_002.pdf.

77. REGIERUNGSKOMMISSION DEUTSCHER CORPORATE GOVERNANCE KODEX, GERMAN CORPORATE GOVERNANCE CODE ⁋ 5.4.2 (2017), https://www.dcgk.de//files/dcgk/usercontent/en/download/code/170214_Code.pdf [hereinafter GERMAN CORPORATE GOVERNANCE CODE]. *See also* Ringe, *supra* note 10, at 411–12.

78. ASSOCIATION FRANÇAISE DES ENTREPRISES PRIVÉES & MOUVEMENT DES ENTREPRISES DE FRANCE, CODE OF CORPORATE GOVERNANCE FOR LISTED COMPANIES ⁋ 8.7 (2018), http://www.ecgi.global/content/codes (click on the "France" link and "Download") (adding that, nevertheless, "beyond a 10% threshold in capital or voting rights, the Board, upon a report from the nominations committee, should systematically review the qualification of a director as independent in the light of the make-up of the corporation's capital and the existence of a potential conflict of interest").

79. CORP. GOVERNANCE COMM., CORPORATE GOVERNANCE CODE, ART. 3.C.1 (2018), https://www.borsaitaliana.it/comitato-corporate-governance/codice/codiceeng2018.en.pdf. [hereinafter ITALIAN CORPORATE GOVERNANCE CODE]. Although it does not lay down such analytical indications as those contained in the Italian Corporate Governance Code, the Swedish Corporate Governance Code also recommends that "[i]n order to determine a board member's independence and integrity, the extent of the member's direct and indirect relationships with major shareholders is to be taken into consideration." *See* SWEDISH CORPORATE GOVERNANCE CODE, *supra* note 75, ⁋ 4.5.

independent also under the regulations of other non-EU countries generally characterized as having predominantly concentrated ownership structures. For example, the Brazilian Corporate Governance Code recognizes that personal and financial ties with shareholders can compromise directors' independence.[80] In India, Clause 49 of the Listing Agreement provides that a director cannot be qualified as independent when she holds, together with her relatives, 2% or more of the total voting power of the company, or has personal and financial links with controlling shareholders.[81] Along the same lines, the Singapore Corporate Governance Code states that an independent director is one who, among other things, does not hold 10% of the shares and is not an immediate family member of a person holding 10% of the shares in the company; or is not or has not been directly associated with a person holding 10% of the shares in the company during either the current or previous financial year.[82] Independence from relevant shareholders is also acknowledged as an essential element of directors' independence in Russia. However, the Russian Corporate Governance Code only requires that independent directors should be "free from the influence of the company's executive bodies, any individual group of its shareholders or other stakeholders."[83]

III. THE LIMITS TO THE FORMAL APPROACH TO DIRECTORS' INDEPENDENCE

This Part lays the foundations for the following analysis by illustrating the shortcomings of the prevalent approach to directors' independence at controlled companies, which focuses almost exclusively on the absence of financial and family ties between directors and the controlling shareholders. This regulatory trend does not adequately consider the fact that independence also touches upon a director's behavior, and that the absence of any personal, business, and financial links with the company, managers, and—if applicable—controlling shareholders, is only a rough proxy for independence.[84] Therefore, this Part argues that, in order to enhance directors' independence in controlled companies, rules and corporate governance principles should pursue a dual purpose: (i)

80. *See* INTERAGENTS WORKING GROUP, BRAZILIAN CORPORATE GOVERNANCE CODE ⁋ 2.2.1 (2015), http://www.ibri.com.br/Upload/Arquivos/novidades/3877_GT_Interagentes_Brazilian_Corporate_Governance_Code_Listed_Companies.pdf.

81. SEC. AND EXCH. BD. OF INDIA, LISTING AGREEMENT cl. 49 (2014), https://www.nseindia.com/content/equities/SEBI_circ_15092014.pdf. *See also* Umakanth Varottil, *Evolution and Effectiveness of Independent Directors in Indian Corporate Governance*, 6 HASTINGS BUS. L.J. 281, 312–314 (2010).

82. MONETARY AUTH. OF SING., CODE OF CORPORATE GOVERNANCE art. 2.3 (2012), http://www.ecgi.global/code/code-corporate-governance-5 (follow "Download" hyperlink). *See also* Dan W. Puchniak & Luh Luh Lan, *Independent Directors in Singapore: Puzzling Compliance Requiring Explanation*, 65 AM. J. COMP. L. 265, 321–24 (2017).

83. *See* ORG. FOR ECON. CO-OPERATION & DEV. RUSSIA CORP. GOVERNANCE ROUNDTABLE, RUSSIAN CODE OF CORPORATE GOVERNANCE ⁋ 2.4.1 (2014), http://www.ecgi.global/code/russian-code-corporate-governance-2014 (follow "Download" hyperlink). However, stricter criteria are set out in the listing rules of the Moscow Exchange according to which a person shall be regarded as an affiliate of the issuer, among other things, if she "provide[s] consulting services to the person that controls the issuer or to the legal entities controlled by the issuer, or are members of the governance body and/or the executive bodies of the entities that provide such services to the issuer or the above-mentioned legal entities, or employees of such entities directly engaged in the provision of such services." *See* MOSCOW EXCH., LISTING RULES OF PUBLIC JOINT-STOCK COMPANY "MOSCOW EXCHANGE MICEX-RTS" Annex 4 (2017), https://www.moex.com/s575 (follow "Listing Rules of Public Joint-Stock Company 'Moscow Exchange MICEX-RTS').

84. *See* Langevoort, *supra* note 25, at 798.

limiting the influence of the controlling shareholder on independent directors, by making them more accountable to public shareholders, and (ii) providing incentives for directors to exercise unbiased oversight over transactions involving controlling shareholders and related-parties.

A. The Basic Distinction Between Independence in Appearance and Independence in Mind

As Professor Langevoort correctly notes, under the formal definition of independence, which focuses on the absence of financial and family ties that threaten independence, "many directors who lack any real desire to take their monitoring role seriously . . . fall into the 'independent' category."[85] This statement effectively explains why reliance on formal independence is unsatisfactory by shedding light on the fact that independence is—first of all—a personal attribute of a director, and can be broken down into two components—"freedom from external influence and the capacity for self-rule."[86] Hence, formal independence, consisting of the absence of any links between the director and threatening parties, signals independence toward third parties, but does not ensure that the director's conduct is truly independent.[87]

Based on this fundamental assumption, the regulations governing independence in the area of audit services draw a fine distinction between the notions of independence in mind and independence in appearance to arrive at a more analytically rigorous understanding of what independence actually means. According to the Handbook of the Code of Ethics for Professional Accountants drafted by the International Ethics Standards Board for Accountants (IESBA),[88] independence in mind consists of "[t]he state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional skepticism."[89] On the other hand, independence in appearance—also called formal independence—is defined as "[t]he avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, would reasonably conclude a firm's, or a member of the assurance team's, integrity, objectivity or professional skepticism had been compromised."[90]

Although this distinction has been thoroughly developed and codified in the area of auditors' independence, it surely applies to independent directors. For example, the OECD

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85. *Id.* at 799 (quoting Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village*, 95 HARV. L. REV. 597, 598–99 (1982)).

86. *See* Le Mire & Gilligan, *supra* note 11, at 450 (explaining that formal independence does not guarantee true independence).

87. *Id.* at 451.

88. The IESBA is an independent standard setting body established by the International Federation of Accountants (IFAC). It aims to develop and issue, in the public interest, high-quality ethical standards and other pronouncements for professional accountants worldwide. For more information, see *About IESBA*, IFAC, https://www.ethicsboard.org/about-iesba (last visited Aug. 30, 2018).

89. INT'L ETHICS STANDARDS BD. FOR ACCTS. (IESBA), HANDBOOK OF THE CODE OF ETHICS FOR PROFESSIONAL ACCOUNTANTS 46 (2016), https://www.ethicsboard.org/iesba-code (Click "Download PDF").

90. *Id.* at 46. *See also* AM. INST. OF CERTIFIED PUB. ACCTS., PLAIN ENGLISH GUIDE TO INDEPENDENCE 8 (2017), http://competency.aicpa.org/media_resources/208106-aicpa-plain-english-guide-to-independence/detail; William T. Allen & Arthur Siegel, *Threats and Safeguards in the Determination of Auditor Independence*, 80 WASH. U. L. Q. 519, 526–27 (2002).

Principles of Corporate Governance embrace—albeit not explicitly—this distinction by stating that, to exercise its duties of monitoring managerial performance and preventing conflicts of interest, "it is essential that the board is able to exercise objective judgement. In the first instance this will mean independence and objectivity with respect to management with important implications for the composition and structure of the board."[91] Along the same lines, the U.K. Corporate Governance Code recognizes the dichotomy between independence in mind an formal independence by requiring the board to determine "whether the director is independent in character and judgement and whether there are relationships or circumstances which are likely to affect, or could appear to affect, the director's judgement."[92] Moreover, when assessing the independence of the special committee appointed in the context of management buyouts (MBO) or parent-subsidiary mergers,[93] the Delaware courts have on some occasions scrutinized the conduct of independent directors in the specific case and not solely the absence of relationships between directors and parties with close personal and business ties to them.[94]

Thus, the dichotomy between independence in mind and independence in appearance helps shed further light on directors' independence and lay the conceptual foundations for the following analysis.

First, based on this dichotomy, it becomes clear that independence requirements specified by law, listing standards or corporate governance codes set preconditions for the conduct of directors to be regarded as independent, but are not able to ensure that directors will actually act in a truly independent way. Therefore, independence in mind and independence in appearance are not necessarily related, since a director who does not comply with formal independence requirements may act with integrity and without conditioning, and also vice versa.[95]

For example, in the EU, this conceptual assumption is explicitly embraced by the Guidelines to assess the suitability of members of management bodies within the European financial sector drafted by the European banking and financial sectors' supervisory Authorities.[96] According to the Guidelines, "[a]cting with 'independence of mind' is a pattern of behavior, shown in particular during discussions and decision-making within the management body," and is required for each member of the board—and not only for directors formally classified as independent.[97] Conversely, "being independent" means that, in her supervisory function, a director "does not have any present or recent past relationships or links of any nature" with the company or its management that could influence the member's objective and balanced judgment and reduce her ability to take decisions independently.[98]

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91. G20/OECD PRINCIPLES, *supra* note 10, at 50.

92. U.K. CORPORATE GOVERNANCE CODE 2016, *supra* note 69, section B.1.1.

93. *See supra* notes 43–44 (discussing the independence special committees).

94. *See infra* Part III.B (explaining Delaware court's approach to conduct of independent directors).

95. *See* Langevoort, *supra* note 25, at 799 (explaining distinctions of the term independence). *See also* Le Mire & Gilligan, *supra* note 11, at 467 (explaining what formal independence and independence of mind mean).

96. *See* EUR. SEC. AND MKT. AUTHORITY & EUR. BANKING AUTHORITY, GUIDELINES ON THE ASSESSMENT OF THE SUITABILITY OF MEMBERS OF THE MANAGEMENT BODY AND KEY FUNCTION HOLDERS UNDER DIRECTIVE 2013/36/EU AND DIRECTIVE 2014/65/EU 37–41 (2017), https://www.eba.europa.eu/-/eba-and-esma-provide-guidance-to-assess-the-suitability-of-management-body-members-and-key-function-holders [hereinafter ESMA & EBA GUIDELINES].

97. *Id.* at 37.

98. *Id.*

Second, the basic distinction between independence in mind and independence in appearance also makes it clear that the requirements set forth in rules, listing standards, or corporate governance codes deal mainly with independence in appearance. Independence standards convey a message about the composition of the board, since their demonstrable nature "provides a badge of independence that indicates the status of the director to both internal and external audiences."[99]

Therefore, in some way, independence standards can also serve the function of incentivizing independence in mind, as they can prevent personal and financial relationships threatening directors' capacity to act independently and with objectivity. Despite this recognition, however, the definitions of—formal—independence provided by rules and standards around the world remain structurally incapable of covering the broad range of factors and circumstances that can affect directors' independence in mind, regardless of compliance with formal independence requirements. In fact, as Professor Brudney noted more than 35 years ago, "[n]o definition of independence yet offered precludes an independent director from being a social friend of, or a member of the same clubs, associations, or charitable efforts as, the persons whose compensation or self-dealing transaction he is asked to assess."[100] What is more, no definition of independence can ever prevent the risk that directors' conduct may be conditioned by inter-group dynamics or structural biases—such as groupthink or self-interest—affecting any board member, irrespective of whether or not qualified as independent.[101]

B. The Need for Incentives Designed to Nudge (Truly) Independent Conduct by Directors

As a multi-country analysis easily shows, the dichotomy between independence in mind and independence in appearance has considerable consequences with regards to the regulation and the enforcement of directors' independence.

First, this distinction shapes the regulatory approach to directors' independence. As far as independence in appearance is concerned, although it is impossible to list comprehensively all of the threats to directors' independence, with the result that nuanced solutions are therefore necessary,[102] legislators, regulators and corporate governance codes are able to set objective and observable independence criteria by providing a list of personal and financial ties and circumstances in the presence of which a director cannot be qualified as independent.[103] By contrast, independence in mind is a pattern of behavior and, consequently, can only be regulated by providing abstract and general descriptions of the conduct that is expected of a director.

