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Delaware Chancery Court Opens Discussion of Enhanced-Independence Director Deference for Controller Transactions

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I. Principles of Corporate Management

Delaware corporate law starts from the bedrock principle that the business affairs of every corporation shall be managed by, or under the direction of, a board of directors. The directors are bound by the fiduciary obligations to manage the corporation with appropriate care and loyalty. Directors may be exculpated from liability for a breach of a duty of care by the corporation's charter, but may not be exculpated from liability for a breach of the duty of loyalty.

More specifically, section 102(b)(7) of the Delaware General Corporate Law (DGCL) provides in pertinent part that a certificate of incorporation may include:

> A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) for any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under §174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit.

When determining whether directors have breached their fiduciary duties, Delaware corporate law distinguishes between the standard of conduct and the standard of review. The standard of conduct describes what directors are expected to do and is defined by the content of the duties of care and loyalty. The standard of review is the test that a court applies when evaluating whether directors have met the standard of conduct.

In terms of the standard of conduct, the duty of care requires that the directors make appropriately informed decisions. This does not require perfect knowledge, but rather turns on what is necessary to make an informed decision. The duty of loyalty mandates that directors maximize the value of the corporation over the long-term for the benefit of the providers of equity capital. In short, this means that when the directors are considering whether to pursue an action that would end or fundamentally alter the stockholders' ongoing investment in the corporation, the loyalty-based standard of conduct requires that the alternative yield value exceeding what the corporation otherwise would generate for stockholders over the long-term. Value can be cash, but can also constitute ownership interest in an entity, a package of other securities or some other combination that will deliver greater value over the anticipated investment horizon.

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The directors' obligation to act for the ultimate benefit of stockholders does not require that the directors fulfill the wishes of a particular subset of the stockholder base. Stockholders often will have idiosyncratic reasons for preferring decisions that misallocate capital. Nevertheless, the directors must exercise their independent fiduciary judgment and not cater to the whim of that particular subset of stockholders.

Unless otherwise specified in the corporation's charter, all of its stock will be common stock. A corporation's charter may also grant a particular class or series of stock special voting powers, designations, preferences and relative, participating, optional or special rights superior to common stock – such issuance is known generally as Preferred Stock. As a general matter, the rights and preferences of Preferred Stock are contractual in nature.

A board of directors does not owe fiduciary duties to preferred stockholders when considering whether or not to take corporate action that might trigger or circumvent the preferred stockholders' contractual rights. Preferred stockholders are owed fiduciary duties only when they do not invoke their special contractual rights and rely on a right shared equally with the common stock. By way of example, just as common stockholders can challenge a disproportionate allocation of merger consideration, so too can preferred stockholders who do not possess, and are not limited by a, contractual entitlement. Under those circumstances, the decision to allocate different consideration is a discretionary, fiduciary determination that must pass muster under the appropriate standard of review, and the degree to which directors own different classes or series of stock may affect the standard of review.

For private equity (PE)-backed companies, it is usual for the board of directors to include designees of the funds. The fund-designated directors will accordingly face the dilemma of dual allegiances. On the one hand, these directors owe a duty of care (if not exculpated) and duty of loyalty to the corporation's common stockholders. On the other hand, these directors also owe duties to the funds with whom they are affiliated. There is no safe harbor under Delaware law for such divided loyalties.

There is however a presumption under Delaware law that such directors have acted independently, with due care, in good faith, and with the honest belief that their actions were in the stockholders' best interest. Because of this presumption, transactions approved by a director designated to the board by a controlling stockholder are not automatically subject to a heightened standard of review. Rather, the controlling stockholder must also engage in a conflicted transaction for a heightened standard of review to apply.

II. What is Controller Under Delaware Corporate Law?

One must therefore determine whether there is a controlling stockholder. There are two ways a stockholder can be considered a controller under Delaware law. The first is where the stockholder owns more than 50% of the voting power of the corporation. The second is where the stockholder owns less than 50% of the voting power of the corporation, but nevertheless exercises control over the business affairs of the corporation.

A controlling stockholder need not be a single person or entity. A group of stockholders may be deemed a control group and considered a controlling stockholder such that its members owe fiduciary duties to their fellow stockholders. Proving a control group is a fact-intensive inquiry that requires evidence of more than mere parallel interests. It requires that the group of stockholders be connected in some legally significant way – *e.g.*, by contract, common ownership, agreement, or other arrangement – to work together toward a shared goal. The law does not require a formal written agreement, but there must be some indication of an actual agreement. Mere concurrence of self-interest among certain stockholders is insufficient to create a control group. One must also determine whether the controlling stockholder is conflicted with regard to the transaction. Conflicted transactions come in many forms, but Delaware courts have put them into two broad categories.

First are transactions where the controller stands on both sides. Second are transactions where the controller competes with the common stockholders for consideration. As respects to the second category of conflicted transactions, Delaware courts cite three common examples: (1) where the controller receives greater monetary consideration for its shares than the minority stockholders; (2) where the controller takes a different form of consideration than the minority stockholders; and (3) where the controller gets a unique benefit by extracting something uniquely valuable to the controller, even if the controller nominally receives the same consideration as the other stockholders. Examples of non-ratable benefits that warrant heightened scrutiny are: (1) security issuances, purchases and repurchases; (2) asset leases and acquisitions; (3) compensation arrangements, consulting agreements and service agreements; (4) settlements of derivative actions; and (5) recapitalizations.

III. Standards of Review

Delaware courts apply one of three standards of review when evaluating stockholder challenge to a board's decision-making: (1) the business judgment rule; (2) enhanced scrutiny; or (3) entire fairness. The applicable standard of review depends initially on whether the board members (i) were disinterested and independent (the business judgment rule); (ii) faced potential conflicts of interest because of the decisional dynamics present in particular recurring and recognizable situations (enhanced scrutiny); or (iii) confronted actual conflicts of interest such that the directors making the decision did not comprise a disinterested and independent board majority (entire fairness).

The default standard of review is the business judgment rule. The rule presumes that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action was taken in the best interests of the company. This standard of review reflects and promotes the role of the board of directors as the proper body to manage the business and affairs of the corporation. Unless one of its elements is rebutted, the court merely looks to see whether the business decision made was rational in the sense of being one logical approach to advancing the corporation's objectives. Only when a decision lacks any rationally conceivable basis will a court infer bad faith and a breach of duty.

Enhanced scrutiny is the intermediate standard of review. Framed generally, it requires that the defendant fiduciaries bear the burden of persuasion to show that their motivations were proper and not selfish and that their actions were reasonable in relation to their legitimate objective. Enhanced scrutiny applies to specific, recurring and readily identifiable situations involving potential conflicts of interest where the realities of the decision-making context can subtly undermine the decisions of even independent and disinterested directors. This standard has historically been applied to address the potential conflicts of interest faced by a board of directors when resisting a hostile takeover, namely the reality that target directors may be influenced by self-preservation to act to further their own interests or those of incumbent management rather than those of the corporation and its shareholders. This standard has been extended to evaluate the board's handling of the sale of a corporation, recognizing that the potential sale has enormous implications for corporate managers and advisors and a range of human motivations, including but by no means limited to greed, can inspire fiduciaries and their advisors to be less than faithful.

Entire fairness is the most onerous standard and applies where the board labors under actual conflicts of interest. Generally speaking, the burden is upon the board to establish to the court's satisfaction that the transaction was the product of both fair dealing and fair price. The court applies a unitary approach in this context, meaning that it will not independently determine fairness of price and process, but rather considers these elements jointly. Fair dealing embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors and how the approvals of the directors and the stockholders were obtained. Fair price relates to the economic and financial considerations of the transactions, including all relevant factors such as assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock.

The board's subjective and honest belief that the transaction was entirely fair is irrelevant. The transaction itself must be objectively fair. The court will initially evaluate whether a majority of the directors making the challenged decision were independent and disinterested. This analysis is conducted on a director-by-director basis. Importantly, fairness is the standard – not perfection.

IV. Commonly Occurring Situations Where PE Has Board Membership

Although individual deals vary, PE typically invests through preferred stock with certain standardized features. The preferred stock usually carries a preference upon liquidation, *i.e.*, a sale of the company, which entitles the holders to receive specified value before the common stock receives anything. It often earns a cumulative dividend which, if unpaid, steadily increases the liquidation preference. It also entitles the preferred holder to convert into common stock at a specified ratio in lieu of receiving the liquidation preference.

There is nothing inherently pernicious about the standard features of PE preferred stock. The sophisticated contract rights, the use of staged financing and the gradual acquisition of board control over the course of multiple financing rounds helps PE reduce the risk of entrepreneur opportunism and management agency costs. This does, however, create the possibility for PE to use its contract rights opportunistically.

This is because the economic incentives of the PE holding preferred stock differs from those of common stockholders generally. PE investors prefer lower-risk, lower-value, relatively short term investment strategies that protect their liquidation preference; whereas, common stockholders typically benefit more from higher-value and higher-risk investment strategies. This clash of interests will affect the choice between (i) selling or dissolving the company and (ii) maintaining the company as an independent private business. Stated differently, prompt liquidity events promise a certain payout, much or all of which flows to the preferred stockholders due to their liquidation preferences. Whereas continuing to operate the firm as an independent company, may expose the preferred-owning PE to risk without sufficient opportunity for gain.

With this background in mind, we consider the common scenario where one or more directors are designated by PE to serve on the board of a portfolio company, with the balance of the board being comprised of the company's founder and/or senior management. One can readily configure a number of scenarios where the PE designees will face the dual-fiduciary dilemma. For example, a sale context that will trigger the liquidation preference for the preferred stockholders and result in no consideration for the common stockholders. Or, the portfolio company is viable, but its returns are not meeting the PE benchmarks, and so the PE writes it off to focus on other investment opportunities.

The burden of proving the entire fairness of a transaction can be a challenging standard to satisfy. There presently are only limited means to blunt the onerous burden of the entire fairness standard. We turn next to suggested methods for doing so.

V. Methods for Addressing Entire Fairness

First, PE investors should reconsider the need to designate a voting member of a portfolio company's board. If the goal is to have a proverbial seat at the table – to be in the board room to monitor and evaluate board activity – then consider whether to have board observer rights rather than designating a voting member of the board. In a precedential opinion, the Third Circuit Court of Appeals in *Obasi Inv., Ltd. v. Tibet Pharm., Inc.*, 2019 U.S. App. LEXIS 21902, distinguished non-voting board observers from directors for purposes of liability under Section 11 of the Securities Act of 1933. While the court was evaluating the differences in the context of an alleged violation of the securities laws, as the court suggests in its opinion, the same principles could very well be applied to other situations.

In *Obasi*, Hayden Zou was an early investor in Tibet and L. McCarthy Downs was the managing director of the investment bank that ultimately served as Tibet's placement agent. Zou and Downs worked together to help Tibet go public and were listed as non-voting board observers chosen by the placement agent in Tibet's IPO registration statement.

The registration statement, however, failed to disclose that Tibet had defaulted on a loan from the Chinese government several months before the effectiveness of the registration statement, and instead simply referenced a long-term loan, without acknowledgement of the default. The Chinese government froze and auctioned off Tibet's assets shortly after the IPO closed, prompting the NASDAQ to halt trading, leading to a drastic decline in Tibet's stock price. Zou and Downs were among a number of defendants sued on behalf of a class of investors who alleged, among other claims, that the defendants had violated Section 11.

Section 11 imposes near-strict liability on certain enumerated categories of defendants for untrue statements or omissions of material facts in a registration statement. Individuals subject to such liability include "every person who was a director of (or performing similar functions)" of the issuer. The U.S. District Court for the District of New Jersey in *Obasi* denied the defendants' motion for summary judgment, concluding that in their capacity as non-voting board observers, Zou and Downs performed similar functions to those of the directors and were therefore subject to Section 11 liability. That decision rested heavily on language in the registration statement advising that, despite their lack of formal powers or duties, the board observers "may nevertheless significantly influence the outcome of the matters submitted to the Board of Directors for approval."

On appeal, however, the Third Circuit placed little import on the observers' ability to influence board decisions. Instead, it established that the basic functions of directorship are "defined by their formal power to direct and manage a corporation." In the Third Circuit's view, three features distinguished the board observers from the fundamental powers and responsibilities that define corporate directorship: (1) the observers could not vote for board action; (2) their loyalties aligned with the placement agent rather than the shareholders; and (3) their tenure was not subject to shareholder vote.

Accordingly, the role served by the board observers was, as a matter of law, not sufficiently similar to the core powers and responsibilities that constitute the function of directors to impose liability under Section 11, and the appeals court directed the entry of summary judgment in favor of the defendants. It is important to note that the factors cited by the court in making its decision are common to most, if not all, situations where an investor obtains the right to appoint a board observer in connection with its investment in a company.

Second, in *Kahn v. MFW Worldwide Corp.*, 2014 WL 996270 (Del. 2014), the Delaware Supreme Court established a mechanism to avoid the entire fairness standard of review and instead be subject to the less onerous business judgment rule when the following six factors are established:

1. The controlling stockholder conditions the procession of the transaction on the approval of both a special committee and a majority of the minority stockholders;
2. The special committee is independent;
3. The special committee is empowered to freely select its own advisors and to say no definitively;
4. The special committee meets its duty of care in negotiating a fair price;
5. The vote of the minority is informed; and
6. There is no coercion of the minority stockholders.

Each of these conditions must be met in order for the business judgment review standard to apply.

Third, as noted at the outset of this presentation, directors, and not stockholders, manage the business and affairs of Delaware corporations. The directors' managerial decision making power includes whether to initiate or refrain from entering litigation on behalf of the corporation. For purposes of this discussion, we address the body of claims that are considered derivative of the corporation's interest, and not a direct claim of a particular stockholder. Since the directors control whether or not to pursue a claim owned by the corporation (*i.e.*, a derivative claim), a stockholder must satisfy the stringent pleading standards of Court of Chancery Rule 23.1 before being permitted to usurp the board's control over such claims.

> **Rule 23.1. Derivative actions by shareholders.**
>
> (a) In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall allege that the plaintiff was a shareholder or member at the time of the transaction of which the plaintiff complains or that the plaintiff's share or membership thereafter devolved on the plaintiff by operation of law. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and the reasons for the plaintiff's failure to obtain the action or for not making the effort.

(b) Each person seeking to serve as a representative plaintiff on behalf of a corporation or unincorporated association pursuant to this Rule shall file with the Register in Chancery an affidavit stating that the person has not received, been promised or offered and will not accept any form of compensation, directly or indirectly, for prosecuting or serving as a representative party in the derivative action in which the person or entity is a named party except (i) such fees, costs or other payments as the Court expressly approves to be paid to or on behalf of such person, or (ii) reimbursement, paid by such person's attorneys, of actual and reasonable out-of-pocket expenditures incurred directly in connection with the prosecution of the action. The affidavit required by this subpart shall be filed within 10 days after the earliest of the affiant filing the complaint, filing a motion to intervene in the action or filing a motion seeking appointment as a representative party in the action. An affidavit provided pursuant to this subpart shall not be construed to be a waiver of the attorney-client privilege.

(c) The action shall not be dismissed or compromised without the approval of the Court, and notice by mail, publication or otherwise of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the Court directs; except that if the dismissal is to be without prejudice or with prejudice to the plaintiff only, then such dismissal shall be ordered without notice thereof if there is a showing that no compensation in any form has passed directly or indirectly from any of the defendants to the plaintiff or plaintiff's attorney and that no promise to give any such compensation has been made. At the time that any party moves or otherwise applies to the Court for approval of a compromise of all or any part of a derivative action, each representative plaintiff in such action shall file with the Register in Chancery a further affidavit in the form required by subpart (b) of this rule.

(d) For the purposes of this Rule, an "unincorporated association" includes a statutory trust, business trust, limited liability company and a partnership (whether general or limited), and a "member" includes a person permitted by applicable law to bring a derivative action to enforce a right or such an unincorporated association.

Rule 23.1 accordingly imposes upon the stockholder the heightened burden to plead particularized facts creating a reasonable doubt that the majority of the board of directors in service when the complaint was filed could not exercise independent and disinterested business judgment in responding to a demand. This analysis is conducted for each director on a claim-by-claim basis. Only when a majority of the board faces a “substantial likelihood” of personal liability will demand be excused. Vague or conclusory allegations of mere threat of personal liability are insufficient.

Challenge to the adequacy of a stockholder's pleading under Rule 23.1 is fact-intensive. Sophisticated stockholder counsel are adept at crafting complaints that sufficiently question the fidelity of at least a majority of the board, thereby minimally satisfying Rule 23.1, and preserving that the court will continue application of the entire fairness standard of review. The court will not dismiss a complaint at the initial pleadings stage where entire fairness review applies.

Fourth, section 141(d) of the DCGL provides in pertinent part that "the certificate of incorporation may confer upon 1 or more directors, whether or not elected separately by the holders of any class or series of stock, voting powers greater than or less than those of other directors. Any such provision conferring greater or lesser voting power shall apply to voting in any committee, unless otherwise provided in the certificate of incorporation or bylaws. If the certificate of incorporation provides that 1 or more directors shall have more or less than 1 vote per director on any matter, every reference in this chapter to a majority or other proportion of the directors shall refer to a majority or other proportion of the votes of the directors."

Consider therefore a provision in the certificate of incorporation that allocates greater voting rights to outside directors with respect to any transaction involving a controller. This, of course, requires that there be at least one outside director who is not conflicted. And, the voting power allocated to the outside directors must be enough to negate the controller's influence over the board's consideration of a conflicted transaction. There has yet to be a Delaware case directly addressing how, if at all, this use of section 141(d) may impact the standard of review.

Lastly, the Delaware Court of Chancery recently raised the question, but did not pursue, whether use of so-called enhanced independence directors can or should result in a standard of review lower than entire fairness for certain transactions with a controller in *Pilgrim's Pride Corp. Derivative Litig.*, 2019 Del. Ch. LEXIS 89 (Del. Ch. Mar. 15, 2019). The plaintiffs in the case are minority stockholders in Pilgrim's Pride Corporation (the Company), a Delaware corporation. They sued the Company's controlling stockholder, JBS S.A. (the Parent), which is an entity organized under Brazilian law. They also sued five of the Company's directors who were elected to the board by the Parent.

The Company's certificate of incorporation designated nine seats on its board. Six of the seats are designated for directors nominated, selected and voted upon by the Parent. Three of the seats are designated for "equity directors," who are for all intents and purposes nominated, selected and elected by the minority stockholders. While the Parent retained the right to veto the nomination of an equity director, it could only do so in the limited circumstances where it "reasonably determines that such person (i) is unethical or lacks integrity or (ii) is a competitor or is affiliated with a competitor of the Corporation."

The transaction that gave rise to the lawsuit involved the Company's purchase of one of the Parent's other subsidiaries, Moy Park, Ltd., for $1.3 billion. The complaint alleged that the Parent needed to raise cash quickly because its controlling stockholder agreed to pay a $3.2 billion fine to the Brazilian government. The plaintiffs challenged that there was not true arms-length bargaining with the Parent. Rather, the Company permitted its management team and financial advisor to lead the negotiations, despite their lack of independence from the Parent. The Company ultimately agreed to pay what was effectively the same price that the Parent demanded in its opening ask, even though that price was higher than what the Company's internal analyses supported and what strategic bidders were willing to pay.

By way of further background, the Batista family controls the Parent through a holding company. In May 2017, the holding company agreed to pay a $3.2 billion fine to the Brazilian government in response to an investigation into the bribery of government officials. Not surprisingly, the Parent needed to quickly raise cash to help its controlling stockholder pay this fine. In June 2017, the Parent announced that one of its subsidiaries, Moy Park, was for sale.

Around that same time, the Parent's CEO, Wesley Batista, who was also personally responsible for a substantial fine following his pleading guilty in the bribery scandal, contacted Andre Nogueira de Souza, an executive officer of the Parent, to say that the Parent would be interested in selling Moy Park to the Company for $1.3 billion. Nogueira shared the overture about selling Moy Park with the Company's CEO William Lovette.

Lovette convened a meeting with the equity directors on June 28, 2017 to discuss the prospect of the Company acquiring Moy Park for $1.3 billion. Other attendees included bankers from Barlays Capital, Inc., who were acting as the Company's financial advisor despite having a longstanding relationship with the Parent, and lawyers from Paul Weiss. Barclays presented valuations of Moy Park that straddled the $1.3 billion price suggestion, although the valuations appeared to be based upon financial projections that did not match Moy Park's historical performance.

The Company's board formed a special committee on July 3, 2017 comprised of the equity directors. The board delegated full authority to the committee with respect to the prospective acquisition of Moy Park. The board further agreed not to approve or recommend an acquisition of Moy Park unless it was approved by the committee. The committee retained Evercore as its financial advisor. Evercore informed Barclays that the committee and its advisors were going to lead the negotiations with the Parent. Notwithstanding the committee's instruction, the Company management and Barclays continued to lead the negotiations with the Parent. The committee also retained Paul Weiss as its legal advisor and there was some suggestion that Company management influenced the committee's decision to use the same legal counsel as the Company.

Based upon Evercore's analysis, the Company was considering an acquisition price of approximately $1 billion. In violation of an exclusivity agreement, the Parent considered an offer from another entity for approximately $1.2 million. Although the committee raised a concern about the Parent's breach of the exclusivity agreement, Lovette counseled them to address it "in a constructive manner," which the committee agreed to do. In reaction, the committee upon consultation with Evercore, determined to increase its offer to remain competitive. There were further negotiations on the deal price and financing terms, all of which involved Company management and its advisors. Ultimately, the committee voted to approve the acquisition of Moy Park at coincidentally a price approximating what Batista had told Nogueira at the outset of the negotiations.

Putting aside the questions surrounding the process and price, because the equity directors were controlled by the minority stockholders, and had been the body who approved the deal, Vice Chancellor Laster questioned whether a standard of review less than entire fairness should apply. Scholarly articles describe minority elected directors as "enhanced independence directors." See for example, INDEPENDENT DIRECTORS AND CONTROLLING SHAREHOLDERS, 165 U. Pa. L. Rev. 1271 (2017) (Bebchuk & Hamdani) (appended as Exhibit A). Ordinarily there is concern over the controller's ability to influence the selection, election and removal of otherwise independent directors. If the minority stockholders have the exclusive power to nominate, elect and remove director representatives, this presumably "enhances" the independence of said directors – hence enhanced independence directors.

As we have discussed, the MFW framework works reasonably well for major transactions, such as a squeeze out merger. However, the costs of implementing the MFW framework undermine its utility for other types of interested transactions involving a controller (*e.g.*, a capital raise that affords preferential rights to a controller who participates in the financing). In such circumstances, a special committee populated by enhanced independence directors can be an efficient mechanism for consideration of the conflicted transaction. And, although Delaware corporate law associates the entire fairness standard of review with any conflicted transaction, it is reasonable to consider that the determination of a committee of enhanced independence directors should be granted a lower standard of review.

There are however a number of additional factors to be addressed before a Delaware court will be comfortable enough to set a lower standard of review for decisions rendered by enhanced independence directors. First, scholars who question the enhanced independence director framework point out that a controller can influence otherwise independent board members through more than power over nomination, election and removal. See for example, BEYOND BEHOLDEN, 44 J. Corp. L. (2019) (D. Lin) (appended as Exhibit B). The controller can also influence through patronage (*i.e.*, reward cooperative directors with perks). The empirical analysis of controller patronage networks and examples in which controllers have appeared to have rewarded cooperative directors is detailed in Beyond Beholden. Of the 222 transactions involving "independent directors" that were analyzed, 20.3 percent (*i.e.* 45 of the 222 transactions) showed that the independent director served as a senior executive or director in at least one other company controlled or dominated by the controlling stockholder.

In other words, a director who may appear independent could be influenced to favor a controller's interest if there is the potential for a future relationship between the director and controller. Thus, the enhanced independence framework must consider not only the controller's lack of power over a director, but also whether the controller has influenced the director's decision-making through patronage (or the offer of patronage). Perhaps this can be accomplished by incorporating into the enhanced independence framework a heightened pleading standard akin to what is required to satisfy Rule 23.1 (*i.e.*, placing the burden upon the plaintiff stockholder to plead non-conclusory, particularized facts of how a controller influenced a director's vote through patronage).

Another challenge facing adoption of the enhanced independence framework is its conflict with a longstanding principle of Delaware corporate law that how a director is nominated and elected is not relevant to the director's independence. This flows from the premise that all directors are presumed to have acted independently, with due care, in good faith and with the honest belief that their actions were in the stockholders' best interest. In other words, merely having been designated to the board by a controlling stockholder does not automatically taint that director as conflicted. Similarly, one cannot automatically presume a director is entirely independent simply because the director was elected by the minority stockholders. Vice Chancellor Laster in *Pilgrim's Pride* suggested that perhaps it is time to move away from the bright-line rule that refuses to consider mechanisms for nomination, election and removal, and instead view the director's path to board membership through a more holistic approach, akin to how the court addresses demand futility.

Finally, Vice Chancellor Laster identified another open question – whether a judicial willingness to deploy a more deferential standard of review for transactions approved by enhanced independence directors warrants moving all the way to the business judgment rule or whether it would mean relaxing the standard to enhanced scrutiny. The latter standard would recognize the structural difficulties that outside directors' face when making a decisions that affect a controller. The intermediate standard is sufficiently deferential to enable courts to dismiss weak complaints, while at the same time permitting meaningful complaints to move forward.

VI. Concluding Remarks and Q&A

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ARTICLE

INDEPENDENT DIRECTORS AND CONTROLLING SHAREHOLDERS

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Independent directors are an important feature of modern corporate law. Courts and lawmakers around the world increasingly rely on these directors to protect

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This Article is part of the research of the Controlling Shareholders Project of the Harvard Law School Program on Corporate Governance. The Article was partly written while Hamdani was a visiting professor at Harvard Law School during the fall of 2015. As detailed below, during the years 2006–2008 and 2011–2012, the authors contributed to reforming Israeli corporate law in directions advocated in this Article, and this Article draws on the authors' work and experience in connection with those reforms.

We have benefitted from presenting this Article at the American Law and Economics Association Meeting, Boston University, University of Delaware, Harvard Law School, and Michigan Law School. We would like to thank John Armour, Jesse Fried, Larry Hamermesh, Scott Hirst, Hans-Christoph Hirt, Reinier Kraakman, Demetrio Maltese, Ted Mirvis, and Mark Roe for

investors from controlling shareholder opportunism. In this Article, we argue that the existing director-election regime significantly undermines the ability of independent directors to effectively perform their oversight role. Both the election and retention of independent directors normally depend on the controlling shareholders. As a result, these directors have incentives to go along with controllers' wishes, or, at least, have inadequate incentives to protect public investors.

To induce independent directors to perform their oversight role, we argue, some independent directors should be accountable to public investors. This can be achieved by empowering investors to determine or at least substantially influence the election or retention of these directors. These "enhanced-independence" directors should play a key role in vetting "conflicted decisions," where the interests of the controller and public investors substantially diverge, but not have a special role with respect to other corporate issues. Enhancing the independence of some directors would substantially improve the protection of public investors without undermining the ability of the controller to set the firm's strategy.

We explain how the Delaware courts, as well as other lawmakers in the United States and around the world, can introduce or encourage enhanced-independence arrangements. Our analysis offers a framework of director election rules that allows policymakers to produce the precise balance of power between controlling shareholders and public investors that they find appropriate. We also analyze the proper role of enhanced-independence directors as well as respond to objections to their use. Overall, we show that relying on enhanced-independence directors, rather than independent directors whose elections fully depend on the controller, can provide a better foundation for investor protection in controlled companies.

INTRODUCTION 1273
I. INDEPENDENT DIRECTORS AND CONTROLLED COMPANIES ... 1278
  A. *Preventing Controller Opportunism* 1279
  B. *The Reliance on Independent Directors* 1280
    1. The United States..1280
    2. Around the World..1282
II. THE LIMITS OF INDEPENDENT DIRECTORS 1284
  A. *Learning from Widely Held Firms*..1285
  B. *Director Independence at Controlled Firms*.................................. 1286
  C. *Toward Enhanced Independence* 1290
III. ENHANCED INDEPENDENCE: BUILDING BLOCKS 1293

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A. *Dimensions* 1293
B. *Veto Rights* 1295
1. Benefits 1296
2. Implementing Veto Rights 1297
C. *Beyond Veto Rights?* 1298
1. Veto Rights May Not Be Enough 1299
2. Public Investors' Election Rights 1299
3. Reelection and Termination 1301
4. Cumulative Voting 1302
IV. DESIGN AND IMPLEMENTATION 1304
A. *Regimes Based on Judicial Review* 1305
B. *Regimes Based on Legislation or Regulation* 1306
C. *Number and Role of Enhanced-Independence Directors* 1306
1. Role 1306
2. Number 1308
D. *Length of Appointment* 1308
E. *Independence from Minority Blockholders* 1309
V. OBJECTIONS 1311
A. *Undermining Control* 1311
B. *Loss of Collegiality and Cohesiveness* 1312
C. *Public Investor Passivity* 1313
D. *Public Investor Opportunism* 1314
CONCLUSION 1315

INTRODUCTION

In 2012, Google adopted a controversial recapitalization plan that allowed it to issue a new class of nonvoting stock.[1] This plan enabled Google to continue raising capital without weakening its founders' control over the company. To address the concern that the plan would benefit the company's controlling shareholders at the expense of its public investors, Google formed a special committee of independent directors to negotiate and approve the terms of the recapitalization.[2] Furthermore, in the settlement of the litigation over the

1 *See* Simon C.Y. Wong, *Google's Stock-Split Plan Would Replace Stewardship with Dictatorship*, HARV. BUS. REV. (Apr. 18, 2012), https://hbr.org/2012/04/googles-stock-split-plan-would [https://perma.cc/8UK4-PVCS] ("[Google's] recent proposal to effect a 2-for-1 stock split by issuing non-voting shares is an abhorrent idea . . . ."); *see also* Steven Davidoff Solomon, *Thorny Side Effects in Silicon Valley Tactic to Keep Control*, N.Y. TIMES, Sept. 4, 2013, at B8 ("Google proposed last year that the company issue a new class of shares with no voting rights.").

2 *See* Paul Lee, Note, *Protecting Public Shareholders: The Case of Google's Recapitalization*, 5 HARV. BUS. L. REV. 281, 284 (2015) (noting that the special committee of independent directors "negotiated certain protections" for other shareholders before voting on the plan).

recapitalization, Google's independent directors were assigned an important ongoing role to enforce certain restrictions on the company's founders.[3]

If a company, like Google, has a controlling shareholder, a main concern of corporate law is to address potential conflicts of interest between the controller and public investors.[4] Corporate law has long relied on oversight by independent directors—directors who have no ties to the controller or the company other than their service on the board—over corporate decisions where the interests of the controller substantially diverge from those of the company or its public investors (hereinafter "conflicted decisions").[5] Both courts and lawmakers have sought to use independent directors to safeguard against such controller opportunism.[6]

As we explain in this Article, the existing arrangements for electing directors undermine the effectiveness of independent director oversight. Because these arrangements provide controllers with decisive power to appoint independent directors and decide whether to retain them, independent directors have significant incentives to side with the controller and insufficient countervailing incentives to protect public investors in conflicted decisions. Thus, independent directors currently relied upon to contain controllers' conflicts cannot be expected to be effective guardians of public investors' interests.

We also show how the rules governing the appointment of independent directors could be refined to make their oversight more effective. To improve the effectiveness of independent directors in cases of controllers' conflicts, some directors should be elected in ways that would make them at least somewhat accountable to public investors. These directors, which we call "enhanced-independence directors," should play a key role in approving self-dealing transactions. We develop a framework of alternative legal rules for obtaining enhanced independence without undermining the controller's ability to determine business strategy in nonconflicted decisions. We also explain how

3 *See In re* Google Inc. Class C S'holder Litig., No. 7469-CS, 2013 WL 5949928, at *2 (Del. Ch. Nov. 6, 2013) (incorporating the parties' settlement agreement, which amended the Transfer Restriction Agreement to include that it could not be waived or modified without consideration and approval by a committee of at least two independent directors); *see also* Revised Stipulation of Compromise and Settlement at 8, *In re* Google Inc. Class C S'holder Litig., No. 7469-CS, 2013 WL 5949928 (Del. Ch. Nov. 6, 2013), https://www.sec.gov/Archives/edgar/data/1288776/000119312514116482/d699828dex404.htm? [https://perma.cc/K49D-BYJ8].

4 We analyze in detail the corporate governance problems of controlled companies in Lucian A. Bebchuk & Assaf Hamdani, *The Elusive Quest for Global Governance Standards*, 157 U. PA. L. REV. 1263 (2009) [hereinafter Bebchuk & Hamdani, *Elusive Quest*].

5 Drawing the line between ordinary business decisions and those that should be treated as conflicted decisions is a complicated task. *See infra* note 112. In this Article, we do not take a view on this question.

6 While independent director oversight is widely accepted, some writers have expressed concerns about the extent to which independence is undermined by the power controllers have over independent directors. For such writings, see, for example, María Gutiérrez & Maribel Sáez, *Deconstructing Independent Directors*, 13 J. CORP. L. STUD. 63 (2013), and Donald C. Clarke, *The Independent Director in Chinese Corporate Governance*, 31 DEL. J. CORP. L. 125, 170-71 (2006).

courts, regulators, and investors could require or encourage companies to introduce enhanced-independence directors.

Consider again the Google example. Suppose that minority shareholders had the right to elect, or at least veto the appointment of, two independent directors. Such enhanced-independence directors would have had greater incentives to resist a recapitalization plan that benefitted the controller at the expense of public investors. The approval of the plan by such independent directors would have been a more meaningful signal than approval by independent directors who serve only at the controller's will.

The enhanced-independence approach that we put forward can address longstanding dilemmas with which the Delaware courts have been wrestling.[7] In well-known decisions involving freezeout transactions, Delaware courts have recognized the structural problems afflicting independent directors, choosing not to defer to the approval of freezeouts by such directors and, instead, to grant judicial deference only to transactions also approved by a majority vote of minority shareholders. Outside the freezeout context, however, the Delaware courts have not always followed such an approach, and some decisions have granted significant cleansing power to independent director approval in cases of controller conflicts.

For example, Delaware courts substantially rely on independent directors to make decisions regarding derivative actions against the controller. Such judicial decisions might be due to concerns about the costs of alternatives. For courts influenced by such concerns, enhanced-independence directors can offer a workable alternative within the existing framework of corporate law doctrine.

We do not argue in this Article that independent directors *should* play a key role in protecting public investors at controlled companies. Some may believe that market forces—such as reputation—will prevent controlling shareholders from expropriating public investors. Others may find other measures—such as public enforcement or approval by minority shareholders—to be necessary or effective in enhancing investor protection. This Article takes as a given that corporate law, both in the United States and in many countries around the world, has long relied substantially on independent directors in controlled companies to protect public investors in cases of controller conflicts. Given this pervasive reliance on independent directors, our contribution is twofold. First, we show that, by itself, approval by independent directors who serve at the pleasure of the controller cannot serve as an effective device for vetting conflicted decisions.

