Corporate Boards of Directors: Advisors or Supervisors

Tamar Frankel
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Tamar Frankel*

INTRODUCTION

What makes for a well-functioning corporate board? In this Article I argue that one important condition is that board members must understand and agree upon the group’s objectives and its roles. If a corporate board of directors (Board) does not agree on what it is supposed to do; or, worse still, if Board members disagree about the Board’s mission and its implementation, then the Board is likely to become dysfunctional—inefficient and ineffective. The Board’s missions, however, may be mixed and their forms of implementation may conflict. In this case, the balance between the two missions must be established, and it is that balance on which Board members must agree and follow. This Article examines the Board’s two roles: One is the Board’s role as advisors to Chief Executive Officers and corporate management (CEOs); the other is the Board’s role as supervisors of CEOs. This Article discusses the many ways in which the two roles differ and the balance that must be achieved between them to create a functional Board.1

Understanding the balance between the Board’s roles depends on the corporation’s history, present condition, its business, and the personality of the actors. These factors are manifested by the Board’s culture, that is, the implicit assumptions that Board members make in their interactions with each other and with the other actors in the corporation. These assumptions are neither specified nor debated, nor clarified, except in times of crises. Usually such assumptions are taken for granted, just as we assume in this country that businesspersons do not hire assassins to eliminate their competitors.

This Article suggests that Board efficiency varies, depending on the extent to which their members understand and agree on the dual roles they should play as advisors and supervisors of their CEOs, and the appropriate balance between these roles. In addition, Boards must trust

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their CEOs and corporate management to tell the truth and abide by their promises. When these two roles of advice and supervision are well balanced, and when Boards can rely on their CEOs for information and compliance, then Boards are likely to be functional. When these roles are either misunderstood; or when Board members, the CEO, management, and the shareholders disagree about the extent and priority of their respective roles, Boards are more likely to fail in executing their mission.

Part I of this Article discusses the differences between the Board’s advisory and supervisory functions. Part II then describes the history of the Board’s roles as advisors and supervisors, its power relationship with CEOs and shareholders, and the law’s view of these roles and relationships. The Board’s initial function was to supervise CEOs, subject to the control of majority shareholders; this function then evolved, and the Board began to advise CEOs, subject to CEO and management control. Currently the Board’s roles are changing again, in an effort to reach a better equilibrium between the two.

Next, Part III examines the law’s view of the Board’s role. Part IV of the Article analyzes specific Boards that did not function efficiently, the consequences of their failures, and recounts a story of a Board that transitioned from inefficiency to efficiency. This part highlights the effect of the CEO’s personality on the Board’s behavior. Part V discusses the rise of activist shareholders, such as hedge funds and individual shareholders, and the effect of their activism on the Board’s dual roles. Part VI concludes by offering some guidelines with respect to the Board’s relationship with CEOs and the Board’s combined advisory and supervisory functions.

I. ADVISING AND SUPERVISING

The roles of advisor and supervisor differ in two fundamental ways. First, there is a different balance of power among advisors and their advisees, as compared to the balance of power between supervisors and those whom they supervise. Advisors do not have the last word regarding the subject on which they give advice; the final decision is in the hands of their advisees. Conversely, supervisors have the last word on the subject they supervise. Therefore, each role involves a different power relationship between the Board and its CEO. When the Board advises—the CEO and management ultimately decide. When the Board supervises—the Board is the ultimate decision maker. The distinction
between advising and supervising does not mean that the roles of advisors and supervisors cannot overlap. Advisors can influence the final decisions of those whom they advise, and supervisors can give advice while refraining from dictating the decision. Nonetheless, the parties act with these two roles in mind, and note the distinctions between them.

Additionally, in any one corporation, the balance between the two roles is not rigidly observed. The balance may change depending on the outside environment, the corporation’s business, and the personality of the actors. Furthermore, although the law does not dictate the precise balance, to be sure, the parties act under the shadow of the law. Because law is not fine-tuned to particular situations and is not as changing as human relationships, the model of power relationships that the law provides affects the background against which the parties act and their patterns of behavior, but not the details.

Second, advising and supervising result in a different balance of trust among the parties. In this context trust is defined as a reasonable belief that the other party will tell the truth and fulfill its promise. If verifying truth and assuring reliance involve low cost, as some relationships and situations do, no trust or a very low level of trust is required. In other relationships, involving a very high cost of verification, trust is crucial. In an advisor-advisee relationship, the higher the advisor’s expertise and the lower the advisee’s understanding are, the more power the advisor commands. In such situations the advisee must either trust the advisor or terminate the relationship.