Because of the difficulty in designing a workable notion of independence in mind, certain corporate governance codes seek to define it, although these have no significant practical implications. For example, both the UK and Italian corporate governance codes require directors to be independent in character and judgment, although only associate

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99. *See* Le Mire & Gilligan, *supra* note 11, at 453.

100. Brudney, *supra* note 85, at 613. *See also Developments in the Law—Corporations and Society*, 117 HARV. L. REV. 2169, 2198–99 (2004).

101. *See generally* Khurana & Pick, *supra* note 26, at 1273–76; Le Mire & Gilligan, *supra* note 11, at 472–74; Antony Page, *Unconscious Bias and the Limits of Director Independence*, 2009 U. ILL. L. REV. 237, 248–62; Frederick Tung, *The Puzzle of Independent Directors: New Learning*, 91 B.U. L. REV. 1175, 1178–83 (2011).

102. *See supra* note 100 and accompanying text. *See also* Ringe, *supra* note 10, at 410–11.

103. As noted above, this approach characterizes all jurisdictions regardless of ownership patterns and any divergences between the legal frameworks for independence adopted at national level.

independence with the absence of relationships or circumstances that are likely to affect—or could appear to affect—the director's judgment.[104]

There is, however, a notable exception, specifically the ESMA and EBA joint guidelines, which provide a list of the factors that must be considered when assessing directors' independence in mind. Amongst the required behavioral skills, the ESMA and EBA include "(i) courage, conviction and strength to effectively assess and challenge the proposed decisions of other members of the management body; (ii) being able to ask questions to the members of the management body in its management function; and (iii) being able to resist 'group-think.'"[105] Furthermore, as mentioned above, the Delaware courts accept a similar definition of independence of mind, holding for instance that "[i]t is the care, attention and sense of individual responsibility to the performance of one's duties, not the method of election, that generally touches on independence,"[106] and examining, among other things, "whether the director's decision is based on the corporate merits of the subject before the board, rather than extraneous considerations or influences."[107]

Second, the dichotomy between independence in mind and independence in appearance influences the enforcement of independence requirements. While formal independence is designed by building on observable criteria, usually coinciding with the absence of certain relationships and circumstances that preclude independence—with some leeway[108]—independence in mind touches upon a director's behavior, and its assessment is necessarily more discretional and can only be conducted ex post.

Thus, the issue of independence in mind has to be treated as "an ad-hoc factual issue,"[109] which the ESMA and EBA joint guidelines recognize, stating that, when assessing the required behavioral skills of a board member, "his or her past and ongoing behavior, in particular within the institution, should be taken into account."[110] Similarly, the Delaware courts adopt a substance over form-based approach that considers a director's behaviour to be an indicator of independence, and looks not merely at the lack of family or financial relationships but at a wider mix of factors.[111] Therefore, it is clear that

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104. *See* U.K. CORP. GOVERNANCE CODE 2016, *supra* note 69, at section B.1.1. (requiring the board to determine "whether the director is independent in character and judgement"); ITALIAN CORP. GOVERNANCE CODE, *supra* note 79, ART. 3, CMT. (stating that "[i]ndependence of judgement is required of all directors, executive and nonexecutive alike: directors who are conscious of the duties and rights associated with their position always bring independent judgement to their work").

105. ESMA & EBA GUIDELINES, *supra* note 96, at 38.

106. Aronson v. Lewis, 473 A.2d 805, 816 (Del. 1984). *See also* Kahn v. Tremont Corp., 694 A.2d 422, 430 (Del. 1997).

107. Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1049 (Del. 2004).

108. For example, the German Corporate Governance Code states that "a personal or business relationship with the corporation, its governing bodies, a controlling shareholder or a company affiliated with the controlling shareholder" is deemed to impair supervisory board members' independence only if "it may cause a substantial and not merely temporary conflict of interest." *See* GERMAN CORPORATE GOVERNANCE CODE, *supra* note 77, ¶ 5.4.2.

109. Yaron Nili, *Out of Sight, Out of Mind: The Case for Improving Director Independence Disclosure*, 43 J. CORP. L. 35, 47 (2017) (referring to the Delaware law).

110. ESMA & EBA GUIDELINES, *supra* note 96, at 38.

111. *See* Usha Rodrigues, *The Fetishization of Independence*, 33 J. CORP. L. 447, 465–66 (2008) (noting that "Delaware courts broaden the inquiry into more amorphous ties that can generate a sense of 'beholdenness.' Common membership in a university, charitable giving, and friendships can all factor into the equation."). *See also* George W. Dent, Jr., *Independence of Directors in Delaware Corporate Law*, 54 U. LOUISVILLE L. REV. 73,

independence in mind presents a "situational" or "contextual" character and cannot be solely determined *ex ante* by looking at observable circumstances, such as the absence of personal or financial ties.[112] Consequently, the courts and regulators determine director independence (of mind), on an ad hoc basis with reference to the circumstances, "only through litigation, most often after the fact, when the damage is already done."[113]

Against this conceptual background, it is indisputable that, to presume "that mere outsider status—defined by lack of ties to the corporation—makes a director an ideal fit for any board, is to fetishize a mere proxy for the good agent,"[114] and that a more nuanced and incentive-based regulatory strategy is necessary to promote the independence of mind of—formally—independent directors.

As far as controlled companies are concerned, preventing any personal, financial, and business relationships between directors and controlling shareholders is not sufficient to limit the risk that the influence of controlling shareholders, and intra-board dynamics might impair the objectivity of independent directors. Taking into account these potential shortcomings, Bebchuk and Hamdani have developed an effective framework by pointing out that controlled companies "should have some directors who (i) lack the incentives produced by the controller's decisive influence over the directors' appointment and retention and (ii) have some incentives that flow from making the directors accountable to public investors," and that "[a] regime of such *enhanced-independence* directors requires measures that will limit controllers' power over the appointment of these directors while providing public investors with some degree of influence over this appointment."[115]

Although appointment and retention regimes are a key factor in effectively turning some of the independent directors into enhanced-independence directors, it seems that the Bebchuk and Hamdani framework can be further extended. First, the effectiveness of the enhanced-independence directors as a monitoring tool largely depends on the presence of minority shareholders—generally meaning institutional investors—that are willing to support their election as well as on the investment style and objectives of these investors. Second, as Professor Enriques notes, even when a director is nominated and appointed with the involvement of minority shareholders "substantial independence is not guaranteed, as that is mainly a function of an individual's assertiveness, ability not to succumb to boardroom biases, and reputational and career concerns."[116] Therefore, given inter-group dynamics and structural biases affecting board members—irrespective of company's ownership structure—enhanced-independence directors should be provided with incentives that aim to promote truly independent conduct, especially in vetting self-dealing transactions by controlling shareholders.[117]

108–09 (2016) (discussing Delaware courts' views on independence).

112. *See* Rodrigues, *supra* note 111, at 466 (discussing independence views in Delaware court).

113. *See* Nili, *supra* note 109, at 63 (emphasizing that "[i]f 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").

114. Rodrigues, *supra* note 111, at 463.

115. Bebchuk & Hamdani, *Independent*, *supra* note 19, at 1277 (emphasis in original).

116. Luca Enriques, *Related Party Transactions: Policy Options and Real-World Challenges (With a Critique of the European Commission Proposal)*, 16 EUR. BUS. ORG. L. REV. 1, 18–19 (2014).

117. On the importance of considering the incentives side of independence regulations, see Ronald J. Gilson & Reiner Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 875 (1991) (discussing reasons that independence may not be sufficient). *See also* Ringe, *supra* note 10, at 418 (relating substitutes for independence).

IV. REDUCING CONTROLLING SHAREHOLDERS' INFLUENCE ON INDEPENDENT DIRECTORS

A. Making Independent Directors More Accountable to Minority Shareholders: Independent Directors' Election and Removal Regime

Within controlled companies, where controlling shareholders have the power to appoint and terminate directors, independent directors—as a regulatory tool—suffer from evident limits, since the election and termination system clearly weakens their incentives to protect minority shareholders.[118]

Building on the experience of certain legal regimes that have adopted a similar solution—specifically Italy, the U.K., and Israel—Bebchuk and Hamdani convincingly tackle this problem by suggesting that minority shareholders should have some power over the election and termination of some independent directors—who are defined as enhanced-independence directors. In particular, they argue that minority shareholders should have at least veto rights over the initial appointment, reelection, and termination of enhanced-independence directors.[119] Enhanced-independence directors should be approved by a majority of the votes cast by minority shareholders—i.e. shareholders unaffiliated with the controller—in addition to an ordinary majority of shareholders.[120] Under such a veto-right regime, minority shareholders cannot appoint enhanced-independence directors or reelect them against the controller's will, but "they can prevent the appointment of an enhanced-independence director who is clearly beholden to the controller or whose reputation suggests that she will not adequately safeguard public investors' interests."[121]

However, Bebchuk and Hamdani contend that such a veto-right could prove inadequate in rendering enhanced-independence directors equally accountable to minority shareholders and controllers, due to informational asymmetry between them, and that "collective action problems might undermine minority shareholders' ability to make effective use of their veto rights."[122] Therefore, they recommend the adoption of alternative regimes that go beyond veto rights. First, public investors could be given the exclusive power to appoint enhanced-independence directors.[123] While such a regime does not

118. *See* Bebchuk & Hamdani, *Independent*, *supra* note 19, at 1290. *See also* Gutiérrez & Sáez Lacave, *supra* note 16, at 85 (noting that "even a model independent director in abstract may try to conform to the interest of whoever has appointed him"); Juan Ma & Tarun Khanna, *Independent Directors' Dissent on Boards: Evidence From Listed Companies in China*, 37 STRATEGIC MGMT. J. 1547, 1549 (2016).

119. Bebchuk & Hamdani, *Independent*, *supra* note 19, at 1296–98.

120. *Id. See also* Bobby V. Reddy, *The Fat Controller: Slimming Down the Excesses of Controlling Shareholders in UK Listed Companies*, OXFORD J. LEGAL STUD. (forthcoming 2018) (manuscript at 21) http://www.law.cam.ac.uk/ssrn (suggesting that "[i]n the presence of a shareholder, or connected shareholders, owning greater than 50 per cent of the voting rights in a listed company, shareholders independent of such controller should be given the unfettered right to approve the appointment or re-election of any director that the board has nominated as an independent non-executive director").

121. Bebchuk & Hamdani, *Independent*, *supra* note 19, at 1296–98 (noting that a veto-right is perhaps most effective in the decision to re-elect an incumbent enhanced-independence director, since minority shareholders can decide how to vote by considering the past performance on the board). *See also* BLACKROCK, PROXY VOTING GUIDELINES FOR U.S. SECURITIES (2018), https://www.blackrock.com/corporate/en-kr/literature/fact-sheet/blk-responsible-investment-guidelines-us.pdf (stressing that BlackRock considers voting against poorly performing directors).

122. Bebchuk & Hamdani, *Independent*, *supra* note 19, at 1299.

123. Under this regime, the subjection of enhanced-independence director election to a majority-of-minority vote is not the only option. Public investors may be allowed to elect directors also by cumulative or slate voting systems. However, as Bebchuk and Hamdani note, cumulative voting is difficult to combine with a regime that

provide enhanced-independence directors "with incentives to favor the controller, whose support is not required for their continued service on the board,"[124] it raises the concern that the minority's exclusive power to appoint some enhanced-independence directors might impair the controller's ability to run the company or lead to the appointment of unfit directors.[125] To counter this concern, Bebchuk and Hamdani recommend an intermediate regime that grants minority shareholders a veto-right over their initial appointment and termination as well as an exclusive power at the reelection stage.[126] According to Bebchuk and Hamdani, under this regime, the controlling shareholder is, on the one hand, able to signal its judgment that these directors are qualified to join the board by supporting the directors' initial election. On the other hand, since the controller has no say on their reelection, enhanced-independence directors "have no significant incentive to accommodate the controller's interests after their initial appointment."[127]

Although the intermediate regime proposed by Bebchuk and Hamdani might be more attractive "for legal systems wishing to pursue a gradual approach to director-election reforms at controlled companies,"[128] it would appear that concerns about the impact of the minority's exclusive power to appoint enhanced-independence directors on the ability of controlling shareholders to run the company should not be overstated. First, as is clearly shown by the Italian system—where non-controlling shareholders are allowed to nominate at least one board member[129]—enhanced-independence directors represent a minority on the board and, consequently, cannot impair the capacity of the controlling shareholders to set the company's strategies.[130] Second, the effectiveness of a potential adversarial role of enhanced-independence directors depends mainly on their function within the board. Therefore, even if enhanced-independence directors had the power to veto self-dealing and other tunneling transactions, they would only be allowed to block value-disrupting tunneling and self-dealing transactions, while the board's majority—appointed by the controlling shareholders—would preserve the power to decide on business transactions not

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assigns special tasks—i.e. vetting self-dealing transactions—to enhanced-independence directors, since it may be difficult to identify directors who have actually been elected by minority shareholders. *See id.* at 1302–04. Moreover, under cumulative voting regimes the ability of minority shareholders to elect at least one director depends also on the number of board members and the possible adoption of a "classified board of directors." *See* Sanjai Bhagat & James A. Brickley, *Cumulative Voting: The Value of Minority Shareholder Voting Rights*, 27 J.L. & ECON. 339, 342–43 (1984). Given these possible drawbacks of cumulative voting, the slate (or list) voting system currently in use in Italy seems to be better. *See* Marco Ventoruzzo, *Empowering Shareholders in Directors' Elections: A Revolution in the Making,* 8 EUR. COMPANY & FIN. L. REV. 105, 135–39 (2011) (explaining why list voting should be preferred over cumulative voting). For an in-depth analysis of the Italian slate voting system, see *infra* Part IV.B.2.

