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What’s Good for the Goose? A Critical Essay on “Best Practices” for Private Firms

I. INTRODUCTION

In light of the 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. While 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 scant or even contradictory evidence that independent boards increase shareholder value, Congress, the Securities and Exchange Commission (SEC) and the Self Regulatory Organizations (SROs) have mandated a greater role for independent directors in publicly traded firms. Furthermore, corporate ratings agencies view board independence as a key factor when ranking the quality of corporate governance of rated companies. Implicit in this


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 E. Ribstein, Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002, 28 J. CORP. L. 1, 11 (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, the New York Stock Exchange (NYSE), and the American Law Institute’s Principles of Corporate Governance.") (footnotes omitted).

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model is the assumption that the independent director will be an effective monitor of otherwise shirking or conflicted managers and thus increase shareholder wealth. 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.

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 firms and non-profits as well. This paper suggests that this trend is ill-advised given the different roles that outside directors play in closely-held business entities. 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 standards. 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 and the regulatory agencies. In the private realm, the primary function of a board is advising, 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 decisions made by independent board members. The state law definitions of “independence” are contextual and do not necessarily mimic the federal rules. Like their federal counterparts, however, the state definitions often miss the mark in dealing with private entities.

This Article 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 Article claims that for private entities, the choice of individuals to serve as outside directors should not be dictated by federal concerns, nor should the decisions of nominally independent directors in private companies automatically enjoy the presumptions and protections now afforded under state law.

First, the Article 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 Article 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 (SOX), which primarily applies to public companies, may have provided the catalyst for the increased mandates relating to independent directors. SOX itself, however, merely requires that public companies establish board audit committees composed entirely of independent directors. 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. Furthermore, SOX mandates that the SEC prohibit the national securities exchanges and associations from listing issuers who do not comply with these audit requirements.
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 of which the director is a partner, member, or officer. This rule 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. With regards to prohibited affiliations, 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. For investment company issuers to be considered independent, the SEC has simply ruled that 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." 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 percent.

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. The NYSE listing rules previ-
ously defined "independence" as "free from any relationship that, in the opinion of [an issuer's] board of directors, would interfere with the exercise of independent judgment as a committee member." 22

The NYSE's current listing requirements, which were promulgated contemporaneously with the congressional activity that resulted in SOX, 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, 23 audit committees composed entirely of independent directors, 24 and compensation and nominating/corporate governance committees composed solely of independent directors. 25 Under current NYSE standards, each company must affirmatively determine and identify which of its directors are independent and disclose the basis for that determination. 26 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 27 and set the threshold of disqualifying (non-director fee) compensa-

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25. Id. §§ 303A.04, .05. "Controlled companies," defined as companies where more than half of the voting power is concentrated in one shareholder or shareholder group, need not have a majority of independent directors or nominating and compensation committees comprised of independent directors. Id. § 303A.00. Proposed changes to NYSE listing requirements clarify that "controlled companies" are those in which more than half the voting power for the election of directors is held by an individual shareholder or group. NYSE Proposed Rules, supra note 23, § 303A.00. While not itself requiring nominating/governance committees consisting of independent directors, the SEC requires 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. 8,340, Exchange Act Release No. 48,825, Investment Company Act Release No. 26,262, 68 Fed. Reg. 66,992 (Nov. 28, 2003), available at http://www.sec.gov/rules/final/33-8340.htm.


27. Post-SOX NYSE Manual, supra note 23, § 303A.02(b); see also NYSE and NASDAQ Order Approving Proposed Rule Changes Relating to Corporate Governance, Exchange Act Release No. 48,745, 68 Fed. Reg. 64,154, 157–58, 164 (Nov. 12, 2003) (discussing the definition of independent director). Audit committee members must also satisfy the requirements of Rule 10A-3 under the Exchange Act to be considered independent. Post-SOX NYSE Manual, supra note 23, § 303A.06 cmt. 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 regarding 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." Id. § 303A.00.
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tion at $100,000 per year.28 The official comment to this section notes that significant stock ownership alone does not bar a finding of independence.29

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 executive officer or employee of the company or any other individual having a relationship which, in the opinion of the issuer's board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director."30 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 for-profit organizations 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.31 The revised NASDAQ independent director requirements closely parallel those of the NYSE.32 NASDAQ now has a broad prohibition against any "relationship which . . . would interfere with the [director's] exercise of independent judgment."33 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 and the issuer.34 NASDAQ sets the disqualifying direct compensation level at $60,000.35

