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MITIGATING DYSFUNCTIONAL DEFERENCE THROUGH IMPROVEMENTS IN BOARD COMPOSITION AND BOARD EFFECTIVENESS

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INTRODUCTION

In two recent articles, Bernard S. Sharfman and Steven J. Toll argue that cases of corporate malfeasance, such as the failure by Enron's board to prevent the fraudulent actions of its top executives, can be explained in part by the "dysfunctional deference"[1] of board members to corporate management.[2] Sharfman and Toll posit that outside directors who are themselves corporate executives—especially CEOs—tend to identify with the goals and interests of fellow members of the "executive class." Instead of questioning the actions of corporate managers as their own knowledge and instincts counsel, such directors defer to the company's insiders. Sharfman and Toll go on to suggest five ways to address the deference problem: (1) "[l]imit the number" of current or former executives sitting on a board; (2) set term limits for directors; (3) require directors to be knowledgeable about the company on whose board they sit; (4) "[n]ominate outside directors with diverse backgrounds"; and (5) require "minimum time commitment[s]" for board members.[3]

This Essay argues that Sharfman's and Toll's argument about the dangers of dysfunctional deference, while insightful, fails to address the problem of excessive deference by directors other than corporate executives. In its annual study of board practices at U.S. companies, RiskMetrics Group (RMG) categorizes outside directors by background into several groups:

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[1] Bernard S. Sharfman & Steven J. Toll, *Dysfunctional Deference and Board Composition: Lessons from Enron*, 103 NW. U. L. REV. COLLOQUY 153, 155 (2008), http://www.law.northwestern.edu/lawreview/colloquy/2008/38/LRColl2008n38Sharfman&Toll.pdf [hereinafter Sharfman & Toll, *Dysfunctional Deference*] (link).

[2] *Id.* at 153–60; Bernard S. Sharfman & Steven J. Toll, *A Team Production Approach to Corporate Law and Board Composition*, 103 NW. U. L. REV. COLLOQUY 380, 390–91 (2009), http://www.law.northwestern.edu/lawreview/colloquy/2009/11/LRColl2009n11Sharfman&Toll.pdf (link).

[3] Sharfman & Toll, *Dysfunctional Deference*, *supra* note 1, at 160–61.

current executives of other companies (a group primarily comprised of CEOs); investors or financial/accounting professionals; consultants; attorneys; academics; real estate professionals; retired persons; and "others."[4] Members of each of these groups bring certain strengths and weaknesses to a board of directors, and a reduction in the proportion of outside executives on a board necessarily means that the proportion of board members from other backgrounds will increase. In order to alleviate the deference problem, while still allowing companies to benefit from the skills and experiences of current and former executives, I argue that shareholders should focus on mitigating the dangers of deferential or laissez-faire boards, rather than focusing on the number of outside directors with a corporate background. Shareholders can help make certain that the board they empanel will not be excessively deferential by:

- Ensuring that directors have sufficient time to devote to board and committee meetings, and to familiarize themselves with the company's operations and business environment;
- Ensuring that board meeting agendas are set by an independent chairman or an independent lead director; and
- Improving board accountability through the elimination of staggered board elections and the replacement of plurality voting standards with the majority vote system seen in most of the world.

Before presenting possible methods for implementing these goals, I explore the ways in which non-corporate outside directors may display dysfunctional deference and identify the strengths and benefits particular to corporate directors. It is important to note, however, that this piece is not intended as a defense of CEOs as board members. Although they can bring certain strengths to a board, the weaknesses Sharfman and Toll identify are real. The purpose of this article, rather, is to urge investors to focus on measures that will improve board performance regardless of who sits on the board.