7 For a more detailed account of the Delaware cases described in the text above, see discussion *infra* Section II.B.

Second, we analyze how to turn independent directors into more effective guardians of the interests of public investors in conflicted decisions.[8]

Our analysis proceeds as follows. Part I provides background on controlled companies and independent directors. Controlled companies constitute a sizeable minority of large, publicly traded firms in the United States, including well-known companies such as Facebook, Google, News Corp, and Viacom. Controlled companies are even more prevalent outside the United States, dominating public capital markets in Europe and in most countries around the world.

In widely held firms, the chief governance concern is to prevent professional managers from behaving opportunistically at the expense of investors. In controlled companies, by contrast, controllers have both the incentives and the power to police management, but they may use their power to divert value at the expense of public investors.[9] In these companies, therefore, a primary governance concern is to protect public investors from controller opportunism and value diversion. Corporate law commonly addresses this concern by requiring or encouraging the use of independent directors and relying on such directors to vet self-dealing transactions and other conflicted decisions.

Part II explains the fundamental shortcoming of this approach. Under existing arrangements, controlling shareholders normally play a decisive role in the appointment and retention of independent directors. Even independent directors, therefore, are inherently dependent on the controller for their election and retention as board members. This regime incentivizes independent directors to favor the controller, and it fails to provide them countervailing incentives to protect public investors.

Learning from widely held firms reinforces our critique. The CEOs of such firms once wielded substantial influence over independent directors' appointments. Today, however, there is widespread recognition that, to enable independent directors to monitor the CEO effectively, we should both limit the CEO's influence over their appointments and make these directors accountable to public investors. This recognition underlies the litany of reforms focused on director elections at widely held firms, including placing director selection in the hands of nominating committees composed solely of independent directors,

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8 Our view is that a majority-of-the-minority vote can be a useful and effective tool in many contexts for guarding the interests of public investors. However, the question of when such a vote should be used in conjunction with or instead of enhanced-independence directors is outside the scope of this Article. In addition, we do not consider in this Article how to define self-dealing and other cases of controller conflicts. Nor do we discuss the proper test for deciding whether a company is controlled. The U.S. corporate law system has answers to these questions, as do other systems, and we take those as given for the purpose of our analysis. Finally, we do not consider in this Article when having a controlling shareholder is desirable; we take as given for the purposes of our analysis that some companies have a controlling shareholder that can shape the strategic direction of the company.

9 *See infra* notes 17–21.

providing for majority voting, and enabling proxy access.[10] If CEOs' informal influence over the selection of independent directors compromises their ability to contain CEO opportunism, controlling shareholders' absolute control over the appointment and retention of independent directors is all the more problematic.

Part II concludes by introducing our proposed approach for making independent directors more effective guardians of the interests of public investors in controlled companies. Such companies, we argue, should have some directors who (i) lack the incentives produced by the controller's decisive influence over the directors' appointment and retention and (ii) have some incentives that flow from making the directors accountable to public investors. A regime of such *enhanced-independence* directors requires measures that will limit controllers' power over the appointment of these directors while providing public investors with some degree of influence over this appointment. Such measures, we show, are not an ivory-tower idea without real-world precedent. The American Stock Exchange (AMEX) required them for dual-class companies that went public during a certain period, and they have been recently introduced in the United Kingdom, Italy, and Israel.

Part III develops a framework for designing enhanced-independence rules with the desired balance between enhancing independence to limit controller opportunism and controllers' legitimate interests in making business decisions. Public investors may participate in three stages of director elections: initial appointment, reelection, and termination. For each stage, we identify different degrees of public investors' input rights and evaluate the impact of these rights on investor protection. Public investors, we argue, should at least have veto rights over the initial appointment, reelection, and termination of enhanced-independence directors. We also explain, however, that there are good reasons to consider going beyond veto rights—for example, by empowering public investors to determine whether enhanced-independence directors are reelected and terminated.

Part IV focuses on the strategies for implementing an enhanced-independence approach. Regimes based on judge-made law, such as in Delaware, can encourage the use of enhanced-independence directors by according significant cleansing powers only to the approval of conflicted decisions by such directors. By contrast, regimes based on legislative or regulatory mandates can require the appointment of some enhanced-independence directors and the approval of certain conflicted decisions by such directors.

We also discuss the desirable number and role of enhanced-independence directors. To protect public investors, these directors should play a dominant role in—and only in—vetting self-dealing transactions and other conflicted decisions. To preserve controllers' ability to set the company's business

10 *See infra* notes 25–31, 49–50 and accompanying text.

strategy, however, such directors should not play a dominant role in other corporate affairs, and they should therefore not constitute a substantial fraction of the members of the board.

Part V considers potential objections to an enhanced-independence approach. We address claims that enhanced-independence directors would be harmful by interfering with the controller's ability to run the company, undermining the board's collegiality and cohesiveness, or facilitating abuse by some opportunistic minority shareholders. We also consider claims that such directors would not add significantly to the protection of public investors. We show that these objections do not undermine the case for enhanced-independence directors.

We shall use the terms "minority shareholders" or "public investors" to refer to shareholders other than the controller. We note that these shareholders sometimes hold a majority of the equity capital. This is likely to be the case when a dual-class structure, or another aspect of the corporate structure, separates voting rights from cash flow rights and enables the controller to retain a lock on control while holding a minority, even a small minority, of the company's equity.[11] A substantial body of evidence suggests that the risk of value diversion increases when controllers use dual-class or other ownership structures for separating cash flow rights from votes.[12] Thus, even those who would not support enhanced-independence directors for controlled companies in general should consider using them for dual-class companies and other structures that separate voting and cash flow rights.

I. INDEPENDENT DIRECTORS AND CONTROLLED COMPANIES

This Part sets the background for our analysis of director independence at controlled companies. Section A describes the prevalence of concentrated ownership and the governance challenges that this ownership structure creates.

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11 *See, e.g.*, Lucian Arye Bebchuk et al., *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights* (examining ownership structures where a controlling shareholder retains a small fraction of the firm's cash flow rights), *in* CONCENTRATED CORPORATE OWNERSHIP 295, 297-301 (Randall K. Morck ed., 2000). Examining whether and to what extent structures that separate cash flow rights from voting rights are desirable is beyond the scope of this Article, and we take the existence of companies with such structures as given for the purposes of our analysis. For a recent contribution to the debate on dual-class firms co-authored by one of us, see generally Lucian A. Bebchuk & Kobi Kastiel, *The Untenable Case for Perpetual Dual-Class Stock* (Harvard Law Sch. John M. Olin Ctr. for Law, Econ., and Bus., Discussion Paper No. 905, 2017; Harvard Law Sch. Program on Corp. Governance, Discussion Paper No. 2017-6, 2017), https://ssrn.com/abstract=2954630 [https://perma.cc/8H6E-ZVAE].

12 For empirical evidence on the link between controllers' wedge between cash flow and voting rights and agency costs, see Marianne Bertrand et al., *Ferreting Out Tunneling: An Application to Indian Business Groups*, 117 Q. J. ECON. 121 (2002), Paul A. Gompers et al., *Extreme Governance: An Analysis of Dual-Class Firms in the United States*, 23 REV. FIN. STUD. 1051 (2010), and Chen Lin et al., *Ownership Structure and the Cost of Corporate Borrowing*, 100 J. FIN. ECON. 1 (2011).

Section B discusses corporate law's reliance on independent directors to guard public investors' interests.

A. *Preventing Controller Opportunism*

Controlled companies are important both in the United States and around the world. In the United States, they constitute a sizeable minority of large, publicly traded firms.[13] As of December 31, 2016, there were 379 Russell 3000 companies with a shareholder holding more than 30% of the company's voting shares, and 220 of these companies had one shareholder holding more than 50% of such shares.[14] Controlled companies are even more prevalent outside the United States. Public companies in Europe, Asia, and Latin America commonly have a controlling shareholder.[15]

The governance challenges at controlled companies are fundamentally different from those at widely held companies.[16] At widely held companies, the fundamental governance problem arises from the divergence of interests between managers and investors, and so corporate law and governance arrangements aim to address managerial agency costs. By contrast, the fundamental governance problem in controlled companies concerns the agency problems between controllers and public investors.

Controlling shareholders own a significant fraction of the firm's cash-flow rights, which gives them a substantial incentive to police management and

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13 *See* Ronald C. Anderson & David M. Reeb, *Founding-Family Ownership and Firm Performance: Evidence from the S&P 500*, 58 J. FIN. 1301, 1302 (2003) (observing that roughly 35% of S&P 500 companies have families as dominant shareholders); Clifford G. Holderness, *The Myth of Diffuse Ownership in the United States*, 22 REV. FIN. STUD. 1377, 1378 (2009) (presenting evidence that "raise[s] doubts about whether ownership in the United States' [public firms] is . . . less concentrated than elsewhere").

14 This data was collected from Factset and ORBIS databases, and was supplemented by information from public filings on the SEC's Electronic Data Gathering, Analysis, and Retrieval (EDGAR).

15 For empirical research documenting that concentrated ownership is prevalent around the world, see M. BECHT & C. MAYER, *Introduction* to THE CONTROL OF CORPORATE EUROPE 1, 4-7 (Fabrizio Barca & Marco Becht eds., 2001); Stijn Claessens et al., *The Separation of Ownership and Control in East Asian Corporations*, 58 J. FIN. ECON. 81, 110 (2000); Mara Faccio & Larry H.P. Lang, *The Ultimate Ownership of Western European Corporations*, 65 J. FIN. ECON. 365, 378 (2002); and Rafael La Porta et al., *Corporate Ownership Around the World,* 54 J. FIN. 471, 511 (1999).

16 *See generally* Bebchuk & Hamdani, *Elusive Quest*, *supra* note 4.

enhance the company's value.[17] Controllers, however, may also use their power to divert value at the expense of the company and its public investors.[18]

Such diversion could take many forms, including selling (or purchasing) assets, goods, or services to (or from) the company they control on terms that favor them;[19] acquiring equity at below-market prices from either the company or public investors in a freezeout transaction;[20] or paying excessive compensation to the controller or family members.[21] In controlled companies, therefore, corporate law and governance arrangements should protect public investors from the controllers' value diversion.[22]

B. *The Reliance on Independent Directors*

A common approach for containing controllers' conflict is to rely on independent directors. Legal regimes in the United States and around the world require or encourage companies to appoint independent directors and assign them the task of approving self-dealing and other conflicted decisions.

1. The United States

Independent directors are an important feature of U.S. boardrooms. As Jeff Gordon has documented, the number of independent directors has

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17 *See* Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. REV. 1641, 1651 (2006) ("[A] controlling shareholder may police the management of public corporations better than the standard panoply of market-oriented techniques employed when shareholdings are widely held."); *see also* Jens Dammann, *The Controlling Shareholder's General Duty of Care: A Dogma That Should Be Abandoned*, 2015 U. Ill. L. Rev. 479, 481 (noting controlling shareholders "have strong financial incentives to make informed decisions in the best interest of their corporations").

18 Such extraction is often referred to as "tunneling." *See* Vladimir Atanasov et al., *Law and Tunneling*, 37 J. Corp. L. 1, 2 (2011). For a review of different methods of tunneling and self-dealing, see *id.* at 3, which identifies three general types of tunneling: cash flow, asset, and equity.

19 For empirical studies on diversion via related-party transactions, see Kee-Hong Bae et al., *Tunneling or Value Added? Evidence from Mergers by Korean Business Groups*, 57 J. FIN. 2695, 2698 (2002), and Guohua Jiang et al., *Tunneling Through Intercorporate Loans: The China Experience*, 98 J. FIN. ECON. 1, 2 (2010).

20 For empirical studies on diversion via equity transactions, see, for example, Jae-Seung Baek et al., *Business Groups and Tunneling: Evidence from Private Securities Offerings by Korean Chaebols*, 61 J. FIN. 2415, 2418-19 (2006), and Borja Larrain & Francisco Urzúa I., *Controlling Shareholders and Market Timing in Share Issuance*, 109 J. FIN. ECON. 661, 661-62 (2013).

21 For empirical evidence on value diversion through excessive compensation to controlling families, see Harry DeAngelo & Linda DeAngelo, *Controlling Stockholders and the Disciplinary Role of Corporate Payout Policy: A Study of the Times Mirror Company*, 56 J. FIN. ECON. 153, 154-56 (2000).

22 *See* Luca Enriques & Paolo Volpin, *Corporate Governance Reforms in Continental Europe*, 21 J. ECON. PERSP. 117, 117 (2007) ("[C]oncentrated ownership can create conditions for a new agency problem, because the interests of controlling and minority shareholders are not aligned.").

increased dramatically over time because of both judicial encouragement and federal mandates.[23]

At the federal level, the Sarbanes–Oxley Act of 2002 (SOX)[24] and the applicable stock exchange listing standards require that boards of widely held companies have a majority of independent directors.[25] These directors are responsible for key issues that might entail a conflict of interest between shareholders and management, such as executive compensation,[26] appointment of auditors,[27] and certain nomination decisions.[28] Federal rules adopt a laxer approach to director independence at controlled companies.[29] While these companies are still subject to the independent audit committee requirements, they are not required to have a majority of their directors be independent,[30] and they are exempt from the independent compensation and nomination committee requirements.[31]

State corporate law has used standards of judicial review to encourage companies to appoint independent directors and assign them a meaningful role

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23 *See generally* 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 (2007) [hereinafter Gordon, *The Rise of Independent Directors*].

24 15 U.S.C. § 7211(e)(6) (2012).

25 *See Developments in the Law—Corporations and Society*, 117 HARV. L. REV. 2169, 2187 (2004) ("The revised listing standards of both the NYSE and NASDAQ . . . require (with a few exceptions) that listed-company boards have a majority of independent directors . . . .").

26 *See* NYSE, INC., LISTED COMPANY MANUAL, § 303A.05(a) (2017), http://nysemanual.nyse.com/LCMTools/PlatformViewer.asp?selectednode=chp_1_4&manual=%2Flcm%2Fsections%2Flcm-sections%2F [https://perma.cc/6PRM-4SVJ] [hereinafter NYSE LISTED COMPANY MANUAL] (requiring a compensation committee consisting solely of independent directors); *see also* NASDAQ, STOCK MKT. INC., MARKETPLACE RULES R. 4350(c)(3)(A)–(B) (2017), https://www.sec.gov/rules/other/nasdaqllcf1a4_5/nasdaqllcamendrules4000.pdf [https://perma.cc/WWV3-WUW5] [hereinafter NASDAQ MARKETPLACE RULES] (requiring active involvement of either a wholly independent compensation committee or a majority of independent directors).

27 *See Developments in the Law—Corporations and Society*, *supra* note 25, at 2191 (2004) ("Each exchange mandates that listed companies create an audit committee . . . and every member must meet . . . rigorous independence requirements . . . .").

28 *See, e.g.*, NASDAQ MARKETPLACE RULES, *supra* note 26, R. 4350(c)(4)(A) (requiring active involvement in director nomination of either a wholly independent nomination committee or a majority of independent directors).

29 *See generally* NYSE LISTED COMPANY MANUAL, *supra* note 26, § 303A.00 (stating that controlled companies are not required to comply with the independent-director provisions of the manual); *see also* NASDAQ MARKETPLACE RULES, *supra* note 26, R. 4350(c)(5) (defining a "controlled company" as "a company of which more than 50% of the voting power [for the election of directors] is held by an individual, a group or another company").

30 *See SEC Approves NYSE and NASDAQ Proposals Relating to Director Independence*, FINDLAW, http://corporate.findlaw.com/finance/sec-approves-nyse-and-nasdaq-proposals-relating-to-director.html [https://perma.cc/6REH-6P39] (undated) (discussing recently approved standards for independent directors for controlled companies on stock exchanges).

31 *See* NYSE LISTED COMPANY MANUAL, *supra* note 26, § 303A.00 (exempting controlled companies from the nominating-committee provisions and the compensation-committee provisions of the manual).

in vetting transactions involving conflicts of interest.[32] Delaware courts, for example, have used the entire fairness standard to review certain self-dealing transactions involving controlling shareholders. Whereas the business judgment rule substantially insulates a transaction from judicial scrutiny,[33] the entire fairness standard requires the defendants to prove that the transaction was fair to public investors by showing a fair process and a fair price.[34] The active involvement of an effective, empowered special negotiation committee consisting solely of independent directors, however, can significantly alleviate the burden that defendants face.[35]

2. Around the World

Other countries are also increasingly viewing independent directors as essential to protecting public investors at controlled companies. Accordingly, these countries have adopted one or more of the following arrangements.[36] First,

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32 *See* Gordon, *The Rise of Independent Directors*, *supra* note 23, at 1523-26 (reviewing the role that Delaware courts played in encouraging public companies to give more power to independent directors); Steven M. Haas, *Note*, *Toward a Controlling Shareholder Safe Harbor,* 90 VA. L. REV. 2245, 2250-70 (2004) (reviewing case law on Delaware's changing standard of review for self-dealing transactions approved by independent directors).

33 *See, e.g.*, Weinberger v. UOP, Inc., 426 A.2d 1333, 1346-47 (Del. Ch. 1981) (discussing the business judgment exercised by the board and finding that this shielded it), *rev'd*, 457 A.2d 701 (Del. 1983); *see also* Kahn v. Tremont Corp., 694 A.2d 422, 428 (Del. 1997) (describing the business judgment rule as "deferential").

34 *See, e.g.*, Ams. Mining Corp. v. Theriault, 51 A.3d 1213, 1239 (Del. 2012) (explaining that the standard of review for controlling-shareholder transactions is entire fairness and the burden falls on the defendant).

35 Such involvement can shift the burden for showing fairness back to the plaintiff. *See, e.g.*, Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1117 (Del. 1994) (stating that "approval of the transaction by either an independent committee of directors or a[] . . . majority of the minority shareholders shifts the burden" in entire fairness review from the interested party to the challenging party). In some cases, the use of both an independent special negotiating committee and approval by a majority of the minority shareholders will prevent Delaware courts from engaging in an entire fairness review. *See* Kahn v. M&F Worldwide Corp., 88 A.3d 635, 642-44 (Del. 2014) (adopting the lower court's ruling that the presence of both procedural safeguards for minority shareholders—an independent committee of directors and a majority of the minority vote—leads to application of the business judgment rule).

36 In 2005, the European Commission recommended that member states adopt governance standards that require directors to be independent of controlling shareholders. *See* Commission Recommendation 2005/162/EC of 15 Feb. 2005, 2005 O.J. (L 52) 52, 63, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32005H0162&from=EN [http://perma.cc/X4B8-QM4M] (recommending "[t]he presence of independent representatives on the board, capable of challenging the decisions of management," and describing what such independence entails). However, some countries' definitions of independence overlook ties between directors and controllers. See, for example, the German approach described in Paul Davies et al., *Boards in Law and Practice: A Cross-Country Analysis in Europe*, *in* CORPORATE BOARDS IN LAW AND PRACTICE: A COMPARATIVE ANALYSIS IN EUROPE 30 & n.120 (Paul Davies et al. eds., 2013), submitting that "in Europe, independent directors are being used for the wrong purposes." *See also* Gutiérrez & Sáez, *supra* note 6, at 74-75 (noting that "European jurisdictions

public company boards are expected to include some fraction of independent directors. Second, independent directors must serve on committees that play an active role in monitoring management and controlling shareholders. Third, many countries specifically require that independent directors play an active role in scrutinizing self-dealing transactions. Below we review some examples of the increasing reliance on independent directors to police controlling shareholders.

In Europe, independent directors are often expected, if not required, to serve on the corporation's audit committee, and they often constitute a significant fraction of the audit committee's members.[37] Japan, India, Korea, and Russia have adopted similar requirements.[38] In Brazil, Japan, and some European countries, independent directors play an important role in nomination and remuneration committees.[39] Their presence on the audit, compensation, and nomination committees provides them with better access to information and the means to monitor value diversion by controlling shareholders.[40]

Some countries specifically require that independent directors play an active role in the vetting of related-party transactions in controlled companies.[41] In

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have failed to make [the] distinction" between "independent directors in corporations with concentrated ownership" and independent directors in other corporations).

37 Some countries (such as Germany) require the appointment of only one independent director. Guido Ferrarini & Marilena Filippelli, *Independent Directors and Controlling Shareholders Around the World* 23 & n.25 (European Corp. Governance Inst. (ECGI), Working Paper No. 258/2014, May 2014). Others require a majority or two-thirds of independent members. *Id.* at 23-24, n.26. Still others require that all members of the committee be independent. *Id.* at 24, n.27.

38 For studies discussing such requirements in various jurisdictions, see Donald C. Clarke, *Three Concepts of the Independent Director*, 32 DEL. J. CORP. L. 73, 99-102 (2007); A.C. Pritchard, *Monitoring of Corporate Groups by Independent Directors*, 9 J. KOREAN L. 1, 16 (2009); Colleen R. Stumpf, Comment, *Diverse Economies—Same Problems: The Struggle for Corporate Governance Reform in Russia and the United States*, 24 PENN ST. INT'L L. REV. 897, 908 (2006); and Umakanth Varottil, *Evolution and Effectiveness of Independent Directors in Indian Corporate Governance*, 6 HASTINGS BUS. L.J. 281, 308-21 (2010).

39 *See, e.g.*, Roberto Barontini et al., *Directors' Remuneration Before and After the Crisis: Measuring the Impact of Reforms in Europe* (analyzing "the impact of recent reforms," including those related to independence in remuneration practices, "on directors' remuneration"), *in* BOARDS AND SHAREHOLDERS IN EUROPEAN LISTED COMPANIES: FACTS, CONTEXT AND POST-CRISIS REFORMS 251 (Massimo Belcredi & Guido Ferrarini eds., 2013).

40 *See* Paul Krüger Andersen & Dorthe Kristensen Balshøj, *Directors' Conflicts of Interests: A Contribution to European Convergence* (describing the value of independent directors on such committees), *in* BOARDS OF DIRECTORS IN EUROPEAN COMPANIES: RESHAPING AND HARMONISING THEIR ORGANISATION AND DUTIES 63-74 (Hanne S. Birkmose, Mette Neville & Karsten Engsig Sørensen eds., 2013).

41 *See* Gerard Hertig & Hideki Kanda, *Related Party Transactions* (discussing how major jurisdictions regulate related-party transactions, including "Japan and much of continental Europe," which "mandate approval by disinterested board members"), *in* THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 101, 105-09, 128-30 (Reinier Kraakman et al. eds., 2004) (discussing how major jurisdictions regulate related party transactions).

Italy, for instance, significant related-party transactions require the approval of an independent committee of the board.[42]

II. THE LIMITS OF INDEPENDENT DIRECTORS

Empowering independent directors to review self-dealing and other conflicted decisions might offer public investors at controlled companies some degree of protection. For example, the incentives of directors to go along with the preferences of the controller might be less powerful when they have no ties to the controller other than through their service on the board. Indeed, academic studies on reforms in Korea, Taiwan, India, China, and other countries provide evidence suggesting that the appointment of independent directors at controlled firms can enhance share value.[43]

In this Part, we argue that independent directors in controlled companies still have incentives to favor controllers, which undermine their effectiveness in overseeing controller conflicts. For independent directors to vet conflicted decisions well, they should have adequate incentives to do so. However, the prevailing regime that governs director elections provides independent directors with incentives to favor controlling shareholders and with few countervailing incentives to protect public investors from self-dealing and other forms of value diversion.

We would like to clarify at the outset that we do not argue that directors are exclusively motivated by their desire to get elected or reelected to the board. Directors' sense of professionalism and integrity, and fiduciary duties and norms, may have significant influence on how directors act. Yet corporate law has chosen, and we believe correctly, not to rely exclusively on such factors. If we could exclusively rely on them, many key corporate law rules as well as financial incentive schemes would be unnecessary.

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42 *See* Guido Ferrarini et al., *Corporate Boards in Italy* (describing measures regarding related-party transactions required by the Italian Civil Code), *in* CORPORATE BOARDS IN LAW AND PRACTICE: A COMPARATIVE ANALYSIS IN EUROPE, *supra* note 36, at 367, 400-05.

43 For empirical studies suggesting that introducing independent directors benefitted public investors in various countries, see Bernard S. Black & Vikramaditya S. Khanna, *Can Corporate Governance Reforms Increase Firm Market Values? Event Study Evidence from India*, 4 J. EMPIRICAL LEGAL STUD. 749, 751 (2007); Bernard Black & Woochan Kim, *The Effect of Board Structure on Firm Value: A Multiple Identification Strategies Approach Using Korean Data*, 104 J. FIN. ECON. 203, 225 (2012); Jay Dahya et al., *Dominant Shareholders, Corporate Boards, and Corporate Value: A Cross-Country Analysis*, 87 J. FIN. ECON. 73, 75 (2008); and Yin-Hua Yeh & Tracie Woidtke, *Commitment or Entrenchment?: Controlling Shareholders and Board Composition*, 29 J. BANKING & FIN. 1857, 1862-63 (2005). For a study finding that firms with high percentages of independent directors tend to "have a smaller magnitude of manipulated transfer prices," see Agnes W.Y. Lo et al., *Can Corporate Governance Deter Management from Manipulating Earnings? Evidence from Related-Party Sales Transactions in China*, 16 J. CORP. FIN. 225, 226 (2010).

Section A explains how recent developments concerning director independence at widely held firms should inform our assessment of controlled companies. In Section B, we discuss the structural incentives of independent directors at controlled companies. In Section C, we turn to examine how to make independent director oversight more effective.

A. *Learning from Widely Held Firms*

At widely held companies, director independence reinforces the accountability created by public investors' right to elect directors. Although lawmakers and investors had focused on regulating director independence, they have increasingly adopted reforms that enhance public investors' role in director elections.

Public investors at widely held companies have the power to elect members to the board. This power arguably makes directors accountable to shareholders and incentivizes members of the board to keep shareholders satisfied with their performance.[44] In fact, courts have relied on shareholders' ability to displace underperforming directors as a reason for deferring to directors' business decisions.[45]

Independence requirements strengthen these market incentives by ensuring that directors have no conflicts that could undermine their effectiveness as monitors of management.[46] For example, a director whose livelihood depends on her business ties with the company might fear that refusing to accept the CEO pay demands would provoke retaliation. Many investors and lawmakers, however, believe that such independence alone may not ensure directors' accountability because management's influence over the appointment of directors can also undermine the effectiveness of those directors as monitors. Even an independent director might fear that adopting a skeptical approach toward the CEO, for example, would reduce her chances of reappointment. Moreover, to the extent that the CEO is involved in appointment decisions, directors may develop a sense of gratitude and

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44 *But see* Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 688-94 (2007) (discussing the impediments to electoral challenges even when shareholder discontent with the board actions and decisions are significant).

45 *See, e.g.*, *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 698 (Del. Ch. 2005) ("The redress for [directors'] failures . . . must come . . . through the action of shareholders . . . and not from this Court."); *see also* Hilton Hotels Corp. v. ITT Corp., 978 F. Supp. 1342, 1351 (D. Nev. 1997) ("One of the justifications for the business judgment rule's insulation of directors from liability . . . is that unhappy shareholders can always vote the directors out of office." (internal quotation marks omitted) (quoting Shoen v. AMERCO, 885 F. Supp. 1332, 1340 (D. Nev. 1994))).

46 *See* NYSE LISTED COMPANY MANUAL, *supra* note 26, § 303A.02; NASDAQ MARKETPLACE RULES, *supra* note 26, R. 5605(2).

obligation to accommodate the CEO's preferences.[47] These concerns underlie the post-Enron requirement that independent directors control the board nomination process, thereby taking from managers the formal power to influence the process—and thus the outcome—of director elections.[48]

Proposed reforms have gradually gone beyond director independence and extended to measures that enhance public investors' influence over director election. The majority voting regime for electing directors, for example, makes it easier for shareholders to prevent the company's candidates from joining the board.[49] Commentators and activist shareholders have called for additional reforms that would give a majority of shareholders the power to elect and fire directors. These include providing shareholders with access to the ballot and dismantling staggered boards.[50]

These developments offer two important lessons for controlled companies. First, controllers' absolute control over the election of independent directors undermines those directors' effectiveness as monitors. Second, enabling public investors to influence the election of independent directors would provide these directors with incentives to guard public investors' interests.

B. *Director Independence at Controlled Firms*

At controlled companies, independent directors are expected to exercise oversight to prevent the controller from expropriating value from public investors. Yet, the same election method that holds directors accountable to

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47 *See, e.g.*, Anil Shivdasani & David Yermack, *CEO Involvement in the Selection of New Board Members: An Empirical Analysis*, 54 J. FIN. 1829, 1851 (1999) (observing that "when CEOs are involved in director selection, companies choose new directors who are less likely to monitor aggressively").

48 *See* NYSE LISTED COMPANY MANUAL, *supra* note 26, § 303A.04(a) ("Listed companies must have a nominating/corporate governance committee composed entirely of independent directors."); *see also* Michael E. Murphy, *The Nominating Process for Corporate Boards of Directors: A Decision-Making Analysis*, 5 BERKELEY BUS. L.J. 131, 148 (2008) (noting that "NYSE rules . . . require the nominating committee to be composed entirely of independent directors").

49 For reviews of majority voting regimes, see Stephen J. Choi et al., *Does Majority Voting Improve Board Accountability?*, 83 U. CHI. L. REV. 1119, 1127 (2016), which notes that "[m]any commentators have argued that majority voting enhances director accountability to shareholders," and William K. Sjostrom, Jr. & Young Sang Kim, *Majority Voting for the Election of Directors*, 40 CONN. L. REV. 459, 463 (2007), which explains how majority voting "affords shareholders, in effect, veto power over managements' candidates." Vanguard, for instance, has emphasized majority voting in its company engagements. *See Our Governance and Executive Compensation Principles*, VANGUARD, https://about.vanguard.com/vanguard-proxy-voting/corporate-governance [https://perma.cc/D5JL-QVG7HRMZ-4SQK] (stating that "directors should be subject to annual elections by majority vote").

50 The proxy access reform allows certain shareholders to include their own nominees on the company's ballot. *See generally* Lucian Arye Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43, 47 (2003) (arguing that proxy access is a moderate step toward improving board accountability); Brett H. McDonnell, *Shareholder Bylaws, Shareholder Nominations, and Poison Pills*, 3 BERKELEY BUS. L.J. 205, 211 (2005) (identifying proxy-access bylaws as a way of challenging management control of the board of directors).

public investors at widely held companies currently also holds them accountable to the controller at controlled companies. Controlling shareholders have decisive power over director appointment. Directors at firms with controlling shareholders—including independent directors—cannot be elected or reelected following their initial term—unless the controlling shareholder supports their candidacies. Nor will they stay in office once the controlling shareholder decides to end their service on the board.[51]

This regime provides directors with substantial incentives to keep the controller satisfied. And incentives aside, social norms often lead individuals who are placed in a position by a given individual to feel some sense of gratitude toward that individual.[52] The existing election regime also fails to provide independent directors with adequate countervailing incentives to protect public investors. Independent directors do not owe their service on the board to public investors, who can neither elect them nor remove them from office. If the controller so wishes, these directors would serve on the board even if a majority of public investors would be happy to see them leave. Directors' initial election and retention solely depend on the controller.

There have been extreme cases in which controllers made explicit threats to fire independent directors that did not go along with their wishes.[53] And while such instances highlight the undesirable incentives produced by the controller's power over director election, we should stress that such incentives exist even when the controller makes no such threat. A well-lawyered controller would likely cite other reasons when removing a director that resists the controller's wishes. Even without explicit threats, directors' structural dependence is always present.

Delaware courts have long expressed concerns about the potential dependence of all directors in controlled companies on controllers.[54] Yet, as

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51 The authority to remove a director generally lies with shareholders, though some states allow for the board to remove one of its members under certain conditions. *See, e.g.*, NEW YORK BUSINESS CORPORATION LAW § 706(a) (specifying conditions under which a director may be removed by action of the board). While removing a director during her term in office may be burdensome, as it requires a special shareholder meeting, the controller can simply decide not to nominate a director for another term.

52 *See* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 80-83 (2006) (arguing that CEO influence on the appointment of independent directors might lead to their having a sense of obligation and loyalty toward the CEO that can contribute to a tendency to go along with CEO pay wishes).

53 *See, e.g.*, *In re* Dole Food Co., Inc. Stockholder Litig., No. 8703, 2015 WL 5052214, at *13-15 (Del. Ch. Aug. 27, 2015) (describing threats that a controlling shareholder made against a director who opposed a transaction proposed by the controller).

54 *See, e.g.*, *In re* Ezcorp Inc. Consulting Agreement Derivative Litig., No. 9962, 2016 WL 301245, at *41 (Del. Ch. Jan. 25, 2016) ("[D]elaware decisions have long worried about a controller's potential ability to take retributive action against outside directors if they did not support the

explained below, the Delaware courts have yet to fully recognize the scope and implications of this structural dependence.

In the context of freezeout transactions, courts have concluded that approval by a special committee of independent directors does not suffice to eliminate the need for judicial review.[55] In doing so, they have explained their reluctance to grant full cleansing power to such a committee by expressly invoking controlling shareholders' decisive power to appoint independent directors. In an influential article, then–Vice Chancellor Leo Strine analogized the controller to "an 800-pound gorilla [that] wants the rest of the bananas" and the independent directors to "little chimpanzees" who "cannot be expected to stand in the way, even if the gorilla putatively gives them veto power."[56]

Outside the freezeout context, however, Delaware courts have stopped short of adopting a similar approach to independent director approval. For example, although derivative suits against the controller involve a significant divergence of interest between the controller and public investors, Delaware courts defer to independent directors' decisions about the fate of these derivative actions.[57] In the seminal *Aronson* case, the court held that for plaintiffs to establish the futility of making a demand on the board to sue the controller, "it is not enough to charge that a director was nominated by or elected at the behest of those controlling the outcome of a corporate election."[58]

Delaware courts have relied on decisions of special litigation committees consisting of independent directors to dismiss claims against controlling shareholders.[59] Some Delaware decisions have also displayed deference to compensation arrangements between public companies and their controllers that

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controller's chosen transaction and whether it could cause them to support a deal that was not in the best interests of the company or its stockholders.").

55 *See, e.g.*, Kahn v. M&F Worldwide Corp., 88 A.3d 635, 642 (Del. 2014) (noting that approval by a Special Committee "of a merger with a buying controlling stockholder" only shifts the burden of proof under the entire fairness standard).

56 Leo E. Strine, Jr., *The Inescapably Empirical Foundation of the Common Law of Corporations*, 27 DEL. J. CORP. L. 499, 509 (2002); *see also In re* Pure Res., Inc., S'holders Litig., 808 A.2d 421, 436 (Del. Ch. 2002) (using the same analogy).

57 Aronson v. Lewis, 473 A.2d 805, 816 (Del. 1984).

58 *Id.*; *see also* Friedman v. Dolan, No. 9425, 2015 WL 4040806, at *6 (Del. Ch. June 30, 2015) (stating that "[t]he mere fact that one [director] was appointed by a controller" does not suffice to overcome the presumption of her independence); Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1051 (Del. 2004) (holding that ninety-four percent voting power was not enough to create reasonable doubt of independence).