31. Id. §§ 4200-1(a)(14)(A)–(E).
34. Id.; see also NYSE and NASDAQ Order Approving Proposed Rule Changes Relating to Corporate Governance, 68 Fed. Reg. at 64,161–63 (discussing NASDAQ independent director rule changes).
35. NASDAQ, Inc., Listed Company Manual § 4200. NASDAQ filed a recent amendment to increase the disqualifying compensation from $60,000 to $120,000, in order to conform its director independence rules to the related person disclosure thresholds of Item 404 of Regulation S-K. See Self-Regulatory Organizations, Exchange Act Release No. 34-54,797, File No. SR-NASDAQ-2006-041 (Nov. 20, 2006). (The NASDAQ interpretive guidance states that the current threshold is at $100,000 rather than the $60,000 contained in the listing standard itself. NASDAQ Manual IM-4200, available at http://nasdaq.cmplinet.com/nasdaq/display/display.html?rbid=17058&element_id=18.). Prior to this November 2006 filing, the SEC noticed a proposed NASDAQ Rule change that would otherwise bring its definition of independence more in line with that used by the NYSE, primarily by eliminating from the definition of "independent director" any director who receives non-
NASDAQ listed companies must have audit committees that adhere both to NASDAQ's own independence requirements as well as those mandated by SOX. 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.

D. State Definitions of Independence

Under state law, the issue of board composition is largely unregulated. State statutes do not regulate the optimal number of directors, board committee structures, or the qualifications of directors. Such decisions are relegated to the stakeholders in the enterprise, and state statutes defer to private judgment on the relative merits of an independent board versus a board that includes 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. To enjoy this presumption and limited judicial review of board decisions, however, the decision makers must be disinterested and independent. 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 of demonstrating that the transaction was fair to the corporation. However, under defined circumstances, if a committee of independent directors approves the transaction 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.

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. Such ratification completely removes the transaction from judicial review. Under Delaware law and the earlier version of MBCA section 8.31 that is still in force in most states, ratification by independent directors of a conflict of interest transaction between insiders and the corporation at least shifts the burden to plaintiffs to prove that the transaction was unfair. Under recent interpretations of the Delaware statute, however, independent director ratification results in only limited judicial review pursuant to the business judgment rule. Director approval of transactions involving

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42. See, e.g., Weinberger v. UOP, Inc., 457 A.2d 701, 710–15 (Del. 1983) (applying entire fairness test to a merger).
43. Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 366 n.34 (Del. 1993); Fliegler v. Lawrence, 361 A.2d 218, 221–22 (Del. 1976) (holding that an interested transaction may be protected if ratified by disinterested or independent shareholders); see also In re Cox Commc’ns, Inc. S’holders Litig., 879 A.2d 604, 606–07, 614–17 (Del. Ch. 2005) (advocating application of business judgment rule review if controlling shareholder transaction is approved by disinterested directors and minority shareholders).
45. Id. § 8.61(b)(1).
49. Benihana of Tokyo, Inc. v. Benihana, Inc., 906 A.2d 114, 120 (Del. 2006) (holding that a court will review an interested director transaction under the business judgment rule if the transaction was approved by a majority of disinterested directors); Marciano v. Nakash, 535 A.2d 400, 405 n.3 (Del. 1987) (complying with ratification provision of section 144 results in a business judgment rule review). There was some apparent confusion conveyed in earlier opinions of the Delaware Court of Chancery concerning the appropriate standard of review of a transaction that has been ratified by disinterested directors. Compare Cooke v. Oolie, No. CIV. A. 11134, 1997 WL 367034 (Del. Ch. June 23, 1997), with Cooke v. Oolie, No. CIV. A. 11134, 2000 WL 710199 (Del. Ch. May 24, 2000) (first stating that the fairness test applied with a burden shift, then subsequently stating that the appropriate review was under the business judgment rule). See also Benihana of Tokyo, Inc. v. Benihana, Inc., 891 A.2d 150, 185 (Del. Ch. 2005) (stating that section 144 ratification only impacted the voidability rule and did not implicate which standard of review should apply).
conflicts with a controlling shareholder, however, are usually reviewed under a fairness test.50

Unlike the rule-based federal standards, state laws typically define independence contextually 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.51 For example, in In re eBay Shareholders Litigation,52 the Delaware Court of Chancery emphasized that the directors' independence was questionable because of "huge financial benefits" the directors received as compensation for their board service.53 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 or control.54 In two recent cases, the Delaware courts have recognized that, under the right circumstances, non-financial ties between interested parties and directors can impinge on independence. In the In re Oracle Corporation Derivative Litigation, the Oracle Board appointed a two member special litigation committee (SLC) to assess whether Oracle should pursue insider trading allegations against certain corporate insiders.55 In spite of the engagement of independent financial and legal advisors and an extensive investigation that culminated in a 1,100 page report,56 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 defendants shared with Stanford University.57

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50. Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1117 (Del. 1994) (holding that approval of a merger transaction by a committee of independent directors, plus other factors, can shift the burden of the fairness issue onto the plaintiff); see also In re PNB Holding Co. S'holders Litig., No. Civ.A. 28-N, 2006 WL 2403999 (Del. Ch. Aug. 18, 2006) (affirming that Kahn mandates special rules to govern controlling shareholder transactions).