124. Bebchuk & Hamdani, *Independent*, *supra* note 19, at 1300 (highlighting that, by contrast, the veto right regime "provides enhanced-independence directors with incentives to protect public investors, as these directors will depend on public investors' support to be elected").

125. *Id.* at 1299–1302.

126. *Id.*

127. *Id.* at 1301–02 (recognizing, however, that "this intermediate regime leaves controllers with considerable influence over enhanced-independence directors" which "might feel gratitude towards the shareholder who appointed them").

128. *Id.* at 1302.

129. *See infra* Part IV.B.2.

130. *See* Bebchuk & Hamdani, *Independent*, *supra* note 19, at 1312 (arguing that "policymakers should ensure that enhanced-independence directors remain a minority of board members").

involving a conflict of interest.[131]

Irrespective of whether shareholders are granted a veto right or an exclusive right over the appointment of enhanced-independence directors, the importance in setting out an election regime for directors at controlled companies that aims to make some directors more accountable to minority shareholders seems to be confirmed by empirical evidence concerning the Italian regime. As a recent study shows, this election regime has a significant impact on directors' dissent in the boardroom, since minority-appointed directors are more likely to dissent than directors appointed by the controlling shareholders.[132] Although dissent is only a rough proxy for independence of mind, and, admittedly, the greater inclination of minority-appointed directors to dissent can raise concerns about the board's cohesiveness, this evidence supports the belief that directors appointed by different shareholder groups can have different priorities even if, once appointed, all directors owe fiduciary duties toward the corporation as a whole and all of its shareholders, and are therefore not the agents of the particular shareholders who appointed them.[133]

B. Who Should Appoint Enhanced-Independence Directors? The Rise of Passive Investing and the Propulsive Role of Activist Hedge Funds

Bebchuk and Hamdani also take potential objections to their proposals into consideration.[134] First, they dismiss the possibility that providing minority shareholders with a say in the appointment of enhanced-independence directors might result in a loss of board cohesiveness.[135] Minority-appointed directors could help overcome the reluctance of individual directors to challenge group consensus, and "board cohesiveness may not be desirable when a genuine conflict arises between controllers and public investors."[136] Second, given the prominent role performed by shareholder activists, institutional investors and proxy advisory firms in the financial markets, Bebchuk and Hamdani discount the risk that minority shareholders—especially activists and institutional investors—might remain passive and fail to effectively use their power to elect directors.[137] Moreover, even when public investors remain passive, the prospect that they might decide to use their election rights when controllers divert value on a large scale—or when an activist shareholder emerges—is likely to have some deterrent effect on controlling shareholders.[138] Third, Bebchuk and Hamdani find the objection that minority shareholders— meaning mainly institutional investors and hedge funds holding relatively large blocks of shares—might opportunistically exploit their influence over the election of directors to blackmail the controller and thereby extract private benefits to be unfounded.[139] In fact, such a strategy

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131. *Id.*

132. Piergaetano Marchetti et al., *Dissenting Directors*, 18 EUR. BUS. ORG. L. REV. 659, 682 (2017).

133. *Id.* at 693.

134. *See* Bebchuk & Hamdani, *Independent*, *supra* note 19, at 1311–14 (addressing potential critiques of their proposals).

135. *Id.* at 1312–13.

136. *Id.*

137. *Id. See also* Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911, 1947–48 (1996).

138. *See* Bebchuk & Hamdani, *Independent*, *supra* note 19, at 1313. *See also* Kobi Kastiel, *Against All Odds: Hedge Fund Activism in Controlled Companies*, 2016 COLUM. BUS. L. REV. 60, 90–91 (2016).

139. *See* Bebchuk & Hamdani, *Independent*, *supra* note 19, at 1313–14 (hypothesizing that shareholder

would harm not only the controller but also the company and, consequently, minority shareholders themselves. Thus, an opportunistic minority blockholder is unlikely to secure the public investor votes required to appoint its candidate. In addition, they note that the common requirement of approval by a majority of minority shareholders for self-dealing transactions "already provide an opportunistic minority blockholder with at least the same power to extract private benefits."[140]

Although most of these arguments are convincing, an additional point must be made in regards to the impact of public investors' passivity, which may significantly impair the effectiveness of the Bebchuk and Hamdani proposal. In fact, especially when minority shareholders are allowed to appoint some independent directors,[141] it seems that collective action problems that might disincline minority shareholders to nominate candidates to the board should not be underestimated.[142] As is shown by empirical evidence demonstrating that investment managers have very limited economic incentives to bear stewardship costs, these problems affect not only minimal dispersed shareholders but also institutional investors which, in fact, usually tend to spend few resources toward stewardship.[143] This is especially true for index funds, whose share in the market for managed investments has increased significantly in recent years.[144] Managers of index funds are affected by a structural collective action problem since, as Bebchuk et al. notes, a "move by any given index fund manager to improve stewardship and raise fees would unravel, because its investors would prefer to free-ride on the investment manager's efforts by switching to another investment fund that offers the same indexed portfolio but without stewardship or

"might deliberately nominate people who would threaten to disrupt the board's work to blackmail the controller").

140. *Id.*

141. Admittedly, collective action problems and, more generally, passivity affecting institutional investors should be less relevant when minority shareholders are provided only with a veto rights over the initial appointment, reelection, and termination of enhanced-independence directors, since institutional investors generally vote at shareholder meeting of the investee companies. However, as noted by Bebchuk and Hamdani, such a solution presents some potential drawbacks and collective action problems could exist as well. Bebchuk and Hamdani contend that "[e]valuating a new candidate for an enhanced-independence director position requires information about the candidate's qualifications and past performance on other boards. Public investors suffer from collective action problems, and they may lack incentives to acquire the information needed for evaluating candidates." *Id.* at 1299. Thus, the argument goes, "controllers enjoy a clear informational advantage over public investors" and "[t]his informational asymmetry between controllers and public investors becomes stronger with respect to reelection and termination decisions, as the controlling shareholder has superior access to nonpublic information about the incumbent director's past board performance." *Id.*

142. *Id.* at 1298 (noting that, on one hand, minority apathy is exacerbated when it is clear that no director can be elected against the wishes of the controller—although this risk is absent when a list voting system is adopted—whilst, on the other hand, the right of minority shareholders to nominate candidates would in any case improve their bargaining position vis-a-vis the controller).

143. *See* Lucian A. Bebchuk et al., *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSP. 89, 100–01 (2017) (noting "[f]or example, large investment managers generally avoid submitting shareholder proposals, nominating directors to the boards of corporations, or conducting proxy contests"); Edward Rock, *Institutional Investors in Corporate Governance*, *in* THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE, *supra* note 12, at 372–74; Paul H. Edelman et al., *Shareholder Voting in an Age of Intermediary Capitalism*, 87 S. CAL. L. REV. 1359, 1392–94 (2014).

144. *See generally* Chris Flood, *ETF Market Smashes Through $5tn Barrier After Record Month*, FIN. TIMES (Feb. 10, 2018), https://www.ft.com/content/5cf7237e-0cdc-11e8-839d-41ca06376bf2 ("The surge in January follows four consecutive years of record breaking inflows into ETFs, a tectonic shift that is sending shockwaves across the entire asset management industry.").

higher fees."[145]

By contrast, activist investors—meaning specifically hedge funds—are much more active in the area of directors' elections.[146] Because of their performance-related fee structure, activist hedge fund managers have stronger incentives to invest in stewardship since they are able to capture a significant share of the value increase generated by governance-related campaigns.[147] In addition, for activist hedge funds, activism is "ex ante and strategic."[148] Therefore, as Rock argues, "[a]ctivists first identify a problematic company, then decide whether intervention can improve matters. If activists conclude that an intervention is warranted, they buy a stake in order to intervene."[149]

Furthermore, empirical evidence shows that the impetuous rise of passive institutional investors is associated with more frequent activist campaigns entailing confrontational tactics, which are often aimed at gaining board seats.[150] Moreover, passive investors' concentrated ownership stakes might facilitate proxy fights by activists in that this factor reduces activists' coordination costs and ultimately increases the chances of a favorable outcome.[151] In keeping with additional empirical evidence that activism in controlled companies is not substantially different in nature from activism in widely held companies, and that activist shareholders engage with a not insignificant number of controlled firms by using their ability to elect minority directors,[152] it is conceivable that activist investors

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145. *See* Bebchuk et al., *supra* note 143, at 98 (noting that the rise in institutional investors has led to a number of issues including an increased concentration of equity owenership). *But see* Ian R. Appel et al., *Passive Investors, Not Passive Owners*, 121 J. FIN. ECON. 111, 111 (2016) (finding that "passive mutual funds influence firms' governance choices, resulting in more independent directors, removal of takeover defenses, and smore equal voting rights"). *See* J. Fisch et al., *Passive Investors* 1–2, 10–13 (U. Pa. Inst. for L. & Econ. Res., Paper No. 414, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3192069.

146. *See* Randall S. Thomas & Patrick C. Tricker, *Shareholder Voting in Proxy Contests for Corporate Control, Uncontested Director Elections and Management Proposals: A Review of the Empirical Literature*, 70 OKLA. L. REV. 9, 38–39 (2017) (observing that hedge funds are the most frequent sponsors of proxy contests. During the period 2003–2012, they sponsored 70% of all proxy contests).

147. *See* Bebchuk et al., *supra* note 143, at 104–06; Edelman et al., *supra* note 143, at 1408–10.

148. Rock, *supra* note 143, at 382.

149. *Id.*

150. *See* Ian R. Appel et al., *Standing on the Shoulders of Giants: The Effect of Passive Investors on Activism* 4–6, 18–24 (Nat'l Bureau Econ. Research Working Paper No. 22707, 2016), http://www.nber.org/papers/w22707 [hereinafter Appel et al., *Standing on the Shoulders of Giants*]. However, empirical evidence does not indicate a positive correlation between ownership by passive funds and the likelihood of a firm experiencing hedge fund activism event or a takeover. Indeed, the holding of a larger ownership stake by passive funds has been found to be associated with a decline in hedge fund activism. *See* Appel et al., *supra* note 145, at 114, 128 (observing that these findings are consistent with the engagement of passive investors, reducing the need for activism by other investors, but "do not exclude the possibility that passive investors' ownership stakes increase the threat of activism by others, and that this perceived threat increases the power of passive investors' voice. For example, companies may be responsive to the governance views of passive investors so as to lessen the likelihood that these investors later lend support to an activist campaign initiated by others.").

151. *See* Appel et al., *supra* note 150, at 4 ("When passive ownership is higher, we document a sizeable increase in the likelihood of a proxy settlement with management, which often results in the activist obtaining board representation."). It is also worth noting that the hypothesis mooted in the text is consistent with the evidence showing that passive investors and large mutual funds frequently vote in favor of activist board candidates, and especially when hedge funds seek only minority representation on the board. *See* Ronald J. Gilson & Jeffrey N. Gordon, *Agency Capitalism: Further Implications of Equity Intermediation* 18 (Eur. Corp. Governance Inst. (ECGI), Law Working Paper No. 239/2014, 2014), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2359690; Thomas & Tricker, *supra* note 146, at 43.

152. *See* Kastiel, *supra* note 138, at 80–99.

may play an increasing role in electing—and selecting—minority-appointed enhanced-independence directors.

Leaving aside the general question as to whether activist hedge funds are the "natural champions" of dispersed and diversified shareholders or, by contrast, have interests that differ materially from those of other shareholders since they privilege short-term strategies that can impair the firm value in the long run,[153] a prominent role of activist shareholders in the director election and selection process may impair the effectiveness of the Bebchuk and Hamdani proposal.

A purely activist-driven approach makes this proposal barely adaptable to less activist-friendly jurisdictions.[154] What is more, the central role of activist hedge funds may raise some concerns about the effectiveness of enhanced-independence directors as monitors acting in the interest of all minority shareholders. First, especially when they are partners of the nominating hedge fund[155] or receive a lucrative compensation package from the activist,[156] directors appointed by activists might be more inclined to favor the nominating shareholder, whose interests might not necessarily be aligned with those of the other minority shareholders. Second, although some activists seem increasingly willing to adopt collaborative engagement strategies,[157] the presence of some activist-appointed directors may threaten the board's cohesiveness, especially when they receive compensation packages from the nominating activist that are focused on the short-term stock price, which "exacerbates dissidents' tendencies to maximize current value at the expense of long-term firm stability and performance."[158]

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153. *See generally* John C. Coffee Jr. & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, 41 J. CORP. L. 545 (2016); Martijn Cremers et al., *Activist Hedge Funds and the Corporation*, 94 WASH. U. L. REV. 261 (2017); Lucian A. Bebchuk et al., *The Long-Term Effects of Hedge Funds Activism*, 115 COLUM. L. REV. 1085 (2015). For an analysis of evidence on the incidence, characteristics, and performance of activist engagements across 23 countries, see Marco Becht et al., *Returns to Hedge Fund Activism: An International Study*, 30 REV. FIN. STUD. 2933 (2017).

154. For an overview of the impact of regulation and ownership structures on the development of shareholders' activism see Wolf-Georg Ringe, *Shareholder Activism: A Renaissance*, *in* THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE, *supra* note 12, at 6–9.