I. NON-CORPORATE OUTSIDE DIRECTORS: STRENGTHS AND WEAKNESSES

In determining the optimum composition of a given company's board of directors, shareholders and nominating committees must consider a wide variety of qualifications. Ideally, directors should have an understanding of the laws applicable to, and general principles of, corporate finance, account-

[4] RISKMETRICS GROUP, BOARD PRACTICES: THE STRUCTURE OF BOARDS OF DIRECTORS AT S&P 1500 COMPANIES 28–29 (2009 ed.).

ing, and management, coupled with an understanding of the company- and industry-specific issues the corporation faces. Additionally, they should have an ability to advise management wisely in the formulation of strategy, and a willingness to say no to charismatic chief executives whose growth strategies cross the line into empire building. Above all, directors must be able to effectively represent the interests of the company's owners, which in turn requires the ability to commit a significant amount of time to the board.[5] An outside board chair or lead independent director (in cases where the chair and CEO roles are combined) must moreover command the respect and support of his or her fellow directors in order to serve as an effective counterweight to the CEO's authority.

Sharfman and Toll focus on the ways in which the effectiveness of directors with a corporate executive background may be impaired by a tendency to be excessively deferential to the managers they are supposed to oversee. But directors with other backgrounds may have their own barriers to effectiveness, and their own reasons for excessive deference.

A. Professional Service Providers

The Sarbanes-Oxley Act of 2002, enacted in the wake of accounting scandals at Enron, Worldcom, and elsewhere, requires the audit committees of U.S. corporations to include at least one designated financial expert.[6] An easy way to meet this requirement is to appoint an active or retired accountant to the board. Where that accountant is employed by the company's own audit firm, however (and in particular where he or she is a revenue-sharing partner of that firm), the potential for conflicts of interest is obvious.[7] Similar conflicts can arise in the context of other professional services and service providers, such as attorneys and management consultants. No matter the industry, the more dependent the service provider is on the revenue from a particular client, the more difficult it will be for that provider to act—in his role as a director—in a way that might cause the corporate client to reconsider its relationship with the firm (by cutting the client company's CEO pay, for example). Large companies that regularly rotate their audit firms, or that employ numerous law firms as outside counsel, may have difficulty finding accountants or lawyers without such conflicts to serve on the board.

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[5] *See, e.g.*, Ed Speidel & Rob Surdel, *High Technology Board Compensation*, BOARDROOM BRIEFING, Spring 2008, at 25, *available at* http://www.directorsandboards.com/BBSpring08proof.pdf ("In 2005, directors spent more than 200 hours fulfilling board-related duties, up from between 100 to 150 hours pre-Sarbanes-Oxley, according to the National Association of Corporate Directors.") (link); David Yermack, Remuneration, Retention, and Reputation Incentives for Outside Directors 10 (Oct. 2002) (unpublished manuscript, on file with the Northwestern University Law Review Colloquy) (observing that "a conscientious outside director may spend about 250 hours a year on company business").

[6] Sarbanes-Oxley Act of 2002, § 407, 15 U.S.C. § 7265 (2006) (link).

[7] For example, such a director would have difficulty objectively evaluating the quality of the audit firm's work or whether it would be appropriate to engage that firm to provide non-audit services.

B. Academic Directors

Business school professors and other academics will likely be free of financial conflicts (except to the extent that they may provide consulting services to corporations on the side) and their knowledge of corporate finance or marketing may add a useful perspective to board deliberations. But there are other factors that may interfere with an academic's ability to perform effectively as an outside director. A perception that they are denizens of the ivory tower may make fellow directors discount their opinions, while a lack of "real-world" executive experience of their own may lead them to defer to the expertise of management—potentially another form of "dysfunctional deference." A desire to not jeopardize a lucrative and prestigious side job may also cause academic directors to not want to rock the boat by challenging the CEO.