When Boards act as advisors to CEOs, the CEOs have the upper hand. CEOs need not vest a high degree of trust in their Boards. The CEOs are often as knowledgeable as their advisory Board members are, and perhaps even more knowledgeable than some of them. CEOs are more informed about the affairs of the corporation than their Board is. Therefore, the CEO’s degree of reliance and dependence on the Board is not necessarily very high, especially when the CEOs can take Board advice or leave it.

In contrast, if Boards act as supervisors, the degree of trust that the Boards must vest in the CEOs is far greater than the trust CEOs must vest in their Boards. This is because the CEOs and management possess the information on which the Boards act, that is, the general operations of the corporations, their structure, and their accounting. Without this information there can be no effective and true supervision. Verifying the necessary information independently of the CEOs and management is

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very costly. Therefore, Boards must trust CEOs for the information on which the Boards base their final decisions. Furthermore, corporate CEOs do not have a legal duty to provide the Boards with information, if the Boards do not ask for it. In fact, if the Boards do not ask for pertinent information, the Boards, not the CEOs, might be faulted for violating their duty of care.

In sum, the power balance between Boards and CEOs may depend on whether the Boards are advisors or supervisors. But even if the Boards exercise supervisory functions, they must trust CEOs far more than the CEOs must trust the Boards (in both capacities). The balance of power between Boards and CEOs, however, depends on two additional factors. The first factor is who hires whom to the position of power. The second, complementary factor is who can remove whom from that position. On this score, history can tell the story.

II. AN OVERVIEW OF HISTORY

A. The early 1900s. The rise of United States corporations in the early 1900s posed issues concerning the status of corporate Boards. Boards were chosen by the majority shareholders; more often Board members were the majority shareholders. The Board’s supervisory powers over the CEOs and management were fairly decisive. In fact, many Board members were the CEOs and management of the corporations. The Board’s powers were usually only tested when minority shareholders complained. During this time period, directors’ roles were analogized to that of trustees. The Board’s powers were limited by the articles of association and corporate laws, and the Board owed fiduciary duties to the shareholders, including the minority shareholders—as trustees would to their beneficiaries.

4. See id. at ch. 4.

5. See Adams, supra note 1 (analyzing the consequences of the board’s dual role as an advisor and monitor of management in the context of both a sole board system, as in the United States, and the dual board system, as in various countries in Europe. The manager in a sole board system faces a trade-off concerning the amount of information he discloses to the board. If he reveals his information he gets better advice, but is exposed to the board’s judgment about his abilities. The board may choose to precommit to reduce its monitoring of the manager in order to encourage the manager to share his information. Adams derives implications for the optimal monitoring intensity of the board as a function of managerial ownership and the manager’s career concerns and tests them in a cross section of Fortune 500 firms. The empirical evidence is consistent with the model’s prediction that monitoring first decreases and then increases as ownership and tenure increase).


This strict interpretation, however, gave way to a more flexible one. In the case of *Dodge v. Ford Motor Co.*, the main issues revolved around the role of Henry Ford, the director-majority-shareholder-CEO of the company. The Board argued that it had the power to reinvest the excess profits in expanding the corporation’s operation rather than distributing all the profits as dividends—as Ford requested. Had the role of the Board been that of a trustee, the Board would have had to distribute all corporate profits to the beneficiaries—shareholders. The minority—the Dodge Brothers—argued that the Board had no choice but to declare dividends of almost the entire amount of the profits. The court held otherwise, stating that the Board had the discretion to withhold dividends and reinvest the profits in expanding the corporation’s operation. When the majority shareholder also occupies the position of CEO and Board director, then the minority shareholders’ powers become quite limited. It was assumed that the interests of the corporation (and consequently, the minority shareholders) were well served, and that assumption—clearly expressed in *Dodge*—was well founded. Thus, during this period the Board had power over the CEO because in most cases they were the one and the same.

**B. The 1970s.** During the evolution of publicly-held corporations, share ownership became dispersed among small shareholders. The Boards of the 1970s emerged as advisors to CEOs. The transformation was slow and perhaps not clearly noticed. CEOs in some corporations still represented the majority or controlling shareholders. These Board members were usually the founders of the corporations and their families. However, as the number of shareholders rose, the shareholders no longer held the majority of the shares or the controlling votes in the corporations. The CEOs became highly paid employees assigned to manage the operation of the corporation’s business. With dispersed shareholder population, the CEOs began to choose the Board members rather than the reverse. The Board’s role became advisory rather than supervisory. Board members were indeed knowledgeable in operating large enterprises. Board members usually included a member of the law firm that served as outside counsel. Sometimes, inside counsels were members of the same firms as well. Similarly, Boards

9. *Id.*
10. *Id.* at 684.
12. MICKLETHWAIT & WOOLDRIDGE, supra note 6, at 104; see also *id.* 113.
included a partner of the investment banker that served as underwriter of the corporation’s securities distribution.\textsuperscript{14} Thus, some Board members played the role of advisor to their client corporations. Other Board members understood that their role as directors was to advise management. During this period CEOs rather than Boards were viewed as the guardians of corporations and their public shareholders.

