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Boards-R-Us: Reconceptualizing Corporate Boards

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Boards-R-Us: Reconceptualizing Corporate Boards

Stephen M. Bainbridge and M. Todd Henderson

THE LAW SCHOOL
THE UNIVERSITY OF CHICAGO

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BOARDS-R-US: RECONCEPTUALIZING CORPORATE BOARDS

Stephen M. Bainbridge and M. Todd Henderson*

Abstract

State corporate law requires director services be provided by "natural persons." This Article puts this obligation to scrutiny, and concludes that there are significant gains that could be realized by permitting firms (be they partnerships, corporations, or other business entities) to provide board services. We call these firms "board service providers" (BSPs). We argue that hiring a BSP to provide board services instead of a loose group of sole proprietorships will increase board accountability, both from markets and judicial supervision. The potential economies of scale and scope in the board services industry (including vertical integration of consultants and other board member support functions), as well as the benefits of risk pooling and talent allocation, mean that large professional director services firms may arise, and thereby create a market for corporate governance distinct from the market for corporate control. More transparency about board performance, including better pricing of governance by the market, as well as increased reputational assets at stake in board decisions, means improved corporate governance, all else being equal. But our goal in this Article is not necessarily to increase shareholder control over firms—we show how a firm providing board services could be used to increase managerial power as well. This shows the neutrality of our proposed reform, which can therefore be thought of as a reconceptualization of what a board is rather than a claim about the optimal locus of corporate power.

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"[Alexander] Hamilton would have no trouble recognizing the corporate board of today. The structure and composition of boardrooms have changed surprisingly little in 200 years."[1]

I. Introduction

Corporate boards of directors are one of the most important institutions in our capitalist system. This is because state law requires boards intermediate the relation between "ownership" and "control" of the corporation.[2] Separating capital and management is thought to be a source of efficiency, since those with capital may not be best positioned to manage publicly held firms.[3] But the separation generates the potential for opportunism, since managers may be less careful spending other people's money than they would their own.[4] To optimize the tradeoff between management efficiency and opportunism, shareholders elect boards of directors to supervise management of the firm by corporate officers.[5] Although day-to-day decisions are made by managers, directors are obligated to make fundamental decisions, like hiring and firing the managers, setting compensation incentives, raising capital, and entering into mergers and acquisitions.[6] This latter category of decisions routinely involves high stakes and potential conflicts among corporate stakeholders, making the board the place where legal rules about corporate governance have the most relevance.[7]

In recognition of the centrality of the board in corporate governance, judicial control of corporate activities is almost exclusively affected through review of board

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[1] Robert A.G. Monks & Nell Minow, Corporate Governance 256 (2012).

[2] See generally Adolf A. Berle & Gardiner C. Means, The Modern Corporation and Private Property 84-89 (1932) (discussing separation of ownership and control in public corporations).

[3] See, e.g., Ramirez de Arellano v. Weinberger, 745 F.2d 1500, 1558 (D.C. 1984) (Scalia, J., dissenting) (noting "the efficiencies generated by the separation of ownership and control which account for much of the success and popularity of the corporate form"); Eugene F. Fama, Agency Problems and the Theory of the Firm, 88 J. Pol. Econ. 288, 289 (1980) (opining that the "separation of security ownership and control can be explained as an efficient form of economic organization").

[4] See Berle & Means, supra note 2, at 6 (stating: "The separation of ownership from control produces a condition where the interests of owner and of ultimate manager may, and often do, diverge and where many of the checks which formerly operated to limit the use of power disappear.").

[5] State law mandates that "the business and affairs" of every corporation be managed by or under the direction of a board of directors. See, e.g., Del. Code Ann., tit. 8, § 141(a); see generally Mod. Bus. Corp. Act. Ann. § 8.01 at TBA (TBA) (providing a summary of comparable state corporation code provisions). In turn, state law provides that the board shall be elected by shareholders. As such, "corporate law provides for a separation of control and ownership." Malone v. Brincat, 722 A.2d 5, 9 (Del.1998).

[6] As early as 1922, the Delaware Chancery Court held that the directors' role was one of supervision and control, with the detailed conduct of the business being a matter that properly could be delegated to subordinate employees. Cahall v. Lofland, 114 A. 224, 229 (Del. Ch. 1921), aff'd, 118 A. 1 (Del. 1922). The board, however, retains the power to hire and fire firm employees and to define the limits of their authority. Moreover, certain extraordinary acts may not be delegated, but are instead reserved for the board's exclusive determination. See, e.g., Lee v. Jenkins Bros., 268 F.2d 377 (2d Cir. 1959); Lucy v. Hero Int'l Corp., 281 N.E.2d 266 (Mass. 1972).

[7] Managerial decisions, like whether to sell particular products or enter particular markets, are thought to be difficult and costly for courts to scrutinize ex post, as well as adequately policed by market forces. Board decisions, on the other hand, present opportunities for expropriation of corporate assets or opportunities by particular firm stakeholders, and courts are thought to be able to police these with greater accuracy and less cost.

decisions and refinement of board duties to shareholders.[8] Through their review of board actions in connection with mergers, executive compensation, supervision of firm risk, approval of conflicted transactions, and so on, state courts have created many of the basic rules of corporate governance.[9]

Legislation (from both states and the federal government), as well as private rules from stock exchanges, also focuses on optimizing corporate governance through attempts to perfect the board and optimally define its position in the corporate decision-making hierarchy.[10] For instance, in response to numerous corporate scandals during the late 1990s, the Sarbanes-Oxley Act of 2002 required, among other things, that all listed companies have audit committees composed entirely of independent directors.[11] Similarly, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 implemented numerous corporate governance reforms, including new disclosures about consultants working for boards and about compensation of directors, as well as new independence standards for board compensation committees.[12]

Influencing boards is the primary focus of good governance advocates of various kinds, as well. Proxy advisor firms, like Institutional Shareholder Services (ISS) and Glass, Lewis & Company, spend considerable resources trying to improve corporate governance by giving shareholders information about how they should vote in director elections. For instance, ISS sells institutional shareholders recommendations on how to vote for every director of large publicly traded firms based on firm policies regarding areas ranging from executive compensation to corporate strategy.[13] Although the power of ISS and the other proxy advisor firms is disputed,[14] it is without doubt that their ability to influence corporate behavior is cabined by the current corporate governance structure. Because shareholders have limited ability to directly effect change, much of their power—and thus that of ISS and its ilk—derives from voting on director elections.[15]

The importance of the board of directors is further illustrated by the considerable extent to which academics hoping to improve corporate governance focus on the role and

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[8] See Seinfeld v. Verizon Communications, Inc., 909 A.2d 117, 119 (Del. 2006) ("Delaware corporate law provides for a separation of legal control and ownership. … The common law imposes fiduciary duties upon the directors of Delaware corporations to constrain their conduct when discharging that statutory responsibility.").

[9] Jill E. Fisch, The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters, 68 U. Cin. L. Rev. 1061, 1074 (2000) (noting that "the majority of Delaware's important legal rules are the result of judicial decisions").

[10] One of us has elsewhere examined at length recent legislative efforts to influence corporate governance, see Stephen M. Bainbridge, Corporate Governance After the Financial Crisis (2012).

[11] See id. at 141-42 (discussing Sarbanes-Oxley § 301's requirements with respect to audit committees of public corporations).

[12] See generally Stephen M. Bainbridge, The Corporate Governance Provisions of Dodd-Frank, Engage, November 2010, at 29 (discussing Dodd-Frank corporate governance provisions applicable to public corporations).

[13] See Bainbridge, supra note 10, at 255 ("Today, ISS services some 1700 institutional investor clients, which collectively manage some $25 trillion in equity securities.").

[14] See Stephen Choi. et al., The Power of Proxy Advisors: Myth or Reality?, 59 Emory L.J. 869 (2010) (arguing that "popular accounts substantially overstate the influence of ISS" and that " the impact of an ISS recommendation is reduced greatly once company- and firm-specific factors important to investors are taken into consideration").

[15] See Harrah's Entertainment, Inc. v. JCC Holding Co., 802 A.2d 294, (Del.Ch. 2002) (opining that "the election of directors may be the most ... important action[ ] that shareholders can take").

composition of the board.[16] Almost every corporate governance reform proposed over the past several decades has focused on the board of directors.[17] The central academic debate is whether boards have too much control over corporate affairs, too little, or just the right amount.[18] This battle is fought on the grounds of who board members are, whether they are independent, who appoints them, how they are elected, how they are compensated, what the standards for their conduct and liability are, whether there should be more independent directors, what the optimal board size is, and so forth.[19] All of these are an attempt to optimize the monitoring and governance role played by the board.[20]

Despite the long and zealous efforts of corporate law reformers to understand and improve the board of directors, there is a gaping hole in the corporate governance literature. No one has yet questioned a fundamental assumption of the current corporate governance model—that is, only individuals, acting as sole proprietors, provide professional board services. To be sure, there seem to be legal reasons why this is the case. For example, state law seems to require directors to be natural persons, as do the provisions of federal law pertaining to corporate governance and the listing requirements of stock exchanges.[21] This Article puts these obligations to scrutiny, asking whether this requirement makes sense. To do so, it posits a novel alternative: board services could be provided by other entities, be they partnerships, corporations, limited liability corporations, or any other type of business association. We call these firms "board

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[16] See, e.g., Kelli A. Alces, Beyond the Board of Directors, 46 Wake Forest L. Rev. 783, 785 (2011) ("Numerous corporate law scholars have critically examined the structure and functions of the board of directors and have evaluated the relative success of various board compositions."); John Haberstroh, Activist Institutional Investors, Shareholder Primacy, and the HP-Compaq Merger, 24 Hamline J. Pub. L. & Pol'y 65, 81 (2002) (explaining that "since the mid-1970s corporate law academics and shareholder activists have effectively lobbied to refashion boards of directors"); Thomas W. Joo, Corporate Governance and the "D-Word," 63 Wash. & Lee. L. Rev. 1579, 1579 (2006) (asserting that "most corporate law academics have come to agree with Berle and Means' famous descriptive argument that corporate decisionmaking power is denied to shareholders and is instead heavily concentrated in the board of directors and upper management");

[17] See, e.g., Barry D. Baysinger & Henry N. Butler, Corporate Governance and the Board of Directors: Performance Effects of Changes in Board Composition, 1 J.L. Econ. & Org. 101, 102 (1985) (noting that corporate board reform proposals typically emphasize changes to board composition and independence); Usha Rodrigues, The Fetishization of Independence, 33 J. Corp. L. 447, 452 (2008) ("Corporate governance reforms generally presume (1) that outside independent boards are better than non-independent boards, and (2) that the more independent a board is, the better.").

[18] See, e.g., Lucian Arye Bebchuk, The Case for Increasing Shareholder Power, 118 Harv. L. Rev. 833 (2005) (arguing in favor of greater shareholder empowerment); Stephen M. Bainbridge, Director Primacy and Shareholder Disempowerment, 119 Harv. L. Rev. 1735 (2006) (arguing for limits on shareholder power); Leo E. Strine, Jr., Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America, 119 Harv. L. Rev. 1759 (2006) (same).

[19] See generally, J.W. Verret, Pandora's Ballot Box, Or a Proxy with Moxie? Majority Voting, Corporate Ballot Access, and the Legend of Martin Lipton Re-Examined, 62 Bus. Law. 1007, 1021-29 (2007) (providing a brief history of the "tug of war between managers and shareholders").

[20] See, e.g., Melvin A. Eisenberg, The Structure of the Corporation 170-85 (1976) (arguing that board reforms focused on director independence would improve monitoring of management); Lisa M. Fairfax, Sarbanes-Oxley, Corporate Federalism, and the Declining Significance of Federal Reforms on State Director Independence Standards, 31 Ohio N.U. L. Rev. 381, 387 (2005) (noting that the Sarbanes-Oxley Act, for example, "focused on director independence" and sought to "eliminate those ties that hindered directors ability to objectively monitor corporate officers").

[21] See infra Part V.

service providers" (BSPs). To be clear, we do not have in mind individual board members forming professional corporations to get the protection of limited liability, but rather all director services being provided by a single firm. In other words, just as companies outsource their external audit function to an accounting firm rather than multiple individuals, the board of directors function would be outsourced to a professional service company.

It is a unique and, we think, odd feature of corporate governance that there are laws requiring board services to be provided by sole proprietorships. We do not see these in other areas: lawyers, doctors, accountants, management consultants, and other providers of professional services routinely form business associations to provide their services because of some well-understood benefits. Associations allow individuals to pool their resources to share risks, obtain gains from economies of scale and scope, optimize the deployment of various resources across space and time, devote time and effort to innovation, and develop large reputational assets that can constrain opportunism.

These benefits seem as applicable or even more so in the context of corporate director services. Although discussed more fully below, a few of these are worth mentioning to see the idea. Board members face substantial legal risk from their service, and pooling this risk through associations may make the costs of board service lower. Conversely, however, outsourcing the board may also make fiduciary duties more robust. If directors are not as afraid to serve as professionals in a firm as they are to serve as individuals, then courts may be less reluctant to hold them liable. In addition, a firm serving as a board increases the number of monitors of board functions—both the shareholders of the underlying company and of the BSP would be interested in the quality of corporate governance decisions for any given company. A BSP may be a more effective way to hold directors accountable, and thereby improve corporate governance.

Outsourcing the board function may also create a new labor market for disciplining firms. Currently, there is no real market for corporate director talent. Directors find their way onto boards largely through personal connections or the opaque headhunter process, and because votes are private and decisions are made collectively, the accountability to shareholders is greatly attenuated. Although it is possible for any individual to run for a board seat on any company, the publicity and voting costs are prohibitive. The returns to winning a seat on the board of a very large company are a few hundred thousand dollars per year, while the costs of mounting a proxy battle run in the many millions. Even if sensible economically, the chances of winning are trivially small. A professional service company with a national reputation and the ability to provide all director functions would be able to increase the gains from winning board seats, while reducing the per seat cost of winning them. This could create a market for corporate governance separate and distinct from market for corporate control.

Finally, a BSP may be an effective means of measuring the value of corporate governance and of those providing director services.[22] For instance, a publicly traded

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[22] A key problem with many corporate governance reform proposals is that they are empirically uncertain or contestable, such that we cannot know for sure if requiring, say, more independent directors, will improve corporate governance outcomes. See, e.g., Roberto Romano, The Sarbanes-Oxley Act and the Making of Quack Corporate Governance, 114 YALE L. J. 1521 (2005) (collecting over 15 studies on the issues). This is largely because governance is inexorably tied up with the corporate performance in product, capital, and labor markets, and therefore the effects of governance are difficult to isolate. We may have a

BSP providing board services to many firms would have the quality of its services measured in the market somewhat independently of the operational outcomes of its clients. Partially decoupling governance and operational performance would allow all stakeholders to more readily measure the former.

To be sure, there are downsides to providing products and services through business associations. Risk sharing creates moral hazard problems, and therefore there may be reduced incentives for individuals providing directors services through a firm to take care. The moral hazard problem and the potential for risk externalization associated with limited liability are commonly understood problems of business associations. These must simply be balanced against the benefits, including the significant potential for the reputation of large-scale organizations to ameliorate this risk. In addition, there are well known ways of reducing this risk, including using the piercing the corporate veil doctrine in extreme cases. Given the broad acceptance and use of corporate forms in other areas of providing goods and services, we think the cost-benefit tradeoff for corporations serving as corporate boards is clearly positive in some and perhaps many cases. But our claim is narrower: we merely argue that firms should be permitted to experiment with having corporate entities provide some or all of their director services.

To see our idea, imagine a firm, Boards-R-Us, Inc., serving as the board of Acme Corporation. Instead of Acme shareholders hiring a dozen or so individual sole proprietors to provide board functions, they instead hire one firm—a BSP—to provide those functions, whatever they may be.[23] Boards-R-Us would still act through individual agents, but the responsibility for managing a particular firm, within the meaning of state corporate law, would be that of Boards-R-Us the entity. This means, for instance, a suit by shareholders for breach of the board's fiduciary duties would be against Boards-R-Us, and not against individuals or groups of individuals.

This Article considers the various details of what this might look like, as well as sets forth the costs and benefits of the BSP approach compared with the current model. To see the basics of the BSP model, it is probably helpful to imagine no other change to governance, that is, holding the current election, function, and liability regimes constant.[24] All of the current rules of federal and state law, as well as stock exchange listing standards, governing the nomination and election of directors would continue to apply. All that would change is that instead of multiple individuals, only a single entity would be selected.[25]

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tendency to judge boards as "good" when the firm is performing well, while a "bad" board is likely associated with bad operational performance. But governance and profitability may be only tenuously related. For instance, highly profitable firms might need better governance, while poor performing ones may have quite good governance. We have no good way of currently making this assessment.

[23] As discussed in Part II.A, boards fulfill a variety of functions, which vary somewhat from firm to firm.

[24] One of us has elsewhere described U.S. corporate governance as a system of director primacy. See Stephen M. Bainbridge, Director Primacy: The Means and Ends of Corporate Governance, 97 Nw. U.L. Rev. 547, 605 (2003) (concluding that "the board of directors is not a mere agent of the shareholders, but rather is a sort of Platonic guardian serving as the nexus of the various contracts making up the corporation."). Nothing in our proposal would change that conclusion.

[25] Our proposal would not exclude from adopting a approach, with some individual board members and a board specialist firm providing other services, but we focus on BSPs herein.

Our proposal is well grounded in state corporate law theory, as well as supported by analogous cases in which firms serve as boards. Corporate law is generally permissive about how companies structure their governance, providing merely a set of default rules that can be altered by contract.[26] Mandatory rules are very rare, and the case for them is weakened when there are significant benefits, as here, that can flow from freedom of choice. In addition, there are many cases in which entities, like our imagined BSPs, are already serving as boards or in board-like capacities. Unincorporated entities, such as partnerships, LLCs, and the like, are typically permitted to have business associations serve in the management role played by a corporate board of directors for corporate entities.[27] In addition, several federal statutes, including the Investment Company Act, permit directors to be incorporated entities, and the Supreme Court has construed portions of the securities laws broadly to include corporations acting as directors when the policy justifications for that result are strong.[28]

Our proposal has no ideological or particular substantive corporate governance valence. The use of BSPs would not necessarily result in more shareholder power or more managerial power. What it would do, however, is make either of these options more likely, depending on the other forces at work. If shareholder access to the proxy with the goal of more competition for board seats is desired, our proposal can achieve this more directly, at lower cost, and with less downside than the current model.[29] On the other hand, if what would maximize shareholder value is greater managerial control and a longer-term view for board decision-making, our proposal could be adapted to this goal as well. In short, both corporate governance experts like Lucian Bebchuk (shareholder power) and Martin Lipton (managerial power) should see the value in our proposed board model. We are trying to reconceptualize the board, not necessarily move it in a particular direction.

Nothing in our proposal should be read to require a firm to hire another firm to provide its board services, in whole or in part.[30] We merely question the current regime in which various laws and regulations effectively forbid firms from hiring BSPs; our proposal is merely to remove this categorical bar. Imagine if there were a state law requiring legal services to be provided by individual sole proprietorships. Such a law might be motivated by a belief that lawyers would be more careful acting alone or that conflicts of interest arising from pooling legal resources outweigh the gains or some other reason. But whatever the reason, such a rule would generate widespread opposition from lawyers arguing that by pooling their resources they could offer better services to their clients. Clients would object too. While some clients might prefer to hire lawyers unaffiliated with a large firm, others might prefer the costs and benefits of hiring a firm instead of a single lawyer. The same is true for corporate governance. It is unlikely that one size fits all, suggesting that a ban on plausible options must be based on an

[26] Delaware, for instance, allows corporations to modify the role of the board of directors, including not having a board, but mandates that boards consist solely of natural persons. See Part V infra.

[27] See Part V infra.

[28] See id.

[29] See Part VI infra.

[30] We say "in part" here because it is possible to imagine individual board members serving along side a BSP. For instance, inside directors, important investors, representatives of creditors, and even the government are possibilities. For simplicity, we leave the details of this issue largely to another day.

overwhelming case. This case has not been made. To the contrary, we think the case for BSPs is quite strong.

Read in the narrowest sense, our proposal is banal. We are simply advocating extending the normal presumption of freedom of contract in state corporate law to the nature of the board.[31] In light of the widespread but largely failed attempts by lawmakers, courts, and academics to reform board performance through various tweaks of independence, compensation, fiduciary duties, and so on, we think it is time to encourage more fundamental experimentation in corporate governance. Our proposal allows this by freeing firms to rethink and reconceptualize the board. We hope to create a market—the market for BSPs or the market for corporate governance—that will allow governance to be priced in more transparent ways.

In this way, our proposal is a half step in the direction of existing mechanisms of governance that is believed to be superior to the model prevailing in publicly traded firms. Venture capitalists, private equity funds, and activist hedge funds often have board representatives, but our proposal differs from what those entities do in important ways. First, board representation is ancillary to the principal investment activities of such funds. In contrast, a BSP's principal activity is not investing in corporations but providing professional board services. To the extent a BSP takes an equity stake in a client, it does so as compensation rather than as an investment, just as law firms who take an equity stake in their clients do. The BSP model of governance is about trying to achieve some of the improved governance benefits of the private equity model without the need for investors to stake an economic bet on the entire firm. If there develops a robust market for governance, BSP firms would be a threat to any existing board. The potential for a takeover of the board function, separate from the takeover of the firm, would be a real possibility, and with it the possibility that management could be improved by the intervention of a third party offering a better governance mousetrap. This model could, of course, be coupled with the board taking a greater stake in the economics of the firm than it currently has, a possibility that we discuss further below. The use of higher-powered board incentives would thus create a sliding scale of governance, with the full private equity model on one end and the current approach on the other. The BSP model would fall somewhere in between depending on the incentives of the board in any particular case.

To make our argument that there seem to be sensible reasons why we should allow, and even encourage, BSPs, this Article considers a series of questions. First, in Part II, what are current boards of directors supposed to do and how and why do so many fail to do so? Second, in Part III, what would a BSP model look like? Third, in Part IV, why might a BSP have advantages, at least for some firms? Fourth, in Part V, what legal changes are necessary to permit firms to adopt the BSP model? With those questions answered, in Part VI, we offer some preliminary ideas for extensions, using the debate about the level of shareholder control of the corporation as a template. We show how BSPs could be used to achieve either greater shareholder control or greater managerial control over the corporation, as the firm's constituencies may prefer. Finally, in Part VII,

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[31] Although freedom of contract as an organizing principle of corporate law is contested both as a descriptive and normative matter, we assume it herein without digressing to defend it. For discussion of the mandatory versus enabling debate, see Stephen M. Bainbridge, Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship, 82 Cornell L. Rev. 856 (1997).

we address two objections to our proposal. The first is that limited liability may undermine proper board functioning by discouraging directors from taking care; the second is that BSPs are unlikely to arise even if laws preventing them from doing so are amended. We conclude that while limited liability does not present a significant objection, there is a significant barrier to adoption arising from transition costs and the fact that our proposal upsets a variety of vested interests. We are content to leave it to others to figure out how best to encourage BSPs after we have raised the possibility.

II. The Jobs and Failures of the Current Board of Directors

The Delaware General Corporation Law provides that the corporation's business and affairs "shall be managed by or under the direction of a board of directors,"[32] as do the corporation statues of almost all other states.[33] Insofar as publicly held corporations are concerned, however, it has been a long time since anyone believed boards actually manage corporations on a day-to-day basis.[34] In order to assess the merits of the BSP model, we therefore need to identify the real world functions performed by modern boards of directors. We then need to explore why the law assumes that those functions ought to be performed by a committee of independent contractors.