155. *See, e.g.*, Kobi Kastiel & Yaron Nili, '*Captured Boards': The Rise of 'Super Directors' and the Case for a Board Suite*, 19 WIS. L. REV. 19, 35 (2017).

156. For on overview of the pro and cons of such compensation arrangements, which are sometimes referred to as "golden leashes," see Jason D. Schloetzer, *Activist Hedge Funds, 'Golden Leash' Special Compensation Arrangements, and Advance Notice Bylaws* 8–9 (The Conference Bd. Dir. Notes DNV7N5, Dec. 2015), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2706170.

157. *See* Lindsay Fortado, *Investing: Activism Enters the Mainstream*, FIN. TIMES (Feb. 14, 2018), https://www.ft.com/content/e04547b8-0d0b-11e8-839d-41ca06376bf2 ("While some remain on the more aggressive side, many stress that they are holding positions for longer and not clamouring for share buybacks or quick sales, but rather urging changes they claim will help the company long-term."). However, this anecdotal evidence seems to contrast with empirical analysis which shows that the rise of passive investors is related to a shift in the likelihood of activists employing hostile tactics in attempts to gain board seats when passive ownership is higher. *See* Appel et al., *supra* note 151, at 18–24.

158. Schloetzer, *supra* note 156, at 9. *See also* Yaron Nili, *Servants of Two Masters? The Feigned Hysteria over Activist-Paid Directors*, 18 U. PA. J. BUS. L. 509, 547–65 (2016) (contending that the golden leash does not impair the independence of activist-appointed directors and harm the cohesiveness of the board). *But see* John C. Coffee Jr., *Shareholder Activism and Ethics: Are Shareholder Bonuses Incentives or Bribes?*, THE CLS BLUE SKY BLOG (Apr. 29, 2013), http://clsbluesky.law.columbia.edu/2013/04/29/shareholder-activism-and-ethics-are-shareholder-bonuses-incentives-or-bribes/ (observing that "a director significantly compensated by third parties should not be seen as an 'independent' director . . . [i]n the new world of hedge fund activism, we need to look to whether individual directors are tied too closely by special compensation to those sponsoring and nominating

1. The Case for Promoting the Involvement of Institutional Investors in the Election of Enhanced-Independence Directors

Against this backdrop, and regardless of what one might think about the impact of hedge fund activism on corporations, it is necessary to consider the workability of an alternative—non-activist-driven—approach to the appointment of enhanced-independence directors. Despite the view that institutional investors[159] are "rationally reticent"—i.e. willing to respond to governance proposals but not to propose them—and use their voting power only when they are stimulated by activist shareholders,[160] the involvement of institutional investors in the selection and the election of enhanced-independence directors might make these directors more able to act in the interest of all minority shareholders and more inclined to perform their role appropriately in vetting tunneling and related-party transactions.

Given the presence of different models of activism in the U.S. and in other countries and that it is, perhaps, impossible to design a model of activism that is suited to all local economic and legal contexts,[161] it would appear that the Italian and Russian legal systems provide some useful insights into how to promote the more active involvement of institutional investors in the election of enhanced independence directors. Although non-governmental organizations (NGOs) and non-profit associations are active corporate governance players in many countries,[162] Italian and Russian experiences are especially relevant for the purposes of this Article. Both in Italy and Russia—where corporate governance rules enable minorities to elect some independent directors and activists' campaigns are not as frequent as in the U.S.,[163] national associations of institutional investors play a major role in promoting the participation of institutional investors in the election of independent directors.

In Russia, Article 66 of the Federal Law on Joint Stock Companies provides that supervisory board members shall be elected by cumulative voting, under which "the

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them. Once we recognize that compensation can give rise to a conflict of interest that induces a director to subordinate his or her own judgment to that of the institution paying the director, our definition of independence needs to be updated. Although not all directors must be independent, only independent directors may today serve on the audit, nominating, or compensation committees. This issue of redefining independence should be high on the agenda of both the NYSE and Nasdaq.").

159. For the sake of simplicity, activist shareholders will be identified hereafter with hedge funds. Moreover, the term institutional investors will be used to refer to all other—active and passive—investment funds.

160. *See* Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 888–902 (2013) (noting rationality of institutional investors); Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1048–57 (2007) (noting rationality of institutional investors); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L. J. 445, 453–64 (1991) (noting rationality of institutional investors). *But see* Zohar Goshen & Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance*, 117 COLUM. L. REV. 767, 803 (2017) (noting that "activist funds can also generate significant principal costs").

161. For a comparative overview of different models of activism in several countries, see Yaron Nili, *Missing the Forest for the Trees: A New Approach to Shareholder Activism*, 4 HARV. BUS. L. REV. 157, 174–99 (2014).

162. *Id.* For the E.U. *see* Hopt, *supra* note 1, at 51–52 (mentioning investors' associations operating in Germany, France and the Netherlands).

163. For an overview of activists' campaigns in Italy, see generally Armand Grumberg et al., *Activist Investing in Europe—2017 Edition*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Jan. 10, 2018), https://corpgov.law.harvard.edu/2018/01/10/activist-investing-in-europe-2017-edition/ (referring that after reaching a record of 12 companies targeted in 2016, activism in Italy has slowed in 2017).

number of votes belonging to each shareholder shall be increased by the number of persons who must be elected to the board of directors (supervisory board) of the company and the shareholder shall be entitled to cast the votes thus received for one candidate or to distribute them among two or more candidates."[164] Given that the number of nominees is often far higher than the number of seats available, with a variety of independent candidates, the cumulative voting system can lead to a dispersion of minority investors' votes, which can act as an impediment on the appointment of enhanced-independence directors.[165]

In order to prevent this negative outcome and promote better corporate governance, starting from 2012, the Russian Association of Institutional Investors (API)—a non-profit association bringing together more than 25 of the largest funds in Russia—has started to play a notable coordination role, providing affiliates and external institutional investors with voting recommendations, [166] and actively lobbying to consolidate investors' votes.[167] To be sure, over the years, the API has favored the ongoing transition of Russian listed companies toward more market-friendly corporate governance "best practices," and, in particular, substantially contributed to opening up the boards to institutional investors. Through the API's coordination role, a large number of independent directors have been appointed, with currently more than 30 independent directors supported by API serving at 25 companies,[168] though the effective capacity of these directors to monitor controlling shareholders remains dubious.[169]

2. The Italian Institutional Investor-Driven Model for the Election of Enhanced-

164. Russian Federal Law on Joint-Stock Companies, Fed. Law, 1995, No. 208-FZ, art. 66(4). The Russian Companies Act refers to the supervisory board since Russia is one of the countries that adopt two-tier structures, with a supervisory board and a management board (appointed by the supervisory board). *See* OECD FACTBOOK, *supra* note 8, at 93 (including Russia among nations with two-tier structures).

165. *See Independent Directors*, ASS'N INST. INV. http://api-russia.org/content/independent-directors (last visited Aug. 30, 2018) (noting that vote dispersion often results in the election of no independent directors). It is worth noting that evidence concerning compliance with the recommendation of the Russian Corporate Governance Code for at least one third of independent directors is mixed. *See* DELOITTE, CORPORATE GOVERNANCE STRUCTURES OF PUBLIC RUSSIAN COMPANIES 3 (2015), https://www2.deloitte.com/content/dam/Deloitte/ru/Documents/risk/corporate-governance-structures-survey-eng.pdf (estimating that no more than 38% of listed companies were compliant with the Russia Corporate Governance Code); SPENCER STUART, RUSSIA BOARD INDEX 6 (2017), https://www.spencerstuart.com/research-and-insight/russia-board-index-2017 (finding that, in the companies surveyed, 36.7% of all board directors were deemed to be independent).

166. For example, the API provide assistance to institutional investors in resolving corporate challenges by engaging in negotiations with management and controlling shareholders, or in public relations work through the media. *See Resolving Corporate Challenges*, ASS'N INST. INV. http://api-russia.org/content/resolving-corporate-challenges (last visited Aug. 30, 2018). On the role of the API and other NGOs in developing corporate governance practices in Russia see Valentina Kostyleva & Hector J. Lehuede, Board Formation: Nomination and Election in OECD Countries and Russia 21–22 (Sept. 1, 2012) (unpublished manuscript), https://ssrn.com/abstract=2393954; James Gillies et al., *The Role of Nongovernmental Organizations in Developing Corporate Governance Practices*, *in* CORPORATE GOVERNANCE IN RUSSIA 173–74 (Daniel J. McCarthy et al. eds., 2004).

167. Kostyleva & Lehuede, *supra* note 166, at 22.

168. *The API welcomes you*!, ASS'N INSTIT. INV., http://api-russia.org/ (last visited Aug. 30, 2018).

169. *See* Alexander Muravyev et al., *The Structure of Corporate Boards and Private Benefits of Control: Evidence from the Russian Stock Exchange*, 34 INT'L REV. FIN. ANALYSIS 247, 254–59 (2014) (finding that "[a]ppointing non-executive and independent directors does not seem to help protect minority investors from expropriation by managers and/or large shareholders in the emerging economy of Russia").

Independence Directors: Curbing Investors' 'Rational Reticence' and Risks for Board Cohesiveness

As it is mainly based on relational and informal coordination activities, the Russian experience with institutional investor-appointed independent directors seems to be highly specific and hardly transplantable to other jurisdictions.[170] By contrast, the Italian system provides a valuable model, which could stimulate institutional investors to appoint some independent directors and could be successfully transplanted into other jurisdictions to address agency problems affecting companies with controlling shareholders. In addition,

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170. It is worth mentioning that a more formal solution (not implying the presence of a coordinating institution representing institutional investors) aimed at granting minority shareholder representation in the board is provided by the Swedish Corporate Governance Code. *See generally* SWED. CORP. GOVERNANCE BD., *supra* note 75. According to the Code, the company is to have a nomination committee which is charged with the function to propose candidates for the post of chair and other members of the board, as well as fees and other remuneration to each member of the board. As regards the composition of the nomination committee, the Code states:

> The nomination committee is to have at least three members, one of whom is to be appointed committee chair. The majority of the members of the nomination committee are to be independent of the company and its executive management. Neither the chief executive officer nor other members of the executive management are to be members of the nomination committee. At least one member of the nomination committee is to be independent of the company's largest shareholder in terms of votes or any group of shareholders who act in concert in the governance of the company. Members of the board of directors may be members of the nomination committee but may not constitute a majority thereof. Neither the company chair nor any other member of the board may chair the nomination committee. If more than one member of the board is on the nomination committee, no more than one of these may be dependent of a major shareholder in the company.

See id. at 14–15. *See also* Rolf Skog & Erik Sjöman, *Corporate Governance in Sweden*, *in* THE NORDIC CORPORATE GOVERNANCE MODEL 261 (Per Lekvall ed., 2014). Given that (due to the requirements for the Committee composition set forth by the Code), usually, representatives of the largest shareholders are appointed members of the committee, the Nomination Committee can arguably favor major institutional investors' engagement with companies and allow them to appoint some directors. *See* George W. Dent, Jr., *Corporate Governance: The Swedish Solution*, 64 FLA. L. REV. 1633, 1636 (2012) (noting that "the traditional owners have to share their influence with other types of owners (i.e., local institutional investors)"). Although some corporate governance experts argue that the Swedish model based on the nomination committee can be fruitfully transplanted in other countries. *See, e.g.*, *id.* at 1662–68; TOMORROW'S CO., TOMORROW'S CORPORATE GOVERNANCE: BRIDGING THE U.K. ENGAGEMENT GAP THROUGH SWEDISH-STYLE NOMINATION COMMITTEES 44–48 (2010), https://tomorrowscompany.com/wp-content/uploads/2016/05/TCG_bridging_the_UK_engagement_gap_through_Swedish_style.pdf, some doubts are cast on the adaptability of the Swedish model to foreign corporate governance contexts. For example, it cannot be neglected that, in Sweden, foreign institutional shareholders are normally not active and that the nomination committee model relies on the propulsive role of the Swedish institutional investors. *See Shareholder Nomination Committees – Just a Different Form of Cronyism?*, MINERVA ANALYTICS BLOG (Jan. 18, 2012), https://www.manifest.co.uk/shareholder-nomination-committees-just-a-different-form-of-cronyism/; Sophie Nachemson-Ekwall & Colin Mayer, *Nomination Committees and Corporate Governance: Lessons from Sweden and the UK* 19 (Saïd Bus. Sch. Res., Paper No. 2018-12, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3170397 (highlighting that "[f]oreign institutional investors, such as Vanguard, Blackrock and Capital group abstain from participation on the [nomination committee], thus limiting engagement from the international community to a few activist hedge funds. The general reason is that they do not understand the model; there is a language barrier and they are unwilling to devote the necessary time. The shareholder led [nomination committee] model, which enrolls members on the basis of institutional size, works against private investor participation. This is especially troubling in SMEs that often lack enough institutional capital.").

the Italian institutional investor-driven model of electing enhanced-independence directors could effectively tackle potential drawbacks within the Bebchuk and Hamdani proposal, such as passivity and opportunism of public investors and the potential loss of the board's collegiality and cohesiveness.