51. In re Oracle Corp. Derivative Litig., 824 A.2d 917, 936 (Del. Ch. 2003) ("Much 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), abrogated by Brehm v. Eisner, 746 A.2d 244 (Del. 2000) (stating that a material financial interest can demonstrate that a board was not independent and disinterested when it considered a stockholder's demand that the board take up a corporation's claim); Rales v. Blasband, 634 A.2d 927, 936 (Del. 1993) (holding that there is reasonable doubt as to the directors' independence because of their financial interests); J. Robert Brown, Disloyalty Without Limits, "Independent" Directors and the Elimination of the Duty of Loyalty, 95 Ky. L.J. 53 (2006) (explaining the financial materiality standard under Delaware precedents).

52. Id. at *2-4.

53. Id. at 923-25.

54. Grimes, 673 A.2d at 1216.

55. Id. at 923.

56. Id. at 923-25.

57. Id. at 942-48. The SLC committee members, Hector Garcia-Molina and Joseph Grundfest, were both tenured professors at Stanford University. Id. at 923-24. The trading defendants included a Stanford Professor and two benefactors of Stanford. Id. Ultimately, after discovery and a motion for summary judgment, the court
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Stewart, the Supreme Court of Delaware 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. The court, however, made it clear that "[n]ot all friendships, or even most of them, rise to this level . . . ." In Beam, the Delaware Court, perhaps retreating from Vice Chancellor Strine’s opinion in Oracle, reaffirmed that plaintiffs face significant hurdles in overcoming the presumption that the directors are independent despite their social ties and personal relationships.

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. SOX itself only regulates public company audit committees, and the independence definitions under the SRO listing standards largely mirror the minimum standards 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 SROs have largely punted on this issue. The SOX references to "independence" with regards to audit committee members do not take shareholder control into account in defining independence, except to create a safe harbor for directors who themselves own less than 10 percent of the issuer’s stock. Similarly, comments to the SRO listing requirements state that a director’s share ownership alone will not bar an independence finding. The comments, however, do not dis-

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59. 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 plaintiffs to plead that the directors lack independence when the allegations involve personal ties rather than family ties. Id. at 1050–52.
60. Id. at 1050; see also Khanna v. McMinn, 2006 WL 1388744 (Del. Ch. 2006) (rejecting sufficiency of allegations of social and business ties to disprove independence). 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 Director Independence Standards, 31 OHIO N.U. L. REV. 381, 409–14 (2005) (criticizing the Delaware courts’ failure to consider social science evidence regarding motivations based upon personal relationships).
61. Beam, 845 A.2d at 1056. Unlike the situation in Oracle Derivative Litigation, where under Zapata v. Maldonado, 430 A.2d 779 (Del. 1981), members of the SLC are required to demonstrate their independence, in the context of demand excused derivative litigation like the Beam litigation, the directors enjoy a presumption of independence. Beam, 845 A.2d at 1054–55.
62. See, e.g., Fairfax, supra note 60, at 391–406 (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 (Aug. 9, 2004), available at http://www.abanet.org/buslaw/newsletter/0027/materials/speech.pdf (arguing that SOX represents only a limited intrusion on Delaware law).
63. 15 U.S.C. § 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 percent 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. SEC Listing Standards Relating to Audit Committees, 17 C.F.R. § 240.10A-3(e)(1) (2005).
cuss the impact of a controlling shareholder on the independence determination.64 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.65

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 court finds that the majority control results in domination of the directors. For example, in Beam v. Stewart, the plaintiff, who was a shareholder in Martha Stewart Living Omnimedia, Inc. (MSO), brought a shareholder's derivative suit alleging that Stewart’s insider trading activities surrounding her sale of ImClone stock damaged the MSO Corporation in violation of Stewart’s fiduciary duties.66 The plaintiff shareholder alleged that the MSO directors could not possibly be deemed independent given that Martha Stewart owned 94 percent of MSO’s voting stock.67 Accordingly, the plaintiff argued the necessity of demanding that the MSO Board pursue a corporate claim against Stewart, thereby allowing the shareholder to proceed with her derivative suit.68 However, the Supreme Court of Delaware 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 the stockholder.”69 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.70 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 standards that require listed companies to have independent nominating committees. The court suggested that such committees might insulate the board members from the domination of the controlling shareholder.71 As explained above, neither SRO requires controlled companies to establish board nominating


65. See Post-SOX NYSE Manual, supra note 23, § 303A.00. Controlled companies need not comply with section 303A.01 (majority of independent directors), section 303A.04 (nominating/governance committee), or section 303A.05 (compensation committee).