A. What Do Boards Do?

A modern board's job has three components: management, oversight, and service.[35] The balance between them has varied over time and from firm to firm. In recent decades, the trend has been to elevate the importance of monitoring at the expense of the others.[36] The question about the optimal mix of these components is orthogonal to our analysis, since a BSP could be deployed for any and all of them. An exploration of the board's current functions is nevertheless an important starting point for our analysis.

1. Management

If one looked solely to corporation statutes for guidance, one would assume that the board of directors plays a very active role in the corporation's management. Besides the general allocation of the conduct of the corporation's business and affairs to the board, corporation statutes include many specific mandates that only the board can fulfill.

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[32] Del. Code Ann., tit. 8, § 141(a).

[33] Model Bus. Corp. Act Ann. § 8.01 stat. comp. (rev ed. 2011).

[34] See Rosenblatt v. Getty Oil Co., 493 A.2d 929, 943 (Del. 1985) ("The realities of modern corporate life are such that directors cannot be expected to manage the day-to-day activities of a company.").

[35] See Jonathan L. Johnson et al., Boards of Directors: A Review and Research Agenda, 22 J. Mgmt. 409, 411 (1996) (describing the board's roles as "control, service, and resource dependence"); see also Lynne L. Dallas, Proposals for Reform of Corporate Boards of Directors: The Dual Board and Board Ombudsperson, 54 Wash. & Lee L. Rev. 91, 98-104 (1997) (distinguishing between the board's monitoring and "relational" roles).

[36] See Franklin Gevurtz, Global Issues in Corporate Law 68 (2006) (stating that many commentators believe the board's primary role is "to monitor management, rather than manage the corporation").

Approval by the board of directors is a statutory prerequisite, for example, to mergers[37] and related transactions such as sales of all or substantially all corporate assets,[38] the issuance of stock,[39] distribution of dividends,[40] and amendments to the articles of incorporation.[41] In addition to those items explicitly assigned by statute to the board, courts have held that some other decisions are so important that the board of directors must make them.[42] In some states, such basic matters as filing a lawsuit[43] or executing a guarantee of another corporation's debts are extraordinary matters reserved to the board.[44]

Even so, in practice the modern public corporation is too big for the board to manage on anything resembling a day-to-day basis. In addition, due to the significant increase in the number of independent directors at public corporations,[45] most board members today are outsiders who have full-time jobs elsewhere and therefore can devote relatively little time to the running of the business for which they act as directors.[46] As early as 1922, the Delaware Chancery Court acknowledged this trend by holding that the directors' principal role was one of supervision and control, with the detailed conduct of the business being a matter that could properly be delegated to subordinate employees.[47]

Corporation statutes likewise reflect the reality of modern boards. Section 8.01(b) of the Model Business Corporation Act (MBCA), for example, thus provides that the "business and affairs of the corporation" shall be "managed under the direction of" the board.[48] This formulation is intended to make clear that the board's role is to formulate

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[37] See Model Bus. Corp. Act § 11.04 (rev. ed. 2011) ("The plan of merger or share exchange must be adopted by the board of directors.").

[38] Id. § 12.02(b) ("A disposition [of assets that would leave the corporation without a significant continuing business activity] shall be initiated by a resolution by the board of directors authorizing the disposition.").

[39] Id. § 6.21(b) ("The board of directors may authorize shares to be issued for consideration consisting of any tangible or intangible property or benefit to the corporation, including cash, promissory notes, services performed, contracts for services to be performed, or other securities of the corporation.").

[40] Id. § 6.40(a) ("A board of directors may authorize and the corporation may make distributions to its shareholders ….").

[41] Id. § 10.03(a) ("The proposed amendment must be adopted by the board of directors.").

[42] See Lee v. Sentina Bros., 268 F.2d 357, 365-66 (2d Cir. 1959) (officers have no apparent authority with respect to extraordinary matters, which are reserved to the board).

[43] Compare Custer Channel Wing Corp. v. Frazer, 181 F. Supp. 197 (S.D.N.Y. 1959) (president had authority to do so) with Lloydona Peters Enter., Inc. v. Dorius, 658 P.2d 1209 (Utah 1983) (no authority to do so); Ney v. Eastern Iowa Tel. Co., 144 N.W. 383 (Iowa 1913) (no authority to do so with respect to the corporation's largest shareholder).

[44] Compare Sperti Products, Inc. v. Container Corp. of Am., 481 S.W.2d 43 (Ken. App. 1972) (president had authority) with First Nat'l Bank v. Cement Products Co., 227 N.W. 908 (Iowa 1929) (no authority to do so); Burlington Indus., Inc. v. Foil, 202 S.E.2d 591 (N.C. 1974) (president lacked authority, inter alia, because making such guarantees was not part of the corporations' ordinary business).

[45] 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, 1471 (2007) (observing that "the fraction of independent directors for large public firms has shifted from approximately 20% in the 1950s to approximately 75% by the mid-2000s").

[46] See Chapin v. Benwood Foundation, 402 A.2d 1205, 1211 (Del. Ch. 1979) (observing that "modern multi-function business corporations" are "large, complex organizations" and that modern boards are comprised mainly "of persons dedicating less than all of their attention to that role").

[47] Cahall v. Lofland, 114 A. 224, 229 (1921), aff'd, 118 A. 1 (1922).

[48] Model Bus. Corp. Act § 8.01(b) (rev. ed. 2011).

broad policy and oversee the subordinates who actually conduct the business day-to-day.[49] The statute also provides that corporate powers may be exercised "under the [board's] authority."[50] This formulation allows the board to delegate virtually all management functions to senior corporate officers, who in turn of course will delegate most decisions to subordinate employees.[51]

Most boards have taken advantage of these rules to delegate most corporate decisions to the firm's top management team.[52] Other than those tasks the law requires be performed by the board, the modern board's involvement in management of the firm is typically limited to hiring and firing the top management team, approving major transactions, and, perhaps, helping set the broad strategic vision for the firm.[53]

2. Service

A diverse board that includes outsiders can provide a number of services to the top management team. Outsiders can provide access to networks to which insiders do not belong, thereby assisting the firm in gathering resources and obtaining business.[54] Outside directors affiliated with financial institutions, for example, facilitate the firm's access to capital.[55] In addition to simply providing a contact between the firm and the lender, the financial institution's representative can use his board membership to protect the lender's interests by more closely monitoring the firm than would be possible for an outsider. In turn, that reduction of risk should result in the lender accepting a lower return on its loans, thereby reducing the firm's cost of capital.

An even more important service provided by boards of directors, especially outside members, is providing advice and counsel to the CEO.[56] By virtue of being outsiders, the board members can offer the CEO alternative points of view.[57] The multi-billion dollar management consulting industry is a testament to the value of this service.

3. Monitoring Managers

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[49] Model Bus. Corp. Act Ann. § 8.01 cmt. (rev. ed. 2011).

[50] Model Bus. Corp. Act § 8.01(b).

[51] Model Bus. Corp. Act Ann. § 8.01 cmt.

[52] See Bayless Manning, The Business Judgment Rule and the Director's Duty of Attention: Time for Reality, 39 Bus. Law. 1477, 1494 (1984) (observing that most board of director activity "does not consist of taking affirmative action on individual matters; it is instead a continuing flow of supervisory process, punctuated only occasionally by a discrete transactional decision").

[53] See Benwood Foundation, 402 A.2d at 1211 (explaining that directors "satisfy their obligations by thoughtfully appointing officers, establishing or approving goals and plans and monitoring performance").

[54] See Johnson et al., supra note 35, at 428 (summarizing studies of the board's service role).

[55] Id.

[56] William T. Allen, Independent Directors in MBO Transactions: Are They Fact or Fantasy, 45 Bus. Law. 2055 (1990) (explaining that "businessmen or women will view their roles as directors in the same way that they probably wish outside directors on the board of their own companies to view their role—as a source of expert advice and judgment, on call to the CEO but not to be officiously interjected").

[57] Edward B. Rock, The Logic and (Uncertain) Significance of Institutional Shareholder Activism, 79 Geo. L.J. 445, 494 (1991) (opining that outside board members can "serve as a sounding board for the CEO, and may, if asked, be able to contribute a differing perspective or alternative solutions").

Modern public corporations are characterized by a separation of ownership and control, which "produces a condition where the interests of owner and of ultimate manager may, and often do, diverge and where many of the checks which formerly operated to limit the use of power disappear."[58] Economists Michael Jensen & William Meckling later formalized this concern by developing the concept of agency costs,[59] which is now widely recognized as "the fundamental concern of corporate law" and governance.[60]

Agency costs arise because a firm's agents have incentives to shirk. Specifically, the principal reaps part of the value of hard work by the agent, but the agent receives all of the value of shirking. In a classic article, economists Armen Alchian and Harold Demsetz offered the useful example of two workers who jointly lift heavy boxes into a truck.[61] The marginal productivity of each worker is difficult to measure and their joint output cannot be separated easily into individual components, which obtaining information about a team member's productivity and appropriately rewarding or punishing it difficult and costly.[62] In the absence of such information, however, the disutility of labor gives each team member an incentive to shirk because the individual's reward is unlikely to be closely related to conscientiousness.[63]

Although agents have strong incentives to shirk once they enter into a contract with the principal, from an ex ante perspective they have strong incentives to agree to contract terms designed to prevent shirking.[64] Bounded rationality and the potential for renegotiation, however, preclude firms and agents from entering into the complete contract necessary to prevent shirking by the latter.[65] Instead, there must be some system of ex post governance by which firms detect and punish shirking.[66] Accordingly, an essential economic function of management is monitoring the various inputs into the team effort: management meters the marginal productivity of each team member and then takes steps to reduce shirking.[67]

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[58] Adolf A. Berle & Gardiner C. Means, The Modern Corporation and Private Property 6 (1932).

[59] Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure, 3 J. Fin. Econ. 305 (1976).

[60] Kent Greenfield, The Place of Workers in Corporate Law, 39 B.C.L. Rev. 283, 295 (1998).

[61] Armen A. Alchian & Harold Demsetz, Production, Information Costs, and Economic Organization, 62 Am. Econ. Rev. 777 (1972).

[62] Id.

[63] See generally Roy Radner, Hierarchy: The Economics of Managing, 30 J. Econ. Lit. 1382, 1405-07 (1992) (providing a detailed treatment of the incentive effects pursuant to which rational agents will shirk).

[64] See Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure, 3 J. Fin. Econ. 305, 308 (1976) (discussing agent incentives).

[65] See generally Oliver E. Williamson, The Economic Institutions of Capitalism 30-32, 45-46 (1985) (defining bounded rationality and describing its effects on the contracting process).

[66] See generally Luigi Zingales, Corporate Governance, in The New Palgrave Dictionary of Economics and the Law 497, 498-99 (Peter Newman ed., 1998) (explaining that if complete contracts were feasible, ex post governance mechanisms such as the board of directors and other corporate structures would be unnecessary, because all potential contingencies would be anticipated and resolved ex ante by contract).

[67] See Alchian & Demsetz, supra note 61, at 794 (explaining that an essential economic function of management is monitoring the various inputs into the team effort; i.e., management meters the marginal productivity of each team member and then takes steps to reduce shirking).

The process just described, of course, raises a new question; namely, who will monitor the monitors? In any organization, one must have some ultimate monitor who has sufficient incentives to ensure optimal productivity without himself having to be monitored.[68] Otherwise, one ends up with a never-ending series of monitors monitoring lower level monitors.[69] Alchian and Demsetz solved this dilemma by consolidating the roles of ultimate monitor and residual claimant.[70] According to Alchian and Demsetz, if the constituent entitled to the firm's residual income is given final monitoring authority, he is encouraged to detect and punish shirking by the firm's other inputs because his reward will vary exactly with his success as a monitor.[71]

Unfortunately, this elegant theory breaks down precisely where it would be most useful. Because of the separation of ownership and control, it simply does not describe the modern publicly held corporation.[72] As the corporation's residual claimants, the shareholders should act as the firm's ultimate monitors. But while the law provides shareholders with some enforcement and electoral rights, these are reserved for fairly extraordinary situations.[73] In general, shareholders of public corporations lack the legal right, the practical ability, and the desire to exercise the kind of control necessary for meaningful monitoring of the corporation's agents.[74] As a result, the legal system evolved various adaptive responses to the ineffectiveness of shareholder monitoring, establishing alternative accountability structures to punish and deter wrongdoing by firm agents, most notably the board of directors.[75]

4. Shifting Priorities

The relative balance between these functions has shifted over time. Survey data and other forms of fieldwork in the 1970s suggested that boards had a mainly advisory

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[68] See id. at 778 (arguing that firms need a "centralized contractual agent"—i.e., a "specialist"—who monitors the marginal productivity of the firm's other employees).

[69] See Ronald J. Gilson, A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers, 33 Stan. L. Rev. 819, 835 (1981) (explaining that "the performance of management must also be monitored, and hiring yet another team of monitors merely recreates the problem one level removed"). As Professor Gilson points out, Dr. Seuss's story of the Hawtch-Hawtcher Bee-Watcher is both an entertaining and highly instructive parable illustrating this point. Id. at 835 n.61.

[70] See Alchian & Demsetz, supra note 61, at 783 (arguing that to best incentivize the ultimate monitor, that person should hold a bundle of five rights: "1) to be a residual claimant; 2) to observe input behavior; 3) to be a central party common to all contracts with inputs; 4) to alter the membership of the team; and (5) to sell these rights ….").

[71] See id. at 782 (identifying the residual claimant as the monitor responsible for metering the productivity of all individual firm inputs).

[72] See Thomas S. Ulen, The Coasean Firm in Law and Economics, 18 J. Corp. L. 301, 312 (1993) ("The modern corporation is, by and large, a publicly-held corporation, and it is not at all clear that the Alchian-Demsetz theory is an apt description of that corporation.").

[73] See generally Michael P. Dooley, Controlling Giant Corporations: The Question of Legitimacy, in Corporate Governance: Past & Future 28, 38 (Henry G. Manne ed., 1982) (discussing "the limited governance role assigned to shareholders").

[74] See Ulen, supra note 72, at 312 n.29 (noting that Alchian and Demsetz themselves "were aware of the difficulty of claiming that common shareholders are monitors of team production").

[75] See Oliver E. Williamson, The Economic Institutions of Capitalism 306 (1985) (arguing that the board of directors "arises endogenously, as a means by which to safeguard the investments" of shareholders).

role. Survey data from the 1990s, by contrast, showed an emphasis on managerial functions in the sense of broad policy making and setting strategy. By the end of the 1990s, survey data showed that boards were becoming active and independent monitors of the top management team.[76] What drove this shift?

Although the modern understanding of the board's role and function has no single parent, if one were to insist on finding someone to whom to give the bulk of the credit—or blame—the leading candidate probably would be Professor Melvin Eisenberg. In *The Structure of the Corporation*, "perhaps the most important work on corporate law since Berle and Means's *The Modern Corporation and Private Property*,"[77] Eisenberg argued that boards were essentially passive, with most of their functions captured by senior executives.[78] According to Eisenberg, the board's principal remaining function was selection and supervision of the firm's chief executive, but most boards failed adequately to perform even that residual task.[79]

As a solution, Eisenberg articulated a corporate governance model that explicitly separated the task of managing large publicly held corporations from that of monitoring those who do the managing.[80] In this monitoring model, directors did not undertake decision making or policymaking, which were assigned to senior management.[81] Instead, the board's principal function was to monitor the performance of the company's senior executives.[82] Other functions such as advising the CEO, authorizing major corporate actions, and exercising control over decision making were of minor importance or were merely pro forma.[83]

Eisenberg's model proved highly influential. It informed the role set out for boards of directors in the American Law Institute's *Principles of Corporate Governance: Analysis and Recommendations*.[84] Aspects of his proposals, such as shifting responsibility for interacting with the auditor from management to the audit committee,[85] have long been incorporated into stock exchange listing standards.[86] As early as the late 1970s, guides to corporate governance best practices had widely adopted the monitoring model.[87] Indeed, the monitoring model quickly "became conventional wisdom, endorsed

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[76] Renee B. Adams et al., The Role of Boards of Directors in Corporate Governance: A Conceptual Framework and Survey, 48 J. Econ. Lit. 58, 64-65 (2010).

[77] Dalia Tsuk Mitchell, Status Bound: The Twentieth-Century Evolution of Directors' Liability, 5 N.Y.U. J.L. & Bus. 63 (2009).

[78] Melvin Aron Eisenberg, The Structure of the Corporation 139-41 (1976).

[79] Id. at 162-72.

[80] Id. at 149.

[81] Id. at 152.

[82] Id. at 155.

[83] Id. at 157-62.

[84] See Evelyn Brody, The Board of Nonprofit Organizations: Puzzling Through the Gaps Between Law and Practice, 76 Fordham L. Rev. 521, 529-30 (2007) ("The ALI articulated and embraced the independent-board monitoring model, under which an unconflicted board oversees a separate staff that carries out day-to-day operations.").

[85] Eisenberg, supra note 78, at 210-11.

[86] See generally Stephen M. Bainbridge, The Complete Guide to Sarbanes-Oxley 178-81 (2007) (describing stock exchange listing standards governing audit committees).

[87] See generally Melvin A. Eisenberg, The Board of Directors and Internal Control, 19 Cardozo L. Rev. 237, 239 (1997) (opining that "the monitoring model of the board has been almost universally accepted"). Several key sources of best practice embraced the model. In 1978, for example, the American Bar Association's Section of Business Law promulgated a Corporate Director's Guidebook that embraced

by the Chairman of the SEC, the corporate bar, and even the Business Roundtable."[88] By 1997, Eisenberg thus was able to declare that "key structural elements of the monitoring model—including a board that has at least a majority of independent directors, and audit, nominating, and compensation committees—[were] already well-established."[89]

The monitoring model of the board's function received further boosts in the major federal corporate governance laws passed in the wake of the Enron scandal and the subsequent financial crisis of 2007-2008. In the wake of the former and the concurrent bursting of the dot-com bubble, Congress passed the Sarbanes-Oxley Act,[90] much of which was intended to require directors to be more effective monitors of corporate management.[91] The post-financial crisis Dodd-Frank Act[92] likewise "includes significant governance reforms designed to enhance director oversight of compensation and risk."[93]

B. Contemporary Boards

Boards of directors long have had bad press. In the 18th Century, Adam Smith famously complained that one could not expect the directors of a joint stock company, "being the managers rather of other people's money than of their own, … should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own."[94] Almost two centuries later, William O. Douglas complained that there were too many boards whose members did "not direct"[95] and dismissed directors as "business colonels of the honorary type—honorary colonels who are ornamental in parade but fairly useless in battle."[96]

More recently, the SEC in 2009 complained that the financial crisis had "led many to raise serious concerns about the accountability and responsiveness of some

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an Eisenberg-like model in which the management and monitoring of management roles were separated with the latter task being assigned to a board comprised mainly of outside directors. ABA Section of Corporation, Banking and Business Law, Corporate Director's Guidebook, 33 Bus. Law. 1591, 1619-28 (1978). A formal statement by the Business Roundtable likewise adopted the monitoring model. Statement of the Business Roundtable: The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation, 33 Bus. Law. 2083 (1978). The absorption of the monitoring model into generally accepted best practice continued throughout the 1990s. See Ira M. Millstein & Paul W. MacAvoy, The Active Board of Directors and Performance of the Large Publicly Traded Corporation, 98 Colum. L. Rev. 1283, 1288-89 (1998) (reviewing best practice guidelines).

[88] Gordon, supra note 42, at 1518.

[89] Melvin A. Eisenberg, The Board of Directors and Internal Control, 19 Cardozo L. Rev. 237, 239 (1997).

[90] Public Company Accounting Reform and Investor Protection Act, Pub. L. No. 107–204, 116 Stat. 745 (2002).

[91] See Renee M. Jones & Michelle Welsh, Toward a Public Enforcement Model for Directors' Duty of Oversight, 45 Vand. J. Transnat'l L. 343, 346 (2012) ("The monitoring model forms the basis of the Sarbanes-Oxley reforms that sought to strengthen the hand of independent directors vis-à-vis corporate management.").

[92] The Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[93] Jones & Welsh, supra note 91, at 399 n.279.

[94] 2 Adam Smith, An Inquiry into the Nature and Causes of the Wealth of Nations 264-65 (Edwin Cannan ed., Univ. of Chicago Press 1976) (1776).

[95] William O. Douglas, Directors Who Do Not Direct, 47 Harv. L. Rev. 1305 (1934).

[96] William O. Douglas, Democracy and Finance 46 (1940).

companies and boards of directors ….”[97] In the same time frame, prominent Canadian corporate governance commentator Stephen Jarislowsky argued that corporate “boards ‘have enormous responsibility for’” for the financial crisis of 2007-2008.[98]

Despite this long history of complaints about board performance, there seems little doubt that the rise of the monitoring model has been accompanied by important improvements in board behavior. In 1995, only one in eight CEOs was fired or resigned under board pressure; by 2006, almost a third of CEOs were terminated involuntarily.[99] Over the last several decades, the average CEO tenure has decreased, which also has been attributed to more active board oversight.[100] In sum, boards of directors, “which once served largely as rubber stamps for powerful CEOs, have become more independent, more powerful, and under more pressure to dump leaders who perform poorly.”[101]

In addition to the evidence from CEO terminations, other studies confirm a general improvement in board performance. Studies of post-SOX boards of directors find that average board size has increased, presumably because companies are adding more independent directors rather than replacing incumbent insiders.[102] Conversely, the average number of companies on whose boards a director sits has gone down, presumably because boards and committees meet more often and have to process more information.[103]

Michael Useem and Andy Zelleke’s survey of governance practices provides additional evidence for improved board performance.[104] They found that boards of directors increasingly view delegation of authority to management as properly the subject of careful and self-conscious decision making.[105] The surveyed board members acknowledged that they do not run the company on a day-by-day basis, but rather are seeking to provide stronger oversight and supervision.[106] Increasingly, boards are establishing written protocols to allocate decision-making rights between the board and management, although the protocols vary widely, ranging from detailed and comprehensive to skeletal and limited in scope.[107] Useem and Zelleke conclude that

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[97] Facilitating Shareholder Director Nominations, Exchange Act Rel. No. 60,089 (June 10, 2009).

[98] Janet McFarland, Jarislowsky Blames Financial Mess on Lax Governance Rules, The Globe & Mail (Toronto), Oct. 24, 2008, at B12.

[99] Chuck Lucier et al., The Era of the Inclusive Leader, Strategy & Bus., Summer 2007, at 3.

[100] Denis B.K. Lyons, CEO Casualties: A Battlefront Report, Directors & Boards, Summer 1999, at 43.

[101] Lauren Etter, Why Corporate Boardrooms Are in Turmoil, Wall St. J., Sept. 16, 2006, at A7.

[102] Houman B. Shadab, Innovation and Corporate Governance: The Impact of Sarbanes-Oxley, 10 U. Pa. J. Bus. & Emp. L. 955, 997 (2008) (“To become SOX compliant, companies tended to add independent directors rather than replace insiders, which is reflected in public company board size increasing on average by 8.4 percent from 2001 to 2004 (which reversed the prior 12-year trend in decreasing board size).”).

[103] James S. Linck et al., The Effects and Unintended Consequences of the Sarbanes-Oxley Act, and Its Era, on the Supply and Demand for Directors 16-17 (Feb. 14, 2007), http://ssrn.com/abstract=902665) (finding that the average number of directorships held by a director in a large firm decreased after SOX).

