Preliminary Working Paper
10/08/2006

WHAT'S GOOD FOR THE GOOSE? A CRITICAL ESSAY ON "BEST PRACTICES" for PRIVATE FIRMS

I. INTRODUCTION

In light of recent large and very public corporate scandals of the past few years, the federal government has obtained unprecedented control over the internal management of American public corporations. Where the regulation of internal corporate governance has historically been the exclusive province of state law, federal mandates now require independent directors to play the central role in the oversight of public companies. In spite of scanty or even contradictory evidence that independent boards increase shareholder value,[1] Congress, the Security Exchange Commission (SEC) and the Self

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[1] *See, e.g.* Sanjai Bhagat & Bernard Black, *The Non-Correlation between Board Independence and Long Term Firm Performance*, 27 Journal of Corporation Law (   ); John F. Olson & Michael T. Adams, *Composing a Balanced and Effective Board to Meet New Governance Mandates*, 59 BUS. LAW. 421, 444–52 (2004) (arguing that independent board members, while perhaps more objective, may not be well informed); COLIN B. CARTER & JAY W LORSCH, BACK TO THE DRAWING BOARD: DESIGNING CORPORATE BOARDS FOR A COMPLEX WORLD 95–98 (2003) (suggesting that outsiders have neither the time or knowledge to effectively monitor managers); Stephen M. Bainbridge, *A Critique of the NYSE's Director Independence Listing Standards*, 30 SEC. REG. L. J. 370, 386–396 (2002), *available at* http://ssrn.com/abstract=317121 (reviewing empirical studies of corporate performance and independent directors); Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921, 921–940 (1999) (suggesting that studies are inconclusive as to whether boards with a majority of independent directors make the most effective decisions for shareholders); Compare Aggarwal, Reena and Williamson, Rohan G., *Did New Regulations Target the Relevant Corporate Governance Attributes?* (February 12, 2006). Available at SSRN: http://ssrn.com/abstract=859264 (finding positive correlation between firm value and governance mandates)

Regulatory Organizations (SROs) have mandated a greater role for independent directors in publicly traded companies.[2] Furthermore, corporate ratings agencies view board independence as a key factor in their metrics utilized to rank the quality of corporate governance of rated companies.[3] Implicit in this model is the assumption that the independent director will be an effective monitor of otherwise shirking or conflicted managers and thus increase shareholder wealth.[4] This theory elevates the monitoring or policing role of corporate boards to a position far above other vital board functions such as policy making and advising.[5]

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[2] The federalization of the monitoring board is perhaps the culmination of a trend that has been underway in public corporations for a number of years. See Larry Ribstein, *Market vs. Regulatory Responses To Corporate Fraud: A Critique Of The Sarbanes-Oxley Act, 28* J Corp. L (2002**)(**"the monitoring board model has come into standard usage by large public corporations pursuant to recommendations over the last twenty years by, among others, the American Bar Association's Committee on Corporate Law of the Section of Corporation, Banking & Business Law the SEC).

[3] See e.g. News Release, Institutional Shareholder Services, Enhanced Corporate Governance Tools Now Available (Apr. 14, 2005), http://www.issproxy.com/pdf/CGIPR041505.pdf. For a critical perspective on the one size fits all approach of the corporate ratings agencies see Rose, Paul, *The Corporate Governance Industry* (May 17, 2006). Northwestern Public Law Research Paper No. 902900 Available at SSRN: http://ssrn.com/abstract=902900; Lynn A. Stout, *Why should ISS Be the New Master of the Corporate Governance Universe,[WSJ cite]*

[4] Michael C. Jensen, *Separation of Ownership and Control*, 26 J. L. & ECON. 301, 304 (1983).

[5] *See, e.g.* Franklin A. Gervurtz, *The Historical and Political Origins of the Corporate Board of Directors*, 33 HOFSTRA L. REV. 89, 168–169 (2004) (outlining the historical function of the board and arguing that the monitoring role of the board has the least support in the historical origins of the corporate board); Bainbridge, *supra* note 1 at 381 (noting managerial and networking functions of corporate boards); Don Langevoort, *The Human Nature Of Corporate Boards: Law, Norms, And the Unintended Consequences Of Independence and Accountability*, 89 GEO. L.J. 797, PINPOINT (2001) (describing board functions as monitoring, legitimizing and service); Lynne L. Dallas, *Proposals for Reform of Corporate Boards of Directors: The Dual Board and Board Ombudsperson,* 54 WASH & LEE L. REV. 91, 98–104 (1997) (distinguishing monitoring role of board from "relational" roles).

While most requirements of the new federal regime only apply to public companies, many provisions including the requirement of independent directors are now touted as "best practices" for private companies and non profits as well.[6] This paper suggests that this trend is ill advised given the different roles that outside directors play in closely held firms. A decision by private enterprises to employ outside directors should be informed by quite different considerations than those that led to the enactment of the federal regime. Whatever the virtues of independent directors as effective board members of public companies, this is not a situation where what is good for the goose is necessarily good for the gander. Outside directors of private firms rarely perform the policing role envisioned by Congress, the regulatory agencies, and the judiciary. In the private realm, the primary function of a board is advisory, not monitoring. The federal mandates constraining the definition of director independence may unduly hamper the development of many private entities.

Unlike the emerging federal regulatory scheme, state statutes rarely dictate board composition. State law provides incentives, however, for corporations to utilize independent directors by providing more deferential or limited judicial review of certain

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[6] *See, e.g*. Robert Half International, Inc., *The Impact of Sarbanes-Oxley on Private Business: Are the New Rules Giving Rise to a Universal Standard?* (July, 2003), http://www.fei.org/download/RHI_9_12_03.pdf (suggesting that private companies adopt SOC governance reforms as a best practice); Joseph Anthony, *Private companies: 4 lessons from Sarbanes-Oxley Act*, http://www.microsoft.com/smallbusiness/resources/finance/legal_expenses/private_companies_4_lessons_from_sarbanes_oxley_act.mspx (suggesting truly independent boards for private companies). For an argument that "mechanical adherence to best practices" does not necessarily lead to better performance of firms See Arcot, Sridhar R. and Bruno, Valentina Giulia, *One Size Does Not Fit All, After All: Evidence from Corporate Governance* (May 16, 2006). Available at SSRN: http://ssrn.com/abstract=887947.

decisions made by independent board members. The state law definitions of "independence" that predate the federal mandates and now operate concurrently with them, are contextual and may either mimic or contrast with the federal rules. Like their federal counterparts, however, the state definitions often miss the mark in dealing with private entities.

This essay evaluates the appropriate definition and role of independent directors in the context of private companies and suggests that true independence is not only illusory in such circumstances but perhaps counterproductive to the best interests of the firm. This essay claims that for private entities, the choice of individuals to serve as outside directors should not be dictated by federal concerns nor should decisions by nominally directors in private companies automatically enjoy the presumptions and protections now afforded under state law.

First the paper examines the varying definitions of independent directors under Sarbanes-Oxley, the SRO listing standards, the common law of Delaware and the Model Business Corporation Act (MBCA). Next, it analyzes the effectiveness of these definitions in the context of private entities and argues that most definitions are either over or under inclusive for the roles we now expect board members to play. Finally this paper analyzes the appropriate role of outside directors in private corporations and argues that "best practices" in this world should not mirror the current universe of public entities.

II. THE ROAD TO INDEPENDENCE

A. Sarbanes-Oxley

The Sarbanes-Oxley Act of 2002,[7](SOX) which primarily applies only to public companies,[8] may have provided the catalyst for the increased mandates relating to independent directors, but the Act itself merely requires that public companies establish board audit committees that are composed entirely of independent directors.[9] To be considered independent under SOX, a director may not accept compensation other than in her capacity as a member of the audit committee and may not be an affiliated person of the issuer or any of its subsidiaries.[10] Furthermore, SOX mandates that the SEC prohibit the national securities exchanges and associations from listing issuers who do not comply with these audit requirements.[11]

The SEC's implementation of the first SOX director independence requirement prohibits the payment of any consulting or other compensatory fee either to the director herself or to indirect recipients such as close family members or financial, consulting, or legal businesses associated with the issuer and to which the director was a partner,

[7] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

[8] *See generally id.* (applying most of the provisions of the Act to public companies). A few sections of SOX do apply to private as well as public companies. *See e.g.* § 802 (criminal liability for document destruction); §803 (securities law liabilities not dischargeable in bankruptcy); §806 (Liability for retaliation against whistleblowers).

[9] [ADD DEFN of public company]15 U.S.C.A. §§ 7201(3), 78j-1(m)(3)(A) (2006).

[10] 15 U.S.C.A. § 78j-1(m)(3)(B). However, the SEC is empowered to provide exemptions for specific relationships that otherwise would jeopardize a director's independence. *Id.* § 78j-1(m)(3)(C).