As is widely recognized at the international level,[171] a distinctive feature of Italian corporate governance regulation is the so-called slate (or list) voting system, which enables minority shareholders to appoint at least one board member. Article 147-ter of the Consolidated Law on Financial Markets states that shareholders holding a minimum threshold of shares—set by the Consob and currently varying between 0.5% and 4.5%—can present lists of candidates for election to the board.[172] At least one member must be elected from the minority slate, having obtained the largest number of votes, and this person must not be linked in any way, even indirectly, to the shareholders who presented or voted on the list which received the largest number of votes.[173] According to the Consob, 96—out of 242—listed companies' boards currently include at least one minority-appointed director.[174]

Although Italian law is not the only system that facilitates involvement by minority shareholders in the process of board nomination and election,[175] the actual functioning of the Italian slate voting system seems to provide some unique and helpful insights. Since the introduction of the slate voting system, the Italian Investment Management Association (Assogestioni)—a non-profit association representing most of the Italian and foreign asset managers operating in Italy—plays a central role in selecting candidates and submitting minority slates.[176] Moreover, in doing so, Assogestioni adopts a more formalized procedure than its Russian equivalent.

In particular, candidates are selected in accordance with the "principles for the selection of candidates for corporate bodies of listed companies" drawn up by the Assogestioni Corporate Governance Committee, which is composed of members of the Association's Board and representatives of member companies.[177] Candidates for the

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171. *See, e.g.*, OECD FACTBOOK, *supra* note 8, at 123 (explaining that generally, shareholders can nominate board members or propose candidates).

172. *See* Commissione nazionale per le società e la borsa (Consob), Regulation no. 11971 of May 14, 1999, Article 144-quater (Regulation implementing Italian Legislative Decree No. 58 of 24 February 1998, concerning the discipline of issuers).

173. *See* Ventoruzzo, *supra* note 123, at 135–39; Massimo Belcredi & Luca Enriques, *Institutional Investor Activism in a Context of Concentrated Ownership and High Private Benefits of Control: the Case of Italy* 8–9 (Eur. Corp. Governance Inst. (ECGI), Law Working Paper No. 225/2013, 2014) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2325421; Massimo Belcredi et al., *Board Elections and Shareholder Activism: The Italian Experiment*, *in* BOARDS AND SHAREHOLDERS IN EUROPEAN LISTED COMPANIES: FACTS, CONTEXT AND POST-CRISIS REFORMS 378–83 (Massimo Belcredi & Guido Ferrarini eds., 2013) (analyzing board elections in Italy).

174. *See* COMMISSIONE NAZIONALE PER LE SOCIETÀ E LA BORSA (CONSOB), REPORT ON CORPORATE GOVERNANCE OF ITALIAN LISTED COMPANIES 15 (2017), http://www.consob.it/web/consob-and-its-activities/report-on-corporate-governance [hereinafter CONSOB REPORT 2017] (examining the corporate boards of Italian listed companies).

175. *See* OECD FACTBOOK, *supra* note 8, at 123 (confirming that other countries engage minority shareholders in the process of board nomination and election).

176. For a brief description of the history and activities of Assogestioni see the Association's brochure available at www.assogestioni.it/index.cfm/1,111,0,49,html/assogestioni.

177. *See* ASSOGESTIONI, PROTOCOL OF DUTIES AND RESPONSIBILITIES OF THE CORPORATE GOVERNANCE COMMITTEE AND THE INVESTMENT MANAGERS' COMMITTEE 20–21 (2017),

election of minority representatives to the corporate bodies of investee listed issuers are selected by the Investment Managers' Committee—which is comprised solely of representatives of Italian or foreign institutional investors—with the assistance of an independent advisor, who is charged with both maintaining a database of possible candidates and submitting to the Investment Managers' Committee a shortlist of those that appear to best meet the requirements for each corporate office.[178] Furthermore, the selection principles elaborated by the Assogestioni Corporate Governance Committee require that candidates must have adequate professionalism, integrity, and independence and also stipulate that in order to avoid possible conflicts of interest, the legal representatives of investment management companies and—unless at least a year has elapsed since the relevant appointments were relinquished—anyone who has served in a senior management or executive role in investment management companies may not be selected as a candidate.[179]

As Belcredi and Enriques note, until 2010 institutional investors were able to appoint directors and statutory auditors within a small group of listed companies.[180] Since 2010, due to the introduction of a record date system for participation in and voting at general meetings,[181] participation by institutional investors in slate voting within board elections has increased significantly and, over the years, a growing number of directors and statutory auditors have been elected by institutional investors.[182] In particular, given the decreasing weight of Italian mutual fund investments in the Italian stock market, the support of foreign institutional investors has proved to be essential.[183] Usually, although the shareholdings of institutional investors formally presenting the lists does not exceed 3.5% of the votes cast, the lists promoted by Assogestioni—which usually have the support of proxy advisors—attract the votes of a sizable number of other Italian and foreign institutional investors, and frequently receive more than 30%–and sometimes around 50%—of the votes cast.[184]

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http://www.assogestioni.it/index.cfm/3,139,12309/protfunzccg_cge_dic_2017.pdf.

178. *Id.* at 24–25 (specifying that "[e]ven when minority slates are presented for elections to boards, the Committee members undertake no obligation in regard to the exercise of voting rights during general meetings").

179. *Id.* at 28–29 (stating also that persons who hold a senior management or executive role in investment management companies may not be selected as candidates for company boards).

180. *See* Belcredi & Enriques, *supra* note 173, at 19–20.

181. According to Article 83-sexies of the Consolidated Law on Financial Markets, shareholders of Italian listed companies are allowed to attend shareholders' meetings by means of a notice of share ownership issued by their financial intermediary to the issuer, based on the intermediary's records at the close of business on the seventh trading day prior to the date of the meeting ("record date"). Therefore, shareholders may attend a meeting and exercise voting rights even if they transfer their shares after the record date. *See id.* at 21. (noting that the stipulation of the record date has greatly reduced transaction costs associated with participation in the general meeting and has proved to be important especially for foreign institutional investors).

182. In 2017, Assogestioni presented 48 listed and appointed 74 candidates in 32 listed companies. STAGIONE ASSEMBLEARE 2017, ASSOGESTIONI, (2017), www.assogestioni.it/index.cfm/3,161,12064/stagione-assembleare-2017.pdf [hereinafter ASSOGESTIONI STAGIONE ASSEMBLEARE].

183. *See* CONSOB REPORT 2017, *supra* note 174, at 27–34 ("In 2017 the attendance by institutional investors has marked its highest rate over the last six years by hitting 19.4% of the share capital. This results from the stable increase in the participation of foreign institutional investors, equaling on average 18.3% of the share capital (eight percentage points higher than its 2012 value), whereas over the time span under consideration attendance of Italian institutional investors has remained substantially unchanged.") (Parentheses omitted).

184. *See* ASSOGESTIONI STAGIONE ASSEMBLEARE, *supra* note 182, at 1–6. *See also* Marco Ventoruzzo & Piergaetano Marchetti, *Italian Boards and The Strange Case of the Minority Becoming Majority*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (May 23, 2016), https://corpgov.law.harvard.edu/2016/05/23/italian-boards-and-the-strange-case-of-the-minority-becoming-majority/ In a few cases, the list presented by

Interestingly, the engagement strategy adopted by Assogestioni and the affiliated institutional investors is very different from that usually adopted by activist hedge funds.[185] Assogestioni seeks to achieve "less confrontational engagement with the management of portfolio companies,"[186] and focuses almost exclusively on the election of directors through the presentation of minority lists comprised of a list of candidates numbering less than half of the positions to which appointments are to be made.[187] This clearly shows that the institutional investor engagement promoted by Assogestioni is primarily aimed at minimizing "the agency costs arising from the presence of a controlling shareholder by sharing management decisions, and thus by exercising closer monitoring,"[188] and not—in contrast to the usual approach of hedge funds—at forcing major changes in corporate strategy or replacing management. Hence, the objectives pursued by institutional investors by participating in director elections seem to be perfectly in line with the oversight role that, according to Bebchuk and Hemdani, enhanced-independence directors are called upon to play in controlled companies.[189]

For all the above reasons, the Italian system seems to suggest that the slate voting system, coupled with the coordination role performed by non-profit associations representing institutional investors, might foster greater involvement by institutional investors in the appointment, reelection, and termination of some enhanced-independence directors and make these directors a useful tool for reducing the agency costs affecting controlled companies. This is consistent with a proposal made by Gilson and Kraakman more than 25 years ago.[190] They suggest that "to develop a market for outside directors, institutional investors might collectively finance a non-profit organization charged with recruiting directors and performing the routine processing and filing tasks that coordinated action among institutional investors would inevitably generate." Such an organization, the argument goes, "could enhance the effectiveness of a core of professional directors in several ways. For example, it might negotiate with the managements of individual

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institutional investors has received more votes than the candidates proposed by controlling shareholders (i.e. those holding less than 50% of votes), and has occasionally even received an absolute majority of the votes. Given that institutional investors present only minority lists, this means that the majority of the shareholders appoints a minority of directors, and the minority appoints a majority. This result, whilst paradoxical, is consistent with the objectives pursued by institutional investors that do not want to appoint a majority of directors and take control of the company.

185. *See* Matteo Erede, *Governing Corporations with Concentrated Ownership Structure: An Empirical Analysis of Hedge Fund Activism in Italy and Germany, and Its Evolution*, 10 EUR. CO. & FIN. L. REV. 328, 370 (2013) (Discussing the engagement strategy adopted by Assogestioni).

186. *Id.* For the U.S., see Coffee & Palia, *supra* note 153, at 560, n.57 ("The goal of the short slate rule also was to encourage 'constructive engagement' through minority board representation-without a confrontational battle between activists and the issuer.").

187. ASSOGESTIONI, *supra* note 177, at 25. Especially in the U.S., hedge funds most often take advantage of short-slate rules. *See, e.g.*, Coffee & Palia *supra*, note 153, at 560 (noting that short-slate rules "encouraged hedge funds to seek board representation with the possible objective of putting the company up for sale, but without themselves acquiring control. Because hedge funds are not typically strategic bidders and traditionally did not want control (which carried some risk of liability), this rule well served their needs").

188. *See* Erede, *supra* note 185, at 371. *See also* Belcredi et al., *supra* note 173, 414; Luigi Zingales, *Italy Leads in Protecting Minority Investors*, FIN. TIMES (Apr. 13, 2008), https://www.ft.com/content/357c40c4-094d-11dd-81bf-0000779fd2ac (observing that a vote for a minority list sponsored by Assogestioni is not "a vote against the management but a vote to ensure truly independent board members and avoid the representation of other opportunistic minority shareholders, who might have other goals in mind").

189. *See supra* Part II.A.

190. *See* Gilson & Kraakman, *supra* note 117, at 886–87 (discussing ways to support professional directors).

corporations on behalf of institutional investors and continue to monitor professional directors after they were elected to office."[191]

Thus, the Italian institutional investor-driven approach seems to be a valid alternative to activist-driven engagement[192] even in countries, like the U.S., where activists' campaigns are more frequent, and any doubts concerning its transplant into the U.S. system should not be overstated.[193] For example, considering that it already takes initiatives in the area of directors' election,[194] the Council of Institutional Investors (CIII)—a non-profit association representing institutional investors with more than $25 trillion of assets under management—might perform a coordination role to promote the participation of institutional investors in director elections and the appointment of minority-supported candidates.

Indeed, such a coordination role performed by the CII—or by an equivalent institutional investors' representative—could bring several advantages. First, in line with the Gilson and Kraakman proposal,[195] it could foster a market for independent directors and help to overcome collective action and resource-related problems[196] underlying the stewardship passivity of institutional investors by favoring the sharing of stewardship-related benefits and costs among investors.[197] Second, the CII—which has the necessary competence to do so—might monitor the conduct of the independent directors appointed by institutional investors,[198] and provide them with any assistance they might need—for example, when assessing a complex transaction. Third, institutional investor-driven engagement could also cover companies that are not targeted by activist hedge funds but that present potential agency problems posed by controlling shareholders. For example, while larger controlled firms are generally less likely to be targeted by hedge funds,[199] the

191. *Id.*

192. For the Italian system, see Erede, *supra* note 185, at 370 (noting that, over the period of time following the global financial crisis, the decline in initiatives by hedge funds has been counterbalanced by an increase in the engagement of institutional investors, led by Assogestioni).

193. *See* Gilson & Kraakman, *supra* note 117, at 894–905 (noting that "none of the regulatory requirements most frequently cited as barriers to coordinated action by institutional investors are truly significant in their own right").

194. For an overview of the current CII's initiatives in the area of director elections see *Director Elections*, COUNCIL OF INSTITUTIONAL INV'RS, http://www.cii.org/director_elections (last visited Aug. 30, 2018).

195. *See* Gilson & Kraakman, *supra* note 117, at 887 (discussing the advantages of using centralized organizations to enhance professional directors' effectiveness).

196. For the scarcity of human resources employed by index funds in their stewardship teams, see Bebchuk et al., *supra* note 145, at 100.

197. For example, in order to allocate costs in proportion with the "size" of associated asset managers, Assogestioni's bylaws state that each member shall pay a fee including a fixed amount and a variable amount established by dividing the remaining portion of the budget amongst all members in proportion with the assets collected and/or managed at the end of the previous year. *See* ASSOGESTIONI, BYLAWS 34 (2016), http://www.assogestioni.it/index.cfm/3,813,11301/statuto-marzo-2016.pdf.

198. *See supra* notes 190–191 and accompanying text. The monitoring role performed by the CII after independent directors were elected to office could also remedy the negative consequences of possible "distraction" of institutional investors. S*ee* Claire Y. Liu et al., *Monitoring the Monitor: Distracted Institutional Investors and Board Governance* 1–9 (Eur. Corp. Governance Inst. (ECGI), Finance Working Paper No. 531/2017, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2934755 (showing that institutional investor distraction weakens board oversight).

