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Questioning Authority: The Critical Link
between Board Power and Process

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Abstract

Few Chief Executive Officers (CEOs) believe their boards of directors understand the strategic factors that determine their corporation's success. In fact, some long-term directors confess that they don't really understand how their companies make money. Yet corporate law expects that boards of directors will stop managers from behaving badly. It assumes that the ultimate governing authority within corporations rests with their boards, and not with the managers who run them. Broadly accepted theories of corporate governance, such as Stephen Bainbridge's Director Primacy, are based on the faulty assumption that boards have actual authority over managers. This Article directly challenges that assumption and argues that managers, not boards, control corporate decision-making processes. The problem is that legal scholars and policymakers have ignored the connection between decision-making processes and authority. This Article is the first to examine this largely unexplored relationship, which is essential to helping boards live up to their normative mandates.

Without an effective decision-making process, regulators will continue to expect boards to perform tasks that exceed their capabilities. Worse still, conventional structural reforms such as increased director independence can actually have dangerous consequences. These reforms lessen boards' actual authority by reducing their ability to utilize effective decision-making processes. Boards must take active steps to improve the quality of their decision making. Unless they do so, they will continue to fail because they lack the power to meet the demands that law and legal theory place on them.

This Article argues that effective decision-making processes, the attributes of which can be found in organizational behavior theory, are essential to securing

a corporate board's actual authority. Analyzing the components of such a process, and identifying which components are truly controlled by boards as opposed to managers, provides a roadmap for what boards need in order to have both de facto and de jure authority in their corporations. This Article provides that original analysis. Process is power, and without it, board authority is only an empty theory, not reality.

QUESTIONING AUTHORITY: THE CRITICAL LINK BETWEEN BOARD
POWER AND PROCESS

Nicola Faith Sharpe[†]

ABSTRACT

Few Chief Executive Officers (CEOs) believe their boards of directors understand the strategic factors that determine their corporation's success. In fact, some long-term directors confess that they don't really understand how their companies make money. Yet corporate law expects that boards of directors will stop managers from behaving badly. It assumes that the ultimate governing authority within corporations rests with their boards, and not with the managers who run them. Broadly accepted theories of corporate governance, such as Stephen Bainbridge's Director Primacy, are based on the faulty assumption that boards have actual authority over managers. This Article directly challenges that assumption and argues that managers, not boards, control corporate decision-making processes. The problem is that legal scholars and policymakers have ignored the connection between decision-making processes and authority. This Article is the first to examine this largely unexplored relationship, which is essential to helping boards live up to their normative mandates.

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INTRODUCTION

The overwhelming majority of outside directors rely exclusively on executive management for information.¹ Few Chief Executive Officers (CEOs) believe their board of directors understands the strategic factors that determine their corporation’s success;² in fact, some long term directors “confess that they don’t really understand how their companies make money.”³ Yet corporate law expects that boards of directors will stop managers from behaving badly. It assumes that the ultimate governing authority within corporations rests with their boards, and not with the managers who run them.⁴ State corporate codes, federal reform efforts, judicial decisions, and a significant body of legal scholarship share an axiomatic assumption: corporate boards exercise significant control within the corporate hierarchy. Even Delaware – whose corporate law enjoys quasi-national authority within the United States – assumes that boards have the power to manage their corporations.⁵ Although boards as a practical matter, delegate the majority of this management work to the

¹ See, e.g., David A. Nadler, *Building Better Boards*, 82 HARV. BUS. REV. 102, 110 (2004) (“[O]nly 28% of the directors in our survey said they have independent channels for obtaining useful information about the company.”)

² See, e.g., COLIN B. CARTER & JAY W. LORSCH, BACK TO THE DRAWING BOARD 23–24 (2003).

³ Nadler, *supra* note 1, at 110.

⁴ DEL. CODE ANN. tit. 8, §141(a) (2010) (“The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.”); Lynn A. Stout, *On the Proper Motives of Corporate Directors (Or, Why You Don’t Want to Invite HomoEconomicus to Join Your Board)*, 28 DEL. J. CORP. L. 1, 2 (2003). Some theories of corporate control, such as director primacy, place the board in position of authority vis-à-vis shareholders as well. For a discussion of director primacy see, e.g. Stephen Bainbridge, *Director Primacy, the Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547 (2003) (discussing the board as the nexus of contracts within the U.S. public corporation). See also discussion *infra* Part I.B.3.

⁵ DEL. CODE ANN. tit. 8, §141(a) (2010). Delaware is not alone in this regard. The corporate codes of all states provide the board with the authority to govern the corporate enterprise. See MODEL BUS. CORP. ACT. ANN. §8.01 cmt. (2005) (listing individual state statutes that delegate authority to the board); see also Bainbridge, *Director Primacy supra* note 4, at 559.

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top-level managers within the firm,⁶ recent legislative efforts only reinforce the assumption that boards effectively control corporate governance.⁷

This assumption is highly dubious. One need only look at recent corporate failures for illustrations of managerial control. Take, for example, Eastman Kodak's recently filed bankruptcy petition.⁸ Although the board decided to file for bankruptcy, it was a series of decisions by management that prioritized Kodak's film business over its digital business that led to the company's decline.⁹ American Airlines also gave into a strategy it had resisted for over a decade and declared bankruptcy last November.¹⁰ Gerard J. Arpey, American's former CEO, was opposed to bankruptcy and in fact, resigned as a result of the Chapter 11 filing.¹¹ It was the CEO's strategic decision, not the larger board of directors, which caused the company to struggle financially while industry competitors profited.¹²

Kodak and American are only a small sampling of widespread corporate failure that illustrate the reality of U.S. businesses – managers, not boards, control most of the steps in the corporate governance decision-making process.¹³ Moreover, courts and legislators have failed to acknowledge this fact. Against the backdrop of repeated corporate failure, there has been a consistent shift away from descriptively accurate managerial models of corporate governance (which assume corporate boards perform a cursory advisory role) to descriptively inaccurate board-oriented models (which assume that independent boards are necessarily well-positioned to actively monitor manager behavior). Many re-

⁶ Nicola Faith Sharpe, *Process Over Structure: An Organizational Behavior Approach to Improving Corporate Boards*, 85 S. CAL. L. REV. (forthcoming 2012) [hereinafter Sharpe, *Process Over Structure*] (“Specifically, overseeing the day-to-day operations of the company, setting strategy, ensuring firm profitability, and managing employees, are all tasks left to the CEO and her closest advisors.”).

⁷ See Sarbanes-Oxley Act of 2002 § 404, 15 U.S.C. § 7262 (Supp. III 2003); see Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 111(a), 124 Stat. 1376, 1392–94 (2010) (to be codified at 12 U.S.C. § 5321).

⁸ Michael J. De La Merced, *Eastman Kodak Files for Bankruptcy*, N.Y. TIMES, Jan. 19, 2012, available at <http://dealbook.nytimes.com/2012/01/19/eastman-kodak-files-for-bankruptcy/>.

⁹ Avi Dan, *Kodak Failed by Asking the Wrong Marketing Question*, FORBES, January 23, 2012.

¹⁰ Jad Mouawad & Michael J. De La Merced, *Deal Book: In Chapter 11, a Bid to Cut Costs at American Airlines*, N.Y. TIMES, Nov. 29, 2011, available at <http://dealbook.nytimes.com/2011/11/29/in-bankruptcy-a-bid-to-cut-costs-at-american-airlines/?ref=opinion>.

¹¹ D. Michael Lindsay, *A C.E.O.'s Moral Stand*, N.Y. TIMES, Nov. 30, 2011, available at <http://www.nytimes.com/2011/12/01/opinion/at-american-airlines-a-departing-ceos-moral-stand.html>.

¹² *Id.*

¹³ See discussion *infra* Part II.B.

cent legislative efforts have been designed with an eye toward solidifying boards' authority within the firm through implementing structural changes in the board. The effect has been the opposite of what legislators intended.

Although the normative mandate animating legislative efforts has been to increase the board's authority vis-à-vis managers, these same efforts have reduced boards' authority by reducing their ability to utilize effective decision-making processes. Listing standards, legislative enactments, and other structural reforms increase boards' ossification by specifying the composition of the board, requiring particular committees, and specifying the tasks that both boards and their committees must undertake.¹⁴ The dominant theories of corporate control in modern corporate governance scholarship similarly emphasize that boards need authority over managers to effectively perform their monitoring function.¹⁵ Under each of these theories – which turn either on shareholder control or board control – boards are necessarily effective at monitoring managers in order to reduce agency costs and maximize shareholder wealth.¹⁶

These attempts to identify and implement ways to prevent corporate failure have accordingly focused on making boards better monitors. Unfortunately, they have failed to recognize the core challenge in giving boards actual “authority” over their managers: managers, not boards, control corporate decision-making processes and the information that underlies them. It is in the largely unexplored relationship between decision-making processes and authority that the key lies to good corporate governance theories and policies. In sum, board authority must originate in an effective decision-making process, not in ossifying structural changes. Analyzing the components of such a process, and identifying which of them are actually controlled by boards as opposed to managers, provides a roadmap for what boards need in order to have both *de facto* and *de jure* authority in their corporations. This Article provides that analysis. In assessing the ways in which boards can improve their decision-making processes to align them with currently unrealistic legal expectations, we can also identify situations where current legal expectations are in fact counterproductive.

¹⁴ Sharpe, *Process Over Structure*, *supra* note 6, at __; Nicola Faith Sharpe, *The Cosmetic Independence of Corporate Boards*, 34 SEATTLE U. L. REV. 1435 (2011) [hereinafter Sharpe, *Cosmetic Independence*]; see discussion *infra* Part I.E.

¹⁵ Although this Article accepts the conventional normative proposition that the board is there to monitor management, and argues that this proposition is not possible in practice, I plan to take issue with this proposition in future articles that argue boards are much more effective in their resource and stewardship roles than in their monitoring role.

¹⁶ See discussion *infra* Part I.C.2 & Part I.C.3.

This Article makes three original contributions to the corporate governance literature regarding the board of directors. First, it disputes one of the central normative and positive propositions of modern corporate law and theory, that boards control corporations. It accepts and revives managerialism's positive assertions that corporate executives, not boards, control corporations and thus identifies the gaping hole between *de jure* and *de facto* board authority. The Article disputes how much authority boards have in practice and shows that the positive assumptions of managerialism are a more accurate description of the board's actual authority. It argues that the structure of the board, which is dominated by independent directors, imposes practical limitations that leave the board without *de facto* monitoring authority.

Second, the Article takes a novel approach to explain why boards lack *de facto* authority. It argues that access to relevant information and information-gathering channels, which is the foundation of an effective decision-making process, is the key means by which the board can exercise *de facto* authority.

Finally, this Article argues that the board as the authority-based decision making body in the firm is an example of dominant legal theories (director primacy and shareholder primacy) and reforms disconnected from practice. This divide must be closed to facilitate the type of monitoring that the public, scholars, and regulators clearly expect of corporate boards. Without an effective decision-making process, regulators will continue to authorize boards to perform roles that exceed their capabilities. In a prior article, I demonstrated how process is more important than structure in improving board efficacy.¹⁷ This Article extends the analysis and is the first to squarely address what constitutes an effective decision-making process. It argues that information access is critical for decision making. Furthermore, it introduces an organizational behavior framework, which provides the foundational attributes of effective decision-making processes that are critical for boards to have the authority that theory and law desire.

The Article proceeds as follows. Part I provides a basic overview of the board's monitoring role, which requires boards to have authority over managers. It then examines the importance of authority to the conventional regulatory approach to board reform as well as the dominant theories of corporate control. These theories assume that directors are well-informed and each director is equally well situated to exercise control in comparison to the next director. Part II argues that there is a gap be-

¹⁷ Sharpe, *Process Over Structure*, *supra* note 6.

tween what theory and law expect and what boards can actually accomplish. Specifically, it argues that outside directors are at a tremendous informational disadvantage, which significantly undermines their authority. Through analyzing the component steps of an effective decision-making process, this Part demonstrates that managers and not boards control the corporation through their informational advantages. Part III argues that without effective decision making boards will have authority in theory and law, but not in practice. It also introduces an organizational behavior framework, which contains the foundational attributes of decision-making processes that are necessary to help the board successfully monitor management. It ends by examining the negative implications of a process-oriented approach for the board of director's authority. Part IV analyzes how structural reforms to the board have decreased the board's ability to exercise authority vis-à-vis managers. It goes on to examine the implications of conventional regulatory reforms. A brief conclusion follows.

I. AUTHORITY IN THEORY AND LAW

In both theory and law the board typically exercises its authority through oversight or monitoring of managers. This Part demonstrates that law and theory expect boards to actively monitor managers. Reforms, however, have simultaneously demanded greater managerial oversight from directors and implemented changes that make it more difficult for directors to meet these demands because policymakers and scholars have overlooked the critical link between authority and process. This Part begins with a short description of the board's monitoring function. Next, it examines the major theories of corporate control, and describes the importance of the board's monitoring function, for which it must have authority, to each. Within each major theory, the Article analyzes how this assumption has informed and shaped the conception of the board in academic literature. Given the widespread acceptance of the board as a monitoring body, under which the board's authority must be paramount, it concludes by analyzing the basis for the board's authority in law.