It is worth noting that, in a recent opinion, Vice Chancellor Laster insightfully highlighted the tension between the *Aronson* line of cases and the recognition in other cases that structural incentives afflict director decisions. *See Ezcorp*, 2016 WL 301245, at *90-91.

59 *See* Pompeo v. Hefner, 1983 WL 20284, at *1-2 (Del. Ch. Mar. 23, 1983) (holding that, by itself, the appointment of the sole member of a special litigation committee by the controller-defendant does not automatically require judicial scrutiny such director's independence); *see also* Biondi v. Scrushy, 820 A.2d 1148, 1164, 1165 n.41 (Del. Ch. 2003) (reiterating this point).

were approved by a special committee of independent directors.[60] In other cases involving controller conflicts, Delaware court decisions have been mixed. Some court decisions granted substantial cleansing power to independent director approval while other decisions declined to do so.[61]

To be sure, Delaware courts have often examined whether directors had some additional ties that provided them with incentives to go along with the controller. For example, Delaware courts have declined to defer to independent directors who co-owned a plane with the controller,[62] who provided consulting services to the controller,[63] or who served as an employee of a company over which the controller had considerable influence.[64] We agree that such ties might strengthen the incentives of directors to go along with the wishes of the controller. However, our key point is that, even without such additional ties to the controller, service on the controlled company's board produces by itself a structural incentives problem.

Independent directors whose service on the board fully depends on the controller do not have adequate incentives to guard the interests of public investors in the face of controllers' conflicts. Using Leo Strine's metaphor, if independent directors cannot be expected in the freezeout context to oppose the big gorilla when it seeks the rest of the bananas, we should not expect them to resist the big gorilla when it pursues a peach, a mango, or any other fruit that it might fancy. Thus, we argue, courts and lawmakers should not

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60 *See Friedman*, 2015 WL 4040806, at *5-8 (applying the business judgment rule to the determination of executive pay and noting that "[e]ntire fairness is not the default standard for compensation awarded by an independent board or committee, even when a controller is at the helm of the company"); *In re* Tyson Foods, Inc. Consol. S'holder Litig., 919 A.2d 563, 587-88 (Del. Ch. 2007) (applying the business judgment rule to dismiss a claim about a consulting contract with a member of the controlling family).

61 For a systematic and careful review of cases going in different directions, see Vice Chancellor Laster's opinion for the court in *Ezcorp*, 2016 WL 301245, at *12-15. Vice Chancellor Laster's analysis highlights the structural incentives that independent directors in controlled companies have, *id.* at *16, and we hope that his analysis will prove influential.

62 *See* Sandys v. Pincus, No. 157,2016, 2016 WL 7094027, at *4 (Del. Ch. Dec. 5, 2016) (noting that co-ownership of a private plane "is suggestive of the type of very close personal relationship that, like family ties, one would expect to heavily influence a human's ability to exercise impartial judgment").

63 *See In re* Emerging Commc'ns, Inc. S'holders Litig., No. 16415, 2004 WL 1305745, at *34 (Del. Ch. June 4, 2004) (finding a lack of independence when a director provided and was compensated for financial advisory services to the controlled company).

64 *See* Del. Cty. Emps. Ret. Fund v. Sanchez, 124 A.3d 1017, 1019 (Del. 2015) (holding that a director was not independent of controller when he had a close friendship of over half a century with the controller and his primary employment was as an executive of a company over which the controller had substantial influence); *see also In re* Orchard Enters., Inc. Stockholder Litig., 88 A.3d 1, 21, 26 (Del. Ch. 2014) (holding that the question of a director's independence created issues of fact for trial when the director had a close relationship and expected future employment with the controller); *In re* Loral Space & Commc'ns Inc., 2008 WL 4293781, at *20-21 (Del. Ch. Sept. 19, 2008) (finding a lack of independence when a director had a long-standing relationship with the controller and solicited an investment from the controller during the special committee negotiations).

grant substantial cleansing power to decisions made by independent directors who serve on the board at the controller's pleasure.[65]

C. *Toward Enhanced Independence*

Legal systems that substantially rely on independent directors to vet conflicted decisions, we argue, should weaken their incentives to favor the controller and provide them with affirmative incentives to protect public investors. Weakening directors' incentives to favor controlling shareholders requires measures that would limit the controller's power to appoint and terminate directors. Providing directors with affirmative incentives to protect public investors requires that the latter have a say in director election and termination.

In the next Part, we develop a conceptual framework that can guide policymakers who wish to turn independent directors into effective monitors of controllers without undermining controllers' ability to run their companies. As we explain below,[66] one could take power away from the controller without giving any power to public investors. The approach we find best, however, is to grant public investors at least some power over director election and termination, as this power is vital for providing directors with affirmative incentives to protect public investors.

We do not suggest that public investors have power to influence the election of *all* directors or even all independent directors. Rather, we believe that the election of some directors—*enhanced-independence directors*—should not be dictated by the controller. The controller should retain the power to appoint a majority of board members and run the company through its representatives on the board. Enhanced-independence directors should play an active role when a conflict arises between the interests of the controller and those of public investors. At the very least, public investors should have the right to veto the controller's candidates for an enhanced-independence director position. As we explain below, however, public investors should wield even greater influence over these directors' election.

Before discussing our framework in detail, we should note that several legal regimes—one of them with our active involvement—have adopted reforms in the direction that we advocate. Below we discuss the regimes adopted by the AMEX stock exchange in the United States, Italy, the United Kingdom, and Israel. Because each of these regimes provided public investors

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65 We do not discuss the claim, which is beyond the scope of this Article, that approval by independent directors, despite its limitations, might provide public investors with some protection and should therefore assist the controller in some way in defending against challenge to a conflicted decision. Our focus is on showing that any significant deference now accorded to such approval by independent directors should be reserved only for approval by enhanced-independence directors.

66 *See infra* Section IV.D.

with rights to influence the selection of independent directors, they suggest that the use of such directors is not merely an "ivory tower" idea but a practical real-world option.

AMEX: In 1976, when the New York Stock Exchange (NYSE) did not allow companies to use the dual-class share structure, AMEX decided to allow dual-class companies to list on the exchange subject to certain guidelines. These AMEX guidelines required that shares with inferior voting rights (normally, public investors) have the power to elect at least one quarter of the board.[67] Although these AMEX requirements have not been in effect since the mid-1980s, a recent study found twenty-six dual-class companies, including *The New York Times* and Dillard, with a governance structure that complies with this AMEX requirement.[68]

Italy: Controlled companies dominate Italy.[69] Italian law requires public companies to provide public investors with the power to elect at least one member to the board.[70] Companies must use the slate system for electing directors:[71] Shareholders who meet minimum shareholding criteria may submit their own slate to compete against the company's slate.[72] Whereas the candidates who obtain the highest number of votes are elected, at least one director is elected from the minority slate that receives the most votes.[73] A 2013 study found that minority slates were submitted in forty percent of director elections.[74]

United Kingdom: In response to a growing number of listings by controlled firms, in 2014 the United Kingdom's Financial Conduct Authority adopted new

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67 *See* Joel Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 GEO. WASH. L. REV. 687, 704 n.90 (1986) ("The limited voting class of the common must have the ability—voting as a class—to elect not less than 25% of the board of directors.").

68 *See* Kobi Kastiel, *Against All Odds: Hedge Fund Activism in Controlled Companies*, 2016 COLUM. BUS. L. REV. 60, 92, 126-27, 127 n.212 (2016) (noting that twenty-six Delaware dual-class firms had proportional voting for directors in 2012, including the New York Times Company and Dillard's, Inc.).

69 Massimo Belcredi & Luca Enriques, *Institutional Investor Activism in a Context of Concentrated Ownership and High Private Benefits of Control: The Case of Italy* 4 (European Corp. Governance Inst. (ECGI), Working Paper No. 22/2013, 2014) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2325421 [https://perma.cc/TKA7-TMZ7].

70 *See id.* at 8 (describing that "minority shareholders' power to . . . have at least one [director] candidate appointed" as a "peculiar feature of current Italian corporate governance regulation").

71 *See id.* (describing the introduction and operation of slate voting in Italy); *see also* Ferrarini et al., *supra* note 42, at 392-93 (reviewing slate voting in Italy, which requires "at least one director [to] be elected from the minority slate of directors").

72 The percentage ownership required to submit a slate cannot exceed 2.5% of outstanding shares. Barontini et al., *supra* note 39, at 381.

73 This holds true "provided that [the minority slate] has no link—even indirect—with the majority slate." Ferrarini et al., *supra* note 42, at 392.

74 *See* Barontini et al., *supra* note 39, at 389. For a systematic analysis documenting the effect of this election regime on directors' dissent in the boardroom, see Piergaetano Marchetti et al., *Dissenting Directors* (European Corp. Governance Inst. (ECGI), Working Paper No. 332/2016, 2016).

listing rules aimed at improving investor protection in premium-listed controlled companies.[75] This rule requires a dual-voting structure for the election and reelection of independent directors in controlled companies.[76] Under this regime, the independent director's election or reelection requires approval by both a majority of shareholders and a majority of minority shareholders.[77]

Israel: Finally, Israeli corporate law requires public companies to have at least two "external directors" on their boards.[78] These directors, who must be independent of the controlling shareholder, serve for three years and can be reelected to two additional three-year terms.[79] While public investors do not have the power to elect these directors, they hold veto rights over their election.[80] Moreover, based on the recommendations of a committee in which we took part, a recent amendment provides public investors with the power to reelect an "external director" to the board even against the controller's objection.[81]

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75 *See* Fin. Conduct Auth., Listing Rules (Listing Regime Enhancements) Instrument 2014, FCA 2014/33, at 12, https://www.handbook.fca.org.uk/instrument/2014/FCA_2014_33.pdf [https://perma.cc/8XCU-2N3D] [hereinafter Listing Rules Instrument 2014] ("[The rules are] intended to ensure that the protections afforded to holders of equity shares by the premium listing requirements are meaningful." (emphases omitted)). For a review of these rules, see generally Simon Witty et al., *Enhancing the Effectiveness of The UK Listing Regime—Implementation*, HARV. L. SCH. F. CORP. GOVERNANCE & FIN. REG. (June 1, 2014), http://blogs.law.harvard.edu/corpgov/2014/06/01/enhancing-the-effectiveness-of-the-uk-listing-regime-implementation [https://perma.cc/4392-ZAHM].

76 *See* Listing Rules Instrument 2014, *supra* note 75, at 19 (requiring a listed company with a controlling shareholder "to have in place at all times . . . a constitution that allows the election and re-election of independent directors to be conducted in accordance with [the dual-voting structure] provisions set out in LR 9.2.2ER and LR 9.2.2FR" (emphasis omitted)).

77 If the results of these two votes conflict, the election of the director in question may be decided by way of another, single (ordinary) majority vote at a meeting to be held at least ninety but not more than 120 days after the original vote. *See* Listing Rules Instrument 2014, *supra* note 75, at 20-21.

78 Companies Law, 5759-1999, § 239, 44 (1999-119) (as amended). We have been involved in the development of the Israeli law governing the power of public investors in controlled companies to influence the election of some external directors. During 2006–2008, Assaf Hamdani chaired, and Lucian Bebchuk served as an advisor to, a government committee that recommended reforms to Israel's corporate law to empower minority shareholders to appoint directors. Subsequently, during 2011–2012, Lucian Bebchuk served as the outside-expert advisor to Israel's Economic Concentration Committee whose recommendation led to further enhancing the power of the minority shareholders to elect directors in a subset of Israeli controlled companies.

79 *Id.* § 245.

80 *Id.* § 239(b).

81 Similarly, we should note that Swedish corporate law provides public investors with influence over the nomination of some directors in a subset of controlled companies. The Swedish Code of Corporate Governance sets forth the procedure for establishing a nomination committee for board members, and typically representatives of the three to five largest shareholders in the company are appointed members of the committee. Even when the company has a dominant shareholder, at least one member of the committee must be independent of the company's largest shareholder. *See* Rolf Skog & Erik Sjöman, *Corporate Governance in Sweden, in* THE NORDIC CORPORATE GOVERNANCE MODEL 247 app. D at 260-62 (Per Lekvall ed., 2014). When the dominant shareholder owns less than fifty percent of the voting power, such shareholder must cooperate with other public shareholders in order to secure a majority vote at the annual general meeting. *See* Rolf H. Carlsson, *Swedish Corporate Governance and Value Creation: Owners Still in the Driver's Seat*, 15 CORP. GOVERNANCE 1038, 1049-50 (2007).

III. ENHANCED INDEPENDENCE: BUILDING BLOCKS

Turning independent directors into enhanced-independence directors raises complex issues of legal design. In Section A, we develop a framework of specific measures that can make enhanced-independence directors more accountable to public investors and less dependent on the controller. In Section B, we argue that public investors at controlled firms should have *at least* veto rights over enhanced-independence directors' initial appointment, reelection, and termination. In Section C, we explain why even this minority-veto regime leaves enhanced-independence directors too dependent on controlling shareholders. Thus, we call for a regime that requires support from controllers and public investors for the initial election of enhanced-independence directors, but leaves controllers with no say over the reelection and termination of these directors.

Providing public investors with a say in director elections raises a host of complementary questions that are not directly related to the election regime's structure. We leave the analysis of these questions to the next Part.

A. *Dimensions*

A regime of director elections consists of many specific rules addressing issues that may seem technical or mundane. The cumulative impact of these rules, however, determines the boundaries of the power held by controlling shareholders, public investors, and members of the board. In this Section, we unpack the important dimensions of any director-election regime and identify the different degrees of influence that public investors can enjoy with respect to each dimension. Shareholders generally make three decisions concerning director elections:

- Election of a new candidate to the board (*initial appointment*);
- Reelection of an incumbent director for another term (*reelection*); and
- Removal of an incumbent director before her term ends (*termination*).[82]

[82] The regime governing director termination is important in our framework for two reasons. First, without restrictions on its ability to terminate enhanced-independence directors, the controller can circumvent public investors' influence over enhanced-independence directors' election. This is consistent with the general rule that only the party who nominates a director can fire her. *See, e.g.*, 8 DEL. CODE ANN. tit. 8, § 141(k) (2016) (limiting the ability to remove directors with no cause to the holders of the class of shares electing them). Second, placing limits on enhanced-independence directors' termination can weaken these directors' dependence on the controller even when public investors have no say on director elections. Perhaps the weakest regime in our context would be to retain the controller's existing rights to elect directors, but to marginally insulate enhanced-independence directors by preventing the controller from firing them, without public investors' consent, before the end of their predetermined terms. This rule would leave intact directors' bond of loyalty stemming from their initial election and from their desire for reelection. But an independent director—or a group of directors—who rises against abuses by the controller would not automatically face the threat of an immediate dismissal.

The powers of the controller and of public investors over each of these dimensions will determine the extent to which enhanced-independence directors are accountable to the latter and insulated from the former.[83] For each of the initial appointment, reelection, and termination decisions, public investors can wield one of the following degrees of influence:[84]

- No say in directors' initial appointment, reelection, and termination. The controller alone has the power to determine the outcome of the vote (the *controller-election rule*). This is the historical norm for director election.[85]
- Power to veto the controller's decisions (the *minority-veto rule* or the *veto-rights rule*).
- Exclusive power to make a decision even against the controller's objection (the *minority-election rule*).

The degree of influence held by controllers and private investors does not have to be the same for each type of decision. Policymakers can vary public investors' degree of influence across dimensions (choosing from among at least twenty-seven specific combinations) to produce the precise balance of power between controlling shareholders and public investors that they find optimal. For example, granting public investors more power over reelection than initial appointment decisions can create an appropriate balance between the need to make enhanced-independence directors accountable to public investors and the concern about undermining the controller's ability to manage the company.

At the same time, policymakers should be aware that adopting one regime to govern one dimension may affect another dimension. Granting public investors a say over initial appointment decisions, for example, will not have much impact if the controlling shareholder has the unlimited power to fire directors at will. Finally, note that lawmakers can take power away from the controller without increasing the degree to which public investors can influence director elections. For example, one could restrict the ability of controllers to fire directors by setting mandatory terms limits without providing public investors with the power to elect or veto directors.

Table A summarizes the options that are available for policymakers vis-à-vis the prevailing regimes in the United States, the United Kingdom, Israel, and Italy.

Although rare, there are cases in which directors decide to confront the controlling shareholder. *See, e.g.*, *In re* Dole Food Co., Inc. Stockholder Litig., No. 8703, 2015 WL 5052214, at *12 (Del. Ch. Aug. 27, 2015) (describing two outside directors' opposition to a self-tender proposed by the controller).

83 A director election regime often addresses other dimensions, such as directors' term limits and the right to nominate directors. We address these dimensions below. *See infra* Sections IV.C–D.

84 We assume for now that public investors make decisions through a majority-of-minority vote. We discuss cumulative voting in subsection III.C.4.

85 *See supra* Section II.B.

Table A: Director Election Regimes

	Controller-Election Rule	Veto Rights	Minority Power
Initial Appointment	United States	United Kingdom, Israel	Italy, AMEX
Termination	United States, United Kingdom, Italy	Israel	AMEX
Renewal	United States	United Kingdom	Israel, AMEX

The gray-shaded column represents the prevailing U.S. regime. As explained in Part II, the default regime in the United States, as in many other countries, follows the controller-election rule for all dimensions: that is, the controlling shareholder has the exclusive power to make initial appointment, reelection, and termination decisions. Public investors have no say over these decisions. A shareholder with a majority of the votes can elect all board members, decide whether to renew their terms, or fire them at will.

Both the old AMEX guidelines and the Italian regime adopt the minority-election rule with respect to directors' initial election decisions.[86] These regimes empower public investors to appoint some fraction of board members even against the controller's objection. The United Kingdom's new listing regime and Israeli corporate law adopt the veto rights rule to govern enhanced-independence directors' initial appointments.[87] Under the UK regime, for example, the appointment of independent directors requires not only a majority of the votes cast at the meeting but also a majority-of-minority shareholder vote.[88]

Israel and the United Kingdom, however, provide public investors with different degrees of influence over director reelection decisions. While the United Kingdom adopts the minority-veto rule, Israeli law adopts the minority-election rule, under which public investors can decide to reelect an incumbent enhanced-independence director even against the controller's objections.

B. *Veto Rights*

In this Section, we argue that public investors should have at least veto rights over enhanced-independence directors' initial appointment, reelection, and termination. Although it will not eliminate these directors' dependence

86 *See supra* text accompanying notes 68–73.
87 *See supra* text accompanying notes 75–77, 79–80.
88 *See supra* text accompanying note 77.

on the controller, this regime offers a compromise between the need to make enhanced-independence directors accountable to public investors and the concern that the minority-election rule will disrupt the controller's ability to run the company.[89]

1. Benefits

For enhanced-independence directors to be accountable to public investors, these investors should have at least veto rights over the directors' initial appointment and reelection. In other words, the minority-veto rule is the threshold requirement for enhanced-independence directors. To prevent the controlling shareholder from circumventing the regime by firing directors who do not favor its own interests, public investors' veto power should also extend to enhanced-independence directors' termination. Under this regime, however, public investors cannot appoint enhanced-independence directors to whom the controlling shareholder objects.

This minority-veto regime offers a compromise between the need to make enhanced-independence directors accountable to public investors and the concern that denying the controller any say over director election would undermine its ability to run the company. Public investors cannot appoint enhanced-independence directors or reelect them against the controller's will, but they can prevent the appointment of an enhanced-independence director who is clearly beholden to the controller or whose reputation suggests that she will not adequately safeguard public investors' interests. Thus, while this regime will not eliminate enhanced-independence directors' dependence on the controller, these directors still need public investors' support for their initial appointment and reelection.

Public investors' veto power is perhaps most effective in the decision to reelect an incumbent enhanced-independence director. Public investors will presumably decide how to vote on the basis of the director's past performance on the board.[90] A director who favored the controller's interests over those of the company or its public investors might be voted out of office. This, then,

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89 *See* Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE L.J. 560, 594-605 (2016) (proposing a theory stressing the value of enabling controlling shareholders to set the firm's strategic direction).

90 For instance, Institutional Shareholder Services (ISS) examines the accountability, responsiveness, composition, skills, and independence of each director and the board as a whole. A combination of poor company performance and poor accountability may lead to a negative vote, as may a lack of proper attendance and sitting on an excessive number of other boards. INSTITUTIONAL S'HOLDER SERVS., UNITED STATES SUMMARY PROXY VOTING GUIDELINES: 2015 BENCHMARKS POLICY RECOMMENDATIONS 11-15 (2015), http://www.issgovernance.com/file/policy/1_2015-us-summary-voting-guidelines-updated.pdf [https://perma.cc/53TM-LTFG].

provides enhanced-independence directors with an incentive to cater to public investors' interests.

Critics may argue that this regime leaves the controller with too much power. As we explain below, controllers are more likely than public investors to make effective use of their veto rights, thereby undermining the accountability incentives generated by the minority-veto rule. By contrast, supporters of this regime may argue that it introduces a significant degree of accountability to public investors while addressing the concern that the minority-election rule will excessively interfere with the controller's ability to determine the company's business strategy.

2. Implementing Veto Rights

The principal mechanism for granting public investors veto rights over an enhanced-independence director's initial appointment and reelection is requiring that the director be approved by a majority of votes cast by public investors—that is, shareholders unaffiliated with the controller—in addition to an ordinary majority of shareholders. For example, assume that the controlling shareholder holds sixty percent of the company's voting rights. To be elected under the minority-veto rule, an enhanced-independence director would have to be approved by an ordinary majority (the controller) and by a majority of the forty percent not affiliated with the controller.[91]

Granting public investors influence over enhanced-independence director elections raises the issue of nomination rights. In other words, who will have the power to nominate candidates for an enhanced-independence director position? One can think of two approaches. Under one approach, only the controlling shareholder (or the company or its nomination committee) can put forward candidates for an enhanced-independence director position, and public investors can only approve or reject the nominated candidate. Alternatively, public investors (holding a certain percentage of shares) as well as the controller can nominate candidates for the enhanced-independence director position.

91 In controlled companies with a one-share-one-vote structure, another mechanism that could be considered is requiring that enhanced-independence directors be approved by a supermajority of the votes—say sixty-six percent. Such a rule has two benefits. First, it relieves companies and courts of the complicated task of classifying shares into those affiliated and those unaffiliated with the controller. Second, it provides a relatively simple mechanism for allowing controllers with larger control blocks to have greater influence in electing enhanced-independence directors. Such an effect is arguably desirable because controllers' incentives to divert resources become weaker as their equity stake increases.

The right to nominate directors is rather consequential for widely held firms,[92] but may not be as important under the veto-rights rule. Even when both public investors and the controlling shareholder have the same nominal power to put a candidate up for election, the controller is more likely to use its nomination right. Collective action problems that discourage dispersed public investors from nominating candidates to the board. This disincentive is exacerbated when it is clear that no director can be elected against the controller's objection. Nevertheless, we believe that public investors should have the right to nominate candidates, as it would improve their bargaining position vis-à-vis the controller.

Finally, one may argue that the veto rights regime can lead to a deadlock in which the controller and public investors cannot agree on a candidate. We believe, however, that this is not a significant concern. Even if a director nominated by the company occasionally fails to get elected, the controller and public investors will ultimately agree on a candidate, and the law could design mechanisms for ensuring continuity in the interim.[93] Moreover, the deadlock threat would discourage controllers from nominating candidates whom public investors are reasonably likely to reject.

C. *Beyond Veto Rights?*

The preceding Section presented the case for providing public investors with at least a veto right over enhanced-independence directors' initial appointment, reelection, and termination. In our work for the Israeli government, however, we recommended the adoption of a regime that went beyond veto rights to provide public investors with the exclusive power to appoint enhanced-independence directors. In this Section, we explain why the veto rights regime, by itself, is unlikely to make enhanced-independence directors effective monitors of controlling shareholders. Based on this analysis, we present the case for a regime under which public investors have at least the exclusive power at least over reelection and termination decisions.

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92 Nomination rights also would be important under the minority-election rule that we discuss in the next Section.

93 Another question is whether shareholders would use their power to vote on director elections. This in turn may depend on whether institutional shareholders are required to cast a vote. *See* Assaf Hamdani & Yishay Yafeh, *Institutional Investors as Minority Shareholders*, 17 REV. FIN. 691, 701 (2012) (finding that institutional investors in Israel do not vote on director elections even when the law grants them the power to veto the controller's candidates); *see also* Belcredi & Enriques, *supra* note 69, at 9 ("[N]o Italian institutional investor is under a legal obligation to exercise its voting rights in investee companies.").

1. Veto Rights May Not Be Enough

In theory, the veto-rights rule would make enhanced-independence directors equally accountable to public investors and controlling shareholders. However, in practice, inevitable differences between public investors and controlling shareholders make this regime tilted in favor of the latter.

First, controllers enjoy a clear informational advantage over public investors. Evaluating a new candidate for an enhanced-independence director position requires information about the candidate's qualifications and past performance on other boards. Public investors suffer from collective action problems, and they may lack incentives to acquire the information needed for evaluating candidates.[94] The controlling shareholder, in contrast, holds a sufficiently large stake to provide it with the incentive to acquire that information. This informational asymmetry between controllers and public investors becomes stronger with respect to reelection and termination decisions, as the controlling shareholder has superior access to nonpublic information about the incumbent director's past board performance.

Second, collective action problems may undermine public investors' ability to make effective use of their veto rights. As explained earlier,[95] dispersed public investors are less likely than the controller to nominate a candidate to an enhanced-independence director position, especially when the controller retains the right to nominate its own candidates to the board. To be sure, a minority blockholder may find it worthwhile to incur the costs associated with nominating a candidate, but, for the most part, public investors will tend not nominate a candidate.

To summarize, these differences would undermine the effective exercise of the powers bestowed on public investors by the veto-rights regime. Public investors are most likely to use veto rights only to prevent the appointment of clearly unqualified directors or the reelection of directors whose past performance demonstrates a willingness to disregard public investors' interests. By contrast, the controller will likely effectively exercise its powers over director nomination, election, and reelection. Even under this regime, therefore, enhanced-independence directors would likely remain more accountable to the controller than to public investors.

2. Public Investors' Election Rights

The minority-election regime provided a stronger measure for making enhanced-independence directors accountable to public investors. This regime

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94 *See* Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 584-91 (1990) (discussing rational apathy and the dynamics of shareholders' incentives to become informed).

95 *See supra* subsection III.B.2.

provides public investors with the right to elect enhanced-independence directors over the objections of the controlling shareholder. As with veto rights, this regime provides enhanced-independence directors with incentives to protect public investors, as these directors will depend on public investors' support to be elected. Unlike veto rights, however, a minority-election regime does not provide enhanced-independence directors with incentives to favor the controller, whose support is not required for their continued service on the board. Such a regime could eventually facilitate a market for professional enhanced-independence directors whom public investors will nominate and elect.[96]

An effective minority-election rule requires that public investors, at least occasionally, use their rights to appoint their own representatives to the board. Moreover, eliminating incentives to favor the controller requires that the controller be unable to exert influence over the election of enhanced-independence directors. However, the experience with widely held firms in the United States demonstrates that even insiders who lack formal power to nominate directors may exert considerable influence over director elections through their de facto control over the nomination process. Therefore, the ultimate impact of the minority-election rule will depend both on the rules governing director nominations and on the degree to which public investors will use their election and nomination rights.

First, consider director nomination rules. Even if public investors have the right to nominate enhanced-independence directors, the likelihood that public investors will do so depends on the preconditions for making nominations. If the percentage of shares required to nominate directors is too high, for example, dispersed public investors may find it too costly to organize and put forward a list of candidates. Thus, unless the company has a minority blockholder with enough at stake, controlling shareholders will continue to influence director nominations.

Next, consider the extent to which public investors are likely to use their nomination rights. Rules that facilitate director nomination by public investors will eliminate the controller's de facto control over the process only to the extent that public investors actually use their power. This in turn may depend on the degree of shareholder activism by institutional investors or on the presence of activist hedge funds in each country.

At any rate, empowering public investors to nominate candidates does not mean that those investors should always use that right. If they trust the controller, public investors may vote for the controller's candidates rather than nominate their own. Yet, the mere power to nominate their own candidates provides public investors with an important check on the controller.

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96 For a proposal for creating a market of professional directors appointed by institutional investors, see Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors,* 43 STAN. L. REV. 863 (1991).

The analysis thus far has addressed the concern that even the minority-election rule would leave controllers with de facto influence over director elections. Another potential objection to this rule, however, is that it provides public investors with too much power. Allowing public investors to elect directors, so the argument goes, would interfere with controlling shareholders' ability to exercise appropriate control over the corporation. Furthermore, it might be argued, this interference would be counterproductive for public investors, who generally benefit from the controllers' monitoring of management.[97]

We consider these objections in Section V.A below. As we explain there, enhanced-independence directors would have an important role only in those cases where the legal system recognizes the need to protect public investors from controllers' conflicts. However, even those who are genuinely concerned that providing public investors with full election rights would interfere with the controller's ability to manage the firm should accept a regime under which public investors have exclusive power only over reelection and termination decisions. We discuss this regime in the next subsection.

3. Reelection and Termination

Under this regime, both public investors and the controller have veto rights at the initial appointment stage. At the reelection stage, however, the minority-election rule applies and public investors can reelect an incumbent director regardless of the controller's position. To prevent controllers from circumventing this reelection power, public investors should also have at least veto rights over termination decisions. This regime addresses the concerns underlying both the minority-veto rule, discussed in Section III.B., and the minority-election regime, discussed in the preceding subsection.

First, the controller's veto right at the initial election stage removes the concern that the minority-election rule will interfere with the controller's ability to run the company or lead to the appointment of unfit directors. After all, by supporting the directors' initial election, the controlling shareholder has signaled its judgment that these directors are qualified to join the board. Even those who believe that the controller should have the power to veto candidates can agree that from this point on, enhanced-independence directors should be most concerned about the views of public investors.

Second, compared to the veto-rights rule, this regime bolsters enhanced-independence directors' accountability to public investors. Because the controller has no formal say over reelection and termination, directors will not depend on the controller for the continuation of their service on the board and, therefore,

97 For an analysis of the potential cost of providing public investors at controlled companies with excessive protection, see Goshen & Hamdani, *supra* note 89, at 595-98.

have no significant incentive to accommodate the controller's interests after their initial appointment.

Third, this regime prevents controllers from circumventing any rules against firing directors. A director who knows that her reelection depends on the controller's support may decide to resign if she feels that the controller is unlikely to support her.[98] With just a hint of the controller's intentions, the director might resign to save herself the embarrassment of not getting reelected or nominated. By giving public investors sole authority for termination decisions, the minority-election rule would preclude such measures.

Finally, this regime can be beneficial for legal systems wishing to pursue a gradual approach to director-election reforms at controlled companies. For example, countries where public investors currently have no say in enhanced-independence director elections may want to start with a regime that grants public investors some limited powers without denying the controller any role.

To be sure, this intermediate regime leaves controllers with considerable influence over enhanced-independence directors. Directors will remain dependent on the controller for their initial appointment, and, as under the prevailing regime, they might feel gratitude towards the shareholder who appointed them—in other words, "You dance with the one who brought you to the party." As we explained above, however, this regime alleviates any concerns that eliminating the controller's ability to conduct initial screening of candidates would prove counterproductive.[99]

4. Cumulative Voting

The analysis has thus far assumed that the mechanism for providing public investors with election rights is subjecting enhanced-independence director election to a majority-of-minority vote. Another way to allow public investors to elect directors is with a cumulative voting system.

Cumulative voting essentially provides for proportional board representation, in which a sufficiently large minority can elect one or more board members.[100] Under "straight" voting, shareholders hold a separate vote for each seat. Thus, a

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98 *See* Michaël Dewally & Sarah W. Peck, *Upheaval in the Boardroom: Outside Director Public Resignations, Motivations, and Consequences*, 16 J. CORP. FIN. 38, 51 (2010) ("[D]irectors resign when they feel they can no longer monitor the CEO.").

99 One can think of complex or intermediate versions of this regime. For example, a regime under which the controller has to elect a list of candidates (say twice the number of open enhanced-independence director positions on the board) from which public investors will have to choose. We do not discuss such complex variations in this Article.

100 For a formal analysis of the likely outcomes of cumulative voting under different patterns of share ownership, see Arthur T. Cole, Jr., *Legal and Mathematical Aspects of Cumulative Voting*, 2 S.C.L.Q. 225 (1950), and Amihai Glazer et al., *Cumulative Voting in Corporate Elections: Introducing Strategy into the Equation*, 35 S.C. L. REV. 295, 299-308 (1984).

shareholder with a majority of the votes can elect all board members. In a cumulative voting system, shareholders vote for candidates as a group: each share entitles its owner to as many votes as there are directors to be elected, and shareholders can allocate their votes among candidates as they choose.[101]

Cumulative voting can, in some cases, enable public investors to elect directors. It might thereby be superior to the prevailing regime, under which the controller alone elects all board members.[102] Nevertheless, we find cumulative voting to be overall inferior to the minority-election rule.

First, cumulative voting cannot be used to produce some of the intermediate regimes designed to balance public investor protection against controller rights. For example, it would be quite challenging to use this mechanism to provide public investors with different degrees of influence over different decisions concerning director election say, one that applies the minority-veto rule to initial appointments but the minority-election rule to reelection and termination decisions.

Second, cumulative voting is difficult to combine with a regime that assigns special tasks to enhanced-independence directors. Enhanced-independence directors should play an active role in monitoring controllers' conflicts, such as vetting self-dealing transactions, but under cumulative voting, it may be difficult to

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101 *See* Jeffrey N. Gordon, *Institutions as Relational Investors: A New Look at Cumulative Voting*, 94 COLUM. L. REV. 124, 127 n.8 (1994) (describing the features of cumulative voting). Another regime that would enable public investors to appoint at least some representatives to the board is "list voting." For an analysis of this regime and a proposal to adopt it even for companies without controlling shareholders, see Marco Ventoruzzo, *Empowering Shareholders in Directors' Elections: A Revolution in the Making,* 8 EUR. COMPANY & FIN. L. REV. 105 (2011).