199. *See, e.g.*, Alon Brav et al., *Hedge Fund Activism: A Review*, 4 FOUNDATIONS TRENDS FIN. 185 (2009). *But see* Kastiel, *supra* note 138, at 84 (noting that "the likelihood of activism, controlled companies are not fully insulated from activist interventions, and the total number of companies subject to activism is not negligible").

Italian experience shows that institutional investors—under the coordination of Assogestioni—have been successful in appointing minority directors to the major Italian listed companies with controlling shareholders.[200] Fourth, as Assogestioni currently does in Italy, the CII might adopt criteria for selecting independent directors that involve an assessment of the candidates' competence and independence and exclude any ties with the institutional shareholders who nominated them. Fifth, the involvement of institutional investors in the appointment of enhanced-independence directors reduces the risk of a loss of collegiality and cohesiveness by the board, since institutional investors are unlikely to use their board representatives to extract private benefits or to disrupt the controller's ability to run the firm.[201]

What is more, the institutional investor-driven approach designed here should not replace the activist-driven approach but should interact with it. On the one hand, it is to be expected that institutional investors will not intervene directly but will prefer to support hedge fund campaigns and proxy fights when they believe that the hedge funds' strategy can improve the governance of targeted companies and enhance their value. On the other hand, empirical evidence shows that the success of activists' campaigns frequently depends on the support from institutional investors.[202] Therefore, institutional investors may discipline activist hedge funds by making them more inclined to adopt a collaborative approach with a focus on the long term.[203] Against this background, the capacity of institutional investors to play a more active role in the enhanced-independence directors' election could foster the discipline-effect toward hedge funds, even when institutional investors abstain from presenting candidates.[204]

To sum up, all the above shows that a switch from a solely activist-driven system to a model where institutional investors are more actively involved in the appointment of enhanced-independence directors might make the oversight function of these directors more effective, and limit possible risks for the board's collegiality and cohesiveness.

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200. *See* ASSOGESTIONI STAGIONE ASSEMBLEARE, *supra* note 182, at 11.

201. *See* Bebchuk & Hamdani, *Independent*, *supra* note 19, at 1310 (recognizing that "[d]irectors with no ties to a blockholder are more likely to advance the interests of the company and its public investors").

202. *See, e.g.*, Alon Brav et al., *Picking Friends Before Picking (Proxy) Fights: How Mutual Fund Voting Shapes Proxy Contests* 2–6 (Colum. Bus. Sch. Research Paper No. 18-16, 2018), https://ssrn.com/abstract=3101473 (discussing the link between successful activist campaigns and support for institutional investors).

203. *See* Appel et al., *Standing on the Shoulders of Giants*, *supra* note 150, at 17–22 (discussing ways that institutional investors can discipline activist hedge funds).

204. The solution developed here, based on the coordination role played by a non-profit organization representing institutional investors, might also favor more "aggressive" institutional investors' initiatives against potential value-disrupting activists' campaigns. For example, it seems that such an approach—by facilitating investors' coordination and sharing of costs—might favor the implementation of an intriguing proposal set forth by Coffee. In a recent article, he suggests that institutional investors who fear they are being disenfranchised by hedge funds' private settlements, could form "a steering committee and assemble a team of outside directors (who were not their employees) that they could seek to place on corporate boards in the event of an activist attack. This would take some advance preparation, but the effort and expense could be shared among the dozen (or more) institutions participating in such a committee. This committee could contact the corporation at the outset of an activist campaign to suggest either its own nominees or its desire [] to be involved in the settlement process." John C. Coffee, *The Agency Costs of Activism: Information Leakage, Thwarted Majorities, and the Public Morality* 26–27 (Eur. Corp. Governance Inst. (ECGI), Law Working Paper No. 373/2017, 2017), https://ssrn.com/abstract=3058319.

V. INDEPENDENT DIRECTORS AT CONTROLLED COMPANIES AND THE SOCIAL NATURE OF THE BOARD: TACKLING SOCIAL TIES AND INTER-GROUP BIASES

Although, as noted by Bebchuk and Hamdani, preventing the risk that controlling shareholders influence independent directors is essential in order to turn independent directors into enhanced-independence directors, giving minority shareholders a say on directors' election, confirmation and termination may not be enough to effectively enhance directors' independence at controlled companies. Namely, Bebchuk and Hamdani do not seem to adequately consider that the social dimension of the board impacts a director's conduct, regardless of the ownership structure of the firm. Thus, this Part contends that incentives should also be aimed at preventing enhanced-independence directors' decisions from being distorted by social ties and inter-group biases affecting the board. In a concentrated ownership context, in particular, measures capable of promoting unbiased decisions of independent directors concerning transactions influenced by controlling shareholders and, more broadly, related-party transactions are needed.

A. Limiting Independent Directors' Tenure

In order to curb the risks for enhanced-independence directors' objectivity posed by social ties and inter-group bias, one must consider the impact that board tenure might have on director independence. Based also on anecdotal evidence concerning certain failures by independent directors (e.g. Enron),[205] it is widely acknowledged that a long tenure can negatively affect directors' ability to act independently.[206] However, contrary to this prevailing wisdom, a growing part of the corporate governance scholarship and practice contends that term limits might impair the ability of independent directors to perform their monitoring role effectively.[207] Long tenure, the argument goes, may even strengthen independence, as it is normally associated with a deeper knowledge of the company.[208]

Against this background, Bebchuk and Hamdani generally admit that "[a]rrangements concerning directors' terms in office can supplement rules concerning their elections," but stress the need for term limits and tenure requirements as part of the election regime for independent directors.[209] As regards companies where minority shareholders do not have any influence on the election of independent directors, Bebchuk and Hamdani conclude that "subjecting them to both term limits and minimum-tenure requirements limits controllers' ability to terminate them and, consequently, weakens their dependence on the

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205. *See* Nili, *supra* note 38, at 125–27. *See also* Stephen Foley, *A Surprising Definition of Board Independence*, FIN. TIMES (Apr. 30, 2017), https://www.ft.com/content/d2c71dc6-2b27-11e7-9ec8-168383da43b7 (recalling the questions recently raised among investors by BlackRock's decision to appoint a 17-year tenured board member as its new lead independent director).

206. *See* Nili, *supra* note 38, at 117–24.

207. *See, e.g.*, Ying Dou et al., *Should Independent Directors Have Term Limits? The Role of Experience in Corporate Governance*, 44 FIN. MAG. 583, 585–86 (2015) (noting that implementing director term limits "would be short-sighted, as experienced directors make a positive contribution to strategic and monitoring decisions").

208. A growing array of corporate governance practitioners and institutional investors share the view that long tenure does not necessarily impair directors' independence and call for a more flexible approach. For an overview see Nili, *supra* note 38, at 142–47; David A. Katz & Laura A. McIntosh, *Director Tenure Remains a Focus of Investors and Activists*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Aug. 1, 2016), https://corpgov.law.harvard.edu/2016/08/01/director-tenure-remains-a-focus-of-investors-and-activists/.

209. Bebchuk & Hamdani, *Independent*, *supra* note 19, at 1308.

controllers."[210] Bebchuk and Hamdani further argue that term limits may be required in order to protect the controller when public investors have only veto rights over an enhanced-independence director's initial appointment, but can reelect that director even against the controller's objections. In this case, the argument goes, "without term limits, public investors could permanently force a director on the majority shareholder simply because of that shareholder's initial consent to her appointment."[211] By contrast, according to Bebchuk and Hamdani, term limits are unnecessary and even harmful under a regime that adopts the minority-election rule and allows non-controlling shareholders to appoint enhanced-independence directors even in the face of objections by the controller. Since enhanced-independence directors will be accountable to public investors and will not be dependent on the controller, "[w]ithout any term limits, they will face ongoing incentives to act in a manner that will be beneficial for public investors."[212]

Although it is in line with the position of the Delaware courts, which have not taken the view that a particularly long period of service on the board of a controlled company will necessarily undermine a director's independence,[213] the Bebchuk and Hamdani approach cannot be completely embraced, especially insofar as it considers term limits to be unnecessary or even harmful under a regime that adopts the minority-election rule. First of all, within a comparative perspective, it is worth noting that, according to the OECD Corporate Governance Factbook, 25 jurisdictions around the world impose a maximum tenure as an independent director, varying between five and 15 years. Upon expiry of that period, these directors are no longer considered to be independent (in 17 jurisdictions), or must substantiate their independence (in eight jurisdictions).[214] Interestingly, a term limit is also recommended in Italy, where Article 3 of the Italian Corporate Governance Code states that—irrespective of whether she was elected by controlling or minority shareholders—a director will usually not be deemed to be independent "if he/she was a director of the issuer for more than nine years in the last twelve years."[215]

Second, and more importantly, the Bebchuk and Hamdani approach does not appear to adequately account for the risk that a long tenure may intensify structural biases and social ties, which could also potentially affect the conduct of enhanced-independence directors. Bebchuk and Hamdani argue that enhanced-independence directors will be accountable to minority shareholders and will act in their interest.[216] However, even though

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210. *Id.* (pointing out that "limiting how many years they can serve constrains the controller's ability to 'reward' directors with reelection").

211. *Id.* at 1309 (recalling that "Israeli corporate law, which adopts this regime, imposes a limit on the number of years that these directors can serve on the board").

212. *Id.*

213. *Id.* at 1308 n.112 (quoting Friedman v. Dolan, No. 9425, 2015 WL 4040806, at *6 (Del. Ch. June 30, 2015); *see also In re* BJ's Wholesale Club, Inc. S'holders Litig., C.A. No. 6623-VCN, 2013 WL 396202, at *6 n. 63 (Del. Ch. Jan. 31, 2013).

214. *See* OECD FACTBOOK, *supra* note 8, at 99–100.

215. *See* ITALIAN CORPORATE GOVERNANCE CODE, *supra* note 79, art. 3.C.1(e). However, the board can nonetheless continue to classify the director as independent, provided that the board's assessment is clearly explained to the market. *See id.* at section 3.C.4. A nine-year term limit is imposed also by Israeli law, under which minority shareholders only have veto rights over an enhanced-independence director's initial appointment, but can appoint that director to two additional terms of three years each even against the controller's objections. *See* Israeli Companies Law, 5759–1999, § 245 (1999-119). *See also* Bebchuk & Hamdani, *Independent*, *supra* note 19, at 1309.

216. Bebchuk & Hamdani, *Independent*, *supra* note 19, at 1309.

Bebchuk and Hamdani explicitly recognize that directors are not exclusively motivated by their desire to be elected or reelected to the board,[217] this prediction seems to rely excessively on the presumption that independent directors are mainly motivated by the desire to be reelected to the board[218] and that, consequently, biases affecting their conduct stem principally from their potential tendency to go along with controlling shareholders' decisions.[219]

Indeed, it should not be neglected that, irrespective of the degree of concentration of ownership, directors' independence is also put at risk by inter-group dynamics, such as groupthink, which can affect boards in general.[220] Tenure normally shapes the board environment, and can in particular foster social interaction between directors and their peers on the board as well as with management, and therefore promote a structural bias resulting from board members' interactions with one another since joining the board.[221] For example, interaction between board members could lead to a herd mentality, which could also affect enhanced-independence directors, irrespective of the fact that they are mainly accountable to minority shareholders.[222] Therefore, also in companies with controlling shareholders, it seems conceivable that—in line with the empirical evidence—independent directors could sometimes be inclined to follow the CEO or non-independent directors, especially where their reputation and competence are valuable.[223]

In addition, taking also the audit context into account—where the mandatory rotation (usually on a nine-year basis) of auditors is widely accepted across different countries—[224]it is worth observing that term limits could foster more accurate scrutiny from enhanced-independence directors nearing the end of their term.[225] Moreover, the rotation of

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217. *Id.* at 1284.

218. *Id.* ("We would like to clarify at the outset that we do not argue that directors are exclusively motivated by their desire to get elected or reelected to the board. Directors' sense of professionalism and integrity, and fiduciary duties and norms, may have significant influence on how directors act. Yet corporate law has chosen, and we believe correctly, not to rely exclusively on such factors. If we could exclusively rely on them, many key corporate law rules as well as financial incentive schemes would be unnecessary.").

219. *See supra* note 118.

220. *See supra* note 101.

221. *See* Nili, *supra* note 38, at 118–21 ("[T]enure could also impact the intra-board environment. As directors spend more time one the board, they not only gain experience and knowledge, but also foster social interaction with their peers on the board and with upper management.").

222. *See, e.g.*, Maximiliano Gonzále et al., *Herding Behaviour Inside the Board: An Experimental Approach*, 14 CORP. GOVERNANCE: AN INT'L REV. 388, 400 (2006) (showing the tendency of external directors to follow a leader on the board).

223. *See* Bernice Grant, *Independent Yet Captured: Compensation Committee Independence After Dodd-Frank*, 65 HASTINGS L.J. 761, 804–06 (2014).

224. *See generally* M. Cameran et al., *The Audit Mandatory Rotation Rule: The State of the Art*, 3 J. FIN. PERSP. 1, 4–9 (2015).