A. The Board's Control Function

Though scholars vary in their characterization of the board's dominant role,¹⁸ the board's control, or monitoring role, is by far the most prevalent role in legal scholarship.¹⁹ This is due in part to the heavy influence of agency theory on our conception of the firm. Significant academic attention has been devoted to identifying and reducing the costs that result from the misalignment of managerial and shareholder incentives.²⁰ These costs, known as agency costs, occur when agents either shirk or behave opportunistically in order to maximize their own interests at the expense of the principal. Implementing monitoring mechanisms is one way a firm can reduce agency costs. The most obvious and commonly used means of monitoring managers has been through the board of directors.²¹

¹⁸ See Jelena Petrovic, *Unlocking the Role of A Board Director: A Review of the Literature*, 46 MGMT. DECISION 1373, 1375 (2008).

¹⁹ See Henry T.C. Hu & Jay Lawrence Westbrook, *Abolition of the Corporate Duty to Creditors*, 107 COLUM. L. REV. 1321, 1351 (2007). For an in-depth analysis of the monitoring model of the board, see Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1278 (1999) ("The managerial model of the board has now been supplanted by a monitoring model."); 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) ("One of the favorite projects of corporate reformers has been the creation of the so-called 'monitoring' board."); Lynn A. Stout, *The Shareholder As Ulysses: Some Empirical Evidence on Why Investors in Public Corporations Tolerate Board Governance*, 152 U. PA. L. REV. 667, 673-77 (2003). In addition to the control or monitoring role, the other roles include the boards relational role, which is grounded in resource dependence theory and the stewardship role, found in stewardship theory. See Mark Macus, *Board Capability: An Interactions Perspective on Boards of Directors and Firm Performance*, 38 INT'L STUD. MGMT. & ORG. 98, 100 (2008) (discussing stewardship theory and the role of the board of directors); *Id.* at 1375-76 (describing the relational function of the board in which directors facilitate business relationships, the empowerment function in which directors use their knowledge and resources to assist managers, and the monitoring function in which directors ensure that managers are dutifully working for the benefit of shareholders). In their relational role, boards use their network of connections and individual resources, such as their expertise, to serve the firm. This is often done through providing access to outside resources, such as sources of credit or supply networks and through providing useful advice. For a more in depth discussion of resources-dependence see, e.g., JEFFREY PFEFFER & GERALD R. SALANCIK, *THE EXTERNAL CONTROL OF ORGANIZATIONS: A RESOURCE DEPENDENCE PERSPECTIVE* (1978). In its stewardship role, the board serves as a steward to management and seeks to empower managers to be better leaders of the company. See generally Stephen M. Bainbridge, *Why a Board? Group Decision Making in Corporate Governance*, 55 VAND. L. REV. 1, 10 (2002).

²⁰ Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976), available at <http://www.sfu.ca/~wainwrig/Econ400/jensen-meckling.pdf>. ("If both parties to the relationship are utility maximizers there is good reason to believe that the agent will not always act in the best interests of the principal.")

²¹ See AM. L. INST. PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 3.02 cmt. d (1992) (discussing the board of director's "oversight function"). Donald C. Langevoort, *Agency Law Inside the Corporation: Problems of Candor and Knowledge*, 71 U. CIN. L. REV. 1187, 1191 (2003) (recognizing that when the principal's rights and responsibilities

In its control or monitoring role²² the board oversees executive management, including the CEO. The role allows the board to oversee and ratify management's actions and thus vests legal decisional control in the board.²³

Boards most commonly exercise their oversight through a handful of specific tasks. These tasks include approving financial statements and disclosures,²⁴ which can help shareholders assess management's perfor-

ties "are divided between the board of directors and the shareholders," there is "a strong bias" toward the board "as it relates to the running of the corporation's affairs") (footnotes omitted); *see also* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 249 (1999); Donald C. Clarke, *Three Concepts of the Independent Director*, 32 DEL. J. CORP. L. 73, 81 (2007); Lisa M. Fairfax, *The Uneasy Case for the Inside Director*, 96 IOWA L. REV. 127, 137 (2010); Jill E. Fisch, *Taking Boards Seriously*, 19 CARDOZO L. REV. 265, 268–69 (1997); Jensen & Meckling, *supra* note 12, at 308–09; Paul E. Juras & Yvonne L. Hinson, *Examining the Effect of Board Characteristics on Agency Costs and Selected Performance Measures in Banks*, 7 ACAD. BANKING STUD. J. 87, 87, 89 (2008); Ira M. Millstein, *The Professional Board*, 50 BUS. LAW. 1427, 1428 (1995) Usha Rodrigues, *The Fetishization of Independence*, 33 J. CORP. L. 447, 457 (2008); James D. Westphal, *Collaboration in the Boardroom: The Consequences of Social Ties in the CEO/Board Relationship*, 42 ACAD. MGMT. J. 7, 8 (1999) (noting that the "function of boards is to reduce agency costs").

²² Board approval in this context has been categorized as part of what some call the board's control function, which is synonymous with the monitoring function. There is a significant amount of scholarship discussing whether the board actually exerts control over management's decisions. The general consensus is that boards do not exercise this control well. For a discussion of the gap between theory and practice in the board's control function see discussion *infra* Part II.B. *See also* Edward S. Adams, *Corporate Governance After Enron and Global Crossing: Comparative Lessons for Cross-National Improvement*, 78 IND. L.J. 723, 729–30 (2003) (noting that, although boards are theoretically supposed to represent the shareholders' interests, the various complexities of corporate governance, including the relationship between the board and management, creates a gulf between theory and practice). Richard Saliterman has stated that:

The corporation, for the most part, has been and presently is governed by a highly theoretical and, arguably, a nonreality oriented framework of perceptions: 1) that shareholders—the principal corporate investors—control the corporations and reflect their shareholder sovereignty by electing boards of directors; and 2) that these boards of directors select or otherwise carefully govern the activities of corporate executives who are subservient to both the board and the shareholders.

Richard Saliterman, *Perceptions Bearing on the Public Policy Dynamics of Corporation Law*, 20 HAMLINE L. REV. 261, 261 (1996).

²³ Eugene F. Fama & Michael Jensen, *The Separation of Ownership and Control*, 26 J.L. & ECON. 301, 307–08 (1983); Daniel P. Forbes & Frances J. Milliken, *Cognition and Corporate Governance: Understanding Boards of Directors as Strategic Decision making Groups*, 24 ACAD. MGMT. REV. 489, 492 (1999).

²⁴ For example, the SEC requires that the principal executive and financial officer, or persons performing similar functions, of each company filing periodic reports make several certifications. The signing officers must certify that they have reviewed the report. In addition, the officers must certify that the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading. Furthermore, the signing officers must certify that based upon such officer's knowledge, the financial statements, and other financial information including in the report, fairly present in all material respects the financial condition and results of operations of the issuer as of, and for, the periods contained in the report. 15 U.S.C. § 7241(a)

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mance,²⁵ and other major managerial decisions like merging or selling the corporation, or buying another one.²⁶ It also includes more direct tasks such as hiring and firing the CEO or other executive managers and setting their compensation.²⁷ Finally, state laws, like the Delaware Corporate Code, empower the board to further protect shareholder interest by cleansing self-interested transactions by managers, where managers conduct business with corporation on behalf of themselves.²⁸ One example of a self-interested transaction would be a manager signing a lease on behalf of the corporation for land that manager owns personally.

Boards enjoy support as a monitoring mechanism. Both modern corporate governance theory and policy-making initiatives have articulated an account of the board that requires significant authority over managers. They also have overlooked the lack of actual authority that boards exercise in practice. It is to a definition of authority that we now turn.

B. Authority Defined

Authority exists when a person or group (group *A*) exerts influence over the decisions and behavior of another person or group (group *B*). In other words, group *A* is able to get group *B* to undertake an action or make a decision not based on group *B*'s independent evaluation of the situation, but based on group *A*'s authority.²⁹ *De jure* authority uses legal measures to formalize the influence it assumes group *A* should have

(2006). Additionally, officers and directors can be liable for their improper influence on the conduct of company audits. 15 U.S.C. § 7424(a) (2006) (stating that it is unlawful for any officer of director of an issuer, or any person acting under their direction, to fraudulently coerce, manipulate, influence, or mislead any independent public or certified accountant performing an audit of the financial statements of that issuer, if the purpose of the officer of director's action is to render the financial statements materially misleading).

²⁵ Donald C. Langevoot, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 802 (2001) [hereinafter *Human Nature*].

²⁶ SYDNEY FINKELSTEIN ET AL., STRATEGIC LEADERSHIP: THEORY AND RESEARCH ON EXECUTIVES, TOP MANAGEMENT TEAMS, AND BOARDS 227 (2009); Fama & Jensen, *supra* note 23 (noting that "boards always have the power to hire, fire, and compensate the top-level decision managers and to ratify and monitor important decisions"); Langevoot, *supra* note 25, at 801–02; Petrovic, *supra* note 18, at 1375.

²⁷ See Sharpe, *Cosmetic Independence*, *supra* note 14.

²⁸ DEL. CODE ANN. tit. 8, § 144 (2010).

²⁹ For definitions of authority see RICHARD H. HALL & PAMELA S. TOLBERT, ORGANIZATIONS: STRUCTURES, PROCESSES, AND OUTCOMES 69 (10th ed. 2009) and HERBERT SIMON, ADMINISTRATIVE BEHAVIOR 9–10 (4th ed. 1997) ("A subordinate is said to accept authority whenever he permits his behavior to be guided by the decision of a superior, without independently examining the merits of that decision.").

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over group *B*; whereas, *de facto* authority exists when such influence actually occurs in practice.

Authority has been analyzed along both structural and processual lines.³⁰ In the structural context, the degree to which formal authority is concentrated in a group or individual within a firm is termed centralization.³¹ Highly centralized organizations have a hierarchical decision-making structure, where actual decision-making authority is held by a small number of individuals.³² In an organization with a low level of centralization, decision-making authority is “widely distributed among different organizational members.”³³ Theoretically, corporations are considered highly centralized organizations, with power concentrated in the hands of the board.³⁴

I do not debate that the structural hierarchy dictated by law places boards in a position of authority over management.³⁵ A processual analysis, however, reveals that boards lack actual authority. Although law and theory may support a particular decision-making hierarchy, when a subordinate group dominates the decision-making process and the superior group lacks an independent means of verification and control over the subordinate’s steps, the superior’s authority only exists in theory. For boards to have authority in a practical sense, they must have greater control over the inputs and steps of their decision-making process. Although law can grant formal authority and theory can support it, it does not mean that real authority exists.

C. Authority in Theory

While legal theories of corporate governance abound, one group of theories consistently examines who controls the corporation. The principal constituents of a corporation are shareholders, managers, and the

³⁰ Authority’s relational component involves the actual influence of *A* over *B*. This Article addresses the structural and processual aspects of authority in order to establish relational, or actual authority.

³¹ STEPHEN P. ROBBINS, ORGANIZATION THEORY: THE STRUCTURE AND DESIGN OF ORGANIZATIONS 6–7, 88 (1983) (Centralization is one of the three structural dimensions that describe a firm’s formal structure. The other two dimensions are complexity and formalization, and centralization. Complexity is the degree “of differentiation within the organization.” Centralization relates to “where the locus of decision-making authority lies.” Formalization is the extent “to which an organization relies on rules and procedures to direct the behavior of employees.”).

³² HALL & TOLBERT, *supra* note 29, at 37.

³³ *Id.* Kenneth Arrow’s description of consensus decision making and authority decision making mirror low centralization and high centralization respectively. See KENNETH J. ARROW, THE LIMITS OF ORGANIZATIONS 6–7 (1974).

³⁴ See discussion *infra* Part I.C.2 & Part I.C.3.

³⁵ See discussion *infra* Part I.D.

board of directors.³⁶ Each of the three main theories of corporate control – managerialism, shareholder primacy, and director primacy – places the corresponding group in charge of the corporation.

Whereas managerialism assumes that managers run the firm free from any significant influence of the boards,³⁷ arguments grounded in the legal rights of corporate constituencies and legislation aimed at improving the board, grant significant authority to the board for monitoring and disciplining managers. Thus a core assumption of theories that grant either shareholders or directors control, is that for the board to effectively monitor managers they must have some degree of authority over managers.

A. Managerialism

Managerialists place the ultimate right of corporate control in the hands of managers, not directors or shareholders.³⁸ Managerialism's roots can be traced to the historical debate between Adolf A. Berle, Jr.³⁹ and E. Merrick Dodd, Jr.⁴⁰ in the 1930s. Berle, along with co-author Gardiner Means, published their seminal *The Modern Corporation and Private Property* in 1932, which argued that due to decentralized shareholder ownership, shareholders had no control over the affairs of the corporation.⁴¹ As a result of this separation of ownership and control, managers were able to exercise significant control over the corporation and its affairs.⁴²

Although modern scholars largely acknowledge that managers control the firm's day-to-day operations,⁴³ managerialism popularity as a

³⁶ There are other stakeholders, including employees, creditors, suppliers, distributors, and customers.

³⁷ See, e.g., Barry D. Baysinger & Richard E. Hoskisson, *The Composition of Boards of Directors and Strategic Control*, 15 ACAD. MGMT. REV. 72, 72–73 (1990) (describing managerial dominance and director capture); see also Charles M. Elson, *Director Compensation and the Management-Captured Board—The History of a Symptom and a Cure*, 50 SMU L. REV. 127 (1996) (describing manager dominance over the board). Sydney Finkelstein, *Power in Top Management Teams: Dimensions, Measurement, and Validation*, 35 ACAD. MGMT. J. 505, 508 (noting that most boards have little influence over managers).