[11] *Id.* § 78j-1(m)(1)(A). The New York Stock Exchange (NYSE) and other SROs have required a majority of audit committee members to be independent since 1977. See *In re* NYSE, Exchange Act Release No. 13,346, 11 SEC Docket 1945 (Mar. 9, 1977); See also AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 3.05 cmt. a (1994) (recommending that large publicly held corporations be required to have independent audit committees).

member, or officer.[12] This rule obviously polices intentional evasion of the independence requirement, but the SEC notes that the rule is not meant to extend so far as to impinge the independence of directors who are non-managing members or mere employees of businesses associated with an issuer.[13] With regards to prohibited affiliations,[14] the SEC promulgated separate tests for non-investment company issuers and investment company issuers. For non-investment company issuers, the SEC has identified an independence-destroying affiliation between a director and an issuer or its subsidiary when that director is under the control of the issuer or subsidiary or is a member of the executive management team.[15]

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[12] SEC Listing Standards Relating to Audit Committees, 17 C.F.R. §§ 240.10A-3(b)(1)(ii)(A), 240.10A-3(e)(8) (2005).

[13] Standards Relating to Listed Company Audit Committees, Securities Act Release No. 8220, Exchange Act Release No. 47,654, 68 Fed. Reg. 18788, 18791–792 (Apr. 16, 2003). While generally narrowing the first SOX independence requirement, the SEC determined that fixed retirement benefits that are not contingent on future service do not preclude the independent status of a director serving on the board of an issuer that might owe him such benefits. 17 C.F.R. § 240.10A-3(b)(1)(ii)(A).

[14] SOX itself does not define "affiliated person" and the SEC has determined that it can define this term through its general rulemaking powers in Sox Section 3(a).

[15] 17 C.F.R. §§ 240.10A-3(b)(1)(ii), 240.10A-3(e)(1). The SEC notes that this definition is consistent with its definitions under other provisions of the securities laws. Securities Act Rule 144." Standards Relating to Listed Company Audit Committees, 68 Fed. Reg. at 18793. The SEC regulations set forth some general exceptions to the audit committee requirements, including exceptions to the non-affiliation requirement for non-investment company issuers for newly registered issuers and for directors serving on the boards of multiple affiliated companies in a strictly independent capacity on each. The SEC states that it does not intend to grant additional exceptions in individual circumstances noting that "given the policy and purposes behind the SOX Act, as well as to maintain consistency and to ease administration of the requirements by the [national securities exchanges and national securities associations (SROs)], we do not intend to entertain exemptions or waivers for particular relationships on a case-by-case basis." Standards Related to Listed Company Audit Committees, 68 Fed. Reg. at 18795.

Under the SEC rules, share ownership does not automatically disqualify a director as independent and there is a safe harbor for share ownership under 10%.[16] For investment company issuers, the SEC has simply ruled that to be considered independent, a director may not "be an 'interested person' of the issuer as defined in section 2(a)(19) of the Investment Company Act of 1940."[17]

B. NYSE

Before the recent spate of federal corporate reform activity, the New York Stock Exchange (NYSE) required that each listed issuer have a "qualified audit committee" consisting solely of "independent" directors.[18] Prior NYSE listing rules simply defined "independence" as "free from any relationship that, in the opinion of its board of directors, would interfere with the exercise of independent judgment as a committee member."[19]

The NYSE's current listing requirements, which were promulgated contemporaneously with the Congressional activity that resulted in the Sarbanes-Oxley Act, extend beyond Congressional and SEC mandates with respect to independent directors. NYSE listed companies must now have a majority of independent directors that meet at least once each year in executive session,[20] audit committees composed entirely

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17 17 C.F.R. § 240.10A-3(b)(1)(iii)(B). The SEC notes that these rules are "tailored to capture the broad range of affiliations with investment advisers, principal underwriters, and others that are relevant to 'independence' in the case of investment companies." Standards Relating to Listed Company Audit Committees, 68 Fed. Reg. at 18794.

18 NYSE, Inc., Listed Company Manual §§ 303.01(A), (B)(2)(a) (1999) [hereinafter Pre-SOX NYSE Manual].

19 In re NYSE, Exchange Act Release No. 13,346, 11 SEC Docket 1945 (Mar. 9, 1977); *see also* NYSE Pre-SOX Manual, *supra* note 19, § 303.01(B)(3) (listing independence requirements of audit committee members).

20 NYSE Inc., Listed Company Manual § 303A.01 (2003) [hereinafter Post-SOX NYSE Manual].

of independent directors,[21] and except for controlled companies, compensation and nominating/corporate governance committees composed of solely of independent directors.[22] Under NYSE standards, each company must affirmatively determine and identify which of its directors are independent and disclose the basis for that determination."[23] The official comment to this section notes that significant stock ownership alone does not bar a finding of independence.[24] Despite this flexible approach, the NYSE also imposes several additional requirements that prohibit specific familial, financial, and professional relationships between the director and the issuer,[25] and sets the threshold of disqualifying (non director fee) compensation at $100,000 per year. [26]

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[21] *Id.* §303A.06.

[22] *Id.* §§303A.04, 303A.05. "Controlled companies" are defined as those in which more that half of the voting power is concentrated in one shareholder or shareholder group. *Id.* §303A.00. While not itself requiring nominating/governance committees consisting of independent directors, the SEC does require disclosure of the composition and operating method of such committees. *See* Disclosure Regarding Nominating Committee Functions and Communications Between Security Holders and Board of Directors, Securities Act Release No. 8340, Exchange Act Release No. 48,825, Investment Company Act Release No. 26,262, 68 Fed. Reg. 66992 (Nov. 28, 2003), *available at* http://www.sec.gov/rules/final/33-8340.htm.

[23] NYSE Post-SOX Manual, *supra* note 21, § 303A.02(a).

[24] *Id.* §303A.02(a) cmt. Stock ownership exceeding 10% does, however, may disqualify a director from audit committee service under SEC regulations implementing SOX. [cite]

[25] *Id.* §303A.02(b); *see also* Order Approving NYSE and NASDAQ Proposed Rule Changes Relating to Corporate Governance, Exchange Act Release No. 48,745, 68 Fed. Reg. 64154, 64157–64158 (Nov. 12, 2003) (discussing definition of independent director). Definitions of independence for audit committee membership also require satisfaction of the requirements of Rule 10A-3 under the Exchange Act. NYSE Post-SOX Manual §303A.06. However, this is largely an unnecessary addition given that the listing standards are more stringent than the statutory requirements. The NYSE listing requirements reflect the SEC's distinction of investment company issuers, defining the director of such a company as "independent if he or she is not an 'interested person' of the company, as defined in Section 2(a)(19) of the Investment Company Act of 1940." NYSE Post-SOX Manual § 303A.00.

[26] Rule 4200 (a)(15)(b).

C. NASDAQ

Like the NYSE, NASDAQ's requirements for independent directors experienced a major transition as part of the Enron-era corporate governance reforms. Previously, NASDAQ simply defined an independent director as a "person other than an officer or employee of the company or its subsidiaries 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."[27] Furthermore, NASDAQ excluded from its definition of independence employees of the issuer (or their immediate family members) who were terminated within the last three years or who had received substantial non-retirement, non-discretionary income from the issuer; principals of a for-profit organization that had done substantial business with the issuer, and any director of another company where one of the issuer's directors served as a member of that other company's compensation committee.[28] The revised NASAQ independent director requirements closely parallel those of the NYSE.[29] NADAQ now has a broad prohibition against any "relationship which . . . would interfere with the [director's] exercise of independent judgment."[30] Fleshing out this broad prohibition are several additional specific elements of independence that, like those of the NYSE, guard against specific familial, financial, and professional relationships between the director

[27] NASD Manual §§ 4200(a)(15), 4200-1(a) (2005).
[28] *Id.* § 4200-1(a)(14)(A)-(E).
[29] The SEC considered the SRO's listing standard requests simultaneously. Order Approving NYSE and NASDAQ Proposed Rule Changes Relating to Corporate Governance, 68 Fed. Reg. at 64154.
[30] NASD Manual §4200(15).

and the issuer.[31] NASDAQ sets the disqualifying direct compensation level at $60,000.[32] NASAQ listed companies must have audit committees that adhere both to the NASDAQ's own independence requirements and as well as those mandated y SOX.[33] Like the NYSE, NASDAQ's listing requirements concerning independent directors apply beyond the scope of the SEC's audit committee regulations and require the board of directors to be composed of a majority of independent directors (with an exception for controlled companies). Under NASDAQ rules, only the independent directors determine the compensation of executive officers, and only independent directors either directly nominate or select a nomination committee to nominate directors.[34]

D. State Definitions of Independence

Under state law, the issue of board composition is largely unregulated.[35] State statutes do not regulate the optimal number of directors, board committee structure or the relative

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[31] *Id.*; *see also* Order Approving NYSE and NASDAQ Proposed Rule Changes Relating to Corporate Governance, 68 Fed. Reg. at 64161-64163 (discussing NASDAQ independent director rule changes).