225. *See* Nili, *supra* note 38, at 123 ("[L]imiting tenure may also foster more scrutiny from directors nearing the end of their term. Just as presidents tend to be more active on controversial issues in their second term, when they can no longer run for reelection, directors might be willing to be more proactive in confronting issues if their term is limited."). Relevant evidence is provided by the Chinese system, where, for publicly-traded companies, the China Securities Regulatory Commission (CSRC) requires public firms to disclose independent directors' dissent during board meetings. *See* Wei Jiang et al., *Reputation Concerns of Independent Directors: Evidence from Individual Director Voting*, 29 REV. FIN. STUD. 655, 674 (2016) (finding that, under the two-term limit laid down by Chinese corporate law, "directors in their first term are less likely to dissent than the second-termers on the same board, plausibly due to the first-termers' stronger incentives to please management in order to be reappointed"); Ma & Khanna, *supra* note 118, at 1553 (finding that "dissent is positively correlated with director

independent directors imposed by term limits can help to address inter-group dynamics that might threaten directors' independence by reducing the establishment of enduring social ties among directors and, more generally, providing "a mechanism for 'shaking up' static group dynamics, infusing new perspectives, and minimizing reciprocity and groupthink."[226] By requiring the rotation of independent directors, a term limit could also help to promote a market for independent directors and increase the number of professionals available to serve as independent or enhanced-independence directors.[227]

In conclusion, in spite of the lack of empirical evidence concerning the impact of tenure on directors' independence at controlled companies, and the unresolved debate concerning the impact of board tenure on directors' independence and the desirability of term limits,[228] several arguments seem to convincingly establish that tenure is more likely to impair independence than to strengthen it, and that term limits are preferable also when minority shareholders are provided with the right to appoint enhanced-independence directors. As auditing regulations suggest,[229] term limits contribute to securing independence in appearance and can incentivize enhanced-independence directors' independence in mind by curbing the risk that they become "familiar" with other board members and the senior management.

As far as the implementation of term limits is concerned, a flexible comply or explain rule might be considered, in line with the Italian Corporate Governance Code. Under that code, directors appointed by minority shareholders are no longer considered to be independent when they have served as directors of an issuer for more than nine years out of the last 12 years, unless the board continues to classify the director as independent and the reasons for the board's decision are clearly communicated to the public. Empirical evidence shows, however, that the high degree of flexibility granted by the Italian Corporate Governance Code undermines the effectiveness of tenure limits.[230] Therefore, the mandatory imposition of term limits would appear to be preferable, at least in contexts where institutional investors and proxy advisors do not adequately target excessive board tenure.[231]

In theory, a more nuanced approach to term limits for enhanced-independence directors can be designed to provide board members and shareholders with more flexibility. In particular, term limits could be restricted to the audit and compensation committees

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midterm departure and chairperson departure; however, directors reaching the six-year term limit are not more likely to dissent").

226. *See* Grant, *supra* note 223, at 798.

227. For more reading on the opportunity to create a market for independent directors, see Gilson & Kraakman, *supra* note 117, at 886–88.

228. *See supra* note 208 and accompanying text.

229. David F. Birke, *The Toothless Watchdog: Corporate Fraud and the Independent Audit - How Can the Public's Confidence Be Restored?*, 58 U. MIAMI L. REV. 891, 918 (2004). *See also* Grant, *supra* note 223, at 805 (discussing the audit firm rotation proposal).

230. *See* ASSONIME, LA CORPORATE GOVERNANCE IN ITALIA: AUTODISCIPLINA, REMUNERAZIONI E COMPLY-OR-EXPLAIN 37 (Feb. 2018), http://www.assonime.it/attivita-editoriale/studi/Pagine/note-e-studi-2-2018.aspx (click on PDF at top of page). (noting that, in 2017, 107 independent directors had been serving on the same board for more than nine years)

231. *See* Nili, *supra* note 38, at 155–56. As an example, the principles for selecting candidates for corporate bodies of listed companies adopted for Italy by Assogestioni state that "[a]nyone who has already served in a given office for a given company for the three previous terms may not be selected as a candidate for the same office." *See* ASSOGESTIONI, *supra* note 177, at 29.

only.[232] Thus, enhanced-independence directors who are not members of these committees could continue to serve as independent board members for more than nine years. While imposing term limits for the enhanced-independence directors who are more closely involved in monitoring activities,[233] such an approach entails a significant drawback as it is unable to curb the risks for independence that may result from long tenure, and all things considered may potentially impair the independence in mind of those enhanced-independence directors for whom term limits are not mandated. Furthermore, given that enhanced-independence directors constitute a minority of the members of the board, it is likely that in practice all enhanced-independence directors will be members of the audit and compensation committees.

B. Promoting Directors' Independence in the Context of Transactions Influenced by Controlling Shareholders: Insights from Italian Related-Party Transactions Regime

Bebchuk and Hamdani clearly state that scrutiny of tunneling and related-party transactions should be the main function of enhanced-independence directors.[234] This Part will expand on the Bebchuk and Hamdani analysis by focusing on how to induce these directors to act in a truly independent fashion in the context of such transactions, despite the potential negative impact of social ties and inter-group bias affecting board members. In doing so, this Part will largely rely on the Italian related-party transactions regime under which directors appointed by minority shareholders play a significant role in defining the internal procedure concerning related-party transactions[235] and are involved in oversight of transactions influenced by controlling shareholders or other related parties.[236]

1. Defining the Role of Independent Directors in the Context of Transactions Influenced by Controlling Shareholders

Bebchuk and Hamdani convincingly observe that enhanced-independence directors cannot protect public investors unless they hold sufficient power over conflicted decisions. The need for a clear mandate and adequate power is consistent with the definition of independence as having the power to achieve a desired outcome.[237] Adequate power is also a necessary precondition for resisting inappropriate influence by the CEO, executive directors and controlling shareholders. Moreover, providing enhanced-independence directors with adequate powers can also curb groupthink and herding behavior that can

232. *See* Nili, *supra* note 38, at 152–54 (discussing tenure restrictions for audit and compensation committees); Grant, *supra* note 223, at 797–808 (discussing rotations).

233. *See* Nili, *supra* note 38, at 152 (discussing tenure restrictions for audit and compensation committees).

234. Bebchuk & Hamdani *Independent*, *supra* note 19, at 1306–08.

235. *See* Bianchi et al., *supra* note 51, at 23 (finding that "[c]ompanies where institutional investors have managed to nominate a director show on average stricter procedures than other companies").

236. *See* Bianchi et al., *Enforcing Rules on Related Party Transactions in Italy: One Securities Regulator's Challenge* 10 (Eur. Corp. Governance Inst. (ECGI), Working Paper No. 409/2018, 2018), http://www.ecgi.global/sites/default/files/working_papers/documents/finalbianchienriquesmilic.pdf (noting that "the word 'involvement' leaves scope for diverse and quite broad interpretations of the role of independent directors: the weakest such involvement entails receiving timely updates on how negotiations proceed, while the strongest involvement entails sitting at the negotiating table, expressing their views and signaling that they will veto the transaction if their advice is ignored").

237. *See* Le Mire & Gilligan, *supra* note 11, at 454–57 (discussing independent directors within an organizational context).

impair their objectivity.[238]

Against this backdrop, Bebchuk and Hamdani suggest providing enhanced-independence directors with "the power to review, negotiate, and approve freezeouts and other self-dealing transactions involving the controlling shareholder."[239] Such a proposal is consistent with the Delaware courts' opinion that ascribes a central role to independent directors in vetting the company's transactions with its controlling shareholders.[240] In particular, the *M&F* decision clarifies that the special committee of independent directors will be classified as an adequate cleansing device if and only if (i) it is "independent"; (ii) it is "empowered to freely select its own advisors and to say no definitively"; (iii) and it "meets its duty of care in negotiating a fair price."[241] Therefore, along these lines, the committee of independent directors must be provided with the power to negotiate better terms to transactions.[242]

To be sure, this approach adopts the strongest possible form of enhanced-independence directors'—and independent directors'[243]—involvement in transactions influenced by controlling shareholders. However, alternative forms of involvement may also be considered.[244] First, enhanced-independence directors may be provided with a veto power over transactions that are influenced by controlling shareholders, without being actively involved in the negotiations. Second, enhanced-independence directors may be given a "weaker" veto power over the transaction. As is the case, for example, in Italy for material related-party transactions, the board can only approve transactions if favorable advice has been received from the committee of independent directors; however, company procedures may stipulate that the board may approve related-party transactions despite the negative opinion of the independent directors if, and only if, a shareholders' meeting is convened and a majority of unrelated shareholders approve the transaction (so-called whitewash).[245] Third, as is provided for under Belgian law[246] as well as Italian law (although only in relation to non-material transactions),[247] independent directors may be required to provide non-binding advice on related-party transactions, whilst non-independent directors—and, sometimes, the controlling shareholders themselves—are nonetheless actively involved in the internal decision-making process.[248]

While it is undisputable that the "independent negotiating committee" approach

238. *Id.*

239. Bebchuk & Hamdani, *Independent*, *supra* note 19, at 1307.

240. *See supra* notes 43–44. *See also* Jonathan Rosenberg & Alexandra Lewis-Reisen, *Controlling-Shareholders Related-Party Transactions Under Delaware Law*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Aug 30 2017), https://corpgov.law.harvard.edu/2017/08/30/controlling-shareholder-related-party-transactions-under-delaware-law/.

241. *See* Kahn v. M&F Worldwide Corp., 88 A.3d 635, 645 (Del. 2014); *In re* MFW S'holders Litig., 67 A.3d 496, 535 (Del. Ch. 2013) (discussing special committee requirements).

242. *See* Rosenberg & Lewis-Reisen, *supra* note 240, at 5 (quoting Kahn v. Lynch, 638 A.2d 1110, 1119 (Del. 1994)).

243. Although Bebchuk and Hamdani do not consider this hypothesis, it is conceivable—as actually occurs in Italy where the appointment of both categories of directors is required—that both independent directors (appointed by the controlling shareholder) and enhanced-independence directors (appointed by minority shareholders) are involved in the vetting of transactions influenced by controlling shareholders.

244. Enriques, *supra* note 116, at 19; Enriques et al., *supra* note 36, at 153.

245. Consob Resolution no. 17221, *supra* note 51, art. 8, 1.

246. *See* Geens, *supra* note 50 and accompanying text.

247. *See* Consob Resolution no. 17221, *supra* note 51, art. 7.

248. Enriques, *supra* note 116, at 19.

promoted by the Delaware courts provides maximum insulation for enhanced-independence directors from social ties and inter-group dynamics that could impair their objectivity, empirical and anecdotal evidence shows that also weaker forms of involvement can adequately empower enhanced-independence directors. As has been noted by Enriques, the provision of non-binding negative advice can serve shareholder interests by providing persuasive evidence of tunneling for the courts, whilst the market may use it as a signal of the dominant shareholder's inclination for tunneling.[249] Moreover, Belgian law clearly shows that, especially where the negative advice is to become public, boards tend not to deviate from the advice of independent directors.[250]

Moreover, as empirical evidence demonstrates, the partially flexible Italian regime provides independent directors with adequate power, even though their veto power does not definitively preclude the conclusion of a related-party transaction. Although almost two out of three firms have opted out of the default rule under which the advice of independent directors is binding,[251] Marchetti et al. found that related-party transactions are the issue regarding about which directors most often disagree, and that minority-appointed directors are more likely than directors appointed by a majority of the votes to dissent.[252] In addition, Bianchi et al. show that the presence of at least one director nominated by minority shareholders is associated with a stricter application of the related-party transaction regime.[253] What precedes may suggest that, when—as usually happens in Italy—both independent directors and enhanced-independence directors are appointed,[254] the participation of at least one director nominated by minority shareholders in the committee designed to approve related-party transactions (or to provide a non-binding advice on them) is to be recommended.[255]

On the whole, all the above suggests that legislators and companies should have a certain degree of flexibility as to how to design the role of enhanced-independence directors. In fact, even a weaker involvement of enhanced-independence directors in related-party transactions can provide them with adequate power and enable them to contrast effectively any value-disrupting transactions influenced by controlling shareholders. Nevertheless, in order to define the role of enhanced-independence directors it is not enough to promote their truly independent conduct, since the actual capacity of enhanced-independence directors to effectively exercise their power is dependent on several other variables, including access to information and the disclosure duties to which they are subject.[256]

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249. *Id.*

250. Geens, *supra* note 50, at 142–44. *See also* Enriques, *supra* note 116, at 19.

251. Bianchi et al., *supra* note 51, at 18.

252. Marchetti et al., *supra* note 132, at 676, 682.

253. Bianchi et al., *supra* note 51, at 25.

254. *See supra* note 243.

255. In the absence of a similar provision, it could in theory be possible to exclude all enhanced-independence directors from the committee formed to oversee related-party transactions, which could thus include only independent directors appointed by the controlling shareholders. Interestingly, even though under Italian law at least one director should be appointed by minority shareholders, Article 8 of the Consob regulations on related-party transactions does not require minority-appointed directors to be included in the special committee designated to approve material related party-transactions. *See* Consob Resolution no. 17221, *supra* note 51, art. 8 (stating only that the special committee shall be composed entirely of independent directors).

256. *See* Enriques, *supra* note 116, at 18–19.