³⁸ George W. Dent Jr., *Academics in Wonderland: The Team Production and Director Primacy of Corporate Governance*, 44 HOUS. L. REV. 1213 (2008) __ .

³⁹ Adolf A. Berle, Jr., *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365 (1932).

⁴⁰ Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1147–48 (1932).

⁴¹ ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 5 (rev. ed. 1967) (1932).

⁴² Barry D. Baysinger & Henry N. Butler, *Revolution Versus Evolution in Corporation Law: The ALL's Project and the Independent Director*, 52 GEO. WASH. L. REV. 557, 559 (1984).

⁴³ Blair & Stout, *supra* note 21, at 282.

theory of *de jure* corporate control, however, has diminished in modern corporate governance scholarship.⁴⁴ Nevertheless, there are still numerous accounts of *de facto* managerial control. These accounts point to the CEO's influence, if not complete control, over selecting the board of directors.⁴⁵ Information asymmetries and control over the board meeting agenda are often cited as other mechanisms by which managers exert control over the board.⁴⁶ This means, that regardless of who selects the director (the CEO or the current board), all directors are subject to the CEO's control because they lack the time, knowledge, and information to make informed decisions and almost exclusively rely on the CEO to fill their knowledge and information gaps.⁴⁷ Through focusing on the *de facto* control that managers exercise over information and corporate decision making, this Article argues that managerialism should remain a vital part of the discussion about how corporations operate in practice.

B. Shareholder Control

The remaining two theories of corporate control place ultimate decision-making authority in the hands of either shareholders or directors, as is evidenced by federal reform efforts, state statutes, and case law. Shareholder primacy is based on the normative proposition that the shareholders, as the ultimate risk bearers of the firm (also called the residual claimants), should both have ultimate control over the corporation and enjoy the maximum benefit from the corporation's production efforts.⁴⁸ Moreover, increasing shareholder power, proponents such as Professor Lucian Bebchuk argue, is the best means to improve corporate governance.⁴⁹

⁴⁴ Bainbridge, *Director Primacy*, *supra* note 4, at 549.

⁴⁵ George W. Dent, Jr., *Corporate Governance: Still Broke, No Fix in Sight*, 31 J. CORP. L. 39, 43 (2005); James D. Westphal & Edward J. Zajac, *Who Shall Govern? CEO/Board Power, Demographic Similarity, and New Director Selection*, 40 ADMIN. SCI. Q. 60, 77 (1995).

⁴⁶ Dent, *Still Broke*, *supra* note 45, at 44; *see also* discussion *infra* Part II.B.6 (discussing how information asymmetries and managerial control over the board's agenda limit the board's authority).

⁴⁷ Sharpe, *Cosmetic Independence*, *supra* note 14.

⁴⁸ Bainbridge, *Director Primacy*, *supra* note 4, at 573 (writing that "shareholder primacy" embraces two principles: "(1) the shareholder wealth maximization norm...and (2) the principle of ultimate shareholder control."). Bainbridge also notes that a competing conception of shareholder primacy argues that shareholders are the actual owners of the corporation. *Id.* at 563. Although I expand on the agency theory variant, both theories use the board to monitor managers to ensure that shareholder wealth is maximized. *See also* Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L. J. 439, 440-41 (terming shareholder primacy the "standard model" of corporate governance).

⁴⁹ Lucian Arye Bebchuk, *The Case For Increasing Shareholder Power*, 118 HARV. L. REV. 833, 842 (2005). ("Even under the existing patterns of ownership, introducing shareholder power to

In the language of agency theory, shareholders are the principals of the corporation. Shareholder primacy argues that directors and officers should run “the corporation in the interests of its shareholders.”⁵⁰ Shareholders exercise their control power through various mechanisms such as voting, proxy contests, and derivative suits.⁵¹ In particular, they control directors by virtue of their right to elect or dismiss a director from her seat on the board.⁵²

Shareholders are subject to potential shirking from their agents because their ownership position is removed from the day-to-day operations of the basic corporate enterprise.⁵³ To help reduce the agency costs associated with the separation of ownership and control, shareholders employ directors as the primary monitoring mechanism. Directors monitor other employees, such as executive managers, who are beneath directors in the corporate hierarchy.⁵⁴

Though shareholder primacy argues that directors are there to serve the shareholder interests, and subject to their ultimate control, directors still have a significant degree of authority over managers. For the theory to be valid this assumption must exist, because directors would be impotent monitors without authority.

C. Director Control

Theories of director control maintain shareholder primacy’s monitoring model of the board, but they go a step further. Not only do directors have authority in relation to managers, they also have authority over shareholders, which gives them the ultimate authority in the firm. The

intervene would considerably change the balance of power between shareholders and management, producing a profound and largely beneficial impact on corporate governance.”)

⁵⁰ Bainbridge, *Director Primacy*, *supra* note 4, at 573. Hansmann & Kraakman, *supra* note 48, at 441; STEPHEN M. BAINBRIDGE, *THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE* 8 (2008).

⁵¹ Bainbridge, *Director Primacy*, *supra* note 4, at 573.

⁵² In practice, however, shareholders rarely exercise these rights. See Lisa M. Fairfax, *The Future of Shareholder Democracy*, 84 IND. L.J. 1259, 1265 (2009); Robert J. Klein, *The Case of Heightened Scrutiny in Defense of the Shareholders’ Franchise Right*, 44 STAN. L. REV. 129, 132 (1991); Marcel Kahan & Edward Rock, *The Insignificance of Proxy Access*, 97 VA. L. REV. 1347, 1358 (2011) (noting that shareholders “have taken little note” of their ability to return a proxy card without voting for the proposed director(s)).

⁵³ ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932); see also discussion *infra* notes 20–23 (describing agency problems within the firm).

⁵⁴ See, e.g., Blair & Stout, *supra* note 21, at 262–63 & Fig. 1 (1999) (describing the “grand-design principal-agent model” where the board of directors is above the CEO, managers, and employees in the corporate hierarchy). Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1469 (2007).

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two most well-know examples of director control theories – director primacy and the team production model – both diverge from the traditional agency theory conception of the firm.⁵⁵ Director primacy situates itself within the contractarian model of the firm, under which directors and officers are shareholders’ contractual agents and the actual nexus of contracts within the firm.⁵⁶ The team production model looks to theories of joint production to expand on the limits of the contractarian school and embraces a broader conception of the ends of corporate governance, which is traditionally limited to shareholders.⁵⁷

In contrast to theories of managerial primacy where boards are confined to an arms-length monitoring function; director primacy argues that directors’ authority is paramount. The theory explicitly rejects the idea that either shareholders or managers control the firm, but instead states that “directors have the ultimate right of fiat.”⁵⁸ The board operates as an authority-based decision-making unit within the broader firm.⁵⁹ This means that due to the information asymmetries and divergent interests among the three potential decision-making bodies within the firm – managers, shareholders, and directors – directors are theoretically best situated to exercise decision control.⁶⁰

The mediating hierarch found in the team production model is distinct from director primacy in several important regards but, for our purposes, it is similar in the most critical characteristic.⁶¹ Directors as mediating hierarchs are also in the position of ultimate decision-making authority within the firm.⁶² They sit at the top of the firm’s hierarchy and

⁵⁵ See, e.g., Blair & Stout, *supra* note 21; Bainbridge, *Director Primacy*, *supra* note 4.

⁵⁶ Bainbridge, *Director Primacy*, *supra* note 4, at 548, 559–60 (“The board of directors thus can be seen as a sort of Platonic guardian—a *sui generis* body serving as the nexus for the various contracts making up the corporation and whose powers flow not from shareholders alone, but from the complete set of contracts constituting the firm.”); Blair & Stout, *supra* note 21, at __.

⁵⁷ Blair & Stout, *supra* note 21, at 31–20.

⁵⁸ BAINBRIDGE, *supra* note 50, at 10. Bainbridge, *Director Primacy*, *supra* note 4.

⁵⁹ Bainbridge, *Director Primacy*, *supra* note 4, at __.

⁶⁰ *Id.* For a more complete description of authority-based decision making, see discussion *infra* Part III.A.1. The discussion points out that managers, not boards, are better situated to exercise authority decision making, and the CEO, in fact, dominates the board’s decision-making process.

⁶¹ See, e.g., Blair & Stout, *supra* note 21, at 250–51 (Blair and Stout describe the mediating hierarchy as the second-best solution to the team production problem of how to “draft explicit contracts that deter shirking and rent-seeking among [] various corporate ‘team members.’” The solution “requires team members to give up important rights . . . to a legal entity [the board of directors] created by the act of incorporation. . . . At the peak of this hierarchy sits a board of directors whose authority over the use of corporate assets is virtually absolute and whose independence from individual team members . . . is protected by law.”)

⁶² *Id.* at 290 (“As the ultimate decision making body within the firm, [directors] are not subject to direct control or supervision by *anyone*, including the firm’s shareholders. . . . Shareholders can elect directors . . . but they cannot tell them what to do.”)

mediate the relationships between various corporate constituencies.⁶³ The hierarch helps to balance the various interests of organizational members in a way that ensures satisfaction and continued production.⁶⁴

In order to “balance the team member’s competing interests,” the hierarch, in this case the board, must have information about the various challenges that face team members. Blair and Stout argue that the board plays an important role in information gathering and processing. In fact, information gathering and processing is one of the three key roles identified for the mediating hierarch.⁶⁵

Although the amount of authority the board possesses may vary from theories of shareholder control and director control, what does not vary is the fact that boards must have significant authority over managers in order to effectively monitor managers. Moreover, information is essential if boards are to effectively exercise their authority and perform their monitoring function. While theory requires this, reality diverges. As we will see in Part II, boards do not have this information.

A major characteristic of modern corporate governance is its focus on reducing agency costs. As a result, managerialism is the phenomena against which reform efforts and the theories that underlie them fight. Each theory works to vest ultimate governing authority in either shareholders or directors and to weaken the governing authority of managers. Like predominant legal theories, law also places significant authority in the hands of the board to help prevent managerial misconduct.

D. Board Authority in Law

The balance between the authority and accountability of the board frequently frames criticism of the board in times of corporate failure. Consequently, reform measures often try to restore confidence in public corporations through increasing accountability measures or through strengthening the authority of the board. This Part briefly examines some of the many structural reforms found in recent legislation. These reforms have been designed with an eye toward solidifying the board’s

⁶³ *Id.* at 288 (“Corporate law does not tread directors as shareholders’ agents but as something quite different: independent hierarchs who are charged not with serving shareholders’ interests alone, but with serving the interests of the legal entity known as the ‘corporation.’”); *id.* at 251 (“The notation that responsibility for governing a publicly held corporation ultimately rests in the hands of its directors is a defining feature of American corporate law.”).

⁶⁴ *Id.* at 281.

⁶⁵ *Id.* at 277-78.

authority within the firm.⁶⁶ Although the board delegates to top-level managers the majority of work associated with the day-to-day affairs,⁶⁷ recent legislative efforts underscore the importance of the board's authority to effective corporate governance. Like conventional policymaking initiatives, Delaware vests the power to manage the corporation in the board.⁶⁸ This Part concludes with an analysis of Delaware law.

1. The Significance of Authority to Legislative Efforts

Multiple reform efforts have sought to empower the board as a way of preventing managerial malfeasance.⁶⁹ Federal regulation, such as the Sarbanes-Oxley Act (SOX)⁷⁰ and the national listing standards have uniformly declared that independent directors are better able to monitor managers than their insider counterparts.⁷¹ Although definitions of independence vary, when it comes to qualifications for board membership, it is clear that anyone employed by the corporation in question fails the test for independence.⁷² The success of this shift from insider dominated boards to majority independent boards is evident from the composition of today's boards, which are now seventy-five percent independent.⁷³

⁶⁶ See Sarbanes-Oxley Act of 2002 § 404, 15 U.S.C. § 7262 (Supp. III 2003); see Dodd-Frank Wall Street Reform and Consumer Protection Act, § 111(a), Pub. L. No. 111-203, 124 Stat. 1376, 1392-94 (2010) (to be codified at 12 U.S.C. § 5321).

⁶⁷ Sharpe, *Process Over Structure*, *supra* note 6 (“Specifically, overseeing the day-to-day operations of the company, setting strategy, ensuring firm profitability, and managing employees, are all tasks left to the CEO and her closest advisors.”).

⁶⁸ DEL. CODE ANN. tit. 8, § 141(a) (2010) (“The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.”). Delaware is not alone in this regard. The corporate code of all states provide the board with the authority to govern the corporate enterprise. See MODEL BUS. CORP. ACT. ANN. § 8.01 cmt. (2005) (listing individual state statutes that delegate authority to the board); see also Bainbridge, *Director Primacy*, *supra* note 4, at 559 (discussing the board as the nexus of contracts within the American public corporation).

⁶⁹ Sharpe, *Process Over Structure*, *supra* note 6.

⁷⁰ See Order Approving Proposed Rule Changes Relating to Corporate Governance, Exchange Act Release No. 4875, 68 Fed. Reg. 64,154, 64,175 (Nov. 12, 2003) [hereinafter Proposed Rule Changes].

⁷¹ Fairfax, *Uneasy Case*, *supra* note 21, at 134; see Order Approving Proposed Rule Changes Relating to Corporate Governance, Exchange Act Release No. 4875, 68 Fed. Reg. 64,154, 64,175 (Nov. 12, 2003) [hereinafter Proposed Rule Changes]; see also NASDAQ QUALIFICATION IM-5605 (2004); NYSE LISTED CO. MANUAL §§ 303A.01 & 303A.02 (2011) available at <http://nysemanual.nyse.com/lcm/>. This Article defines an independent director as a non-affiliated, outside directors. For a more detailed discussion, see Sharpe, *Process Over Structure*, at note 47.