It is useful to consider the example of Korea, where an especially large percentage of outside directors have an academic background, to illustrate these potential problems.[8] In practice, Korean boards tend to be highly deferential to the corporation's chairman—who is always an executive and is usually the company's founder or the founder's heir.[9] Korean board members have been so deferential, in fact, that the boards of several corporations have retained top executives who were convicted of felonies.[10] On paper, such directors generally appear to be independent: they seem to have no relationships that will compromise their independence, and to have very different career paths from the executives whose actions they are retained to

[8] Out of a sample of 538 outside directors at 148 large Korean companies, whose backgrounds were categorized by RMG in 2008, exactly 200 (37.2 percent) were classified as "academic." By contrast, only six percent of outside directors in the United States were classified as academics. Data compiled by author from an internal RMG study (2009) (on file with author).

[9] Most major chaebol companies—the large corporate groups that dominate the Korean economy—have hereditary succession within the founding family. Examples of such dynasties include the Lee family at the Samsung group, the Chey family at the SK group, and the Chung family at the Hyundai group—which divided into sub-groups headed by different family members after the death of patriarch Chung Ju-Yung. *See* Craig Ehrlich & Dae Seob Kang, *Independence Within Hyundai?*, 22 U. PA. J. INT'L ECON. L. 709, 720–25 (2001); Shu-Ching Jean Chen, *Samsung's Lee Family Accused of Corrupt Dealings*, FORBES.COM, Nov. 13, 2007, http://www.forbes.com/2007/11/13/samsung-corruption-investigation-face-markets-cx_jc_1113autofacescan01.html (link); *SK Corp. Chairman Imprisoned*, BBC NEWS, Jun. 13, 2003, http://news.bbc.co.uk/2/hi/business/2986698.stm (link).

[10] Examples of companies that kept founding family members in office despite felony convictions include Hyundai Motor Co. and the former SK Corporation, now SK Holdings. SK Corp. Chairman Chey Tae-Won was convicted of fraud and breaches of fiduciary responsibilities in 2003 for events that took place at an affiliated company; he served several months in prison. *See, e.g.*, Song Jung-A, *SK Head Denies Fraud Conviction at Appeal*, FIN. TIMES, Mar. 31, 2005, at 28 (link); Andrew Ward, *Battle for Influence over SK Corp Intensifies*, FIN. TIMES, Mar. 9, 2004, at 30 (link). Hyundai Motor Chairman & CEO Chung Mong-Koo was convicted of fraud and embezzlement in 2007 and received a three-year prison sentence, though his sentence was suspended due to concern that locking him up could damage the Korean economy. *See, e.g.*, Evan Ramstad & Lina Yoon, *Hyundai Chairman Is Found Guilty*, WALL ST. J., Feb. 5, 2007, at A2; Evan Ramstad, *ISS Backs Rejecting Hyundai Chief*, WALL ST. J., Feb. 29, 2008, at B5; Song Jung-A, *Korean Fund to Oppose Hyundai Head*, FIN. TIMES, Mar. 13, 2008, at 15 (link). Chey and Chung remain chairmen of their respective companies as of this writing.

oversee. Under Sharfman's and Toll's theory, the divergence of the academic director's career path from that of the corporation's CEO should imply that the academic director is unlikely to identify with the executive team. Yet there is little evidence that the academic's "unexecutive" background leads to stricter scrutiny of Korean management.[11]

C. Shareholder Representatives

Of all the categories of outside directors, investor representatives should be the least likely to exhibit excessive deference to management. Yet there are other reasons why investor representatives are not always ideal candidates for the board. In the United States, when investor representatives serve on a board, it is generally the result of a proxy contest or a compromise reached to forestall a proxy contest. This, in turn, means that the company in question is likely to have underperformed its peers. The circumstances surrounding an investor representative's election to the board may therefore lead to an adversarial relationship between the shareholder representatives and management. Such tension can be beneficial for all shareholders if it leads to stricter oversight.