2. Granting Enhanced-Independence Directors Full Access to Relevant Information Concerning Transactions with Controlling Shareholders

Irrespective of the nature of the involvement of enhanced-independence directors' in controlling shareholders transactions, their decisions or advice concerning the transaction—which may also be given jointly with other independent directors[257]—must be made outside the boardroom and before the board meeting called to decide on the matter, without the presence of the CEO or the dominant shareholders.[258] As is acknowledged across various jurisdictions,[259] the formation of a separate committee can enhance independence by providing greater autonomy from the CEO and the controlling shareholders, and curb potential distorting inter-group dynamics.[260]

Nevertheless, as a large body of scholarship recognizes, the formation of committees also entails costs. In particular, the delegation of responsibilities to sub-committees composed entirely of outside directors can make access to the relevant information more difficult for committee members and render outside directors relatively less informed.[261] Unsurprisingly, the CEO and the senior management could be more reluctant to reveal relevant information to a committee with a monitoring function.[262] These drawbacks, depending on the form of independent directors' involvement, can be especially significant for the independent committee charged with overseeing transactions involving controlling shareholders.

Enhanced-independence directors have full access to all relevant information they might need when, as frequently happens under Delaware law, a special negotiation committee is formed. As mentioned above, in line with approach of the Delaware courts, the special committee has complete control over the transaction and is granted responsibility for conducting negotiations in relation to the transaction—potentially by searching for alternative counterparties—and for reaching a decision in relation to it.[263] Therefore, when a special negotiation committee is formed, independent directors are

257. As it is conceivable that a board will include both independent directors and enhanced-independence directors, the special committee can also include both categories of directors. In Italy, this happens regularly since enhanced-independence directors normally comprise a minority of independent directors. *See* CONSOB REPORT 2017, *supra* note 174, at 15, 19 (on average, almost 5 directors are independent, while, on average about 2 members are appointed by minorities). This outcome is consistent with Article 147 of the Consolidated Law on Financial Markets, which provides that at least one member shall be elected from the minority.

258. *Id.*

259. For a cross-country analysis see OECD FACTBOOK, *supra* note 8, at 66, 72–74. For the U.S. see Geeyoung Min, *The SEC and the Courts' Cooperative Policing of Related Party Transactions*, 2014 COLUM. BUS. L. REV. 663, 676–97 (2014).

260. *See, e.g.*, Kevin D. Chen & Andy Wu, *The Structure of Board Committees* 1, 7 (Harv. Bus. Sch. Working Paper No. 17-032, 2016), http://www.hbs.edu/faculty/Publication%20Files/17-032_22ea9e7a-4f26-4645-af3d-042f2b4e058c.pdf; Randall Morck, *Behavioral Finance in Corporate Governance - Independent Directors and Non-Executive Chairs and the Importance of the Devil's Advocate* 14 (Nat'l Bureau of Econ. Research, Working Paper No. 10644, 2004), http://www.nber.org/papers/w10644.

261. *See* Renee B. Adams et al., Death by Committee? An Analysis of Delegation in Corporate Boards 30–34 (Dec. 24, 2016) (unpublished manuscript), www.aeaweb.org/conference/2017/preliminary/1980?page=9cper-page=50.

262. *See id.* at 9 (suggesting that "as communication from inside to independent directors worsens, independent directors should exert more effort gathering information from other corporate sources"); Nicola Faith Sharpe, *Informational Autonomy in the Boardroom*, 2013 U. ILL. L. REV. 1089, 1117–18 (2013); *see also* Enriques, *supra* note 116, at 19.

263. *See supra* note 241 and accompanying text.

involved in a timely manner and have full and prompt access to all information required in order to make an informed decision.[264]

By contrast, the risk that enhanced-independence directors may not have full access to relevant information is greater where they are asked to approve the transaction or to provide non-binding advice about the transaction, without being responsible for conducting negotiations. In this case, enhanced-independence directors remain dependent on the CEO and senior management for any information they need to perform their oversight role. In addition, the disclosure of relevant information to an independent committee might come too late in order to receive due consideration.[265]

Nevertheless, the Italian related-party transaction regime shows that the independent directors' committee can be provided in a timely manner with full access to the relevant information even where it is not responsible for conducting negotiations concerning the transaction.[266] In fact, according to Article 8 of the Consob regulation on related-party transactions, the committee composed entirely of independent directors or one or more of its members are involved in the negotiation phase and the initial investigation phase on account of the receipt of complete and timely information as well as their ability to request information from and comment to the managing bodies and entities responsible for the conduct of negotiations or the investigation.[267]

Therefore, the Italian related-party transaction regime demonstrates that full and timely access of enhanced-independence directors to the relevant information they need to perform their role in vetting and approving transactions involving controlling shareholders does not necessarily entail total control by independent directors over the transaction, as is by contrast required by the Delaware courts. Under a comparative perspective, this leads to the conclusion that enhanced-independence directors can perform their oversight role—albeit, perhaps, not with the same effectiveness as under Delaware law—even in jurisdictions that do not provide them with full and exclusive control over related-party

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264. *See* Enriques, *supra* note 116, at 20. Delaware law explicitly requires that the special committee—and the financial advisor appointed by the independent directors—should have access to current financials and projections. *See generally* Rosenberg & Lewis-Reisen, *supra* note 240, at 4 (quoting Kahn v. M&F Worldwide Corp., 88 A.3d 635, 651 (Del. 2014) and *In re* Emerging Commc'ns, Inc. S'holders Litig., C.A. No. 16415, 2004 WL 1305745, at *7, *12–*13, *35 (Del. Ch. June 4, 2004)). Therefore, as corporate governance practitioners suggest, "[t]he board resolutions creating the special committee and establishing its mandate should specifically state that the committee will have full access to all reasonably available information." *See, e.g.*, Frank Aquila & Samantha Lipton, *Making Good Use of Special Committees*, PRAC. L. 47 (Oct. 2010).

265. *See* Gordon, *supra* note 1, at 1494 (discussing the risks of independent directors).

266. *See* Bianchi et al., *supra* note 236, at 10 (highlighting that "the lack of timely and appropriate information in transactions of high complexity, especially when their terms are modified shortly before their final approval, can hamper the effectiveness of independent directors' assessment").

267. Consob Resolution no. 17221, *supra* note 51, Art. 8 section 1(a). Although the wording of Article 8 of Resolution no. 17221 is partially misleading, it is undisputable that the involvement of independent directors entails only the right to receive complete and timely information and to request additional information, whilst they are not allowed to conduct negotiations or to make proposals. *See, e.g.*, Paolo Montalenti, *Le Operazioni con Parti Correlate [Related-Party Transactions]*, 38 GIURISPRUDENZA COMM. 331 (2011) (discussing the Italian related party transaction regime); Alessandro Pomelli, *Related-Party Transactions and the Intricacies of Ex Post Judicial Review: The Parmalat/Lactalis Case*, 13 EUR. COMPANY & FIN. L. REV. 73, 79 (2016) (highlighting that "[w]hile Delaware case law wants the special committee of independent directors to be empowered by the board of directors to freely conduct the negotiations with the controlling shareholder and, if necessary, to veto the transaction, the special committee of independent directors formed by Italian companies is not vested with the authority to negotiate deals in lieu of, or alongside, the executives and then submit its own proposal to the board").

transactions

3. Disclosure Duties Concerning Related Party Transactions as an Independence-Enhancing Tool

Mandatory disclosure and the involvement of independent directors are usually considered as alternative, although jointly usable, legal strategies for dealing with related-party transactions.[268] However, as Enriques notes, mandatory disclosure alone may be insufficient to prevent tunneling and its importance "is more in supporting internal decision-makers' independence (they will act more assertively if they know the RPT they may approve will be subject to public scrutiny) and in facilitating private and public enforcement against tunneling."[269] Although disclosure of the characteristics and terms and conditions of the transaction imposed at the national level is per se capable of promoting directors' independence in mind within the context of related-party transactions, [270] a more extensive use of disclosure obligations as a tool for enhancing directors' independence (in mind) may be considered.[271]

First, legislators may require the disclosure of additional information to facilitate public scrutiny of independent directors' decisions concerning related-party transactions. For example, under the Italian related-party transactions regime, listed companies are required to disclose in a timely manner the opinions of independent experts selected by the independent committee and any opinion given by the committee.[272] Along the same lines, Article 524 of the Belgian Companies Code requires that the opinions of the independent committee charged with overseeing related-party transactions must be included in the board's annual report.[273]

Full disclosure, as required under the Italian related-party transaction regime may incentivize truly independent conduct of independent directors insofar as, by facilitating the public scrutiny of their decisions, it exposes independent directors to a reputational risk where their decisions or opinions are perceived to be not sufficiently motivated or objective, or where they do not adequately take the independent advisor's opinion into account. Indeed, according to the argument proposed by Fama and Jensen that independent directors "have incentives to develop reputations as experts in decision control" since shocks to director reputation negatively affect career opportunities,[274] empirical evidence

268. *See generally* Enriques et al., *supra* note 36, at 147–56 (discussing related party transactions and mandatory disclosures).

269. *See* Enriques, *supra* note 116, at 21 (discussing the use of mandatory disclosures to prevent tunneling).

270. For a comparative overview of disclosure obligations provided at a national level, see OECD FACTBOOK, *supra* note 8, at 70–71.

271. On the use of disclosure to encourage the development of independent monitoring boards see, e.g., Elliott J. Weiss & Donald E. Schwartz, *Using Disclosure to Activate the Board of Directors*, 41 LAW & CONTEMP. PROBS. 63, 79–83 (1977).

272. *See* Consob Resolution no. 17221, *supra* note 51, Art. 4 (discussing required disclosures for companies conducting transactions with related parties).

273. *See* Geens, *supra* note 50, at 143 (discussing the law governing corporate boards in Belgium).

274. *See* Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J. L. & ECON. 301, 315 (1983). *See also* Renée B. Adams et al., *The Role of Boards of Directors in Corporate Governance: A Conceptual Framework and Survey*, 48 J. ECON. LITERATURE 58, 94–96 (2010). *But see* Doron Levit & Nadya Malenko, *The Labor Market for Directors and Externalities in Corporate Governance*, 71 J. FIN. 775, 778 (2016) (noting that "improving boardroom transparency is likely to strengthen corporate governance if aggregate governance is already strong, but is likely to weaken governance further if aggregate governance is already

shows that independent directors' reputational concerns are capable of ensuring that the positions of independent directors are more aligned with those of investors than with those of the management, thereby increasing the quality of monitoring.[275]

Second, it is worth observing that the Italian related-party transaction regime also requires the disclosure of the names of the directors who voted for or against the transaction or that abstained, along with the reasons for any dissent or abstention.[276] An additional disclosure obligation of this type may further promote directors' independence in mind in that increased public scrutiny strengthens the link between a director's individual vote and their reputation.[277] Thus, as boards are usually reluctant to expose any internal disagreements to the public, disclosure of directors' individual votes can stimulate discussions and dissent within the board prior to the vote, even where the vote is more likely to be unanimous.[278]

VI. CONCLUSION

Independent directors at controlled companies are different, as their main role is to vet transactions influenced by controlling shareholders or involving related-parties, rather than to monitor managers—who are already monitored by the controlling shareholders. Therefore, a director who is independent from the management but has ties with controlling shareholders lacks the incentives to monitor tunneling and transactions that conflict with the interests of public investors. Hence, within controlled firms, the key characteristic of the directors who are expected to monitor transactions influenced by controlling shareholders should be accountability to minority shareholders, rather than mere independence. As independent directors whose election and retention are fully dependent on controlling shareholders cannot be relied upon to perform their oversight role adequately, Bebchuk and Hamdani convincingly argue that public investors should have the power to influence the election or retention of some "enhanced-independence" directors.

Starting from this convincing outcome, a comparative and functional analysis has made it possible to extend the Bebchuk and Hamdani framework in several directions to make it more effective and adaptable to different jurisdictions around the world. It is argued here that reliance solely on the initiatives of activist hedge funds can raise concerns vis-à-vis the effectiveness of enhanced-independence directors as monitors along with the cohesiveness of the board. It has also been argued that there is a case for stimulating the involvement of institutional investors in the process of selecting and electing enhanced-independence directors. For these purposes, it has been suggested that a non-profit organization representing institutional investors could be granted the role of coordinating their stewardship activities to help overcome collective action problems and resource scarcity underlying the stewardship passivity of institutional investors. It has also been

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weak").

275. *See* Jiang et al., *supra* note 225, at 655, 659, 692. *See also* Lisa Fairfax, *Reputation Sanctions for Outside Directors*, THE CONGLOMERATE (Aug. 9, 2007), http://www.theconglomerate.org/2007/08/reputation-sanc.html.

276. Consob Resolution no. 17221, *supra* note 51, Annex 4.

277. *See* Levit & Malenko, *supra* note 274, at 795–96.

278. *See* Nadya Malenko, *Communication and Decision-Making in Corporate Boards*, 27 REV. FIN. STUD. 1486, 1511–12 (2014). *See generally* Marchetti et al., *supra* note 132.

shown that, if the independence of directors at controlled companies is to be enhanced, it is also necessary to take the "human nature" of corporate boards into consideration. Along these lines, this Article has provided an in-depth analysis of the regulatory strategies available to limit the distorting effects of the board's relational dimension and to induce enhanced-independence directors perform their oversight role in a truly independent way.

On the whole, this Article has shown that enhanced-independence directors can be—possibly in conjunction with other procedural safeguards—a useful tool in regulating related-party transactions and in curbing opportunism on the part of controlling shareholders. The conceptual framework developed by this Article might also help lawmakers, regulators, and corporate governance experts reconsider the widely accepted formal approach to directors' independence and opt in favor of more incentive-based regulatory strategies.