[104] Michael Useem & Andy Zelleke, Oversight and Delegation in Corporate Governance: Deciding What the Board Should Decide, 14 Corp. Gov.: An Int’l Rev. 2 (2006).

[105] Id. at 2.

[106] Id.

[107] Id.

executives still set much of the board's decision-making agenda.[108] At the same time, they found that boards are increasingly asserting their sovereignty in recent years and that a norm is emerging among managers that, at the very least, they must be mindful of what information boards want to hear and what decisions directors believe the board should make.[109]

C. Room for Improvement

While many modern boards demonstrably outperform their predecessors, it would be Pollyannaish to deny that there is still much room for improvement. The financial crisis of 2007-2008, for example, revealed widespread board failures in areas such as enterprise risk management. According to a 2002 survey of corporate directors, 43 percent said that their boards had either an ineffective risk management process or no process for identifying and managing risk at all.[110] According to the same survey, 36 percent of directors felt they had an incomplete understanding of the risks faced by their companies.[111]

A 2008 Towers Perrin survey of CFOs suggests that risk management remained underdeveloped when the financial crisis hit. Seventy-two percent of the respondents, for example, "expressed concern about their own companies' risk management practices and ability to meet strategic plans."[112] Instructively, 42 percent "foresaw more energized involvement by boards of directors in risk management policies, processes and systems,"[113] which implies that pre-crisis boards were inadequately engaged with risk management. This inference finds support in a 2006 observation that risk management was still "a work in progress at many boards."[114]

Respondents to the Towers Perrin survey pointed to these failures as a root cause of the financial crisis. Sixty two percent of respondents blamed "poor or lax risk management at financial institutions as a major contributor to the current financial mess."[115] Instructively, surveyed CFOs were more likely to point to risk management failures by boards as a reason for the financial crisis than either the complexity of financial instruments or speculation (55% and 57%, respectively).[116]

Still another widely asserted criticism is that boards have failed to rein in allegedly runaway executive compensation. In an influential critique, for example, Lucian Bebchuk and Jesse Fried argued that "directors have been influenced by

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[108] Id. at 11.

[109] Id.

[110] Carolyn Kay Brancato & Christian A. Plath, Corporate Governance Handbook 2005 75 (2005). This finding is supported by a 2003 study, in which 45% of respondent directors said their firms had no risk management plan. Susan Schmidt Bies, Director and Officer Responsibility: A Plan for Action, 8 Fordham J. Corp. & Fin. L. 81, 86 (2003).

[111] Brancato & Plath, supra note 110, at 75.

[112] Towers Perrin, Financial Crisis Intensifies Interest in Risk Management Among CFOs (Sept. 2008), http://www.towersperrin.com/tp/showdctmdoc.jsp?country=global&url=Master_Brand_2/USA/News/Spotlights/2008/Sept/2008_09_30_spotlight_cfo_survey.htm.

[113] Id.

[114] Michel Crouhy et al., The Essentials of Risk Management 85 (2006).

[115] Towers Perrin, supra note 112.

[116] Id.

management, sympathetic to executives, insufficiently motivated to bargain over compensation, or simply ineffectual in overseeing compensation."[117] As a result, they claim, executive pay has greatly exceeded the levels that would prevail if directors loyal to shareholder interests actually bargained with managers at arms'-length.[118] Many other commentators have leveled similar criticisms at boards.[119]

D. Why Boards Fail

The reasons boards continue to struggle include inadequate time, misspent time, inadequate information, improper skill sets, and insufficient incentives. It is worth looking at each of these symptoms of director dysfunction in order the stage for our proposed cure.

1. Time constraints

As the monitoring model came to dominate thinking about the board's role, the board's composition inevitably came to the fore. A board comprised of insiders is poorly positioned to monitor the CEO. Research on group decision making shows that in mixed status groups, higher status persons talk more than lower status members.[120] Managers, for example, talk more than subordinates in business meetings. Such disparities result in higher status group members being more inclined to propound initiatives and having greater influence over the group's ultimate decision.[121] Group dynamics thus help ensure the CEO's dominance over inside directors. As a practical matter, moreover, the CEO typically serves as the chairman of the board, giving the CEO substantial control over both the selection of new directors and the board's agenda.[122] Not surprisingly, director independence therefore is a longstanding goal of corporate reformers, especially those affiliated with the monitoring model school of thought.[123]

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[117] Lucian Bebchuk & Jesse Fried, Pay Without Performance: The Unfulfilled Promise of Executive Compensation 5 (2004).

[118] See id. at 2 (arguing that "that the pay-setting process in publicly traded companies has strayed far from the arms'-length model" because "managerial power has played a key role in shaping managers' pay arrangements").

[119] Michael B. Dorff, Confident Uncertainty, Excessive Compensation & the Obama Plan, 85 Ind. L.J. 491, 493 n.7 (2010) (citing authorities).

[120] Sara Kiesler & Lee Sproul, Group Decision Making and Communication Technology, 52 Org. Beh. & Human Decision Processes 96 (1992).

[121] Id.

[122] See Sydney Finkelstein & Richard A. D'Aveni, CEO Duality as a Double-Edged Sword: How Boards of Directors Balance Entrenchment Avoidance and Unity of Command, 37 Acad. Mgmt. J. 1079, 1082 (1994) (explaining that the chairman of the board often controls the director nominating process); Chamu Sundaramurthy et al., Board Structure, Antitakeover Provisions, and Stockholder Wealth, 18 Strategic Mgmt. J. 231, 233 (1997) (arguing that when the CEO also serves as chairman of the board the CEO ends setting the agenda).

[123] See, e.g., Donald C. Clarke, Three Concepts of the Independent Director, 32 Del. J. Corp. L. 73, 73 (2007) ("Independent directors have long been viewed as a solution to many corporate governance problems."); Melvin A. Eisenberg, Corporate Law and Social Norms, 99 Colum. L. Rev. 1253, 1278 (1999) (arguing that the monitoring model "requires that the board consist of at least a majority of directors who are independent of the senior executives, and that the board have audit, nominating, and compensation committees composed exclusively of such independent directors"); See Laura Lin, The Effectiveness of

The move towards more "independence" is clear. The NYSE's listing standards require all listed companies, other than those with a controlling shareholder, to "have a majority of independent directors."[124] In addition, the NYSE has mandated the use of several board committees comprised of outsiders.[125] The NASDAQ and AMEX have listing standards similar to those of the NYSE.[126]

Under pressure from the stock exchanges and reformers, the percentage of board members who are independent has risen dramatically.[127] As a result, boards today are dominated by part timers, the vast majority of whom have full-time employment elsewhere, which commands the bulk of their attention and provides the bulk of their pecuniary and psychic income.[128] Historically, moreover, directors did not spend much time together working as a group.[129] Board meetings were few and short. According to one survey, for example, during the 1980s directors in large manufacturing companies averaged a total of 14 board and committee meetings per year, with the average board meeting lasting only three hours.[130]

To be sure, as we have seen, the legislative and regulatory fallout from the financial crises of the last decade resulted in directors devoting greater time to board service. Yet, independent directors by their very nature remain part-timers, which has very real costs:

> Independent directors are part time participants in a corporation's affairs. By definition they are outsiders. However intelligent, hardworking or strong minded they may be they do not have the time or the mandate to challenge management's judgments except as to a discrete number of issues. If they spend all of their time trying to audit the auditors and assure that executive compensation is reasonable, they will have no time for focusing on important business and strategy matters.[131]

It appears, moreover, that much of the time directors do spend directing is misspent. Given that time is a scarce resource—especially for the sort of successful individuals likely to be tapped for board memberships—this is a potentially serious problem with contemporary board governance.

Outside Directors as a Corporate Governance Mechanism: Theories and Evidence, 90 Nw. U. L. Rev. 898, 899-900 (1996) (explaining that reformers commonly identify independent directors as a key element of good corporate governance).

[124] NYSE Listed Company Manual § 303A.01.

[125] See Stephen M. Bainbridge, Corporate Law 84-89 (2d ed. 2009) (discussing stock exchange listing standards applicable to board committees).

[126] Id. at 81.

[127] See Gordon, supra note 42, at 1473-76 (summarizing multiple studies finding that the percentage of independent directors on boards of U.S. public companies increased from 20 percent in 1950 to 70 percent in 2005).

[128] See Colin B. Carter & Jay W. Lorsch, Back to the Drawing Board: Designing Corporate Boards for a Complex World 22 (2004) (observing that "most directors today … are *very* part-time"; emphasis in original).

[129] See id. (noting that "part-time directors don't spend much time together).

[130] The Conference Board, Membership and Organization of Corporate Boards 25 (1990).

[131] Roberta S. Karmel, Realizing the Dream of William O. Douglas—The Securities and Exchange Commission Takes Charge of Corporate Governance, 30 Del. J. Corp. L. 79, 132 (2005).

Much of the additional time appears to be devoted to oversight activities, which is hardly surprising given that both the Sarbanes-Oxley and Dodd-Frank Acts reinforced the monitoring model's influence.[132] If so, the additional time and effort being expended by directors may have important costs. The rise of the monitoring model long has threatened to generate unproductive adversarial conflict between boards and management. A certain amount of cognitive tension in the board—top management team relationship is beneficial to the extent that it promotes the exercise of critical evaluative judgment by the former.[133] Groups that are too collegial run the risk of submitting to groupthink and various other decision-making errors.[134] If aggressive monitoring fosters an adversarial relation between directors and managers, however, this beneficial form of conflict may transform into more harmful forms. At best, rigid adherence to the monitoring model may transform a collaborative and collegial relationship into one that is cold and distant.[135] At worst, it can promote adversarial relations that result in destructive interpersonal conflict.[136] Adversarial relations between two groups tend to encourage each group to circle the wagons and become defensive vis-à-vis the other, which can encourage zero sum gamesmanship rather than collaboration and divert energies into unproductive areas.[137] Unfortunately, as Peter Wallison observes, the "congressional imprimatur" Sarbanes-Oxley put on the monitoring model has compounded the problem by encouraging "an adversarial relationship between managements and boards that will, over time, impair corporate risk-taking and thus economic growth."[138]

Even if a firm's board and management maintain an appropriately balanced relationship, the additional time and effort elicited by the Sarbanes-Oxley Act may not be directed productively. Boards today "are more focused on compliance with standards and regulations than they are on obtaining a competitive advantage."[139] This leaves boards with less time to devote to their traditional functions, including management oversight.

2. Directors have an inherent information disadvantage

At the minimum, the presence of outsiders on the board increases decision-making costs simply because the process takes longer. Part-time outsiders by definition

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[132] See Bainbridge, supra note 10, at 59-60 (discussing how Sarbanes-Oxley and Dodd-Frank codified the monitoring model).

[133] See Daniel P. Forbes & Frances J. Milliken, Cognition and Corporate Governance: Understanding Boards of Directors as Strategic Decision Making Groups, 24 Acad. Mgmt. Rev. 489, 497 (1999) ("Cognitive conflict can help to prevent the emergence of groupthink in cohesive groups by fostering an environment characterized by a task-oriented focus and a tolerance of multiple viewpoints and opinions.").

[134] See Stephen M. Bainbridge, Why a Board? Group Decision Making in Corporate Governance, 55 Vand. L. Rev. 1, 32 (2002) ("Highly cohesive groups with strong civility and cooperation norms … may strive for unanimity even at the expense of quality decisionmaking.").

[135] See Carter & Lorsch, supra note 128, at 19 (discussing ways in which increasing power of the board may disrupt its relations with management).

[136] See id. at 52 (discussing how tension between the board and management can cause "the board's ability to perform effectively" to suffer).

[137] Cf. Bainbridge, supra note 134, at 49 ("Relational teams … respond to external monitoring efforts by 'circling the wagons' around the intended subject of sanctions.").

[138] Peter J. Wallison, Capital Punishment, Wall St. J., Nov. 4-5, 2006, at A7.

[139] Id.

need more information and are likely to take longer to persuade than are full-time insiders.[140] In addition to having greater access to formal intra-firm information flows by virtue of being full-timers, insiders have lots of informal contacts within the firm, which provide even better access to information than are available to outsiders whose interactions with firm employees is limited.[141] More subtly, and perhaps more importantly, long-term employees make significant investments in firm-specific human capital.[142] Any employee who advances to senior management levels necessarily invests considerable time and effort in learning how to do his job more effectively. Much of this knowledge will be specific to the firm for which he works, such as when other firms do not do comparable work or his firm has a unique corporate culture.[143] An employee who has made significant investments in firm-specific human capital is likely to make better decisions for the firm than an outsider, even assuming equal levels of information relating to the decision at hand. The insider can put the decision in a broader context, seeing the relationships and connections it has to the firm as whole.

3. Directors are generalists

In contrast to insiders, independent directors have little incentive to invest in firm-specific human capital. As noted, they typically have full-time jobs elsewhere and often serve on multiple boards simultaneously. As a result, they tend to be generalists with little firm-specific knowledge, skills, or expertise.[144] Modern boards thus tend to be "composed of individuals who are not qualified to assess the strategic viability of the corporations they direct."[145]

> Corporate casualties in the most recent crisis represent instances of board members lacking expertise. In years past, some of Merrill Lynch's board members were leaders of prestigious colleges and universities. However, nothing would indicate that these individuals had meaningful accounting or financial expertise. Their backgrounds and lack of corresponding expertise raise concerns as to their ability to effectively monitor an investment bank such as Merrill. Similarly, Citigroup has been criticized for a board that had a dearth of independent directors with a financial

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[140] 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, 533 (1989). Board dysfunctionality can be the result of having too little or too much information. On some boards, directors are deprived of information. Ralph D. Ward, Saving the Corporate Board: Why Boards Fail and How to Fix Them 1 (2003). At other corporations, however, "as indigestible overload of information" is dumped on directors. Id.

[141] See Ward, supra note 140, at 123 (asserting that "outside board members are amazingly out of touch with the corporation for which they bear ultimate legal responsibility").

[142] See Stephen M. Bainbridge, Interpreting Nonshareholder Constituency Statutes, 19 Pepp. L. Rev. 971, 1006-07 (1992) (discussing ways employees develop firm-specific human capital).

[143] See Raghuram G. Rajan & Luigi Zingales, Power in a Theory of the Firm, 113 Q.J. Econ. 387, 392 (1998) (discussing how managers invest in firm-specific human capital).

[144] See Carter & Lorsch, supra note 128, at 53 ("Directors are the archetypal generalists in a world that values and needs specialization.").

[145] Nicola Faith Sharpe, Rethinking Board Function in the Wake of the 2008 Financial Crisis, 5 J. Bus. & Tech. L. 99, 109 (2010).

> background. Critics have attributed the independent board members' lack of financial skill as a major contributing factor to the company's problems.[146]

Unfortunately, the rules mandating director independence virtually ensure that this problem will remain insoluble. The standards defining what constitutes independence effectively rule out "just about anybody who has firsthand knowledge of the company and its industry."[147] While independent directors can develop such knowledge over time, doing so can be a very lengthy process.[148] Many independent directors thus never develop more than a "rudimentary understanding of their companies' workings."[149]

While at least some long serving directors may develop a reasonable knowledge of the company's inner workings, long service can give rise to close friendships between nominally independent directors and the managers with whom they serve.[150] This can compromise the director's ability to take strong action when management falters. In some case, but not all, long serving directors "may find it difficult to be truly independent in deciding what's in the shareholders' best interests."[151]

4. Improper incentives

The most basic way of incentivizing people to do a good job is to pay them for doing so.[152] Oddly, however, it long was against the law for corporations to compensate directors at all.[153] Because boards at that time consisted mainly of people associated with the firm, such as founding entrepreneurs, insiders, or representatives of major shareholders, their stake in the company provided alternative incentives for good performance.[154] As independent directors with no such stake in the company became more common, however, legislatures and courts recognized that compensation now was a necessary incentive and changed the law to allow it.[155] By the mid-1970s, almost all public corporations paid their directors, and the amount of director compensation grew rapidly in the following years.[156]

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[146] Id. (footnotes omitted).
[147] Carter & Lorsch, supra note 128, at 45.
[148] Id.
[149] Id. at 45.
[150] See id. at 49 (discussing relationship between service length and interpersonal relations).
[151] Id.
[152] For an application outside the common practice, *see* M. Todd Henderson and Fredrick Tung, Pay for Regulator Performance, 85 U.S.C. L. REV. 1003 (2012).
[153] See Charles M. Elson, Director Compensation and the Management-Captured Board—The History of a Symptom and a Cure, 50 SMU L. Rev. 127, 135-48 (1996).
[154] First Nat. Bank v. Daugherty, 250 P. 796, 797 (Okla. 1926) ("Corporate offices are usually filled by those chiefly interested in the welfare of such institutions by reason of interest in stock or other advantages, and such interests are presumed to be the motive for executing duties of office without compensation.").
[155] See Elson, supra note 153, at 144-46 (discussing evolution of state corporation codes and case law towards allowing director compensation).
[156] See id. at 147 ("By 1975, virtually all public companies compensated their directors and, among manufacturing companies, the median annual compensation, including fees and retainers, had grown to $6000, with the largest companies paying a median of $13,000.").

Unfortunately, the combination of growing cash compensation and management's control of the board nomination process acted "to align the interests of the outside directors with current management rather than with the shareholders…. Directors whose remuneration is unrelated to corporate performance have little personal incentive to challenge their management benefactors."[157] In response, Charles Elson proposed a radical change in the form of director compensation:

> To ensure that directors will examine executive initiatives in the best interest of the business, the outside directors must become substantial shareholders. To facilitate this, directors' fees should be paid primarily in company stock that is restricted as to resale during their term in office. No other form of compensation, which serves to compromise their independence from management, should be permitted. The goal is to create within each director a personally based motivation to actively monitor management in the best interest of corporate productivity and to counteract the oversight-inhibiting environment that management appointment and cash-based/benefit-laden fees create.[158]

In 1996, a NACD blue ribbon panel adopted many of Elson's ideas, recommending the use of stock-based compensation and further opining that directors should personally invest an amount in company stock sufficiently large so as to decouple the director's financial interests from those of management.[159] The core idea rapidly caught on, although few firms went so far as to eliminate all cash compensation and benefits. According to a 2007 report by the Conference Board, 90 percent of surveyed companies made some form of stock-based compensation to directors, with 38% paying all or part of the basic retainer in stock.[160]

In theory, this change in board compensation practices should align director incentives with the interests of shareholders. If directors have skin in the game, their interests will be more closely aligned with those of the shareholders. The problem is that the practice of paying directors in stock occurred simultaneously with a dramatic increase in the use of stock options to pay management.[161] There's some evidence that stock-based compensation is associated with an increase in managerial manipulation of financial results.[162]

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[157] Id. at 162-64.

[158] Id. at 165.

[159] National Association of Corporate Directors, Report of the NACD Blue Ribbon Commission on Director Professionalism (1996).

[160] The Conference Board, Directors' Compensation and Board Practices in 2006 6-8 (2007).

[161] See Charles M. Yablon, Bonus Questions—Executive Compensation in the Era of Pay for Performance, 75 Notre Dame L. Rev. 271, 272 (1999) (observing that there has been a "substantial increase in the use of stock options, performance-based bonuses and other forms of pay for performance" since the early 1990s).

[162] Jap Efendi et al., Why Do Corporate Managers Misstate Financial Statements? The Role of Option Compensation and Other Factors, 85 J. Fin. Econ. 667, 667 (2007) (observing that "the likelihood of a misstated financial statement increases greatly when the CEO has very sizable holdings of in-the-money stock options."); Jesse M. Fried, Hands-Off Options, 61 Vand. L. Rev. 453, 456 (2008) (citing evidence that "managers ... often inflate the short-term stock price before selling to boost their trading profits.").

The incentives of directors with substantial stock holdings or in-the-money options are more closely aligned with managers than those of shareholders.[163] As a result, if managers inflate the company's stock prices by manipulating financial data or otherwise cooking the books, "directors may go along because they also stand to benefit."[164] There is thus an inherent tension between the competing goals of ensuring director independence and incentivizing them to perform at a high quality level. The more stock a director owns, the less independent the director becomes.[165]

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With this diagnosis of the symptoms of board failures or shortcomings in hand, in the next Part, we present a proposed treatment in the form of a new model for providing corporate board services. We show what a BSP might look like, although a precise accounting is impossible to make given the numerous degrees of freedom. Only experimentation in real-world settings is likely to generate answers to the questions about the optimal type of BSP scope and structure. Our goal therefore is merely to show the significant potential upside and limited downside of doing away with the natural person requirement.

III. The Basic BSP Model

In this Part, we briefly sketch out the basics of our proposal for BSPs, that is, that firms be permitted to provide professional director services to other firms. There are innumerable permutations for how exactly a BSP would be appointed, function, be held liable, be removable, and so on, some of which are obvious but many of which are beyond our capacity to imagine at this point. Our goal in this Article is not to devise the optimal BSP, assuming such at thing even exists. But rather, consistent with the enabling nature of state corporate law and the freedom of firms generally to devise their own approaches to corporate governance, we propose only that firms be permitted to design their own, tailored, and locally optimal BSP structures. For illustrative purposes, however, we set forth in this Part what one basic version of the BSP idea might look like. Later, we explore some possible extensions. Our goal is to create a small legal change—one that is consistent with the spirit of state corporate law in Delaware and elsewhere—that could unleash experimentation by firms in improving corporate governance, and thereby perhaps create an entirely new industry. If our idea takes root, we hope and expect dozens of BSPs to arise, and the landscape of boards to look much different than it does today and than we can imagine. The BSPs we expect would develop from our innovation would be designed to address the sources of current board weakness or failure described in the prior Part.

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[163] Carter & Lorsch, supra note 128, at (noting the conflict of interest faced by managers and directors "loaded up with stock and options").

[164] Id.

[165] See id. (noting link between increasing stock ownership and loss of "some aspects" of the director's independence).

A. The Basic Idea

Instead of a corporate board being comprised of a bunch of individuals acting as independent contractors, we have in mind a business entity, be it a partnership, LLC, corporation, or other association, acting as the board of another company. In our model, the board would be an it, not a group of hes and shes. Instead of nominating and electing a slate of unrelated individual independent contractors to serve as board members, a BSP would be chosen to provide director services.[166] Our proposal can thus be distinguished from merely permitting individual directors to form professional corporations (or some other limited liability entity) to shield their personal assets from liabilities from their work as a director. Such a regime would bring only the benefits of reduced director liability, without any of the other benefits we think arise from having the entire board function being provided by a single firm.

The best way to understand how the BSP model differs from the current board model is to compare the differences along the key dimensions of board activity. These include how directors are appointed, who they are, what functions they serve, how they make decisions, how they are elected and removed, and what the liability rules governing there conduct are.

B. Institutional Choices

In the next several Sections, we compare and contrast the generic BSP model with the current approach. For simplicity, in this Part, we limit this discussion to the simplest approach. In Part VI below, we offer some extensions and potential areas for experimentation.

1. Appointment and Elections

The first issue to compare and contrast is how directors get their jobs on the board in the first place. Under the current approach, a company's initial board members are either its incorporators or are named in the corporate charter.[167] Thereafter, shareholders

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[166] We imagine that if firms providing board services were legal, there would arise a competitive market for the provision of these services, just as there is for legal, accounting, and consultancy services for companies. In fact, we can imagine many of the firms that currently provide these services offering board services. The specialty BSPs we imagine, could be in competition with The Boston Consulting Group (a consultancy), Sidley Austin (a law firm), Towers Watson (a compensation consultancy), Aon (an insurer of directors), and KPMG (an accountancy), each of whom could expand their operations to include providing director services. Many of these firms already provide strategic and management advice to large corporations; a role that used to be provided by boards. Many of them also serve compliance and monitoring functions as a compliment to or substitute for board actions. Our proposal is simply a natural extension of these activities to a full recognition of statutory board functions as being provided by outside firms.