There will be situations, however, in which the interests of the investor who nominates these directors do not correspond to the interests of other shareholders. For example, an investment fund with a large enough stake to win board representation may, because of its large size, be unable to easily sell that stake on the open market. Accordingly, the investment fund will be concerned about an exit strategy—generally with a much shorter time horizon than that of an index fund or other long-term investor.[12] This is one reason institutional shareholders often find it difficult to support the dissident slate in a proxy contest. Meanwhile, pension funds and mutual funds seldom own enough shares in any single company to justify the costs of entering a proxy contest in order to win direct board representation or of maintaining such presence once successful.[13] This means that the shareholder representatives on U.S. boards tend to represent hedge funds and the small group of relational investment funds.[14]

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[11] Governance problems at Korean companies, and in particular the lack of oversight by boards over Korean executives, have been widely blamed for the existence of the so-called "Korea discount," whereby Korean companies trade at lower multiples of earnings than their counterparts in other countries. *See, e.g.*, Ward, *supra* note 10.

[12] *See* Robert C. Illig, *What Hedge Funds Can Teach Corporate America: A Roadmap for Achieving Institutional Investor Oversight*, 57 AM. U. L. REV. 225, 251–52 (2007) (link).

[13] *Id.* at 251. *Cf.* Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1048–1056 (2007) ("Mutual funds . . . suffer from a number of disadvantages that impede their ability to act as effective [corporate] monitors.") (link).

[14] *See* Illig, *supra* note 12, at 228. The potential enactment of a "proxy access" mechanism, whereby long-term shareholders with a significant stake may directly nominate board candidates to appear on the company's proxy ballot, could facilitate the election of more shareholder representatives to U.S. boards in a less adversarial manner than typical proxy contests. Business organizations have strongly

In some other countries, notably Japan, it is nearly always long-term shareholders who are granted seats on the board. Such shareholders are generally customers of, or suppliers or lenders to, the company in question. The shareholding is less a portfolio investment than a manifestation of the far more important transactional relationship between the two companies. These shareholders have a much longer time horizon than typical shareholders, and their nearly unconditional support for management is precisely what makes them highly desirable owners from a management perspective. Yet the possibility of a conflict of interest between these business partner representatives and other unaffiliated shareholders is acute, particularly in a takeover situation. An executive of supplier company ("S") who sits on the board of a takeover target ("T") will have a fiduciary duty to the shareholders of S that requires her to preserve and enhance all of S's key business relationships—which may require rejecting the takeover offer for T, even at a significant premium. The executive's duty to supplier company S can easily conflict with her fiduciary duty to the shareholders of takeover target T: her duty to maximize the value of their investment.[15] For this reason, representatives of lenders and business partners do not meet most investors' definition of independence, and their presence on the board is considered a mixed blessing at best.

In light of these grounds for concern about the suitability of professional service providers, academics, and shareholder representatives, it is perhaps not surprising that active and retired corporate executives make up a substantial percentage of directors in the United States.[16] Nor, it seems, can those who fault the American corporate governance system because it allows CEOs to collect excessive pay and assume excessive risk place the

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resisted proxy access, however, and have succeeded in forestalling SEC action on the issue for several years. *See, e.g.*, Kara Scannell, *Corporate News: Policy Makers Work to Give Shareholders More Boardroom Clout*, WALL ST. J., Mar. 26, 2009, at B4 ("David T. Hirschman, a policy executive at the U.S. Chamber of Commerce, the nation's largest business lobby, said proxy access could hurt companies. 'The system is designed for shareholders to entrust the board to do the job right,' he said. 'Anything that makes it harder for that to happen is a step backward.'") (link); Melissa Klein Aguilar, *Activists Vow Litigation over Proxy Access*, COMPLIANCE WEEK, Dec. 4, 2007, *http://www.complianceweek.com/article/3818/activists-vow-litigation-over-proxy-access* (link); Subodh Mishra, *Analysis: Legislating Reforms*, RISKMETRICS GROUP RISK & GOVERNANCE WEEKLY, Sept. 26, 2008, http://www.riskmetrics.com/governance_weekly/2008/185 (link).