66. Beam, 845 A.2d at 1044.

67. Id. at 1054.

68. Id. at 1052–54.

69. Id. at 1054 (citing Aronson v. Lewis, 473 A.2d 805, 815 (Del. 1984)).

70. Id. at 1056.

committees that are independent of the controlling shareholder. 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 Stewart's 94 percent 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 a books and records request under the Delaware statute. The procedural posture of the Beam demand-excused derivative litigation and the inherent presumption of independence given to 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. 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. In a later article comparing Beam and Oracle, Justice Veasey 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." On the other hand, the Delaware courts tend to apply a unitary definition of independence in a variety of circumstances involving controlling shareholders. For example, in Kahn v. Tremont Corp., the Court evaluated a special committee's recommendation involving a merger between a controlled public corporation and its controlling shareholder. Expressly doubting 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 the plaintiff, requiring instead that the controlling shareholder affirmatively prove the entire fairness of the trans-

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72. See supra text accompanying note 65.
73. 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 E. Norman Veasey, Counseling Directors in the New Corporate Culture, 59 Bus. Law. 1447 (2004) (noting that Delaware courts have urged plaintiffs to obtain corporate books and records before filing derivative litigation). Justice Veasey is a retired Chief Justice of the Delaware Supreme Court and the author of Beam.
74. 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 presuit 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.

Beam, 845 A.2d at 1055.
76. Veasey, supra note 62, at 15.
77. 694 A.2d 422, 423–24 (Del. 1997).
action. The factors employed by the court to determine independence, however, were consistent with existing precedent and largely based on financial conflicts of interest. Kahn thus supports the general perception that the definition of independence for directors under Delaware law remains fairly constant.

It is probable, therefore, that 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 CEO defendant is a 94 percent 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. There is conflicting evidence about whether there is a market for independent directors at all and less evidence still of how such a

78. Id. at 428–30. 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 persuasion. Id. at 428. In Beam, the Court referenced this non-derivative suit line of cases, distinguishing them due to “[their] own special procedural characteristics.” Beam, 845 A.2d at 1055 n.45.

79. Kahn, 694 A.2d at 429–30. 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 an important component of the court’s decision was the lack of independence of committee members on an absolute scale. Kahn, 694 A.2d at 428–30.

80. A more realistic reading of the Beam decision suggests that it retreats from Oracle and is more in line with earlier Delaware precedent in rejecting allegations of personal and professional relationships as sufficient to demonstrate a lack of independence. See, e.g., Crescent/Mach I Partners v. Turner, 846 A.2d 963 (Del. Ch. 2000); see also In re I.P. Morgan Chase & Co. S’holder Litig., 906 A.2d 808 (Del. Ch. 2005), aff’d, 906 A.2d 766 (Del. 2006); In re Walt Disney Derivative Litig., 731 A.2d 342 (Del. Ch. 1998).

81. Beam, 845 A.2d at 1044 n.3.

82. See Charles M. Elson, Director Compensation and the Management-Captured Board—The History of a Symptom and a 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.”); Ronald J. Gilson & Reinier Kraakman, Reinventing the Outside Director: An Agenda for Institutional Investors, 43 Stan. L. Rev. 863, 874–75 (1991) (noting that directors who are financially independent still have social ties that prevent them from engaging in effective monitoring); Renee M. Jones, Law, Norms and the Breakdown of the Board: Promoting Accountability in Corporate Governance, 92 Iowa L. Rev. 105 (2006) (arguing that social norms do not adequately constrain corporate directors to act appropriately); Donald C. Langevoort, Monitoring: The Behavioral Economics of Corporate Compliance With Law, 2002 Colum. Bus. L. Rev. 625, 686 (arguing that people tend to give agents an excessive benefit of doubt when attempting to monitor friends); Julian Velasco, Structural Bias and the Need for Substantive Review, 82 Wash. U. L.Q. 821, 854–70 (2004) (reviewing literature on social impediments to independent director actions and concluding that courts underestimate the value of friendship and collegiality).