⁷² Fairfax, *Uneasy Case*, *supra* note 21, at 134.

⁷³ KORN/FERRY INST., 34TH ANNUAL BOARD OF DIRECTORS STUDY, APP. A (2008); see also Sydney Finkelstein & Ann C. Mooney, *Not the Usual Suspects: How to Use Board Process to Make Boards Better*, 17 ACAD. MGMT. 101, 101 (2003) (finding that “outsiders now account for seventy-five percent of directors on the average board” of the S&P 500); Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market*

More recently, the Dodd-Frank Act authorized the SEC to increase shareholder access to the proxy ballot, which is the means by which shareholders elect directors.⁷⁴ Although the D.C. Circuit struck down the rule that the Securities and Exchange Commission (SEC) adopted,⁷⁵ Exchange Act Rule 14a-11 would have required corporations to allow shareholders who had at least a three percent ownership interest in the corporation for three years, to place their candidate on the proxy ballot for election to the board of directors.⁷⁶ The rule limited the number of potential candidates to the greater of one nominee or twenty-five percent of the seats on the board. Implicit in the measure was an assumption that the board of directors plays a pivotal role in monitoring managers and maximizing shareholder wealth. To achieve this goal, the board must have some degree of authority over management.

2. The Business Judgment Rule and Authority

In addition to the Model Business Corporations Act, Delaware Code, and the numerous other states that have delegated authority to the board, Delaware courts have acknowledged the tremendous authority that boards of directors enjoy through the deference they are afforded under the business judgment rule.⁷⁷ As a general matter, courts abstain from second-guessing a director's business decisions. This deference to board authority is known as the business judgment rule, which presumes that directors fulfill their duties in good faith, with due care, and for accepta-

Prices, 59 STAN. L. REV. 1465, 1474 (2007) (writing that in 1950 boards were only twenty percent independent).

⁷⁴ See James D. C. Barrall, *Dodd-Frank and the 2011 Proxy Season: SEC Adopts Final Proxy Access Rules*, L.A. & S.F. DAILY J., Aug. 31, 2010, at 1–3, http://www.lw.com/upload/pubContent/_pdf/pub3789_1.pdf (“Dodd-Frank does not mandate proxy access or establish conditions for shareholder access. Instead in Section 971, Dodd-Frank amends Section 14(a) of the Securities Exchange of 1934 to expressly authorize the SEC to adopt proxy access rules and to set the terms and conditions of shareholder access.”). See also Lucian Arye Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43, 63 (2003) (arguing that the best way to align director interest with shareholder interest is to allow shareholders to elect them); J.W. Verret, *Pandora’s Ballot Box, or a Proxy with Moxie*, 62 BUS. LAW. 1007, 1037–38 (2007) (noting that access to the proxy ballot is important for the success of a shareholder voting initiative); but see generally Martin Lipton & Steven A. Rosenblum, *Election Contests in the Company’s Proxy: An Idea Whose Time Has Not Come*, 59 BUS. LAW. 67 (2003) (presenting an argument against the calls for greater shareholder access to proxy documents).

⁷⁵ *Business Roundtable v. SEC*, 647 F. 3d 1144, 1150 (D.C. Cir. 2011).

⁷⁶ Troy A. Paredes, *Concerns About New Proxy Access Rule*, HARV. L. SCH. FORUM CORP. GOVERNANCE & FIN. REG. (Aug. 26, 2010, 10:49 AM), <http://blogs.law.harvard.edu/corpgov/2010/08/26/concerns-about-new-proxy-access-rule/>. A limitation is the fact that a company would be required to include no more than one shareholder nominee or the number that represents twenty-five percent of the company’s board of directors, whichever is greater. SEC ADOPTING RELEASE, 138.

⁷⁷ See *supra* note 68 accompanying text and references.

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ble business purposes. The rule is one of the strongest statements of board authority in corporate governance.

The rule turns on the board's decision-making process and its access to information. It is well established Delaware law that under the business judgment rule directors have a duty to inform themselves of "all material information reasonably available to them," and that whether directors have fulfilled their duty is measured by gross negligence.⁷⁸ When shareholders challenge how board's performed the most common tasks within their monitoring function, the court's turn to an assessment of the board's decision-making process, and the information that supported it to evaluate whether or not the board will be protected under the business judgment rule. The courts have neither analyzed what the process requires nor acknowledged the limitations in the board's ability to effectuate such a process.

Even though the Delaware courts have mentioned, and have even been critical of, certain board processes, they have yet to provide detailed guidance on what constitutes an effective process.⁷⁹ The Delaware Supreme Court held that "we do not suggest that a board must read . . . every contract or legal document which it approves, but . . . there must be credible contemporary evidence demonstrating the directors knew what they were doing"⁸⁰ Delaware courts have barely scratched the surface.

E. Structural Impediments to Authority

Legal theory and reforms are consistent with the notion that the board is in control of the firm – control is the key to their authority. Reforms, however, have weakened the practical authority of the board. Policymakers have failed to recognize the relationship between board structure, authority, and process. Where law requires particular types of

⁷⁸ Aronson v. Lewis, 473 A.2d 805,812 (Del. 1984); *In re Citigroup Inc. Shareholder Derivative Litigation*, 964 A.2d 106, 122 (Del. Ch. 2009).

⁷⁹ *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345 (Del. 1993) (finding that the defendant directors breached their duty of care by reaching an uninformed decision to approve the sale of the company for a per-share sale price of \$23. Directors "have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them. Having become so informed, they must *then* act with requisite care in the discharge of their duties." (quoting Aronson v. Lewis, 473 A.2d 805, _ (Del. 1984)); *Aronson*, 473 A.2d at _ (holding that to invoke the business judgment rule's protection, directors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them and being so informed, they must then act with requisite care in the discharge of their duties). It is difficult to identify a process that will work for all companies, as each business is unique. However, elements of an effective process are generalizable and can be beneficial to many corporations. See discussion *supra* Part II.B.

⁸⁰ *Smith v. Van Gorkom*, 488 A.2d 858, 883 (Del. 1985).

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board structures, like independent directors, directors are actually less able to perform as expected.

Independent directors by definition have no employment relationship with the company, and as a result have limited knowledge or information about the firm or its business.⁸¹ Furthermore, independent directors' ability to monitor management is impaired by their necessary dependence on the CEO for information, which causes significant information asymmetries. Additionally, the CEO sets the agendas for board meetings, which determines the scope of the issues the board sees. As Chair of the board (as is the case in over seventy percent of large U.S. public corporations), the CEO also controls the very board that is tasked with monitoring her. In sum, the CEO determines when and what to share with the board. She controls the board's decision-making process. Thus, management holds the authority in the firm, not the board, and as a result effective monitoring is not occurring.

In previous work, I have addressed the broader limitations inherent in current board structure that make it difficult for boards to monitor managers.⁸² This includes limitations on directors' knowledge about the company, the time they have to perform their directorial duties, and the information with which they make decisions.⁸³ Structural reforms exacerbate these challenges. Specifically, the reforms increase the degree of formalization within the firm. This directly and negatively impacts the context the board's decision making.⁸⁴

Groups with a higher degree of formalization rely more heavily on rules that specify how, and by whom, tasks are to be performed.⁸⁵ This affects the board's discretion, its decision making stance (reactive instead of proactive), the scope of its monitoring, information flow, and goal setting. Groups with a highly formalized structure are better suited to making programmed decisions, which is the opposite of what an effective board must do.⁸⁶ In instances where decisions address unprecedented situations or unpredictable problems, less formalization is better.⁸⁷

⁸¹ HALL & TOLBERT, *supra* note 29, at 35; *see also* discussion *supra* Part I.C.1.

⁸² *See, e.g.,* Sharpe, *Cosmetic Independence*, *supra* note 14; Sharpe, *Process Over Structure*, *supra* note 6.

⁸³ *See, e.g.,* Sharpe, *Cosmetic Independence*, *supra* note 14.

⁸⁴ CYERT & MARCH, *supra* note 84, at 99.

⁸⁵ James W. Fredrickson, *The Strategic Decision Process and Organizational Structure*, 11 ACAD. MGMT. REV. 280, 283 (1986); Danny Miller & Cornelia Droge, *Psychological and Traditional Determinants of Structure*, 34 ADMIN. SCI. Q. 539, 543 (1986).

⁸⁶ HALL & TOLBERT, *supra* note 29, at 35 (“[O]ne disadvantage of formalization is that it may prevent members from responding to problems in an effective way, especially when the problem is not one that was anticipated by the rule-makers.”). *See* discussion *infra* Part III.A.2.

⁸⁷ *Id.* (Hall and Tolbert)

The decisions boards make vary in their complexity and importance to the success of the firm. As discussed below, the most important decisions directors make are the “nonprogrammed decisions” or those that are unique and nonroutine.⁸⁸ These are the decisions where the most value can be added or loss averted. In contrast, conventional reforms work best for decisions that are “programmed” or routine. The decision-making environment in which the board operates also shapes the types of decision-making processes that are accessible to the board.

Managers are better positioned to make nonprogrammed decisions because of their proximity to information and ability to adapt quickly to rapid changes in the environment. Unfortunately, they do so with relatively little influence or oversight from the board. The process-oriented approach suggested below makes many of the informational resources exclusively available to managers, concurrently available to the board, which improves their decision making and monitoring competency.

The board’s decision-making process is crucial to monitoring. Boards, however, face significant hurdles to engaging in such a process. It is evident that there is disconnect between what statutes and courts envision for boards and the board’s capabilities. Part II undertakes a critical and detailed examination of how current board structure denies the board access to the components of an effective decision-making process that would give the board *de facto* as well as *de jure* authority.

II. THE GAP BETWEEN DOMINANT LEGAL THEORY, REFORMS, & PRACTICE

Although dominant theories of corporate governance and legislative efforts expect boards to perform a critical control role in protecting and preserving corporate value, aspects of recent regulation actually diminish the authority of the board vis-à-vis managers. Simply put, these reforms are not well designed to accomplish their goals. Similarly, theories of control that vest authority in the board fail to account for the distance between the theoretical authority granted to the board and the way that boards struggle to exercise that authority in practice. This Part directly disputes the theoretical and legal notion that boards actually have the authority to monitor managers or control the corporation. It begins by defining and then identifying the components necessary for boards to exercise authority. The Part concludes by analyzing the ways in which

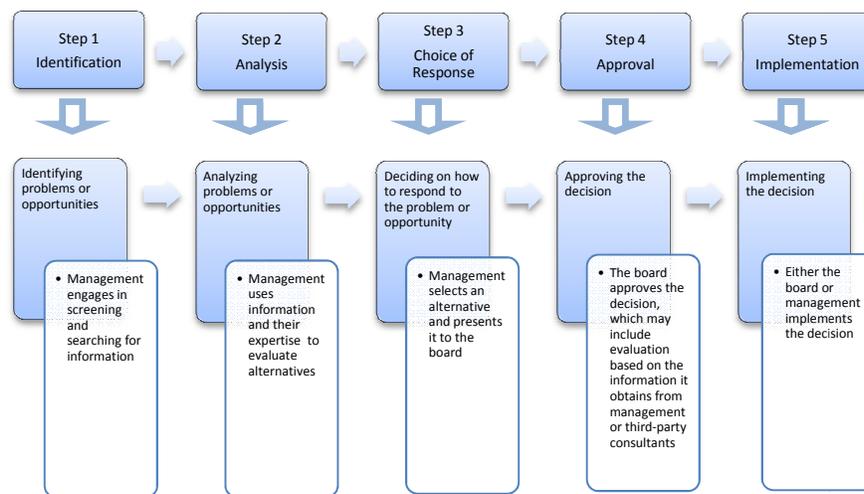
⁸⁸ See discussion *infra* Part III.A.2.

recent reforms have weakened the authority of the board through limiting their access to effective decision-making processes.

A. Process and Authority

Studies of corporate control have found that boards do not exert significant authority over managers.⁸⁹ This raises the question of how can boards gain the influence they currently lack? The process of authority is *how* influence is actually exhibited between the actors in the firm, or how authority plays out in practice. The process component is what allows a formal authority structure to literally influence the behavior of the actors. This decision-making process is made up of several component steps ranging from identifying the problem for which a decision must be made to implementing the final decision.⁹⁰ A step-by-step illustration of strategic decision making is diagramed in Figure 1 below.

FIGURE 1



⁸⁹ Peter Brantley & Neil Fligstein, *Bank Control, Owner Control, or Organizational Dynamics*, 98 AM. J. SOCIOLOGY 280–307 (1992) (finding that boards have little influence on manager’s behavior).

⁹⁰ For an example of a systematic decision-making process see JOHN R. SCHERMERHORN ET AL., *ORGANIZATIONAL BEHAVIOR* 298–99 (10th ed. 2008) (“The five basic steps involved in systematic decision making are: 1. Recognize and define the problem or opportunity. 2. Identify and analyze alternative courses of action, and estimate their effects on the problem or opportunity. 3. Choose a preferred course of action. 4. Implement the preferred course of action. 5. Evaluate the results and follow up as necessary.”).

The choices made at each level of the decision-making process influence and shape the subsequent levels of decision making. While recognizing that the choices are “linked” is an important aspect of appreciating the complexity of group decision making,⁹¹ separating the steps provides an opportunity to examine the specific aspects of each step that are primarily within management’s domain or the board’s domain. Part B examines each step in turn and analyzes how the structure of the firm advantages managerial authority over directorial authority in the actual life of the firm.