[167] Del. Code Ann. tit. 8, §§ 107, 108.

vote to elect board members each year.[168] The firm's shareholders or the shareholders' agent (e.g., the CEO) nominate individual directors to run for election. For exchange-listed public corporations, the nominating committee of the board of directors is tasked with selecting new directors and nominating the directors to be elected at the annual shareholder meeting.[169] Directors so nominated are submitted as a group (known as a "slate") to shareholders via the company's proxy voting materials, but run as individuals. Because directors generally run unopposed, the shareholder vote is more advisory than anything else. Indeed, under traditional plurality voting rules a vote of less than 50 percent suggests only shareholder dissatisfaction, because directors with even a single vote can continue to serve.[170] Of over 17,000 individual directors who stood for election to publicly traded firms in 2012,[171] only six directors (0.04%) stepped down or resigned because they did not get shareholder support.[172] Forty-one directors in 2012 lost their elections (by conventional understanding of the term), and yet remained as directors.[173] The only sure way to remove a director is through a proxy contest, in which a rival pays, win or lose, the full costs of distributing ballots to shareholders and convincing them to vote for the rival. Firms pay incumbents' costs no matter what, and incumbents are effectively spending shareholders' money to maintain their jobs.[174] Given the asymmetry of costs and benefits of this strategy, proxy contests are exceedingly rare, and are seen primarily in cases in which the benefits of winning a board seat include gaining control of the entire board, and thus the economics of the entire firm. [175] There is no market for corporate governance, only a market for corporate control.

Most of this process could stay the same with a BSP. The promoters of the firm would choose a BSP to serve until the first meeting of shareholders, or name the first BSP in the corporate charter. Once the company goes public, the nominating committee

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[168] See Del. Code Ann. tit. 8, 211(b) (providing that an annual meeting of stockholders shall be held for the election of directors on a date and at a time designated by or in the manner provided in the bylaws).

[169] See, e.g., New York Stock Exchange, Listed Company Manual § 303A.04(a) ("Listed companies must have a nominating/corporate governance committee composed entirely of independent directors.").

[170] Until recently, state law merely required a plurality shareholder vote. Delaware General Corporation Law § 216(3) formerly provided, for example, that "Directors shall be elected by a plurality of the votes of the shares present in person or represented by proxy at the meeting and entitled to vote on the election of directors." Stephen M. Bainbridge, Mergers and Acquisitions 153 (3d ed. 2012). Today, however, state law permits—but does not require—firms to adopt various schemes having the effect of requiring director candidates to receive a majority of the votes cast in order to serve. See id. at 154-57 (discussing state law developments).

[171] James B. Stewart, "For Boards, Re-Election is a Slam Dunk," Mar. 30, 2013 (? I saw it in the IHT). Quoting Patrick S. McGovern (ISS).

[172] Id. Although 61 directors received less than a majority of shareholder votes, directors run unopposed, and therefore even a single vote (which could be their own!) suffices to be elected as a legal matter.

[173] See, James B. Stewart, When Shareholder Democracy Is Sham Democracy, NY TIMES, Apr. 12, 2013, available at http://www.nytimes.com/2013/04/13/business/sham-shareholder-democracy.html?_r=1&adxnnl=1&ref=jamesbstewart&adxnnlx=1366121251-7wtOwup7xCraPpGPvzw79A.

[174] See, e.g., Eisenberg v. Flying Tiger Line, Inc., 451 F. 2d 267 (2d Cir. 1971) (describing reimbursement rules for proxy contests).

[175] Bainbridge, supra note 170, at 177 (discussing rarity of proxy contests and reasons therefor).

of the board of directors would take over the process of selecting a BSP to be submitted to the shareholders for approval. The chosen BSP would serve until the next annual meeting and could be renominated and reelected indefinitely, as is the case today with individual directors. Likewise, a BSP would be subject to removal by the shareholders under the same rules governing removal of individual directors.

But it could be radically different too, either by statutory command, or, preferably, the choice of individual firms. Other options for the nomination and election procedures, including ones that could reduce board turnover, thus are discussed below.[176]

2. Composition and Function

Another dimension along which we can compare and contrast the current board model and our proposed alternative is the composition and function of the board. Today, board members are most commonly current or former CEOs of other companies, as well as high-profile individuals from business, science, law, academia, accounting, politics, and other fields.[177] The choice of directors is undoubtedly based on many factors and is highly situational. For early stage companies, directors with access to key fundraising connections or with industry expertise may be highly prized, while for later stage companies, directors with political connections or leadership positions at firms in complimentary industries might be more valuable. Boards going through a crisis might need the help of an expert in risk management, someone with government connections, or someone who has led an organization through a crisis. Other factors, such as personal relationships and diversity considerations, may also be involved in choosing directors. Some of these reasons may be desirable from the perspective of shareholders, including access to lower-cost capital, business connections, political influence, and strategic vision. Others may not be, including the personal satisfaction of the CEO, in terms of quid pro quos or rubbing elbows with great figures.[178]

Our idea is to do away entirely with having individuals sitting on the board. Just as a firm outsources much legal work to a law firm rather than a committee of lawyers

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[176] See Part VI infra.

[177] Consider, for instance, the board Walmart. As of June 2013, it has 14 members, 12 of whom are not otherwise employees of Walmart. These include two business professors, three former CEOs, three current CEOs, the former head of an accounting firm, the former head of an advertising firm, the former head of the Small Business Administration, and the general partner of an investment fund. See http://corporate.walmart.com/our-story/leadership/board-of-directors.

[178] For instance, the board of Walt Disney Co., which infamously paid Michael Ovitz about $150 million for one-year's work, consisted of several personal friends of Disney CEO Michael Eisner, including actor Sydney Poitier, the principal of an elementary school Eisner's children attended, and the architect who designed one of Eisner's homes. Such cronyism may be difficult to unpack from appointments that are in the interest of shareholders. For instance, media conglomerate IAC/InterActiveCorp recently appointed 31-year-old graduate student Chelsea Clinton to the board. http://www.bloomberg.com/news/2011-09-26/chelsea-clinton-joins-board-of-directors-at-iac-interactivecorp-.html Perhaps this makes business sense, since political connections are (unfortunately) valuable for firms. But it also may a way for IAC's chairman, Barry Diller, to maximize his utility, as opposed to IAC's shareholders—Diller is a big donor to the Democrats, and helping Ms. Clinton is an obvious way to continue that practice. There is reason to suspect the latter, since former board members of IAC include Diller's wife, the fashion designer Diane von Furstenburg, and General Norman Schwartzkopf, and the current board also includes von Furstenburg's son, Alex.

and its external audit function to an accounting firm rather than a committee of CEOs, the board function would be outsourced to Boards-R-Us and its ilk. To be sure, there would be individuals serving as the point of contact between the corporation and the BSP, just as individual partners serve as the contact point between the corporation and its law firm and auditor. Where the board is called upon to make a decision, such as whether to approve a merger, the CEO would meet with the contact person at the BSP, who would then bring the full resources of the BSP to bear on making the decision. The precise composition of decision-making team within the BSP might vary with the type of decision at hand, just as law firms put together different teams to handle a given client's varying matters.[179]

Under the BSP approach, the type of individuals providing board member-like services could more or less be what they are today or they could be completely different, depending on how BSP developed over time to meet the needs of their clients. A BSP could hire the exact mix of individuals that currently serve on corporate boards—current and former CEOs, politicians, lawyers, and so on.[180] These contractual relationships could be permanent or temporary, meaning some individuals might have a relationship with one BSP or for one particular board service contract, while others might offer their services on a freelance basis. If the current composition of board members is optimal, there is nothing about our proposal that would upset this.[181] One benefit of the BSP model, however, is that it would discourage on the margin the hiring of individual board members as window dressing or because of domination of the board by the CEO.[182] Current boards still all too often include, say the child of a president or famous actor, a

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[179] As discussed below in Part V, we envision Boards-R-Us as a broad service, consulting firm containing experts from multiple disciplines whose expertise who would combine as necessary to make decisions for client corporations.

[180] Our approach does not prevent the use of mixed boards. Consistent with our emphasis on providing enabling rather than default rules, we believe that companies should have the ability to have a BSP serve as part of a larger board that also includes individuals chosen via the traditional model. The most obvious case for a mixed board would be where the firm wished to continue having inside directors (i.e., current or recently retired employees, especially the CEO) serve on the board. On the desirability of having inside directors serving on the board, see Stephen M. Bainbridge, A Critique of the NYSE's Director Independence Listing Standards, 30 Sec. Reg. L.J. 370 (2002). Large shareholders may demand a board seat as well. Indeed, investors with large stakes in particular firms often seek influence over firm policies by nominating (either directly or with the consent of management) directors to represent their interests. See Chris Cernich et al., Effectiveness of Hybrid Boards 7-11 (2009), available at http://www.irrcinstitute.org/pdf/IRRC_05_09_ EffectiveHybridBoards.pdf (discussing hedge funds efforts to obtain representation on portfolio company boards of directors so as to effect changes in top management team composition or corporate strategy). The government also occasionally asserts its interest in particular firms through the appointment of a board member. See, e.g., Anton Troianavski et al., US Steps Into Sprint's Board, Wall St. J., May 23, 2013, at B1. If valuable in a particular case, this tactic could continue to be used, either by convincing the BSP (through management) to add a particular individual to the team for a particular firm, or by expanding the board to include individual members in addition to a BSP's role.

[181] Some additional contracting might be necessary to form coherent firms out of a changing mix of individuals, but this is a rather small cost.

[182] If having the relative inexperienced daughter of a former president and secretary of state on the board will improve governance for a particular firm, then a BSP would have an incentive to hire that person to be part of a board services team. This "value" could include reasons that aren't about shareholder or firm value, such as pleasing the individual or group making the decision on which BSP to hire.

BSP hired to provide such services is less likely to include such individuals because it has a profit motive in selecting the best candidates.[183]

3. Compensation

Another dimension of comparison is in how directors are compensated for their work. Directors of large, publicly traded American firm are paid a mix of cash and equity grants in the corporation. [184] The latter, a relatively recent innovation, are designed to align the wealth of directors and shareholders so that director incentives are improved from the perspective of the firm's residual claimants.[185]

In the BSP model, we expect that the BSP would bill client corporations a basic annual fee for services, just as law firms and external auditors do. Unlike the latter types of service providers, however, we anticipate that client corporations may wish to pay part of the BSP's compensation in equity—such as restricted stock—so as to align the interests of the BSP with those of the client's shareholders. [186] Nothing prevents firms from owning stock in other firms, and the stock holding requirements and restrictions currently applied to director compensation could be readily transferred to the BSP.

4. Liability

In the BSP model, liability for board misconduct or breaches of fiduciary duty would reside at the entity level, instead of the individual level. In the event of alleged director misbehavior, the shareholders of the company would sue the BSP derivatively for breaches of fiduciary duties. Liability for any violations would be born by the BSP as an entity, rather than the directors being individually, jointly and severally liable for the total damages. Entity liability would not preclude individual liability as well under extraordinary circumstances. As with any case of entities facing liability, individual agents may also be held liable if there are facts and circumstances suggesting the policy undergirding the legal rule would be furthered by individual liability.

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[183] One might conclude that appointing board members is a fringe benefit of the CEO, in which case the move toward a BSP that makes idiosyncratic appointments less likely might require compensating the CEO, either with additional compensation or with some other power. There are, however, reasons to doubt the importance of the work done by our proposal in this regard. CEOs are already less closely involved in board appointments, given the rise of the independent nominating committee, now required by law for public companies. Insofar as it remains an issue for CEOs, the move to a BSP may make this issue less salient and important. In other words, once CEOs no longer think about board seats as theirs to fill and instead think about firms to hire to provide service to the company, the importance of this power will likely be lower.

[184] See supra notes 153-156 and accompanying text (discussing evolution of director compensation practices).

[185] See supra notes 157-161 and accompanying text (discussing incentive effects of director stock ownership).

[186] Although some professional services firms did not historically take equity stakes in their clients, in recent years consultancies, law firms, and other service providers have increasingly done so. See, e.g., David Leonhardt, Consultants Are Putting A New Price on Advice, NY TIMES, Jan. 19, 2000.

IV. Mapping the BSP to the Current Board

As the preceding Part showed, the basic version of our proposal is substantially similar to the current board model, with the one key difference that the board consists of an it instead of a collection of individuals. In the next Part, we explain why we think that small change might have significant advantages, at least for some corporations. To do so, we map our discussion of BSPs against the analysis and critique of current board functions lay out an affirmative case for a legal change to permit entities to provide board services laid out in Part II above. As an organizational matter, however, it turns out to be advantageous to reverse the order in which we take up the questions of functions and failures.

A. How BSPs Address the Reasons Current Boards Fail

The advantages of hiring a business association, as opposed to a solo practitioner, working alone or as part of a larger team, to provide professional services are well known in other contexts. These include the ability to capitalize on economies of scale and scope, to share risk, to invest in specialization, and to generate large reputational assets that can help constrain opportunism. These benefits are the reasons why nearly every other professional service has the option of being provided by any type of business association. Lawyers, accountants, compensation consultants, investment bankers, insurance companies, management consultants, and all other providers of professional services to firms are free to organize the provision of these services in whatever way they believe is optimal. There is enormous heterogeneity, and all business association forms, from sole proprietorships to corporation, are used. The choice varies by firm, by industry, and over time. Law firms used to be partnerships, but now are largely limited liability companies or limited liability partnerships.[187] The same is true for investment banks and stock and commodities exchanges, which also used to be partnerships, but now are predominately publicly traded corporations.[188] The variation and the dynamic nature of the choices reflect the fact that the choice of associative forms is responsive to the needs of service providers and clients, as well as to the background economic and technological conditions. In other words, the experience of other service industries suggests that locking in one type of business association as the sole mechanism for providing the services would have resulted in some serious inefficiency.

Although the benefits of forming various business associations are well known, it is worth unpacking them to see how they would apply in the context of director services, since this will demonstrate the appeal of our proposed reform. Specifically, we focus on the ways a BSP could address the ways current boards fail.

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[187] See, e.g., Michael Bobelian, Dewey's Downfall Exposes the Demise of Partnerhsips, FORBES, June 7, 2012 (tracing the transition away from the partnership model to the change in about 40 states in the mid-1990s that allowed law firms to organize themselves as Limited Liability Partnerships).

[188] See, e.g., Reena Aggarwal, Demutualization and Corporate Governance of Stock Exchanges, 15 J. APPLIED CORP. FIN.105 (2002) (listing numerous examples of stock exchanges around the world demutualizing since 1993, and discussing implications).

1. Economies of scale and scope

In Part II, we saw that independent individual board members are part-timers. As a result, they face three important sets of constraints: limited time, information asymmetries vis-à-vis management, and a lack of specialist expertise.[189] A significant advantage of the BSP model is the potential to ameliorate those problems by taking advantage of the potential economies of scale and scope inherent created when economic activity is brought within an organization rather than conducted by individuals.

Economies of scale and scope allow firms to increase quality and/or lower cost by finding efficiencies in production, spreading fixed costs across a larger asset base, investing in technology, and so on.[190] Economies in the production of goods or services are common across all areas of the economy.[191] They explain the fact that everything from the production of consumer products to the delivery of highly specialized services are provided primarily by large enterprises.[192]

Even in highly fragmented professional services industries, like law and accounting,[193] a substantial part of the industry thus is provided by the largest enterprises. In legal services, one of the most highly fragmented industries, there are about 180,000 law offices in the U.S., generating nearly $250 billion in revenue.[194] But, according to an industry report by First Research, over 15 percent of total revenue comes from the largest 50 law firms.[195] For example, Baker & McKenzie, the world's largest law firm by both revenue and number of lawyers, has nearly 4000 lawyers who produce over $2 billion in revenue.[196] The top ten firms worldwide have revenues of nearly $18 billion and employ over 23,000 lawyers.[197]

Economies of scale are most commonly understood in the context of the manufacture of products. The leading text on organizational theory describes their benefits observing that a larger manufacturing "firm may be able to afford more specialized equipment, more distribution outlets located nearer to customers, a larger number of plants, training programs for its employees tailored to particular circumstances, and so on."[198] Although directors do not need more factories or specialized equipment, any more than lawyers do, the logic of economies of scale readily transfers over to the provision of professional services. As applied to the problem at hand, the economies of

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[189] See supra Parts II.D.1-II.D.3.

[190] Paul Milgrom & John Roberts, Economics, Organization & Management 106 (1992) ("By definition, economies of scale in production allow a firm to reduce its costs compared to small-scale production. . . .")

[191] Id at 110. See also Joaquim Silvestre, Economies and diseconomies of scale, The New Palgrave: A Dictionary of Economics 80–84 (1987).

[192] Id at 105.

[193] The Big Four accounting firms dominate the accounting industry, and extremely large firms are present in consulting (e.g., Accenture, Bain, Booz Allen, Deloitte Consulting, and IBM Global Services). The top 50 companies account for less than 30 percent of industry revenue. http://www.hoovers.com/industry-facts.consulting-services.1071.html

[194] http://www.firstresearch.com/Industry-Research/Legal-Services.html

[195] http://www.firstresearch.com/Industry-Research/Legal-Services.html

[196] http://en.wikipedia.org/wiki/List_of_largest_U.S._law_firms_by_number_of_lawyers; http://en.wikipedia.org/wiki/List_of_100_largest_law_firms_by_revenue.

[197] Id.

[198] Paul Milgrom & John Roberts, Economics, Organization & Management 106 (1992).

scale that a BSP can achieve help redress all three of the problems faced by individual board members.

a. Time

A large organization providing multi-member teams to carry out the BSP function inevitably will be able to devote more person-hours to gathering and processing information and exercising evaluative judgment on the basis of that information than can an individual, part-time director. Full-time directors would, by definition, be able to devote more time than part-time ones, and the BSP model provides a mechanism to create professional directors with no other employment. In addition, a BSP would allow professionals to leverage support staff to increase the time spent on any matter, all else being equal. Professional service firms in other areas, like accounting, law, and consulting, deploy pyramidal structures with multiple levels of full-time professionals, and this allows them to spend considerable more time on a given project than if a single, part-time individual were working on the same project alone. In addition, because of the economies of scale achievable by a BSP, it can do so at a lower cost per person-hour. As noted above, time, so to speak, can be bought in the market place as well, but the Coasian efficiency concerns raised above obtain here as well.

b. Information

As just noted, a BSP will be able to devote more time—and, of course, other resources—to gathering information and at lower cost. In addition, a single BSP wielding the full powers of the board may be in a better position to demand forthrightness by the top management team than would a single, lone wolf director acting alone. Even a subgroup of individual directors acting in concert would have less bargaining power vis-à-vis top management than a BSP acting as the entire board. Although the information asymmetry between a top management team and the BSP could never be fully eliminated, just as there are persistent information asymmetries between top management and the firm's outside lawyers and accountants,[199] we would expect BSPs to have better access to information than do individual directors. Not only is the BSP likely to have better information about the firm it is serving, it will also have much more information about the particular questions it is considering, whether they are about compensation, strategy, finance, or the like. As we consider next, BSPs will enable much greater general knowledge and information to be brought to bear on firm decisions and at much lower cost.

c. Specialization

In addition to firm-specific information, board members need general human capital in various areas of knowledge and expertise. A board thus may benefit from

[199] Cf. Stephen M. Bainbridge, Corporate Lawyers as Gatekeepers, 8 UCLA School of Law Journal of Scholarly Perspectives 5, 13 (2012) (noting that "in many of the recent corporate scandals, the misconduct was committed by a small group of senior managers who took considerable pains to conceal their actions from outside advisors, such as legal counsel").

members with experience in finance, international business, government and regulation, risk management, marketing, social media, and the companies' specific industries, not to mention the inclusion of minorities and women.[200] Even if a board were to include individuals with all of these skills, however, any reasonably sized board will necessarily be under-inclusive of the skills and experience needed to address all of the issues that may arise. In addition, the ideal mix of board expertise is likely to vary over time or even from decision to decision. Directors serve for long periods—the average tenure for directors of S&P 500 firms in 2012 was nearly nine years[201]—and are generally not replaced during any individual year to address particular issues. This means the current board model is likely to be far lumpier than the expertise needed for any particular issue on any particular day.

As noted above, an obvious solution to these limitations is for a board to buy the expertise needed at a particular time instead of seeking it internally. This has been and largely remains the practice. Most obviously, management provides much of the information, analysis, and expertise the board needs to make decisions. Unfortunately, of course, this dependence on management is one of the key factors that undermines current boards' ability to function as independent decision-making bodies, especially because forthrightness from management may be least likely precisely when the board's oversight is needed most.

In addition, external consultants of various sorts provide the board with advice or information. Compensation consultants are routinely hired to advise the compensation committee; headhunters advise nomination committees; audit firms help audit committees; and so on. The independence of such advisors, however, was questionable because management traditionally hired them. There are thus two problems with the current model—efficiency and conflict of interest.

At least with respect to the audit and compensation functions, federal law now seeks to ameliorate the conflict of interest problem. Federal law now requires reporting companies to have a compensation committee comprised exclusively of independent directors and provides that that committee shall have exclusive authority to hire, fire, and compensate compensation consultants.[202] The same statute further requires the SEC to promulgate rules designed to ensure that compensation consultants are independent of management.[203] Likewise, federal law requires reporting companies to have an audit committee comprised exclusively of independent directors.[204] The audit committee must have exclusive power to hire, fire, and compensate the firm's external auditors.[205] There is doubt these new rules have solved the conflict-of-interest problems in these areas because of continued management control and influence. Even assuming that these developments have solved the conflicts of interest that long plagued the consultant-corporate client relationship in those areas, conflict-of-interest problems persist outside of

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[200] Spencer Stuart Board Index 2012, available at http://content.spencerstuart.com/sswebsite/pdf/lib/Spencer-Stuart-US-Board-Index-2012_06Nov2012.pdf, at 14.

[201] Id at 19.

[202] 15 U.S.C. § 78j-3.

[203] Id.

[204] 15 U.S.C. § 78j-1.

[205] Id.

those contexts. Boards remain dependent on management and outside advisors selected by management for much of the information they need. Even if one believes, however, that firms are now at the optimal equilibrium in the build-versus-buy decision for board expertise along this dimension, efficiency considerations remain.

The problem is one identified by Ronald Coase in his work on the theory of the firm.[206] As Coase explained when describing why firms exist in the first place, there are significant gains from bringing functions or services bought in the market inside of a given firm.[207] Buying services or information in the market involves numerous costs, including search costs, bargaining costs, transaction costs, monitoring costs, enforcement costs, and so on. Ringing the boundaries of a firm around these functions or services can reduce these costs by virtue of the reduced costs of the fiat allocation system, but at some point in size these gains are swamped by the costs of bureaucracy.[208] Coase's insight was that firms should be the size where the marginal gain from the addition of another individual or function is equal to the costs of that addition in terms of optimal decision making.[209] It is difficult to imagine that the optimal Coasian firm for provision of director services is comprised of a single individual in all cases, just as it is not for legal or consulting services. As such, potential efficiencies in the operation of boards could be realized by removing the statutory constriction on the Coasian firm.