83. See Gilson & Kraakman, supra note 81, at 876 (“[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 Nw. U. L. Rev. 898, 917, 940–45 (1996) (noting that while the evidence is far from conclusive, some equivocal findings suggest the existence of a “well-functioning market for outside directors”).
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market (if it did exist) would discipline a compliant outside director. The director's reputation among social peers may be a more powerful motivating force. 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. Nonetheless, taken (and cited) at face value, these statements by the Delaware courts can cause great mischief given the relatively few cases outside of Delaware (or jurisdictions applying Delaware law) that deal with director independence in the presence of a controlling shareholder.

IV. GOVERNANCE IN PRIVATE CORPORATIONS

A. The Federal Mandates

While SOX and its related regulations apply primarily to public companies, the impact of these reforms has also permeated many private businesses under the guise of "best practices." 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. Information about governance structures and practices in private

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85. Velasco, supra note 82, at 859 ("To pretend that financial interests are inherently stronger than the bonds of friendship is both substantively indefensible and morally insulting.").

86. Id. at 844–60.

87. See, e.g., Shapiro v. Greenfield, 764 A.2d 270 (Md. Ct. Spec. App. 2001) (citing Delaware public corporation cases to help define "interested director"); Einhorn v. Culea, 612 N.W.2d 78 (Wis. 2000) (explaining that Wisconsin SLC statute derived from MBCA does not differentiate between public and closely held companies). A recent Indiana decision based upon an MBCA inspired statute endorsed the Delaware view that a board subcommittee in a public corporation could dismiss shareholder derivative litigation provided it demonstrated that the committee was disinterested, independent and operated in good faith, but the decision did not delve into the definition of independence. In re Guidant S'holders Derivative Litig., 841 N.E.2d 571 (Ind. 2006).

88. James A. DiGabriele, The Sarbanes-Oxley Act and the Private Company Discount: An Empirical Investigation 15–17 (2007), available at http://ssrn.com/abstract=908061 (presenting evidence that the private firm discount is higher Post-SOX, and suggesting that the private firms were more negatively impacted by SOX than public firms).


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enterprises is extremely difficult to obtain because private firms face no disclosure obligations. In January of 2006, Foley & Lardner LLP conducted one of the few surveys directed to board members in private corporations. This survey found that 86 percent of private company respondents felt that the new federal corporate reform requirements had impacted their companies. Over 70 percent of survey respondents reported that they were adopting governance reforms, including the establishment of independent boards, at the request of auditors (36 percent), customers (14 percent), lenders (13 percent), and/or because they self-imposed the reforms as a "best practice" (70 percent).

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. In 2005, PricewaterhouseCoopers conducted a similar survey of CEOs of 346 fast growing private companies. Thirty percent of the companies in this survey indicated that they had or were planning to voluntarily institute some SOX governance reforms including an independent board. The rationales for those planning to institute SOX reforms included best practices (60 percent), addressing potential problems (59 percent), recommendations of constituencies such as lenders and stockholders (43 percent), and posturing for a potential sale or IPO (43 percent).

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. In spite of

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C. L. Rev. 39 (2004) (corporate governance principles of SOX should apply to private as well as public companies).

90. BROUDE, supra note 89, at 5.

91. Id. at 6. These results were consistent with findings from previous surveys in 2004 and 2005. Id.

92. An independent board was mentioned by 21 percent of those instituting or planning to institute SOX reforms.

the publicity engendered by these surveys, however, we cannot read too much into these results. The Foley & Lardner results were derived from data from 36 for-profit private companies that responded to the survey." 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." Given the small sample size and lack of further delineation of private companies by size, it is difficult to accurately assess from the Foley & Lardner data whether this trend towards independent boards reaches smaller private entities that comprise the vast majority of private business enterprises in the U.S. The PricewaterhouseCoopers data was derived from so-called "trend-setter" companies that averaged $46.2 million in revenue and averaged a 387 percent increase in revenue over the past five years. This is consistent with other evidence that private companies that are adopting SOX principles are the larger entities who may be positioning themselves for an initial public offering or potential acquisition. A 2003 white paper by Robert Half International, Inc., however, suggests that smaller companies may also be impacted if they rely heavily on insurers or lenders, or do business with governmental entities. The potential for copycat state legislation is another catalyst that may spur private companies to adopt the federal reforms. There is per-

1.html (discussing the changing role of the board and the importance of outside directors for private companies, particularly family-owned businesses); Richard A. Wiley, Sarbanes-Oxley: Does It Really Apply to Non-Profit and Private Corporations?, 2006 Bos. B.J. 10 (good corporate practice clearly indicates that private companies employ independent directors as defined by SROs); Perkins Coie LLP, The Impact of Sarbanes-Oxley on Private Companies, Sept. 16, 2004, available at http://www.perkinscoie.com/content/en/us/updates/corp/091604.htm (sug-

94. Perhaps demonstrating the difficulty of obtaining information on closely held businesses, the Foley & Lardner survey, while distributed to 9,000 participants in private enterprises, returned only 56 responses, 36 from for-profit enterprises. Broude, supra note 89, at 5; see also Eric L. Teksten et al., Boards of Directors for Small Businesses and Small Private Corporations: The Changing Role, Duties and Expectations, 28 Mgmt. Res. News 50, 50 (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).