B. Managerial Authority in the Decision-Making Process

Each step in the decision-making process, identification, analysis, choice of response, approval, and implementation impact the authority held by the relative decision makers. This Part evaluates how each of these steps operates in practice and examine why information asymmetries and directors’ position as outsiders leave them with less authority vis-à-vis managers. The step-by-step examination of the decision-making process reveals how structure, without an adaptive process has proven to be an impediment to the board’s authority.

1. Identification

The first step, identification, is an example of where organizational behavior enriches our understanding of the power dynamics in corporations and real-world decision making. Using this literature, this Part first explains the importance of information identification and then shows why managers are in a better position than boards to exclusively identify the problems and opportunities the corporation faces.

Identification is a gate-keeping step for the scope of problems and opportunities a firm considers. Identifying and gathering information should be an active process, not a process where the decision maker passively waits for information to be given to them.⁹² How individuals choose to search for relevant information and how they go about obtaining it influences the scope of information available to the decision maker. The process of obtaining information involves a decision about which alternatives to explore and in what order. This means information is ob-

⁹¹ *Id.* at 299 (“Each aspect of the decision-making process is a linked choice.”).

⁹² CYERT & MARCH, *supra* note 84, at 10.

tained sequentially. The order determines the opportunities available to the firm and the problems it is likely to identify. In other words, it determines which decisions a firm will make.⁹³

The quest to obtain information is biased by the searcher's goals and experience.⁹⁴ For instance, imagine a biotech firm. Suppose the firm has an engineering department that rapidly develops new products and a marketing department that must just as quickly attempt to generate consumer interest. The engineers may not be aware of the marketing issues a particular piece of information presents; whereas, a marketing executive may not be aware of the engineering issues. Furthermore, an engineer and market executive may have very different goals when identifying relevant information. Consequently, an engineer may fail to identify information that would help the marketing department avoid loss or increase gains.

Variations in expertise and goals are only two of the biases that narrow the types of information that an organization processes. An additional, potentially more problematic bias is self-interest bias. Both individuals in the above hypothetical are less likely to look for information that undermines their credibility, detracts from their goals, or makes an important project less feasible. In fact, if either individual comes across such information, they may fail to interpret it correctly (believing it not to be as damaging as it actually is), fail to realize its significance, or fail to share it with others.

Managers actively work on searching for information that is relevant to the problems and opportunities management has identified. Managers are the most of aware of the challenges the firm faces and are motivated to obtain the information that will help them to address the problem or find new opportunities. As a general matter, most searching for information focuses in the neighborhood of the problems or opportunities the searcher has identified.⁹⁵ This limits the ability of the firm to consider alternatives that radically depart from the status quo.⁹⁶

Boards do not have an active information identification role. A firm's success is closely tied to the information decision makers possess. Because identifying information literally determines the decisions a firm will ultimately face, it is fair to say, managers control the issues that the firm will address. Their exclusive ability to set the firm's agenda plays a

⁹³ *Id.* (Cyert & March, 10)

⁹⁴ *Id.* at 169. (Cyert & March 169)

⁹⁵ *Id.* at 170. (Cyert & March)

⁹⁶ *Id.* (Cyert & March); *see* discussion of Kodak, *infra* Part III.A.2.

significant role in determining the success of the corporate enterprise and is a major source of practical authority.⁹⁷

2. Analysis

After identifying potential problems or opportunities, decision makers then analyze the problem or opportunity. This may include estimating their costs and benefits to the organization, examining different responses to the problem or opportunity and estimating the response's effect on the problem or opportunity.⁹⁸ Analysis is also an information-intensive step. Although the decision maker is operating in a world of imperfect information, she is still primarily responsible for determining what information goes into the analysis and interpreting to what extent that information supports or negates a course of action.

Boards are passive recipients of the information that managers identify; they are also passive recipients of management's analysis and their subsequent recommendations. Managers are closer to the resources the firm needs to continue operations and the information from and about those resources. Managers then engage in more direct analysis of the information and how it either supports or undermines particular firm strategies.

In the event that managers are delegating analytical responsibility to subunits within the organization, managers are likely to select employees that will support their view points and favor their positions.⁹⁹ Similarly, any analysis a manager directly conducts will be subject to the manager's biases and limitations.¹⁰⁰

3. Choice of Response

Once the alternative courses of action have been analyzed, managers decide how to respond to the problem or opportunity. One of the most significant limitations on decision making is what Nobel Laureate Herbert Simon terms satisficing. Assuming the decision maker is operating in good faith, this means that a decision maker will adopt the first available course of conduct that gives an acceptable resolution to the situation at hand. Simon writes: "Most human decision making, whether individual or organizational, is concerned with the discovery and selection of

⁹⁷ HALL & TOLBERT, *supra* note 29, at 118.

⁹⁸ HUNT ET AL., *supra* note 112 at 298.

⁹⁹ HALL & TOLBERT, *supra* note 29, at 118.

¹⁰⁰ See discussion *infra* Part II.B.1 describing biases confronting managers in identifying information.

satisfactory alternatives; only in exceptional cases is it concerned with the discovery and selection of optimal decisions.”¹⁰¹ A biased decision maker is more likely to select a less than acceptable resolution to the problem.

This is concerning because managers have access to more information than board members. In both good faith and bad faith scenarios, a natural byproduct of most communications processes is that the process changes the information, resulting in information that is withheld or distorted. Managers are therefore likely to select a course of action that they deem acceptable, although not necessarily optimal. The information used when explaining and justifying that course of action to the board, may be incomplete or distorted. Consequently, boards are being asked to approve a suboptimal choice of response presented by managers who provide far less information than was used in formulating the response.

4. Approval

It should be evident that boards only influence one of the five steps of the decision-making process. Boards participate in the approval phase, which many have argued is pro forma at best. Boards receive the majority of their information from managers.¹⁰² Managers dictate the content of, analysis pertaining to, and recommendations regarding the matters that are subject to board approval. In some instances, the matters themselves are determined by management’s choices.¹⁰³ Managers set the agendas for board meetings and control when and what information the board receives.¹⁰⁴ As a result outside directors are passive recipients of the information managers have deemed relevant. The information is limited by the underlying biases of the managers that obtained it. It will likely favor the goals and positions of the managers preparing and presenting it. Board approval is based on this deeply flawed decision-making process where managers have the clear and overwhelming informational advantage.

5. Implementation

Implementation is almost completely within the purview of management.¹⁰⁵ They are responsible for general operations and daily man-

¹⁰¹ HERBERT SIMON, ORGANIZATIONS (1958).

¹⁰² See Sharpe, *Cosmetic Independence*, supra note 14; see discussion infra/supra at note _.

¹⁰³ See discussion infra Part II.B.1.

¹⁰⁴ *Id.*

¹⁰⁵ Exceptions include decisions such as mergers and acquisitions, amending bylaws, proxy proposals, which are all subject to board approval.

agement. Managers, then, have tremendous discretion as to how to operationalize the decisions that the board has approved. Since boards almost always agree with management's proposals,¹⁰⁶ the problem is not whether management will zealously implement the decision, but whether the manner of implementation is consistent with the understanding of the board and the long-term health of the corporation.

6. Summary

The decisions made by those with authority are a function of the information the group receives.¹⁰⁷ Information is at the core of an effective decision-making process. Multiple individuals and groups possess the information relevant to the decision.¹⁰⁸ In order for a group, such as the board, to have decision-making authority they must have multiple information-gathering channels.¹⁰⁹ Without these channels, the board would lack relevant information and the ability to make effective decisions.

All of the decision-making steps diagramed in Figure 1 above, including the first three steps, are critical to decisional control and to the board's authority. Managers, however, are in a much better position to perform the first three steps of the decision-making process than are boards of directors. This is not surprising since managers, as the day-to-day operators of the corporate enterprise, are closer to the business's challenges and opportunities. Conventional structural reforms that have transformed boards to supermajority entities, however, have widened the divide between directors and the firms they monitor. Specifically, they have changed the way information flows from management to the board, and made it more difficult for the board to monitor the CEO and other executive managers.

III. FILLING THE GAP: DECISION-MAKING PROCESS — THE CORNERSTONE OF AUTHORITY

The reasons that boards may be effective or ineffective vary greatly. Both endogenous and exogenous factors play a role.¹¹⁰ The single most

¹⁰⁶ See discussion at note _ to _.

¹⁰⁷ ARROW, *supra* note 51, at 48–49 (“Decisions are necessarily a function of information.”).

¹⁰⁸ HERBERT SIMON, ADMINISTRATIVE BEHAVIOR 209.

¹⁰⁹ *Id.*

¹¹⁰ Exogenous factors may include the state of the economy and natural disasters, which can all influence board performance. Endogenous factors may include directors' relationships with the CEO, intraboard dynamics, boardroom norms, and the decision-making process the board employs.

important endogenous factor that affects how much authority a board has is information and its impact on the board's decision-making process.

This Part makes a crucial connection between an effective decision-making process and the authority required for boards to properly monitor managers. It begins by identifying opportunities for the board to add value to the firm through the types of decisions it makes. It then uses an organizational behavioral decision-making framework to analyze how an effective board process can help the board to establish true authority.

A. *Adding Value through Effective Decision Making*

Part II established that the typical decision-making process leaves the board without true authority; this Part answers the question of how to fix it. In contrast to policy-making efforts that heavily emphasize board independence, Delaware courts have identified decision making, and more importantly, the processes that inform the board's decisions, as the core of the board's monitoring function.¹¹¹ There are two broad categories that describe these steps. The key difference between the two is how information is shared.

1. Types of Decision-making processes

There are two approaches to decision making within organizational behavior, classical and behavioral. Classical behavioral theory assumes that perfect information exists both in regard to the problem and the solutions, along with any possible consequences.¹¹² This model is most often used as a normative and prescriptive approach to decision making. In other words, it describes how decisions should be made.

In contrast, behavioral decision making is better suited for the actual decisions boards make. It accepts the now common premise that rationality is bounded.¹¹³ This means that the behavioral decision maker must make decisions in an uncertain world with imperfect information about solutions to problems and their possible consequences.¹¹⁴ Organizational behavior theory and behavioral law and economics often apply this approach.¹¹⁵

¹¹¹ Sharpe, *Process Over Structure*, *supra* note 6, at 119; *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996).

¹¹² JAMES G. HUNT, RICHARD N. OSBORN, JOHN R. SCHERMERHORN, *ORGANIZATIONAL BEHAVIOR* 303 (10th ed. 2008).

¹¹³ *Id.* at 304.

¹¹⁴ *Id.*

¹¹⁵ *See e.g.*, *BEHAVIORAL LAW AND ECONOMICS* (Cass R. Sunstein ed., 2008).

Within the behavioral approach, there are several types of decision-making processes. The two most common categories are consensus-based decision making and authority-based decision making. Consensus-based decision making seeks to secure agreement from most of the members within a group on the course of action that is best for the entire group.¹¹⁶ It works best when group members have similar interests and uniform access to relevant information.¹¹⁷ In contrast, under authority-based decision making a single group makes decisions on behalf of the entire enterprise.

There is significant scholarly agreement that a board functions as an authority-based decision making body within the firm.¹¹⁸ Structurally, authority-based decision making is best suited for situations “where there are information asymmetries among potential decision makers and the decision makers have different interests.”¹¹⁹ Harvard Business School Professor Jay Lorsch writes, “At the same time, the board sits at the pinnacle of its company’s organization structure, right at the top of the company hierarchy. At least in theory, it is the body from which all power flows. In every country of which we are aware, the law makes clear that the board is the boss and the CEO works for it.”¹²⁰ Professor Stephen Bainbridge has characterized the relationship between shareholders and directors as one with divergent interests and information asymmetries,¹²¹ which leaves boards well-placed for authority-based decision making. In contrast, this Article argues that this characterization more accurately describes the relationship between the board and management, where management maintains a strong informational advantage.

Although theory assumes that the board is an authority based decision-making body within the firm, the board itself is thought to be a consensus decision-making unit.¹²² This Article sharply disputes that assumption. Lorsch writes, “[T]here is an almost complete absence of formal hierarchy within the board. No director’s opinion is supposed to be more important than another’s. Even the chairman is supposed to deal

¹¹⁶ HUNT ET AL., *supra* note 112, at 183.

¹¹⁷ Bainbridge, *The Business Rule as Abstention Doctrine*, 106.

¹¹⁸ Bainbridge, *Director Primacy*, *supra* note 4; Blair & Stout, *supra* note 21. CARTER & LORSCH, *supra* note 2, at _ (2003). This Article does not attempt to settle debate as to whether it is the board or shareholders who hold the ultimate decision-making authority within the firm; it simply points out that regardless of which theory one subscribes to, the board still holds a position of authority. For a discussion of shareholder versus director primacy see discussion *supra* Part I.B.

¹¹⁹ Bainbridge, *Abstention Doctrine*, *supra* note 117, at 70.

¹²⁰ CARTER & LORSCH, *supra* note 2, at _ (2003).

¹²¹ Bainbridge, *Abstention Doctrine*, *supra* note 117, at 106 (citing ARROW, *supra* note 51, at 70).