[32] NASD Manual

[33] NASD Manual § 4350(d)(2)(A).

[34] *Id.* § 4350(c). These edicts give more power to independent directors than do the analogous NYSE rules that permit the board as a whole to override committee decisions regarding compensation and nomination committees. Consistent with SEC and NYSE requirements, the NASDAQ listing requirements use a different test for investment company issuers, specifically asking whether the director "is an 'interested person' of the company as defined in Section 2(a) (19) of the Investment Company Act of 1940, other than in his or her capacity as a member of the board of directors or any board committee."*Id.* § 4200(15) (G).

[35] This paper will reference both the Delaware corporate statutes and the Model Business Corporation Act (MBCA) (2003), *available at* http://www.abanet.org/buslaw/library/onlinepublications/mbca2002.pdf. The MBCA has been adopted in some form by 35 states. Model Business Corporation Act, http://everything2.com/index.pl?node_id=1768602&lastnode_id=1768602 (Dec. 7, 2005). ADD MBCA and other proposals to impact board composition at the state level

balance on a board between inside and outside directors or independent directors.[36] Such decisions are relegated to those who are stakeholders in the enterprise and state statutes defer to private judgment on the relative merits of an independent board versus a board dominated by inside directors. However, while there are no state statutory requirements mandating director independence, there are incentives under state law for companies to utilize outside, independent directors. The foremost incentive is embodied in the business judgment rule under which courts presume that board actions are a result of good faith decisions made in the best interest of the company.[37] To enjoy this presumption and limited judicial review of board decisions, however, there is a prerequisite that the decision makers are disinterested and independent.[38] Also independent board members can function under state law to validate conflict of interest transactions or at least to permit a more lenient standard of judicial review. In general terms, conflict of interest transactions that involve self dealing transactions between insiders and their corporations are subject to judicial review under the "entire fairness test" where the defendant has the burden to demonstrate that the transaction was fair to the corporation.[39] However, under defined circumstances, if a committee of independent directors approves the transaction

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[36] *See* MODEL BUS. CORP. ACT § 8.01(b) (2003) (limiting the board to the regulations set forth in the corporation's articles of incorporation or an authorized shareholder agreement); *See also* Roberta S. Karmel, *Realizing the Dream of William O. Douglas-The Securities and Exchange Commission Takes Charge of Corporate Governance*, 30 DEL. J. CORP. L. 79 (2005) (describing efforts of SEC to regulate corporate governance in situations where states did not act).
[37] Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).
[38] *Id.*
[39] *See, e.g.* Weinberger v. UOP, Inc., 457 A.2d 701, 710–712 (Del. 1983) (applying entire fairness test to a merger).

or decision at issue, there will be a less exacting standard of judicial review, or at a minimum a shifting of the burden of proof.[40]

For example, under the Model Business Corporation Act (MBCA), so called "qualified directors," who can roughly be defined as "independent directors" under the new federal mandates, can ratify a defined conflict of interest transaction between a non-qualified director or officer and the corporation.[41] Such ratification completely removes the transaction from judicial review.[42] Under Delaware law[43] and the earlier version of the MBCA still in force in most states,[44] ratification by independent directors of a conflict of interest transaction between managers and the corporation at least shifts the burden to plaintiffs to prove that the transaction was unfair[45] or under some interpretations of the Delaware statute, permits limited judicial review only pursuant to the business judgment rule. [46] Director approval of transactions involving conflicts with a controlling shareholder are usually reviewed under a fairness test.[47]

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[40] Flieger v Lawrence, 361 A 2d 218 (Del. 1976); ( ) Cede and Co v Technicolor, 634 A. 2d 345, 366 n. 34 (Del 1993). See also In re Cox Commc'ns, Inc. Shareholders Litig., 879 A.2d 604 (Del. Ch. 2005) (advocating change to BJR review if controlling shareholder transaction is approved by disinterested directors and minority shareholders).
[41] MODEL BUS. CORP. ACT § 8.62.
[42] *Id.* § 8.61(b)(1).
[43] Del. Code Ann. tit. 8, § 144 (2001).
[44] MODEL BUS. CORP. ACT § 8.31. [old version date?]
[45] *See, e.g.*, Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1134, 1154 (Del. Ch. 1994) (holding that compliance with section 144 shifts the burden of proving fairness to plaintiffs).
[46] Marciano v Nakash, 535 A 2d 400, 405. 3 (Del 1987)(compliance with ratification provision of Section 144 results in a business judgment rule review). There is some apparent confusion evidenced in opinions of the Delaware Court concerning the appropriate standard of review of a transaction that has been ratified by disinterested directors. See Cooke v Oolie, 1997 WL 367034 (Del. Ch. 1997) and 2000WL 710199(Del Ch. 2000) where the Delaware Chancery Court in two separate decisions on the same case first stated that the fairness test applied with a burden shift and subsequently stated that the appropriate review was under the business judgment rule. In

Defining independence under state law has proceeded on a case-by-case basis. Not surprisingly, most of the common law development in this arena has been worked out in the courts of Delaware in litigation involving public corporations. Consistent with federal definitions, the definition of independence under Delaware law has traditionally focused upon the presence of material financial ties between the interested party and the director whose independence is at issue.[48] For example, in *In re eBay Shareholders Litigation,*[49] the Delaware Chancery Court emphasized that the "huge financial benefits" the directors received as compensation for their board service gave the court reason to question the director's independence.[50] Other disqualifying relationships under Delaware precedent include familial ties to an interested party or lack of independence due to some other reason, such as domination and control.[51] In two recent cases, the Delaware courts have recognized that, under the right circumstances, non-financial ties between interested parties and directors can also impinge on independence. In the *Oracle Derivative*

Benihana of Tokyo, Inc v Benihana Inc, 891 A 2d 150, 185(Del Ch. 2005), the court stated that Section 144 ratification only impacted the voidability rule and did not implicate which standard of review should apply.

[47] Kahn v. Lynch Communication Systems, Inc., 638 A.2d 1110, 1117 (Del. 1994) (holding that approval of a merger transaction by a committee of independent directors shifts the burden of the fairness issue onto the plaintiff).

[48] *In re* Oracle Corp. Derivative Litigation, 824 A.2d 917, 936 (Del. Ch. 2003) ("[M]uch of our law focuses the bias inquiry on whether there are economically material ties between the interested party and the director whose impartiality is questioned, treating the possible effect on one's personal wealth as the key to the independence inquiry."). *See also* Grimes v Donald, 673 A.2d 1207, 1216 (Del 1996) (stating that a material financial interest can demonstrate that a board was not independent and disinterested when the board considered a stockholder's demand that the board take up a corporation's claim), *overruled in part on other grounds* by Brehm v. Eisner, 746 A.2d 244 (Del. 2000); Rales v. Blasland, 634 A.2d 927, 936 (Del. 1993) (holding that there is reasonable doubt as to the directors' independence because of their financial interests).

[49] *In re* eBay, Inc. S'holders Litig., No. C.A. 19988-NC, 2004 WL 253521 (Del. Ch. Feb. 11, 2004).

[50] *Id.* at *2–*4.

[51] *Grimes*, 673 A.2d at 1216.

Litigation, the Board appointed a two member special litigation committee (SLC) to assess whether Oracle should pursue insider trading allegations against certain corporate insiders.[52] In spite of the engagement of independent financial and legal advisors and an extensive investigation that culminated in a 1,100 page report,[53] Vice Chancellor Strine held that the SLC had not met its burden of establishing its independence due to the interwoven relations that the committee members and the named defendant shared with Stanford University.[54] In *Beam v Martha Stewart*,[55] the Delaware Supreme Court similarly noted that non financial ties could impede independence and that "a variety of motivations, including friendship" could cause bias that would preclude a director from objectively evaluating the decision at hand.[56] The Delaware Supreme Court, however, made it clear that "not all friendships, or even most of them, rise to this level . . . ."[57] In *Beam*, the Delaware Court, perhaps retreating from Vice Chancellor's Strine's opinion in