C. The 1980s. In the 1980s problems arose concerning CEO and management conflicts of interest. Insider trading issues emerged under Rule 10b-5 of the Securities Exchange Act. Before the 1980s, Rule 10b-5 existed and was dormant. It was in the 1980s that the rules began to be used by the courts. Concerned about liability for insider trading, many lawyers left their positions on Boards, especially when these lawyers’ law firms were managing large pension funds for their partners, or were serving as trustees of clients’ large trust assets.\textsuperscript{15} They did not wish to be privy to the financial situations in the corporations and be accused of then using insider information, or have to avoid trading in the stocks of these corporations.\textsuperscript{16} Yet the slow disappearance of lawyers from Boards did not change the Board’s role as advisors.

During this period, however, one element of a supervisory corporate Board did appear. This element was derived from the Investment Company Act of 1940.\textsuperscript{17} The Boards of investment companies were required by law to have a number of “independent” directors, that is, Board members who were not affiliated with the management of the corporation, whose function is similar to that of the corporate CEO.\textsuperscript{18} The importance of these independent directors grew when the CEOs acted in conflict with their corporate interest and the Board’s independent directors could approve these conflict of interest transactions. In such activities, the consenting Board members were acting as supervisors. They had the legal power to disapprove such transactions. In practice, however, the power of approval did not significantly change the role of the Board or its members. Neither did the courts change their attitude in any fundamental way. The Business Judgment Rule sheltered Boards from liability (barring conflict of interest and lack of care, narrowly defined, in most cases).\textsuperscript{19} The courts

\begin{itemize}
  \item \textsuperscript{14} Id.
  \item \textsuperscript{15} Blackmar v. Lichtenstein, 438 F. Supp. 803 (E.D. Mo. 1977), \textit{rev'd}, 578 F.2d 1273 (8th Cir. 1978).
  \item \textsuperscript{16} 17 C.F.R. § 240.10b-5 (2007).
  \item \textsuperscript{17} Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to -64 (2006).
  \item \textsuperscript{18} 15 U.S.C. § 80a-10(a) (2006) (prohibiting a registered investment company from having more than 60% directors “who are interested persons” of the company).
  \item \textsuperscript{19} \textit{E.g.}, \textit{In re Caremark Int’l. Inc. Derivative Litig.}, 698 A.2d 959, 967–68 (Del. Ch. 1996).
\end{itemize}
did not focus on whether Board members were advisors, or whether they had various affiliations with the CEOs as long as they were not corporate officers, and as long as they were not interested in the transactions that they approved.

D. Historical attempts to shore up the Board’s supervisory functions. Professor Jeffrey Gordon noted that “[b]etween 1950 and 2005, the composition of large public company boards dramatically shifted towards independent directors, from approximately 20% independents to 75% independents. The standards for independence also became increasingly rigorous over the period. The available empirical evidence provides no convincing explanation for this change.” The writer explains the developments as a shift “to shareholder value as the primary corporate objective” and “the greater [informative power] of stock market prices.” Therefore, “independent directors are more valuable than insiders” and “less committed to management and its vision.”

In the year 1984 one observer wrote:

Most modern analyses of the internal power structures of the large corporations have found the top insiders to be the power and decision-making center, with the outside directors usually serving in an advisory role. This is based on the factors just mentioned—command over resources, special skills, plus the tendency of the top insiders to build up a congenial board. Also, board traditions in the United States make outsiders invited guests, not policy makers. They have fiduciary and advisory duties and responsibilities, but normally they behave passively and reactively. There is considerable variation in the level of activity and power of outside directors, but this general pattern of power is well-accepted as a fact in the corporate world. Such a version of corporate control is consistently reported in Conference Board studies of the structures of boards and the evolution of board power.

E. The 2000s. Currently, history is repeating itself; though not precisely, as it never does. By law, the roles of Boards have been shifting towards supervision, even in large corporations with dispersed small shareholders or large passive shareholders. In practice, Boards have retained their advisory role, or, put differently, have not acquired sufficient backing to exercise a meaningful supervisory role. CEO discretion may have been shorn in some areas, but they were left with discretion focusing on maximizing profits. In fact, Boards were put in

22. See Gordon, supra note 20, at 1535–41.
an impossible position.

Professor Fanto has interpreted Board behavior by comparing their behavior to that of whistleblowers. He argues that corporate scandals have occurred in corporations which had an inner circle that perpetrated and benefited from the fraud. The Boards and advisors that worked closely with these corporate inner circles were reluctant to object to the fraud, and remained uninvolved in these activities. In contrast, whistleblowers that cared about the corporations did not fare well.