¹²² CARTER & LORSCH, *supra* note 2, at _; Langevoort, *Human Nature*, *supra* note 25, at 797.

with other directors as peers . . . [Directors] operate very much as would a genuine partnership.”¹²³

This does not hold true in practice. The CEO is extremely influential as is her management team, which we can see through analyzing each step of the decision-making process. Due to the information asymmetries and dynamics in the corporation, consensus decision making is not occurring within the boardroom. In most cases, the CEO has the informational advantage and therefore holds the true authority. This Article does not suggest that CEO/Chair duality should be ended because a simple structural change such as separating this role does not address the larger informational and knowledge asymmetries that exist. Empowering the board through better information-gathering and decision-making processes can help. For effective monitoring to occur, we need the type of effective decision-making processes suggested below.

Organizations and the groups within them do not need to adopt the same decision making approach. Where public corporations tend to be optimized for authority-based decision making, the groups within the corporation often adopt various forms of consensus-decision making approaches. Research on how executive teams operate has explored which approach works best for teams and have found that consensus-decision making offers significant advantages.¹²⁴ Similarly, the corporate board of directors should operate as a consensus decision making body within the firm.

Theoretically the goal of the board is to monitor managers in order to maximize shareholder value. Due to the information asymmetries between the board and management, it does not have the authority necessary to perform this function well. Specifically, the board is unable to effectively make the types of decisions that would add the most value to the firm.

2. Programmed Versus Nonprogrammed Decisions

The types of decisions that organizations and the groups within them make can be divided into two broad categories: programmed and nonprogrammed decisions. Programmed decisions address routine problems through standardized responses.¹²⁵ Familiarity with the situation

¹²³ CARTER & LORSCH, *supra* note 2, at _ .

¹²⁴ *Id.*

¹²⁵ HUNT ET AL., *supra* note 112, at 302.

allows decision makers to implement established solutions to the problem.¹²⁶

Arguably the most important decisions directors must make are nonprogrammed decisions.¹²⁷ Nonprogrammed decisions are decisions that respond to nonroutine problems. These decisions, which address unfamiliar situations, require creative problem solving that is specifically tailored to the unique problem that has arisen.¹²⁸ Past experience and old data can help deal with these situations, but the immediate decision requires knowledge of the company, timely knowledge of the company's market situation, and the ability to craft a creative response.¹²⁹ In other words, the decisions are not susceptible to predetermined responses.¹³⁰ They have a high degree of uncertainty, particularly in regard to whether deciding on action *A* will result in outcome *B* and only outcome *B*.¹³¹ In other words, there is a lack of certainty about cause and effect.¹³² Nonprogrammed decisions require a much greater level of information and information processing than programmed decisions.¹³³

Independent directors are ill-suited to make nonprogrammed decisions. Specifically, their limited knowledge about the company and lack of proximity to the problems at hand, leave them at a significant disadvantage compared to managers.¹³⁴ When managers bring recommendations to the board, independent director's informational disadvantages and inability to independently verify or evaluate the situation means they are engaged in suboptimal monitoring.

Turning back to the Kodak example discussed earlier, it is clear that Kodak's board deferred to the CEO and did not stop the strategic mis-

¹²⁶ *Id.*

¹²⁷ For definitions of unstructured decisions see Henry Mintzberg et al., *The Structure of "Unstructured" Decision Processes*, 21 ADMIN. SCI. Q. 246 (1976) ("*Unstructured* refers to decision processes that have not been encountered in quite the same form and for which no predetermined and explicit set of ordered responses exists in the organization."). For definitions of strategic decisions see HALL & TOLBERT, *supra* note 29, at 115 (defining strategic decisions as "big, high-risk decisions made at high levels of organizations that significantly affect organizational outcomes."); Mintzberg et al., *id.* And *strategic* simply means important, in terms of the actions taken the resources committed, or the precedents set.").

¹²⁸ HUNT ET AL., *supra* note 112 at 302.

¹²⁹ *Id.*

¹³⁰ Mintzberg et al., *supra* note 127.

¹³¹ Adapted from Tolbert & Hall's description of certainty and uncertainty in the cause and effect relationship. TOLBERT & HALL, *supra* note 29, at 114.

¹³² *Id.* (describing the effect of bounded rationality on an individual's decision-making process).

¹³³ Jay R. Galbraith, *Organizational Design: An Information Processing View*, in READINGS IN ORGANIZATIONS: BEHAVIORS, STRUCTURE, PROCESSES 244 (James L. Gibson et al. eds., 3d ed. 1979).

¹³⁴ See Sharpe, *Cosmetic Independence*, *supra* note 16.

steps and subsequent decline of the company. Although Kodak is credited with inventing the digital camera, the business model emphasized its tried and true success with film.¹³⁵ After several years of watching its film sales decline, and continual failure to make a net profit, the company finally decided to stop investing in film in 2003.¹³⁶

In the decade preceding that decision, the company was first under the leadership of CEO, George M.C. Fisher and then Daniel Carp.¹³⁷ Under Fisher, Kodak divested many of its businesses including its health segment, and focused on its core business.¹³⁸ The company continued to react to decline profits with programmed decisions.¹³⁹ Fisher employed the “hardware based digital strategy” that had made him successful as CEO of Motorola, only to find that by 1997 sixty percent of Kodak’s losses were linked to “digital cameras, scanners, thermal printers, writable CDs and other products.”¹⁴⁰ Despite Kodak’s move toward a more digital business, Kodak path dependency was evident from its heavy investment in film. As of 2000, eighty percent of its revenue still came from traditional film products, which were barely profitable.¹⁴¹

Kodak’s response to these challenges was to continue to emphasize film and to export the business model that had made it the leader in film to the digital arena.¹⁴² Where it once had dominated all aspects of the photography business, which included film, chemicals, and photo paper, its strategy was to offer a similar one stop shop for integrated digital photography.¹⁴³ The model included cameras, online photo services, and image output devices such as digital kiosks.¹⁴⁴ Although Kodak continued to suffer losses in its digital camera and film sales, two of the core strate-

¹³⁵ De La Merced, *supra* note 8. *Kodak Files for Bankruptcy as Digital Era Spells End to Film*, BUSINESS WEEK, January 25, 2012.

¹³⁶ *Id.*

¹³⁷ Mark Maremont, *Kodak’s New Focus*, BUSINESS WEEK, Jan. 30, 1995, at 62 – 63.

¹³⁸ Geoffrey Smith, *Can George Fix Kodak?*, BUSINESS WEEK, Oct. 20, 1997. *See also Eastman Kodak Company Annual Report 2000: Notes to Financial Statements*, KODAK.COM, <http://www.kodak.com/US/en/corp/annualReport00/financialInfo/notes/note17.shtml>

¹³⁹ *Kodak changes digital strategy*, ELECTRONICS, Nov., 17, 1997.

¹⁴⁰ *Id.*

¹⁴¹ Brian Upbin, *Kodak’s Digital Moment*, FORBES, Aug. 21, 2000, *available at* <http://www.forbes.com/forbes/2000/0821/6605106a.html>.

¹⁴² ¹⁴³ Kodak’s website describes each of its Kodak Express stores as “a one-stop shop for practically all your photography needs.” *Kodak: Consumer Products*, KODAK.COM, http://www.kodak.com/IN/en/consumer/PrintingSharing/printingSharing.jhtml?type=2_3_4&id=0.2.4.10&lc=en. *See also* Oon Yeoh, *Lessons from Kodak*, THE SUN DAILY, Jan. 18, 2012, <http://www.thesundaily.my/news/269564> (describing Kodak’s dominance in the industry in both quantitative and qualitative terms, including references to the popular catchphrase “Kodak Moment.”).

¹⁴⁴ Upbin, *supra* note 141.

gies announced by Carp in 2002 were to expand its film business and continue to grow its integrated digital business.

One might ask where the board was during these major strategic initiatives. The board suffered from the same executive culture that venerated authority.¹⁴⁵ Kodak director Roberto C. Goizueta, who was also the chairman of Coca-Cola's board, described their selection of Fisher as choosing God's runner up.¹⁴⁶ Fisher found a company that disfavored conflict.¹⁴⁷ Kodak "a custodial mentality geared to protecting current businesses rather than seeking new frontiers."¹⁴⁸

When Fisher failed to produce the kind of change he predicted, he resigned from the company, handpicking his successor Daniel Carp.¹⁴⁹ As the company approached the precipice of the most recent cliff, critics asked the question, "Where was Kodak's Board of Directors?"¹⁵⁰ The board, as well as the company, was complacent.¹⁵¹ It put its faith in the CEO and did not help the company to successfully transition into the digital era. Kodak is one illustration of how boards could have averted corporate losses or even added value to their corporations had the directors been better situated to engage in nonprogrammed decision making and elements of an effective decision-making process discussed below.¹⁵²

B. Organizational Behavioral Decision-Making Framework

Organizational behavior literature that studies effective decision making teams identifies attributes that exert greater influence on the board's decision making ability. These attributes provide the board with greater authority than conventional structural and compositional reforms, such as increasing cosmetic independence.¹⁵³ The contemporary model of corporate governance reform has assumed that if the definition of independence is changed to include more observable traits of independ-

¹⁴⁵ Maremont, *supra* note 137.

¹⁴⁶ Smith, *supra* note 138 ("When we began this search, our No.1 candidate was God, and we stepped down from that.").

¹⁴⁷ Maremont, *supra* note 137.

¹⁴⁸ *Id.*

¹⁴⁹ *Kodak Chief Executive to Step Down*, L.A. TIMES, June 10, 1999, available at <http://articles.latimes.com/1999/jun/10/business/fi-46029>.

¹⁵⁰ Douglas A. McIntyre, *Where Was Kodak's Board of Directors?*, 24/7 WALL ST. WIRE (Nov. 4, 2011), <http://247wallst.com/2011/11/04/where-was-kodaks-board-of-directors/>.

¹⁵¹ Chunka Mui, *How Kodak Failed*, FORBES, Jan. 18, 2012, available at <http://www.forbes.com/sites/chunkamui/2012/01/18/how-kodak-failed/>.

¹⁵² See discussion of constructive conflict *infra* Part III.C.4.

¹⁵³ G. Tyge Payne et al., *Corporate Board Attributes, Team Effectiveness and Financial Performance*, 46 J. MGMT. STUDIES 704, 708 (2009).

ence, firms will perform better. Recent empirical evidence and scholarship indicates otherwise.¹⁵⁴

This Article offers an alternative, process-oriented approach grounded in organizational behavior theory. Organizational behavior scholars have noted that boards are similar to other decision making teams within organizations.¹⁵⁵ Like most teams, there is a connection between a board's process, its effectiveness, and ultimately the outcomes it produces.¹⁵⁶ Through focusing on the components necessary for individuals and groups to make sound decisions and perform their roles well, organizational behavior can help identify the key attributes of an effective decision-making process.

C. Attributes of an Effective Decision-Making Process

The illustrations above highlight the gap between our expectations of boards and the reality of what they can accomplish. A process-oriented approach to board function provides directors with the means to engage in effective decision making, which will help them to better fulfill the duties they have been given. Adopting a process-oriented approach

¹⁵⁴ Michael Bednar & James D. Westphal, *Pluralistic Ignorance in Corporate Boards and Firms' Strategic Persistence in Response to Low Firm Performance*, 50 ADMIN. SCI. Q. 262, 263 (2005) ("Yet there is considerable qualitative and anecdotal evidence that boards often fail to check executives' tendencies to persist with failing strategies, regardless of the number of outside directors on the board."); see Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231 (2002) (finding that firms with more independent boards do not perform better than other firms); see also Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAWER 921, 922 (1999) (presenting evidence that overall firm performance was not correlated to the composition of the board and that "[i]ndependent directors often turn out to be lapdogs rather than watchdogs") [hereinafter Bhagat & Black, *Uncertain Relationship*]; Dan R. Dalton et al., *Meta-Analytic Reviews of Board Composition, Leadership Structure, and Financial Performance*, 19 STRATEGIC MGMT. J. 269, 278 (1998) (finding "little support for a systematic relationship" between "board composition and financial performance"); Finkelstein & Mooney, *supra* note 25, at 102 (studying the relationship of several indicia of board independence to shareholder returns and finding that there was "no significant difference in the number of outsiders, director shareholdings, board size, and CEO duality" between the firms that performed in the upper quartile of the S&P 500 and those that performed in the lower quartile). See generally John A. Wagner et al., *Board Composition and Organizational Performance: Two Studies of Insider/Outsider Effects*, 35 J. MGMT. STUD. 655, 655 (1998) (Their results "suggest the existence of a curvilinear homogeneity effect in which performance is enhanced by the greater relative presence of either inside or outside directors.").

¹⁵⁵ Payne et al., *supra* note 69, at 707 ("Corporate boards are defined groups of individuals who each bring unique skills and backgrounds along with their own personal interests and agendas, but must work together interdependently to achieve common goals."); Daniel P. Forbes & Frances J. Milliken, *Cognition and Corporate Governance: Understanding Boards of Directors as Strategic Decision making Groups*, 24 ACAD. MGMT. REV. 489, 491–92 (1999) (noting that although boards differ from other work groups, group decision making literature is still instructive; writing that "boards of directors can be characterized as large, elite, and episodic decision-making groups that face complex tasks pertaining to strategic-issue processing").

¹⁵⁶ Payne et al., *supra* note 69, at 707.

means that directors should employ a decision-making process that has at least four elements: (1) a forward looking approach to information and data; (2) independent information gathering mechanisms; (3) directors that play a proactive role in organizational goal setting; and (4) a system for generating and resolving constructive conflict.