[15] The dominance of such so-called "stable shareholders" is what has enabled Japanese companies such as Hokuetsu Paper Mills (in 2006) and Bull-Dog Sauce Co. (in 2007) to reject unsolicited takeover offers, denying independent shareholders the right to tender their shares for substantial premiums, and has enabled many other companies to fend off shareholder proposals calling for share buybacks and dividend increases. *See, e.g.*, Hiroto Tanaka & Takenori Miyamoto, *Japan Firms Seize on Court Ruling to Further Cross-Shareholdings*, NIKKEI.COM, July 30, 2007 ("More than 80% of shareholders approved Bull-Dog Sauce's defense measures at its annual meeting mainly because the Worcester sauce maker was able to secure the backing of its business partners and creditor banks."); Takeshi Kawasaki, *Market Scramble: Shareholders Overlooked in Battle for Hokuetsu Paper*, NIKKEI.COM, Aug. 22, 2006.

[16] Active corporate executives constitute 15 percent of outside directors at S&P 1500 companies, while retired persons, a large percentage of whom are retired executives, constitute 33 percent of outside directors. *See* RISKMETRICS GROUP, *supra* note 4, at 28.

blame solely on the shoulders of the "executive class": directors with non-executive backgrounds may suffer from excessive deference problems and a lack of independence as well. Moreover, current and former executives do have certain strengths that can enable them to play a positive role on boards as outside directors, provided the proper mechanisms exist to keep their interests aligned with those of ordinary shareholders.

II. THE STRENGTHS OF THE CORPORATE EXECUTIVE

Corporate executives, particularly those who have served successfully as CEOs, have the ability to draw on their own management experience not only in advising management of the company on whose board they sit, but also to rally support from other outside directors when it becomes necessary to break with management's plans. In fact, a recent study of director appointments at 5,400 U.S. companies found that "firms that appoint CEOs to their board have the best performance."[17]

One reason why outside CEOs on the board may correlate with improved performance may simply be that they serve as a check on the authority of the target company's CEO. CEOs of most large U.S. companies tend to chair their own boards,[18] which gives them the ability to set the board's agenda and to guide deliberations. Such concentration of power is widely considered unacceptable in the United Kingdom,[19] but institutional investors in the U.S. have largely accepted it—provided the company designates one of its outside directors as a "lead independent director."[20] The duties of the lead director include, at a minimum, approving board meeting schedules and agendas, being available for direct communication with shareholders, and presiding over meetings of the independent directors that management does not attend. Common sense would dictate, however, that for a lead director to serve effectively as an alternate locus of board authority, that individual would need to convince her fellow directors to join with her in opposition when necessary. To overcome what is likely to be an inherent

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17 Rüdiger Fahlenbrach et al., *Why Do Firms Appoint CEOs as Outside Directors?* 18 (Fisher College of Business Working Paper Series, Paper No. 2008-03-009, July 27, 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1160276 (link). The authors hypothesize that CEOs are more willing to serve at companies whose performance is good to begin with and that one effect of appointing a CEO to the board is to "certify" that the company's performance and governance are good. *Id.*

18 Only 38 percent of S&P 500 companies separated the chairman and CEO positions as of 2008, while 46 percent of S&P 1500 companies did so. Five years earlier, in 2003, the percentages were 21 percent and 30 percent, respectively. *See* RISKMETRICS GROUP, *supra* note 4, at 22.

19 *See* FIN. SERVS. AUTH., THE COMBINED CODE ON CORPORATE GOVERNANCE § A.2.1, at 6 (2003) (U.K.), *available at* www.fsa.gov.uk/pubs/ukla/lr_comcode2003.pdf ("The roles of chairman and chief executive should not be exercised by the same individual. The division of responsibilities between the chairman and chief executive should be clearly established, set out in writing, and agreed by the board.") (link).

20 *See, e.g.*, Evelyn Brody, *The Board of Nonprofit Organizations: Puzzling Through the Gaps Between Law and Practice*, 76 FORDHAM L. REV. 521, 548 (2007) (link).

tendency on the part of directors to defer to management, the lead director will need to be able to formulate an alternative plan and to sell that plan to the other directors. In such a scenario, the "CEO skill set" is likely to come in handy.