The contrast between the behavior of the executives, board members, and corporate advisors who were reluctant to challenge the corporate misbehavior, and the small number of corporate whistleblowers who did, points to a disturbing social psychological reality that has been overlooked in the discussion and reforms addressing the corporate scandals: namely, a group dynamic that binds group members together and blinds them to their failings and abuses. This social psychological reality . . . , long known to and studied by social psychologists, is a basic cause of the corporate scandals.

Thus, regardless of pressures in publicly-held corporations, the equilibrium between the Board's two roles of advisors and supervisors has not been well-balanced or effective to date.

III. THE LAW

A. Corporate governance reflects the political structure of the United States. Boards are similar to legislatures and CEOs are similar to the executive branch. Boards have the duty to lay out general guidelines for the management of their corporations, and CEOs are required to execute these general guidelines. In some respect this division of functions makes sense. In terms of their objectives and functions, however, corporations may differ from the political system. The political system is concerned with excess of power. The three branches of government are designed to maintain a balance of power. Each branch is assigned functions, and is restrained from encroaching on the functions of other branches. This is especially important in gray areas, which are prone to the "creeping" acquisition of power.

Notwithstanding its resemblance to the political structure, the balance of power in corporations differs from that in the political arena.

24. Id. at 435.
25. Id. at 435–36.
26. Id. at 441.
Corporate governance is policed by government law enforcement and by private sector gatekeepers: attorneys, accountants, in-house counsels, ombudsmen, and others to ensure compliance with the law and internal rules. But corporate governance lacks a court system to maintain the balance between the CEOs and the Boards. Courts are reluctant to draw the line, and are subject to far more legislative pressures in designing the balance.

In fact, the courts have averred that they cannot and will not deal with the details of the corporate functions. They announced the constraints on their power in the Business Judgment Rule. If we compare the Business Judgment Rule with the courts’ decisions for refraining to deal with sub judice matters we find that the judicial self-restraint in the corporate arena is far greater than in the political arena. This withdrawal from decision-making and the absence of precise rules on the division between the Board’s advising and supervising functions may be desirable, especially because more than the political system, corporations are many and varied. This different judicial approach, however, allows for inappropriate division or balance between the Board’s two functions.

Courts have recognized the low level of the Board’s supervisory role. For example, in In re Caremark International Inc. Derivative Litigation, involving a claimed breach of directors’ duty of care regarding employee violations of law, a Delaware court discussed directors’ duties to monitor corporate operations. The court held that “absent grounds to suspect deception, neither corporate boards nor senior officers can be charged with wrongdoing simply for assuming the integrity of employees and the honesty of their dealings on the company’s behalf.” The court stated that “a director’s obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists.” In finding the directors not liable, the court said, “Generally where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation, ... only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a

29. 698 A.2d 959 (Del. Ch. 1996).
30. Id. at 969 (citing Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130–31 (1963)).
31. Id. at 970.
reasonable information and reporting system exits—will establish the lack of good faith that is a necessary condition to liability."\textsuperscript{32}

\textbf{B. The markets develop their practices in the shadow of the law.} Yet, law might reflect changing market perceptions of the Board’s functions. Market pressures might induce lawmakers to restrict harmful corporate actions after they threaten the financial system, such as the Sarbanes-Oxley Act (the Act), which imposed a stronger supervisory role on Boards.\textsuperscript{33} In practice, however, little can be changed if the same power balance between Boards and CEOs persists. Boards cannot act as supervisors unless they have the shareholders’ backing and unless they can trust the information they receive from CEOs and management. As long as the CEOs have contacts with the shareholders and choose the proposed list of Board members on which shareholders are invited to vote, the Boards are not likely to become more supervisory. The recent rise in activist shareholders does not necessarily increase the Board’s supervisory power, unless the Board members are appointed by the shareholders. In such a case, the Board represents the controlling shareholders and in that capacity can supervise the CEO.\textsuperscript{34}

\textbf{C. Where does the law end and social controlling mechanisms begin to take its place?} It seems that market discipline may help Boards define and balance their dual roles. The recent termination of two CEOs (although with significant amounts of “farewell” money) could indicate pressure on Boards to restrain corporate risk-taking, especially risk-taking that may endanger the financial system.\textsuperscript{35} The court-confirmed story at Disney Corporation has caused the disappearance of both Michael Eisner and Michael Ovitz from the scene, at least for some time.\textsuperscript{36} In the mutual funds area the Boards have been imposed with more supervisory tasks accompanied by shadow liabilities, and more transparency as to their own Board discussions.\textsuperscript{37} And even though substantive discussions can be carried on before the formal meetings and


\textsuperscript{34} SCOTT GREEN, SARBANES-OXLEY AND THE BOARD OF DIRECTORS 216 (2005).


formal meetings can then be staged, the added concern about legal requirements renders Boards more sensitive to their supervisory role.