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52 *In re Oracle*, 824 A. 2d at 923.
53 *Id.* at 923–925.
54 *Id.* at 942–48. The SLC committee members, Hector Garcia-Molina and Joseph Grundfest were both tenured professors at Stanford University. The trading defendants included a Stanford Professor and two benefactors of Stanford. *Id.* at 923–24. Ultimately, after discovery and a motion for summary judgment, the court dismissed the case utilizing roughly the same rationale as had the SLC. *In re* Oracle Corp., 867 A.2d 904, 908 (Del.Ch. 2004), *aff'd In re* Oracle Corp. Derivative Litigation, 872 A.2d 960 (Del. 2005).
55 845 A.2d 1040 (Del. 2004).
56 *Id.* at 1050. To be sure, the procedural posture of the Delaware cases, especially in the context of derivative suits makes it extremely difficult for plaintiff to plead that the directors lack independence when the allegations involve personal ties rather than family ties. *Id.* at 1050–52.
57 *Id.* at 1050. The definition of independence employed by the Delaware Courts is not without its critics. *See, e.g.*, Lisa M. Fairfax, *Sarbanes-Oxley, Corporate Federalism, and the Declining Significance of Federal Reforms on State Independence Standards*, 31 OHIO N.U.L. REV. 381, 409–414 (2005) (criticizing the Court's failure to consider social science evidence regarding motivations based upon personal relationships)

Oracle, reaffirmed that plaintiffs face significant hurdles in overcoming the presumption that the directors are independent despite their social ties and personal relationships.[58]

III CONTROLLED COMPANIES

The state definitions of independent directors escape largely unscathed by the federal standards set forth in SOX and the SRO listing standards.[59] SOX itself only regulates public company audit committees and the independence definitions under the SRO listing standards largely mirror those now employed by courts under state law. Neither the state nor federal definitions of independence, however, adequately deal with the presence of a controlling shareholder. SOX and the SRO's have largely punted on this issue as it involves public corporations. The SOX references to "independence" with regards to audit committee members do not take control into account in defining independence except to create a safe harbor for directors who themselves own less than 10% of the issuer's stock.[60] Comments to the SRO listing requirements state that share ownership alone will not bar an independence finding. The comments do not discuss the impact of a controlling shareholder on the independence determination for outside

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[58] *Id.* at 1056. Unlike the situation in *Oracle Derivative Litigation* in which members of the SLC must demonstrate their independence, in the context of demand excused derivative litigation like the *Beam* litigation, the directors enjoy a presumption of independence. *Id.* at 1054–1055.

[59] *See, e.g.*, Fairfax, *supra* note 55, at 391–406 (2005) (arguing that the federal reforms do "not reflect a significant departure from [the states'] rules and norms"); E. Norman Veasey, Retired Chief Justice of Del., *Musings from the Center of the Corporate Universe*, Remarks at the Section of Business Law Luncheon, American Bar Association Annual Meeting at 16 (Aug. 9, 2004), http://www.abanet.org/buslaw/newsletter/0027/materials/speech.pdf (arguing SOX represents only a limited intrusion on Delaware law).

[60] 15 U.S.C.A. § 78j-1(m)(3) (2006). While the SEC provisions provide a safe harbor for the independence label for directors who themselves own less than 10% of the issuer's stock, they do not deal with the independence puzzle where another shareholder is in control and through that control elects members of the board.

directors.[61] In fact, controlled companies are excluded under SRO listing requirements from the mandates that they have a majority of independent board members and have compensation and nominating/governance committees comprised solely of independent directors.[62]

Under Delaware law, the presence of a majority shareholder may impact the presumptions that would otherwise apply to the question of director independence but only under circumstances where the plaintiff can convince the court that the majority control results in domination of the directors. For example, in *Beam v Stewart,* the plaintiffs, who were shareholders in Martha Stewart Living Omnimedia, Inc. (MSO), brought a shareholder's derivative suit alleging that Stewart's activities surrounding her sale of Imclone stock damaged the MSO Corporation in violation of Stewart's fiduciary duties.[63] The plaintiff shareholder alleged that the MSO directors could not possibly be deemed independent given Martha Stewart's 94% stock ownership of the voting stock of MSO.[64] Accordingly, the plaintiffs argued that the necessity of demanding that the MSO Board pursue a corporate claim against Stewart should be excused, thereby allowing the shareholders to proceed with their derivative suit.[65] However, the Delaware Supreme Court held that "[a] stockholder's control of a corporation does not excuse pre-suit demand on the board without particularized allegations of relationships between the directors and the controlling stockholder demonstrating that the directors are beholden to

[61] *See e.g.* Post-SOX NYSE Manual, *supra* note 21, § 303A.02 (standards for independence), NASDAQ.
[62] *See supra* note and accompanying text.
[63] Beam v Stewart, 845 A.2d 1040, 1044 (Del. 2004).
[64] *Beam*, 845 A. 2d at 1054.
[65] *Id.* at 1048.

the stockholder."[66] The Court in *Beam* conceded that evidence of "irregularities or 'cronyism' in MSO's process of nominating board members" might persuade the Court to rebut the presumption of independence.[67] Conversely, the court noted that evidence of an independent board nominating committee might strengthen the presumption of independence. The Delaware Court then, in an unusual error, misstated the impact of the recent NYSE and NASDAQ listing requirements that listed companies have independent and effective nominating committees that might insulate the board members from the domination of the controlling shareholder.[68] As explained above, neither SRO requires controlled companies to establish board nominating committees that are independent of the controlling shareholder.[69] The exchanges apparently view independent directors as monitors only of management, not of other shareholders.

Perhaps the Delaware Court's refusal to excuse demand based upon Stewarts 94% control could be downplayed given the particular procedural posture of the litigation. The Delaware judiciary appears increasingly frustrated with plaintiffs' counsel who file generalized pleadings in derivative suits without first availing themselves of books and records request under the Delaware statute.[70] The procedural posture of the *Beam* demand excused derivative litigation and the inherent presumption in of independence given to

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[66] *Id.* at 1054 (citing Aronson v. Lewis, 473 A.2d 805, 815 (Del. 1984)).
[67] *Beam,* 845 A. 2d at 1056.
[68] *Id.* at 1056 n.48 (citing New York Stock Exchange Corporate Governance Rule 303A.04 (2003), available at http://www.nyse.com/pdfs/finalcorpgovrules.pdf; Nat'l Ass'n Sec. Dealers Rule 4350(c)(4), NASD Manual Online (2003), http://cchwallstreet.com/NASD/NASD_Rules).
[69] [Cite]
[70] In critiquing the plaintiffs generalized pleadings, the court in *Beam* states: "Both this Court and the Court of Chancery have continually advised plaintiffs who seek to plead facts establishing demand futility that the plaintiffs might successfully have used a Section 220 books and records inspection to uncover such facts." *Beam*, 845 A. 2d at 1056. See also [Cite]

board members even in controlled corporations may therefore explain the result in *Beam* and differentiate it from *Oracle* where the burden lay with the SLC to prove independence.[71] In other words, the Beam decision could implicitly be a judicial recognition of the potential mischief inherent in derivative suits and an attempt to reinforce the strict procedural rules precedent to bringing such a suit.[72] In a later article, comparing *Beam* and *Oracle*, Justice Veasey (retired Chief Justice of the Delaware Supreme Court and the author of *Beam*) noted that "[t]here were different presumptions, different burdens, and different underlying policies between pre-suit demand in *Martha Stewart* and the SLC issues in *Oracle*." [73]

On the other hand, the Delaware court tends to apply a unitary definition of independence in a variety of circumstances involving controlling shareholders. For example, in *Kahn v Tremont Corp.,*[74] the court evaluated a special committee's recommendation involving a merger between a controlled public corporation and its controlling shareholder. Expressly doubt as to the independence of committee members and their advisors due to the interlocking financial connections among the parties, the court declined to shift the burden to plaintiff requiring instead that the controlling

[71] In *Beam*, the Court references the Chancery Court opinion in *Oracle* stating that: "We need not decide whether the substantive standard of independence in an SLC case differs from that in a pre-suit demand case. As a practical matter, the procedural distinction relating to the diametrically-opposed burdens and the availability of discovery into independence may be outcome-determinative on the issue of independence." *Id.* at 1055.
[72] *See* Roberto Romano, *The Shareholder Suit; Litigation Without Foundation?* 7 J. L. Econ. And Org. 55 91991);E. Norman Veasey, *Seeking a Safe Harbor from Judicial Scrutiny of Directors' Business Decisions--An Analytical Framework for Litigation Strategy and Counseling Directors*, 37 BUS. LAW. 1247, 1260 (April 1982).
[73] Veasey, *supra* note 57, at 15.
[74] 694 A. 2d 422.

shareholder to affirmatively prove the entire fairness of the transaction.[75] The factors employed by the court to determine independence, however, were consistent with existing precedent and largely based upon financial conflicts of interests. [76] *Kahn* thus supports the general perception that the definition of independence for directors under Delaware law remains fairly constant.