For instance, associating with other professionals allows individuals to develop and invest in specialized knowledge and expertise. Service professionals are routinely organized as business associations comprised of managers[210] who have decision-making authority and who supervise other professionals who provide support services. The typical law firm or consultancy fits this model. The pyramidal structure of such firms allows professionals to become experts in particular areas, and then to be deployed as needed as part of a team. Consider a typical management-consulting firm. These firms deploy experts with particular skills or knowledge of different industries or fields, technical experts in certain areas (e.g., econometrics, finance, and so forth), lawyers, accountants, scientists, psychologists, and countless other professionals, as well as generalist consultants. Just as directors currently are required by law to buy all of their support services, either from the company they serve or from the market, one could imagine consultants or lawyers or accounts being required to do so as well. But the Coasian equilibrium for these professional services firms are larger than one person firms, and we expect the same is true of directors.

To see how this might translate into the market for BSPs imagine a BSP vertically integrating with some or all of the experts that currently provide board members with information and advice. In the pure BSP model, one or more of the BSP's senior

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[206] See Ronald H. Coase, The Nature of the Firm, 4 ECONOMICA 386 (1937).

[207] Id at 389. For a discussion of these issues in a related area, see, M. Todd Henderson & Fred Tung, Reverse Regulatory Arbitrage: An Auction Approach to Regulatory Assignments, 98 IOWA L. REV. __ (2013) (applying the Coasian insight to the question of how bank examiners are allocated to their regulatory assignments).

[208] Id at 390.

[209] Id at 395.

[210] The precise title of these individuals varies depending on which form of business organization they have chosen to adopt, running from shareholders (corporation), managers or members (LLC), to partners (partnerships and limited partnerships). Unless otherwise indicated, we use manager herein as a generic for all of these alternatives.

managers act as liaison between the BSP and client, just as a lead law firm or accounting partner often acts as the primary liaison between such firms and their clients. Alternatively, the individuals currently serving the client as directors could be hired by the BSP and thereafter continue functioning as the client's board. In either case, the BSP would be a large firm that vertically integrates the BSP function with all board advisory services, excepting law and accounting, such compensation consultants, management consultants, and others serving in support roles. The economies of scale and scope described above would allow the partners in this model to have board service as their full-time occupation.[211] The result would likely be not only an improvement in the quality and incentives of directors (or those now serving in that role) but also in the creation of a new profession, that of professional director. Professions, as such, are thought to be valuable because they develop codes of conduct and engage in self-regulation to encourage profession-specific reputation.[212]

Our proposal for BSPs is thus a potential mechanism for achieving Ronald Gilson and Reiner Kraakman's dream of professional directors.[213] In "Reinventing the Outside Director," they proposed creating a class of professional directors who will serve on a portfolio of boards as their full-time job.[214] These professionals would know their portfolio companies better, because they will be able to devote more time to following those companies, and they will be more dependent on institutional shareholders for their position.[215] They recommend the use of a central clearinghouse to take care of the logistics of helping institutional shareholders select professional directors to serve on their companies' boards.[216] The Gilson and Kraakman proposal went nowhere, perhaps because the idea of turning over the governance of a company to a clearinghouse was a step too far for corporate managers. Our proposal for BSPs is a more modest step, in that it could achieve the same goal but within the current power structure of firms. Yet we can imagine this simple change leading to a new profession, just as envisioned by Gilson and Kraakman.

2. Incentives

In this Section, we consider a variety of ways in which the BSP model could provide improved incentives that would help ameliorate some of the dysfunctions of the

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[211] Management consultants, for instance, use their large firm size to invest heavily in training consultants, to produce knowledge and expertise, to allow specialization, and to permit deployment of talent at the optimal point across time and space. CITE These firms have hundreds if not thousands of professionals, some who provide front-line services, but many of whom provide those employees with research, expertise, support services, technology, and so on. CITE Having front line professionals under the same corporate umbrella as these ancillary functions allows services to be provided at lower cost because of the ability to allocate them across a wider asset base. This allows specialization and cost savings from shared services.

[212] See, e.g., William Birdthistle & M. Todd Henderson, Becoming A Fifth Branch, __ CORNELL L. REV. __ (2013) (describing self regulation of professional stock brokers).

[213] Ronald Gilson & Renier Kraakman, Reinventing the Outside Director: An Agenda for Institutional Shareholders, 43 Stan. L. Rev. 853 (1991).

[214] Id at 865.

[215] Id at 886.

[216] Id at 888.

current board model. Although directors are well paid for the work they do, their monetary incentives to work hard and do well are fairly limited, since they capture so little of any gains and suffer so little any of the losses from the decisions they make. In light of this fact, reputation plays an important role in the incentive calculus. But, as discussed above, the reputational gains and losses are also highly attenuated from performance. This creates the possibility of large welfare gains from improved incentives for directors.

a. Compensation incentives

Large, publicly held corporations generally pay directors a few hundred thousand dollars annually for their work, and require directors to hold a fairly trivial amount of the corporation's stock.[217] Microsoft Corporation is typical of very large, publicly held corporations. In 2011, Microsoft had a ten-member board, and each director was paid $100,000 in cash, and granted stock worth $150,000.[218] This mix of cash and stock is designed to give board members a stake in the outcome of their decisions, while compensating them for the time they spend preparing for and in board meetings. Although the stock-holding requirement undoubtedly gives board members some incentives to care about firm value, the amounts are routinely so small that critics believe they do little to optimally align shareholder and board incentives.[219]

Under the BSP approach, compensation may look much as it does today or could be quite different.[220] For instance, if a BSP assigns a number of individuals to serve as permanent board members, the firm might simply replicate the current pay structure of the underlying client company, paying a fixed salary (equal to the company's current annual retainer) and requiring individual employees of the BSP to hold equity in the client, as in the Microsoft example. If instead the BSP deployed a variety of professionals to a particular client depending on the situational needs, then one might expect the stock in the client to be held at the BSP level, and the payment to board members to be based on an algorithm tied to individual performance as a director for one or more firms. If the BSP and client opted for the full BSP model, with one or two liaison managers interfacing between client and BSP and the BSP itself serving as the board, we would

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[217] See, e.g., Spencer Stuart Board Index 2012, available at http://content.spencerstuart.com/sswebsite/pdf/lib/Spencer-Stuart-US-Board-Index-2012_06Nov2012.pdf, at TBA.

[218] Microsoft Corporation 2012 Proxy Statement at 30-31. Board members were required to hold stock equal to three times their annual retainer of $100,000. In addition, directors received additional payments of $15,000 for service on various committees.

[219] See Lucian A. Bebchuk, Tackling the Managerial Power Problem: The Key to Improving Executive Compensation," *Pathways Magazine,* August 2010.

[220] The optimal work structure and incentives needed to achieve the most efficient form of governance are far beyond our scope, and, in any event, are likely not knowable in advance without experimentation and market-provided information and discipline. They likely will vary widely over time and across firms and industries. For purposes of proving our model feasible, we'll note, however, that there is nothing obviously problematic about moving toward an entity model of board services. The key point is simply that the purposes of current board compensation structure can easily be achieved with the professional services firm setting.

expect compensation structures with such BSPs to resemble those of other consultancies.[221]

But there are some possibilities for innovation that could improve the incentives of board service providers. One option would be for the BSP to take a much larger stake in the client company. A greater ownership stake by the board has the potential to improve incentive alignment, but there are two barriers to this. The first is that giving boards large upside stakes with limited downside risks skewing decision making in a socially undesirable fashion. The potential solution to this is discussed below. The second is that individual, part-time board members are not well positioned to bear this kind of risk and their work does not routinely justify such large stakes. Hiring a BSP could help address these concerns. Because of risk pooling, greater reputational stakes, greater efficiency, and so on, a BSP could hold a much larger stake in its client than the sum of the stakes held by individual board members.

This prospect raises a potential analogy to the private-equity model of governance. One of the chief virtues of the private equity industry is that it consolidates the ownership interests of the firm, and thus helps undo the harms that flow from the separation of ownership and control.[222] Managers of private-equity-owned firms have a tremendous economic stake in the success of these firms, and therefore, it is thought, better incentives to take care and make good decisions.[223] A downside, however, is that the improved governance only obtains when the entire firm is taken over, and the public shareholders are displaced. A market for corporate governance could be a half step in this direction, since we could see BSPs taking a larger stake in the client company than current board members but without having to take over the entire company. BSPs could bear more risk than individual directors, and would be likely be willing to and have an interest in greater economic ownership than the current, rather low levels of current board ownership. For instance, Microsoft's directors are required to hold stock equivalent to three times their board service fee of $100,000. As of April 2013, this means the board was required to hold about 0.001% of the value of shares of Microsoft.[224] Accordingly, even if a BSP took just a 1 percent stake in its client, on top of any service fees, this would amount to a thousand-fold increase in incentive alignment of Microsoft's board.

We could go further, and expect BSPs to do so as the market evolves and the initial design and conflict issues are resolved, in the direction of giving BSPs greater stakes to the residual corporate claims. One possibility would be for companies to hold an

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[221] For instance, professional services firms, like consultancies or restructuring firms, typically pay executives two components: a "salary" based on work performed, and a "bonus" tied to the overall profitability of the firm. The former is based on work done on specific projects, successful pitches, and any management or supervisory work; the latter is based on a share of the residual based on overall value to the firm. For lower level employees, a mix of salary, performance-based incentives, stock ownership, and other techniques are used depending on the firm and the situation.

[222] See George W. Dent, Jr., Stakeholder Governance: A Bad Idea Getting Worse, 58 Case W. Res. L. Rev. 1107, 1142-43 (2008) ("The proliferation of private equity stems in large part from the benefits of avoiding the agency costs of the separation of ownership and control characteristic of public companies.").

[223] See Robert C. Illig, The Promise of Hedge Fund Governance: How Incentive Compensation Can Enhance Institutional Monitoring, 60 Ala. L. Rev. 41, 73-74 (2008) (explaining that private equity fund managers often hold significant ownership stakes in their funds, which improves their incentives).

[224] On April 23, 2013, Microsoft's market capitalization was about $255.71 billion.

auction for board services on a periodic basis (e.g., annually or biennially) in which rival BSPs would compete to win the work. In an auction model, the company looking to hire a BSP would write a board-services contract specifying the financial and other terms of the deal. For instance, the company might offer the winner of the auction a portion of the residual claim on the firm's assets, such as a guaranteed dividend or number of shares. BSPs would then submit bids for the minimum amount of dividend or shares they would take in order to perform the work. This would have the dual virtues of giving BSPs greater incentives to perform by making them hold residual claims on firm value, and making BSPs compete in a transparent way for the board role.

Another potential change to the compensation structure was alluded to above in the discussion of vertical integration of the board services industry. Firms pay a lot more for board services than simply the cash and stock issued to directors. Firms buy directors insurance, self-insure for certain claims against directors, and, as noted above, hire various consultants, accountants, lawyers, and other experts to assist the board in fulfilling its duties. Consider again the case of Microsoft. For a company of Microsoft's size and industry, D&O insurance costs about $4 million or about $400,000 per director.[225] In addition, Microsoft's corporate charter, like most firms, contains a provision indemnifying directors against breaches of the duty of care. This self-insurance is difficult to quantify, but is likely a significant cost as well. In addition, boards routinely hire experts of various kinds, including management and compensation consultants, law firms, and other service providers. While there are no good estimates of these costs, there is reason to believe they are in the range of several million dollars per firm per year. All told, for example, Microsoft pays at least $2.5 million for board services, plus a minimum of several million more in insurance costs and other services, making the total costs of director services nearly $10 million per year.[226] If Microsoft's costs are typical, this means the director services market—for just the Fortune 500 firms—is a $3 to $4 billion per year industry. Costs for smaller firms likely are lower, but given that there are about 15,000 publicly traded firms in the U.S., if the average publicly traded firm has just $1to $2 million in direct and indirect director costs, there is the potential for $15 to $30 billion per year BSP industry.

That this huge industry is delivered entirely through the actions of a group of part-time, sole proprietors is surprising. As noted above, there are likely significant gains to be had from industry consolidation across the supply chain. This could mean that BSPs would house some combination of decision making, insurance, and support in one corporate body. In terms of compensation, the payment for board services could reflect this combination of services with BSPs bidding on multi-million dollar contracts. There are a few potential positive effects of this. First, the significant size of these payments would likely be sufficient to justify the creation of BSPs and to generate competition amongst them for a given board service contract. The vertical integration would help create a vibrant market for corporate governance by raising the stakes of taking over the board. Second, this model would increase the transparency of board costs for shareholders, who currently do not have good information on the total costs of boards.

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[225] *See* "Evaluating how much D&O insurance to purchase" (Zurich American Insurance Company) (2011)

[226] *See* Christine Kang, "Directors' and Officers' Insurance: Ordinary Corporate Expense or Valuable Signaling Device?" Dep't of Economics, Stanford University (2011)

Third, the introduction of potentially more efficient competitors in this space may have the effect of driving down board costs, while holding constant or improving corporate governance.

b. Liability-based incentives

We think the use of BSPs may also have salutary effects on the quality of corporate governance through improved judicial supervision of board activities. Courts may be more willing to hold BSPs liable than individual directors, and this could help make fiduciary duties more robust. The logic is straightforward. As noted above, directors are independent, amateurs without deep pockets, but who face enormous potential liability for the decisions they make. For instance, the sloppy approval of a merger could subject directors, including individual directors to multi-million dollar liability, not to mention the significant risk to their personal reputation. Courts seem reluctant to impose liability on directors,[227] and perhaps increasingly so in recent years.[228] This could be because of institutional competency concerns, worries about hindsight bias, the potential chilling effect on risk taking, the reluctance to hold individuals (some of whom are not super rich) liable for potentially huge damage awards, and the potential impact of increased liability on the supply of individuals willing to provide director services. Whatever the reasons, if directors form associations to share risk, this reduces the potential negative cost on individuals, and thereby may increase the willingness of courts to impose liability.

To see the point, consider the impact that the availability of directors and officers insurance (D&O insurance) has on judicial enforcement of board duties. In the absence of any insurance, courts would be significantly less likely to find individual board members liable for breach of their fiduciary duties. In this way, third-party insurance can, at least in theory, be a mechanism for enhancing compliance with law.[229] Sharing risk (in this case through insurance contracts) reduces the costs of liability for individual directors, and therefore may make a finding of liability more likely, all else being equal. The downside of insurance—the moral hazard or shirking problem—can be reduced through monitoring (both ex ante and ex post) and some risk bearing, in the form of deductibles or the like.

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[227] Tamar Frankel, Trust and Honesty: America's Business Culture at a Crossroad 183-84 (2006) ("There are some departures from the historical strong protection of corporate boards. For example, in the past two decades, the Delaware courts . . . were reluctant to make corporate directors liable for the wrongs committed by their corporations. The courts respected the directors' business judgment and, with a few notable exceptions, shielded the directors from the claims of shareholders."); See, e.g., Lisa M. Fairfax, Spare the Rod, Spoil the Director? Revitalizing Directors' Fiduciary Duty Through Legal Liability, 42 Hous. L. Rev. 393, 409 (2005) ("[T]he tremendous deference courts grant to board decisions means that courts hold directors liable for only the most egregious examples of director misconduct.").

[228] Compare *Smith v. Van Gorkom* and *In re Disney Shareholder Litigation.* Jonathan R. Macey & Geoffrey P. Miller, Trans Union *Reconsidered*, 98 YALE L.J. 127, 131 (1988); Fred S. McChesney, *A Bird in the Hand and Liability in the Bush: Why* Van Gorkom *Still Rankles, Probably*, 96 NW. U. L. REV. 631 (2002). The claim was settled for nearly $24 million, of which less than half was covered by D&O insurance. Id. See also WILLIAM M. OWEN, AUTOPSY OF A MERGER (1986). In re Walt Disney Co. Derivative Litigation, 907 A.2d 693, 697 (Del. Ch. 2005); In re Walt Disney Co. Derivative Litigation, 906 A.2d 27, 56 (Del. Supr. 2006).

[229] Tom Baker & Sean J. Griffith, Ensuring Corporate Misconduct: How Liability Insurance Undermines Shareholder Litigation (2011).

Self-insurance in the form of organizational choice is simply an extension of this idea to areas of liability beyond those currently covered by contractual insurance. Directors who are able to pool their risk through a business form we call the BSP can reduce their risk. The ability to share, and thus reduce, risk is one of the most powerful reasons for forming a business association. A single individual running a business faces all of the risk if the business fails or generates liabilities that exceed its assets. If all businesses were required by statute to be run by an individual acting as a sole proprietor, risk alone would work a serious impediment to the provision of all sorts of products and services. By forming a business association in which risk is shared among various owners, the business can take on more risk than could and would a sole proprietor.[230] This is because some individuals will have greater risk tolerances than others, and these may not line up with other attributes that can be brought to use by a firm.[231]

The additional liability in such cases would be doing work primarily in cases in which potential damages exceed liability coverage, since this is the extensive margin where courts are most likely to feel whatever pressure they feel to take it easy on misbehaving directors. The existence of insurance for breaches of certain fiduciary duties already reduces the downside for directors, and therefore makes judicial supervision more robust than it would likely be in the absence of insurance. The additional risk reduction from operating as a business association would therefore act mostly in those cases in which the expected liability exceeds the insurance coverage. This could either be for large damage awards or for certain actions, such as breaches of the duty of loyalty.

The risk-sharing of organizational choice may also do some work in cases in which the conduct is completely covered by insurance. There is reason to believe that the D&O insurance market does not work optimally,[232] and adding self-insurance or replace the D&O model with self-insurance could help make corporate liability more effective. While one would expect insurance costs to discipline firms, it is not obvious this translates readily into the market for director talent, since liability is so rare, is not often linked with necessarily bad behavior, and, in any event, the labor market for directors is thought to be so dysfunctional. Directors do not feel the liability personally, except in the rarest and most extreme circumstances, and there is some evidence that directors' reputations, which we expect to do most of the discipline, are not highly correlated with past performance. There is also some evidence that insurance prices do not obviously respond to incidents of director liability. Bringing the insurance function within the firm providing the service (either through vertical integration of the D&O function or simply through risk-pooling inherent in providing services through firms) may improve the pricing of risk and the judicial treatment of defendants.

Not only might the BSP model make courts less reluctant to impose fiduciary duties on boards, but the corporate model for boards is also likely to generate more

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[230] Risk-sharing could also be done by contract, but this is costly. See infra note __ and surrounding text.

[231] See Ronald J. Gilson & Robert H. Mnookin, Sharing among the Human Capitalists: An Economic Inquiry into the Corporate Law Firm and How Partners Split Profits,' 37 Stan. L. Rev. 339 (1984) (making a related argument to explain partnerships, noting that the lack of perfect skill correlation across special areas of knowledge or expertise provide a type of insurance for partners).

[232] Tom Baker & Sean J. Griffith, Ensuring Corporate Misconduct: How Liability Insurance Undermines Shareholder Litigation (2011).

fiduciary duty litigation. Every allegation of serious board misconduct is likely to result in multiple suits: one by the company against the BSP and one by the shareholders of the BSP against the directors of that firm. The addition of the second type of suit could work as an additional deterrent to board misconduct, malfeasance, or gross negligence. Of course, if one believes that the current amount of litigation is optimal (or even excessive) because directors face the perfect incentives to behave well, then additional liability may add costs in excess of the benefits.

c. Reputational incentives

Another benefit of our model is that it will *increase* the reputational stakes of every board decision, meaning more incentive for good work, all else being equal.

Reputation is already an important element of the corporate governance regime. Harnessing the reputation of directors to prevent cheating and shirking is a vital element of effective corporate governance.[233] Lawsuits, whether settled or reduced to judgment, alleging disloyalty or insufficient care by directors can harm directors' reputations.[234] This can cost directors their position on the board in question or seats on other boards either now or in the future. Since directorships are lucrative for little work, and one well done usually leads to another,[235] a director's reputation could be worth several hundred thousand dollars per year or more. In addition, lawsuits may result in more general losses to directors' reputation in their other endeavors, be it business, law, academia, politics, or other fields. Modern corporate boards often have directors who have made large investments in their reputation, and these directors can be expected to act in ways to minimize the collateral damage from misbehaving as a director.[236] For instance, the Enron board famously included the former dean of the Stanford business school, three CEOs of other companies, political luminaries from the UK, and the former head of the M.D. Anderson Cancer Center.[237] These are important positions that these directors worked very hard to achieve, which adds to the reputational hit for director wrongdoing.[238]

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[233] David A. Skeel, Jr., Shaming in Corporate Law, 149 U. Pa. L. Rev. 1811, 1812 n.3 (2001) (quoting a statement by corporate governance expert Nell Minow to the effect that public corporation directors are "the most reputationally sensitive people in the world").

[234] John C. Coffee, Jr., Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions, 86 Colum. L. Rev. 669, 718 (1986) (noting that reputation is impacted by litigation, even if settled);

[235] According to the 2011 U.S. Director Compensation and Board Practices Report, produced by the Conference Board, NASDAQ OMX and NYSE Euronext, over 70 percent of directors were directors of at least two for-profit enterprises. http://blogs.law.harvard.edu/corpgov/2011/11/11/the-2011-u-s-director-compensation-and-board-practices-report/

[236] See, e.g., Jayne W. Barnard, Reintegrative Shaming in Corporate Sentencing, 72 S. Cal. L. Rev. 959, 966-68 (1999) (describing the importance of reputation for directors).

[237] See 2001 Proxy Statement of Enron Corp. at 5 (as filed with the SEC on March 27, 2001) [hereinafter Enron Proxy Statement] (listing biographical information on Enron director Robert K. Jaedicke), available at http://budurtha.georgetown.edu/enron/Proxy-2001_March_27.htm.

[238] [Isn't there a recent paper about director reputations. . .] An example of the reputational cost is shown by the way Enron's failure has trailed economist and columnist Paul Krugman, a former advisory board member. See James Taranto, Happy Enroniersary, WSJ Jan. 27, 2012, http://online.wsj.com/article/SB10001424052970204573704577187081831886976.html

Some scholars believe reputation is the most important constraint on director behavior, and that it alone can induce efficient board conduct.[239] Others, pointing to failures by boards filled with individuals with seemingly valuable reputations, note that the evidence suggests reputation is not doing all the work necessary to ensure good governance.[240] Of course, the existence of some corporate failures does not mean directors are engaging in suboptimal care levels or that reputation is not sufficient; the optimal level of governance failure is not obviously zero.

But we need not resolve this debate to demonstrate the value of BSPs. This is because reputation and legal sanctions are complementary mechanisms for policing corporate decision-making, and as noted above, there is reason to believe legal sanctions are likely ineffective at inducing the optimal actions by directors. The business judgment rule may be the optimal rule, but it surely lets some sloppy and self-serving transactions happen without scrutiny. Accordingly, the more work that reputational sanctions can do, the less work that law needs to do or the less we need to worry about judicial enforcement of director duties. From the current baseline of whatever work reputation is doing, greater reputational stakes can only improve governance, especially since it can relieve pressure on courts to policy corporate decisions.

In theory, the size of reputation, and therefore the work done by reputational assets in disciplining behavior, is correlated with the number of individuals whose reputation is influenced by a particular decision. This is because for associations providing services, "the reputation of the entire firm is at stake whenever a single [service] is sold."[241] If an individual makes a decision, then only the individual's reputation is at stake; if a firm of 100 individuals makes the same decision, the reputation of the entire firm is at stake. If each of the individuals has the same amount of reputation, the stakes are 100 times greater in the case of a firm making the decision. Of course, the full reputation of each person in a large organization may not be reduced in the event of a failure, but the net impact of reputational losses is likely increasing in the number of individuals comprising the decision-making entity.[242] Therefore, a significant advantage of creating large business associations to provide services is that they can generate greater reputational assets than the sum of the individual reputations at stake for a given transaction.