In 2002, with the passage of the Sarbanes-Oxley Act, Boards acquired greater supervisory powers. The Act imposed structural requirements on Boards and allocated powers among Board members, accompanied by liabilities. Yet, the disagreement about the functions and role of corporate Boards is by no means over.

IV. SAMPLING DYSFUNCTIONAL BOARDS

A. Some Boards neither advise nor supervise but instead attempt to micro-manage. The following example demonstrates the elements of dysfunctional Boards. One type of a dysfunctional Board is a Board that neither advises nor supervises but attempts to manage the details of the operation. There are Boards that interfere in the management of their corporations, either in the details or in the fundamental business strategy—the domain of CEOs. One example is the case of Westbrae. As one expert noted: "Westbrae's problem was... a dysfunctional board of directors that suppressed growth and investments. We took off the cuffs and let that growth potential flourish."

When Westbrae merged with Hain, the deal "brought Hain into categories like soy milk and provided it with an excellent management team, says Irwin Simon, president and CEO of Hain." That also released Westbrae of its restrictive Board.

Another example of a dysfunctional Board is the Board of Hewlett-Packard Corporation. In this Board, in addition to disagreement over the corporate business strategy, there was a serious rift among the Board members, the controlling shareholders, and the CEO. The rift led a few Board members to anonymously tip the media on internal discussions. The CEO then hired a private detective to identify these members. The detective tapped the telephones of Board members and engaged in illegal activities. Neither the corporate legal advisers nor other Board

40. Id.
42. See Wong, supra note 41.
43. Id.
members seemed to be able to control these developments, which led to a public scandal.\textsuperscript{44} However, because the employees of the corporation and its culture are exceptionally trustworthy, trusting, and productive, the corporation managed to overcome the Board’s poor composition and behavior, survive, and flourish. It could be the exception, however.

B. Some dysfunctional Boards remain entirely passive: neither advising nor supervising. For example, the Board of Walt Disney Co. remained passive in the face of an inappropriate choice of the company’s president by a controlling Chairman. That led to the unusual strong active signal of the shareholders. “On March 3, 2004, in dramatic and historic fashion, shareholders of Walt Disney Co. (Disney) delivered a powerful message to management at their annual election: a ‘startling’ forty-three percent withheld their vote for incumbent Michael Eisner as Chairman of the Board.”\textsuperscript{45}

C. Some dysfunctional Boards fail to supervise or control fraudulent CEOs and fraudulent corporate culture. The CEO of Hollinger International ruled the corporation without much regard to its Board.

Conrad Black and his executives were not the only people who were on trial in this case. The spotlight was also on the conduct of Black’s directors, lawyers and auditors who failed on several occasions to question or sound the alarm about a number of transactions that were at the heart of the case. The Black trial painted a picture of a dysfunctional board of directors who “skimmed” key documents and never questioned deals that screamed for scrutiny. Hollinger International’s board was handpicked by Lord Black to include aging government celebrities such as Henry Kissinger and Richard Perle and they operated more like a political salon than public company board. These directors trusted Lord Black and almost never challenged him. The embarrassment and lawsuits they have suffered as a result of this case is the final nail in the coffin to compliant boards.\textsuperscript{46}

Professor Hamilton discussed the cases of corporations that “engaged in a fair amount of fraud.”\textsuperscript{47} In most, if not all, the exercise of the Board’s supervisory role was weak, or did not exist. One of these corporations was WorldCom, Inc., where the CEO was actively

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44. Id.


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manipulating the corporate books. Another was Adelphia Communications Co., which had grown to be “the nation’s sixth-largest cable operation,” and in 2002 announced an off-balance sheet debt of $2.3 billion; the CEO and other officers were charged with looting the company. Yet another example was Qwest Communications International Inc.; “the dominant local telephone company in fourteen states from Minnesota to Washington,” experienced an improper booking of $1.16 billion. “Joseph P. Nacchio, the former Qwest CEO, sold $230 million of Qwest stock before the value of the shares collapsed.” Global Crossing, founded in 1997, built an extensive undersea phone network. The founder, who controlled the company, “went through six CEOs in five years.” While the company went bankrupt in January 2002, the founder of the company, profited to the tune of $735 million by selling the company’s stock in time. In each of these instances, the company’s Board did not act to prevent these activities.