95. Broude, supra note 89, at 12.

96. See Small Bus. Ass'n, Employer Firms, Establishments, Employment, and Annual Payroll Small Firm Size Classes (2003), available at http://www.sba.gov/advo/research/us_03ss.pdf (showing that more than 78 percent of United States businesses have nine or fewer employees).


99. See Baker & Griffith, supra note 98, at 14 (discussing states' efforts at passing copycat legislation and accompanying impact on private companies).
haps an emerging consensus that independent directors provide a valuable tool for family business as well.100

The few available surveys concerning the use of independent directors of private firms do not reveal the respondents' definition of "independence" or 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 general arena of private firms.

Private companies can certainly benefit from the presence of outside directors, and more enlightened owners and managers have placed outsiders on their boards for many years.101 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 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 functions of the advising board in a private enterprise.102

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.103 Literature is only re-

101. See, e.g., James Darazsdi, Private Company Boards: Results of the 1999 NACD Private Company Survey (2006), available at http://www.lcvco.com.br/english/docs/Pes-CapFec-NACDI.doc (noting that more than 60 percent of 165 respondents from companies ranging in size from annual revenue of less than $5 million to more than $1 billion, reported that more than half the board members were not part of management). Darazsdi's finding, however, is not statistically valid given that the membership of NACD consists primarily of outside board members, meaning that the survey was distributed to a non-representative sample of companies.
cently emerging suggesting that the monitoring role of the board may hinder its advisory role given the rational incentives of management. For example, independent boards by nature must rely heavily upon the CEO for information. 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 wants 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, lessening its value to shareholders. 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. Therefore some scholars argue that a mixed board containing both inside and independent directors may provide a more optimal governance structure for a firm.

Another looming danger in applying the federal definition of independent directors to the private realm is the elimination of otherwise qualified directors who can add value to a closely held firm from the pool of candidates. 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 or connections that may prove useful in advancing a corporation’s business interests. This species of independence may lead to a board populated with ineffective, largely ignorant directors.

104. Bainbridge, supra note 1, at 376.
105. Adams & Ferreira, supra note 103, at 220–38 (modeling problem and suggesting dual boards). Donald Langevoort similarly suggested that “in the face of serious monitoring, the CEO will be very careful what she does or does not tell the outsiders.” Langevoort, supra note 5, at 812; see also Charu Raheja, Determinants of Board Size and Composition, A Theory of Corporate Boards, 40 J. Fin. & Quantitative Analysis 283 (2005) (modeling interaction of firm insiders and outsiders and finding that optimal board structures vary and will contain a mix of independent and inside directors).
108. See Carter & Lorsch, supra note 1 (noting that independence has to have limits since directors with no links to the company do not know much about it); see also Jill E. Fisch, Taking Boards Seriously, 19 Cardozo L. Rev. 265, 267, 281–82 (1997) (arguing that increased independence may come at the cost of management capacity); Leo E. Strine, Jr., The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (and Europe) Face, 30 Del. J. Corp. L. 673, 686 (2005) (noting that the move to independent directors will leave the CEO as the sole decision-maker on company matters as boards will be unable to aid in setting business strategy).
109. In a recent paper, Jeffrey Gordon argues that in public corporations today, the sole function of the board is to monitor, and boards can adequately perform 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 in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices, 59 Stan. L. Rev. 1465 (2007). Other scholars, however, suggest that directors who fail to meet the regulatory independence criteria but have thorough company or industry knowl-
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 roles of the board. While independent monitoring boards have been increasingly dominant in large public entities over the past twenty years, there is evidence that before SOX, smaller public firms and firms with higher growth opportunities had less independent boards. Moreover, recent evidence suggests that smaller public firms with high managerial ownership tend to have smaller, less independent boards, perhaps supporting the theory that managerial ownership (common in private firms) is a suitable proxy for a monitoring board.