The greater reputation at stake for a given transaction means higher quality services. Reputation is a way of bonding the quality of a product or service, and for a

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[239] John C. Coffee, Jr., Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions, 86 Colum. L. Rev. 669, 718 (1986); Eisenberg, supra note __, at 1265 (claiming directors' respond more to social norms than the threat of liability); see also Frank H. Easterbrook & Daniel R. Fischel, Mandatory Disclosure and the Protection of Investors, 70 Va. L. Rev. 669, 675 (1984) (discussing the reputation concerns of managers). See David M. Phillips, Principles of Corporate Governance: A Critique of Part IV, 52 Geo. Wash. L. Rev. 653, 673 (1984) (arguing reputation can fully displace legal sanctions); Jayne W. Barnard, Reintegrative Shaming in Corporate Sentencing, 72 S. Cal. L. Rev. 959, 966-68 (1999) (noting the significance of reputation for corporate officers and directors).

[240] See, e.g., Jayne W. Barnard, Reintegrative Shaming in Corporate Sentencing, 72 S. Cal. L. Rev. 959, 966-68 (1999).

[241] Edward M. Iacobucci, "Reputational Economies of Scale, with Application to Law Firms, 14 Am Law Econ Rev 3 (2012).

[242] Id at 18.

given level of legal scrutiny, the greater the firm's reputation, the more likely the product or service will be of high quality. The bonding theory of reputation holds that "[t]he more [services] sold, all things equal, the more valuable is a reputation for high quality, and thus the stronger is the reputational bond to provide high quality."[243] Therefore, as a matter of reputation theory, there is reason to believe BSPs will be able to provide higher quality services than individual board members acting as a group of sole proprietors. Associations of individuals can better commit to quality than individuals acting alone or as a loosely affiliated group.[244]

Larry Ribstein applied this bonding argument to the law firm setting, which is closely analogous to the director services model we propose.[245] Ribstein argued there was a strong relation between reputation and the size of a professional services firm: the larger the firm, the greater the cost of reputational losses, and therefore the stronger commitment to quality.[246] Applying the insight of Ronald Coase, Ribstein notes, however, that increasing size also adds organizational costs, and accordingly professional services firms will increase the number of professionals until the point where the marginal cost of monitoring an additional professional for quality equals the reputational gain from adding the professional.[247] It is highly unlikely that this equilibrium point is a single professional, as state corporate law rules require for director services provision.

In a recent paper, Ed Iacobucci extends Ribstein's work, pointing out some additional downsides of size. Although Iacobbuci starts from the position that business associations "are better able to commit to providing high quality for reputational reasons than sole proprietors,"[248] he notes that size has an additional cost beyond monitoring—large size "increases the short-run profits from sacrificing reputation and providing low-quality service" in an individual case.[249] For large firms, the negative effects from cheating fall on a per service basis as the size of the firm grows. In addition, the transparency of cheating is reduced across a very large firm, as clients in one part of the world may not learn about poor performance in another part of the world, as they would for much smaller firms.[250] Iacobucci resolves this tradeoff by providing conditions in which the reputational gains from scale outweigh the potential for reputational opportunism. For instance, the long-term gains are greater than the short-term opportunism where services are provided nonsimultaneously, such that each sale risks the reputation of the entire firm, but the gains from cheating are limited to a single product or

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[243] Id at 2.

[244] Although individuals currently providing board services to companies undoubtedly value their reputation and act in ways to preserve it, this theory suggests that, all else being equal, the total reputation at stake in any transaction would be significantly higher if the individual were part of a larger firm. In that case, when the director made a decision, say to approve a merger or not, the decision would be betting not only the reputation of the individual director, but that of all other employees of the director services firm. So, no matter how much an individual values their reputation, additional reputational bonding can be achieved through association with other individuals.

[245] Larry Ribstein, Ethical Rules, Agency Costs and Law Firm Structure, 84 Virginia Law Review 1707 (1998).

[246] Id at 1715.

[247] Id at 1717.

[248] Edward M. Iacobucci, "Reputational Economies of Scale, with Application to Law Firms," 14 Am Law Econ Rev 3 (2012).

[249] Id at 4.

[250] Id at 12.

service.[251] Giving partners in the association an equal stake the outcome also ameliorates the potential risk of short-termism. Applying this model to professional service firms, in his case law firms, Iacobucci concludes "[t]o the extent that the firm adopts profit sharing, a partner's incentives to provide low quality are weaker than a sole proprietor's. This in turn makes a larger firm, all things equal, better able to commit to maintaining a reputation for high-quality legal service."[252]

The conclusion that size leads to higher quality because of investments in reputation is supported by empirical evidence in the case of law firms. Profits per partner, a standard measure of law firm quality, are generally higher for larger law firms.[253] Larger law firms also perform better along other metrics of quality. For instance, Marc Galanter and Bill Henderson find that ethical violations are more common for sole proprietors and small firms than for larger law firms.[254] Other work by Henderson finds more equal sharing of profits by more prestigious law firms, which is consistent with Iacobucci's claim about profit sharing being an important check on opportunism.[255] As Iacobucci concludes, all of these "findings are consistent with larger law firms having better reputations, and thus consistent with the theory" about reputation increasing in firm size, but subject to limits that can be reduced through incentive structures.

The theory of reputations, subject to the caveats provided by Ribstein and Iacobucci, is as applicable to the provision of board services as it is to the provision of legal, accounting, or consulting services. One can easily imagine a BSP of similar size to the large professional services firms in these other industries. As noted above, the size of the director industry is as many as 15,000 or more firms spending tens of billions of dollars per year on hiring, insuring, and otherwise supporting directors.[256] If even ten percent of those firms switched to a BSP, one could imagine an industry arising with numerous large BSPs each employing hundreds or thousands of professionals serving as corporate decision makers and support staff. This is not even considering the other industries that are related to director service or provide services to directors that could easily be integrated into a larger BSP. For instance, companies or their boards routinely hire consultants or experts in tax, compliance, internal controls, auditing, strategy, and other areas. Many of these are billion dollar industries, and BSPs could theoretically provide some or all of these directly, either directly or indirectly. In short, the potential for the creation of large, multi-billion dollar firms with significant reputational assets is not far fetched. BSPs with numerous professionals, serving as directors, researchers,

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[251] Id at 20.

[252] Id at 26.

[253] See S. Samuelson & L. J. Jaffe, A Statistical Analysis of Law Firm Profitability, 70 BU L. REV. 185 (1990).

[254] Marc S. Galanter & William D. Henderson, The Elastic Tournament: The Second Transformation of the Big Law Firm, 60 STAN. L. REV. 102 (2008).

[255] William D. Henderson, An Empirical Study of Single-Tier versus Two-Tier Partnerships in the Am Law 200, 84 N.C. L. REV. 1691 (2006).

[256] See, e.g., Spencer Stuart Board Index 2012, available at http://content.spencerstuart.com/sswebsite/pdf/lib/Spencer-Stuart-US-Board-Index-2012_06Nov2012.pdf, at TBA.

experts of various kinds, and so forth, would have a large reputation at stake in each transaction, and this would lead to higher quality services, all else being equal.[257]

d. Exposure to market forces

Effective corporate governance depends on ensuring directors are accountable for corporate decisions. This is done through several mechanisms, some internal to and some external to the company. Businesses use incentive contracts and the power to reappoint directors, as well as reputational sanctions and legal liability.

A related benefit of the BSP model is that BSPs would be more accountable than the group of individuals currently providing board services; indeed, we believe that the accountability of the whole would be greater than the sum of the liabilities of the parts. We have already identified a variety of ways in which the BSP model will likely increase accountability: reducing the impact of personal liability through risk pooling, and thus increasing the robustness of fiduciary duties; providing a second-order accountability regime through the threat of suits by two distinct sets of corporate owners (i.e., both the owners allegedly mistreated by the BSP, and the owners of the BSP); and increasing the reputation at stake in each transaction. Beyond these, however, there is at least one additional way in which BSPs are likely to be more accountable for bad performance than individual directors.

Currently, there is a mismatch between decision-making authority and the mechanisms of accountability. Although board members vote individually on all corporate decisions, their actions are made and recorded as a group. This has the potential to undermine the efficiency of the market for corporate directors. The votes of an individual director are not made public, and therefore the ability of shareholders or other corporate observers to hold directors to account for their decisions is limited. Directors may get reputations in the limited market for director talent, but information is extremely limited, and the incentives of decision makers (e.g., CEOs) may be misaligned with those of shareholders. It is in part for this reason that critics have pointed out that the market for independent directors is not well functioning. Professors Gilson and Kraakman describe that the argument that the choice of outside directors is disciplined by market forces as a "myth" akin to a belief in "directorial noblesse oblige."[258] There is effectively no robust market for board seats based on externally measured performance. This means that internal metrics, like the CEOs' preferences, will be determinative of who sits on the board.

There is some evidence suggesting the market for directors is not functioning as robustly as possible. Professors Steve Kaplan and David Reishus examined whether the performance of CEOs influences their ability to earn and retain seats on the boards of

[257] We should be clear that we do not believe this means there will be no governance failures or even the optimal number of such failures. This is also not to say that we agree with those scholars who believe that reputation alone is or, under our model, would be sufficient to provide optimal incentives for directors. Our more modest claim is that there are improvements to be had in corporate governance from the deployment of the reputational assets of large BSPs. And, this additional benefit of BSPs supports permitting companies to hire boards that are not natural persons.

[258] Ronald Gilson & Renier Kraakman, Reinventing the Outside Director: An Agenda for Institutional Shareholders, 43 Stan. L. Rev. 853 (1991).

other companies.[259] They found CEOs of companies with large dividend cuts (as a proxy for poor performance) are less likely to serve on the boards of other companies, although they cannot distinguish between a theory of labor market constraint and a theory of choice by managers to spend more time on their own firms.[260] Importantly, however, they find that while negative performance is correlated with serving on fewer boards, it does not result in board members losing their current board seats very often. The data show that over 80 percent of directors who are CEOs of poorly performing firms retain their board seats at other firms four years after the poor performance.[261] This data led observers to note that the director market, as it may exist, is "quite ineffective."[262]

The use of BSPs has the possibility to improve accountability by identifying a single entity as the decision maker, and by creating a more robust market for board services. Rival board-service firms will likely compete for the work, creating a competitive market for governance that exists outside of and beneath the market for corporate control. As discussed in Part TBA below, for example, BSPs could offer their services to shareholders in a competitive election. If a BSP is providing directors services to Acme, and rival Board Services Inc. believes it can do the work better or at lower cost, it could bid for the work, either by convincing the individual responsible for nominations of its superiority or by going directly to shareholders in a proxy contest.

Importantly, rival BSPs might have the financial incentive to do so in ways that individual directors currently do not. Currently, individual directors run as a slate, and any competition for individual places on the board happens behind the scenes, through networks, head hunters, building relations with management, and so on. This state of affairs has been criticized as leading to too much deference to management, since board members only get seats by pleasing the choosers.[263] The competition does not happen in the open because it is not feasible or cost effective for an individual board member or group of board members to run as a rival slate or for a particular seat in a proxy battle. Although it is theoretically possible for an individual wanting to serve on the board of Acme, Inc. to communicate with all the shareholders of Acme urging them to vote to put that person on the board, the cost of identifying the shareholders, convincing them to support the candidate, and then obtaining and voting their proxies would be prohibitively expensive. This is why the current model of board service generates competition only when votes for board members are linked to an economic stake in the firm. Running for a board seat or seats makes sense only when the economic gains from taking over the firm, and thereby having a claim on operational profits, generate sufficient benefits to offset the (large costs) of a proxy vote. In other words, the market for board seats is inexorably tied to the market for economic control of the firm.

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[259] Steven Kaplan & David Reishus, "Outside Directorships and Corporate Performance," 27 J. FIN. ECON. 389 (1990).

[260] Id at 409.

[261] Id at 390.

[262] The data suggest to us that such market as may exist is quite ineffective. For similar data, see Stuart C. Gilson, Bankruptcy, Boards, Banks, and Blockholders: Evidence on Changes in Corporate Ownership and Control When Firms Default (Mar. 29, 1990) (paper presented at conference on The Structure and Governance of Enterprise, Harvard Business School, March 1990) (on file with the *Stanford Law Review).*

[263] See, e.g., Lucian A. Bebchuk & Jesse M. Fried, Pay Without Performance: The Unfulfilled Promise of Executive Compensation (2002) (describing the power managers have over board members).

The BSP approach would delink these to a certain extent. The BSP model would reduce the costs of multiple board members coordinating to take control of a board, and would perhaps lower the costs of providing board services sufficiently to make it economically feasible to win a board election without needing an economic stake in the firm. Large BSPs could have economies of scale and a brand that would lower the costs of communicating their value to shareholders. It isn't difficult to imagine a BSP becoming sufficiently well known, like a prominent law firm, auditing, or consulting firm, such that the costs of communicating with and persuading shareholders would be dramatically lower than for individual board members. If Boards-R-Us is the incumbent BSP, and Board Services Inc. believes it can perform board services more efficiently (that is, better governance for the same cost or the same governance at lower cost), then it could inform shareholders of its intention to run for the job and stand for election at the annual meeting.

Our approach would create market competition, in a sense, for board services without the need to change the economic structure or ownership composition of the company. So, if Boards-R-Us is the incumbent board, and Board Services Inc. displaces it in a shareholder election, this would not have any impact on the underlying ownership of Acme's shares. It would be similar to Acme changing its accountants from KPMG to Ernst & Young. Although board members control the corporation in ways that accountants do not, this does not necessarily turn a contested board election into a battle for control of the firm in the way we think of what is at stake in today's market for corporate control. Today, because board elections are not competitive in the absence of an economic stake giving voting control to a corporate raider, changing the board and controlling the economic fate for the corporation are inexorably linked. In other words, if one wants economic control of the corporation, one takes a large enough economic stake to be able to control the election of the board. But in our imagined world, board elections would be competitive, even in the absence of insurgents taking large equity stakes in the firm. Board services would be awarded based on a majority (or super-majority or whatever voting rule the firm thinks makes the most sense) vote of the shareholders. Then, once board members (or, in this case, a BSP) are elected, they owe fiduciary duties to the firm's shareholders, and this would be true regardless of the associative type of the board.

e. Measurability

Another benefit of using a BSP is that it may make measuring board governance quality more straightforward. A significant problem in reaching the goal of improved corporate governance is our ability to measure governance quality at particular firms. This is because "governance" is not something that can be measured precisely in the abstract, since it is conflated with operational performance. Firms are valued based on their operational performance, that is, their ability to generate cash, not on whether they have "good" or "bad" governance. Although governance and performance might be correlated in some cases, this is not necessarily the case; some good performing firms could improve their governance, and some bad performing firms undoubtedly have great governance.

Shareholders, academics, and other corporate observers try to measure governance in a variety of ways, all of which have limitations. First, we can attempt to measure the quality of firm governance or a particular governance change (e.g., the appointment of a board member or the declassification of a board) by estimating the impact of the announced change on the firm's overall value. The use of event studies is a widely accepted technique for doing this, but these studies are also subject to many criticisms, not the least of which are that they will not work for small changes to governance that would not be material to shareholders. In addition, there may be confounding variables and the results may be noisy and subject to design criticisms. For individual firms, operational performance may make governance less salient or important for shareholders.

Second, most of the studies of governance do not consider the value for a particular firm or director, but rather involve the decisions by many firms on a particular issue, like whether to have a classified board, whether to separate the role of chair and CEO, and so forth. These studies, while valuable, suffer from the same problems identified above, as well as endongeneity and causation direction concerns, and the possibility that they cannot identify local maxima in broad trends.

The use of BSPs could help us better measure board performance separate from the operational performance of the underlying firms. This would be possible, for example, if a group of BSPs provided director services to multiple companies. The stock price of the BSPs would reflect the market's judgment about the quality of these services for a basket of companies. Assuming that the operational performance of these companies was not perfectly correlated, it would be possible to get a better estimate of the quality of governance. Of course, this metric would be imperfect, as governance and operational performance may be impossible to untangle perfectly. But market-traded BSPs would give us more information about governance quality than the current "market" for director services, which is not transparent and not priced directly by the market. To be sure, directors occasionally serve many firms, and one could try to estimate the market value of directors who do so. But the trend is against multiple directorships, and, in any event, there is no market pricing in the way that publicly traded BSPs would be.

B. Board Functions

In the previous Section, we examine ways in which BSPs could help reduce the pathologies of the current board model of corporate governance. We think the case is strong that BSPs could, at least in some instances, deliver better corporate governance at lower cost. In this Section, we offer some additional reasons that justify permitting experimentation with the BSP model. These reasons track the discussion in Part II above, where we discussed the functions played by the modern board: management, service, and monitoring management. In each of these areas, the BSP has the potential to make improvements or at least do no harm.

1. Managing the Firm

One of us has elsewhere argued that corporate law favored multimember boards because groups are better at the sort of critical evaluative judgment that characterizes

most board decisions than are individuals.[264] While it might seem that a BSP might undermine this by consolidating the multi-member board into a single decision making point, this is not necessarily the case. If the client opted to have multiple representatives of the BSP serve as its board (or on a mixed[265] board), the board itself would continue to function as a group decision maker. If the client opted for the pure BSP model, the team within the BSP servicing that client would continue to use group decision making as part of its process. In short, in both cases multiple individuals will be analyzing and voting, either directly or indirectly, on a particular course of conduct. We see no reason why this group decision making process need take place among sole proprietors serving as board members instead of among employees of a BSP. Furthermore, as noted in Part V below, state corporate law has moved away from a requirement that boards consist of multiple members, and this suggests that the group decision making benefits may not alone justify the statutory bar on BSPs.

At the same time, for the reasons discussed in Part IV.A above, we expect that BSPs would make better decisions than current boards. They would have better information, access to specialists with fewer conflicted interests, more person-hours available for exercising judgment, better incentives, and so on. The BSP thus combines the advantages of group decision making with a group composition likely to be better informed and motivated.

2. Providing Services

As noted in Part II above, board members provide various services to their clients, including access to capital, information about industries, experience as CEOs, and so forth. But this alone cannot justify a bar on the use of BSPs. It is possible that particular BSP may not be able to provide as diverse a set of networks as can a multi-member board of unrelated individuals. For some firms, the importance of, say, access to a network of investors, may be sufficient to outweigh the benefits of hiring a BSP. For that firm, for that particular time in its life cycle, there is nothing in our proposal that requires the use of a BSP. Moreover, we see no obvious reason, however, why a BSP may not be able to provide these services. For one, modern day consulting firms and investment banks provide important networks of information and access for companies without relying on individual contracts as in the board model. Large BSPs comprised of hundreds or thousands of professionals, including many individuals currently serving as board members, could likely do the same thing. If current or former CEOs are valuable members of companies' decision making process, their services will be demanded by BSPs, who could hire them on a permanent or ad hoc basis. Finally, where this is not

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[264] See Bainbridge, supra note 134, at 12-42 (discussing theory and empirical evidence about group decision making). To be sure, all groups vulnerable to certain systematic errors. See id. at 31-32 (discussing groupthink and other group biases). The BSP model cannot solve that problem so long as it depends on team production.

[265] We think in practice a mixed board is likely to be used rarely, since the BSP will, under current law, be held jointly and severally liable for all board decisions, and therefore will be reluctant to share power with individuals with much less wealth.

feasible, a BSP could serve as a matchmaker between clients, just as invest banks often do.[266]

One final point is worth mentioning. While the current composition of boards may be optimal, opening up new possibilities through the BSP innovation may reveal benefits previously unappreciated. BSP may be superior to current boards at advising CEOs, since the BSP will have better information, better incentives, and specialists at call. While one might object that if this were the case, companies would already be deploying them, as we note below, the current situation may be an artifact of law and the stickiness of the status quo more than a reflection of a first-best equilibrium.

3. Monitoring Management

The final key function of modern boards is to serve as a monitor of management. In this role, there is an argument that corporate law favors multi-member boards because such boards provide a mechanism for horizontal monitoring that solves the monitoring problems inherent in a vertical hierarchy:

> A hierarchy of individuals whose governance structures contemplate only vertical monitoring cannot resolve the problem of who watches the watchers. Instead, it seems the vicious circle can be broken by placing a group at the apex of the hierarchy. Where an individual autocrat would have substantial freedom to shirk or self-deal, the internal dynamics of group governance may constrain self-dealing and shirking by individual team members and, perhaps, even by the group as a whole. Within a production team, for example, mutual monitoring and peer pressure provide a coercive back- stop for a set of interpersonal relationships founded on trust and other noncontractual social norms.[267]

As with the board's managerial functions, a BSP contains mechanisms for group decision making that help replicate the advantages current boards receive from organizing as a group. Likewise, the enhanced incentives and superior motivation associated with a BSP should help it be a superior monitor compared to current boards for the reasons discussed above.

V. BSPs and the Law

Current law provides numerous obstacles to effecting our proposal, all of which therefore require rethinking. The most obvious hurdle is the requirement of state corporate law that directors be natural persons. The Delaware General Corporation Law,

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[266] See Eugene F. Brigham et al., Financial Management: Theory and Practice 804 (2011) (discussing investment banks matchmaking function in bringing clients together for mergers and acquisitions).

[267] Bainbridge, supra note 134, at 35-36.

for example, flatly states that each member of the board of directors "shall be a natural person."[268] The Model Business Corporation Act (MBCA) affects the same result in a somewhat more roundabout fashion. Section 8.03 states that a board "must consist of one or more individuals,"[269] while § 1.40(13) defines individual as "a natural person."[270] In either case, "legal persons," such as corporations and other forms of business organization, clearly cannot serve as members of a board or as a replacement for the board.[271] Even if a firm wanted to hire a BSP to provide board services and be accountable under state law for board decisions, they could not do so, even with shareholder approval. The natural-person requirement thus falls into a very small category of mandatory corporate law rules. As we will show below, we think it does not deserve such special treatment.

The listing requirements of the various stock exchanges follow state law. This makes logical sense, since it would be odd for the requirements of being a public company to be incompatible with the state law requirements for being a lawful company. It is for this reason that listing requirements have typically served to narrow the range of potential governance arrangements, rather than broadening them beyond what is otherwise legal. For instance, the NYSE Listed Company Manual requires the board of any listed company to be composed of a "majority of independent directors,"[272] and the independence test requires the director have "has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company).[273] In addition, the listing rules require boards to have compensation, audit, and nomination committees of the board, all with a majority of independent directors.[274] The rules also implicitly contemplate that directors shall be natural persons by drawing a distinction between "persons or organizations."[275] Taken together, these rules seem difficult to reconcile with a model in which an entity serves the entire board function.

Federal law also seems to presume service by individual directors acting as sole proprietors. Although no statute specifically requires directors to be natural persons, the premise of recent reforms following the accounting scandals of the early 2000s and the financial crisis of the late 2000s is service by individual directors acting alone. For instance, the rules implementing the Securities Exchange Act, as amended by the Sarbanes-Oxley Act, require "independent directors" to constitute a majority of firm audit committees, and the definitions of independence seem to envision individuals acting alone.[276] The response to board failures to monitor firm accounting practices was to make sure board members were more independent of the firm and each other. A similar

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[268] Del. Code Ann., tit. 8, § 141(b).

[269] Mod. Bus. Corp. Act § 8.03 (2010).