1. Forward Looking Information

Boards add the most value to the firm when they encounter and resolve nonroutine problems. What constitutes sound decision making differs in routine and nonroutine situations. Similarly, how a company should respond to crisis is different from what it is required to do to prevent one. Nevertheless, the type of information required for boards to make nonprogrammed decisions share several common qualities. Boards, who are asked to make decisions or find alternatives to the problems confronting the corporation, are limited in their ability to perform well. This is because they lack the information necessary to effectively evaluate and address the situation.

The process of finding and identifying alternatives to nonroutine problems is largely information dependent. Organizations generally use records of past decisions and situations predicatively.¹⁵⁷ In other words, record keeping is a form of institutional memory which consequently determines what aspects of the market environment the firm will observe and the menu of alternatives decision makers will consider when confronted with nonprogrammed decisions.¹⁵⁸ Situations for which there is no exact analog in recent firm memory are at the heart of the definition of nonprogrammed decision making. When the board faces these decision making environments, the board relies on the organization's institutional memory, which it had little to no role in forming.

Records of past decisions provide stability to future organizational decisions, but where the organization lacks prior experience with the situation, such as where a major environmental change occurs, like the asset backed mortgage crisis, most organizations adapt slowly.¹⁵⁹ The board, which is removed from day-to-day decision making, is more likely to adapt slowly and acquiesce to using the firm's existing environmental framework and existing records for handling the novel situation.¹⁶⁰ Although organizational records are of tremendous value when the situa-

¹⁵⁷ CYERT & MARCH, *supra* note 84, at 126.

¹⁵⁸ *Id.* at 126–27.

¹⁵⁹ *Id.* at 126.

¹⁶⁰ *Id.* (discussing generally the manner in which organizations depend on past records for predictive purposes).

tion is familiar, but the individual lacks prior experience; reliance on this type of information greatly impedes rapid adjustment to new circumstances.¹⁶¹ In order for a board to better monitor managers, it should utilize forward-looking information in addition to the backward-looking information it typically receives.

2. Multiple Information Gathering Channels

Independent information channels are a core component of effective decision making. The method by which a team gathers or searches for information affects the type of information available for decision making and, as a result, the possible outcomes of the decisions.¹⁶² How a board obtains information and who provides it affects the types of information available, and, just as with forward-looking information, determines the range of alternatives and outcomes available to the board.

Management controls the information the board receives.¹⁶³ Management has tremendous private information about the corporation's operations, strategic outlook, and future prospects.¹⁶⁴ The CEO and her management team play a gate keeping function in determining what information will and will not be shared with the board. CEOs are generally cautious in what they share, especially if they believe it might be subject to criticism.¹⁶⁵ In addition to their self-interest biases, Chief Executives also suffer from cognitive biases which leave them favoring the firm's current strategies and heavily invested in the propositions they support.¹⁶⁶ This may result in information distortions and unnecessary managerial pressure on the board to support the CEO's position.¹⁶⁷ Additionally, it can increase the board's sense of disempowerment.

Limiting the information channels to those that are directly filtered through the CEO burdens the board with the same failings of the CEO. There are many avenues for independent information gathering that corporations can employ. As information becomes increasingly digital and remotely accessible, management scholars have suggested that corporations open access to information, so that directors can gather the information they want, when they want it.¹⁶⁸

¹⁶¹ *Id.* at 127.

¹⁶² See discussion of step 1 in the decision making process *supra* Part II.B.1.

¹⁶³ Millstein, *supra* note 21, at 1429.

¹⁶⁴ Langevoort, *Human Nature*, *supra* note 25, at 812.

¹⁶⁵ *Id.* (Langevoort, at 812)

¹⁶⁶ *Id.* at 803. (Langevoort, at 803)

¹⁶⁷ *Id.* at 812.

¹⁶⁸ CARTER & LORSCH, *supra* note 2, at 154.

While an independent information-gathering channel would substantially enhance the board's monitoring capabilities, it is important to remember that any CEO-independent information-gathering process should be balanced against respect for the CEO's leadership. Many CEOs are understandably concerned about directors interfering in management, and are territorial about their information and their employees.¹⁶⁹ For example, a Boston Consulting Group/Harvard Business School Survey of 132 CEOs in 2001 found that almost half of North American CEOs did not agree with the proposition that directors should have to be able to access employees and facilities outside of the boardroom, while another quarter was unsure about the idea.¹⁷⁰

Without a specific requirement to do so, CEOs may not be willing to open these channels to the directors. A legal requirement reduces the costs of directors confronting managers and demanding more information.¹⁷¹ In the absence of a legal requirement, directors (who are likely themselves CEOs at other companies) may be hesitant to interfere with the discretion and autonomy of the CEO.¹⁷² Directors may feel that asking for information could lead to interpersonal conflict with the CEO and create more tension in the relationship between the CEO and the board.¹⁷³ In order to avoid undermining the CEO's ability to effectively manage the firm, it would be advisable for any corporation that provides for greater board information gathering to adopt sensible control mechanisms. The goal of the board should be to develop a deeper understanding of the business and procure the information it needs to perform effectively, not to unduly undermine the authority of the CEO.

¹⁶⁹ *Id.*

¹⁷⁰ *Id.* at 149, 212 (A BCG HBS Global Survey of 132 CEOs in 2001 found that only forty-six percent agree that boards "understand the factors that drive performance in each of the [firm's] main businesses").

¹⁷¹ Lynn A. Stout, *In Praise of Procedure: An Economic and Behavioral Defense of Smith v. Van Gorkom and the Business Judgment Rule*, 96 NW. U. L. Rev. 675, 688–89 (2001) (describing how the business judgment rule reduces the "cost of confronting," which includes "the costs associated with asking the company's management for more information, or even challenging management's conclusions when the director does not agree with them").

¹⁷² Benjamin E. Hermalin & Michael S. Weisbach, *Boards of Directors as an Endogenously Determined Institution: A Survey of the Economic Literature*, 9 ECON. POL'Y REV., no.1, at 7, 18 (2003); Michael L. McDonald & James D. Westphal, *A Little Help Here? Board Control, CEO Identification with the Corporate Elite, and Strategic Help Provided to CEOs at Other Firms*, 33 ACAD. MGMT. J. 343, 370 ("[C]orporate elite [is] the collection of top managers of large corporations who sit on multiple boards of directors of large firms." The article goes on to suggest that CEOs who are subject to boards that exert greater control over their decisions are less likely to provide strategic assistance to CEOs when they sit on another corporation's board.).

¹⁷³ Stout, *In Praise of Procedure*, *supra* note 171, at 689.

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3. Proactive Goal Setting

Goals frame organizational choices. The strategic vision of a corporation sets the outer boundaries of the opportunities the organization will consider and the problems it is most likely to identify. Managers typically set the broader corporate agenda and determine the priority for each item, or goal, the corporation will try to achieve. Where a particular group, such as management, sets the firm's strategies, management is more likely to adopt arguments and seek information that supports the strategy.¹⁷⁴ Cognitive biases lead managers to be "overconfident" and "heavily invested" in the firm's strategic position – a position they helped to establish.¹⁷⁵ This means that they are less likely to seek information that would contradict their position.¹⁷⁶ This in turn frames the scope of information the board will and will *not* receive, and the associated recommendations.

Common situations corporations encounter include problems within a particular industry or opportunities to expand and the decision of how to allocate resources in response.¹⁷⁷ Examples include the decision at Medtronic, Inc. to expand beyond its pacemaker business and become a major player in the vascular, neurologic, and spinal surgery therapy industries¹⁷⁸ or Coca-Cola Company's decision not to buy Quaker Oats (owner of Gatorade).¹⁷⁹ When firms are confronted with either problems or opportunities, there are numerous ways a firm can respond.¹⁸⁰ One approach would be that the firm is too heavily invested in the particular industry and should diversify, for instance, Medtronic's heavy investment in the pacemaker business.¹⁸¹ Alternatively, it may be argued that the firm is too widely invested and needs to focus on its core competency to protect its position in that industry.¹⁸² For instance, Coca-Cola could reasonably conclude that its core focus on soft drinks meant that acquiring a sports drink would stretch itself too thin.

¹⁷⁴ Westphal & Fredrickson, *supra* note __, at 1116.

¹⁷⁵ Langevoort, *Human Nature*, *supra* note 25, at 803.

¹⁷⁶ *Id.*

¹⁷⁷ Example adapted from Westphal & Fredrickson, pg. 1116

¹⁷⁸ Jay W. Lorsch and Alex Chernak, Harvard Business School, November 16, 2007.

¹⁷⁹ *Coca-Cola's Plan to Buy Quaker Oats Loses Its Fizz*, L.A. TIMES, Nov. 22, 2008, available at <http://articles.latimes.com/2000/nov/22/business/fi-55573>.

¹⁸⁰ *Id.*

¹⁸¹ *Id.*

¹⁸² *Id.*

Research on top-level management strongly suggests that managers, not directors, establish corporate goals or strategies.¹⁸³ The board's lack of authority is evident in the minimal amount of independent influence directors exercise over the corporation's strategic goals.¹⁸⁴ Management is in charge of identification, analysis, choice of response, and implementation. Managers and the CEO identify and evaluate the possible strategic goals for the company, decide which is best, and then operationalize that vision.¹⁸⁵ Boards participate in the approval phase, but have little interaction with the other steps of the strategy-setting process. Their passive involvement in the formation of strategic plans or goal setting leaves them in a reactive decision-making posture. Directors respond to the priorities and strategies already established by management. Consequently, directors are frequently viewed as nothing more than a pawn of management.¹⁸⁶

In contrast, active involvement in the form of collaborative strategic planning and goal setting facilitates more proactive decision making. Boards engaged in strategic planning are better positioned to make the types of nonprogrammed decisions that offer the greatest value to the firm and to avoid the most costly problems.¹⁸⁷ Proactive involvement in this particular aspect of organizational decision making complements the informational needs of the board. Through *ex ante* involvement in goal setting, directors increase their awareness of the types of information necessary for overseeing the progress and outcomes of the goal-setting process. This improves their ability to monitor management's performance.¹⁸⁸ In contrast, if boards remain confined to a reactive role, they will continue to confront problems that are already out of control.

¹⁸³ James D. Westphal & James W. Frederickson, Who Directs Strategic Change? Director Experience, The Selection of New CEOs, and Change in Corporate Strategy, 22 *STRAT. MGMT. J.* 1113, 1113-14 (2001); Ira M. Millstein, *supra* note 21, at 1429 at 1434 (1995).

¹⁸⁴ Westphal & Fedrickson, *Id.* at 1114.

¹⁸⁵ Millstein, *supra* note 21, at 1434 (1995) (offering one view of the process, writing that "Typically, strategic plans are developed by senior management in the divisions, further developed by the CEO's staff and then the CEO, approved by the board, and carried out by senior management at the CEO's direction.")

¹⁸⁶ JAY W. LORSCH WITH ELIZABETH MACIVER, PAWNS OR POTENTATES: THE REALITY OF AMERICAS CORPORATE BOARDS 92-95 (1989); MYLES MACE, DIRECTORS: MYTH AND REALITY 106-07, 109 (1971).

¹⁸⁷ Millstein, *supra* note 21, at 1428 (1995) ("Ideally, meaningful monitoring is aimed at detecting and responding to performance problems before they develop into crises. To do so requires that the board's role expand . . . into more substantive areas, including participation in strategic planning . . .").

¹⁸⁸ *Id.* at 1434. (Millstein) (suggesting that a board involved in strategic planning might be able to "identify benchmarks that would inform it of the plan's progress after a plan is ultimately approved.").

Those responsible for setting corporate strategy are often the most motivated to see it succeed and have the best incentive to identify any risks to its success. It is uncontroverted that management handles the day-to-day affairs of the firm. It is therefore crucial that management is committed to the strategy, so as to ensure managements investment in the initiative.¹⁸⁹ Moreover, boards cannot have exclusive responsibility for strategic planning. In other words, “the board cannot write the plan.”¹⁹⁰ It is essential that the process is a collaborative one that significantly increases the active involvement of the board above the status quo, but is also careful to make sure that the board’s monitoring function does not become a managing function. Some simple solutions that have gained traction among organizational behavior scholars include board involvement in agenda setting and strategic planning.¹⁹¹

4. Conflict Management

Corporations that create a robust process for conflict management are more likely to facilitate the type of open and honest discourse necessary to adjust strategic decisions. A “constructive conflicts” process, also known as a Devil’s Advocate¹⁹² approach, is essential for a company to grow and to change direction through producing better information.¹⁹³ There are multiple impediments to encouraging and resolving conflict. Limitations on the information boards are given lessen director’s ability to critically assess the pros and cons of strategic proposals. Another example is captured board members who may be hesitant to present ideas that contradict the CEO or create tension. These directors operate more as a rubberstamp on management’s ideas. Instead of providing insightful advice, offering constructive criticism, and acting as gatekeepers in the instance of strategic change, they do little more than show up to meetings a few times a year.

¹⁸⁹ *Id.* at 1433.

¹⁹⁰ *Id.* at 1434.

¹⁹¹ For an illustration of board involvement in formulating corporate goals and strategies through agenda setting see BACK TO THE DRAWING BOARD 146-8 (2003); *See also* HALL & TOLBERT 118 (discussing agenda setting as an influential mechanism in decision making).

¹⁹² Theodore T. Herbert & Ralph W. Estes, *Improving Executive Decisions by Formalizing Dissent: The Corporate Devil’s Advocate*, ACAD. MGMT. REV., Oct. 1977, at 662, 663 (suggesting that formalized dissent can add value to corporate decision making. Additionally Herbert and Estes write, “One of the oldest examples of the formalized dissent role occurs within the Roman Catholic Church; the ‘Devil’s Advocate’ (formally termed ‘promoter of the faith’) has been a continuing office since the early 1500s, with the prescribed function of thoroughly investigating proposals for canonization and beatification.”).