102 Cumulative voting offers two advantages over the majority-of-minority regime. First, it obviates the need to engage in the complicated task of identifying shareholders unaffiliated with the controller. Second, it provides controllers with greater influence. Assume that the board has ten members. A controller with fifty-one percent of the votes would be able to elect at least five board members; a controller with eighty percent of the votes, in contrast, would be able to elect at least eight board members. This outcome is consistent with the view that public investors' protection should become weaker as the percentage of the controller's economic ownership increases. *See* Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911, 1947-49 (1996) (arguing that cumulative voting can give "large minority shareholders a place on the board and a voice in board actions"); *see also* Bernard Black et al., *Corporate Governance in Korea at the Millennium: Enhancing International Competitiveness: Final Report and Legal Reform Recommendations to the Ministry of Justice of the Republic of Korea*, 26 J. CORP. L. 537, 589-90 (2001) (recommending that Korea strengthen cumulative voting to protect large minority shareholders); Pritchard, *supra* note 38, at 21-22 (arguing that making cumulative voting mandatory would allow institutional investors in Korea "to have an effective voice" on board composition). Cumulative voting is common in Chile. *See* WORLD BANK, REPORT ON THE OBSERVANCE OF STANDARDS AND CODES (ROSC): CORPORATE GOVERNANCE COUNTRY ASSESSMENT: CHILE 4 (2003), https://openknowledge.worldbank.org/bitstream/handle/10986/14493/350180CL0Corporate0govern anceorosc1chlcg.pdf [https://perma.cc/4UBP-V7WM]. In Brazil, cumulative voting is a right of "shareholders holding at least 10% of the common shares." Bernard S. Black et al., *Corporate Governance in Brazil*, 11 EMERGING MARKETS REV. 21, 29 (2010).

identify the directors whom public investors actually elected. Third, cumulative voting can enable a minority shareholder with a substantial stake to appoint a director of whom the majority of public investors disapprove. In contrast, a majority-of-minority requirement ensures that such a minority blockholder will be able to get a director on the board only if the majority of public investors support her; the requirement thus addresses the concern that the blockholder would be able to use the director to its benefit at the expense of the majority of public investors.[103]

IV. DESIGN AND IMPLEMENTATION

In the remainder of this Article, we use the term *enhanced-independence directors* to refer to independent directors whose appointment, reelection, and termination are at least subject to the minority-veto regime. In this Part, we turn to discuss how policymakers could implement reforms designed to promote enhanced-independence directors.

Section A focuses on legal regimes—most notably Delaware's corporate law—that use judicial review standards for encouraging the use of independent directors. We explain that, in such regimes, courts can similarly encourage the use of enhanced-independence directors by according substantial deference to director approval of conflicted decisions only when the approval is made by enhanced-independence directors. Section B in turn considers regimes that use legislation, regulations, or listing standards to require publicly traded companies to appoint independent directors and have them play a role in vetting conflicted decisions. We explain that, in such regimes, it would be desirable to replace substantial reliance on independent directors with reliance on enhanced-independence directors.

The remainder of this Part discusses implementation issues that both regimes need to consider. Section C examines the number of enhanced-independence directors that should be on a board and the role that they should play. Section D considers the role of term limits in supplementing enhanced-independence director election rules. Section E discusses whether enhanced-independence directors should be independent from minority blockholders.

103 Another difficulty with cumulative voting is that it requires complicated adjustments for companies with a staggered board, for companies with a dual-class voting structure, or for companies whose shareholders have special election rights. *See* McDonough v. Copeland Refrigeration Corp., 277 F. Supp. 6, 7-8 (E.D. Mich. 1967) (discussing an attempt to evade mandatory cumulative voting rules by staggering the board).

For completeness, we should also note that cumulative voting has the advantage of making it unnecessary to identify shareholders unaffiliated with the controller. Still, for the reasons explained above, we view cumulative voting to be overall inferior to the minority-election regime.

A. *Regimes Based on Judicial Review*

For concreteness, we shall focus below on Delaware, the most well-known regime that is based on judicial review. Delaware's corporate statute does not require companies to appoint independent directors. Rather, Delaware's courts use standards of judicial review to encourage companies to appoint independent directors and to assign them a role in approving conflicted decisions.[104]

As we explained above, however, directors whose appointment, retention and termination are solely determined by the controller cannot be relied on to guard against controller opportunism. Therefore, Delaware courts should not grant any substantial cleansing power to approval of conflicted decisions by independent directors. Courts can encourage the use of enhanced-independence directors by according substantial deference to director approval of conflicted decisions only when the approval is made by enhanced-independence directors. Reliance on enhanced-independence to guard against controller opportunism would be far superior to reliance on independent directors who are completely dependent on the controller for their appointment.

Indeed, adopting the enhanced-independence approach might, in some cases, provide an option to avoid more costly interventions. Some Delaware court decisions, such as the recent decision by Vice Chancellor Laster in *EzCorp*, have expressed reluctance to defer to approval of self-dealing transactions by independent directors appointed by the controller.[105] Under this approach, any self-dealing transaction by the controller, however small in scale, would be subject to close judicial scrutiny if challenged unless approved by a majority-of-the-minority shareholder vote. Either route would involve significant costs. Enhanced-independence directors offer an alternative route with a cleansing device that some might deem to be sufficiently effective to forgo such interventions.

Finally, we should note that the judicial approach considered in this Section would encourage rather than require companies to have enhanced-independence directors. Controllers could decide not to have enhanced-independence directors if they viewed them as too costly. In such a case, the controller would have to

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104 *See supra* text accompanying notes 32–34. The analysis here applies to any legal system that relies on courts to encourage companies to appoint independent directors and entrust them with reviewing self-dealing transactions. For a thoughtful analysis of the role of judicial review in regulating self-dealing transactions, see Zohar Goshen, *The Efficiency of Controlling Corporate Self-Dealing: Theory Meets Reality*, 91 CALIF. L. REV. 393 (2003).

105 *See In re* Ezcorp Inc. Consulting Agreement Derivative Litig., No. 9962, 2016 WL 301245, at *11 (Del. Ch. Jan. 25, 2016) ("Under current law, the entire fairness framework governs any transaction between a controller and the controlled corporation in which the controller receives a non-ratable benefit."); T. Rowe Price Recovery Fund, L.P. v. Rubin, 770 A.2d 536, 552 (Del. Ch. June 23, 2000) ("[B]oth the Supreme Court and this court explicitly held that the entire fairness standard of review applies in the non-merger context to interested transaction involving controlling stockholders.").

either avoid self-dealing transactions and other conflicted decisions or bear the costs of having them subject to judicial scrutiny.

B. *Regimes Based on Legislation or Regulation*

As explained above, jurisdictions in other parts of the world have legal rules requiring controlled companies to have independent directors and requiring that these directors approve certain conflicted decisions.[106] Our analysis indicates that it would be preferable for these jurisdictions to replace their substantial reliance on independent directors with substantial reliance on enhanced-independence directors.

To implement the enhanced-independence approach, such jurisdictions would have to adopt their own system of rules that address the aspects of the enhanced-independence regime that we discuss in this Article. Among other things, such a jurisdiction would have to specify the required number of enhanced-independence directors; the type of input rights that public investors would have at the initial election, retention, and termination stages; and the type of corporate decisions that enhanced-independence directors would have to approve. The framework that we provide in this Article could be useful for the design of the necessary rules and regulations.

C. *Number and Role of Enhanced-Independence Directors*

Our analysis thus far has focused on the director election regime. In this Section, we discuss the supplementary arrangements required to ensure that, once elected, enhanced-independence directors will be able to play a meaningful role in vetting conflicted decisions. Our analysis aims to highlight the principal considerations that should guide policymakers. A full analysis of these issues is beyond the scope of this Article.

Enhanced-independence directors cannot protect public investors unless they hold sufficient power over conflicted decisions. At the same time, providing these directors with too much power might undermine the controller's ability to run the firm. Thus, enhanced-independence directors should play a dominant role in reviewing conflicted decisions but take a backseat with respect to other corporate affairs.

1. Role

On the one hand, as enhanced-independence directors become more accountable to public investors, the controller and the directors it puts in place might try to marginalize enhanced-independence directors. Even if they are

106 *See supra* text accompanying notes 36–42.

genuinely accountable to public investors, enhanced-independence directors cannot adequately safeguard public investors' interests if such directors lack the power to veto self-dealing and other tunneling transactions.[107]

On the other hand, providing enhanced-independence directors with overly broad powers can interfere with the controller's ability to run the company even when its interests align with those of public investors. Practically, the controller exercises its control by appointing its representatives to the board. As directors become less dependent on the controller for their election, the controller's ability to exert influence over the company's direction declines. Under the minority-election regime, for example, public investors can elect directors even against the controller's objection. These minority-elected directors may have their own views concerning the direction that the company should take, thereby interfering with the controller's ability to exercise control.[108]

Therefore, lawmakers should not grant enhanced-independence directors too much power over issues that raise no conflict between the controller and public investors. As a matter of principle, the role of enhanced-independence directors should track the fundamental distinction between business and self-dealing transactions. These directors should play a critical role in decisions that raise concerns about a conflict of interest between the controller and public investors. They should thus have the power to review, negotiate, and approve freezeouts and other self-dealing transactions involving the controlling shareholder.[109] But the controller-elected directors should be able to decide such issues as the firm's business strategy even over enhanced-independence directors' objections.[110]

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107 *See, e.g.*, Donald C. Clarke, *The Independent Director in Chinese Corporate Governance*, 31 DEL. J. CORP. L. 125, 209-10 (2006) (noting, with respect to Chinese corporate law, that "[c]orporate officers and fellow directors have few incentives to listen to independent directors because independent directors have little in the way of veto power over corporate actions").

108 One of us has recently argued that controllers may find it difficult to convey to independent directors the value of their vision for the company. *See* Goshen & Hamdani, *supra* note 89, at 601 ("[A]symmetric information and differences of opinion could prevent the controller-entrepreneur from credibly communicating her idiosyncratic vision . . . .").

109 Should enhanced-independence directors play a role in monitoring financial disclosure? While a full analysis of this question is outside the scope of this Article, we are inclined to answer this question in the negative for two reasons. First, although controllers may occasionally have reasons to mislead public investors (when they raise capital, for example), it seems that financial disclosure is not a pervasive source of conflicts between controllers and public investors. Second, given the severe legal and reputational sanctions associated with misreporting, it is unclear that making directors accountable to minority investors would play a meaningful role in inducing independent directors to ensure accurate reporting.

110 Drawing the line between conflicted and nonconflicted decisions regarding the public investors' interests is not always easy. For discussions of the difficulties involved in drawing this line, see Luca Enriques, *Related Party Transactions: Policy Options and Real-World Challenges (With a Critique of the European Commission Proposal)*, 16 EUR. BUS. ORG. L. REV. 1, 2 (2014); and Goshen & Hamdani, *supra* note 89, at 606-08. As noted earlier, this Article does not seek to contribute to the identification of the corporate decisions that the law should regard as conflicted.

2. Number

Because enhanced-independence directors should play an important role in evaluating and approving conflicted decisions, we believe that companies should appoint at least two such directors.[111] At the same time, enhanced-independence directors should not constitute a majority of the board. As we explained above, granting these directors too much say over corporate affairs may undermine the controller's ability to set the strategic direction of the firm. Were enhanced-independence directors to constitute a majority of the board, they would have the power to set the firm's direction and make other decisions over the objections of the controller's representatives, even in the absence of any conflict of interest. Thus, limiting enhanced-independence directors to a minority of the board offers a reasonable balance between controller management and minority protection.

D. *Length of Appointment*

Arrangements concerning directors' terms in office can supplement rules concerning their elections. The need for term limits and tenure requirements generally arises when the director election regime leaves even enhanced-independence directors somewhat dependent on the controller, such as under the minority-veto rule. As we explain in this Section, however, this need may arise for other reasons, including when public investors have substantial influence over director elections.

Consider first the prevailing regime, under which the controller-election rule applies and companies do not have enhanced-independence directors. Although independent directors are not accountable to public investors, subjecting them to both term limits and minimum-tenure requirements limits controllers' ability to terminate them and, consequently, weakens their dependence on the controllers. To be sure, these directors will depend on the controller for their initial appointment and reelection. Yet, limiting how many years they can serve constrains the controller's ability to "reward" directors with reelection.[112] At some point, these directors will have to leave the board

111 As described above, the regime in Italy requires only one enhanced-independence director. *See* Belcredi & Enriques, *supra* note 69, at 8; *see also supra* text accompanying notes 70–73.

112 Note that Delaware courts have not taken the view that an especially long time of board service at a controlled company categorically undermines director independence. *See, e.g.*, Friedman v. Dolan, No. 9425, 2015 WL 4040806, at *6 (Del. Ch. June 30, 2015) (holding that "[n]either long-term board service nor the mere fact that one was appointed by a controller suffices" to subvert independence (citations omitted); *In re* BJ's Wholesale Club, Inc. S'holders Litig., No. 6623, 2013 WL 396202, at *6 n.63 (Del. Ch. Jan. 31, 2013) (explaining that allegations of "'nearly twenty years of Board service alongside [one director] and a long-term relationship with [another director]' . . . [did] not raise a reasonable doubt as to . . . independence under Delaware law" (quoting Verified Consolidated Second Amended Class Action Complaint ¶ 68, BJ's Wholesale Club, Inc. S'holders Litig., No. 6623, 2013 WL 396202 (Del. Ch. Jan. 31, 2013) (No. 6623))). For a thorough analysis of the effect of director tenure on

regardless of the controller's satisfaction with their service. Similarly, requiring that directors serve for some predetermined number of years before they can be replaced ensures that the controller would not be able to displace directors who do not cater to its interests.[113]

Now consider a regime that adopts the minority-election rule, in which public investors can appoint enhanced-independence directors against the controller's objection. Under this regime, term limits are unnecessary and even harmful. These enhanced-independence directors will be accountable to public investors and have no dependence on the controller. Without any term limits, they will face ongoing incentives to act in a manner that will be beneficial for public investors.

Finally, consider the regime in which public investors have only veto rights over an enhanced-independence director's initial appointment but can reelect that director even against the controller's objections. In this case, term limits may be required to protect the controller. This regime's underlying premise is that the controller's support for a director at the initial appointment stage ensures that this director is qualified to serve on the board. Yet, without term limits, public investors could permanently force a director on the majority shareholder simply because of that shareholder's initial consent to her appointment. Indeed, Israeli corporate law, which adopts this regime, imposes a limit on the number of years that these directors can serve on the board.[114]

E. *Independence from Minority Blockholders*

Should enhanced-independence directors be independent from public investors, especially from significant blockholders who nominated them?[115] We do not take a firm position on this question but would like to flag it. Policymakers should consider this issue, especially where enhanced-independence arrangements provide public investors with full election rights.

To illustrate, assume that the controller owns sixty percent of the company's shares and that the minority-election rule applies. In this regime, public investors have the exclusive right to appoint enhanced-independence directors regardless of the controller's view. Assume further that a large investor, owning eight percent of the shares, nominates an enhanced-independence

director independence, see generally Yaron Nili, *The "New Insiders": Rethinking Independent Directors' Tenure*, 68 HASTINGS L.J. 97 (2016).

113 *See, e.g.*, *In re* Dole Food Co. Stockholder Litig., 2015 WL 5052214, at *1528 (Del. Ch. Aug. 27, 2015) (describing how a controlling shareholder and one of his senior executives forced an outside director who opposed a self-tender offer proposed by the controller to resign).

114 They can serve no more than three terms of three years. *See* Israeli Companies Law, 5759–1999, § 245, 44 (1999-119).

115 For a discussion raising concerns about directors who are not independent of the minority shareholders that nominated them, see Gutiérrez & Sáez, *supra* note 6, at 91.

director. Clearly, this director should be independent of the controller and the company. But should she be independent from the blockholder who put forward her candidacy?

The case *against* this new independence requirement relies on the premise that shareholders with a significant equity stake have an incentive to monitor corporate insiders for the benefit of the company and its public investors. Having blockholders' representatives on the board will enable them to monitor corporate insiders more effectively. Indeed, studies have found that the presence of blockholders on the board tends to improve pay practices and CEO accountability.[116] Moreover, unlike controlling shareholders under the majority-election rule, blockholders in our setting (i.e., minority shareholders with a significant equity stake) cannot dictate the outcome of a shareholder vote. Rather, a blockholder-nominated candidate will join the board only if a majority-of-minority shareholders support her candidacy.[117] This majority-of-minority requirement alleviates the concern that blockholders might appoint directors in order to pursue their own agendas.[118]

The case *for* requiring extra independence focuses on the concern that blockholders who nominate directors may pursue their own agendas to extract private benefits or disrupt the controller's ability to run the firm. Directors with no ties to a blockholder are more likely to advance the interests of the company and its public investors even when that blockholder nominated them for the position.[119]

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116 *See* Lucian A. Bebchuk et al., *Lucky CEOs and Lucky Directors*, 65 J. FIN. 2363, 2365 (2010) (finding that having a compensation committee that is both independent and includes at least one blockholder reduces the likelihood of "lucky" option grants to corporate executives); *see also* Anup Agrawal & Tareque Nasser, Blockholders on Boards and CEO Compensation, Turnover and Firm Valuation 26 (Sept. 1, 2012) (Am. Fin. Ass'n 2012 Chi. Meetings Paper, 2012), https://ssrn.com/abstract=1443431 [https://perma.cc/G4GC-97EA] (finding that CEOs of firms with blockholder directors tend to have lower pay and higher turnover-performance sensitivity).

117 As we explained earlier, the need to prevent blockholders from having the power to appoint directors not supported by a majority of minority investors is an important reason to disfavor cumulative voting. *See supra* subsection III.C.4.

118 Some of the issues that we analyze here arise also in the context of widely held firms, where the question is whether directors nominated by activist investors should be independent from these investors. For a discussion of these issues in the latter context, see generally Matthew D. Cain et al., *How Corporate Governance Is Made: The Case of the Golden Leash,* 164 U. PA. L. REV. 649 (2016), and Yaron Nili, *Servants of Two Masters? The Feigned Hysteria over Activist-Paid Directors,* 18 U. PA. J. BUS. L. 509 (2016).

119 Note that the need for independence from a nominating blockholder is significantly reduced when the controller can veto public investors' candidates to the board. The controller would presumably use its veto power to prevent the appointment of a director whose goal is to enable blockholders to extract private benefits of control.

V. OBJECTIONS

This Part considers potential objections to our proposals. Section A addresses the claim that providing public investors—that is, minority shareholders—with a say over director elections will undermine the controller's ability to run the company. Section B considers the claim that enhanced-independence directors might undermine board effectiveness and collegiality. Section C discusses the claim that granting public investors a say over director elections might enable minority blockholders to extract private benefits. Section D explains why enhanced-independence directors improve investor protection even when self-dealing transactions are subject to a vote by public investors.

Before considering these objections, we would like to note that our framework accommodates many different degrees of public investor influence. Thus, even if one finds any of the following objections convincing, the appropriate response may be to choose a regime that provides a different balance between public investors and the controller's power to appoint enhanced-independence directors.

A. *Undermining Control*

The first objection we address is that allowing public investors to elect directors will interfere with the controlling shareholders' ability to exercise control over the corporation. On this view, minority shareholders in a controlled company have accepted, and might indeed prefer, that the controller will determine the strategic and business path of the company. We have discussed this objection at several points above, so our analysis in this Section can be brief. Ultimately, enhanced-independence directors would not undermine the controller's ability to determine business decisions that do not involve a conflict.

Recall that our analysis focuses on regimes that chose to rely on independent directors to contain controllers' opportunism. The goal of encouraging companies to appoint enhanced-independence directors is to provide at least some directors with incentives to stand up to the controller when undesirable self-dealing takes place. The question, however, is whether directors who are genuinely accountable to public investors will disrupt the controller's ability to make other business decisions or determine the company's direction. For the reasons we explain below, we believe that enhanced-independence directors will not necessarily interfere with the controller's ability to make business decisions.

First, note that controlling shareholders occasionally grant minority blockholders the right to board representation.[120] Having these representatives

120 *See* J. Travis Laster & John Mark Zeberkiewicz, *The Rights and Duties of Blockholder Directors*, 70 BUS. LAW. 33, 60 (2014/2015) (arguing that both majority and minority constituency directors should

on the board, however, does not necessarily undermine the controllers' ability to run the company. Our framework can be viewed as granting dispersed public investors rights similar to those that minority blockholders may receive.

Second, as explained in subsection IV.C.2, policymakers should ensure that enhanced-independence directors remain a minority of board members and play a key role only when the controller is conflicted. Ensuring that enhanced-independence directors can veto only a limited subset of decisions would address disruption concerns while preserving the directors' incentives to protect public investors. Indeed, as public investors have more power over director elections, policymakers should take greater care to ensure that enhanced-independence directors can block only those transactions in which a clear conflict of interest exists.

Third, the concern that the minority-election rule undermines the controller's ability to run the firm should not necessarily preclude public investors from having a say over director elections. At most, this concern suggests that the veto-rights rule should govern initial appointment decisions; that is, controllers should have veto power over initial appointments while the minority-election rule applies to reelection and termination decisions.

Finally, note that we do not argue that legal systems *should* rely on independent directors to monitor conflicted decisions. Those who believe that enhanced-independence directors would impose an excessive burden on corporate decisionmaking should consider replacing independent director approval with other measures for addressing controller opportunism. However, as we have shown in this Article, they should not place substantial reliance on independent-director vetting of conflicted decisions.

B. *Loss of Collegiality and Cohesiveness*

The second objection we consider focuses on the unique nature of the board's work. An effective board requires an environment that facilitates cooperation among board members and fosters trust between the board as a whole and corporate insiders. Having even a few directors who represent public investors, so the argument goes, would interfere with board cohesiveness and undermine the trust between the board and corporate insiders, as directors will become adversarial and uncooperative when seeking reelection by public investors.

compromise to ensure a balance of rights); Simone M. Sepe, *Intruders in the Boardroom: The Case of Constituency Directors*, 91 WASH. U. L. REV. 309, 365-77 (2013) (taking the position that current fiduciary rules should be reformed to keep constituency directors in check); E. Norman Veasey & Christine T. Di Guglielmo, *How Many Masters Can a Director Serve? A Look at the Tensions Facing Constituency Directors*, 63 BUS. LAW. 761, 774-75 (2008) (arguing that the current standards of fiduciary duty and liability are sufficient to ensure that constituency directors act on behalf of all shareholders).

We would first like to note that objections of this type arise, even at widely held companies, against any form of external intervention in the boards' work or composition, including the fundamental requirement for independent directors and even director liability.[121] Yet, as recent developments in the U.S. regime governing widely held companies demonstrate, the goal of incentive alignment prevails over collegiality concerns. Indeed, there are those who believe that external intervention is necessary to overcome the reluctance of individual directors to challenge group consensus.[122] Moreover, board cohesiveness may not be desirable when a genuine conflict arises between controllers and public investors.

C. *Public Investor Passivity*

We have thus far addressed arguments that enhanced-independence directors would overburden public companies and their controllers. One may argue, however, that enhanced-independence directors would provide public investors with insufficient protection, because public investors are likely to remain passive. Rationally apathetic investors, the argument goes, would fail to make an effective use of their power to elect directors. This, in turn, would make enhanced-independence directors too favorable to the controller and insufficiently attentive to the interests of the minority shareholders.

This concern is clearly inconsistent with market conditions in the United States and other developed markets where shareholder activists, institutional investors, and proxy advisory firms are prominent. Even in less developed capital markets, however, this claim does not undermine the case for our proposed regime.

The proposed regime introduces an important safety valve that can bolster investor protection even when public investors largely remain passive. Public investors may decide to use their election rights when controllers divert value on a large scale or when an activist shareholder emerges. The prospect of public investors rejecting that shareholder's candidate or nominating their own candidates (under the minority-election regime) will thus have some deterrent effect on controlling shareholders.

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121 *See, e.g.*, Stephen M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1, 49-50 (2002) (arguing that judicial review might destroy the "interpersonal relationships" that foster internal board governance); Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 800 (2001) (arguing that "too much true independence in the boardroom . . . [can] reduc[e] the level of trust that comes from closer or less adversarial relationships, [] chill[] communication . . . and interfere[] with the board as a productive team in all its capacities, including monitoring").

122 *See generally* Marleen A. O'Connor, *The Enron Board: The Perils of Groupthink*, 71 U. CIN. L. REV. 1233, 1237 (2003) (explaining the role of social psychology in the Enron Board's actions).

At any rate, the introduction of enhanced-independence directors would be an improvement over the prevailing regime of director election. Concern over public investors' passivity, however, may require policymakers to supplement the proposed regime with other measures of investor protection, such as private or public enforcement.

D. *Public Investor Opportunism*

One may argue that minority shareholders holding relatively large blocks of shares might opportunistically use veto rights or the minority-election regime to blackmail the controller to extract private benefits.[123] Under the minority-election rule, for example, these blockholders might deliberately nominate people who would threaten to disrupt the board's work to blackmail the controller.

We find this critique unconvincing. A strategy of disrupting value-enhancing projects will harm not only the controller but also public investors. Thus, an opportunistic minority blockholder—one who nominates board candidates for the sole purpose of blackmailing the controller—is unlikely to secure the public investor votes required to appoint its candidate. Moreover, it is now commonly believed that significant controller-backed self-dealing transactions should be subject to a vote by public investors, i.e., a majority of minority shareholders.[124] Such votes already provide an opportunistic minority blockholder with at least the same power to extract private benefits as would public investor votes on director elections.

Finally, enhanced-independence directors could be required to be independent from blockholders who put forward their nomination. This requirement, in turn, would address concerns that blockholders may use their influence over director nominations to extract private benefits.

123 *See, e.g.*, Feedback Statement: Summary of Responses to the Commission Green Paper on the EU Corporate Governance Framework 16 (Nov. 15, 2011), http://ec.europa.eu/internal_market/company/docs/modern/20111115-feedback-statement_en.pdf [https://perma.cc/VKR9-YVAE] (explaining that many people believe granting minority shareholders additional rights to help them represent their interests could increase the potential for the abuse of those rights and would be "contrary to shareholder equality").

124 *See, e.g.*, *In re* MFW S'holders Litig., 67 A.3d 496, 500-05, 520-36 (Del. Ch. 2013) (noting that "the majority-of-the-minority vote condition qualifies as a cleansing device under traditional Delaware corporate law principles"); Simeon Djankov et al., *The Law and Economics of Self-Dealing*, 88 J. FIN. ECON. 430, 461 (2008) (surveying the prevalence of majority-of-minority shareholder approval for self-dealing transactions in a large number of jurisdictions, and emphasizing this requirement's crucial role in protecting public investors).

CONCLUSION

Corporate law has long relied on independent directors to protect public investors from controller opportunism in conflicted decisions. In this Article, however, we have shown that independent directors whose election and retention is fully dependent on the controller cannot be relied upon to adequately perform their oversight role.

To make independent directors more effective in overseeing conflicted decisions, we have argued, public investors should have the power to influence the election or retention of some "enhanced-independence" directors. These enhanced-independence directors should play a key role in vetting conflicted decisions, but they should not be able to prevent the controller or their fellow directors from making other corporate decisions.

We have discussed how the Delaware courts, as well as other lawmakers in the United States and around the world, can introduce enhanced-independence arrangements. In Delaware, judicial doctrines encouraging the introduction of enhanced-independence directors can address challenges that courts have faced in reviewing conflicted decisions in controlled companies. We have identified alternative mechanisms for providing public investors with a say over the appointment or retention of enhanced-independence directors, and we have analyzed the tradeoffs that these mechanisms entail. We have also discussed the desirable role of such directors and have responded to a number of objections to their use. Our hope is that the approach and framework of analysis we have put forward in this Article will serve courts and lawmakers in improving investor protection in controlled companies.

BEYOND BEHOLDEN

Da Lin[*]

Abstract. Corporate law has long been concerned with director independence. In controlled companies, the conventional wisdom focuses on "beholdenness" as the main threat to independence. The prevailing theory argues that directors might feel pressured to reciprocate a past kindness from the controlling shareholder or fear retaliation. This Article argues that this conventional narrative is troublingly incomplete. I show that directors are also influenced by the prospect of rewards, or patronage, from the controller.

This Article is the first to identify controlling shareholder patronage as a systemic phenomenon and to explore how anticipation of future patronage can affect director behavior. It presents an original empirical study on professional relationships between directors who are nominally independent and the controlling shareholders of their firms. My findings reveal that these relationships are far more pervasive than is usually recognized. In fact, some controlling shareholders regularly re-appoint cooperative "independent" directors to senior positions and directorships at other firms under their control. From a director's perspective, this pattern of behavior means that the potential upside of getting along with the controlling shareholder is significant. I further demonstrate that the likelihood of patronage from the controlling shareholder depends on two factors: the controlling shareholder's base of controlled entities and the concentration of its decision-making authority. Together, these factors provide an analytic framework for assessing which controllers have greater potential to create conflicts of interest. Disaggregating controlling shareholders in this way opens up opportunities and new challenges for how we define independence, analyze decisions made by putatively independent directors, and judge the utility of independent directors as a safeguard against controller opportunism.

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INTRODUCTION 3
I. INDEPENDENT DIRECTORS IN CONTROLLED COMPANIES: THE STANDARD ACCOUNT 8
A. Independent Directors as Monitors 8
B. Who is Independent? 11
1. Past and ongoing relationships 11
2. The controller's power over director retention and termination 14
3. "Boardroom atmosphere" and psychological factors 16
4. Risk to reputation 17
II. INDEPENDENT DIRECTOR REALITIES 20
A. Data Sources and Methodology 21
B. Controller-Independent Director Ties 24
C. Creating a Taxonomy of Controlling Shareholders 30
1. Base 32
2. Concentration 35
III. DOCTRINAL AND THEORETICAL IMPLICATIONS 40
A. Enhanced scrutiny for powerful controllers 41
B. A harder look at post-transaction relationships 43
C. Understanding freezeouts as presenting an asymmetric final period problem 45
CONCLUSION 47

Electronic copy available at: https://ssrn.com/abstract=3335195

INTRODUCTION

Independent directors have long been a core part of corporate law's answer to the agency problem that arises in controlled companies. The presence of a controlling shareholder produces the potential for private benefits: the controlling shareholder can extract benefits from the corporation at the expense of other shareholders.[1] To contain this risk of opportunism, courts and policymakers have promoted the engagement of independent directors to vet contracts between companies and their controllers.[2] As Guhan Subramanian observes, the move to independent directors is now "standard practice" in controlled firms.[3]

The conventional notion of independence translates roughly into the absence of substantial prior or ongoing relationships to the controlling shareholder.[4] This definition reflects corporate law's persistent preoccupation

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[1] *See infra* notes 24–25 and accompanying text. In this Article, I use both "minority shareholders" and "public shareholders" to refer to investors other than the controller. Controllers can hold an effective majority of the firm's votes without owning a majority of equity rights. For instance, in a firm with a dual-class structure or another capital structure that separates voting rights from cash rights, controllers can have a lock on control while holding only a minority—even a small fraction—of total outstanding shares. *See, e.g.*, Lucian Arye Bebchuk et al., Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights, in CONCENTRATED CORPORATE OWNERSHIP 295, 297–301 (Randall K. Morck ed., 2000).

[2] *See, e.g.*, *In re* MFW S'holders Litig., 67 A.3d 496, 529–30 (Del. Ch. 2013) ("The premise that independent directors with the right incentives can play an effective role on behalf of minority investors is one shared by respected scholars sincerely concerned with protecting minority investors from unfair treatment by controlling stockholders."); Kahn v. Lynch Commc'n Sys., 638 A.2d 1110, 1120–21 (Del. 1994) (stating that approval by a special committee of independent directors shifts the burden of proving the fairness of a transaction to the plaintiff); Leo E. Strine, Jr., *The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (and Europe) Face*, 30 DEL. J. CORP. L. 673, 677–78 (2005) (explaining how Delaware's approach to conflict of interest transactions encourages the use of independent directors). *See generally* Guhan Subramanian, *Fixing Freezeouts*, 115 YALE L.J. 2, 11–17 (2005) (documenting the judiciary's promotion of independent directors as a protective device for minority shareholders in freezeout mergers).

[3] Subramanian, *supra* note 2, at 12.

[4] *See infra* Part I.B.i (discussing Delaware courts' approach to independence). There is a separate inquiry for assessing director independence under listing standards promulgated by the New York Stock Exchange ("NYSE") and NASDAQ. *See* NEW YORK STOCK EXCHANGE, INC., NEW YORK STOCK EXCHANGE LISTED COMPANY MANUAL § 303A.02 (2017) ("Independence Tests"); Nasdaq, Inc., Nasdaq Stock Market Rules § 5605(a)(2) (2017) (definition of "Independent Director"). In cases involving controlling shareholder conflicts, Delaware courts treat the listing standards as illustrative but emphasize that directors' compliance with the standards "does not mean that they are necessarily independent [from the controller] under [Delaware] law." Kahn v. M & F Worldwide Corp., 88 A.3d 635, 648 n.26 (Del. 2014).

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with "beholdenness" as the main threat to independence.[5] The paradigmatic concern is that a director with lucrative ties to the controlling shareholder may be subtly pressured by the fact that the controller can cut off those ties or even unseat him from the board.[6] This diagnosis, in turn, has prompted calls to insulate nominally independent directors from the controlling shareholder's ire.[7]

Corporate governance scholarship focuses extensively on the incentives generated by the controlling shareholder's ability to *retaliate* against insubordinate directors. What the literature overlooks, however, is that directors may also be influenced by the prospect of *reward*. What happens when the controlling shareholder is not angered but instead pleased?

The result, it turns out, is often new opportunities or future benefits from the controlling shareholder to the favored directors. Controlling shareholders can direct their resources or those owned by the controlled company in ways that reward friends. For instance, Charles Dolan, whose family controlled Cablevision Systems until 2016, invested his own money with a fund founded by one of Cablevision's former "independent" directors.[8] Some controllers have substantial influence over other companies as well. When the controlling shareholder of M & F Worldwide, Ronald Perelman, sought to "freeze out"[9] the company's minority shareholders, the company formed a special committee of four "independent" directors to negotiate with Perelman over the terms of his acquisition.[10] Less than a year after the deal closed, two members of the special

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[5] *See* Usha Rodrigues, *The Fetishization of Independence*, 33 J. CORP. L. 447, 486 (2008) (describing Delaware's approach to independence as one that focuses on "ties that can generate a sense of 'beholdenness.'").

[6] *See, e.g.*, Leo E. Strine, Jr., *The Inescapably Empirical Foundation of the Common Law of Corporations*, 27 DEL. J. CORP. L. 499, 506 (2002) (observing that "even the independent directors will be subtly influenced by the fact that [the controlling shareholder] has the voting power to unseat them"); Larkin v. Shah, 2016 WL 4485447, at *9 (Del. Ch. Aug. 25, 2016) (explaining that directors "might feel beholden to a controller who placed them on the board, supported them during election season, or could fire them at any moment"); Kahn v. Tremont Corp., 694 A.2d 422, 428 (Del. 1997) (describing the risk that "those who pass upon the propriety of the transaction might perceive that disapproval may result in retaliation by the controlling shareholder"); Lucian A. Bebchuk & Assaf Hamdani, *Independent Directors and Controlling Shareholders*, 165 U. PA. L. REV. 1271, 1274 (2017) (arguing that because "controllers [have] decisive power to appoint independent directors and decide whether to retain them, independent directors have significant incentives to side with the controller and insufficient countervailing incentives to protect public investors in conflicted decisions").

[7] For example, Lucian Bebchuk and Assaf Hamdani recently proposed increasing minority shareholders' role in director elections, such as giving them veto rights over the appointment and termination of certain "enhanced-independence directors." *See generally* Bebchuk & Hamdani, *Independent Directors and Controlling Shareholders*, *supra* note 6.