[270] Id. § 1.40(13).

[271] This requirement is not unique to US corporate law. In the European Union, only natural persons can be members of the board of a Societas Privata Europaea (SPE). Rolandino Guidotti, The European Private Company: The Current Situation, 13 German L.J. 331, 341 (2012).

[272] New York Stock Exchange, Listed Company Manual § 303A.01.

[273] Id at § 303A.02(a).

[274] Id at § 303A.04, § 303A.05, and § 303A.06.

[275] New York Stock Exchange, Listed Company Manual § 303A.02 cmt.

[276] See Rule 10A-3(b)(1)(i) (defining "independent" in a way that cannot be achieved by a firm providing board services).

approach was taken in the Dodd-Frank Act in response to allegedly irresponsible compensation practices at publicly traded firms during the run up to the financial crisis. For instance, Section 952 of the Dodd-Frank Act requires the SEC to direct the stock exchanges to adopt listing rules requiring greater independence for board members serving on compensation committees.[277] The statute, SEC rules, and listing requirements all accept the sole-proprietor model of board service.[278]

The case for effecting the necessary legal change is fairly straightforward. State corporate law statutes consist mostly of default rules that can be changed by firm owners.[279] State law thus provides an off-the-rack set of default rules regarding basic corporate law, but generally allows firms to vary widely in their approach, so long as the divergences are set forth in the corporate charter, and are effectuated in ways consistent with law (for example, done with shareholder consent).[280] For instance, the Delaware statute provides that firms shall be managed by a board of directors, "except as may be otherwise provided . . . its certificate of incorporation."[281] It is curious that Delaware thus allow corporations to substantially modify the role of the board of directors—and even to opt out of the board model—but mandates that boards consist solely of natural persons. In contrast, our reform brings the statutory rules governing boards even closer into alignment with the fundamental enabling principle of state corporate law.

Viewed in that way, several analogous legal developments suggest themselves. First, unincorporated entities (that is, partnerships, LLCs, and the like) are typically permitted to have business associations serve in the management role played by a corporate board of directors for corporate entities. For instance, limited partnerships are managed under the direction of the general partner, and state laws typically permit limited partnerships to have corporations or other business entities serving as their general partner.[282] The policy of allowing non-natural persons to manage the affairs of partnerships is designed to encourage free contracting, which allows governance to be

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[277] http://www.sec.gov/spotlight/dodd-frank/corporategovernance.shtml

[278] Although changing state law, federal law, and stock exchange listing rules may seem like a daunting task, the linkage between these rules makes the case more straightforward. If state laws were amended to allow firms to serve as directors, the change would cascade through the rest of the various corporate governance rules at the state, federal, and private regulator level. State law sets the baseline from which all of these other statutes and rules, both private and public, operate. For instance, independence requirements of federal law and the exchanges could be met simply by ensuring that the company and the BSP were not under common control. Some tweaks might be required here and there, but it would not require much beyond amending the underlying state corporate law.

[279] Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law 15 (1992); Larry E. Ribstein, The Mandatory Nature of the ALI Code, 61 Geo. Wash. L. Rev. 984, 989-91 (1993).

[280] Easterbrook & Fischel, supra note 279, at 2 (explaining that "enabling statute[s] allow[] managers and investors to write their own tickets, to establish systems of governance without substantive scrutiny from a regulator").

[281] Del. Code Ann. tit. 8, § 141(a)

[282] See Larry E. Ribstein, An Applied Theory of Limited Partnership, 37 Emory L.J. 837, 868-71 (1988) (discussing incorporated general partners). The Delaware Limited Partnership Act defines a "general partner" as "a person who is named as a general partner in the certificate of limited partnership . . .," 6 Del. Code § 17-101(5), and then "person," as "a natural person, partnership . . ., limited liability company, . . ., corporation . . . or any other individual or entity." Id. at § 17-101(14). See generally Robert W. Hamilton, Corporate General Partners of Limited Partnerships, 1 J. Small & Emerging Bus. Law 73 (1997) (noting the availability of corporate general partners).

tailored to particular circumstances and to permit more complete markets.[283] The driving force, however, is limited liability.[284] Many limited partnerships in Delaware and elsewhere take advantage of this flexibility to use firms as board equivalents. This suggests that there is a latent demand for governance to be performed by business entities, instead of individuals, for some companies. The same rules apply for other unincorporated entities, such as limited liability companies and business trusts. Indeed, the Delaware LLC Act and the Delaware Statutory Trusts Act are based on the Limited Partnership Act, and permit business associations of all sorts to serve in the managerial or board of directors analog role.[285]

Second, the definition of "director" in the Investment Company Act includes incorporated entities. Section 2 of the ICA defines a director as "any director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or unincorporated . . .."[286] In *Chabot v. Empire Trust Co.,* the Second Circuit held an incorporated investment company manager was a director for purposes of the ICA.[287] In so holding the court noted that Empire, the corporate entity in the case, was empowered by the trust certificate to act with all the powers of a typical director, and this therefore brought it within the definition in the ICA.[288] The fact that Empire was a corporation was not a barrier to it acting like or, for purposes of the ICA, being treated as a director. What mattered to the court was function, not form, and so long as the corporation was acting as a director would, the law would consider it a director.

Third, the Supreme Court has construed portions of the securities laws broadly to include corporations acting as directors. In *Blau v. Lehman*, the Supreme Court held that for purposes of liability under the short-swing profit rule in § 16(b), a corporation may be

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[283] 6 Del. Code 17–1101(c) ("It is the policy of this chapter to give maximum effect to the principle of freedom of contract and to the enforceability of partnership agreements"); Martin I. Lubaroff & Paul M. Altman, Lubaroff & Altman on Delaware Limited Partnerships § 1.2 (1995 & 2010 Supp.). One of the key reasons for the use in the unincorporated context is to provide managers with limited liability. It is important to note that while reducing individual liability (through risk pooling) is a key feature of our proposal for BSPs, there are other advantages of our proposal for BSPs for corporations, especially large, publicly traded corporations that do not obtain in the case of unincorporated entities, like LLCs or partnerships. These are discussed further below. These additional benefits make the case for BSPs for corporations stronger than for unincorporated entities.

[284] See, e.g., Frigidaire Sales Corp. v. Union Properties, Inc., 562 P.2d 244 (Wash.1977) (holding that the incorporated general partner was entitled to limited liability such that its shareholders could not be held liable for partnership debts).

[285] *See supra* note 282

[286] 15 U.S.C.A. § 80a-2 (West)

[287] Chabot v. Empire Trust Co., 301 F.2d 458, 460-61 (2d Cir. 1962).

[288] "Empire is responsible for the entire management of the fund, except the purchase and sale of the portfolio securities. Empire is empowered 'to do all acts, take all proceedings and exercise all such rights and privileges relating to any property at any time held by it as Trustee as could be done, taken or exercised by the absolute owner thereof, except as expressly restricted herein.' (Trust Agreement § 8.5.) 'At any time the Trustee may take such action as it in good faith may believe to be required for the benefit of the trust property.' (§ 8.8) Empire is charged with responsibility for selecting a successor investment advisor (§ 10.2) and must consent to the creation of any new series of shares (§ 11.1). It is unnecessary to describe in detail all of the many aspects of authority granted to Empire by the instrument. It is clear that the functions exercised by it as trustee are 'similar' to those exercised by a director; indeed they are identical in many respects."

treated as a director if it effectively deputized a natural person to perform its duties on the board.[289] The Court noted that whether a company is a director by deputation is "a question of fact to be settled case by case and not a conclusion of law."[290] The takeaway from this case is that if the policy rationale behind a particular law would be served by treating a corporation as a director, then courts will be willing to look at what the entity was doing rather than whether it was an individual.

Fourth, policy considerations have led most states to abandon the requirement that boards have multiple members, thus opening up the possibility of corporations or other business associations serving the board function through a single seat. Until 1969, Delaware required that the board of directors of corporations with more than three shareholders have a minimum of three members.[291] In 1969, however, the Delaware General Corporation Law was amended to permit all corporations to have single-member boards.[292] The MBCA likewise permits single-member boards.[293] The shift to permitting single-member boards was driven by concerns about the governance of close corporations. As the drafters of the Model Act explain, requiring close corporations with one or two shareholders to have a minimum of three directors could "require the introduction" to the board "of persons with no financial interest in the corporation."[294] But we think the application of this logic could easily be extended to accommodate our proposal for BSPs. Since states are willing to forego the advantages of multi-member boards by allowing single-member boards, they ought to be willing to allow a BSP to serve as that single member.[295]

Fifth, the bankruptcy code permits corporate entities to serve in roles analogous to the board of directors. Trustees are empowered by the code to represent and manage the estate as would the board of directors.[296] Section 321 then sets for the eligibility requirements for trustees: "a) A person may serve as trustee in a case under this title only if such person is—. . . (2) a corporation authorized by such corporation's charter or bylaws to act as trustee, and, in a case under chapter 7, 12, or 13 of this title, having an office in at least one of such districts."[297]

As these examples suggest, hiring a firm to provide board or board-like services is not as radical a change as it may appear at first glance. To the contrary, this precise model is permitted in many related areas. The inescapable conclusion from this set of

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[289] 368 U.S. 403, 410, 82 S.Ct. 451, 7 L.Ed.2d 403 (1962) ("Lehman Brothers would be a 'director' of Tide Water, if as petitioner's complaint charged Lehman actually functioned as a director through Thomas, who had been deputized by Lehman to perform a director's duties not for himself but for Lehman.").

[290] Feder v. Martin Marietta Corp., 406 F.2d 260, 263 (2d Cir.1969); accord Blau, 368 U.S. at 408-09, 82 S.Ct. 451.

[291] Edward P. Welch et al., Folk on the Delaware General Corporation Law § 141.3 at GCL-IV-200.6 (5th ed. 2007).

[292] Id.

[293] Model Bus. Corp. Act § 8.03 (Rev. ed. 2011). Only six states now mandate multi-member boards. Model Bus. Corp. Act Ann. § 8.03 stat. comp. 1 at 8-37 (Rev. ed. 2011).

[294] Id. § 8.03 cmt. 1.

[295] As we described above, see supra Part TBA, the BSP model has the advantages of a single-member board while retaining aspects of group decision making that make multi-member boards attractive in the first instance.

[296] 11 USC § 704.

[297] 11 USC § 321.

examples is that legislators, courts, and other regulators are willing to accept or even encourage corporate entities to act as directors or boards when the firms are serving director functions and the policy rationale for a particular application (such as the insider-trading rules) warrant such treatment. In short, where there are good policy reasons to tolerate BSPs, we see the law tolerating them. We see no reason why the same should not be true for BSPs of reporting corporations.

VI. Extensions

In this Part, we consider a few potential modifications or extensions of the Boards-R-Us model of corporate governance. The examples below demonstrate the flexibility of the model to achieve various and disparate governance ends. We demonstrate how the BSP could be used to achieve greater shareholder power or greater managerial power, for example, depending on how it is deployed. Our point here is to show that the BSP is just a tool, not a means towards a particular end result. We believe that it is potentially very useful tool, however, as using the BSP model likely will allow various governance innovations to be implemented at lower overall cost and with greater transparency and accountability than the current model.

A. Shareholder Access to the Proxy

As a theoretical matter competition for board control could improve governance, and thereby increase firm and social value.[298] A proxy contest that threatens to remove all or part of the current board, and thus management as well, provides an incentive for board members and managers to take care to avoid the contest, and therefore reduces agency costs.[299] Under the current board model, however, there is a very limited threat of a proxy fight.[300] This is because the competition for board seats is, because of its costs,

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[298] J. Harold Mulherin & Annette B. Poulsen, Proxy Contest & Corporate Change: Implications for Shareholder Wealth, 47 J. Fin. Econ. 279 (1998) (describing the motivation for and results of a study of the effect of proxy cintests on shareholder wealth).

[299] See generally Lucian Arye Bebchuk & Marcel Kahan, A Framework for Analyzing Legal Policy Towards Proxy Contests, 78 Cal. L. Rev. 1071 (1990) (arguing that proxy contests and there threat thereof can be an important constraint on agency costs). Note that the proxy access proposals discussed below typically would not provide a mechanism for removing the entire board in one election cycle. A proxy access proposal put forward by the SEC, for example, would have limited shareholders to putting forward a short slate and made the mechanism available only to those shareholders who expressly disavowed intent to obtain control of the firm. See Bainbridge, supra note 170, at 185 (describing proposal).

[300] See Bainbridge, supra note 170, at 177 (noting rarity of proxy contests even though they have become somewhat more common in recent years). This does not necessary mean the number of proxy fights or the pressure from them is suboptimal. There is thus a debate about whether this incentive is optimal under the current structure of corporate governance. Lucian Bebchuk argues that the proxy mechanism is ineffective at disciplining management, and therefore argues for increasing shareholder access to the proxy. Lucian A. Bebchuk, The Myth of the Shareholder Franchise, 93 Va L. Rev. 675 (2007). Bebchuk's argument is premised on the fact that proxy contests are extremely rare, given that they are expensive and are reimbursable only if the insurgents rest control of the firm from the incumbent board. Fos documents 792 over period 1994-2008 (*8). Id. cite Rothschild In a recent paper, however, Vyacheslav Fos applies the theory of contestable markets to estimate the indirect effect the threat of a proxy contest has on firms that do not experience an actual proxy contest. He shows that although rare proxy contests provide

currently embedded in the market for corporate control.[301] As noted above, anyone can run for a board seat, but bearing the cost of identifying, contacting, lobbying, and tallying the votes of shareholders is prohibitively expensive for the gain of a single board seat. Accordingly, proxy contests are usually conducted only when those seeking control of board are holders of large economic stakes in the firm, and therefore have more to gain from controlling the board than just the cash flows from governance.

The Holy Grail for many corporate governance reformers thus has been obtaining shareholder access to the corporate proxy.[302] Subject to varying restrictions and exceptions, proxy access proposals typically would allow shareholders to nominate one or more slates of directors whose names would be placed on the corporation's proxy card.[303] There is some evidence that giving shareholders access to the proxy to create more governance competition would increase firm value.[304] The Dodd-Frank Act accepted the premise of these proposals, and specifically authorized the SEC to adopt rules that would allow shareholders greater access to the corporate proxy for purposes of creating more competition for director seats.[305] In 2010, the SEC promulgated Rule 14a-11, which gave shareholders (either individually or as a group) that have held at three percent of a company's voting shares for at least three years the right to include their

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significant impetus for firms to make changes, such as replacing management and decreasing expenditures that increase profitability and shareholder value. Vyacheslav Fos, "The Disciplinary Effect of Proxy Contests," Columbia Business School Working Paper (Jan. 2010). If the critics are correct, our proposal could be used to achieve greater competition for board services. If the current amount of competition is optimal, then it would likely do no harm, and would be able to achieve the same level of competition at lower costs. The real virtue of our proposal, however, is that it could also make directors more insulated from shareholder control, if that would be the optimal approach to governance.

[301] See supra notes TBA and accompanying text.

[302] Lucian A. Bebchuk & Scott Hirst, Private Ordering and the Proxy Access Debate, 65 Bus. Law. 329, 331 (2010) (noting that "the adoption of a federal proxy access regime has received significant support from shareholder groups and those who work with them"); Lisa M. Fairfax, The Model Business Corporation Act at Sixty: Shareholders and Their Influence, 74 Law & Cont. Prob. 19, 28 (2011) (noting "the important weight that shareholders have placed on the proxy-access issue).

[303] See generally Bainbridge, supra note 10, at 224-28 (discussing various versions of proxy access proposals). For instance, Melvin Eisenberg proposed allowing large shareholders (e.g., greater than 5 percent of outstanding stock) to nominate directors. Melvin A. Eisenberg, The Structure of the Corporation 117-121 (1976). Similarly, Louis Lowenstein suggested shareholders have an exclusive right to elect a defined portion of the board, such as one-fifth to one-quarter of the seats. Louis Lowenstein, What's Wrong With Wall Street: Short-Term Gain and the Absentee Shareholder 209-11 (1988). Most expansively, George Dent proposed turning the entire board election process over to a committee of a corporation's ten or twenty largest shareholders. George W. Dent, Jr., Toward Unifying Ownership and Control in the Public Corporation, Wis. L. Rev. 881, 907-08 (1989). Lucian Bebchuk has built a cottage industry supporting shareholder access to the proxy. He has authored numerous academic publications and engaged in shareholder advocacy trying to achieve, through legal and firm-based reforms, more competitive elections. See, e.g., Lucian A. Bebchuk, The Myth of the Shareholder Franchise, 93 Va. L. Rev. 675 (2007).

[304] See, e.g., Bo Becker, et al., Does Shareholder Proxy Access Improve Firm Value? Evidence from the Business Roundtable's Challenge, 56 J. LAW & ECON. 127 (2013) (finding negative stock price reaction to SEC and court actions derailing efforts to give shareholders access to the proxy for those firms most vulnerable to shareholder challenges).

[305] Section 971 of the Dodd–Frank Wall Street Reform and Consumer Protection Act amended Section 14(a) of the Securities Exchange Act of 1934 to permit the SEC to adopt rules that will allow shareholders access to a public company's proxy solicitation materials for purposes of nominating their own directors. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 971, 124 Stat. 1376, 1915 (2010).

nominees for up to 25% of the available board seats in the company's proxy materials.[306] The DC Circuit vacated the rule because the SEC failed to do a sufficient cost-benefit analysis of the rule,[307] meaning shareholders still have to bear their own expense in mounting a proxy battle.

Our proposal would open up the possibility of shareholder access to the proxy without necessarily requiring a new SEC rule. The BSP model readily could be modified to facilitate competitive board elections. To increase competition, corporations could specify in their articles of incorporation a nomination and election process designed to create competitive elections. One option would be for someone, say the CEO, to nominate two (or more) firms to run at each annual shareholder meeting. Shareholders would then choose a firm to serve as the board for that year. Annual turnover might be too frequent, so one can imagine companies prescribing in advance a minimum term (subject to removal by shareholder vote), such as three years.

This approach could be modified in numerous ways to make elections more or less competitive, more or less under managerial control, and so forth. For instance, if criticisms about excessive managerial control are true, in general or for a specific firm, the process of choosing the firms competing to provide board services could be insulated from managerial domination, either by statute (if the former) or by corporate charter (if the latter). For example, firms could be required or permitted to have large shareholders who have held their shares for a specified period nominate BSPs to stand for shareholder election at the annual meeting. A minimum number of names, say, two, would be submitted on the firm's proxy materials to elect the BSP for that year (or longer, as the case may be).

If the market did not give rise to the desired level of competition or shareholder involvement, a state law or new SEC rule similar to Rule 14a-11 could be used to achieve the desired result. Arguably, the objections to proxy access have less traction with respect to BSPs than with respect to individual directors. As one of us has elsewhere articulated them, those objections come in two general flavors. One is that proxy access inefficiently shifts the locus of decision making about board composition to shareholders, who have an informational disadvantage about the proper qualifications and fit of board members.[308] The other is that electing a minority of directors will lead to factions on the board representing different shareholder interests, and this would impede board functioning and decision making.[309] Although the BSP model still suffers to some extent from the first problem, we think it likely shareholders will have better information about BSPs than individual board candidates, especially if publicly held BSPs arise, so that the market can price their skill set. The BSP model arguably does even more to reduce the magnitude of the second objection, because it reduces the potential mischief of dissident directors

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[306] See Business Roundtable v. S.E.C., 647 F.3d 1144, 1147 (D.C. Cir. 2011) (describing rule).

[307] Id. at 1148 ("We agree with the petitioners and hold the Commission acted arbitrarily and capriciously for having failed once again … adequately to assess the economic effects of a new rule.").

[308] See Bainbridge, supra note 10, at 240-41 (arguing that maintaining limits on shareholder participation enhances the efficiency of corporate decision making).

[309] See id. at 230 (arguing that, "because proxy access' effect will be to increase the number of short slates, albeit to an uncertain extent, its impact on corporate governance likely will be analogous to that of cumulative voting," which the author argues has deleterious effects on board decision making).

elected off a short slate, while still using competition and shareholder voice to improve governance.

B. Increasing Managerial Power

The flexibility of our proposal is demonstrated because one could alternatively tweak the appointment and election rules to go not in the director of shareholder empowerment but rather towards what one of us refers to as director primacy.[310] To encourage an even more robust form of director primacy, while simultaneously reducing the potential for shareholder disenfranchisement or abuse, one could imagine, say fixed five-year board terms for BSPs with no removal during that period (except for cause) but with mandatory rotation.[311] This idea builds off a proposal by Martin Lipton and Steven Rosenblum for a quinquennial election for board members to give firm governance the time and insulation from the pressures of short-term investors to focus on creating long-term shareholder value.[312] Combining this insulation with the idea of mandatory rotation might look something like this: A company would nominate at least two BSPs to stand for election. Shareholders would elect one to serve a set, say five-year, term. During that five-year term, the BSP would have all the powers enumerated by Lipton and Rosenblum, as well as the limitations they proposed. For instance, the board could not be removed except for conduct that was illegal or amounted to gross malfeasance of duty. As such, the board would have the power to resist any hostile takeovers, since its control of the corporation for that period would be nearly absolute. Then, at the end of the five-year term, the incumbent BSP would have to rotate off and a new BSP would be elected.

There is an analogy here to the mandatory rotation of auditors. After the accounting scandals of the late 1990s-early 2000s, the idea of mandatory rotation of auditors became a live issue. As of this writing, the Public Company Accounting Oversight Board (PCAOB) is considering mandatory rotation of auditors, such that an audit firm would serve a maximum number of years before it would have to be replaced by another firm. One can imagine adopting this approach for BSPs either alone or in combination with other governance arrangements. For instance, a firm could put in its charter or the legislature could require a mandatory rotation of BSPs after a set number of years. The arguments here for and against such a requirement are straightforward, and are similar to those now being debated by the PCAOB with respect to accountants.[313] Mandatory rotation has the benefit of reducing capture by managers, bringing new ideas, and reducing agency costs. On the downside, any rule will be both overinclusive—forcing out competent boards—and underinclusive—allowing incompetent boards to remain in placing longer than they deserve. One might think that a company would have the proper incentives to optimize how long a board stayed in place, thus making any mandatory rule unnecessary. While we think there are reasons to doubt companies'

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[310] See supra note 24 (discussing Bainbridge's director primacy model).

[311] Of course, the term need not be five years, and one can imagine competition among firms in their corporate charters on the optimal amount of insulation needed.

[312] Martin Lipton & Steven A. Rosenblum, A New System of Corporate Governance: The Quinquennial Election of Directors, 58 U. Chi. L. Rev. 187 (1991))

[313] *See* Dena Aubin, "PCAOB's debate over auditor rotation moves to Congress" (Reuters) (http://blogs.reuters.com/taxbreak/2012/03/29/pcaobs-debate-over-auditor-rotation-moves-to-congress/)

incentives are perfect, in the absence of some significant experimentation, it is far too early to propose a set time period as an optimal, assuming one exists across many firms.

The chief advantage of combining our idea with that of Lipton and Rosenblum is that the virtues of BSPs help reduce the potential objections to their quinquennial election proposal. BSPs would be more accountable, more agile and able, and more transparent in terms of performance, thus reducing the risks from giving them free reign for a period of five years. If courts impose stronger fiduciary duties on BSPs, as we expect, boards are staffed with more capable individuals, board performance in terms of governance is measured by the market, and BSPs have large reputational capital, there is less reason to suspect that reducing shareholder oversight to once every five years would result in more managerial slack or self-serving behavior.