D. Group dysfunction. Chris Blake and Bob Harris described group behavior signals of dysfunctional Boards. I suggest that this behavior represents the failure of a group to agree on the balance between its position as advisor and supervisor. Consequently, the Board is unable to set or focus on its group’s goals. It has too many agendas, and experiences difficulties in making decisions. These behavioral problems seem to relate to the lack of clarity about the balance necessary in performing the Board’s duties. In addition to—and perhaps because of—this lack of clarity, the behavior of the members signals dysfunctional boards as well. Such behavior include inability to work together as a team, destructive criticism, personality clashes and infighting, too much analysis and too little action, and unequal division of the work. These difficulties demonstrate another imbalance, an inability to combine different views and be enriched by diversity.
these cases, again, one underlying missing factor is the balance between
the advisory and supervisory capacities of Boards.

E. Personality of the CEOs. Corporations that are unsupervised
appear to invite persons with a certain psychological and personality
makeup. When power vests in one party without supervision or
counterbalancing power, we can expect dysfunctional governance.
Power develops reduced inhibitions in people. This tendency "involves
acting on your own desires in a social context without considering the
effects of your actions. It implies a heightened sensitivity to your own
internal state and also a reduced sensitivity to other's interests and
experiences." Executives with such a personality "are enamored with
risk taking and whose fatal flaw is unbridled confidence in their own
ideas and abilities combined with a willingness to push, and frequently
exceed, the legal limits of corporate executive action." They crave to
control large enterprises; the larger the enterprises become, the more
powerful the CEOs become. Inevitably, the supervisory function of the
Boards declines with the growth of the enterprises. This psychological
makeup is manifested in the behavior of the actors, be they CEOs or
Board members.

Thus, under such a CEO, Tyco International, Ltd., became a very
aggressive deal-machine (acquiring about seven hundred companies
between 1998 and June 2002). The CEO "was indicted for evading
more than $1 million in New York state sales taxes on art purchases."
He "regularly used Tyco funds for various personal purchases....
Shortly [after the indictment], Tyco reported a $2.32 billion loss for its
fiscal third quarter, a number that itself may have been based on
questionable accounting." This CEO and a former CFO were indicted
on "grand larceny, enterprise corruption, and falsifying business
records." To the extent that Boards could affect the choice of corporate
CEOs, these Boards failed to choose the right kind of persons.

F. Where were the Boards in these fraud cases? They either did not
know but should have known of the manipulations and

59. Marguerite Rigoglioso, Behaving Badly May Be Natural at the Top, STANFORD BUS. MAG.,
(interview with Deborah Gruenfeld).

60. Edwin J. Greenlee, in Keeping Up with New Legal Titles, 98 LAW LIBR. J. 169, 185 (Amy
Flaws in Corporate America and Where They Came from (2005)).


62. Id.

63. Id. at 27.

64. Id.; see also Robert L. Dilenschneider, When CEOs Roamed the Earth, WALL ST. J., Mar. 15,
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misappropriations, or they knew of the wrongful acts and did nothing to prevent them. After the discoveries and indictments of these frauds, when the regulators, investigators, and prosecutors entered the scene, only then did the Boards take action, and remove or force the resignation of their CEOs. But even then, the Boards did not necessarily enforce discipline. For example, Tyco’s CEO took a personal loan from the corporation and “[r]epayment of [the CEOs’ private loan] was subsequently forgiven by Tyco’s board of directors without advising its shareholders.” The Board’s advisory function was pushed to the point of subservience.

V. ACTIVIST SHAREHOLDERS

Individual activist shareholders emerged in the 1980s. Their fight to control the Boards, (and the CEOs), and consequently the corporations, has been reflected in law. These attempts gave rise to poison pills and other mechanisms designed to thwart activist shareholders. Wresting control of Boards from CEOs is no easy matter; it takes significant funds and time. It also is constrained by the law. In contrast, incumbent CEOs and their Boards can use corporate assets to fight off proxy solicitations by activist shareholders.

Not all activist shareholders aim at benefiting all shareholders or the corporate enterprise. Some activist shareholders are accused of draining the corporate assets and exiting the scene. Some are accused of betting against the acquisition and success of their target corporations. Some have no stake in the corporations but rather borrow shares to vote without risk to their equity. State courts are less adamant in imposing supervisory roles on Boards, and more attendant to the arguments and

65. Hamilton, supra note 47, at 27.
The importance of activist shareholders is the effect of their activism in strengthening the supervisory role of the Boards. Judging by the reaction of Martin Lipton, a lawyer who speaks for management and protects its entrenchment (according to his statement), activist shareholders may have some effect. Lipton's argument is that the "[shareholder-]owners are bent on wrecking the companies they have bought and upon which they hope to build a prosperous retirement... [Lipton] seems to see shareholders as infants who should stay in their cribs and leave big corporate decisions to wise men on the board, in the corner suite and, of course, in law offices." Thus, there is a movement and public pressure to involve shareholders in corporate governance. It is not surprising that this movement is strengthened by the falling share prices on the one hand and the enormous compensation for CEOs on the other.