Therefore, the statements by the court in *Beam* may in fact reflect the Delaware Court's definition of independent directors in general terms making the case more problematic. It is unrealistic to expect that board members in a company such as MSO can act independently under circumstances where the potential CEO defendant is a 94% shareholder who appointed the members to the board. This task is especially difficult under circumstances where the board members and CEO defendant were admitted friends, moving in the same close social circles. The Court's statement that the directors are less likely to "risk his or her reputation than risk the relationship with the interested director" at worst shows a lack of understanding of human nature and perhaps of the market in which a director's reputation matters.[77] There is conflicting evidence that there

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[75] In non demand excused derivative cases, there is often a more developed record as to the true independence of the directors and even then, fairness is always before the court. The determination of the director's independence only goes towards the allocation of the burden of proof. See Kahn v. Tremont Corp., 694 A 2d 422, 428 (Del 1997). In *Beam,* the Court referenced this non derivative suit line of cases distinguishing them due to "[their] own special procedural characteristics."

[76] In *Beam*, however, the Court implicitly distinguished *Kahn* as a case involving the function of the committee, not its composition. *Beam*, 845 A.2d at 1055 n. 45. Even a cursory analysis of *Kahn* itself however reveals that the independence of committee members on an absolute scale was an important component of the court's decision. *Kahn*, 845 A.2d at 428–430.

[77] *Beam*, 845 A. 2d at 1052. See Julian Velasco*, Structural Bias and the Need For Substantive Review,* 82 Wash. U. L. Q. 821 (2004)(reviewing literature on social impediments to independent director actions and concluding that courts underestimate value of friendship and collegiality)*;* Ronald J. Gilson & Reinier Kraakman, *Reinventing*

is a market for independent directors at all [78] and less evidence still of how such a market (if it did exist) would discipline a compliant outside director. [79] The director's reputation among social peers may be a more powerful motivating force.[80] One must suspect that the pronouncements of Delaware Courts are more practical in nature and intended to preserve the essence of the business judgment rule against attacks based upon the inevitable prior relationships among board members in public entities.[81]

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the Outside Director: An Agenda for Institutional Investors, 43 STAN. L. REV. 863, 874–875 (1991) (noting that directors who are financially independent still have social ties that prevent them from engaging in effective monitoring); Charles M. Elson, *Director Compensation and the Management-Captured Board-The History of a Symptom and Cure*, 50 SMU L. REV. 127, 161 (1996) ("It is always tough to challenge a friend, particularly when the challenging party may one day, as an officer of another enterprise, end up in the same position."); Donald C. Langevoort, *Monitoring: The Behavioral Economics of Corporate Compliance With Law*, 2002 Col. Bus. Law Review 71 (when attempting to monitor friends, people tend to give agents an excessive benefit of doubt).

[78] See Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 Stan. L. Rev. 863, 875 (1991) ("[T]here is simply no evidence that anything like an effective market for outside directors exists at all"); Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence, 90 N.W. U. L. Rev. 898 (1996)* (noting that while the evidence is some empirical findings suggest the existence of a well-functioning market for outside directors). For a contrary view see Edward B. Rock and Michael Wachter, I*slands of Conscious Power; Law, Norms and the Self governing Corporatio*n, 149 PA. L. Rev. 1619 (2001)( ).

[79] Bebchuk & Fried, Pay Without Performance: The Unfulfilled Promise of Executive Compensation (2004); Lucian Arye Bebchuk et al., Managerial Power and Rent Extraction in the Design of Executive Compensation, 69 U. CHI. L. REV. 751, 771 (2002) Bu See David A. Skeel, Jr., *Shaming in Corporate Law, 149 U. Pa. L. Rev. 1811 (2001)*. (social norms may bee enforced against corporate directors through shaming mechanisms).

[80] Velasco, supra at 859. ('To pretend that financial interests are inherently stronger than the bonds of friendship is both substantively indefensible and morally insulting").

[81] Id. at 844-45.

There are relatively few cases outside of Delaware (or jurisdictions applying Delaware law) that deal with director independence in the presence of a controlling shareholder. [82] [ADD]

IV. GOVERNACE IN PRIVATE CORPORATIONS

A. The Federal Mandates

While SOX and its related regulations apply primarily to public companies, the impact of these reforms has permeated many private businesses as well under the guise of "best practices." [83]At the urging—or even insistence—of their auditors, lenders, insurance companies and legal advisors, at least some private companies are adopting changes to their governance structures including the use of independent directors.[84]

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[82] A recent Indiana decision based upon a MBCA inspired statute endorsed the Delaware view that a board subcommittee in a public corporation could dismiss shareholder derivative litigation provided it demonstrate that the committee was disinterested, independent and operated in good faith but did not delve into the definition of independence. In re Guidant Shareholders Derivative Litigation, 841 N.E.2d 571 (Ind., 2006.)

[83] James A. DiGabriele and Aron A. Gottesman, , *The Sarbanes-Oxley Act and the Private Co*mpany Discount: An Empirical Investigation (June 12, 2006). Available at SSRN: http://ssrn.com/abstract=908061 (presenting evidence that the private firm discount is higher Post-Sox and suggesting that they were more negatively impacted by SOX than public firms)

[84] PAUL D. BROUDE, FOLEY & LARDNER, LLP, THE IMPACT OF SARBANES-OXLEY ON PRIVATE AND NONPROFIT COMPANIES (March 9, 2006), http://www.foley.com/files/tbl_s31Publications/FileUpload137/3511/ndi%202006%20private%20study.pdf. ( ); Richard A. Wiley, *Sarbanes-Oxley: Does it Really Apply to Non-profit and Private Corporations?*, Boston Bar Journal March/April 2006 (Good corporate practice clearly indicates that private companies employ independent directors as defined by SROs); Irwin Brum and Seth Trubin, *Sarbanes-Oxley: It is Not Just for Public Companies [cite]* (outlining pressures on private firms to adopt SOX governance mandates); HTEH, *Private and Nonprofit Corporate Governance* [cite](same); Jeremy Vanderloo, *Encouraging Corporate Governance for the Closely Held Business*, 24 Miss. C. L. Rev. 29 (2004)(corporate governance principles of Sox should apply to private as well as public companies).

Information about governance structures and practices in private enterprises is extremely difficult to obtain given that private firms face no disclosure obligations. In January of 2006, Foley and Lardner LLP conducted one of the few surveys directed to board members in private corporations. This survey found that 86% of private company respondents felt that the new federal corporate reform requirements had impacted their companies.[85] Over 70% of survey respondents reported that they were adopting governance reforms, including the establishment of independent boards, at the request of auditors (36%), customers (14%), lenders (13%), and/or because they self imposed the reforms as a "best practice" (70%).[86] Comments by survey participants indicate that they viewed the reforms as a "best practice," were fearful that the reforms would eventually be imposed upon them by regulators, or that they were preparing in advance for public company status.

The publication of these survey results predictably resulted in a slew of articles proclaiming that private companies are adopting many of the SOX inspired governance standards and suggesting that all private companies get on board.[87] In spite of the publicity engendered by this lone survey, however, we cannot read too much into these

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[85] *Id.* at 5.

[86] *Id.* at 6. These results were consistent with findings from previous surveys in 2004 and 2005. *Id.*.

[87] *See, e.g.*, William M Sinnett, *Even Private Company Boards of Directors Are Changing*, Financial Executive (Oct. 2003), *available* at http://www.allbusiness.com/periodicals/article/671974-2.html, James Gentry, *Sarbanes-Oxley impacts extends far beyond public compani*es, BUSINESSJOURNALISM.ORG, June 29, 2006, http://www.businessjournalism.org/pages/biz/2006/06/sarbanesoxley_impact_extends_f/. Dennis J. Doucet, *What Sarbanes-Oxley Means for Private Companies ; 11/21/2003;* Perkins Coie: *The Impact of Sarbanes- Oxley on Private Companies* [web address/](suggesting that private companies interested in "best practices" add independent members to their boards);

results as they were derived from data from 36 for profit private companies who responded to the survey.[88] The companies were categorized into "large organizations" defined as those with over $300 million in revenue and "small organizations" defined as those with less than $300 million in revenue.[89]

Given the small sample size and lack of further delineation of private companies by size, it is difficult to accurately assess from this data whether this trend towards independent boards reaches smaller private entities which comprise the vast majority of private business enterprises in the U.S.[90] There is some indication that private companies that are adopting SOX principles are the larger entities positioning themselves for an IPO or potential acquisitions.[91] A 2003 white paper by Robert Half International, Inc, however, suggests that smaller companies may also be impacted if they rely heavily on

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[88] BROUDE, *supra* note 77, at 5 (March 9, 2006), http://www.foley.com/people/bio.aspx?employeeid=23943 (follow hyperlink to article under "Publications"). Perhaps demonstrating the difficulty of obtaining information on closely held businesses, the Foley and Larder survey, while distributed to 9,000 participants in private enterprises, returned only 56 responses, 36 from profit enterprises. See also Eric L. Teksten et al, *Boards of Directors for Small Businesses and Small Private Corporations: The Changing Role, Duties and Expectations*, 28 Management Research news (2005) (reporting on results of a pre-Sox survey returning 32 responses from private firms and concluding that boards structures in small businesses vary according to the needs of the company)

[89] *Id.* at 12

[90] *See* SMALL BUSINESS ASSOCIATION, EMPLOYER FIRMS, ESTABLISHMENTS, EMPLOYMENT, AND ANNUAL PAYROLL SMALL FIRM SIZE CLASSES, (2003), http://www.sba.gov/advo/research/us_03ss.pdf (showing that more than 78% of United States businesses have nine or fewer employees).