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There are undoubtedly countless other ways in which the board-services model could be used to achieve corporate governance improvements or changes. We leave these to future work and to the market for corporate governance to determine.

VII. Objections

In this Part, we briefly address two significant objections to our proposal. Some may argue that our burden is a heavy one, because the limitation of eligibility to serve as a corporate director to natural persons is ubiquitous and long standing. We have shown a strong affirmative case for BSPs, however, and in this Part we show that the case against them is surprisingly weak.

A. Limited Liability

One objection to our proposal is the potential mischief arising from allowing board services to be provided behind a cloak of limited liability. Although commentators generally agree that fiduciary duties are an imperfect mechanism for policing corporate decision making, the concern would be that legalizing BSPs would further undermine whatever work the duty of care and loyalty are now doing. As mentioned above, there are two countervailing impacts of limited liability for directors. On the one hand, limited liability could be thought to decrease the incentives for the directors to take care, since its owners will not be liable beyond their capital contribution. On the other hand, there are well-known benefits of limited liability, which make it widely accepted for the provision of all types of goods and services. Limited liability may make judgments against corporate entities more likely because judgments against limited liability firms may be more acceptable to courts. Limited liability also encourages shareholder investment, since investors need not worry about their private wealth being endangered and do not have to worry about monitoring each other to reduce the risks of joint and several liability.

We’ve addressed much of this concern above, showing how the use of corporations as boards is likely to increase legal and non-legal constraints on board misconduct. For instance, large BSPs will be composed of numerous individuals with human capital and reputational assets in the firm, and these will be lost if the BSP fails. This reputation multiplier has been shown to do significant work in reducing opportunism

by firms. So here we will take on another related objection—the infinite regress problem.[314] A firm serving as the board of another firm, and so on through many layers could result in liability being dissipated completely in corporate shells. We can think of the problem as suggesting the need for some individual to ultimately be liable for the conduct of any firm. This is, however, an objection about limited liability generally, as it would equally apply to the current rules allowing the general partner of a limited partnership to incorporate, not about limited liability in the context of BSPs.

In all cases in which limited liability is used, moreover, there are mechanisms in place to help reduce the chance that the corporate fiction is used to deliberately shield misconduct. First, private ordering could ameliorate this problem. There is nothing that prevents companies that hire BSPs from requiring these firms be well capitalized, have insurance or post a bond, or agree to be bound by fiduciary duties that run to the owners of the BSP. Reputation can also play a complimentary role, since both the hiring firm and the BSP are likely repeat players with incentives not to cheat. It is the combination of contract and monitoring by investors and consumers that provides the primary mechanism for reducing the downside of limited liability in other areas, and it can do some work here too.

Second, there are legal tools available to catch those cases in which private ordering and market mechanisms fail to prevent fraud and abuse enabled by limited liability. Piercing the corporate veil, for example, is available to hold the owners of a firm personally liable in cases in which the courts determine the use of a corporate form is effectively just a fraud designed to externalize costs onto others.[315]

Piercing could be used in the case of BSPs, as it is used when firms provide other products and services. If a BSP met the test that justified piercing—e.g., thinly capitalized, disregards corporate formalities, etc.—then holding owners liable would be possible. Thus, if a BSP were merely designed to reduce liability in an individual case without any of the offsetting benefits, the firm would be disregarded and the individual owners of the firm would be liable. Consider, for instance, a group of ten directors that formed a corporation solely for the purpose of avoiding liability. Assuming a company would hire them to provide board services without any guarantees, the BSP could, without veil piercing, lead to a worse outcome. But, if the directors put no capital into the firm and do not respect the legal difference between the firm and the individuals, courts would have no trouble holding the individual directors liable.[316]

Delaware precedents support this argument. In cases in which entities have served as in roles similar to boards, the courts will disregard the entity when necessary to avoid allowing the entity to serve merely as a way of externalizing harm or reaping private benefits for those behind the entity. For instance, in *In re USACafes, L.P. Litigation*, the court looked through a partnership entity serving in a quasi-director role to individuals

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[314] My opponent's reasoning reminds me of the heathen, who, being asked on what the world stood, replied, "On a tortoise." But on what does the tortoise stand? "On another tortoise." With Mr. Barker, too, there are tortoises all the way down. Barker, Joseph (1854). *Great Discussion on the Origin, Authority, and Tendency of the Bible, between Rev. J. F. Berg, D.D., of Philadelphia, and Joseph Barker, of Ohio*. Boston: J. B. Yerrinton & Son, Printers. pp. 48.

[315] Robert B. Thompson, Piercing the Corporate Veil: An Empirical Study, 76 Cornell L. Rev. 1036 (1991)

[316] *Id.*

behind the entity.[317] In that case, the limited partners of USACafes, L.P., sued the directors of USACafes General Partner, Inc., its corporate general partner, for breach of fiduciary duty. The directors of the general partner held 47% of the limited partnership interests and owned 100% the stock of the corporate general partner. In the challenged transaction, the partnership sold its assets to a third party, which made a $15 million side payment to the directors of the general partner that was allegedly a breach of duty to the limited partners. The defendants argued that while the general partner owed fiduciary duties to the limited partners, "the members of the board of the corporate general partner only owed fiduciary duties to its stockholders, not to the limited partners." The court rejected this argument, extending fiduciary duties to the individuals behind the legal entity serving as the manager of the partnership. The court deployed the equitable tradition of looking to where control actually resided, and held that "[w]hen control over corporate property was recognized to be in the hands of the shareholders who controlled the enterprise, the fiduciary duty was found to extend to such persons as well."[318]

This was necessary to avoid allowing a manager, like a general partner or BSP, to engage in a self-dealing transaction at whim. Another court described it this way:

> Consider, for example, a classic self-dealing transaction: assume that a majority of the board of the corporate general partner formed a new entity and then caused the general partner to sell partnership assets to the new entity at an unfairly small price, injuring the partnership and its limited partners. Can it be imagined that such persons have not breached a duty to the partnership itself? And does it not make perfect sense to say that the gist of the offense is a breach of the equitable duty of loyalty that is placed upon a fiduciary?[319]

The *USACafes* doctrine has been extended to other analogous situations, such as the managers of LLCs and statutory trusts.[320]

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[317] *In re USACafes, L.P. Litigation.* , 600 A.2d 43 (Del.Ch.1991)

[318] *Id.* at 48

[319] Feeley v. NHAOCG, LLC., __ A.3d __, 2012 WL 6840577 (Del. Ch. Nov. 28, 2012).

[320] *See, e.g., Paige Capital Mgmt. LLC v. Lerner Master Fund, LLC,* 2011 WL 3505355, at *30 (Del.Ch. Aug.8, 2011) (imposing fiduciary liability on individual who was the managing member of the LLC that acted as general partner for limited partnership); *Gelfman v. Weedon Investors, L.P.,* 792 A.2d 977, 992 n. 24 (Del.Ch.2001) (applying doctrine to directors and officers of corporate general partner); *Gotham P'rs, L.P.,* 795 A.2d at 34 (Del.Ch.2001) (applying *USACafes* to individuals and entities who controlled corporate general partner), *aff'd in part* 817 A.2d 160 (Del.2002); *Bigelow/Diversified Secondary P'ship Fund 1990 v. Damson Birtcher P'rs,* 2001 WL 1641239, at * 8 (Del.Ch. Dec.4, 2001) (explaining that "affiliates of a general partner who exercise control over the partnership's property may find themselves owing fiduciary duties to both the partnership and its limited partners"); *Wallace,* 752 A.2d at 1182 (applying *USACafes* and stating that "unquestionably, the general partner of a limited partnership owes direct fiduciary duties to the partnership and its limited partners."); *In re Boston Celtics Ltd. P'ship S'holders Litig.,* 1999 WL 641902, at *4 (Del.Ch. Aug.6, 1999) (applying *USACafes* to directors of corporate general partner); *James–River Pennington, Inc. v. CRSS Capital, Inc.,* 1995 WL 106554, at *11 (Del.Ch. Mar.6, 1995) ("The JRP Directors have fiduciary duties to the Partnership and its limited partners because they control the Partnership property."); *Bay Ctr.,* 2009 WL 1124451, at *8–9 (holding that complaint stated claim for breach of fiduciary duty under *USACafes* against sole member of LLC that acted as managing member for LLC); *see also Paige Capital,* 2011 WL 3505355, *30 (applying *USACafes* at two levels, first to LLC that acted as general partner for limited partnership, and second to managing

The key point to recognize is that the arguments for limited liability for most businesses translate well to the provision of director services. If one believes the virtues of limited liability outweigh the costs for regular business activities, like oil refining, pharmaceutical design, and air travel, then this calculus should have the same bite for the provision of director services. Directors acting through a corporate entity are akin to the shareholders protected by limited liability: they could worry less about risk, would not have to monitor each other, and so on. Limited liability thus serves as a rough analogy to risk pooling, which is a key benefit of our proposal.

B. Sticky Equilibria

Another objection is that firms are risk averse when it comes to governance innovations,[321] and therefore even if legislators permitted non-natural persons to serve as directors, the current model might be quite resilient, even if not optimal. As a practical matter, we know of no company that has challenged this requirement or lobbied to try to change it. This is not necessarily an indication that some firms might not benefit from such a change. Any firm that wanted to change the rule would have to bear all of the costs of lobbying or litigation, as well as the uncertainty in the market as the innovation were tried out, but would not be able to capture all of the upside relative to its competitors, who, after all, could simply adopt the new approach once it was accepted.[322] So although we are not certain there would be demand for board services provided by firms as opposed to individuals, we do not think the absence of them is evidence of the lack of demand. The current equilibrium may be a suboptimal one and not the only possible one.

The sticky equilibrium issue may be especially problematic, however, for two reasons. First, many of the benefits from the Boards-R-Us model of governance may be only available or especially available if large BSPs exist and are competing in a robust market for board services. There are many vested interests whose fortunes are tied to the current arrangement, and we expect they will resist upsetting the current equilibrium. As with the creation of any new market or industry out of existing ones, there will be transition costs, given the increase in uncertainty and need for experimentation and learning in the short run.

Second, in jurisdictions in which corporate entities were permitted to serve as boards or in board-like roles, BSPs did not arise naturally. For instance, in Hong Kong, unlisted private companies unaffiliated with listed companies were until recently able to have corporate directors. The experience in Hong Kong was not a good one. According to a report by the Standing Committee on Company Law Reform, which proposed eliminating incorporated directors, the use of corporate directors had two problems: the corporation delegated as director changed with frequency, making "it very difficult to

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member of LLC); *Cargill, Inc. v. JWH Special Circumstances LLC*, 959 A.2d 1096, 1111–12, 1119–21 (Del.Ch.2008) (holding that complaint stated claim for breach of fiduciary duty under *USACafes* against the parent and grandparent entities who controlled the managing owner of a statutory trust).

[321] Michael Abramowicz et. al., Randomizing Law, 159 U. Pa. L. Rev. 929 (2011)
[322] See *Id.*

know who was responsible for the conduct of the business of a company"; and the lack of a person as a director made attaching liability to the director more difficult.[323] For reasons discussed above, these concerns are not significant in a world with BSPs, but the creation of a market for governance is important to reducing their potential negative impact. We are confident that the robust activism of US capital markets and the prominent role played today by investors and stakeholders in governance is sufficiently different from that in Hong Kong and the other jurisdictions in which corporate directorships (of a variety) have been tried.

While our goal in this Paper is not to plot the precise way forward as a practical matter, we think there is significant potential for vertical integration of the board services industry to generate profitable opportunities for BSPs. In addition, the existence of existing firms in this space—serving as consultants and advisors to existing sole-proprietor board members—means that the costs of vertical integration are lower than if new firms had to be created to start the industry from scratch. The current corporate governance space is replete with activist shareholders, investors, good-governance advocates, and pension funds all of which may have an incentive to experiment with the BSP model, either by creating one or by pushing companies to adopt them. If this is insufficient, some encouragement or experimentation might be warranted. There is a literature on point,[324] and we will not repeat the arguments here. We've argued for BSPs, both as a matter of theory and practice, and therefore think the case for them is strong enough to support steps to make them a reality.

One mechanism for achieving some movement in the direction of a robust market for BSPs is the possibility that a court could hold managers of a particular firm liable for failing to consider, if not hire, a BSP.[325] If we are correct that hiring a BSP could bring substantial governance improvements, then for an underperforming company with an entrenched board, the failure to open the board up to competition from a BSP or a move to shut out a BSP from competing for control of the board could be viewed as a violation of managers' and board members' fiduciary duties.

C. Special Interest Representatives

One may object that the use of a BSP would make it more difficult for particular individuals to serve on corporate boards. We noted above how the BSP model could accommodate the hiring of individuals with valuable connections, be they political, personal, financial, managerial, or otherwise.[326] If a particular individual, say, the daughter of a political leader, would make a valuable addition to the board of a particular firm, that same person could be hired by the BSP to work on the team serving the board function for that particular firm. This is true regardless of what value a particular individual is providing.

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[323] Report of the Standing Committee on Corporate Law Reform, Chapter 4: Corporate Directorship, available at http://www.cr.gov.hk/en/publications/docs/042008_ch4-e.pdf.

[324] *See* John Stuckey and David White, "When and when not to vertically integrate," McKinsey Quarterly (1993) (http://bit.ly/14G7tH7)

[325] Thanks to Peter Oh for suggesting this possibility.

[326] See Part III.C infra.

Here, however, we address a particular objection, which is that institutional investors occasionally nominate board members in order to influence governance of a particular firm.[327] Although it is contestable whether such special-interest directors add value,[328] assuming that they do, one could read our proposal as effectively stripping investors of the ability to nominate board members, and therefore of the board's ability to directly represent a diverse set of interests. If one believes that the board serves as an intermediating function for heterogeneous shareholder preferences, then this could be a significant cost of a move to BSPs. Even if special-interest directors are not always a positive for firms, they may be in some cases, and the hiring of a BSP could lead to the flight of institutional capital, especially where it would serve as a valuable constraint on management failures.

There are several responses. First, this is just one cost that must be weighed against the benefits of the BSP model. It may be, for instance, that the gains from increase competition for board seats are sufficient that the need for special institutional shareholder board seats is reduced or eliminated. After all, if institutional shareholders seek board representation solely as a mechanism for disciplining bad boards, an overall improvement in boards through the use of BSPs may obviate the need for special representation. Further, we would expect these decisions of costs and benefits to be made by firms in the market for investor capital. If firms internalize the costs of governance, which we have every reason to believe, then they have the right incentives to maximize this tradeoff.

Second, special access to board processes for important firm stakeholders, be they investors or unions or the government, can be achieved by contract. If an institutional investor wants to access to information or to be able to monitor management, it could contract with the company for this right, much as creditors contract with firms using various covenants that give them access to information or types of control. Alternatively investors could intermediate their access or monitoring role through the BSP, by contracting with the BSP for the information or monitoring function to be fulfilled by the BSP.

Third, if contracting with either the firm or the BSP is costly or impossible, the investor could sponsor their own BSP to compete against the current board for the board service function. In a world in which the costs of changing or improving firm governance are lowered dramatically by this option, the value of special interest access to the board is greatly diminished.

D. The Value of Personal Leadership

There is also a Burkean objection that we've alluded to above: that is, the long-standing tradition of individual directors may suggest a deep wisdom about personal

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[327] As with the private equity example mentioned above, there is a sliding scale in which the number of nominated board members could scale roughly with the ownership stake of particular investors.

[328] For an argument that activism is valuable, see Brav, et al., For Hedge Fund Activism, Corporate Governance and Firm Performance," 63 J. FIN. *1729* (2008) (finding benefits of increased CEO turnover and decreased CEO pay when activist investors target a firm).

service that would be lost in the move to the BSP model. The objection would go something like this. Not only have boards since the days of the Dutch East India Company been composed of individual sole-proprietorships, but board members may also simply be another category of leader that we think of as necessarily being an individual. For instance, the Constitution requires the president to be an individual person, and it would seem strange to suggest that we hire Presidents-R-Us to be president, even though many of the arguments advanced above could apply to that situation as well. The same could be said about a variety of leaders, from mayors to law school deans.

One response is that our proposal is about corporate directors, not political leaders, and the cost-benefit calculation may be quite different in those cases. For instance, firms have to compete in various markets, and these provide discipline for bad governance choices in ways that political leaders do not feel as intensely. We pick a president every four years, whereas the governance of Microsoft is priced every second.

Another response is that boards are different than the president or the law school dean because of the nature of the role they play. While it might make sense to hire a firm to be a dean or a president, there is something personal about leadership in these cases that is not as true in the board context. Individuals feel invested in the personal connection with political leaders for reasons deep in the human psyche, but it is difficult to imagine that any corporate stakeholder – be it an employee, customer, or investor – feels this way about a particular board member or the board as a whole. It is possible that some CEOs serve this function, and that this may make the use of a firm to provide CEO services more problematic, but it is hard to see this value for the board. As noted above, the board provides a variety of functions, none of which is about the kind of personal leadership that we commonly associate with individual leaders.

A final response is to point out that the use of boards is largely a product of historical path dependency, and that the reasons for its initial use no longer obtain as firmly as they once did. Professor Franklin Gevurtz traces the origin of corporate boards back to medieval guilds and towns, concluding that corporate board antecedents where "a reflection of political practices and ideas widespread in Western Europe in the late Middle Ages." [329] Gevurtz's detailed historical account concludes that the reason corporate boards developed was in order to give "political legitimacy" to corporate activity.[330] While the article concludes with a sop to modern defenders of boards and greater shareholder participation in corporate affairs, there is nothing about our idea that would upset the idea of "consent through elected representatives" continuing as part of the corporate tradition. In fact, our proposal is likely to *increase* the political legitimacy of corporate boards by opening up possibilities for more transparent and active participation of shareholders in deciding who will represent their interests in supervising corporate management.

[329] Franklin A. Gevurtz, The Historical and Political Origins of the Corporate Board of Directors, 33 HOFSTRA LAW REV. 84, 129 (2004).

[330] Id at 170-73.

E. Other Objections

A couple of other potential objections are worth mentioning briefly. First, one may argue that for the BSP model to work well, BSPs will have to provide service to more than one company, and this will create conflict of interest problems. While this is obviously true, it is not an insurmountable problem. Other service firms, such as those providing accounting, legal, and consulting services, have access to proprietary information and significant power to influence corporate behavior in ways that could raise significant conflict problems if serving rival firms. These firms nevertheless have developed tools and procedures that enable them to convince their clients that they are able to minimize the potential losses from any conflicts. We would expect BSPs to do so as well, perhaps simply parroting the tried-and-true techniques used by law firms and the like for years. BSPs who do this well will thrive, and those who do not will die off. In addition, there are existing laws that will do work here, such as those banning certain informed trades by insiders or constructive insiders. These have been used against board members, most famously in the recent case of Rajat Gupta, who used his position as a board member at Goldman Sachs to enrich himself and others based on private information.[331] Reputational sanctions will do work here as well. Professionalism may too, since, as noted above, the creation of BSPs may create a new class of professional directors. If this happens, a professional organization, akin to those found in other areas like law, accounting, and brokerage services, may arise to enforce soft-law norms of conduct in this area.[332]

Second, there is the possibility that BSPs may complicate the takeover market. On the one hand, a more independent BSP would be expected to be more amenable to a valuable takeover offer, and the transparency of a large corporation would make any kind of side deals less likely. On the other hand, the potential loss of business to a particular BSP from a merger – e.g., if the acquirer wants to install their own BSP or board – could mean a BSP could oppose a merger that would increase shareholder value. While this is possible, this is also true about current boards. Moreover, insofar as a BSP would have increased financial incentives tied to the value of the underlying company, this conflict could be reduced relative to the current board model. In addition, BSPs that develop reputations for opposing valuable mergers may find their brand diminished in what we expect will be a vigorous market for board control. Finally, there are existing legal mechanisms, such as fiduciary duty suits common today in mergers, to police egregious board reluctant or entrenchment in the face of a valuable acquisition offer.

Finally, one might argue that there is value in independent deliberation by individual board members, and this will be lost if those providing board services are all working for a single firm that has hiring and firing authority over them. Like other objections, however, this is just a cost to be weighed against the benefits of BSPs. There is also reason to believe this concern is overblown. The current board model puts enormous authority over directors in the hands of a single individual – the CEO – and it

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[331] See, e.g., Anita Raghavan, Rajat Gupta's Lust for Zeros, NY TIMES, May 17, 2103.

[332] For a discussion of this type of self-regulation in the brokerage context, see William Birdthistle and M. Todd Henderson, Becoming a Fifth Branch, __ CORNELL L. REV. __ (forthcoming 2014).

is not obvious why this is a superior mechanism for eliciting independent judgment and deliberation than if those doing the deciding work for a firm instead. Moreover, if it is valuable to have independence in this way, there are solutions within the BSP model. BSPs can organize as partnerships or LLPs, and thus replicate the board deliberation model at the top of the BSP. Deliberation and independent judgment could also be built into the way in which BSPs staff projects, and, as noted above, one would expect this to be a dimension on which BSPs would try to differentiate their services. BSPs that can best replicate the value, if any, that exists in the current board model will thrive and be able to charge more for their services. One last point is worth making. The value of independence and individual deliberation may be situational, and something that a BSP could buy in the spot market for particular transactions. This would be an analogy to boards' current use of "special committees" of independent directors in final-period transactions, like mergers. If in a particular transaction or for a particular firm there is a need for independent deliberation by individuals unaffiliated with the company or the BSP, such individuals could be hired by the BSP to provide this value on an ad hoc basis.

VIII. Conclusion

Professional director services are statutorily required to be personal service contracts. This is extremely odd, yet widely accepted by corporations and corporate observers. We know of no other service provided for corporations that is obligated by law to be performed by a sole proprietorship, and for good reason. Lawyers, consultants, accountants, doctors, and so on, all associate with each other to form corporate entities to provide their services for a host of well understood reasons. Business associations allow for risk sharing, for investments in training and information, for capturing economies of scale, and for increased accountability through greater reputational stakes and better judicial supervision. If the state law requirement that board members be "natural persons," were amended to permit all legal persons, including partnerships, LLCs, and corporations, to provide them, we believe the market for directors and for governance could be fundamentally improved. A market for corporate governance, separate and distinct from the market for corporate control, could arise that would have the power to make boards the true fulcrum of corporate governance that the law presumes they are or should be. Board services could become a true market, with competition bringing the expected benefits of better service at lower cost.

Our proposal is consistent with the spirit of state corporate law as a set of default rules that merely enable firms to create their own governance arrangements designed to generate local maxima. Mandatory rules are the exception, not the rule, and should be based on clear and convincing evidence that freedom of contract would be unlikely to lead to social welfare improvements. We believe such a case is not made, and, in fact, the opposite is true. In addition, there are a variety of contexts in which law, including state and federal law, already tolerates corporate entities serving in a board or board-like role. Partnerships, for instance, can have any legal person serving in the board-like role of general partner. Extending this right to corporations seems like a logical next step.

This is not to argue that all firms should hire other firms to provide their board services. We doubt one-size-fits-all arguments generally, and are confident that such a rule here would be hopelessly overbroad. Firms should merely have a choice, subject to the constraints of the market and judicial review for opportunism in the use of corporations to provide these services. As we've shown, the Boards-R-Us idea is one that could be used to achieve a host of governance ends, ranging from increased shareholder power to better director primacy over corporations. In either case, and all those in between, what our proposal does is increase the transparency and competition for board services in a way that should increase confidence that firm choices about the role of the board are ones that are in the interests of shareholders and society in general, rather than based on a hidden agenda.

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