To the extent that activist shareholders occupy positions on Boards or nominate persons who share their views, they can strengthen the Board's supervisory role, provided these shareholders have a stake in the corporation's success. The very activism of these shareholders may strengthen the Board's supervisory role over CEOs. This activism might be achieved by gaining the power to name proposed directors without the expenses of proxy fights, or acquiring the right to amend the articles of associations to achieve this goal, or simply voting "No" on particular proposed directors.

VI. CONCLUSION: REACHING FOR THE BALANCE

Boards must play two roles: advisors and supervisors to their CEO and their corporation. These two roles are usually combined and draw on each other. Boards do not, however, have the tools necessary to perform either function well. To advise well, one must know what is going on in the corporation. To supervise well, one must know what is going on in the corporation and take some advisory action as well. It is not enough for Boards to demand results without giving general directives; without suggesting and designing an area of discretion to those who execute the tasks. Thus, in both roles Boards must receive sufficient and adequate information: not too little but also not so much as to drown Board members in the details. Boards must be populated by persons with diversified expertise to both advise and supervise the corporation's

operations. Yet, notwithstanding the scandals of the 1990s that seem to continue into this century, the independent directors did not strengthen the supervisory function of Boards.\(^2\)

The Board's supervisory requirements cannot be achieved without a measure of supporting power. Experience has shown that CEOs cannot and should not represent the corporate shareholders' interests or the interests of the corporations. The attempt to clone CEOs as shareholders by awarding CEOs stock options was an admired theoretical success, and a disastrous failure in reality. The shameful behavior of a fair number of powerful CEOs of very large corporations, and the incredible rise in CEO compensation regardless of investors' losses, demonstrate that CEO identification with shareholders' interests usually does not exist. Therefore, Boards must supervise CEOs. Yet, where will the board's power and precise information come from?

CEOs are fighting the pressure to increase Board supervision, and have had supporters among the legislators, some of the courts, and in academia. A number of quick removals of CEOs in recent months\(^3\) might signal a change in the Board's perceptions. However, as long as the CEOs, rather than the Boards, have contact with the large shareholders, and as long as the CEOs hand-pick the Board members, it is doubtful that Boards will be able to supervise. The exercise of supervision backed by the threat of legal liability is not very effective. Besides, the courts are not likely to send directors to jail for slack supervision of their CEOs. The courts recognize that

> [W]hen a company fails, it's usually because of the chief executive's mistakes. But don't expect the CEOs to 'fess up. CEOs offer every excuse in the book, says Fortune—a bad economy, market turbulence, a weak yen, hundred-year floods, perfect storms and other forces outside their control. Among the mistakes that actually lead a company to fail are fear of the boss by underlings, the lust for acquisitions, a dysfunctional board of directors, "overdosing on risk," ignoring mistakes and being a "slave to Wall Street."\(^4\)

Regardless of the merits of resorting to judicial enforcement of fiduciary duties, it is doubtful whether the Board's stronger supervisory role would emerge by judicial caveat. The structure of fiduciary law may not be suitable for designing specific duties to variable environments,

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\(^2\) There is one model which may have been the source of the idea of "independent directors" and may continue to provide a model in the future. That is the model of the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to -64 (2006).

\(^3\) Farrell, \textit{supra} note 35; \textit{see also} Zarroli, \textit{supra} note 35.

such as corporate businesses. The courts' tradition also might not be so easily or quickly changed. Today's courts avoid interfering in, and imposing duties on, either CEOs or Boards when their duties are closely related to operating corporate businesses. The courts do not impose duties on directors or officers, for example, to restructure the corporations even though their existing structure contributes to legal violations by the employees of the corporations.\(^\text{75}\)

Presently, there are suggestions to highlight the status of the CEOs as fiduciaries and invite the courts to impose strict fiduciary duties on them. One commentator argued: "Chief executive officers wield enormous power in the modern corporation. . . . When they and other senior officers perform well, the enterprise and its stockholders are likely to flourish; when they misbehave—as many have in recent years—the company, stockholders, creditors, employees, and others in society suffer significant loss."\(^\text{76}\)

Professor Lucian Bebchuk has argued for opening the Board's nomination power to large shareholders. These proposals have met with strong opposition by the Business Roundtable, a strong and influential conservative organization for corporate management.\(^\text{77}\)

One clear-cut solution to the problem of dysfunctional Boards is to remove Boards. That was the way in which an airline in New Zealand was rescued. The dysfunctional Board just left.\(^\text{78}\) Other suggestions are less extreme. They include, for example, standards proposed by the New York Stock Exchange (the Exchange) board of directors, which include the selection of "a majority of independent directors,"\(^\text{79}\) who will serve on audit,\(^\text{80}\) compensation,\(^\text{81}\) and nominating\(^\text{82}\) committees (for listed

\(^\text{75. See In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996).}\)