[91] Michael Petrecca, *Private Companies Voluntarily Adopt Sarbanes-Oxley Principles*, SARBANES-OXLEY COMPLIANCE J., Jan. 25, 2006, http://www.s-ox.com/News/detail.cfm?ArticleID=1589. See also Richard S. Savich, *Cherry Picking Sarbanes-Oxley*, 201 J. of Accountancy 71 (2006) (discussing why a non-profit or private business may adopt requirements for a public corporation in SOX).

insurers or lenders or do business with governmental entities.[92] The potential for copycat state legislation is another catalyst that may spur private companies to adopt the federal reforms.[93] There is perhaps an emerging consensus than independent directors provide a valuable tool for family business as well.[94]

The few available surveys of outside directors of private firms do not reveal the respondents definition of "independence" and whether the perceived trend of such organizations to utilize outside board members includes the limitations now embodied in federal regulations. For the reasons outlined below, the wholesale importation of the federal regime makes little if any sense in the arena of private firms.

Private companies can certainly benefit from the presence of outside directors, and more enlightened owners and mangers have placed outsiders on their boards for many years.[95] The rationale for employing outside board members in private companies, and thus the role of the board differs, however, from the dominant monitoring role that

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[92] Robert Half International, Inc., supra note 6, at 6. See also Baker, Tom and Griffith, Sean J., *Predicting Corporate Governance Risk: Evidence from the Directors' and Officers' Liability Insurance Market* (June 15, 2006). Available at SSRN: http://ssrn.com/abstract=909346 (examining D & O underwriting in the public sphere as it relates to metric measuring "good" corporate governance)

[93] *See Id.* at 7 (discussing states' efforts at passing copycat legislation and accompanying impact on private companies).

[94] Sinnett, *supra* note 80. But See Suzanne Lane , Joseph H. Astrachan, Andrew Keyt and Kristi A McMillan, *Guidelines for Family Business Boards of Directors*, Family Business Review, Vol. 19, Issue 2, pp. 147-167, June 2006.
(outlining different considerations when choosing directors of family owned firms)

[95] *See, e.g.*, James Darazsdi, *Private Company Boards: Results of the 1999 NACD Private Company Survey*, http://www.lcvco.com.br/english/docs/Pes-CapFec-NACDI.doc (last visited Aug. 13., 2006) (noting that of 165 respondents from companies ranging in size from annual revenue of less than $5 million to more than $1 billion, more than 60% reported that more than half the board members were not part of management). This finding is not statistically valid given that the membership of NACD consists primarily of outside board members and thus the survey itself was distributed to a non-representative sample of companies.

boards are now expected to play in the public arena. Boards of most private firms operate as advising boards. Directors function on a more collaborative and less adversarial basis than is now expected of their public counterparts. The private firm directors remain as sounding boards for management and provide strategic advice utilizing expertise and networking opportunities that might not otherwise exist in the enterprise. Independence as measured by public company norms could very well impede these essential functions of the advising board in a private enterprise.[96]

While the advising role of boards has long been recognized as a paramount function of public as well as private firm directors, it has received relatively little attention in the academic literature, especially when compared to the empirical studies analyzing the impact of independent monitoring directors. [97] Literature is only recently emerging suggesting that the monitoring role of the board may hinder the advisory role of directors given the rational incentives of management. For example, independent boards

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[96] F. Douglas Raymond, *Independence and the Private Company Board*, 29 Dirs. & Bds. 14 (2005), *availabl*e at http://www.drinkerbiddle.com/files/Publication/ec360e2a-0de3-40dc-8c58-0070486fed2f/Presentation/PublicationAttachment/ab36c84b-3a92-4d82-b208-05d645b59c3f/Raymond_DB_0705.pdf. (arguing that federally defined independent directors may hinder the operation of a private firm); Scott, Hal S. and Dallas, George S., *Mandating Corporate Behavior: Can One Set of Rules Fit All?* Standard & Poor's, Spring 2006 Available at SSRN: http://ssrn.com/abstract=907346 (noting the tradeoff between independence and detailed knowledge concerning company affairs).

[97] Robert Charles Clark, *Corporate Governance Changes in the Wake of Sarbanes-Oxley: A Morality Tale for Policymaker Too* 24 (Harvard Law and Econ. Discussion Paper No. 525, Dec. 5, 2005), *available* at http://ssrn.com/abstract=808244 (suggesting that question of whether advising role of boards is threatened by Sarbanes-Oxley mandates is an empirical one yet to be answered); Renee B. Adams & Daniel Ferreira, *A Theory of Friendly Board*s 17–20 (ECGI-Finance Working Paper No. 100/2005, Oct. 2005), *available* at http://ssrn.com/abstract=453960 (noting lack of empirical study and the tradeoffs between the dual roles of board members).

by nature must rely heavily upon the CEO for information.[98] As pressures build for an increasing number of independent directors on public boards, the information producing role of the CEO becomes more paramount. Yet, as Adams and Ferreira demonstrate, the manager faces trade offs in sharing information with the Board. The more intensely the board desires to monitor the manager rather than advise her, the greater the incentive for the manager to withhold information making board interference less likely. Withholding information however, impedes the advisory functions of the board and can lessen value to shareholders.[99] Managers may be more likely to accept advice from those they know and trust rather than from those with no personal or financial connection to the firm. [100] Therefore some scholars argue that a mixed board containing both inside and independent directors may provide a more optimal governance structure for a firm.[101]

Another looming danger in the wholesale importation of federally qualified independent directors to the private realm is the elimination from the pool of otherwise qualified directors who can add value to a closely held firm. The federal definition is thus over inclusive in excluding those who may have financial or professional ties to a private entity but may have knowledge that may be desirable to the company in an advisory role or connections that may prove useful in advancing the business interest of the

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[98] Bainbridge, *supra* note 1, at 376; CHARLES N. WALDO, BOARD OF DIRECTORS: THEIR CHANGING ROLES, STRUCTURE AND INFORMATION NEEDS 95-118 (1985).

[99] Adams & Ferreira, *supra* note , at 2–3, 18-20 (modeling problem and suggesting dual boards). Don Langevoort similarly suggested that: "In the face of serious monitoring, the CEO will be very careful what she tells the outsiders." Langevoort, *supra* at 812 .

[100] HEWLETT-PACKARD DEBACLE

[101] Don Langevoort, *The Human Nature Of Corporate Boards: Law, Norms, And the Unintended Consequences Of Independence and Accountability*, 89 GEO. L.J. 797, PINPOINT (2001);

corporation.[102] This species of independence may lead to a board populated with ineffective, largely ignorant directors.[103]

Finance literature suggests that left to their own devices, firms structure their boards consistent with the relative costs and benefits of the advising versus the monitoring role of the board. While independent monitoring boards have been increasingly dominant in large public entities in the past 20 years, there is evidence that pre-SOX, smaller public firms and those with higher growth opportunities had less independent boards.[104] Moreover, recent evidence suggests that smaller public firms with high managerial ownership tend to have smaller less independent boards perhaps

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[102] See Colin Carter and Jay Lorsch, BACK TO THE DRAWING BOARD: DESIGNING CORPORATE BOARDS FOR A COMPLEX WORLD [publisher/?] (noting that independence has it limits, "directors with no links to the company so not know much about it'); Leo R. Strine, *The Delaware Way: How We Do Corporate law and some of the New Challenges We (and Europe) Face*, 30 Del. Journal of Corporate law 673 (2005) (noting that move to independent directors will leave CEO as sole decision maker on company matter as board will be unable to aid in setting business strategy); Jill E. Fisch, *Taking Boards Seriously,* 19 Cardozo L. Rev. 265 (1997)(arguing that increased independence may come at the cost of management capacity).

[103] In a recent paper, Jeffrey Gordon argues in public corporations today, the sole function of the board is to monitor and boards can adequately performed that function by utilizing outside performance signals such as stock prices. Directors in this model therefore need not be conversant on matters internal to the management of the firm. Jeffrey N. Gordon, *Independent Directors and Stock Market Prices: The New Corporate Governance Paradigm* (August 2006). ECGI - Law Working Paper No. 74/2006 Available at SSRN: http://ssrn.com/abstract=928100. Other scholars, however, suggest that whether directors who fail to meet the regulatory independence criteria but have thorough company or industry knowledge may in fact provide a better monitoring service. Hall S. Scott and George S. Dallas, *Mandating Corporate Behavior: Can One Set of Rules Fit All?* Standard & Poor's, Spring 2006 Available at SSRN: http://ssrn.com/abstract=907346.