[8] *See* Cablevision Sys. Corp., Proxy Statement (Schedule 14A), at 6 (May 21, 2007) ("Since 1995, Charles F. Dolan, the Company's Chairman, has had a personal investment in Regent Equity Partners, a limited partnership in which Mr. Hochman is one of the general partners.").

[9] A freezeout is a transaction in which the controlling shareholder buys out the public shareholders of a publicly-traded corporation.

[10] *In re* MFW S'holders Litig., 67 A.3d 496, 505–07 (Del. Ch. 2013).

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committee—including the chairman—joined the boards of other firms under Perelman's control.[11]

This Article is the first to identify controlling shareholder patronage as a systemic phenomenon and to consider how anticipation of future patronage can influence director behavior. I study these issues using an original dataset of nominally independent directors who negotiated with a controlling shareholder over a freezeout transaction between 2000 and 2014. Examining the professional connections—specifically, directorship and employment relationships—between those directors and controllers, I find that some controlling shareholders regularly re-appoint cooperative "independent" directors to executive and board positions at other firms under their control. 36 percent of the controlling shareholders in my sample have re-appointed at least one nominally independent director in this way. Illustrating this point from a different angle, 20 percent of the directors in my data have served on the board or as an executive in at least two different companies controlled by the same controlling shareholder. In many cases, the director was independent in the conventional sense when he negotiated the freezeout, meaning that he had no ongoing or prior connections with the controller at that time. But after the freezeout closed, he obtained a job at another company that the controlling shareholder controlled. From a director's perspective, these findings mean that he can obtain future benefits from the controlling shareholder if he acts in the controlling shareholder's interests.

The likelihood of future patronage from the controlling shareholder is driven by factors that have not been recognized by courts. The current doctrinal regime is based on a generic and stylized idea of the controlling shareholder. But in reality, controlling shareholders come in different forms, hold control through different mechanisms, and acquire control for different reasons. Treating the controlling shareholder as an undifferentiated category obscures the many moving parts that can affect the extent of controlling shareholders' power to influence director behavior. As I show, two important determinants of this power are what I call the *base* of controlled entities and the *concentration* of decision-making authority.

Base refers to the size of the network of companies over which a controlling shareholder has control. I find that controllers with a wider base—controllers that control multiple public companies—are much more likely to have repeat relationships with the nominally independent directors who serve on their boards (54.8 percent compared with 4.5 percent). This result makes intuitive sense: controllers with a wider base have greater ability to reward or sanction because they have power over more resources and more boards.

Concentration refers to the number of actors that share the power to control within the controlling shareholder. I find that controllers who are single natural

[11] This information was collected from the Boardex database. See *infra* Part II.A for a description of my methodology.

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persons, as opposed to family groups or widely-held corporations, are also more likely to have repeat relationships with the nominally independent directors that they appoint (48.3 percent compared with 30.4 percent for widely-held corporations and 25 percent for family groups). This finding is consistent with classic narratives about power: a single person with consolidated control has greater power to reward or sanction than a group of decision-makers who share control because the single person can act unilaterally and his authority over the controlled company is plenary.[12]

Together, these two factors provide an analytic framework for assessing which controlling shareholders have greater potential to create conflicts of interest. By disaggregating controllers in this way, courts can move towards a more nuanced doctrine for constraining private benefits of control. Most concretely, courts can tailor the level of scrutiny given to independent directors' decisions, such as approval of a transaction proposed by the controlling shareholder, to the controlling shareholder's ability to influence director behavior.

Ultimately, my findings illustrate how undertheorized controlling shareholders and the risks they pose to director independence remain. For example, doctrines concerning controlling shareholders do not account for real differences among the people and entities within that broad category; nor do they provide any explanation for why we presume that the bargaining dynamics are the same when nominally independent directors negotiate with controllers who are repeat players—such as venture capital firms that routinely obtain control over the firms they invest in—and when those directors negotiate with one-off controllers.[13] There has also been no serious discussion about how courts might obtain information on a director's expectations about future events, even though basic game theory teaches us that the director's behavior will be shaped by these beliefs.[14] Courts are sometimes presented with evidence

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[12] S*ee infra* notes 129–131 and accompanying text.

[13] *See In re* Trados Inc. S'holder Litig., 73 A.3d 17, 54 (Del. Ch. 2013) (acknowledging but disregarding the fact that the nominally independent directors negotiated in the shadow of the "VC ecosystem").

[14] *See generally* DOUGLAS G. BAIRD ET AL., GAME THEORY AND THE LAW 1 (1994) (explaining that game theory studies strategic behavior, which arises when "two or more individuals interact and each individual's decision turns on what that individual expects the others to do"); ERIC RASMUSEN, GAMES AND INFORMATION: AN INTRODUCTION TO GAME THEORY 11 (4th ed. 2007) ("Game theory is concerned with the actions of individuals who are conscious that their actions affect each other"). For examples of this insight in other contexts, *see, e.g.*, Rui J. P. de Figueiredo, Jr. et al., *The New Separation-of-Powers Approach to American Politics*, in THE OXFORD HANDBOOK OF POLITICAL ECONOMY 208 (Donald A. Wittman & Barry R. Weingast eds., 2008) ("The courts also constrain the other players in separation-of-powers games. Because judicial action shapes policy outcomes, Congress, the president, and agencies will anticipate court decisions, and the potential for judicial review will be taken into account during the law-making process."); JOHN C. COFFEE, JR., GATEKEEPERS: THE ROLE OF THE PROFESSIONS AND CORPORATE GOVERNANCE 66 (2006) ("[I]f accounting firms were intent on

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that a director received post-negotiation benefits from the controlling shareholder[15] or that a particular controlling shareholder has a reputation for re-appointing friendly directors to other boards,[16] but we have no principled framework for incorporating these insights into doctrine. This Article fills these gaps.

This Article proceeds in four parts. Part I provides background on controlled companies and independent directors. It briefly describes the conventional marker of independence—that is, the absence of any ongoing or prior relationship with the controller other than as a director. It also summarizes several other factors, such as social norms and reputation, whose impact on director independence has been the subject of some debate. Part I shows that, while controlling shareholders can influence nominally independent directors through negative threats or positive incentives, the contemporary discourse has overwhelmingly focused on threats. Part II presents my empirical findings on the professional ties between nominally independent directors and controlling shareholders. Building on these findings, Part II also presents a taxonomy of controlling shareholders. Part III provides implications for policymakers and the Delaware courts, and Part IV concludes.

Before I proceed, a caveat is in order. While independent boards have become a mandatory part of good governance in practice, debate about the value of independent directors persists in the scholarly literature.[17] This Article does

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maximizing consulting revenues, they should be prepared to acquiesce to the demands of any client in a position to potentially direct consulting business to them.").

[15] For example, in *In re MFW Shareholders Litigation*, the plaintiffs presented evidence that one of the nominally independent directors on MFW's special committee joined the board of another firm controlled by MFW's controlling shareholder, Ronald Perelman, after the freezeout. 67 A.3d at 512.

[16] For example, in *In re Ezcorp Inc. Consulting Agreement Derivative Litigation*, the plaintiffs presented evidence that EZCORP's controlling shareholder, Phillip Ean Cohen, had in the past invited EZCORP's nominally independent directors to join the boards of EZCORP's affiliates. No. 9962, 2016 WL 301245, at *4 (Del. Ch. Jan. 25, 2016). The plaintiffs also offered evidence that Cohen "clean[ed] house" by firing those directors after they displeased him. *Id.* at *6.

[17] *Compare* 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 (2010) (providing an account of independent directors as "an essential part of a new corporate governance paradigm" oriented toward shareholder wealth maximization), *and* Usha Rodrigues, *supra* note 5, at 486 (arguing that independent directors have value "in the specific situations where a conflict exists between the interests of management and those of the shareholder"), *with* STEPHEN M. BAINBRIDGE, CORPORATE GOVERNANCE AFTER THE FINANCIAL CRISIS 101–02 (2011) (observing that "the empirical evidence on the merits of board independence is mixed" and arguing that "[b]y establishing a highly restrictive definition of director independence and mandating that such directors dominate both the board and its required committees, the [stock exchange listing standards] fail to take into account the diversity and variance among firms"), *and* Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231, 247–48 (2002) (concluding that the evidence suggests that increased board independence does not lead to better firm performance).

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not enter that debate. My critique of directors' independence-in-fact is not meant to suggest that genuinely independent directors are an unalloyed good. Rather, my objective is to show that so long as independent directors continue to play an important role in monitoring controlling shareholders, we need to have a fuller account of their incentives.

I. INDEPENDENT DIRECTORS IN CONTROLLED COMPANIES: THE STANDARD ACCOUNT

The focus of this Article is on American companies with a controlling shareholder. While firms in the United States have historically been characterized by a dispersed ownership structure, controlled companies—such as Google, Facebook, and 21st Century Fox—are becoming an important part of the modern U.S. corporate landscape.[18] According to a 2014 study by the law firm Davis Polk & Wardwell LLP, 54 of the 100 largest initial public offerings between September 2011 and October 2013 were of companies with one shareholder holding more than 50 percent of the voting power.[19] As of 2015, seven percent of companies in the S&P 1500 index have one shareholder or group holding more than 30 percent of the company's voting shares.[20]

This Part explains the role of independent directors in the governance of controlled companies, laying the groundwork for the empirical analysis in Part II. In broad strokes, I show that courts turned to independent directors as the best available protection against private benefits of control—benefits obtained by diverting value from the company and its other investors. I then unpack the concept of "independence" in the context of controlled companies, exploring both the conventional marker of independence and other prominent views.

A. Independent Directors as Monitors

Controlled companies pose different governance challenges than do widely-held companies.[21] The agency problem facing widely-held corporations arises

[18] *See, e.g.*, Bebchuk & Hamdani, *Independent Directors and Controlling Shareholders*, *supra* note 6, at 1279 (stating that "[a]s of December 31, 2016, there were 379 Russell 3000 companies with a shareholder holding more than 30% of the company's voting shares, and 220 of these companies had one shareholder holding more than 50% of such shares").

[19] Davis Polk & Wardwell LLP, Corporate Governance Practices in U.S. Initial Public Offerings 3 (2014), *available at* https://www.davispolk.com/files/ControlledCompanySurvey.pdf.

[20] Edward Kamonjoh, Controlled Companies in the Standard & Poor's 1500: A Follow-up Review of Performance & Risk 15 (2016), *available at* https://irrcinstitute.org/wp-content/uploads/2016/03/Controlled-Companies-IRRCI-2015-FINAL-3-16-16.pdf.

[21] For an in-depth comparison of the nature of the agency problem in controlled and widely-held firms, see Lucian A. Bebchuk & Assaf Hamdani, *The Elusive Quest for Global Governance Standards*, 157 U. PA. L. REV. 1263, 1281–82 (2009).

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from the separation of ownership and control, which produces the potential for opportunism by corporate officers.[22] Because these officers are "managers of other people's money,"[23] they lack the incentive to look after the money with the same care as they would with their own money. In widely-held companies, therefore, governance devices—most notably the board of directors—monitor corporate officers.

At controlled companies, the controlling shareholder has the ability and incentive to police management effectively because of its large equity stake.[24] But the controller can also use its voting clout to self deal and extract private benefits of control.[25] Controllers can, for example, cause the controlled company to enter into transactions on terms that favor them, such as compensation arrangements that overpay them. They can also acquire equity at below-market prices from either the firm or other shareholders in a freezeout transaction. Governance devices at controlled companies, therefore, protect the public shareholders vis-à-vis the controlling shareholder.

In the United States, the traditional approach for constraining the controller's ability to extract private benefits is to encourage board processes that give a strong hand to independent directors.[26] To be clear, "independence"

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[22] *See id.* (arguing that, in widely-held firms, "the fundamental concern that governance arrangements need to address is management's potential to behave opportunistically at the expense of shareholders"). Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 312–13 (1976) (arguing that the separation between ownership and control creates incentives for managers to engage in self-interested behavior that reduces the firm's value).

[23] In *The Wealth of Nations*, Adam Smith argued that "managers of other people's money" would never watch over this money with the "same anxious vigilance with which the partners in a private copartnery frequently watch over their own." 2 ADAM SMITH, THE WEALTH OF NATIONS 229 (J.M. Dent & Sons 1963) (1776).

[24] *See* Bebchuk & Hamdani, *The Elusive Quest for Global Governance Standards*, *supra* note 21, at 1281 (arguing that, in controlled firms, "controlling shareholders commonly have both the effective means to monitor management and the incentives to do so"); Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. REV. 1641, 1651 (2006) ("Because she holds a large equity stake, a controlling shareholder is more likely to have the incentive either to monitor managers effectively or to manage the company itself and, because of proximity and lower information costs, may be able to catch problems earlier.").

[25] *See In re* Ezcorp Inc. Consulting Agreement Derivative Litig., No. CV 9962-VCL, 2016 WL 301245, at *11 (Del. Ch. Jan. 25, 2016) ("A controlling stockholder occupies a uniquely advantageous position for extracting differential benefits from the corporation at the expense of minority stockholders."). For a review of different methods of extracting private benefits of control, see Ronald J. Gilson & Jeffery N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785, 787 (2003), which identifies three methods: taking from the firm's ongoing earnings, selling control, and freezing out the minority shareholders.

[26] *See In re* MFW S'holders Litig., 67 A.3d 496, 529–30 (Del. Ch. 2013) ("The premise that independent directors with the right incentives can play an effective role on behalf of minority investors is one shared by respected scholars sincerely concerned with protecting minority investors from unfair treatment by controlling stockholders."). But some scholars have voiced

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is measured in different ways depending on the conflict at hand.[27] In the special litigation committee context, for example, where independent directors must evaluate the merits of a lawsuit against the company's officers or fellow directors, "independence" is tested as independence from the interested officers or directors.[28] In the context of a transaction between a controller and the controlled company, "independence" means independent from the controller.[29]

Delaware courts, in particular, have strengthened the appeal of independent directors by giving credit to conflicted transactions that were vetted and approved by a special committee comprised of independent directors. Under Delaware law, controlling shareholders are normally required to prove the intrinsic fairness of their transactions with the companies they control.[30] If, however, the interested transaction was negotiated and approved by an independent special committee, the burden of proving the deal's fairness shifts to the plaintiffs.[31] Recently, in 2014, the Delaware Supreme Court added a new doctrinal twist. In *Kahn v. M&F Worldwide Corp.*, the court held that a freezeout merger initiated by a controlling shareholder that is conditioned on approval by both an independent special committee and a majority-of-the-minority shareholder vote should be reviewed under the highly deferential business judgement standard.[32] The court reasoned that this deal structure would afford

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concerns that independent directors, as they are currently defined, will inevitably be conflicted in representing the minority's interests. For recent examples of this literature, see, for instance, Bebchuk & Hamdani, *Independent Directors and Controlling Shareholders*, *supra* note 6, *and* María Gutiérrez & Maribel Sáez, *Deconstructing Independent Directors*, 13 J. CORP. L. STUD. 63 (2013).

[27] For a careful and extensive discussion of how Delaware's approach to "independence" varies with context, see generally Rodrigues, *supra* note 5, at 464–84.

[28] *See* James D. Cox & Donald E. Schwartz, *The Business Judgment Rule in the Context of Termination of Derivative Suits by Independent Committees*, 61 N.C. L. REV. 541, 542–43 (1983) (describing independence as "judged by objective evidence regarding the [special litigation] committee members' relationship to the defendants and the misconduct underlying the suit").

[29] *See* Strine, *supra* note 6, at 507 (asking "[d]oes the average independent director have sufficient integrity, information, and motivation to resist overreaching by a majority stockholder?").

[30] Kahn v. M & F Worldwide Corp., 88 A.3d 635, 642 (Del. 2014).

[31] *Id.* Until recently, it was unclear whether Delaware courts would give more credit to independent shareholder approval as a cleansing device outside of the freezeout context. Some earlier opinions had applied the business judgment rule to non-merger transactions approved by a special committee of independent directors, *see* Friedman v. Dolan, No. CV 9425–VCN, 2015 WL 4040806, at *6 (Del. Ch. June 30, 2015) (controller compensation); *In re* Tyson Foods, Inc. S'holders Litig., 919 A.2d 563, 587 (Del. Ch. 2007) (consulting agreement with controller), but more recent decisions generally endorse the view that the same standard of judicial review should apply to the different mechanisms by which controllers can extract private benefits of control. *See, e.g.*, *In re* Ezcorp Inc. Consulting Agreement Derivative Litig., No. CV 9962-VCL, 2016 WL 301245, at *20–30 (Del. Ch. Jan. 25, 2016) (advisory services agreements with entities affiliated with controller); In re Martha Stewart Living Omnimedia, Inc. Stockholder Litigation, No. 11202–VCS, 2017 WL 3568089, at *18 (Del. Ch. Aug. 18, 2017) (one-sided controlling shareholder transaction involving allegations of disparate consideration).

[32] M & F Worldwide, 88 A.3d at 644.

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minority shareholders the same robust protections that are built into an arms-length merger process, so the same standard of review should apply.[33]

Delaware courts thus place great faith in the ability of independent directors to bargain meaningfully with the controlling shareholder. Whether ostensibly independent directors can serve this role depends on what exactly constitutes "independence." I now turn to this question.

B. Who is Independent?

According to the conventional understanding, independent directors are directors without substantial prior or ongoing professional or personal connections to the controlling shareholder.[34] This is the marker of "independence" that the Delaware courts have mostly focused on.[35] Of course, the absence of ties to the controller does not guarantee independence in fact. A broad scholarly debate has emerged about other mechanisms that might influence directors' ability to be objective, including the controlling shareholder's power over director retention and termination, psychological or norm-based constraints, and reputational penalties.

1. Past and ongoing relationships

Delaware law frames the independence inquiry as a simple question: whether "through personal or other relationships the directors are beholden to the controlling person."[36] Although seemingly straightforward, Delaware's conception of disqualifying relationships is in fact highly contextual, deliberately infused with an air of "I know it when I see it" mushiness.[37] Still, broad patterns

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[33] *See id.* (explaining that "where the controller irrevocably and publicly disables itself from using its control to dictate the outcome of the negotiations and the shareholder vote [by employing both procedural protections], the controlled merger then acquires the shareholder-protective characteristics of third-party, arm's-length mergers, which are reviewed under the business judgment standard").

[34] *See, e.g.*, Bebchuk & Hamdani, *Independent Directors and Controlling Shareholders*, *supra* note 6, at 1274 (defining independent directors as "directors who have no ties to the controller or the company other than their service on the board"); *cf.* Rodrigues, *supra* note 5, at 453 ("The conventional corporate governance understanding of 'independence' translates roughly as 'lack of ties to the corporation.'").

[35] Usha Rodrigues has observed that, under Delaware's approach, "the independence of directors is evaluated not just in terms of their lack of ties with the acquirer, but also in terms of their behavior." Rodrigues, *supra* note 5, at 478.

[36] Aronson v. Lewis, 473 A.2d 805, 815 (Del. 1984).

[37] *See In re* Oracle Corp. Derivative Litig., 824 A.2d 917, 941 (Del. Ch. 2003) (explaining that "[b]y taking into account all circumstances, the Delaware approach undoubtedly results in some level of indeterminacy, but with the compensating benefit that independence determinations are tailored to the precise situation at issue"); *What's Wrong with Executive Compensation*, HARV. BUS. REV., Jan. 2003, at 68 (quoting former Chief Justice of the Delaware Supreme Court, E. Norman Veasey, as saying that "[w]e can't set down rules for independence

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emerge.

For example, the mere fact that the controlling shareholder elected a director to the board is insufficient to raise doubts about the director's independence.[38] As the Delaware Supreme Court wryly explained in *Aronson v. Lewis*, "[t]hat is the usual way a person becomes a corporate director."[39] Friendship or social ties are treated much in the same way. Mere allegations that "directors are friendly with [or] travel in the same social circles" as the controller are not usually enough to taint a director's independence.[40] An extremely "close" relationship, such as a friendship that lasted for more than fifty years, could however be disqualifying.[41]

Familial relationships, on the other hand, will normally discredit a director's independence. In *Mizel v. Connelly*, for instance, the Delaware Chancery Court did not believe that a director could impartially consider a lawsuit adverse to his grandfather's interests, calling the grandfather-grandson relationship one of "great consequence."[42] But courts have not treated family ties with perfect consistency either. In *Seibert v. Harper & Row, Publishers, Inc.*, the Chancery Court determined that a director was independent even though the interested party was his cousin.[43]

Many cases involve business dealings, such as fees from consulting or legal services. Delaware judges have recognized that when a controlling shareholder has the power to decide whether a director "continues to receive a benefit," such as fees from professional services, there is reason to doubt the director's impartiality.[44] But this taint only exists if the benefit is material to the director given his actual economic circumstances.[45] Thus, in *In re MFW Shareholders*

. . . . But we didn't just fall off the turnip truck, you know. We can tell whether somebody is acting independently or not").

[38] Aronson, 473 A.2d at 816.

[39] *Id.*

[40] *In re* Martha Stewart Living Omnimedia, Inc. Stockholder Litig., No. CV 11202-VCS, 2017 WL 3568089, at *19 (Del. Ch. Aug. 18, 2017).

[41] Del. Cty. Emps. Ret. Fund v. Sanchez, 124 A.3d 1017, 1023 (Del. 2015) (concluding that a fifty-year friendship with the interested party creates a reasonable doubt as to a director's independence); *see also* Sandys v. Pincus, 152 A.3d 124, 130 (Del. 2016) (noting that co-ownership of the private airplane with the controlling shareholder "signaled an extremely close, personal bond" that provides reason to doubt the director's independence).

[42] No. CIV. A. 16638, 1999 WL 550369, at *4 (Del. Ch. July 22, 1999).

[43] No. CIV. A. 6639, 1984 WL 21874, at *3 (Del. Ch. Dec. 5, 1984).

[44] Orman v. Cullman, 794 A.2d 5, 25 n.50 (Del. Ch. 2002).

[45] *See id.* ("The key issue is not simply . . . whether another person or entity has the ability to take some benefit away from a particular director, but whether the possibility of gaining some benefit or the fear of losing a benefit is likely to be of such importance to that director that it is reasonable for the Court to question whether valid business judgment or selfish considerations animated that director's vote on the challenged transaction."); *In re* MFW S'holders Litig., 67 A.3d 496, 509–10 (Del. Ch. 2013) (noting that "[c]onsistent with the overarching requirement that any disqualifying tie be material, the simple fact that there are some financial ties between the interested party and the director is not disqualifying," and "it is necessary to look to the

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Litigation, the Chancery Court found that the receipt of $100,000 in consulting fees did not call into question a director's independence, because she was a wealthy "banking bigshot."[46] In contrast, in *In re The Limited, Inc.*, the Chancery Court concluded that annual consulting fees of $150,000 compromised the independence of a director who worked as a university official.[47] Given the university official's modest existing wealth, it was reasonable to infer that he "was 'beholden' to [the company's CEO] because of a desire to continue with those consulting services."[48]

To be sure, controlling shareholders can have the power to benefit a director in the future even if they have had no relationships with each other in the past. Consider, for example, a director who is a partner in a law firm that has never provided services to the controller. The controller or the companies under its control can still be the director's future clients. Delaware courts, however, have been reluctant to conclude that the prospect of future benefits, without more, can compromise independence. In *In re MFW Shareholders Litigation*, one member of the special committee that negotiated and approved the freezeout transaction, Viet Dinh, subsequently joined the board of another company controlled by the same controller, but the court nevertheless found that Dinh was independent.[49] Then-Chancellor Strine explained:

> If Dinh's [subsequent] directorship . . . were to be relevant to his independence at the time of the MFW transaction, the plaintiffs would need to provide record evidence creating a triable issue of fact that he was offered the directorship *before* the special committee approved the deal, or that it had at least been discussed with him before this time.[50]

Plainly, what then-Chancellor Strine is looking for is evidence that the second directorship was used as a bribe. Applying this standard, in *In re Orchard Enterprises, Inc. Stockholder Litigation*, the Chancery Court found a director potentially lacking in independence because he solicited a post-deal consulting engagement with the controlled company *during* the freezeout negotiations.[51]

In sum, Delaware's approach to independence is unquestionably nuanced, probing deeply into relationships to determine if the director is capable of truly independent judgment. But it is also starkly lopsided. It concentrates on negative incentives, such as the prospect of retribution from the controller or the prospect of losing a lucrative stream of income, while all but ignoring

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financial circumstances of the director in question to determine materiality").

[46] 67 A.3d at 511–12 n.54.

[47] No. CIV.A. 17148-NC, 2002 WL 537692, at *6 (Del. Ch. Mar. 27, 2002).

[48] *Id.*; *see also In re* Ply Gem Indus., Inc. S'holders Litig., No. CIV.A. 15779-NC, 2001 WL 755133, at *8 (Del. Ch. June 26, 2001) (finding that a director's receipt of $1 million in legal fees raised a reasonable doubt as to his independence where the facts showed that "his was a small law firm").

[49] 67 A.3d at 513, *aff'd sub nom.* Kahn v. M & F Worldwide Corp., 88 A.3d 635, 648 (Del. 2014).

[50] *Id.* at 513 n.65.

[51] 88 A.3d 1, 21, 26 (Del. Ch. 2014).

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positive ones, such as the prospect of reward.

2. The controller's power over director retention and termination

In the scholarly literature, the absence of disqualifying ties to the controlling shareholder is just the first criterion. Other mechanisms can also create incentives for director behavior.

Some commentators, for example, argue that controlling shareholders' decisive influence over director re-election and termination can undermine directors' impartiality.[52] It is well known that corporate directorships are coveted. After all, the median annual director compensation of Russell 3000 companies in 2017 is $203,380.[53] In addition to income, there are often lavish perks; for example, General Motors' directors can use a new company car every six months, and yearly after retirement.[54] Board experience can also lead to business contacts and help executives advance in their own careers. Indeed, Steven Boivie and his co-authors find that a board seat improves executives' likelihood of being promoted to CEO and boosts their subsequent pay.[55]

Controlling shareholders possess a formidable weapon to distort the incentives of directors who wish to stay on the board. As Lucian Bebchuk and Assaf Hamdani have observed, "[d]irectors at firms with controlling shareholders—including independent directors—cannot get elected—or reelected once their initial terms end—unless the controlling shareholder supports their candidacies. Nor will they stay in office once the controlling shareholder decides to end their service on the board."[56] To put this point bluntly, directors depend on controllers for their board seats. As a result, they have substantial incentives to go along with the controllers' proposals.

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[52] For an excellent recent article arguing that controlling shareholders' decisive power to appoint and terminate independent directors undermine the effectiveness of those directors' oversight, see Bebchuk & Hamdani, *Independent Directors and Controlling Shareholders*, *supra* note 6. Bebchuk and Jesse Fried have made a similar point in the executive pay context, arguing that the CEO's influence over director nominations prevents directors from bargaining effectively with the CEO over pay. *See* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 25–27 (2004).

[53] EY Center for Board Matters, Corporate Governance by the Numbers 1 (2017), *available at* http://www.ey.com/Publication/vwLUAssets/ey-cgbtn-monthly-print-version-sept-2017/$FILE/ey-cgbtn-monthly-print-version-sept-2017.pdf.

[54] Theo Francis & Joann S. Lublin, *Corporate Directors' Pay Ratchets Higher as Risks Grow*, WALL ST. J., Feb. 24, 2016, https://www.wsj.com/articles/corporate-directors-pay-ratchets-higher-as-risks-grow-1456279452.

[55] *See generally* Steven Boivie et al., *Come Aboard! Exploring the Effects of Directorships in the Executive Labor Market*, 59 ACAD. MGMT. J. 1681 (2016); *see also* Joann S. Lublin, *Grooming Top Executives Includes Outside Board Experience*, WALL ST. J., Mar. 29, 2016, https://www.wsj.com/articles/grooming-top-executives-includes-outside-board-experience-1459243802 (observing that "external directorships have become a key ingredient of executive-development efforts").

[56] Bebchuk & Hamdani, *Independent Directors and Controlling Shareholders*, *supra* note 6, at 1287.

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As a theoretical matter, the controlling shareholder's power to remove an uncooperative director from the board is merely a manifestation of his power to withdraw a benefit that the director is currently getting. As the previous section explained, Delaware decisions have held that a director's independence could be tainted by the fear that the controller would withdraw an ongoing business benefit in retribution.[57] But Delaware courts have firmly refused to hold that a director's independence could be similarly compromised by the fear that the controller would take away the directorship—unless the controller has explicitly threatened to do so.[58] At the same time, Delaware judges worry that the power imbalances could create an inherently coercive environment: that is, "when an 800-pound gorilla[, the controlling shareholder,] wants the rest of the bananas, little chimpanzees, like independent directors and minority stockholders, cannot be expected to stand in the way."[59]

Reconciling these seemingly contradictory positions is a Herculean task. At bottom, the likely answer to the tangle is Chief Justice Strine's statement that the fact "[t]hat a director sits on a controlled company board is not, and cannot of course, be determinative of director independence . . . as that would make the question of independence tautological."[60] Whatever its reality, the claim that directors in controlled companies could be structurally or *per se* biased has been emphatically rejected by the Delaware courts.[61]

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[57] *See supra* notes 44–48 and accompanying text.

[58] *See In re* Dole Food Co., Inc. Stockholder Litig., No. 8703, 2015 WL 5052214, at *28 n.15 (Del. Ch. Aug. 27, 2015) (noting that "controlling stockholder status does not, standing alone, give rise to concern," but "when controllers actually make retributive threats, that fact is evidence of unfair dealing"); Kahn v. Lynch Commc'n Sys. Inc., 638 A.2d 1110, 1114 (Del. 1994) (holding that the special committee's ability to negotiate effectively was compromised by threats from the controlling shareholder); *cf. In re* Ezcorp Inc. Consulting Agreement Derivative Litig., No. CV 9962-VCL, 2016 WL 301245, at *41–42 (Del. Ch. Jan. 25, 2016) (citing retributive behavior by the controlling shareholder as a reason to doubt a director's ability to consider a litigation demand).

[59] Strine, *The Inescapably Empirical Foundation of the Common Law of Corporations*, *supra* note 6, at 509. Recent Delaware decisions, however, have shown less concern with the specter of coercion present in controlling shareholder relationships. *See, e.g.*, *In re* CNX Gas Corp. S'holders Litig., 4 A.3d 397, 413 (Del. Ch. 2010) ("Post–Lynch experience shows that special committees can negotiate effectively with controllers and . . . reject squeeze-out proposals."); *In re* Pure Res., Inc. S'holders Litig., 808 A.2d 421, 445 (Del. Ch. 2002) (describing concerns about the integrity of the special committee process as "premised on a less trusting view of independent directors").

[60] Sandys v. Pincus, 152 A.3d 124, 133 (Del. 2016).

[61] Chief Justice Strine has expressly made this point to explain Delaware courts' reluctance to find that director independence can be compromised by structural realities. *See* Leo E. Strine, Jr., *Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle*, 57 BUS. LAW. 1371, 1378–79 (2002) (describing judges' concern that, if the presumption of independence can be lightly pierced, "in any scenario in which the role of independent directors has been declared most useful—such as the approval of an interested transaction or a takeover fight—the independent directors simply do not exist").

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3. "Boardroom atmosphere" and psychological factors

Another strand of scholarship focuses on social and psychological factors that could subtly undercut independence.[62] Commentators have identified at least three forms of cognitive bias.

First, a director's judgment may be tainted by ingroup bias, the unconscious tendency to "evaluate one's own groups more positively in relation to other groups."[63] As James Cox and Harry Munsinger lamented in their classic article on director bias, "the boards of American corporations continue to be distinguished by their homogeneity."[64] With a median age of 63,[65] directors today are predominantly white males with experiences as CEOs or executive officers of other corporations.[66] Cox and Munsinger explained that the cultural and socioeconomic similarities among directors and managers make them especially prone to ingroup bias.[67] Directors tend to approach their task "with a deep personal understanding of, and respect for, the burdens of management."[68] An executive or former executive, for example, is likely to have formed a belief that management should have the ability to implement their business ideas in the manner that they see fit—that it is even counterproductive for management to spend a great deal of time responding to issues raised by shareholders or the board. As a director, then, the executive or former executive will tend to defer to management even when he has a different view.

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[62] For a classic account of this problem, see James D. Cox and Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 LAW & CONTEMP. PROBS. 83 (1985). For a more recent article arguing that courts have not responded to social and psychological bias in a consistent manner, see Julian Velasco, *Structural Bias and the Need for Substantive Review*, 82 WASH. U. L.Q. 821 (2004). For a skeptical discussion of these factors, see Michael P. Dooley & E. Norman Veasey, *The Role of the Board in Derivative Litigation: Delaware Law and the Current ALI Proposals Compared*, 44 BUS. LAW. 503, 534–35 (1989) (arguing that the structural bias argument is unconvincing because it presumes that independent directors are more willing to risk financial income and reputational harm than question insider misbehavior).

[63] Christopher L. Aberson et al., *Ingroup Bias and Self-Esteem: A Meta-Analysis*, 4 PERSONALITY & SOC. PSYCHOL. REV. 157, 157 (2000).

[64] Cox & Munsinger, *supra* note 62, at 105.

[65] *See* Jon Lukomnik, *Board Refreshment Trends at S&P 1500 Firms*, HARV. L. SCH. FORUM ON CORPORATE GOVERNANCE & FIN. REGULATION (Feb. 9 2017), https://corpgov.law.harvard.edu/2017/02/09/board-refreshment-trends-at-sp-1500-firms.

[66] *See id.* (reporting that women hold 17.8% of S&P 1500 board seats and minorities hold just over 10%); Stephen Foley et al., *US board composition: male, stale and frail?*, FIN. TIMES, Aug. 15, 2016, https://ig.ft.com/sites/us-board-diversity (finding that U.S. boards are "maler, staler and frailer" than European boards); Joann S. Lublin, *This Is Why Corporate Boards Aren't More Diverse*, WALL ST. J., Apr 15, 2014, https://blogs.wsj.com/atwork/2014/04/15/this-is-why-corporate-boards-arent-more-diverse (reporting that around 67% of male directors, 65% of white directors, 54% of minority directors, and 45% of female directors have experience as CEOs or chief financial officers).

[67] Cox & Munsinger, *supra* note 62, at 105–07.

[68] *Id.*

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Second, it is often in a director's self-interest to play by the rule "there but for the grace of God go I."[69] Directors may show favoritism for other directors even when the decision does not offer a concrete, personal benefit because this type of behavior benefits directors indirectly as a class.[70] This self-interest extends to decisions that favor corporate officers as well as other directors.[71] Executives serving as directors have an incentive to favor management in order to encourage similar treatment on their own boards. Consider, for example, decisions about executive compensation. By approving generous pay arrangements for other corporate officers, executives contribute to a business environment that is conducive to better pay for themselves.