\(^\text{76. Lyman P. Q. Johnson & David Millon, Recalling Why Corporate Officers Are Fiduciaries, 46 WM. & MARY L. REV. 1597, 1599 (2005) (footnote omitted); id. at 1600–02 (the arguments are aimed at distinguishing between the fiduciary duties of CEOs and Board members. Both are fiduciaries, but each group plays a different role in the corporate governance. Failure to differentiate the duties of officers, who manage daily corporate operations, from directors, who more remotely monitor corporate affairs, stems from a puzzling failure to address an even deeper issue in corporate law: What exactly is the theoretical and conceptual basis for the widespread claim that corporate officers owe fiduciary duties to a corporation and its stockholders?).}\)


\(^\text{78. Phil Pennington, The Most Reluctant Rescue Ever, EVENING POST (WELLINGTON), Oct. 6, 2001, at 18.}\)

\(^\text{79. NYSE, Inc., Listed Company Manual § 303A.01 (2009).}\)

companies). "Independent" Board members are defined as those who have "no material relationship" with the corporation. The nature of the material relationship is defined by the Boards, but the definition of "independent director" excludes, among others, former employees and outside auditors who personally worked on the audit for three years after the employment or service provision ends.

In addition, independent directors must conduct meetings without the CEO-management directors. Listed companies must have an audit committee, and the audit committee independent directors' compensation must be the only remuneration they receive from the listed company. In addition, equity compensation plans must be subject to shareholder approval, with limited exceptions including employment inducement awards and merger-related exemptions. Listed companies must adopt corporate governance guidelines, and disclose these guidelines and the charters of their most important committees (including the audit committee, and the compensation and nominating committees if applicable), and must adopt and disclose a code of business conduct and ethics. The Exchange may issue a public reprimand letter to a company that violates a listing standard.

This proposal had "widespread support, [with] strong endorsements from President Bush, [former] SEC Chairman Harvey Pitt, members of Congress, CEOs of listed companies, institutional investors, state pension funds, representatives of the financial-services industry, and organizations such as the Business Roundtable and the Council of Institutional Investors." The proposed standards were approved in 2003.

82. Id. § 303A.04(a).
83. Id. § 303A.02(a).
84. Id. § 303A.02(a) cmt.
85. Id. § 303A.02(b)(i)-(ii).
86. Id. § 303A.03.
87. Id. § 303A.06.
89. Id. § 303A.08.
90. Id. § 303A.09.
91. Id. § 303A.10.
92. Id. § 303A.13.
93. Hamilton, supra note 47, at 43-44.
94. Self-Regulatory Organizations; New York Stock Exchange, Inc. and National Association of
There are also weighty arguments to allow institutional investors simply to vote: No. Professor Joseph Grundfest argues for this approach.\textsuperscript{95}

Despite the fact that it is impossible to determine with precision the cause and effect relationship between shareholder threats to “just vote no” and CEO or policy changes at targeted firms, the fact that CalPERS and other institutional investors were able to identify several major firms on the verge of significant corporate management changes or restructurings is consistent with the proposition that institutional shareholders can accurately target corporations that are \textit{in extremis} and at which fundamental reform is warranted.\textsuperscript{96}

Renee Jones has shown that extralegal mechanisms such as markets and social norms fail to provide adequate safeguards against corporate mismanagement and opportunism.\textsuperscript{97} Yet, there are many forces that seem to turn Boards into more active supervisors. These are actions by large investors, reactions by the markets, threats of criminal sanctions for joining wrongful actions, the rise of CEOs who refuse to compete on fraud, the media, and public opinion. If institutional investors turn to the Boards rather than to the CEOs, and if markets demonstrate and strongly express the public’s opinion and outrage, as it seems to have done recently, then the Boards might better balance their supervisory and advisory roles over CEOs and exercise their supervisory functions more actively.

\textbf{POST SCRIPT}

This Article was written at the beginning of 2008. Since then, the financial and economic crisis has deepened. The number of CEOs that were asked to leave or were removed has grown. The number of large institutions that were acquired by other institutions or by the government, and whose CEOs are likely to be replaced, has risen as well. It seems that the Boards have become more active and assertive. When their corporation is on the verge of bankruptcy Board members hesitate to resign, concerned about damaging their own reputations. Then they are pressed to act: inviting CEOs to leave and replacing them.

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\begin{itemize}
  \item Id. at 934 (emphasis in original).
\end{itemize}
is one such action. It seems that a number of Boards have taken this step. If the trend continues, Boards may become more aggressive and begin supervising CEOs more than they did in the past. Thus, when concentrated shareholding is missing and courts exercise a "hands-off" attitude, then perhaps the pressure of public opinion will move Boards to act as supervisors of CEOs. Whether this is the wave of the future remains to be seen.