[104] See e.g. Linck, James S. Linck, Jeffry M. Netter and Tina Yang, *The Determinants of Board Structure* (September 5, 2006). Available at SSRN: http://ssrn.com/abstract=729935 or DOI: 10.2139/ssrn.729935 (reviewing prior literature and presenting results confirming a strong relationship between board structure and firm characteristics).

supporting the theory that managerial ownership (common in private firms) is a suitable proxy for a monitoring board.[105]

Perhaps not surprisingly, the advising role is what directors like best, think they perform best and motivates board service. A recent Price-Waterhouse survey of 1279 directors of public companies reveals that the number one issue the directors would prefer to spend more time on was strategic planning, followed closely by other advising functions such as meeting with key managers, succession planning, and visiting company sites.[106] Monitoring the performance of insiders ranked very low on the list of priorities.[107] While no systematic data is currently available concerning board motivations and preferences in the private realm, it is not much of a stretch to suspect that the advisory theme common in public boards will be even stronger among directors of private firms.

The directors' preferences to perform as advisors to managers rather than as monitors of them should not engender much angst in the legal academy as it impacts board choices in the private realm. In most private companies, stock ownership is concentrated in relatively few people who also manage the firm, thus eliminating or significantly reducing the agency costs that justify the imposition of independent

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105 Id.

106 Corporate Board Member, *What Directors Think: The Corporate Board Member/PricewaterhouseCoopers Survey*, 2005, http://www.pwc.com/extweb/pwcpublications.nsf/docid/870C33ACFC7C57C385256FA3007252CF/$file/cbm-wdt-2005.pdf. Of the respondents to the survey, 59% indicated they would like to devote more time to strategic planning, with 44% indicating they would like to spend more time meeting key managers and succession planning. 42% would like to spend more time visiting company sites.

107 *Id.* (only 2% of respondents indicated they would like to spend more time on Section 404 analysis).

directors as monitors in the public sphere.[108] Owner-managers are perhaps the most effective method to eliminate agency costs as they are generally understood to occur given the inevitable in the separation of control and ownership in most public firms.[109] The presence of a controlling shareholder or shareholder group, a facet of most private companies in the U.S.,[110] however, creates a different kind of agency problem when the interests of those in control conflicts with minority shareholders. Whatever the efficacy of independent directors as monitors of controlling shareholders in public companies, in the private arena independence as a proxy for effective monitoring is illusory. In a private company, even outside directors are ordinarily selected by the inside mangers and/or the controlling shareholder. Seldom do we encounter the mediating influence of a board nominating committee in any but the very largest of the private entities. In a closely held enterprise, the stockholders often even dispense with the formality of director elections given the predetermined outcome of the endeavor. Undoubtedly, outside directors can perform some useful monitoring signals to institutions such as banks that contract with private firms or at least signal the owner's business acumen in placing outside members on their boards. However, in many private companies, actions by a nominally

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[108] Perhaps the seminal work in this field is the 1983 article of Eugene F. Fama and Michael C. Jensen, *Separation of Ownership and Control*, 26 J. L. & ECON. 301, 304 (1983). *See also* Bainbridge, *supra* note , at 381, 384–386.

[109] *See, e.g.*, JACKY YUK-CHOW, AGENCY COSTS AND OWNERSHIP STRUCTURE: EVIDENCE FROM THE SMALL BUSINESS FINANCE SURVEY DATA BASE, SMALL BUS. RESEARCH SUMMARY 1 (Dec. 2005) http://www.sba.gov/advo/research/rs268.pdf (arguing based upon statistical analysis that agency costs do not exist for smaller firms). See also, Gilson, Ronald J. and Gordon, Jeffrey N., *Controlling Controlling Shareholders* (June 2003. (arguing that in the arena of public corporations, the presence of a controlling shareholder reduces agency costs).

[110] [SBA CITE]

independent director that displease the majority shareholder will generally result in the swift removal of the director from the board.[111]

B. <u>State Law Implications</u>

While the new federalized definition of independence is over inclusive when applied to outside directors for most private firms, state law definitions may be under inclusive. Under state law constructs, the classification of a director as independent is useful only in certain contexts usually involving conflict of interest transactions. Given the convergence between majority share ownership and managers in private firms, the most conflicts occur among the owners of the firm with those in control accused of appropriating an unfair share of firm resources. Reliance upon facially independent board members to validate these conflict of interest transactions involving corporate insiders (or even to lessen the appropriate standard of judicial review) is even more problematic for private companies than in the public arena.

The Delaware Court decisions concerning director independence rarely take place in the context of controlled private corporations given the relatively small number of closely held corporations domiciled in Delaware.[112] The few Delaware derivative cases litigated among members of private firms, however, suggests that the Delaware courts

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[111] The manager's power to eject board members has been extensively studied in the public arena. *See* Vincent A. Warther, *Board Effectiveness and Board Dissent: A Model of the Board's Relationship to Management and Shareholders*, 4 J. of Corp. Fin. 53, 53-70 (1998); Benjamin E. Hermalin & Michael S. Weisbach, *Endogenously Chosen Boards of Directors and Their Monitoring of the CEO*, 88 AM. ECON. REV. 96, (1998); Andres Almazan, Javier Suarez, & Sheridan Titman, *Stakeholder, Transparency and Capital Structure* PAGE (CEPR Discussion Paper No. 4181, 2004), *available* at http://ssrn.com/abstract=491143.

[112] One estimate suggests that in spite of Delaware's dominance in the public incorporation market, less than 3.5% of non public corporations are incorporated in Delaware. Thompson, Robert B. and Thomas, Randall S., *The Public and Private Faces of Derivative Lawsuits*, -- Vanderbilt Law Review – (2004).

will look to precedent developed in the context of public corporations although there may be principled reason to differentiate such entities from controlled public companies. [113] Moreover, when opining on the validity of public corporation theories to the private realm in other contexts, the Delaware Courts do not take into account the special nature of private firms absent the corporation's election to avail itself of special statutory treatment under Delaware's close corporation statute.[114] Even if of questionable applicability, the pronouncements of Delaware courts in response to public company litigation permeate the jurisprudence in this field. This suggests that statements by the Delaware courts in cases involving controlled public corporations will have nationwide impact in litigation involving private firms. Today such is more likely to be outside of Delaware and based upon claims of minority oppression rather than breach of fiduciary claims styled as derivative suits.

The following case of a multiyear battle of a family corporation played out in the courts of Oregon will serve to illustrate the folly of the wholesale transference of principles designed for public corporations to the private realm. Oregon's corporate statute, like those of the majority of states is based upon the MBCA, yet the Oregon Courts, like those of many other jurisdictions, rely on Delaware precedent given its ubiquity.[115] *Naito v Naito*[116] involved a long-standing dividend dispute in a multi-

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[113] See e.g. Beneville v York, 769 A 2d 90 (Del. Ch. 2000).

[114] Nixon v Blackwell, 626 A. 2d 1366, 1380–81 (1993). Thompson, Robert B. and Thomas, Randall S., *"The Public and Private Faces of Derivative Lawsuits."* Vanderbilt Law Review, 2004 (noting that Delaware is "on the trailing edge among all U.S. jurisdictions" in providing dispute resolution devices for closely held entities.)

[115] Indeed comments to the MBCA in force in Oregon reference Delaware judicial decisions.

[116] 35 P.3d 1068 (Or. Ct. App. 2001).

generational family business.[117] Plaintiffs alleged that the corporation should be dissolved under a state statute providing this remedy under circumstances of oppressive or illegal conduct by the controlling shareholder.[118] The trial court found evidence of oppression and ordered the annual payment of a fixed dividend.[119] In between the trial court judgment and the appeal, the controlling shareholder (with the advice of counsel who had lost at trial) had his board adopt a dividend policy that included the creation of a dividend subcommittee of the board that would consist of non-family outside directors.[120] The policy provided that the "independent directors" would solicit input from all stakeholders including minority shareholders before recommending a dividend to the full board that was controlled by the majority shareholder.[121] The Oregon Court of Appeals rejected the defense argument that the new policy eradicated the trial court's finding of oppression, but reversed the fixed dividend remedy imposed by the trial court in order to give the newly created dividend policy time to work.[122] The Oregon Appellate court, parroting business judgment rule rhetoric, stated that it was reluctant to impose its judicial will upon the board.[123] In the years following the litigation, the minority shareholders continued to complain of oppression resulting from activities of the

[117] *See* Robert C. Art, *Shareholder Rights and Remedies in Close Corporations: Oppression, Fiduciary Duties, and Reasonable Expectations*, 28 J. CORP. L. 371, 398-401 (2003) (describing the genesis of this litigation).
[118] OR. REV. STAT. § 60.661 (2005). The cause of action for shareholder oppression was well established in Oregon at this time. *See generally* Art, *supra* at 374–404 (discussing the moorings for and interpretations of "oppression" in dissolution statutes).
[119] *Naito* v. Naito, 35 P.3d at 1076–77.
[120] *Id.* at 1077.
[121] *Id.*
[122] *Id.* at 1084.
[123] The Court stated that while the Oregon courts "would not ignore corporate misconduct, it is not their role to second-guess business decisions that within the range of reasonableness" id at 1083.

controlling shareholders, including low dividends, misrepresentations from the insiders to the board, and increased compensation for insiders.