Perhaps not surprisingly, the advising role is what directors like best, what they think they perform best, and what motivates board service. A recent PricewaterhouseCoopers survey of 1,300 directors of public companies revealed that the key issues that directors prefer spending time on are industry analysis and strategic planning, followed closely by other advising functions, such as meeting with key managers, succession planning, and visiting company sites. Monitoring the performance of insiders ranked very low on directors' list of priorities. While no systematic data is currently available concerning board motivations and preferences in private companies, it is not much of a stretch to suspect that in this arena, the advisory theme will be even stronger.

On one level, the directors' preference to advise managers rather than monitor 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 the relatively few people who also manage the firm, thus eliminating or significantly reducing the agency costs that justify the imposition of independent edge may in fact provide a better monitoring service. Usha Rodrigues, Let the Money Do the Governing: The Case for Reuniting Ownership and Control, 9 STAN. J.L. BUS. & FIN. 254, 256 (2004).


111. Id.

112. CORPORATE BD. MEMBER, WHAT DIRECTORS THINK: THE CORPORATE BOARD MEMBER/PricewaterhouseCoopers Survey (2006), available at http://www.pwc.com/extweb/pwcpublications.nsf/docid/870c33ac07c7c385256fa3007252cf. Of the respondents to the survey, 60 percent would like to spend more time discussing the competition, 36 percent indicated they would like to devote more time to strategic planning, and 48 percent needed more time to discuss the industry in general. Id. at 7–8. In addition, 43 percent of respondents indicated they would like to spend more time meeting key managers and succession planning and 38 percent would like to spend more time visiting company sites. Id. PricewaterhouseCoopers obtained similar results in its 2005 survey of directors. See CORPORATE BD. MEMBER, WHAT DIRECTORS THINK: THE CORPORATE BOARD MEMBER/PricewaterhouseCoopers Survey (2005), available at http://www.pwc.com/extweb/pwcpublications.nsf/docid/870c33ac07c7c385256fa3007252cf/$file/cbm-wdt-2005.pdf.

113. CORPORATE BD. MEMBER (2006), supra note 112. Only 3 percent of respondents indicated they would like to spend more time on section 404 analysis, and 16 percent of respondents wanted to spend more time monitoring management. Id.
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directors as monitors in the public sphere.\textsuperscript{114} Owner-managers are perhaps the most effective method to eliminate agency costs. After all, agency costs are generally understood to result from the inevitable separation of control and ownership in most public firms.\textsuperscript{115} The presence of a controlling shareholder or shareholder group, a facet of most private companies in the United States,\textsuperscript{116} 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 managers 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 due to 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 independent director that displease the majority shareholder will generally result in the swift removal of the director from the board.\textsuperscript{117}

B. State Law Implications

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, most conflicts occur between those owner/managers and minority shareholders who accuse those in control of appropriating an unfair share of

\textsuperscript{114} See perhaps the seminal work in this field, the 1983 article of Eugene F. Fama & Michael C. Jensen, \textit{Separation of Ownership and Control}, 26 J.L. & Econ. 301 (1983). See also Bainbridge, supra note 1, at 381, 384-86.


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. The few Delaware derivative cases litigated among members of private firms, however, suggest that the Delaware courts will look to precedent developed in the context of public corporations, even though there may be principled reasons to differentiate such entities from controlled public companies. 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. Even if it is questionable whether they apply, 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 a nationwide impact on litigation involving private firms.

At present, there are relatively few cases involving private companies that involve the utilization of independent directors to ratify questionable transactions by those in control. As the call for private entities to employ independent directors expands, however, this may become an emerging trend. Most of the few existing private company cases involve the attempted use of an SLC to dismiss shareholder derivative claims although there are examples involving direct shareholder claims as well.