Finally, bias might result from what Warren Buffett calls the "boardroom atmosphere."[72] Except perhaps in times of crisis, directors are expected to be "team players" who "get along" with each other and with the firm's executives.[73] In the boardroom, some things are just not done. Buffett offers this example: it is "almost impossible," he explains, for a director "to question a proposed acquisition that has been endorsed by the CEO, particularly when his inside staff and outside advisors are present and unanimously support his decision. (They wouldn't be in the room if they didn't.)."[74] In this form, bias exists because unspoken social norms, which prize collegiality and consent over conflict, dictate the actual course of behavior in board meetings.

4. Risk to reputation

Finally, reputation plays an important role in directors' incentive calculus. Corporate directors have been described as the "most reputationally sensitive people in the world."[75] On the traditional account, reputational concerns enhance independence in fact. As Eugene Fama and Michael Jensen have argued, independent directors' desire to join other boards should make them tougher monitors of management in order to "develop reputations as experts in decision control."[76] A reputation for director talent, the argument goes, will

[69] *See* Zapata Corp. v. Maldonado, 430 A.2d 779, 787 (Del. 1981).

[70] *See* Velasco, *supra* note 62, at 856–57 (describing one paradigm of structural bias as an "implicit conspiracy" that causes independent directors to show favoritism for management and other directors because they will indirectly benefit from promoting those groups' interests).

[71] *See id.*

[72] Letter from Warren Buffett, Chairman, Berkshire Hathaway Inc., to Shareholders 16 (Feb. 21, 2003), http://www.berkshirehathaway.com/letters/2002pdf.pdf.

[73] JONATHAN R. MACEY, CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN 61–62 (2008); *accord* Cox & Munsinger, *supra* note 62, at 91 (noting that boardroom norms disfavor "[i]ndividuals who are quarrelsome, disagreeable, or rigid").

[74] Letter from Warren Buffett, *supra* note 72, at 17.

[75] David A. Skeel, Jr., *Shaming in Corporate Law*, 149 U. PA. L. REV. 1811, 1812 (2001) (quoting corporate governance expert Nell Minow).

[76] Eugene F. Fama & Michael Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 315 (1983).

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translate into more directorship opportunities. Association with a corporate scandal can also be embarrassing to directors and disrupt other aspects of their careers, including their full-time jobs.[77] Presumably most directors would not be willing to sacrifice the value of their human capital in order to appease a controlling shareholder.[78]

Bebchuk and Jesse Fried have suggested an alternative account. They contend that reputational concerns only deter independent directors from severe malfeasance or actions that starkly empower the management at the expense of other shareholders, such as an egregious pay arrangement.[79] In the more common situation involving underperformance, which is often the result of a complicated set of events, there is little or no reputational penalty.[80] In addition, although board members vote individually on corporate decisions, their actions are recorded as a group, making it hard for public shareholders to reward or discipline a particular director for his contributions.[81] Consistent with this observation, studies have found that proxy advisory firms frequently issue

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[77] For example, following the Enron scandal, several of Enron's former directors resigned from their directorships at other corporations. *See* Brooke A. Masters, *Enron's Quiet Outages Uncharged in the Fraud, Directors Settled, Resigned, Lay Low*, WASH. POST, June 2, 2006, at D1; MACEY, *supra* note 73, at 208 (noting that the careers of Enron's former directors "virtually ended when their weak oversight of Enron was revealed"). But other commentators have argued that directors rarely suffered labor market consequences, even when they failed to prevent egregious conduct. For instance, Steven Davidoff Solomon has observed that "many of the directors of Lehman and Bear Stearns continue to serve on other boards, and one Lehman director, Jerry A. Grundhofer, has apparently been so chastened about the liability issue surrounding large banks that he is serving on the Citigroup board." Steven Davidoff Solomon, *Despite Worries, Serving at the Top Carries Little Risk*, N.Y. TIMES: DEALBOOK (June 7, 2011, 5:58 PM), https://dealbook.nytimes.com/2011/06/07/despite-worries-serving-at-the-top-carries-little-risk.

[78] *See* Dooley & Veasey, *supra* note 62, at 534–35 (expressing skepticism that "outside directors generally are more willing to risk reputation and future income than they are to risk the social embarrassment of calling a colleague to account"); *In re* MFW S'holders Litig., 67 A.3d 496, 528–29 (Del. Ch. 2013) (describing the Delaware Supreme Court's belief that "directors have a more self-protective interest in retaining their reputations as faithful, diligent fiduciaries") (citing *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040, 1048 (Del. 2004)).

[79] *See* BEBCHUK & FRIED, *supra* note 52, at 35–36.

[80] *See id.* Ronald Gilson and Reinier Kraakman have also expressed this skepticism, calling the idea that the market will punish underperforming directors a "myth" akin to "directorial noblesse." Ronald Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 875 (1991).

[81] *See* Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 771 (2002) (arguing that "the signal provided by independent directorships is likely to be quite noisy"). A recent study by Reena Aggarwal and her co-authors found that directors who receive low shareholder support in elections—which can be seen as a director-specific assessment—do suffer negative consequences, including a reduction in directorships at other firms. *See* Reena Aggarwal et al., *The Power of Shareholder Votes: Evidence from Uncontested Director Elections* 27 (Robert H. Smith School Research Paper No. RHS 2609532, 2017), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2609532.

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conflicting recommendations for a director who is up for election in multiple firms: proxy advisors would recommend that shareholders of firm A withhold their votes for the director because of poor performance but simultaneously recommend that shareholders in firm B vote for the director.[82]

Bebchuk and Fried also question whether a reputation for tough monitoring is a plus or minus for a director's prospects of securing directorships in other companies.[83] They argue that because CEOs heavily influence—and controlling shareholders control outright—director selection, a reputation as a director who does not rock the boat will likely be more useful in obtaining additional board seats.[84] While this view has some intuitive appeal, the empirical evidence is decidedly mixed.[85] On the one hand, there is evidence that outside directors who take shareholder-friendly actions are rewarded. Studies have found, for example, that independent directors who opted out of state anti-takeover laws—laws that entrench management—observe an increase in the number of future board opportunities;[86] directors who fail to implement shareholder proposals are more likely to lose board seats at other firms;[87] and outside directors at highly-performing firms are more likely to gain additional directorships, at least under certain empirical models.[88] On the other hand, several papers have concluded that directors suffer only trivial labor market penalties for poor monitoring, even when a crisis erupts under their watch. Researchers have observed, for instance, that outside directors of firms that engaged in option backdating or that substantially underperformed their peers were no less successful than other directors at gaining future board seats.[89]

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[82] *See* Yonca Ertimur et al., *Reputation penalties for poor monitoring of executive pay: Evidence from option backdating*, 104 J. FIN. ECON. 118, 136 & n.30 (2012) (finding no instances where the proxy adviser Institutional Shareholder Services recommended withholding votes from a director at one firm because of the director's association with a different firm that was involved in option backdating, and reporting that ISS does not automatically carry over negative recommendations to a director's other boards except in the most egregious cases); Stephen Choi et al., *Director Elections and the Role of Proxy Advisors*, 82 S. CAL. L. REV. 649, 686–87(2009) (finding no evidence that proxy advisers considered a director's performance on one board in issuing a recommendation for a different board).

[83] *See* BEBCHUK & FRIED, *supra* note 52, at 36.

[84] *See id.*

[85] For a summary of the empirical evidence, see Steven M. Davidoff et al., *Do outside Directors Face Labor Market Consequences—a Natural Experiment from the Financial Crisis*, 4 HARV. BUS. L. REV. 53, 61–63 (2014).

[86] *See* Jeffrey L. Coles & Chun-Keung Hoi, *New Evidence on the Market for Directors: Board Membership and Pennsylvania Senate*, 58 J. FIN. 197, 229 (2003).

[87] *See* Yonca Ertimur et al., *Board of directors' responsiveness to shareholders: Evidence from shareholder proposals*, 16 J. CORP. FIN. 53, 67 (2010).

[88] *See, e.g.*, David Yermack, *Remuneration, Retention and Reputation Incentives for Outside Directors*, 59 J. FIN. 2281, 2302 (2004) (finding statistically significant results only when using a lagged performance variable and stock returns).

[89] *See, e.g.*, Davidoff et al., *supra* note 85, at 72 (finding no significant correlation between the performance of one firm associated with the outside director and the director's ability to

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In this Part, I showed that "independence" in the standard Delawarean parlance reduces roughly to a lack of substantial past or ongoing connections to the controlling shareholder. The inquiry recognizes and responds to the concern that negative incentives may lead directors to favor controllers: the worry is that directors with lucrative ties to the controlling shareholder might be influenced by the fact that the controller can cut off those ties. Yet it all but ignores the fact that positive incentives—the prospect of future patronage from the controlling shareholder—can provide the same spur to appease. Attempts by corporate governance reformers to refine the markers of independence are similarly lopsided, identifying mostly sticks (the *loss* of a directorship, the risk of *harm* to reputation) but no carrots.

Is the prospect of future patronage substantial enough to bear on the average independent director's ability to be impartial? To put the point more bluntly, is this conflict more than a mere theoretical danger? The answer turns in large part on another empirical question: do controlling shareholders reward cooperative directors? I now turn to this question.

II. Independent Director Realities

This Part presents my empirical results. After describing the data sources and methodology in Part II.A, I show in Part II.B that controlling shareholders re-appoint nominally independent directors to executive positions and directorships at other firms that they control. (In what follows, I will refer to these ties simply as "professional" ties). My results suggest that many nominally independent directors received opportunities from the controlling shareholder after acting to favor the controlling shareholder's interests.

In Part II.C, I argue that the monolithic conception of controlling shareholders that pervades the jurisprudence and literature is too coarse to capture the complex ways in which controlling shareholders can undermine director independence. Building off of my empirical results, I offer a more nuanced taxonomy that theorizes how much and what kind of pressure a controlling shareholder can exert. The taxonomy divides controllers along two dimensions: the base of controlled entities and the concentration of decision-

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obtain other board seats); Ertimur et al., *supra* note 82, at 137 (finding that association with a firm involved with option backdating did not significantly affect other directorship opportunities); Christopher S. Armstrong et al., *Inelastic Labor Markets and Directors' Reputational Incentives* (Working Paper 2017), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2991624 3–7 (finding that directors with poor stock returns over their tenure are more likely to lose their board seat, but they are also more likely to gain a seat on another, and often better, board).

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making authority. A given controller's power to incentivize director behavior depends on its mix of these attributes.

A. Data Sources and Methodology

I constructed a new database of nominally independent directors who vetted recent freezeouts of Delaware targets. I searched the Thomson Reuters Corporation's SDC Platinum database for all completed transactions that were coded as "acquisitions of remaining interest" or "going private"; were announced between January 1, 2000, and December 31, 2014; and in which the target was a Delaware corporation and the acquirer (or the ultimate parent of the acquirer) was a U.S. entity. I eliminated transactions where the acquirer held less than 35 percent of the target's voting shares when the transaction was announced (Delaware courts have deemed a shareholder with as little as a 35 percent holding to be a controlling shareholder[90]), as well as transactions that were actually one step of a two-step acquisition by an outside third party (because whether such transactions are "true" freezeouts is a gray area[91]). I also excluded transactions where the acquirer held 90 percent or more of the outstanding shares because such transactions can be executed as short-form mergers, which are treated differently by Delaware law.[92] Finally, I eliminated transactions where the target did not establish a special committee of independent directors to assess the offer. The final data includes 88 transactions.

For each deal, I examined SEC filings to collect information on the special committee formed to review and negotiate the terms. The resulting data includes 222 nominally independent directors. I gathered information about board directorships and employment history for each director from the BoardEx database, news reports, and SEC filings of companies associated with the director. Using this information, I hand coded relational links among directors and controlling shareholders. With one exception, I identified instances where the nominally independent director either served on the board

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[90] *See, e.g.*, *In re* Cysive Inc. S'holders Litig., 836 A.2d 531, 535, 551–53 (Del. Ch. 2003). In fact, the Delaware Chancery Court recently found it reasonably conceivable that Elon Musk, a 22.1% stockholder of Tesla Motors, Inc., was a controlling shareholder in light of "his domination of the Board . . . against the backdrop of his extraordinary influence within the Company generally, the Board level conflicts that diminished the Board's resistance to Musk's influence, and the Company's and Musk's own acknowledgements of his outsized influence." *See* In re Tesla Motors, Inc. Stockholder Litig., No. CV 12711-VCS, 2018 WL 1560293, at *19 (Del. Ch. Mar. 28, 2018).

[91] *See* Victor Brudney & Marvin A. Chirelstein, 87 YALE L.J. 1354, 1360 (1978) (explaining that "[a]lthough the tag-end merger appears to be an example of self-dealing by the majority stockholders, it is only superficially of that class").

[92] *See* Del. Code Ann. tit. 8, § 253; *see generally* Glassman v. Unocal Exploration Corp., 777 A.2d 242 (Del. 2001).

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of another company controlled or dominated by the controlling shareholder or as an executive of such a company. The exception is Ronald Joseph, who was a director of Great American Financial Resources and whose son served as a director of another company controlled by Great American's controlling shareholder. I classified Joseph as having a professional tie to the controlling shareholder, but the major findings reported in this section remain unchanged if I exclude him from the analysis.

To be clear, I looked at connections to the ultimate controlling person or entity, which is not necessarily the acquirer.[93] While my data includes 88 deals, it includes only 77 unique ultimate controlling shareholders because several freezeouts were executed by the same controlling entity. (For example, the Cox family completed a freezeout of both Cox Communications and Cox Radio during the sample time period). In four cases, I classified a person or entity as the ultimate controlling shareholder even though it held less than 35 percent of the acquirer's voting shares at the time of the freezeout, because the acquirer or Delaware courts treated it as the ultimate controlling shareholder: Leslie Wexner (The Limited's freezeout of Intimate Brands)[94]; John Malone (Liberty Media International's freezeout of UnitedGlobalCom)[95]; Bennett LeBow (Vector

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[93] Both Delaware courts and the United States Supreme Court have looked beyond the formal corporate entities behind the transaction to the persons or entities "who wiel[d] control in substance." *In re* Ezcorp Inc. Consulting Agreement Derivative Litig., No. 9962, 2016 WL 301245, at *18–21 (Del. Ch. Jan. 25, 2016) (holding that a person could owe fiduciary duties to minority shareholders when he controlled a corporation through intervening entities); *accord* Southern Pac. Co. v. Bogert, 250 U.S. 483, 491–92 (1919) (holding that a firm that exercised control through a subsidiary entity could owe fiduciary duties to the controlled company's minority shareholders).

[94] *See In re* The Limited, Inc. S'holders Litig., No. CIV.A. 17148-NC, 2002 WL 537692, at *1, *5 & n.33 (Del. Ch. Mar. 27, 2002) (suggesting that Leslie Wexner controlled The Limited's board because of his 25% holding coupled with "his position, as chairman, chief executive officer, and director"). At the time of The Limited's freezeout of Intimate Brands, Wexner and the entities subject to his fiduciary duties as trustee held approximately 24% of The Limited's outstanding shares. *See* The Limited, Inc., Amendment No. 26 (Schedule 13D/A), at 12–13 (Nov. 3, 2004).

[95] *See* Liberty Media Int'l, Inc., Information Statement (Exhibit 99.1 to Form 10-12G/A) (May 28, 2004), *available at* https://www.sec.gov/Archives/edgar/data/1284698/000104746904018909/a2132563zex-99_1.htm ("By virtue of Mr. Malone's [29%] voting power in our company as well as his positions as our Chairman of the Board, President and Chief Executive Officer, Mr. Malone may be deemed to control our operations."). At the time of Liberty Media International's freezeout of UnitedGlobalCom, John Malone controlled approximately 33% of Liberty Media International's voting power. *See* Liberty Media Int'l, Inc., Amendment No. 2 (Schedule 13D/A), at 6 (Jan. 19, 2005).

Electronic copy available at: https://ssrn.com/abstract=3335195

Group's freezeout of New Valley)[96]; and the Lindner family (American Financial Group's freezeout of Great American Financial Resources).[97]

Finally, using SEC filings, I classified ultimate controlling shareholders along two dimensions. First, I categorized each controlling shareholder as either an individual person, a family group, an investment manager,[98] or a widely-held corporation. Second, among controlling shareholders that are persons or family groups, I identified those that have controlled more than one publicly-traded company between 1993 and 2017. I excluded controlling shareholders that are investment managers from this classification because investment managers typically acquire attributes of control through large but non-controlling stakes (the hedge fund model) or by taking companies private (the private equity model).[99] The purpose of this second classification is to identify controlling shareholders who maintain operational control of a portfolio of companies, and it is well known that private equity firms often function as repeat players in the market for operational control in this way.[100] I also excluded controlling shareholders that are widely-held companies from this second classification because they are, by definition, a part of a family of public companies (at a minimum, the family consists of the widely-held controller and the public subsidiary it froze out).

[96] *See* Vector Grp. Ltd., Definitive Proxy Statement Relating To Merger or Acquisition (Schedule 14A), at 6 (Nov. 7, 2005) (describing Bennett LeBow's "controlling interest in Vector"). At the time of Vector Group's freezeout of New Valley, LeBow held approximately 33.4% of Vector Group's outstanding shares. *See id.* at 4.

[97] *See* Am. Fin. Grp., Annual Report (Form 10-K), at 19 (Mar. 1, 2007) ("[C]ertain members of the Lindner family have the ability to exercise significant influence over AFG's management, including over matters requiring shareholder approval."). At the time of American Financial Group's freezeout of Great American Financial Resources, the Lindner family members held approximately 32.6% of Vector Group's outstanding shares. *See id.*

[98] I drew on John Morley's work for my definition of investment managers. In his article, *The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation*, Morley argues that investment funds are characterized by the separation of funds and managers. *See generally* John Morley, *The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation*, 123 YALE L.J. 1228, 1238–40 (2014). As a practical matter, investment managers can overlap with the other three categories because investment management companies can be controlled by a single person, controlled by a family, or widely held (for instance, the hedge fund ESL Investments, Inc. is controlled by a single person, Edward Lampert). For present purposes, I coded controllers that manage investment funds as investment managers even if they fall under one of the other categories as well to focus on those controllers' status as repeat players in the market for corporate control or influence.

[99] *See* Brian R. Cheffins & John Armour, *The Past, Present, and Future of Shareholder Activism by Hedge Funds*, 37 J. CORP. L. 51, 58–60 (2011) (comparing the business models of hedge funds and private equity firms).

[100] *See, e.g.*, Ronald W. Masulis & Randall S. Thomas, *Does Private Equity Create Wealth? The Effects of Private Equity and Derivatives on Corporate Governance*, 76 U. CHI. L. REV. 219, 222–23 (2009) (explaining that private equity firms typically control their portfolio companies' operations through control of their boards of directors); *In re* Trados Inc. S'holder Litig., 73 A.3d 17, 54 (Del. Ch. 2013) (describing venture capital firms as repeat players).

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There are important limitations to my data, particularly as related to my focus on freezeouts and certain types of relationships. I limited the study to directors who were tasked with reviewing and negotiating freezeout transactions. The freezeout data offers a conservative picture of independence—that is, a vantage point on who is labelled an "independent" director when the stakes are high and litigation is nearly inevitable. So any evidence that directors who are appointed to negotiate freezeouts have other relationships with the controlling shareholders would be particularly suggestive.

Additionally, out of an abundance of caution, I chose to focus exclusively on connections routinely reported in public databases and filings: directorships and senior executive positions in, for the most part, public companies. Controlling shareholders can benefit directors in a myriad of other, less visible ways, including appointing them to senior positions at privately-held companies.[101] I tried to mitigate this concern by studying each director's biography in SEC filings, which sometimes provide information on a director's employment at private firms. However, given these unavoidable data constraints, the full list of controller-independent director business dealings is almost certainly much longer.

B. *Controller-Independent Director Ties*

Table 1 shows the incidence of nominally independent directors who have multiple professional connections to the controlling shareholder. At the highest level, Table 1 shows that 20.3 percent of all directors in the data (45 of 222) have served as a director or a senior executive in at least one other company controlled or dominated by the controlling shareholder, and 2.3 percent (5 of 222) have ties to at least three other companies. This basic finding calls into question the familiar trope that directors who are labelled "independent" have *no* relationship to the controlling shareholder other than their service on the board.[102]

The special committee that approved the 2011 M&F Worldwide deal typifies the kinds of connections in the sample. M&F Worldwide formed a special committee of four nominally independent directors to negotiate and review the offer from MacAndrews & Forbes and its controlling shareholder, Ronald

[101] Other scholars have discussed the limited available data on private firms. *See, e.g.*, Robert J. Jackson, Jr., *Private Equity and Executive Compensation*, 60 UCLA L. REV. 638, 647 (2013); Robert Anderson IV, *The Delaware Trap: An Empirical Analysis of Incorporation Decisions*, 91 S. CAL. L. REV. 657, 661 (2018).

[102] *See* Bebchuk & Hamdani, *Independent Directors and Controlling Shareholders*, *supra* note 6, at 1274 (defining independent directors as "directors who have no ties to the controller or the company other than their service on the board"); Marcel Kahan & Edward Rock, *When the Government is the Controlling Shareholder: Implications for Delaware*, 89 DEL. J. CORP. L. 409, 414 (2011) (describing directors who "work for the controlling shareholder or have other business relationships with the controlling shareholder" as non-independent).

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Table 1. Incidence of independent (special committee) directors with professional ties

	n	At least one other professional tie	At least 3 other professional ties
All special committee directors	222	45 (20.3%)	5 (2.3%)
Directors by controlling shareholder characteristics[1]:			
Single natural person	85	23 (27.1%)	4 (4.7%)
Widely-held company	66	14 (21.2%)	1 (1.5%)
Family group	41	4 (9.8%)	0
Investment manager	32	4 (12.5%)	0
Controlling shareholder controlled multiple public companies and is a[2]:			
Single natural person	50	22 (44.0%)	4 (8.0%)
Family group	14	4 (28.6%)	0

1. Two directors, Charles Crocco Jr. and Viet Dinh, served as special committee members for two freezeouts in the sample. Crocco Jr. was a member of the special committee that negotiated First Banks's freezeout of First Banks America and Anthony Gumbiner's freezeout of the Hallwood Group. Dinh was a member of the special committee that negotiated JDS Capital Management's freezeout of Orchard Enterprises and Ronald Perelman's freezeout of M&F Worldwide. Because these deals involve controlling shareholders with different attributes, Crocco and Dinh are counted twice.
2. For the reasons discussed in Part II.A, widely-held companies and investment manager controllers were not categorized by the number of public companies under their control.

Perelman. Just three months after the deal closed, the chairman of the special committee, Paul Meister, was invited to be an independent director of Scientific Games, which at the time was 34.2 percent owned by Perelman. Meister also subsequently became the president of MacAndrews & Forbes in 2014 and joined the boards of two other Perelman-controlled companies, vTv Therapeutics and Revlon, Inc.[103] Meister's path is not unique: as I mentioned earlier, Viet Dinh, another special committee member, became an independent director of Revlon in June 2012, less than a year after the freezeout. In 2017, Dinh left Revlon to join the Scientific Games board. A third special committee member, Carl Webb, previously served as the president, chief operating officer and director of several Perelman-controlled entities (notably entities associated with First Nationwide Bank) between 1988 and 2002.[104]

[103] Because of his role as president of MacAndrews & Forbes, Meister was not deemed an independent director of vTv Therapeutics or Revlon. *See* vTv Therapeutics Inc., Definitive Proxy Statement (Schedule 14A), at 11 (Mar. 24, 2016); Revlon, Inc., Definitive Proxy Statement (Schedule 14A), at S-ii (Apr. 29, 2016).

[104] In the ensuing litigation over the MFW freezeout, minority shareholders challenged the special committee's independence, citing Dinh's and Webb's relationships to Perelman. *Id.* at 512–14 (Del. Ch. 2013). The Delaware Chancery Court ruled that the ties were insufficient to call into question the special committee's independence, *id.*, and the Delaware Supreme Court affirmed. Kahn v. M & F Worldwide Corp., 88 A.3d 635, 647–48 (Del. 2014). The plaintiffs did not challenge Meister's independence, *In re* MFW, 67 A.3d at 509, perhaps because Meister's connections to other Perelman-affiliated entities were only formed after the MFW freezeout closed.

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With respect to controlling shareholder type, Table 1 shows that independent directors on boards controlled by a single natural person are most likely to have professional ties to other companies controlled or dominated by the controlling shareholder. 23 of 85 directors in that subset, or 27.1 percent, have repeat relationships of this sort. Among independent directors on boards controlled by a widely-held corporation, 21.2 percent (14 of 66) have professional ties with at least one other controlled company. This result reflects the reality that directors of subsidiaries sometimes join the boards of the widely-held parent corporations once the subsidiary is taken private. Among the 32 independent directors on boards controlled by an investment manager, only 4 have professional ties to at least one other controlled company. This figure is likely an underestimate, however, because some investment managers invest mostly in private companies, and little is known about whom they hire as directors or executives.[105] Only four directors (9.8 percent) serving on boards controlled by a family group have professional ties to another controlled company.

The lower half of Table 1 focuses on the subset of controlling shareholders that have controlled multiple public companies, which for convenience I will call "portfolio" controllers. In this subsample, the incidence of independent directors with professional ties to at least one other controlled company is notably higher than in the full sample—and quite high in absolute terms as well. Among independent directors on boards controlled by portfolio controllers who are individual persons in particular, 44 percent have repeat relationships. These results suggest that reappointment behavior may be a function of the controlling shareholder's power. Not all controlling shareholders can hire a director for a position at another entity; a controller who controls only one firm cannot offer a director a job at another firm. As I will explain in Part II.C, a controlling shareholder is likely to be more able to engage in reappointment behavior as the size of its portfolio increases.

It is possible that these director-level results are skewed by the actions of just a few controlling shareholders, and the vast majority of controllers do not have other ties to the directors they label as independent. To explore this, I break down the controlling shareholders in the sample by reappointment behavior. The results are presented in Table 2. I find that 36.4 percent of controlling shareholders (28 of 77) have repeat relationships with at least one nominally independent director on their board, and 26 percent (20 of 77) have repeat relationships with at least half of the special committee members who negotiated the freezeout. This result confirms that the director-level outcomes are not driven by outliers. Moreover, like Table 1, Table 2 shows that reappointment behavior is more common among portfolio controllers. Strikingly, among portfolio controllers that are individual persons, 73.3 percent

[105] *See supra* note 101.

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Table 2. Controlling shareholders by reappointment behavior

	n	Repeat relationships with: At least one director	Half or more of SC[1]
All controlling shareholders	77	28 (36.4%)	20 (26.0%)
Controlling shareholder characteristics:			
Single natural person	29	14 (48.3%)	12 (41.4%)
Widely-held company	23	7 (30.4%)	5 (21.7%)
Family group	12	3 (25.0%)	1 (8.3%)
Investment manager	13	4 (30.8%)	2 (15.4%)
Controlling shareholder controlled multiple public companies and is a[2]:			
Single natural person	15	13 (86.7%)	11 (73.3%)
Family group	4	3 (75.0%)	1 (25.0%)

1. Five controlling shareholders (Thermo Electron, the Cox family, Barry Diller, John Malone, and Carl Icahn) executed multiple freezeouts in the sample. These controllers were coded as having repeat relationships with half or more of the special committee if they had such ties with at least one of the special committees they negotiated with.
2. For the reasons discussed in Part II.A, widely-held companies and investment manager controllers were not categorized by the number of public companies under their control.

(11 of 15) have repeat relationships with at least half of the special committee that negotiated the deal.

If controlling shareholders reward cooperative directors with future patronage, then we should observe new relationships between directors and controlling shareholders after the freezeout closed. While professional ties from before the freezeout was announced are evidence of repeat relationships and reappointment behavior, it would be surprising if no director joined another company that the controller controlled after the freezeout. Figure 1 focuses on the 45 independent directors that have multiple professional ties to the controlling shareholder, broken down by when the connections were formed. Consistent with the rewards thesis, I find that 44.4 percent of these directors only have past or ongoing ties with the controller from before the freezeout was announced, and conversely, 55.6 percent formed new post-freezeout connections. Curiously, past ties to the controlling shareholder appear to be a poor predictor of future ties: only 16 percent of independent directors who joined another controlled company after the freezeout (4 of 25) had a pre-freezeout relationship with the controller as well. A potential explanation for this finding is that courts are currently willing to believe that directors who have worked with the controller once before can be independent, but they are more skeptical when two or more past connections exist. As a result, most controlling shareholders may be less inclined to select an individual for an independent directorship if they have worked together at two or more prior companies.

Finally, to render this discussion more concrete and to identify interesting cases for further investigation, Table 3 describes the five independent director-

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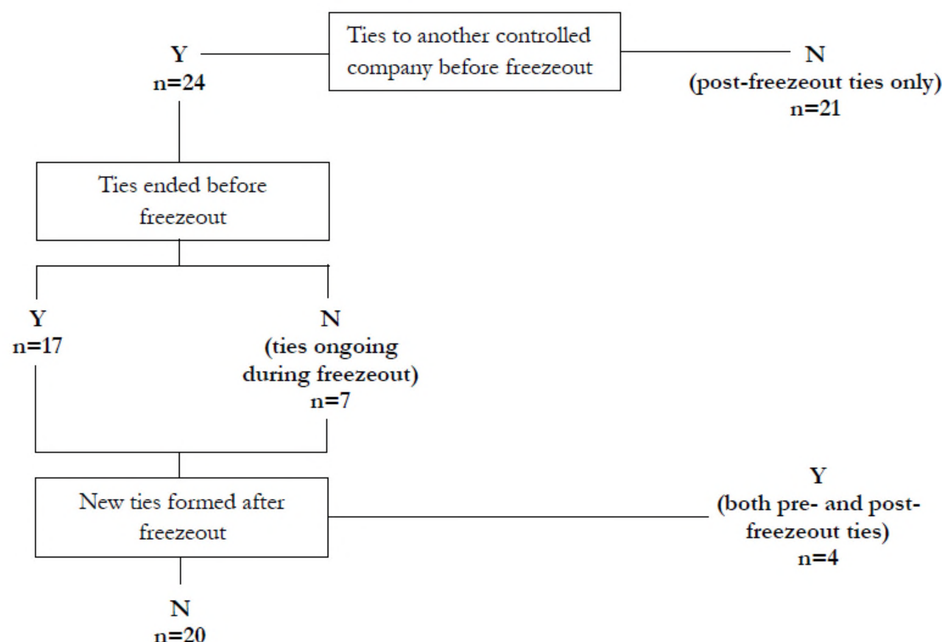

Figure 1. Breakdown of independent directors with multiple professional ties

controlling shareholder pairings that share the largest number of professional ties. These vignettes illustrate how some directors have over time developed a mutually-beneficial network of relationships with the controlling shareholder. Consider, for example, J. David Wargo, who was a member of the special committee that blessed media mogul John Malone's 2003 offer to freeze out the minority shareholders of On Command Corporation. Between 1998 and 2003, while he was a director at On Command, Wargo simultaneously served on the boards of two other Malone-affiliated entities, Liberty Digital and OpenTV. Since the freezeout, Wargo has joined the boards of four more of Malone's companies: Liberty Global (and its predecessors), Discovery Communications (and its predecessor), Liberty Broadband, and Fun Technologies. Wargo has served on the board of seven of Malone's companies since 1999, making the Wargo-Malone link the most extensive in the dataset. Indeed, a shareholder activist group recently called Wargo one of "Malone's go-to directors over the years."[106]

As another illustration, consider Paul Gould, who was a member of the

[106] Letter from Dieter Waizenegger, Exec. Director, CtW Inv. Grp., to shareholders of Discovery Commc'ns, Inc. 4 (Apr. 2016), *available at* http://ctwinvestmentgroup.com/wp-content/uploads/2016/04/CtW-to-Discovery-SH-letter-_4.21.16.pdf.

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Table 3. The Five Most-Entangled Controller-Independent Director Pairings

Controlling Shareholder	Director	Professional Ties #	Professional Ties Description
John Malone	J. David Wargo	7	• Independent Director, Liberty Digital (1999 to 2002) • Independent Director, Special Committee Member, On Command (1998 to 2003) • Independent Director, OpenTV[1] (2002 to 2007) • Director, Fun Technologies[1] (2007 to 2008) • Independent Director, Liberty Global[1] (2004 to Present) • Independent Director, Discovery Communications[1] (2005 to Present) • Independent Director, Liberty Broadband (2015 to Present)
John Malone	Paul Gould	5	• Independent Director, Special Committee Member, Tele-Communications Inc.[1] (1996 to 1999) • Independent Director, Liberty Interactive[1] (1999 to 2009) • Independent Director, DirectTV[1] (2009 to 2010) • Independent Director, Special Committee Member, Liberty Global[1] (2004 to Present) • Independent Director, Discovery Communications[1] (2005 to Present)
Ronald Perelman	Paul Meister	5	• Independent Director, Special Committee Member, MFW (1995 to 2011) • Independent Director, Scientific Games[1] (2012 to Present) • President, MacAndrews & Forbes (2014 to 2018) • Director, vTv Therapeutics (2015 to Present) • Director, Revlon (2016 to Present)
Barry Diller	Alan Spoon	4	• Independent Director, Special Committee Member, Ticketmaster (1997 to 2002) • Director, The HealthCentral Network[2] (2005 to 2011) • Independent Director, IAC/InterActiveCorp (2003 to Present) • Independent Director, Match Group (2015 to Present)
Thermo Electron Corp.	Polyvios Vintiadis	4	• Independent Director, Special Committee Member, Thermo TerraTech (1992 to 2000) • Independent Director, Special Committee Member, Thermo Instrument Systems (1993 to 2000) • Independent Director, Special Committee Member, Spectra Physics (1999 to 2001) • Director, Randers Killam Group (1997 to 1999)

1. Denotes companies in which the controlling shareholder held a large but less than 35 percent voting stake at the time of appointment.
2. Alan Spoon became a director of HealthCentral in 2005 as a representative of venture capital firm Polaris Partners. Barry Diller, through IAC/InterActiveCorp, acquired a significant minority stake in HealthCentral in 2008. This type of connection where the controlling shareholder invests in a company that the independent director is already affiliated with is not typical of the ties in the sample.

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special committee that negotiated Malone's 2005 offer to freeze out the remaining shareholders of UnitedGlobalCom. According to the proxy statement, the fact that Gould had previously served on the boards of at least two of Malone's companies and was contemporaneously serving on a Malone-affiliated board was insufficient to disqualify his independence:

> The Special Committee noted that Mr. Gould's service on the boards of directors of various entities affiliated with Mr. Malone or in which Mr. Malone, directly or indirectly, was a substantial investor consisted in each case of service as an independent director. The Special Committee deemed Mr. Gould's receipt of fees with respect to this service as a director to be *insufficiently material to undermine his independence*, given Mr. Gould's personal finances.[107]

Ultimately, the most striking point that emerges from Table 3 is that, contrary to the practice assumed by most academics, controlling shareholders and controlled companies do not always treat business dealings—even extensive connections like the Wargo-Malone or Gould-Malone networks—as antithetical to independence. For instance, Gould was called an independent director in at least five of Malone's companies, and Wargo was an independent director at six. This odd reality is almost certainly a result of Delaware's indeterminacy towards director independence, which invites controlling shareholders to push the envelope.[108]

Thus far in this Part, I have offered evidence that controlling shareholders will re-appoint friendly nominally independent directors to senior positions and directorships at other firms under their control. As a result, directors can use their directorships as a portal of entry by which to form additional connections with and gain future benefits from controlling shareholders. From the perspective of the directors, other lucrative posts may be obtainable—if the directors remain on good terms with the controllers. Controlling shareholders' power to grant or withhold these benefits then has the potential to shape the directors' allegiances. I turn to that power next.