¹⁹³ Finkelstein & Mooney, *supra* note 25, at 103 (coining the phrase “constructive conflict” to describe the system of investigation needed for effective decision making to occur).

Similar to board capture, the tendency to value agreement among all group members, or groupthink, is more likely to occur among board of directors, which are cohesive groups working toward consensus-decision making.¹⁹⁴ While group cohesion can have positive consequences,¹⁹⁵ one danger is that the board's quest for unanimity will produce a more superficial level of analysis that results in less effective decisions.¹⁹⁶ Groupthink limits the board's independence for purposes of monitoring.

Constructive conflict is a nonconfrontational way of encouraging diverse options and challenges to the path dependency that might govern most board decision making. Importantly, it distinguishes between the process of deciding and the outcome of the decision. Earlier board involvement allows directors to ask difficult questions that help "uncover unfounded assumptions, unattainable forecasts, untreated deal fever, or otherwise flawed thinking."¹⁹⁷ In practical terms this approach incorporates the board at the analysis and choice of response stages of the strategic decision-making process.¹⁹⁸

Like all aspects of a sound decision-making process, constructive conflict's efficacy is dependent on the information received. In addition to forward-looking information about the strategic prospects and ensuring that supporting information has come from diverse channels within the organization, the description of the strategy in question and its underlying assumptions should be detailed and explicit.¹⁹⁹ One of the many deficiencies that plague boardrooms is the cursory PowerPoint that uses jargon to communicate ideas that warrant more complex analysis.²⁰⁰ For instance an acquisition that provides for "cross-selling" opportunities

¹⁹⁴ For a more detailed discussion of groupthink, see Marleen A. O'Connor, *The Enron Board: The Perils of Groupthink*, 71 U. CIN. L. REV. 1233 (2003); see also IRVING L. JANIS, VICTIMS OF GROUPTHINK: A PSYCHOLOGICAL STUDY OF FOREIGN-POLICY DECISIONS AND FIASCOES (1972); Bainbridge, *supra* note 21, at 32; Forbes & Milliken, *supra* note 25, at 496.

¹⁹⁵ Empirical research has emphasized that close social ties can provide greater board involvement in their advisor/counselor roles, though it may not have as positive an effect on their monitoring role. Westphal, *supra* note 23, at 8; see also Forbes & Milliken, *supra* note 25, at 496.

¹⁹⁶ See Bainbridge, *supra* note 21, at 32; see also O'Connor, *supra* note 194, at 1238–39 (noting that the quest for unanimity affects decision making by impeding "critical reflection and reality testing").

¹⁹⁷ Paul B. Carroll & Chunka Mui, *7 Ways to Fail Big*, HARVARD BUS. REV., Sept. 2008, at 82, 86.

¹⁹⁸ A constructive conflict system of Devil's Advocate approach is appropriate for other groups within the corporation, including the business-unit generating the proposed strategy. *Id.* at 82, 87 (suggesting that an executive or manager from a different business-unit may lead the inquiry at that level, whereas a knowledgeable outside director might lead the "corporate-level review.")

¹⁹⁹ *Id.* at 87.

²⁰⁰ CARTER & LORSCH, *supra* note 2, at _ (criticizing the format of board meetings); Carroll & Mui, *supra* note 186, at 87 (noting that a detailed description of what might otherwise be summarized in a PowerPoint slide bullet point, often requires clarity about how and why something will be done).

does not provide the board with enough information to know whether the target company utilizes similar sales techniques as the acquirer.²⁰¹ A late 1990s merger of two disability insurance companies failed for that reason. One company, Unum, sold group policies, while the other company, Provident, sold individual policies.²⁰² The sales representatives at the two companies had different skill sets that failed to result in the predicted cross-selling synergies.²⁰³ Another example might be as common as independently auditing problems that the CEO brings to the board's attention to verify that the problems are of enough strategic significance to warrant concern.

In sum, a constructive conflict process improves board decision making in several ways. It reduces the biases, such as groupthink and indebtedness to the CEO, that keep the board from vigorously questioning the CEO's proposals and/or decisions.²⁰⁴ By separating the role of proponent and opponent of the strategic proposal in question, it also reduces the individual biases that might keep a CEO from identifying the failings of her proposal.²⁰⁵ Additionally, a constructive conflicts system improves the board's information gathering and information evaluation abilities. This can help to reduce the informational asymmetries that characterize the current director/CEO relationship.

Reducing the knowledge gap between the CEO and the board through better information can help to empower outside directors. Specifically, scholars have noted that there is a tendency amongst some outside directors to avoid potential embarrassment by self-censorship.²⁰⁶ Correcting information asymmetries may help to lessen an individual director's reluctance to voice her concerns because she feels uninformed.²⁰⁷

²⁰¹ Carroll & Mui, *supra* note 186, at 87 (using cross-selling as an example of a phrase that can benefit from the clarity of prose).

²⁰² *Id.* at 84.

²⁰³ *Id.* (writing that merger "proved costly and complicated. . . . Unum eventually undid the merger . . . Its stock price plummeted and is still less than half what it was in 1999").

²⁰⁴ Forbes & Milliken, *supra* note 25, at 497 ("Cognitive conflict can help to prevent the emergence of groupthink in cohesive groups by fostering an environment characterized by a task-oriented focus and a tolerance of multiple viewpoints and opinions").

²⁰⁵ Carroll & Mui, *supra* note 186, at 86; Theodore T. Herbert & Ralph W. Estes, *Improving Executive Decisions by Formalizing Dissent: The Corporate Devil's Advocate*, 2 ACAD. MGMT. REV. 662 (1977); Langevoort, *Human Nature*, *supra* note 25, 803 & 812-13.

²⁰⁶ Paul B. Carroll & Chunka Mui, *Change the Dialogue with Management: This Is What Directors Need to do to Head Off Embarrassing Strategic Errors*, DIRECTORS & BOARDS, pg. 18; see also LORSCH WITH MACIVER, *supra* note __, at 84-85; Sharpe, *Cosmetic Independence*, *supra* note 16, __.

²⁰⁷ Paul B. Carroll & Chunka Mui, *Change the Dialogue with Management: This is What Directors Need to do to Head Off Embarrassing Strategic Errors*, DIRECTORS & BOARDS, pg. 18 ("Because outside directors have less information than management does and generally have less experi-

A constructive conflicts process can lead to the type of discourse that allows boards to engage in critical analysis that should improve the quality of board decisions and the authority with which the board makes those decisions. Boards that use this process to identify a broader range of opportunities and alternatives to problems, and examine each opportunity or alternative more carefully, are engaged in a higher quality decision-making process than those who forego constructive conflict.²⁰⁸ Studies of group decision making have shown that having *negative* as well as positive feedback leads to better decision making.²⁰⁹

Despite its positive impact on the quality of group decision making, constructive conflict is not without drawbacks. Individuals within a group engaged in such a process may have negative feelings toward other group members that reduce positive social interaction.²¹⁰ Although it has some disadvantages that may impact each director's commitment to the group as a whole, done well, constructive conflict can lead to stronger decisions. Organizational behavior scholars have suggested various approaches to a system of constructive conflict. This Article does not attempt to design a system that would work well for every corporation. Instead it argues, a well tailored system should be part of all corporate decision making. More importantly, a constructive conflicts process is a critical part of improving a board's *de facto* authority.²¹¹

D. Implications

Compliance-based reforms have drastically increased the amount of time the board must spend on compliance issues. One estimate suggests that SOX's audit committee requirements alone double the time for audit committee meetings.²¹² Moreover, many of the compliance mandates ask directors to focus on corporate policing at a level far removed from strategy and value creation. SOX reporting requirements further emphasize short term earnings, which are considered a contributing factor the 2008 financial crisis.²¹³ Boards, therefore, are forced into an even more passive/reactive decision-making stance.

ence in the industry in which the company operates, board members may censor themselves. Why take the chance of looking silly?"); See also LORSCH WITH MACIVER, *supra* note __, at 84–85; Sharpe, *Cosmetic Independence*, *supra* note 16, __.

²⁰⁸ Forbes & Milliken, *supra* note 25, at 494.

²⁰⁹ *Id.*

²¹⁰ *Id.* Forbes & Milliken

²¹¹ *Id.* Forbes & Milliken

²¹² Jay W. Lorsch & Robert C. Clark, *Leading from the Boardroom*, 86 HARV. BUS. REV. 104, 107 (2008)

²¹³ *Id.* at 106.

Listing exchange, SOX, and Dodd-Frank provisions have placed significant demands on companies to staff independent audit, nominating, and compensation committees.²¹⁴ Under SOX, each member of listed company's audit committee must be independent.²¹⁵ Additionally, provisions of the Dodd-Frank Act require that companies have an independent compensation committee.²¹⁶ Similarly, the listing exchanges mandate an independent nominating committee and SEC specifies that where a company chooses to have one, it is subject to increased disclosure requirements.²¹⁷ Each committee generally must be staffed by at least three directors.²¹⁸ These provisions leave companies with no less than nine director slots that must be filled by independent directors.

The heavy requirements for independent directors on committees, as well as the generic provisions that mandate a majority independent board²¹⁹ further reduce the board's authority in practice. Increasing the number of independent directors on boards has exacerbated information asymmetries between the board and executive management and weakened the board's decision-making authority.²²⁰ This is the overarching reason why an independent board is quite limited in its ability to monitor management. Boards are almost exclusively dependent on management for information and the information they receive is deeply deficient. The information is not of the sort that one would expect the firms most trusted monitors to receive; in fact it "is no more current and insightful" than the information stock analysts receive.²²¹

²¹⁴ Sharpe, *Process Over Structure*, *supra* note 6, at __. See also NASDAQ QUALIFICATION IM-5605 (2004); NYSE LISTED CO. MANUAL §§ 303A.01 & 303A.02 (2011) available at <http://nysemanual.nyse.com/lcm/>. See Sarbanes-Oxley Act of 2002 § 301, 15 U.S.C. § 7262 (Supp. III 2003); Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 111(a), 124 Stat. 1376, 1392-94 (2010) (to be codified at 12 U.S.C. § 5321).

²¹⁵ See U.S. SEC. & EXCHANGE COMM'N, S7-02-03, STANDARDS RELATING TO LISTED COMPANY AUDIT COMMITTEES (Apr. 10, 2003), <http://www.sec.gov/rules/final/33-8220.htm>.

²¹⁶ See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 111(a), 124 Stat. 1376, 1392-94 (2010) (to be codified at 12 U.S.C. § 5321) at Section 10C, 124 Stat. at 1900-03.

²¹⁷ For more information about the SEC disclosure requirements, see <http://www.sec.gov/rules/final/33-8340.htm>. See also Proposed Rule Changes, 68 Fed. Reg. at 64,158-59.

²¹⁸ *Id.*

²¹⁹ For a discussion of how SOX and the listing exchanges emphasize director independence see Usha Rodrigues, *The Fetishization of Independence*, 33 J. CORP. L. 447, 452-455 (2008).

²²⁰ For a discussion of information asymmetries between boards and management, see Lawrence E. Mitchell, *Structural Holes, CEOs, and Informational Monopolies: The Missing Link in Corporate Governance*, 70 BROOK. L. REV. 1313, 1319 (2005). For a discussion of how information asymmetries limit outside director efficacy, see Fairfax, *Uneasy Case*, *supra* note 21, at 161-67.

²²¹ Millstein, *supra* note 21, at 1434.

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As previously established, information is at the core of each step in the decision-making process. Recent regulations increase the information disparity between the board and executive management because the board is less knowledgeable about the company and forced to devote what little time they do have to compliance matters. As a result, CEO's have more power and boards have less.²²²

Regulations have been designed to move boards from the pre 1970s model of arms-length monitoring to a more active, hands-on monitoring role. The normative propositions that inform these regulations support the idea of more active board involvement. For this to be effective, boards need deeper knowledge and familiarity with the corporations on whose boards they sit. In short, they need better access to information. Regulations, however, have impeded access to information. Policymakers have ignored the importance of decision-making processes and impeded access to information through increasing director independence. As a result, directors have reduced knowledge and familiarity. Put differently, boards are designed to fail. The attributes of an effective decision-making process suggested above, help the boards to overcome the limitations inherent in current board structure by giving them the tools necessary to fulfill their normative mandate.

CONCLUSION

In practice, corporate boards of directors do not have the authority granted to them in theory and law. As a normative matter, dominant theories of corporate control and legal reforms meant to improve corporate governance require directors to monitor managers and exercise authority in doing so. This Article directly challenges the assumption that boards have *de facto* authority—they do not. It argues that for boards to fulfill their normative mandate, they must have both *de jure* and *de facto* authority. Directors cannot exercise the authority granted to them in theory and law unless they have better mechanisms with which to make decisions. By utilizing insights into group decision making from organizational behavior theory, this Article identifies the attributes of an effective decision-making process that can help establish the board's decision-making authority. These processes are undermined by recent structural regulations, and boards must take active steps to improve the quality of their decision making. Unless they do so, they will continue to fail as monitors because they lack the power to perform the role law and legal scholarship assigns to them. In other words, an effective process pro-

²²² See discussion *supra* Part II.B. and Figure 1.

vides power, and without one, board authority is only an empty theory, not reality.