On the other hand, the job of CEO is considered by investors to be an extremely demanding one, and there are serious questions as to whether an active CEO can devote the time needed to serve as an effective outside director of another company.[21] An inability to prepare adequately for board and committee meetings, as much as a feeling of solidarity with fellow members of the executive class, may account for any observed tendency of boards with higher concentrations of executives to exhibit greater deference to management.[22]

If this is true, one solution may be for nominating committees to give preference to retired CEOs over active CEOs. Retirees may possess both experience (enabling them to identify when a management initiative is likely to damage shareholder value and the salesmanship skills to persuade the other directors that is the case), and the time to devote to board service, making them likely to be effective in the oversight role. On the other hand, an increase in the number of retired CEOs on U.S. boards may further fuel the stereotype that corporate directors are primarily elderly white men. Additionally, bringing about such an increase may require many companies to ease or abolish their policies mandating a retirement age for directors. To the extent that there is a developing consensus among shareholders and regulators that current supervisory arrangements are inadequate, companies and shareholders will need to balance the benefits of experience and free time against those of youth and diversity in deciding how best to strengthen the oversight function.

III. THE ROAD TO IMPROVEMENT

Regardless of who is chosen to serve on the board, however, there are various steps that a company can take to improve the board's effectiveness. In Part III, I consider four such measures: an infrastructure to support the board of directors; term limits for individual board members; share ownership requirements; and enhancements to director accountability.[23]

[21] RMG guidelines consider a director to be "overboarded"—triggering a recommendation to shareholders to oppose the director's election—when he or she serves on more than six boards. RISKMETRICS GROUP, U.S. PROXY VOTING MANUAL 23 (2009 ed.). Those guidelines specify that an active CEO, however, should serve on no more than three boards including that of the company where he or she is CEO. *Id.* at 24.

[22] This is consistent with the conclusions of Fahlenbrach et al., *supra* note 17, at 34, who speculate that "these directors are simply too busy with their day job to use their prestige, authority, and experience to have a substantial impact on the boards they sit on."

[23] Senator Charles E. Schumer recently announced plans to introduce a "Shareholder Bill of Rights Act," which, if enacted as proposed, would mandate many of the reforms discussed in this Essay, including proxy access, majority voting for directors, declassification of boards, and separation of the chair-

A. Support Infrastructure for the Board

Sharfman and Toll suggest that "nominating committees should select outside directors who have knowledge of the Company's business or who could potentially learn quickly and with a sufficient depth of understanding."[24] Beyond this, companies should establish an infrastructure to support the board, ensuring that directors receive timely updates on the company's operations and financial condition, and that directors can receive prompt answers to any questions they may have. It is important to ensure that directors can receive corporate information that is not filtered through the CEO; the board, in other words, should have other "touch points" at the company. This infrastructure should also include regular evaluations by the directors of both their own performance and that of the CEO.

B. Limited Tenure

To ensure that boards are regularly refreshed with new blood, and to prevent outside directors from excessively identifying with the company and its management team, many investors (particularly in the United Kingdom) favor limiting the tenure of outside directors.[25] Any gains from such increased turnover, however, must be weighed against the risk of forcing out a board's most effective outside voices—voices that may have served long enough to become familiar with the company's operational and competitive environment. To the extent that directors need time to familiarize themselves with a company, it may be that newly appointed directors are more inclined to defer to management than directors who have served long enough to form their own opinions about the company. Nevertheless, all boards should consider the need for new members and fresh ideas (and skills), and think about replacing long-serving directors whose skills might no longer be critical. But any mechanism to limit board tenure should be designed and implemented such that a certain amount of institutional memory is preserved. This can be achieved by ensuring that there are always a few experienced outside directors on the board at any given time.