C. Creating a Taxonomy of Controlling Shareholders

The extent of controllers' ability to influence directors is not uniform. This distinction rarely appears in existing scholarship or jurisprudence about controlling shareholders. Controllers are instead portrayed with the attributes of a single person with plenary control: an "800-pound gorilla"[109] that can always get its way or a "king"[110] or queen who likes the ego boost from her tremendous

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[107] *See* Liberty Media Int'l, Inc., Definitive Proxy Statement Relating To Merger or Acquisition (Schedule 14A), at 21–22 (May 3, 2005).

[108] For a similar point in the deal protection setting, see Fernán Restrepo & Guhan Subramanian, *The New Look of Deal Protection*, 69 STAN. L. REV. 1013, 1015, 1024 (2017).

[109] Strine, *The Inescapably Empirical Foundation of the Common Law of Corporations*, *supra* note 6, at 509.

[110] Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE L.J.

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clout.[111] In reality, however, controlling shareholders come in many forms, such as families, widely-held corporations, investment companies, or as the recent financial crisis demonstrates, the U.S. government. The power of decision-making actors within these various controlling entity types can be arrayed on a spectrum, with decision-making authority concentrated solely in one person's hands at one end and divided authority where decisions are reached by consensus at the other. Moreover, some controllers have influence over a vast portfolio of companies; others have far fewer holdings. Controlling shareholders also exhibit different attitudes towards director independence and the qualities they look for in their boards. For example, Dole's controlling shareholder David Murdock has said that, at his companies, he is "the boss" and "[t]he boss does what he wants to do."[112] By contrast, Warren Buffett, who controls Berkshire Hathaway, has said he prefers directors who not only "think and speak independently" but are also "shareholder-oriented";[113] Buffett in fact handpicked some of Berkshire's outside directors from shareholders whose families own substantial Berkshire holdings to ensure that the directors' interests are aligned with those of Berkshire's minority shareholders.[114]

These attributes are not meant to be exhaustive or to create sharp lines; they simply illustrate that controlling shareholders are not uniform. The stark dichotomy between controlling and non-controlling shareholders that pervades the jurisprudence obscures the complex ways in which controllers can undermine director independence. Assessing how much and what type of pressure a controller can exert requires a more nuanced taxonomy. Drawing from the corporate governance and political science literature on power,[115] I

560, 571 (2016).

[111] For notable exceptions, see Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. REV. 1641, 1663–64 (2006) (recognizing that "controlling shareholders come in different forms—for example, families as opposed to widely held corporations"); Kobi Kastiel, *Executive Compensation in Controlled Companies*, 90 IND. L.J. 1131, 1161 (2015) (collecting data on the "significant heterogeneity" across U.S. controlling shareholders and arguing that some types of controllers may be unwilling or unable to effectively monitor managerial pay). Some scholars have observed that different controlling shareholders establish control through different devices and argued that controllers who hold control through mechanisms that separate voting rights from equity ownership, such as dual class stock, are more likely to engage in self-dealing. *See, e.g.*, Bebchuk et al., *supra* note 1, at 301–05 (finding high agency costs in firms with dual-class shares). These works, however, focus on controlling shareholders' incentives to extract private benefits; no one has addressed the variations in controllers' ability to do so.

[112] *In re* Dole Food Co., Inc. Stockholder Litig., No. 8703, 2015 WL 5052214, at *5 (Del. Ch. Aug. 27, 2015).

[113] Letter from Warren Buffett, *supra* note 72, at 17.

[114] *Id.* at 19.

[115] There is a massive literature on "power" in public law, political science and the social sciences. *See, e.g.*, 1 MAX WEBER, ECONOMY AND SOCIETY 53 (Guenther Roth & Claus Wittich eds., 1978) (defining power as "the probability that one actor within a social relationship will be in a position to carry out his own will despite resistance"); Daryl J. Levinson, *The Supreme Court,*

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offer an important first cut at such a framework by distinguishing controlling shareholders along two dimensions: the base of controlled entities and the concentration of decision-making authority. I discuss each factor in turn, with illustrations from the freezeouts in my data and other cases as appropriate.

1. Base

Base refers to the size of the network of businesses over which a controlling shareholder has authority. Empire builders—heads of conglomerates like Alphabet (formerly Google) and Berkshire Hathaway—are clear examples of controllers with a wide base of control. Companies that routinely retain control blocks in a portfolio of firms, such as venture capital and private equity funds, fall into this category as well.

Just as increased firm size tends to mean more CEO power,[116] a wider base tends to mean more controlling shareholder power. In particular, base size does not affect the controller's power to remove directors from the board, but it does increase the controller's ability to reward for the simple reason that those who control more resources have more ways to dole out benefits. Most obviously, a controlling shareholder who controls a portfolio of companies can cause controlled firm A to enter into transactions that benefit a director on the board of controlled firm B. Two nominally independent directors on MFW's board, for instance, received fees for legal and consulting services from another Perelman company, Scientific Games.[117] Deborah Norville, a nominally independent director of Sumner Redstone's Viacom, is an anchor of "Inside Edition," which is produced by another Redstone-controlled company, CBS.[118]

Increased base size also translates into more opportunities to make appointments for high-level posts. Controlling shareholders with control over a large portfolio of companies can reward a director who has served loyally on the board of one firm by asking him to join the board of another firm, and then another and another. My empirical observations are consistent with this

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2015 Term -- Foreword: Looking for Power in Public Law, 130 HARV. L. REV. 31, 39 (2016) (defining power in public law as "the ability of political actors to control the outcomes of contested decision-making processes and secure their preferred policies"). *See generally* Robert A. Dahl, *The Concept of Power*, 2 BEHAV. SCI. 201 (1957). For a discussion of power in corporate governance, see Marcel Kahan & Edward Rock, *Embattled CEOs*, 88 TEX. L. REV. 987, 992–95 (2010), which measures CEO power along three dimensions: decision making, second-guessing, and scope.

[116] *See* Marcel & Rock, *supra* note 115, at 993 (explaining that "[g]iven the CEO's power within a firm, a CEO of a larger firm is more powerful than a CEO of a smaller firm."); *cf.* DAVID A. BALDWIN, POWER AND INTERNATIONAL RELATIONS: A CONCEPTUAL APPROACH 77 (2016) (recognizing that, while power is not simply a function of resources, resources can be a convenient way of measuring power).

[117] *See In re* MFW S'holders Litig., 67 A.3d 496, 510–13 (Del. Ch. 2013).

[118] *See* Leslie Picker, *Viacom in Cross Hairs of Activist Investor*, N.Y. TIMES: DEALBOOK (Jan. 19, 2016), https://www.nytimes.com/2016/01/20/business/dealbook/viacom-in-cross-hairs-of-activist-investor.html.

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intuition. A majority of the controlling shareholders in the data that have controlled multiple public companies—meaning that they have controlled multiple boards—have formed repeat relationships with at least one "independent" director on their board. Conversely, among controlling shareholders with only one public firm in their portfolio, only one has formed repeat ties with a nominally independent director.[119]

For a real-world illustration of how a wide base enables a system of patronage, consider the boardrooms controlled by the late Harold Simmons. Between 2000 and his death in 2013, Simmons controlled seven public companies: Keystone Consolidated Industries, Valhi, NL Industries, Kronos Worldwide, CompX International, Titanium Metals, and Tremont Corporation. Figure 2a depicts the network of individuals who were designated as independent directors of Simmons' companies during this time.[120] The white nodes represent controlled or dominated firms. The gray nodes represent nominally independent directors, with the shade of gray varying by the number of connections between the director and controlled companies. The darker the gray, the more connections that director has. As the visualization of Simmons' network reveals, Simmons regularly recruited directors of one controlled company to the board of another. Overall, of the 29 nominally independent directors in Simmons' companies, 45 percent served on at least two Simmons-controlled boards.

Also consider Figures 2b–2e, which shows the independent director networks for four other controlling shareholders with large bases: the Dolan family, John Malone, Rupert Murdoch, and Sumner Redstone. These four controlling shareholder controlled at least two firms within the S&P 1500 in 2015.[121] In each network, there are highly connected "independent" directors—including special committee members in most cases—who have served on the boards of multiple controlled or dominated companies. These are the controlling shareholders' "go-to" directors, and the directors whose relationship with the controller are mostly likely to be characterized by mutual indebtedness and reliance. As expected, controllers that control a very large base of subsidiary

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[119] The controlling shareholder is Richard Hokin, who owns privately-held Intermountain Industries, Inc. A.J. Schwartz was an independent director at one of Intermountain's subsidiaries, Petroglyph Energy Inc., from 1997 to its acquisition in 2000, *see* Petroglyph Energy, Inc., Proxy Statement (Schedule 14A), at 6 (Apr. 27, 2000), and then became a director of Intermountain. *See* INTERMOUNTAIN INDUSTRIES, INC., http://www.intermountainindustries.com/industries.php (last visited Dec. 18, 2017).

[120] Data from BoardEx (on file with author).

[121] Edward Kamonjoh, Controlled Companies in the Standard & Poor's 1500: A Follow-up Review of Performance & Risk 84–90 (2016), *available at* https://irrcinstitute.org/wp-content/uploads/2016/03/Controlled-Companies-IRRCI-2015-FINAL-3-16-16.pdf. I excluded the Scripps family, which also held control over two S&P 1500 firms, because neither company is incorporated in Delaware and thus the concept of independence in Delaware law does not govern.

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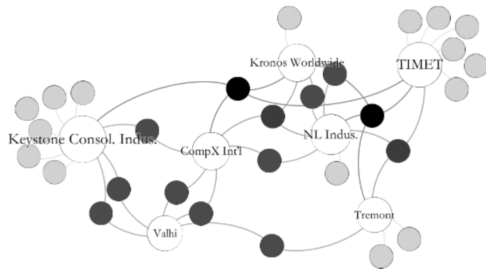
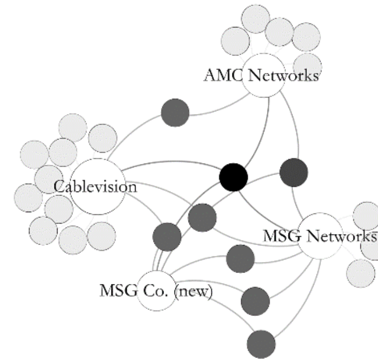
Figure 2. Examples of "independent" director networks

The white nodes represent controlled or dominated firms. The gray nodes represent nominally independent directors, with darker gray nodes representing directors with more connections to controlled or dominated companies. The networks include only nominally independent directors of publicly-traded controlled or dominated companies. In addition, the networks cover different time periods based on the availability of data on nominally independent directors.

a. Harold Simmons (2000 to 2013)

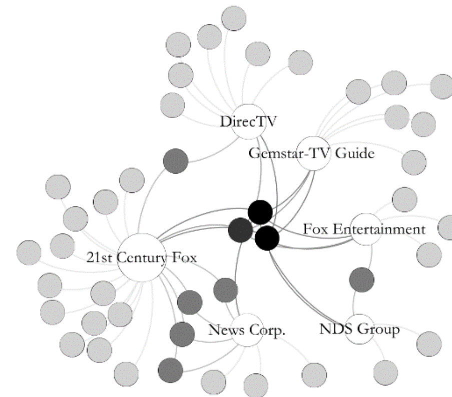


b. The Dolan family (2000 to 2016)

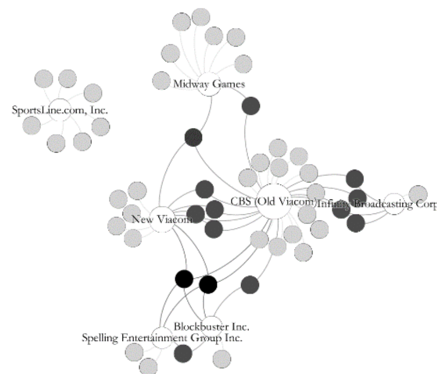


c. John Malone (1998 to 2016)

d. Rupert Murdoch (2000 to 2016)



e. Sumner Redstone (1995 to 2016)



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boards, like Malone, have many go-to "independent" directors.

The idea that a controller's power to influence increases with the size of its base has particular relevance for private equity firms. Private equity has grown rapidly in the past two decades and the industry now owns over a trillion dollars' worth of American businesses.[122] When a private equity firm makes an investment, it normally obtains significant control rights in the portfolio company, including the right to one or more board seats.[123] As a result, private equity firms can appoint individuals to a large number of boards over time. In *In re Trados Inc. Shareholder Litigation*, for example, Trados outside director Joseph Prang initially developed a relationship with venture capital firm Sequoia Capital after Sequoia invested in a company where Prang was president.[124] Based on the success of that relationship, Sequoia designated Prang as a director of several other Sequoia-backed firms, including Trados.[125] Because private equity firms are long-term repeat players, directors like Prang have substantial incentive to favor their interests.[126] However, Delaware courts rarely consider a controlling shareholder's repeat-player status in assessing independence, and they have not recognized private equity firms' enhanced influence over directors.[127] As I argue in the next Part, the courts should adopt a more granular approach, one that pays more attention to controlling shareholder characteristics.

2. Concentration

Concentration relates to the number of decision-making entities that share the power to control within the controlling shareholder. Concentration, in turn, has two related facets: decisional allocation and spheres of influence.

a. Decisional Allocation

Controlling shareholders vary with respect to whether decision-making power is concentrated in the hands of a single actor or diffused across multiple actors with potentially different preferences and interests. Most of the controlling shareholders discussed in this Article, such as Perelman, Malone, and Simmons, are examples of the former; founding families, widely-held

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[122] Simon Clark & William Louch, *Private Equity Bubble? What Private Equity Bubble?*, WALL ST. J., Sept. 11, 2017, https://www.wsj.com/articles/private-equity-bubble-what-private-equity-bubble-1505122201.

[123] *See* Jesse M. Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U. L. REV. 967, 987 (2006); Jackson, *supra* note 101, at 644.

[124] *In re* Trados Inc. S'holder Litig., 73 A.3d 17, 54–55 (Del. Ch. 2013).

[125] *Id.*

[126] *See* Fried & Ganor, *supra* note 123, at 989 (arguing that directors of portfolio companies are often not truly independent because they "have—or can expect to have—long-term professional and business ties" with the funds).

[127] *See infra* notes 161–164 and accompanying text.

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corporations and partnerships are common examples of the latter.[128]

All else equal, when the authority to control is highly centralized in a single person, he has more power because he can secure his preferred outcomes.[129] He stands at the apex of a neatly hierarchical chain of command and can always get his way because he alone calls the shots. By contrast, when decision-making authority is divided among several actors, no single actor can independently impose his will. Instead of giving commands, each must bargain, cajole, appeal, reason or litigate against others to influence decision outcomes.[130] These actors, put simply, only have the "power to persuade."[131] My findings corroborate this conclusion. Controlling shareholders who are single natural persons are more likely than controlling entities that are family groups or widely-held firms to have repeat relationships with the nominally independent directors on their boards.

For a recent illustration of how diffuse power structures constrain decisional power, consider the ousting of Ferdinand Piëch, the former chairman of the German automaker Volkswagen. The Porsche-Piëch family, which also controls the automaker Porsche, gained 50.8 percent of the Volkswagen Group in 2008.[132] The family's holdings are organized with a holding company, Porsche Automobil Holding, in which family members separately own voting rights.[133]

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[128] *Cf. Family firms, Business in the blood*, ECONOMIST, Nov. 1, 2014, https://www.economist.com/news/business/21629385-companies-controlled-founding-families-remain-surprisingly-important-and-look-set-stay (reporting that family-controlled firms comprise 19% of Fortune Global 500 companies).

[129] *See* Michael J. Gerhardt, *Constitutional Arrogance*, 164 U. PA. L. REV. 1649, 1651 (2016) (arguing that one factor contributing to the growth in presidential power is the "[t]he executive's unique design, with a single official at its apex, [which] positions Presidents perfectly to take positive independent action and invests them with the capacity to do so"). The Founding Fathers in fact emphatically rejected the idea of a plurality in the executive, observing that the difficulties of cooperation among a group of people may "tincture the exercise of the executive authority with a spirit of habitual feebleness and dilatoriness." THE FEDERALIST NO. 70 (Alexander Hamilton).

[130] *See* Daryl J. Levinson, *The Supreme Court, 2015 Term—Foreword: Looking for Power in Public Law*, 130 HARV. L. REV. 31, 39 n.18 (2016) (suggesting that when decision-making authority is shared among multiple actors, each actor can only exert "influence"); Kevin M. Stack, *The President's Statutory Powers to Administer the Laws*, 106 COLUM. L. REV. 263, 319–20 (2006) (arguing that the President faces a lower transaction cost in asserting power because the President can take unilateral actions); Terry M. Moe & William G. Howell, *Unilateral Action and Presidential Power: A Theory*, 29 PRESIDENTIAL STUD. Q. 850, 862–63 (1999) (arguing that Congress is "poorly equipped to take almost any kind of coherent, forceful action" because of its collective action problem).

[131] RICHARD E. NEUSTADT, PRESIDENTIAL POWER AND THE MODERN PRESIDENTS: THE POLITICS OF LEADERSHIP FROM ROOSEVELT TO REAGAN 11 (Free Press rev ed 1990).

[132] *See* Dietmar Hawranek, *The VW Debt Trap: Has Porsche Bitten Off More than It Can Chew?*, SPIEGEL ONLINE INT'L, Apr. 20, 2009, http://www.spiegel.de/international/business/the-vw-debt-trap-has-porsche-bitten-off-more-than-it-can-chew-a-620020.html.

[133] *See* Dietmar Hawranek & Dirk Kurbjuweit, *Behind the Scenes of Volkswagen's Dynastic Battle*, SPIEGEL ONLINE INT'L, May 6, 2015, http://www.spiegel.de/international/business/the-families-at-the-center-of-the-power-struggle-at-volkswagen-a-1032210.html.

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For many years, Ferdinand Piëch owned a hefty thirteen percent of the holding company, sat on its board, and as Volkswagen's CEO and later chairman, was considered the ruling patriarch of the Porsche-Piëch family.[134]

In 2015, Piëch publicly undermined Volkswagen's then-CEO, Martin Winterkorn, saying "I am at a distance to Winterkorn."[135] Piëch soon discovered, however, that he had neither his family's support nor enough votes from other stakeholders on the Volkswagen board. Members of the family bluntly disagreed with Piëch's remarks, commenting that Piëch's "private" opinion about Winterkorn was not the opinion of the family.[136] Volkswagen's worker representatives, who also sit on its board, backed Winterkorn as "one of the most successful car industry managers."[137] Two weeks after he moved to oust Winterkorn, Piëch was himself forced to resign from Volkswagen's board.[138] Just before his departure, Piëch was at the helm of his family which in turn controlled Volkswagen's voting shares, but his power rested on his family members' confidence and support. As German magazine Der Spiegel summarized, Piëch's inability to get his way resulted from the fact that, this time, he couldn't "succeed in persuading [his family] that his position was the right one."[139]

The boundaries between concentrated and diffuse power structures can appear porous. Michael Eisner, the longtime CEO and Chairman of Disney, was able to "enthron[e] himself as the omnipotent and infallible monarch of his personal Magic Kingdom" and bypass his board, which ostensibly had veto authority over his decisions, when he hired his good friend as Disney's president.[140] While Eisner formally shared power with his board, he gained such a substantial bargaining advantage from his status and prestige that he could essentially rely on commands to get what he wants.[141]

But the fact that status yields bargaining advantages should not be allowed to conceal a basic difference between leadership and unilateralism: when power is diffused, decisions are always the product of give-and-take. No matter his leverage, each actor's ability to influence the outcome is ultimately dependent on the consent of the other actors, and this power reduces to nothingness if

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[134] *See id.*; Dalia Fahmy, *With Piech in the Exit Lane, Porsche Family Feud Draws to Close*, BLOOMBERG, Mar. 17, 2017, https://www.bloomberg.com/news/articles/2017-03-17/ferdinand-piech-in-talks-to-sell-shares-in-volkswagen-s-owner (describing Piëch as "the family's undisputed patriarch").

[135] *See* Chris Bryant, *Volkswagen power struggle deepens as Porsche weighs in*, FIN. TIMES, Apr. 12, 2015, https://www.ft.com/content/71d27596-e0f2-11e4-9b30-00144feab7de.

[136] *See id.*

[137] *See* Chris Bryant, *VW chairman hints at tension with CEO*, FIN. TIMES, Apr. 10, 2015, https://www.ft.com/content/be7f1b4c-df8a-11e4-b6da-00144feab7de.

[138] *See* Hawranek & Kurbjuweit, *supra* note 133.

[139] *Id.*

[140] *See* In re Walt Disney Co. Derivative Litig., 907 A.2d 693, 760–62 (Del. 2005).

[141] *Cf.* Dahl, *supra* note 115, at 203 (describing the source of Presidential power as including "his influence with the national electorate, his charisma, his charm, and the like").

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consent is withdrawn. Peter Strauss has recognized this, arguing that a meaningful difference exists between "ordinary respect" and deference and "[c]ompelled obedience."[142] Eisner, like Piëch, was ultimately forced to resign from Disney when he lost the support of two directors, who successfully rallied Disney's shareholders to oppose Eisner's re-election to Disney's board.[143]

b. Spheres of influence

Acting in concert with decisional allocation, sphere of influence refers to the types of decisions over which an actor has control.[144] In some controlling entities, power can be somewhat specialized; that is, a decision-maker who can determine the outcome of one type of decision cannot determine the outcome of another type. For example, when the U.S. government was the controlling shareholder of the American International Group ("AIG"), the Treasury Department appointed a special master for executive compensation, popularly known as the pay czar, who had final authority over compensation decisions for AIG's senior executives.[145] Meanwhile, the Treasury Department and the Federal Reserve created a separate entity, the AIG Credit Facility Trust, which had the sole power to vote the government's AIG shares.[146] Among the trustees' main responsibilities was recruiting and appointing new directors to ensure that AIG had "an effective, independent and capable board."[147] Still other divisions in the government had broad influence over AIG's restructuring plans and risk management policies.[148]

Dispersing qualitatively different aspects of the power to control to different spheres, governed by different personnel, further limits each actor's ability to reward or retaliate.[149] AIG's Credit Facility trustees, for instance, could appoint directors to or remove directors from AIG's board, but they could not direct

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[142] Peter L. Strauss, *Foreword: Overseer, or "The Decider"? The President in Administrative Law*, 75 GEO. WASH. L. REV. 696, 704 (2007).

[143] *See* David Teather, *Disney shareholders force Eisner out of chairman's role*, THE GUARDIAN, Mar. 4, 2004, https://www.theguardian.com/business/2004/mar/04/usnews.citynews; Laura M. Holson, *A Quiet Departure for Eisner at Disney*, N.Y. Times, Sept. 26, 2005, http://www.nytimes.com/2005/09/26/business/media/a-quiet-departure-for-eisner-at-disney.html.

[144] Robert Dahl refers to this concept as the "scope" of an actor's power. "Scope" measures the types of responses A can evoke from B. *See* Dahl, *supra* note 115, at 203.

[145] Deborah Solomon, *Pay Czar Gets Broad Authority Over Executive Compensation*, WALL ST. J. (June 11, 2009, 11:59 PM), https://www.wsj.com/articles/SB124464909136002467.

[146] *AIG: Where is the Taxpayer's Money Going?: Hearing on the Collapse and Federal Rescue of AIG Before the H. Comm. On Oversight & Gov't Reform*, 111th Cong. 1 (2009) (statement of the AIG Credit Facility Trust).

[147] *Id.* at 6–8.

[148] *See id.*

[149] *See* Marcel & Rock, *supra* note 115, at 993 (explaining that "[t]he more comprehensive the type of decisions [over which the CEO has authority], the more powerful is the CEO").

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AIG's business towards cooperative directors because the trustees are barred from interfering with AIG's operational decisions.[150] For the same reason, the trustees could not punish directors who displease them by cutting off an existing service contract.

De jure barriers are of course not de facto barriers. In many cases, there is a pronounced gap between an actor's limited de jure sphere of influence and the extent of the decisions over which he has power in practice. From a strictly de jure vantage, CEOs of most widely-held corporations have no authority to elect members of its board. Post-Enron rules require that nominating committees consisting entirely of "independent" directors control the director selection process.[151] Commentators have noticed, however, that formal barriers to CEO involvement are not sufficient to actually insulate nomination decisions from CEO influence.[152] Some nominating committees "receiv[e] names from the CEO."[153] Moreover, nominating committees are often "unlikely to nominate a director clearly opposed by the CEO," so at a minimum, CEOs have the power to block nominations.[154] These informal practices enable CEOs to dominate the selection process despite barriers that exist on paper.

To summarize, controlling shareholders are weaker when the power to control is diffused or functionally separated because of the difficulties of cooperation among a group of actors. As a result, they are less able to pressure directors effectively.

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[150] *See AIG: Where is the Taxpayer's Money Going?*, *supra* note 146, at 5.

[151] *See* Michael E. Murphy, *The Nominating Process for Corporate Boards of Directors: A Decision-Making Analysis*, 5 BERKELEY BUS. L.J. 131, 148 (2008) (explaining that "NYSE rules . . . require the nominating committee to be composed entirely of independent directors"); *see also* Gordon, *supra* note 17, at 1498–99 (describing SEC disclosure requirements that are intended to shield nominating committees from CEO influence).

[152] *See, e.g.*, BEBCHUK & FRIED, *supra* note 52, at 25–27 (arguing that "[e]ven CEOs not formally serving on the nominating committee have had a significant influence on the nomination process"); Murphy, *supra* note 151, at 148–49 (arguing that "it is clear that CEO's [sic] may have the dominant voice in the nominating process even if not included in the membership of a nominating committees composed of independent directors"); *cf.* Nadia Damouni et al., *Dimon Wields Large Influence Over Who Serves On JPMorgan Board*, HUFFPOST, July 16, 2013, https://www.huffingtonpost.com/2013/05/16/dimon-jpmorgan-board_n_3283683.html (explaining that "JPMorgan board's governance committee, responsible for hiring new members, relies almost entirely on referrals from management to find director nominees").

[153] ROBERT A.G. MONKS & NELL MINOW, CORPORATE GOVERNANCE 246 (4th ed. John Wiley & Sons 2008). A CEO told Robert Monks and Nell Minow, "My nominating committee is very independent. Sometimes they turn down the names I send them." *Id. See also* JAY W. LORSCH WITH ELIZABETH MACIVER, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS 20 (1989) (finding that 55% of directors reported that "the CEO was the major source of ideas for new candidates).

[154] BEBCHUK & FRIED, *supra* note 52, at 26–27.

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This Part provides the first empirical evidence on professional connections between directors who are nominally independent and the controlling shareholders they are supposed to be independent from. The revelation that some "independent" directors share repeat relationships with a controlling shareholder—and in particular, some directors obtain new ties to a controlling shareholder after concurring with that controller's views—offers powerful support for my theory that controlling shareholders will reward cooperative directors. By extension, these findings suggest that nominally independent directors can be biased by the prospect of those future benefits.

Recognizing reward's role in the director's incentive calculus is important because patronage triggers no special scrutiny and little disclosure, and thus can work better than threats. The firing of an independent director receives intense media attention,[155] and even the threat of firing or other retribution can trigger a higher level of judicial scrutiny.[156] In contrast, a controlling shareholder can discuss a future benefit at any time without public notice. When a director actually joins another board under the controlling shareholder's control, he is not required to disclose information about their past relationship.[157] Controlling shareholders thus have every incentive to prefer seducing directors with the prospect of future rewards over using threats.

Of course, not all controlling shareholders are created equal or are equally able to dole out benefits (or punishment). The two factors that I have identified in this Part provide an analytic framework for assessing which controlling shareholders have greater potential to offer future patronage, and by extension, create conflicts of interest. As the next Part argues, courts can move towards a more nuanced doctrine for constraining private benefits of control by disaggregating controllers in this way.

III. Doctrinal and Theoretical Implications

In this Part, I offer three doctrinal and theoretical responses to my empirical findings. First, Delaware courts should depart from the operative assumption

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[155] *See* Sallie Hofmeister, *Cablevision Power Play Alarms Wall Street, Governance Experts*, L.A. TIMES, Mar. 4, 2005, http://articles.latimes.com/2005/mar/04/business/fi-dolan4 (describing how Charles Dolan fired four Cablevision directors who voted to end his pet project); Emily Steel, *Redstone Moves to Replace Five Viacom Directors, Escalating Battle*, N.Y. TIMES, June 17, 2016, at B1 (describing how Sumner and Shari Redstone fired five of Viacom's independent directors who did not show sufficient loyalty).

[156] *See supra* note 58 and accompanying text.

[157] *Cf.* Yaron Nili, *Out of Sight, Out of Mind: The Case for Improving Director Independence Disclosure*, 42 J. CORP. L. 45, 58–60 (2017) (arguing that important information is often omitted in a company's disclosures about director independence in part because companies are only required to report relationships that they consider "material"). My review of SEC filings for the controlled companies in this Article is consistent with Nili's argument.

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that all controlling shareholders hold equal sway over the directors who serve on their boards. Rather, courts should tailor the level of deference afforded to independent directors' decisions by the controlling shareholder's ability to influence director behavior. Second, Delaware courts should not assume that, absent signs of a bribe, post-transaction relationships contain no information relevant to a director's independence at the time of the deal. Again, courts should examine controlling shareholder attributes to identify cues about a director's expectations at the time he approved the transaction. And third, Delaware courts and scholars should understand freezeout transactions as presenting an asymmetric final period problem, meaning that nominally independent directors may be influenced by the fact that their relationship with minority shareholders will end once the freezeout closes but their relationship with the controlling shareholder can still continue. This insight contributes a new perspective on freezeout doctrine and recent proposals to improve it. I discuss each of these implications in turn.

A. Enhanced scrutiny for powerful controllers

The findings presented in this Article should change the contours of the ongoing debate over structural pressures. As mentioned above, scholars like Bebchuk and Hamdani have argued that nominally independent directors will inevitably be influenced by structural realities, such as the fact that the controlling shareholder has the power to remove them from the board.[158] On the other hand, recent Delaware cases have retreated from the view that independent directors cannot be truly independent from a controlling shareholder.[159] By their account, structural incentives will not prevent most nominally independent directors from pushing back and performing their monitoring duties "with fidelity."[160]

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[158] *See, e.g.*, Bebchuk & Hamdani, *Independent Directors and Controlling Shareholders*, *supra* note 6 (arguing that the controlling shareholders' decisive power to appoint and fire directors prevent directors from being truly independent); María Gutiérrez & Maribel Sáez, *Deconstructing Independent Directors*, 13 J. CORP. L. STUD. 63 (2013) (arguing that nominally independent directors lack incentives to effectively monitor controllers for a variety of structural reasons).

[159] In early cases, the Delaware court "implicitly endorse[d] the view that independent directors cannot be truly independent from the controlling shareholder, and that courts still need to scrutinize freezeout transactions for entire fairness because of the inability to replicate an arms-length process between the controlling shareholder and the [special committee]." Subramanian, *supra* note 2, at 43 (describing *Kahn v. Lynch Communication Systems*, 638 A.2d 1110, 1118 (Del. 1994)). In contrast, more recent cases seem to have abandoned the court's prior skepticism. *See In re* MFW S'holders Litig., 67 A.3d 496, 528 (Del. Ch. 2013) (concluding that "[a]lthough it is possible that there are independent directors who have little regard for their duties or for being perceived by their company's stockholders (and the larger network of institutional investors) as being effective at protecting public stockholders, the court thinks they are likely to be exceptional").

[160] *Id.*

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This debate is misdirected if controlling shareholders are not monolithic and if variation exists in how much pressure they can exert over the directors who serve on their boards. Structural pressures may pose a very serious risk to directors' independence vis-à-vis some controlling shareholders but not others. A more useful question then is how to distinguish controllers who tend to hold more sway from those who tend to hold less. The two factors presented in Part II give courts an analytic framework for thinking about this problem. For example, courts should be particularly wary when the controlling shareholder is an individual person who controls a vast conglomerate and can single-handedly determine the outcomes of important company decisions. Courts should also pay more attention to reward-oriented structural incentives if the potential for repeat relationships is high, for example, if the controlling shareholder is an investment firm that regularly appoints directors to the boards of its portfolio companies.

Delaware courts have never considered these or any other controlling shareholder characteristics in its independence inquiry. In the *In re Trados Inc. Shareholders Litigation* decision,[161] however, the Delaware Chancery Court noted that the venture capital "ecosystem" may provide incentives for nominally independent directors to favor venture capital firms over other shareholders when their interests diverge:

> Many of these [supposedly independent] directors have—or can expect to have—long-term professional and business ties with the VCs, who are more likely to be repeat players than are most of the common shareholders. Cooperative outside directors can expect to be recommended for other board seats or even invited to join the VC fund as a "venture partner."[162]

However, the court then said that "general characterizations" of this ecosystem cannot carry the plaintiff's burden of proving non-independence at trial.[163] Because the plaintiff also introduced evidence of the director's "long history" with the venture capital fund, the court agreed that the director's independence was compromised.[164]

While the court in *Trados* explicitly disavowed placing weight on broad structural influences, the fact that venture capital firms can secure coveted jobs for friendly directors in the future was unmistakably on the court's mind. Subsequent Delaware doctrine should incorporate this attention to controlling shareholders' ability to exert pressure.

To be clear, I am not suggesting that controlling shareholder characteristics should be determinative of director independence. My point, rather, is that courts should be aware of the fact that some controllers have more means to influence directors and thus pose a greater risk to independence. And while it may not be possible for courts to neatly separate the wheat from the chaff, there

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[161] *In re* Trados Inc. S'holder Litig., 73 A.3d 17 (Del. Ch. 2013).
[162] *Id.* at 54 (quoting Fried & Ganor, *supra* note 123, at 989).
[163] *Id.*
[164] *Id.* at 54–55.

