THE PUZZLE OF INDEPENDENT DIRECTORS: NEW LEARNING

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INTRODUCTION

I am honored to participate in this Symposium celebrating the prodigious contributions of my colleague Tamar Frankel to the field of corporate law. One important theme of Tamar's recent work is the idea of trust in corporate law.[1] It seems fitting, therefore, to take a fresh look at the promise and perils of independent directors in corporate governance. The independent director has always held a special place in the hearts and minds of corporate lawmakers as an idealized monitor of executives' behavior. Independent directors are trusted to make the right decisions on major issues when insiders are conflicted. They also play an important advisory role for management.

Recent governance reforms – the Sarbanes-Oxley Act[2] and then the Dodd-Frank Act[3] – reinforced this centrality of independent directors by mandating

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[1] *See, e.g.*, TAMAR FRANKEL, TRUST AND HONESTY: AMERICA'S BUSINESS CULTURE AT A CROSSROAD (2006).

[2] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended

independent majorities on all public company boards and requiring that crucial board committees be comprised solely of independent directors. In our hopes and dreams, then, the independent director offers something of a magic bullet for corporate governance.

Yet we corporate law scholars have always harbored some ambivalence about the magic of this bullet. As much as we seem to trust independent directors to do the right thing, no solid empirical evidence exists to suggest that independent directors add value.[4] Moreover, we have seen spectacular failures in the face of independent boards.[5]

How do we account for this disconnect between our intuitions and best intentions, on the one hand, and the stubborn refusal of the empirical evidence to confirm our faith in independent directors? Several possibilities come to mind. First, existing definitions of independence may be too lax. Only financial or familial ties between a director and an officer of the firm will definitively disqualify the director from independent status.[6] Many corporate scholars share a suspicion that this focus is too narrow; the list of disqualifying relationships may fail to capture the full range of incentives that outside directors might have to favor management.[7] So our intuitive faith in independent directors could be correct, but perhaps existing independent directors are simply not independent *enough*.

A second possibility (not exclusive of the first) is that firms may be heterogeneous, such that optimal board composition may vary across firms. Inde-

in scattered sections of 15 and 18 U.S.C.).

[3] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (to be codified in scattered sections of U.S.C.).

[4] *See* Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231, 233 (2002) ("The conventional wisdom favoring highly independent boards lacks a solid empirical foundation."); Benjamin E. Hermalin & Michael S. Weisbach, *Boards of Directors as an Endogenously Determined Institution: A Survey of the Economic Literature*, FRBNY ECON. POL'Y REV., Apr. 2003, at 8 (stating that empirical research has established that board composition is not correlated with firm performance); Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1530-32 (2005) (summarizing the empirical literature showing that neither independent boards nor fully independent audit committees improve firm performance).

[5] *See* Bhagat & