THE INDEPENDENT BOARD OF DIRECTORS AND GOVERNANCE IN THE UNITED STATES: WHERE IS THIS HEADING?

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A downturn in the American economy has been greatly attributed to events resulting from the terrorist attacks of September 11, 2001.1 Although justifiable to a large extent, investors and others affected by the recent downfall of some major companies cannot rely on the same excuse. Two such companies, Enron and WorldCom, filed for the largest bankruptcies in United States history in December 2001 and July 2002, respectively.2 Even more disturbing and scandalous, the collapse of both companies stemmed directly from corporate mismanagement.3 Consequently, the finger undoubtedly points at the inadequacy of the corporate governance rules, with certain questions still to be answered about the oversight role of corporate directors.4 The undisputed questions are whether the boards of directors failed to exercise oversight function over management and, if so, why? In other words, has board independence been compromised to the extent that a board’s decisionmaking undermines the interest of the shareholder and stakeholders in violation of the directors’ statutory fiduciary duty of care?5 Why is the board so

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3. See Paul Gompers, Joy Ishii & Andrew Metrick, Special Report—Corporate Boards: The Way We Govern Now—Corporate Boards, The Economist 59, 59 (Jan. 11, 2003). Corporate mismanagement is an issue that became a paramount concern not only in the United States, but also in other countries. Many countries are reviewing the way companies are managed; in Germany, a committee under Gerhard Cromme produced the country’s first corporate-governance code in 2002; in Canada, the Council of Chief Executives (a body of 150 persons holding positions in upper levels of management proposed new guidelines for listed companies). France “launched a review of best corporate-governance practices.” In Britain, a report on the role of nonexecutive directors was prepared. Id.
4. Jeffery N. Gordon, Governance Failures of the Enron Board and The New Information Order of Sarbanes–Oxley, 35 Conn. L. Rev. 1125, 1126-27 (2003). The Enron case was especially troubling because “it represent[ed] a failed stress test for many of institutions of U.S. shareholder capitalism . . . .” Many separate systems also failed at the same time—“auditing and accounting, executive compensation, internal monitoring by the board, and external monitoring by securities analysts.” Id. at 1127.
5. This fiduciary duty of care is satisfied where the board makes an informed decision, in good faith and in honest belief that the action was taken in the best interest of the corporation. If the board satisfies this duty, it is protected by the business judgment rule and its decision cannot be challenged. Arison v. Lewis, 473 A.2d 805, 812 (Del. 1984). Hence, the business judgment rule serves as a shield that protects directors from liability for their decisions; once it is found that a director should receive this protection, the courts would not interfere with or second-guess her decision. See id. Although this rule has been criticized by academics, the rule is not without a rational basis. Compare William L. Cary & Sam Harris, Standard of Conduct Under Common Law, Present Day Statutes and the Model Act, 27 Bus. Law. 61 (1972) with Charles R. T. O’Kelley & Robert B. Thompson, Corporations and Other Business Associations: Cases and Materials 259-61 (3d ed., Aspen L. & Bus. 1999).

In Joy v. North, Judge Winter illustrates this rational basis by showing that, first, investors voluntarily undertake the risk of bad business judgment, as they have a choice of not buying stocks from a company less prone to mistakes in judgment. 692
reluctant to confront and expose management and vice versa? The famous case of Smith v. Van Gorkom still begs the question of whether the board of directors is anything more than a rubber stamp of decisions made by corporate management.\(^6\) What is the effect of the inside versus outside director dichotomy with regards to the board’s independence? In this light, much has been said about loosening the outside directors’ ties to management and recreating a vital and independent board [that] will engage in active oversight, [rather than] passive agreement.\(^7\) Is this plausible, given that the same board members in one company may be outside directors or officers for other companies? If the tacit consent of “scratch my back and I’ll scratch yours” inevitably prevails and leaves room for corrupt practices, as evident by the recent downfall of some blue chip companies, how do we achieve a truly independent board? Should the board be composed exclusively of outside directors?\(^8\) Are the Sarbanes-Oxley Act of 2002 (SOX or the Act) and the New York Stock Exchange (NYSE) proposed rules helpful in addressing these issues?

Although there is much debate on the inadequacy of accounting rules and their enforcement, this article approaches the problem from the perspective of the role of the board of directors as an oversight body of the corporation. Hence, this article aims to address these questions by:

- Looking at corporate boards of directors, their authority and responsibilities, and their interaction with senior executive officers.

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F.2d 880 (1982). Failing to do so means they recognize certain voluntariness in undertaking the risk of bad business decision. Id. at 885.

“Second, courts recognize that after-the-fact litigation is a most imperfect device to evaluate corporate business decisions.” That the “entrepreneur’s function is to encounter risks and to confront uncertainty, and a reasoned decision at the time made may seem a wild hunch viewed [ ] later against a background of perfect knowledge.” Id. at 886. Third, higher profits often corresponds to high risks, thus it is in the interest of the shareholders that the law not create incentives for overly cautious corporate decisions, especially given that shareholders can choose to diversify their portfolio holding to the level of their risk tolerance. Id.


8. Even if one assumes that the independent board or outside directors is the solution, who will monitor the monitors? This is a problem often left out of the monitoring equation but aptly expressed by Dr. Seuss over 30 years ago in a rhyme entitled, “Did I Ever Tell You How Lucky You Are?”

Oh, the jobs people work at!
Out west, near Hawtch-Hawtch,
there’s a Hawtch-Hawtcher-Bee-Watcher.
His job is to watch...

is to keep both his eyes on the lazy town bee.
A bee that is watched will work harder, you see.
Well...he watched and he watched.

But, in spite of his watch,
that Bee didn’t work any harder. Not Mawtch.
So then somebody said,
“Our old bee-watching man
just isn’t bee-watching as hard as he can.
He ought to be watched by another Hawtch-Hawtcher!
The thing that we need
is a Bee-Watcher-Watcher!”

WELL...
The Bee-Watcher-Watcher watched the Bee-Watcher.
He didn’t watch well. So another Hawtch-Hawtcher had to come in as a Watch-Watcher-Watcher!
And today all the Hawtchers who live in the Hawtch-Hawtch are watching on Watch-Watcher-Watchering-Watch,
Watch-Watching the Watcher who’s watching that bee.
You’re not a Hawtch-Watcher. You’re lucky, you see!

• Discussing the inside and outside director dichotomy in light of directors’ independence. Looking at the Act, as well as the NYSE, and their potential impact upon the board of directors. (For example, does the Act enable the board of directors to be more independent?)

• Incorporating in my discussion a survey of the top 100 boards of public companies in the United States to see how the boards have evolved, if at all, since the new regulations.

• Considering what are the strengths and weaknesses of an independent board?

• Recommending what should be done to make the board an independent decision-making body of the corporation.

• Discussing possible shortcomings and conclusion.