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are some simple cues that courts should factor in when assessing whether to defer to nominally independent directors' judgements. One straightforward way to incorporate the insights here into doctrine is to change the operative assumption that a special committee of nominally independent directors should either receive full credit as a "cleansing" device for a conflicted transaction or none at all. This approach is hardly novel; in many other contexts, Delaware courts already use intermediate standards of review for "specific, recurring, and readily identifiable situations" where the "realities of the decision-making context can subtly undermine the decisions of even independent and disinterested directors."[165] When the context warrants intermediate scrutiny, courts have given nominally independent directors a form of partial deference by reviewing the reasonableness of their actions.[166]

B. A harder look at post-transaction relationships

In *In re MFW Shareholders Litigation*, the Delaware Chancery Court explained that Viet Dinh's subsequent directorship at another Perelman-controlled firm would only be relevant to Dinh's independence if the evidence also showed that Dinh "was offered the directorship before the special committee approved the deal, or that it had at least been discussed with him before th[at] time."[167] Finding no such evidence in the record, the court deemed Dinh to be sufficiently independent of Perelman.[168]

MFW and similar cases demonstrate judges' reluctance to see a conflict of interest absent a smoking gun: an outright bribe. But this narrow fixation depends on a judgment that otherwise independent directors are unlikely to have *tacit* expectations of future patronage. My findings challenge this assumption. Among the nominally independent directors who served on boards dominated by Perelman-type controlling shareholders—individual persons who control a large conglomerate—almost half were re-appointed by the controller to a directorship or an executive position at another controlled company. When faced with these odds, most sophisticated directors would recognize that it is in their self-interest to cultivate their relationship with the controlling shareholder,

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[165] *Id.* at 43.

[166] As every student of corporate law knows, where a board adopts antitakeover defensive measures, Delaware courts will examine whether the measure was reasonable in response to the threat. *See* Unocal Corp. v. Mesa Petrol. Co., 493 A.2d 946, 955 (Del. 1985); Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1367 (Del. 1995). Further, where a company is in *Revlon* mode (when a sale or break-up of the company is inevitable), Delaware courts will examine whether the board proceeded "reasonably" in its role as auctioneer. Equity-Linked Investors, L.P. v. Adams, 705 A.2d 1040, 1055 (Del. Ch. 1997).

[167] *In re* MFW S'holders Litig., 67 A.3d 496, 513 n.65 (Del. Ch. 2013), *aff'd sub nom.* Kahn v. M & F Worldwide Corp., 88 A.3d 635, 648 (Del. 2014); *see supra* note 49–50 and accompanying text

[168] *Id.* at 513.

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even if no discussion about a future appointment has taken place.

The court in *MFW* also missed a second contextual cue that relates to Dinh's expectations about Perelman. Like Dinh, the chairman of M&F Worldwide's special committee also joined the board of a Perelman-dominated company three months after the freezeout closed.[169] And a third member of the special committee had a long history of working at Perelman-controlled entities before joining M&F Worldwide's board.[170] In cases involving threats of retaliation, Delaware courts have held that when the controlling shareholder *actually* removes an uncooperative director, "[t]hat action convey[s] more strongly than words the type of retributive threat that [the controlling shareholder i]s willing to carry out" against the remaining directors.[171] By the same token, it seems appropriate to infer that Perelman's demonstrated willingness to re-appoint other familiar (and presumably friendly) directors would have increased Dinh's expectations of a similar reward.

Viewed in this light, Dinh's subsequent directorship is probably evidence that Dinh's independence was tainted at the time that the special committee approved the transaction. At the very least, it reveals the question of Dinh's independence to be far closer than the Chancery Court allowed. My general point is that Delaware courts should not presume that post-transaction ties contain no relevant information absent signs of a bribe.

It bears emphasis that post-transaction ties are subject to the same critiques that many have leveled at using past and ongoing connections as proxies for independence.[172] Most fundamentally, directors do not become genuinely independent just because they have no ties to the controlling shareholder, and conversely, directors do not automatically become supine just because they do.[173] Eliminating pre- or post-transaction ties, moreover, may not be costless. For one thing, it shrinks the overall pool of qualified candidates for independent director positions and may promote directors "who lack any real desire to take their monitoring role seriously" as independent.[174] This second concern can be

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[169] Data from BoardEx (on file with author).

[170] *In re* MFW, 67 A.3d at 513 (describing Perelman's ties to Carl Webb).

[171] *In re* Ezcorp Inc. Consulting Agreement Derivative Litig., No. CV 9962-VCL, 2016 WL 301245, at *41 (Del. Ch. Jan. 25, 2016)

[172] *See infra* note 173 and accompanying text.

[173] *See, e.g.*, MONKS & MINOW, *supra* note 153, at 286 ("Directors do not become independent just because they have no economic ties to the company beyond their job as a director"); Letter from Warren Buffett, Chairman, Berkshire Hathaway Inc., to Shareholders 18 (Feb. 28, 2007), http://www.berkshirehathaway.com/letters/2006ltr.pdf ("[M]any directors who are now deemed independent by various authorities and observers are far from that."); Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 798–99 (2001) (noting the same).

[174] Langevoort, *supra* note 173, at 798–99; *accord* Kenneth B. Davis, Jr., *Structural Bias, Special Litigation Committees, and the Vagaries of Director Independence*, 90 IOWA L. REV. 1305, 1341 (2005) (arguing that the prevailing requirements for independence does not produce "the combination of traits that the corporation would have prioritized had its sole objective been to assemble the

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somewhat blunted if courts keep in mind that not all relationships are equally probative of a director's motivations or expectations. An economic connection to a controlling shareholder who is a repeat player and has shown a willingness to reward pliable directors in the past is very different from a social connection to a controller with a small base of influence and no history of repeat relationships.

What giving attention to post-transaction ties will do, however, is promote doctrinal consistency. A central claim of this Article is that just as a feeling of beholdenness towards the controlling shareholder can compromise a director's impartiality, the prospect of future reward from the controlling shareholder can also impact director behavior. Delaware courts scrutinize directors' past or ongoing relationships to the controlling shareholder because, so the argument goes, these ties can signal that a director is beholden to the controller at the time of the deal negotiations.[175] Post-transaction relationships are informative for the exact same reason: they can be cues about a director's expectations at the time the director approved the transaction. Judges and scholars do not seem to be making this connection across relationships formed at different times, and in particular they currently only take a hard look at past or ongoing relationships, not post-transaction relationships, without any acknowledgement of or justification for the distinction.

C. Understanding freezeouts as presenting an asymmetric final period problem

One of the basic tenets of game theory is that two rational actors who expect to engage in future dealings have an incentive to cooperate.[176] The risk that one party will self-deal or cheat is constrained by the threat of retribution from the other party in subsequent interactions.[177] This accountability breaks down, however, when participants know that a transaction is the last in the series.[178] In the final period, participants are more likely to put their own interests over those of the other party because the penalty for doing so has disappeared.[179]

It is well understood that third-party acquisitions present a final period problem because the target's shareholders will be bought out by the acquirer.[180]

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best possible board team").

[175] *See supra* Part II.B.i.

[176] *See generally* ROBERT AXELROD, THE EVOLUTION OF COOPERATION 174–75 (Rev. ed. 2006) (describing "conditions for the evolution of cooperation").

[177] *See* RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 720 (2d ed. 1995).

[178] *See id.*

[179] *See id.*

[180] *See, e.g.*, J. Travis Laster, *Omnicare's Silver Lining*, 38 J. CORP. L. 795, 809 (2013) (describing a "negotiated corporate acquisition" as "a paradigmatic example of a final period problem"); Bernard Black & Reinier Kraakman, *Delaware's Takeover Law: The Uncertain Search for Hidden Value*, 96 NW. U. L. REV. 521, 536 (2002) (describing acquisitions as a scenario in which "the target's

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As a result, the efficacy of shareholders as a constraint on directors self-dealing loses traction.[181] Less familiar is the idea that freezeouts can present an *asymmetric* final period problem if the controlling shareholder has the ability to provide future patronage. On the one hand, a director's relationship with minority shareholders will normally end after a freezeout because outside directors typically leave the target board once the company goes private. On the other hand, a director's relationship with the controlling shareholder can still continue, as the numerous examples of post-freezeout ties that I have already offered illustrate.

Recognition of this asymmetric final period dynamic advances on at least two debates in the literature about freezeout doctrine. Most directly, it confounds the theoretical assumption that nominally independent directors might block some freezeouts that are actually fair to public shareholders to advance their personal self-interest. Guhan Subramanian, for example, has argued that special committee directors might resist against a freezeout offer in order to entrench themselves in office.[182] Subramanian thus concluded that freezeout doctrines that provide the special committee with veto power over the deal will discourage some value-increasing freezeouts.[183] But the exact opposite is true in the asymmetric final period model: if the controlling shareholder has the power to act as a repeat benefactor, then self-interest would more likely propel special committee directors to go along with the controlling shareholder's proposal. A director who votes to reject a freezeout offer will likely be unseated by the controlling shareholder at the next election, if not earlier, so any benefits of resistance will be fleeting. Accommodation is the far better strategy for reaping long-term benefits. From this perspective, there is no conceptual reason to believe that giving the special committee veto power will deter some socially efficient freezeouts.

Second, some scholars have suggested that nominally independent directors would be more effective in overseeing controlling shareholders if minority shareholders can hold directors accountable at the ballot box.[184] In a recent article, Bebchuk and Hamdani proposed empowering minority shareholders

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managers and board will likely lose their positions" and thus "are in a final period where reputation and fear of future discipline lose their force as constraints on self-interested behavior."). *See generally* Sean J. Griffith, *Deal Protection Provisions in the Last Period of Play*, 71 FORDHAM L. REV. 1899, 1941–47 (2003).

[181] *See id.* at 1945; Laster, *supra* note 180, at 809–10.

[182] *See* Subramanian, *supra* note 2, at 39–40 (describing the "obvious concern" that independent directors "might reject some freezeout offers out of self-interest rather than the interest of minority shareholders").

[183] *See id.*

[184] *See, e.g.*, Bebchuk & Hamdani, *Independent Directors and Controlling Shareholders*, *supra* note 6; *cf.* George W. Dent, Jr., *Toward Unifying Ownership and Control in the Public Corporation*, 1989 WIS. L. REV. 881, 907–08 (proposing giving a firm's ten or twenty largest shareholders control over the director election process).

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over certain director appointment, reelection, and removal decisions—for instance, by giving minority shareholders veto rights over those outcomes.[185] Bebchuk and Hamdani argued that these "enhanced-independence directors" should play a dominant role in negotiating self-dealing transactions, such as freezeouts, because they are properly motivated to safeguard minority investors' interests.[186]

I agree with the core intuition that nominally independent directors would be better guardians in ordinary conflict situations if they had incentives to be accountable to minority shareholders. But the same result does not necessarily follow for freezeouts. Nominally independent directors will typically be less responsive to minority shareholder discipline during freezeout negotiations because the director-shareholder relationship will soon end.[187] At the same time, those directors will be motivated to stay on good terms with controlling shareholders that remain a source of potential benefits. The key point is this: merely increasing the degree to which minority investors can influence director elections, without reducing controlling shareholders' ability to reward directors after the deal, cannot effectively induce nominally independent directors to have robust freezeout negotiations with controllers.

CONCLUSION

This Article establishes the prospect of reward, or patronage, from the

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[185] *See* Bebchuk & Hamdani, *Independent Directors and Controlling Shareholders*, *supra* note 6, at 1293–1304.

[186] *Id.* at 1306–07.

[187] Of course, if the minority shareholders also can appoint directors to new board seats post freezeout or provide other benefits, then the directors might be more motivated to resist controller opportunism. While the fact that institutional shareholders now own approximately 80% of outstanding shares in S&P 500 companies might suggest that they have leverage over independent directors as repeat players, *see* Neil Stewart, *Retail Shareholders: Looking Out for the Little Guy*, IR MAG. (May 15, 2012), http://www.irmagazine.com/articles/shareholder-targeting-id/18761/retail-shareholders-looking-out-little-guy, these shareholders have proven reluctant to interfere in their portfolio companies. *See* Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 886–88 (2013) (discussing the evidence showing that institutional investors have not played an active steward role in their portfolio firms); Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1048 (2007) (citing regulatory constraints, incentives, and conflicts of interest as factors that prevent mutual funds from acting as effective monitors); Lucian A. Bebchuk, et al., *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSPECTIVES 89, 90 (2017) (demonstrating that "index funds have especially poor incentives to engage in stewardship activities that could improve governance and increase value"); *cf. also* Giovanni Strampelli, *How to Enhance Directors' Independence at Controlled Companies*, 44 J. CORP. L. 103, 127, 133–36 (2018) (arguing, for a reason different from my own, that institutional investor passivity "may significantly impair the effectiveness of the Bebchuk and Hamdani proposal" and suggesting the need for an entity to coordinate institutional investor voting).

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controlling shareholder as an important factor in the incentive calculus of nominally independent directors. Judges and scholars miss half the story when they view independence solely through the lens of beholdenness and retribution. I show that controlling shareholders can and do form repeat relationships with the nominally independent directors who serve on their boards, and the prospect of this patronage can compromise those directors' ability to prevent controlling shareholder opportunism.

By orienting the independence inquiry towards reward, this Article also exposes the value of a more granular account of controlling shareholders—one that contends with the heterogeneity among the people and entities within that broad category. When jurists and scholars invoke the term "controlling shareholders," they are in fact pointing to a plurality of actors, governance techniques, and bargaining dynamics. Efficient regulation of companies with controllers requires a better understanding of this heterogeneity than we now have. I have offered a framework that disaggregates controlling shareholders to allow more precise analysis of their ability to influence director behavior, and I hope this Article will encourage more work in a similar vein.

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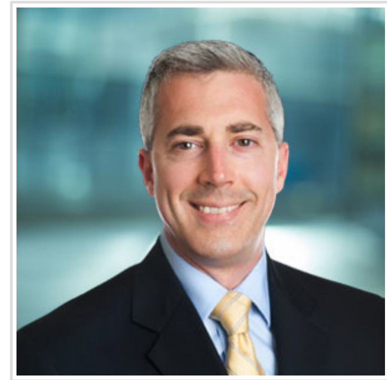

Marc S. Casarino

Partner

Courthouse Square | 600 N. King Street, Suite 800 | Wilmington, DE 19801-3722
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casarinom@whiteandwilliams.com

Marc helps his clients to achieve their business objectives, manage risk, and resolve disputes. He regularly advises individuals and businesses on the nuances of Delaware commercial and business entity law, corporate governance, shareholder rights, partnership conflicts, employment issues, and commercial real estate transactions. He is also experienced in all aspects of corporate restructuring, reorganization and bankruptcy matters.

In addition to trial experience in all Delaware State and Federal Courts, Marc represents clients in alternative dispute resolution proceedings, including arbitration and mediation, as well as proceedings before administrative bodies such as the EEOC and Delaware Department of Labor. He is often trusted by insurers to handle complex insurance coverage claims and defend insured parties under third-party liability policies.

Representative Matters

- Member of deal team that negotiated workout of complex refinancing transaction to salvage a commercial development project
- Member of deal team for transaction of interest in iconic hotel property
- Obtained defense verdict for property developer in trial involving environmental trespass and injunctive relief claims
- Obtained defense verdict for employer in federal jury trial involving FMLA retaliation claims
- Obtained defense verdict for commercial property owner in state jury trial involving catastrophic injuries to a patron
- Secured full recovery for creditor constituency as co-counsel for Official Committee of Unsecured Creditors of debtor Phoenix Payment Systems, Inc
- Obtained Trial Court decision that faulty workmanship was not an occurrence triggering coverage under contractor’s CGL policy
- Obtained Trial Court decision that insurer had no duty to defend general contractor or subcontractor employer of worker injured on construction site
- Successfully litigated equitable claims for temporary and permanent injunctions involving restrictive covenants and non-compete disputes
- Defended a variety of employment-based claims brought before the EEOC and Delaware Department of Labor

Practice Areas

General Commercial Litigation

Financial Lines

Labor and Employment

Financial Restructuring and Bankruptcy

Insurance Coverage and Bad Faith

Finance

Real Estate

Bar and Court Admissions

Delaware

U.S. Court of Appeals for the Third Circuit

U.S. District Court for the District of Delaware

Education

Widener University School of Law, JD, 1997

University of Delaware, BS, Economics, 1994

Memberships

Delaware State Bar Association, Corporate Law, Commerical Law and Labor & Employment Sections

Recognition & Involvement

Marc is the Pro Bono Coordinator for the Delaware office. He regularly donates time each year to assisting pro bono clients through the Office of the Child Advocate and similar organizations.

In his spare time, Marc volunteers at a no-kill animal shelter near his home.

Publications

Delaware Trial Court Interprets Coverage Under a D&O Policy to Include an Appraisal Action as a Securities Claim
Financial Lines Alert | August 13, 2019

Delaware Supreme Court Clarifies That a Response to a Books and Records Demand Is Not Presumptively Confidential
Taking Care of Business | August 8, 2019

Delaware Chancery Court Addresses the Seller's Preservation of Privilege Post-Closing
Taking Care of Business | June 18, 2019

Trust the Process – A Process That Develops Reasonable Justification for a Coverage Determination Will Disarm a Bad Faith Claim
Insurance Coverage and Bad Faith Alert | June 10, 2019

Delaware Supreme Court Rejects the Trial Court's Statutory Appraisal Analysis in Aruba Networks
Taking Care of Business | April 19, 2019

Delaware Chancery Court Opens Discussion of Enhanced-Independence Director Deference for Controller Transactions
Taking Care of Business | April 15, 2019

Delaware Chancery Court Orders Papa John's to Deliver Materials Responsive to a Director's Books and Records Demand
Taking Care of Business | January 17, 2019

Delaware Chancery Court Invalidates Charter Provisions Requiring Federal Forum Selection for Claims Under The Securities Act Of 1933
Taking Care of Business | December 21, 2018

Delaware Superior Court Applies "Capacity" Exclusion to Deny Coverage Under D&O Policy
Directors and Officers Alert | December 4, 2018

Delaware Chancery Court Declines to Apply *Zapata*-Like Analysis to Deceptive Conduct Affiliated With an Independent Board
Taking Care of Business | November 30, 2018

Delaware Supreme Court Rules Insured's Claim Too Late, Reverses Bad Faith Judgment
Insurance Coverage and Bad Faith Alert | November 30, 2018

Delaware Enforces Common Stockholder Contractual Waiver of Appraisal Rights
Taking Care of Business | October 11, 2018

Delaware Adopts New Anti-Sexual Harassment Law
Labor and Employment Alert | September 10, 2018

The Viability of Dually Direct and Derivative Claims Is Under Fire in Delaware Corporate Litigation
Taking Care of Business | September 10, 2018

Back to Basics: Board and Special Litigation Committee Investigations in Shareholder Derivative Litigation
The D&O Diary | August 22, 2018

A Teachable Moment on Adequate Disclosures
Law360 | August 20, 2018

Delaware Supreme Court Offers a Cautionary Reminder on Disclosure Adequacy
Taking Care of Business | July 26, 2018

Delaware Bankruptcy Court Sustains Objection to Claim on a Note Transferred in Violation of Anti-Assignment Restriction
Financial Restructuring and Bankruptcy Alert | June 22, 2018

Delaware Seeks to Incentivize Start-Up Technology Companies to Headquarter in the First State
Taking Care of Business | June 14, 2018

Delaware Chancery Court Applies Strict Statutory Construction to Reject Appraisal Rights Following Reverse Merger
Corporate and Securities Alert | June 8, 2018

Delaware Supreme Court Continues Recent Spate of Decisions Appraising Fair Value of a Company's Stock Below Deal Price
Corporate and Securities Alert | April 25, 2018

Insurers of Directors and Officers of Delaware Corporations Must Take Heed of The Superior Court's Recent *Murdock* Decision
Directors and Officers Alert | April 10, 2018

Delaware Chancery Court Clarifies That Section 144 Compliance Will Not Automatically Bestow Business Judgment Protection
Taking Care of Business | March 6, 2018

Delaware Chancery Court Brings Further Clarity to the Influence of Deal Price on Fair Value In Statutory Appraisal Actions
Corporate and Securities Alert | March 2, 2018

Delaware Chancery Court Finds Unaffected Market Price to Be Fair Value in a Post-Dell Appraisal Decision
Taking Care of Business | February 26, 2018

Delaware Shoots Down Right-to-Work Legislation
Labor and Employment Alert | January 22, 2018

Choosing Delaware Law Does Not Mean You Can Litigate in Delaware
Corporate and Securities Alert | August 14, 2017

Revisiting Stock Transfer Restrictions
Law360 | August 8, 2017

Delaware Allows Blockchain to Create and Maintain State Corporate Records
Corporate and Securities Alert | August 2, 2017

Delaware Chancery Court Clarifies Effectiveness of Share Transfer Restrictions
Corporate and Securities Alert | July 17, 2017

Third Circuit Rejects Automatic Denial of Tolling of Statute of Limitations During Pendency of Section 220 Books and Records Action
Corporate and Securities Alert | June 23, 2017

Employment Agreement Class Action Waiver Deemed Unenforceable by Delaware Court
Labor and Employment Alert | October 13, 2016

Recent Amendments to the DGCL Affect Appraisal Rights, Mergers and the Chancery Court's Jurisdiction
Corporate and Securities Alert | June 27, 2016

Delaware Supreme Court Determines Timing of Action for Bad Faith Failure to Settle Third-Party Claim
Insurance Coverage Alert | March 8, 2016

Unsecured Creditor Appeals Delaware Bankruptcy Court Ruling as to Postpetition Interest on an Unsecured Claim
Financial Restructuring and Bankruptcy Alert | December 16, 2015

Independent Contractors and Employees in the Gig Economy
Labor and Employment Alert | October 29, 2015

Lessons Learned From FMLA Retaliation Trial
Labor and Employment Alert | October 20, 2015

Delaware State Court Holds that Defective Workmanship Claims do not Trigger Coverage by a Builder’s Commercial General Liability Policy
Insurance Coverage Alert | April 3, 2015

Delaware Lawmakers Seek to Raise the Minimum Wage … Again
Labor and Employment Alert | March 20, 2015

Delaware Court of Chancery Provides Guidance On Application of MFW On Motion To Dismiss
Corporate and Securities Alert | September 11, 2014

Delaware Supreme Court Allows Shareholders Access to Corporation’s Attorney-Client Privileged Documents
Corporate and Securities Alert | August 12, 2014

Delaware Bar Reacts to Recent Decision on Fee Shifting Bylaws
Corporate and Securities Alert | May 27, 2014

New Strategy for Deterring Intracorporate Litigation?: Delaware Supreme Court Supports Fee-Shifting Bylaws
Corporate and Securities Alert | May 13, 2014

Delaware “Bans the Box”: Criminal History no Longer Permitted on Job Applications
Labor and Employment Alert | May 9, 2014

The Duties of a Delaware Insurance Professional
Insurance Alert | May 6, 2014

To Infinity And Beyond - Long Dissolved Corporations Remain Subject To Claims According To The Delaware Supreme Court
Insurance Alert | December 20, 2013

Doing Well by Doing Good?
Business and Corporate Alert | September 12, 2013

Delaware Law Prohibits Adverse Employment Action Against Volunteer Emergency Responders
Labor and Employment Alert | September 9, 2013

The Combined Impact of the Economic Downturn and Increased Employment Regulations
Aspatore Thought Leadership: Employment Law 2013 | February 15, 2013

Delaware Legislature Expands Exception for Self-Administered Medication
Education Alert | July 31, 2012

Delaware Whistleblowers' Protection Act Update
Labor and Employment Alert | July 31, 2012

Recent Regulatory Changes, Technological Advances, and Case Law Impacting Employer Clients
Inside the Minds: The Impact of the Recent Regulatory Developments in Employment Law (Aspatore Books) | January 10, 2012

Cases & Deals

White and Williams Team Leads Corporate Restructuring and Financing for Transformation of Heating Plant into Luxury Residences
July 24, 2019

White and Williams Represents Progress Physical Therapy In Multimillion Dollar Sale To Ivy Rehab
May 14, 2019

MIS Training Institute Acquires LeaderQuest
April 1, 2019

White and Williams LLP

Ryan J. Udell
Partner

Chair, Corporate and Securities Group

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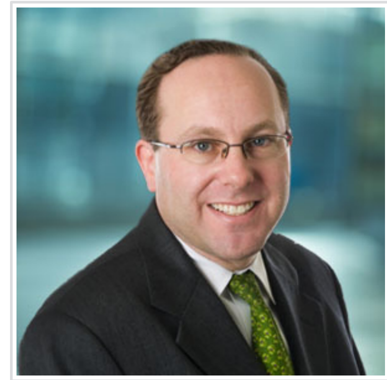

Ryan Udell concentrates his practice on equity and debt financings, mergers and acquisitions, intellectual property counseling and transactions, and general corporate issues, with special emphasis on technology focused industries, such as software, healthcare IT, pharmaceuticals, biotechnology, medical technology, and those that support such industries.

Employing scalability, Ryan offers creative and efficient solutions – be they simple or complex – tailored to suit his clients' particular needs. Whether it's an emerging growth firm or a multinational company, or an angel, venture or private equity investor, Ryan's clients appreciate his willingness to leverage his extensive business and professional network in helping them achieve their business and financial goals, from formation to capital raising to procurement and operations to cross-border transactions.

Prior to joining White and Williams, Ryan was a law clerk to the Honorable Vincent A. Cirillo of the Superior Court of Pennsylvania.

Ryan is a member of the Philadelphia Chapter of the Association for Corporate Growth and serves on the new member committee. He is also an adjunct professor at Lehigh University's Baker Institute for Entrepreneurship, Creativity and Innovation.

Representative Matters

- Led the representation of Boathouse Capital in its investment in Finch, a Salt Lake City-based paid digital media automation platform for marketing professionals
- Represented Progress Physical Therapy in a multimillion dollar membership interest purchase agreement with Ivy Rehab, a network of more than 175 outpatient physical and occupational therapy clinics in 10 states
- Represented a life sciences revenue analytics software company in its merger with a life sciences commercial data and analytics company, creating an updated "best-in-class" data and analytics solutions company
- Represented a Philadelphia-based private equity firm in its investment in a leading information and advisory services firm

Practice Areas

Corporate and Securities

Intellectual Property

Private Equity and Venture Capital

Food and Beverage

Bar and Court Admissions

Pennsylvania

New Jersey

Education

Temple University School of Law, JD, *magna cum laude*, 1996

Emory University, BA, 1993

Memberships

Association for Corporate Growth

Life Sciences Collaborative

Pennsylvania Alliance for Capital and Technologies

Pennsylvania BIO

Pharmaceutical Consulting Consortium International

- Represented an industry-leading provider of pharmacy benefit management services in its sale to a technology, connectivity and information solutions provider
- Represented provider of business and technology solutions in its sale to a strategic buyer
- Represented manufacturing company in its sale to a privately-held, diversified manufacturing company
- Represented national healthcare platform in round of equity funding
- Represented premier provider of business and technology solutions in acquisition of engineering firm
- Represented a multinational automotive supplier in the sale of its business to a Hong Kong based private equity firm
- Represented a multinational firm in the sale of its automotive leather wrapping business to Johnson Controls
- Represented a laboratory business in the sale of its bio-analytic lab division to Laboratory Corporation of America
- Represented a multi-national pharmaceutical manufacturing and development company in the sale of its European distribution business to a European-based pharmaceutical marketing firm
- Represented a privately held technology company in a $30 million venture capital investment
- Represented a venture partner in a joint venture between a large privately held distributor of consumer electronics and appliances and a fulfillment services provider
- Represented a publicly held venture partner in several joint ventures with Canadian venture partners for work on nuclear power reactors in Canada
- Represented a foreign manufacturer of pharmaceutical products and medical devices in the domestic license and distribution of its products to a U.S. based pharmaceutical company
- Assisting national dental care provider in developing and implementing trademark strategy
- Assisting world's largest creative competitions firm in procuring and maintaining its intellectual property portfolio
- Represented a specialty pharmaceutical firm in obtaining a trademark license from a multi-national pharmaceutical company
- Represented a clothing manufacturer in obtaining trademark licenses from large, publicly traded automotive manufacturers
- Represented a privately held medical device development firm in the license of a patent-pending drug delivery instrument from a publicly traded pharmaceutical company
- Represented specialty software developer in license of its software to a national healthcare company
- Represented specialty software firm in license of its software to several large pharmaceutical companies

Recognition & Involvement

In 2005, 2006, 2007, 2008, 2010 and 2011, Ryan was named in a survey of his peers as a Pennsylvania "Rising Star" attorney by *Law & Politics* Magazine. In 2010 and 2011, Ryan was also named as one of Philadelphia's Legal Elite, by Philadelphia *SmartCEO* Magazine.

Ryan sits on the Board of Directors of Federation Learning Services, a 100 year-old non-profit organization which operates early childhood education centers in the Philadelphia region. He is also a member of FELS' Executive, Operations and Investments Committees.

Publications

3rd Circ. Decision Limits Liability of Board Observers
Law360 | August 12, 2019

Third Circuit Decision Highlights Important Distinction Between Directors and Board Observers
Taking Care of Business | July 26, 2019

FCC Proposes Pilot Program to Fund and Promote Telehealth in Underserved Communities
Taking Care of Business | July 25, 2019

Delaware Chancery Court Addresses the Seller's Preservation of Privilege Post-Closing
Taking Care of Business | June 18, 2019

Cannabis and Cannabis-Derived Compounds: FDA Announces Public Hearing and TTB Issues Industry Circular
Taking Care of Business | May 31, 2019

Reps & Warranties Insurance Claims – Observations on AIG's 2018 Claims Report
Taking Care of Business | September 24, 2018

The #MeToo Rep: M&A in the #MeToo Era
Taking Care of Business | August 27, 2018

PA Green Lights Dry Leaf Cannabis and Other Updates to Medical Marijuana Laws
Taking Care of Business | April 25, 2018

FTC Issues Updated Guidance for Avoiding Antitrust Liability for "Gun Jumping" During M&A Negotiation and Due Diligence
Corporate and Securities Alert | April 13, 2018

Insurers of Directors and Officers of Delaware Corporations Must Take Heed of The Superior Court's Recent *Murdock* Decision
Directors and Officers Alert | April 10, 2018

Technology, the New Frontier of National Security: Trump Blocks Broadcom's Proposed Takeover of Qualcomm
Taking Care of Business | April 10, 2018

McConnell Set to Propose Legislation to Legalize Industrial Hemp
Taking Care of Business | April 9, 2018

Delaware Chancery Court Clarifies That Section 144 Compliance Will Not Automatically Bestow Business Judgment Protection
Taking Care of Business | March 6, 2018

The "Hungry Tapeworm" of Healthcare the New Joint Focus of Amazon, Berkshire Hathaway, JP Morgan
Healthcare Alert | January 30, 2018

President Blocks Chinese Acquisition of U.S. Corporation
Corporate and Securities Alert | October 18, 2017

Recent Ruling a Caveat to Private Equity Investors
Corporate and Securities Alert | September 5, 2017

The Fraud Carve-Out Revisited - EMSI and its Warnings for Dealmakers
Corporate and Securities Alert | June 16, 2017

Proposed "Tech Tax" Could Derail PA Start-Up Businesses
Corporate and Securities Alert | June 15, 2017

Pennsylvania Department of Health Releases Draft Rules for Doctors Prescribing Medical Marijuana
Healthcare Alert | April 21, 2017

House Passes Bill Relaxing Reporting Requirements for Private Equity Funds
Private Equity Alert | September 13, 2016

Employers Beware: New Developments Require Changes in Employment Agreements
Corporate and Securities Alert | August 23, 2016

SEC Releases Compliance and Disclosure Interpretations on Crowdfunding
Corporate and Securities Alert | May 19, 2016

HALOS Act Provides Clarification on General Solicitation Under Federal Securities Laws
Corporate and Securities Alert | May 2, 2016

Effective Non-Reliance Provisions Must be Drafted with Precision in Delaware
Corporate and Securities Alert | March 11, 2016

Delaware Court Expands Scope of "Books and Records" Requirement in Favor of Shareholders
Corporate and Securities Alert | February 19, 2016

Title III Securities-Based Crowdfunding: Ten Things You Should Know If You Are Considering Participating as an Issuer, Investor or Intermediary
Corporate and Securities Alert | November 19, 2015

Regulating the Gatekeepers: The Regulatory Scheme for Funding Portals in Crowdfunding Offerings
Corporate and Securities Alert | November 13, 2015

SEC Adopts Final Equity Crowdfunding Rules – Will They Be Worth the Wait?
Corporate and Securities Alert | November 6, 2015

IRS Proposes Changes to the Tax Treatment of Certain M&A Costs for Consolidated Groups
Tax and M&A Alert | June 3, 2015

Cases & Deals

White and Williams Represents Boathouse Capital in Investment in Finch
August 5, 2019

White and Williams Represents Progress Physical Therapy In Multimillion Dollar Sale To Ivy Rehab
May 14, 2019

MIS Training Institute Acquires LeaderQuest
April 1, 2019

Life Sciences Companies, IntegriChain and DaVIZta, Merge
March 6, 2019

CyberRisk Alliance Acquires MIS Training Institute's InfoSec World Conference and Expo
February 26, 2019

Eastern Warehouse Distributors, Parts Authority Purchase 11 National Auto Parts Supply Locations
February 21, 2019

RCM Technologies Acquires Thermal Kinetics
November 16, 2018

Cal Net Technology Merges With NexusTek
August 7, 2018

Frontier Strategy Group Acquires Ducker Worldwide
February 23, 2018

Boathouse Capital Invests in Sageworks
January 19, 2018

Atrio Acquires Microsoft Practice from RCM Technologies
January 4, 2018

RCM Acquires Eastern European Engineering Company
October 1, 2017

KD Pharma Group Invests in Nutriceutical Holdings
June 1, 2017

Friend Skoler Invests in Hex Performance LLC
May 4, 2017

RCM Acquires Assets of RAF Services
May 4, 2017

White and Williams Represents S.R. Smith, LLC in Sale to Champlain Capital
May 4, 2017

NYSE Acquires National Stock Exchange
January 31, 2017

White and Williams Represents Cal Net Technology in Acquisition of IT Provider
July 25, 2016

White and Williams Represents Jordan Reses in Sale to Mitchell
January 5, 2016

White and Williams Represents RCM Technologies in Sale of QAD Business Unit
January 1, 2016

White and Williams Represents LLR Portfolio Company in Sale to J.B. Poindexter & Co
November 2, 2015

Dorado Systems Secures Private Equity Funding
October 31, 2015

Corporate Lawyers Counsel Client in Acquisition of Engineering Firm
August 10, 2015

Horizon Healthcare Services Invests in Oncology Management Technology with Counsel from Corporate Group
September 23, 2014

White and Williams Represents Leading Specialty Nutriceutical Company in Sale
July 28, 2014

Guest-tek Acquisition of iBahn Takes Hotel Technology to a Higher Level
March 21, 2014

HUB Parking Technology Strengthens Parking Business with Assist from White and Williams
November 8, 2013

White and Williams Counsels Technology Company in Sale
September 27, 2013

Technology Provider Expands Business with Assist from Corporate Group
August 8, 2012

White and Williams Represents DDJ Capital Management in Strategic Acquisition
June 1, 2012

Private Equity and Venture Capital Group Facilitates Deal Between Friend Skoler and Salon Lofts Group
March 8, 2012

Corporate Group Assists with Recapitalization of Electronic Content Management Solutions Provider
March 7, 2012

Seton Company Relies on Broad Experience of White and Williams
August 31, 2011

Mentzel and Udell Handle Corporate Matters for Innocoll Holdings, Inc.
November 2008

Blog

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