120. Nixon v. Blackwell, 626 A.2d 1366, 1380–81 (Del. 1993); see also Thompson & Thomas, supra note 118, at 1763 (noting that Delaware is "on the trailing edge among all American jurisdictions" in providing dispute resolution devices for closely held entities).
122. See, e.g., Jeffrey S. Cronn & Joshua K. Simko, When Should a Board Appoint a Special Committee, 7 OR. BUS. L. 1 (2006) (suggesting that private companies should use SLCs to gain judicial deference to board decisions that may impact fiduciary duty litigation).
123. See, e.g., Allied Ready-Mix, 994 S.W.2d 4; Bender v. Schwartz, 917 A.2d 142 (Md. Ct. Spec. App. 2007); Shapiro, 764 A.2d 270; Einhorn, 612 N.W.2d 78.
124. See, e.g., Cutshall v. Barker, 733 N.E.2d 973 (Ind. Ct. App. 2000) (shareholders filed direct claims against individual directors in addition to derivative claims); Skoglund v. Brady, 541 N.W.2d 17 (Minn. Ct.
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The following case will serve to illustrate the folly of the bulk transference of principles designed for public corporations to the private realm. The case was played out in Oregon, where the 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.\(^2\) *Naito v. Naito*\(^2\) involved a multi-year dividend dispute in a multi-generational family business.\(^2\) The plaintiffs alleged that the corporation should have been dissolved under a state statute providing this remedy under circumstances of oppressive or illegal conduct by the controlling shareholder.\(^2\) The trial court found evidence of oppression, and ordered the annual payment of a fixed dividend.\(^2\) 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 consisting of non-family outside directors.\(^2\) The policy provided that the “independent directors” would solicit input from all stakeholders including minority shareholders before recommending a dividend to the full board, which was under the control of the majority shareholder.\(^2\) 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.\(^2\) The Oregon appellate court, parroting business judgment rule rhetoric, stated that it was reluctant to impose its judicial will upon the board.\(^2\) In the years following the litigation, the minority shareholders continued to complain of oppression resulting from activities of the 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. Among the myriad issues litigated in the second trial (*Naito II*) was the impact of the so-called independent directors’ dividend recommendations. 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. *Aronson*, as explained above, established the standard of independence under Delaware law for demand excused derivative litigation, beginning with the presumption of independence. Assuming the applicability of the *Aronson* standard to a claim of minority oppression in a private corporation, 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 considerations or influences” rendering the director “incapable of acting independently for some other reason such as domination or control.” While initially established in *Aronson*, these definitions of independence appear to be consistent with definitions used in other contexts by the Delaware courts that considered the independence of the directors. As explained above, under Delaware precedent, the presence of a controlling shareholder does not, without more, negate independence.

The plaintiffs argued that because the majority shareholders personally appointed the outside directors to the board and dominated the board decisions, the outside directors were not independent. Perhaps underscoring the difference be-
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tween 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 Naito 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 complete control over the board member selection process. 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. Like the defendants, the plaintiffs based their arguments in large part upon Delaware precedent involving public corporations. The plaintiffs argued that the dividend decision, when coupled with the activities that arguably constituted oppression, should be deemed a conflict of interest transaction involving a controlling shareholder and analyzed under the fairness test in Kahn v. Lynch Communication Systems, Inc. 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 unfair. The ultimate court decision on both the director independence question and the appropriate standard of review remained in extreme doubt throughout the proceedings. In the end, the court rejected the defense contentions, engaged in a fairness review, and found that the majority had engaged in oppressive conduct. The court ordered the company dissolved unless the parties could settle their differences.

143. See Beam v. Stewart, 845 A.2d 1040, 1051 (Del. 2000); Lewis v. Aronson, No. 6919, 11 DEL. J. CORP. L. 243, 248–57 (Del. Ch. May 1, 1985) (on remand) (holding that demand was excused because the plaintiff’s amended complaint alleged sufficient specific facts where it suggested that outside directors were under the control of a 47 percent shareholder).

144. 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 business judgment rule review would result in a defense victory given that the dividend decision was at least rational. Defendants could have (but did not) also relied upon more closely analogous Delaware conflict of interest cases arising under Delaware Rule 144, which closely tracks the Oregon conflict of interest statute based upon the MBCA. See OR. REV. STAT. §§ 60.001–.992 (2005).

145. 638 A.2d 1110 (Del. 1994).


147. Kahn, 638 A.2d at 1120–21.

148. Moreover, the dividend decision at hand was actually made by the majority-controlled board, not the independent directors.
The Naito II litigation serves to highlight the frustration in attempting to apply public company jurisprudence to the private realm. Oregon is not generally known as a 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. 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 of the Naito Company by utilizing outside directors to legitimize dividend, employment, and other decisions that impact 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. The independence definition should 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 not only be inappropriate for directors of private companies, but it is also 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 of independence. These definitions based solely upon financial or familial conflicts of interest miss the mark by ignoring the very real personal pressures that directors may face to support the decisions of those controlling 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 that 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

149. Art, supra note 127, at 373 n.9 (listing cases through 2002).
151. Scholarly work on the governance dynamics in controlled entities lags far behind the scholarly work 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 that predominate outside the U.S. and the U.K. See, e.g., Ronald J. Gilson, Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy, 119 HARV. L. REV. 1641 (2006). More work is needed in the arena of controlled private firms.
independence standards are problematic for public firms that have no choice—and if of questionable benefit to the goose, they are truly inappropriate for the gander. Calls for private firms to voluntarily adopt the newly federalized independence regime as “best practices” are ill advised.