Three years after the Court of Appeals decision, now referred to as *Naito* I, the parties were back in court. [124] Among the myriad of issues litigated in the second trial (*Naito* II) was the impact of the dividend recommendations of the so called independent directors.[125] Citing *Aronson v Lewis*, defense counsel argued that the utilization of an independent dividend committee made the dividend decision immune from judicial review except under the business judgment rule.[126] *Aronson,* as explained above, established the standard of independence under Delaware law for demand excused derivative litigation and begins with the presumption of independence.[127] Assuming the applicability of the *Aronson* standard to a claim of minority oppression in a private corporation,[128] the burden would fall on the plaintiff to prove that the dividend committee was not independent. Under Delaware law, the independence question turns on whether the directors' decisions are compromised by "extraneous consideration or influence"[129] rendering the director "incapable of acting independently for some other reason such as

[124] Ironically, the Naito Board declared dividends in the amount ordered by the trial court in *Naito I* and only defendants' subsequent appeal and the appellate court's reversal of the original trial court order paved the path for future litigation.
[125] Naito v Naito (*Naito II*), Multnomah County Circuit Court, Case. No. 0210-10929 (2004).
[126] *Id*.
[127] *Aronson* 473 A.2d at 812–815. *See also supra* notes 38, 64 and accompanying text.
[128] In Oregon a claim for oppression of minority shareholders requires an allegation of wrongdoing on the part of those controlling the entity. *See e.g.* Art, *supra* note 101, at 375. This generally equates to a finding of a conflict of interest transaction by the majority shareholder. In some jurisdictions, the oppression suit can proceed without a showing of wrongdoing by the majority. See e.g. Douglas Moll, *Shareholder Oppression & Reasonable Expectations: Of Change, Gifts, And Inheritances In Close Corporation* 86 Minn. L. Rev. 717, 746 (2002).
[129] *Aronson*, 473 A. 2d at 816.

domination or control."[130] While initially established in *Aronson*, these definitions of independence appear to be consistent with definitions used in other contexts by the Delaware courts where independence of the directors was a pertinent consideration.[131] As explained above, under Delaware precedent, the presence of a controlling shareholder does not, without more, negate independence.[132]

Plaintiffs contended that the presence of a majority shareholder who personally appointed the outside directors to the board and evidence of domination of those directors negated a finding or a presumption of independence and prevented a mere business judgment rule review. Perhaps underscoring the difference between derivative suits and other kinds of litigation, however, the determination of the independence question in the *Naito* II litigation took place after discovery and trial. Facts uncovered by plaintiffs in N*aito* II indicated that prior "independent" directors who did not accede to the majority shareholder's wishes when it came to dividend decisions were replaced with more accommodating nominees. These are the kinds of facts that even the *Beam* court recognized could impede independence, especially given the majority shareholder's

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[130] Grimes v. Donald, 673 A.2d 1207, 1216 (Del. 1996), *overruled in part on other grounds* by Brehm v. Eisner, 746 A.2d 244 (Del. 2000)).

[131] *S*ee, e.g., McMullin v Beran, 765 A 2d 910 (Del. S. Ct. 20000(analyzing independence in a class action challenging sale of company with reference to derivative cases)

[132] *See, e.g.*, *Aronson*, 473 A.2d at 815 (allegation that defendant dominated and controlled board because he owned 47% of company's outstanding stock and personally selected other directors was insufficient absent additional facts demonstrating that "through personal or other relationships the directors are beholden to the controlling person."); *Brehm*, 746 A.2d at 257 (stating proper demand futility inquiry was whether the directors were "incapable, due to personal interest or domination and control, of objectively evaluating the demand").

complete control over the board member selection process. [133] In the context of most controlled private companies, the directors face enormous implicit (if not explicit) pressures to conform to the will of the majority shareholder who appointed them to the Board.

The next inquiry, even assuming the presence of independent directors, involved the appropriate standard of judicial review. The *NAITO II* defendants argued that the dividend decision by the outside directors should be accorded a business judgment rule review under *Aronson* and the prior Delaware (and Oregon) decisions applying this limited judicial review to dividend decisions outside of the shareholder oppression arena.[134] Like defendants, plaintiffs' based their arguments in large part upon Delaware precedent involving public corporations. Plaintiffs argued that the dividend decision when coupled with the activities that arguably constituted oppression[135] should be deemed a conflict of interest transaction involving a controlling shareholder and analyzed under the fairness test *Kahn v. Lynch Communications Systems, Inc.*[136] and its progeny. Under *Kahn* fairness is always before the court and the presence of independent decision makers merely shifts the burden of proof to the plaintiffs to prove that the decisions were

[133] Lewis v. Aronson, Del.Ch., C.A. No. 6919, Hartnett, V.C. (May 1, 1985) (on remand) (holding that demand was excused because the plaintiff's amended complaint alleged sufficient specific facts suggesting that outside directors were under the control of a 47% shareholder).

[134] Traditionally, dividend decisions were viewed as board decisions protected by the business judgment rule even in close corporations where the independence of the Board was in doubt. It seemed to be a consensus view in *Naito II* that a BJR review would result in a defense victory given that the dividend decision was at least rationale. Defendants could have (but did not)also relied upon more closely analogous Delaware conflict of interest cases arising under Del 144 which closely tracks the Oregon conflict of interest statute based upon the MBCA. See e.g.

[135] CITE

[136] 638 A.2d 1110 (Del. 1994).

unfair.[137] The ultimate court decision on both the director independence question and the appropriate standard of review remained in extreme doubt.[138] In the end the court rejected the defense contentions, engaged in a fairness review and found that the majority had engaged in oppressive conduct and ordered the company dissolved unless the parties could settle their differences.[139]

The *Naito II* litigation serves to highlight the frustration on the ground in attempting to apply public company jurisprudence to the private realm. The State of Oregon is not generally known as bastion of corporate law, yet in Oregon, there are more than two dozen appellate opinions involving the relative rights of participants in non public corporations.[140] Nonetheless, Delaware decisions involving public corporations provided the fodder for the parties and ultimately the court's legal analysis. As the statutory and judicial underpinnings of minority shareholder oppression suits continue to grow, well advised companies may follow the lead in of the Naito Company and utilize outside directors to legitimize dividend, employment and other decisions impacting minority shareholders. Judicial decisions concerning the deference to afford the judgments of such outside board members should be informed by considerations relevant to closely held entities and not by unfiltered extrapolation from public corporations where quite different policy rationales prevail.[141] The independence definition should

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[137] *Id.* at 1120–1121.
[138] Moreover, the dividend decision at hand was actually made by the majority controlled board, not the independent directors.
[139] [CITE]
[140] Art, supra note -- at n.9 (listing cases through 2002).
[141] Scholarly work on the governance dynamics in controlled entities lags far behind that of effort devoted to studying widely held public firms that remain dominant in the U.S. With the emergence of a global market, scholars are turning attention to controlled public firms which predominate outside of the U.S. and the U.K. See e.g. Gilson, Ronald J.,

necessarily vary according to the special nature of private firms with the recognition of the probable necessity of more intensive judicial review.

V. CONCLUSION

The SOX and SRO mandates towards greater board independence attempt to dictate a more active policing role for directors of public corporations. This role may only not be appropriate for directors of private companies, it is largely illusory given the complete power the majority shareholder exerts over the firm and the board. There is a danger however, that private firms may attempt to clothe suspicious transactions with the appearance of propriety by employing directors who meet the federal standards. These definitions based solely upon financial or familial conflicts of interest miss the mark in ignoring the very real personal pressures directors may face to support the decisions of those in control of the corporation. Similarly, the public company jurisprudence provided by the courts of Delaware provides an under inclusive definition of independence as applied to directors in a private firm.

The real value outside directors bring to a private entity is advisory or relational. Here, the definitions of independence in the federal scheme are over inclusive as a benchmark to measure desirable outside directors. The federal definitions may preclude those from board service who may add value to a firm in an advisory role given their firm or industry knowledge and their connections. The new federal independence standards are problematic for public firms that have no choice. Calls for private firms to voluntarily adopt the newly federalized independent regime as "best practices" are ill advised.

Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy (August 2005). ECGI - Law Working Paper No. 49/2005 Available at SSRN: http://ssrn.com/abstract=784744. More work is needed in the arena of controlled private firms.