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man and CEO positions. *See* Letter from Charles E. Schumer, Senator of New York, to his Senate leagues (April 2009) (on file with the Author), *available at* http://activistinvesting.blogspot.com/2009/05/sen-schumers-dear-colleague-letter-re.html (link). *See also* Dan Eggen, *Opponents of 'Shareholder Bill of Rights' Reach Out to Sen. Schumer*, WASHINGTONPOST.COM, Apr. 30, 2009, http://www.washingtonpost.com/wp-dyn/content/article/2009/04/30/AR2009043002966.html (discussing corporate lobbying efforts aimed at persuading Schumer not to introduce the legislation) (link).

[24] Sharfman & Toll, *Dysfunctional Deference*, *supra* note 1, at 161.

[25] *See, e.g.*, FIN. SERVS. AUTH., § A.3.1, *supra* note 19, at 7 (calling on companies to state reasons for believing a director is independent notwithstanding having served on the board for more than nine years).

C. Director Share Ownership

To align the interests of directors with those of shareholders, and to ensure that lapses in oversight by the directors will be felt in their own pocketbooks, all directors should be required to own a meaningful number of shares.[26] Director share ownership can be accomplished by requiring directors to buy their own shares. In order to prevent persons of relatively modest means from being scared away from directorship, however, another option is to pay director fees in stock instead of cash, and to require those shares to be held throughout the director's membership on the board.

D. Enhanced Accountability

Finally, many shareholders would argue that the most effective way to ensure that directors remain focused on shareholder value—and do not become overly deferential to management—is to establish a credible means for voting them out of office. For this reason, majority voting for directors, declassification of boards, and "proxy access" (the ability of shareholders to nominate directors without engaging in a costly proxy contest) are shaping up as key issues for investors and regulators alike as they seek ways to enhance accountability and to prevent a reoccurrence of the financial market meltdown.[27] With public outrage over executive compensation at an all-time high, few compensation committees—no matter how many CEOs they include—could afford to ignore the possibility that excessive deference to management on pay and other issues could lead to their dismissal and replacement.

CONCLUSION

The implosion of so many financial institutions, and the dramatic fall in share prices across nearly all sectors of the economy, have caused many observers to question the role of boards. Why did boards apparently allow corporate executives to take excessive risks and fail to ensure that executive

[26] At Exxon Mobil Corp.'s 2008 annual meeting, a shareholder attempted to establish minimum ownership requirements at the firm. Exxon Mobil Corp., Definitive Proxy Statement (Schedule 14A), at 49–50 (Apr. 10, 2008), *available at* http://idea.sec.gov/Archives/edgar/data/34088/000119312508078618/ddef14a.htm#toc87659_15 (link). The proponent of the resolution argued that if directors own too few shares to feel a "genuine" sense of "fiduciary responsibility" to investors, they are likely to feel allegiance instead to the chairman or CEO who appoints them, and suggested that ownership can serve as a corrective against excessive deference. *Id.* at 50.

[27] Under the plurality voting system, which is still the norm in the United States, in an uncontested election a company's director nominees are elected as long as they receive at least one vote in favor. Thus, the only way to replace a director is to mount a proxy contest. A classified board raises a further hurdle by requiring a dissident shareholder to mount proxy contests in two successive years in order to gain a majority of seats on the board. "Proxy access" would give shareholders the ability to include director nominees in the company's proxy statement, rather than having to print and distribute a proxy of their own.

compensation would be properly linked to long-term performance? Understanding the factors that tend to undermine board effectiveness and improving the functioning of boards is critical to restoring the confidence of investors and the general public in equity markets and in the entire corporate system. Pension funds and other institutional shareholders, who have the biggest stake in ensuring that the equity markets function smoothly and create sustainable value, have been urging companies to take steps to improve their boards for years. Reforms such as those proposed above, many of which are in place at companies outside the United States and even at some U.S. companies, are akin to "shovel-ready" infrastructure projects: the necessary groundwork has already been laid, and they can be implemented quickly as long as the will exists.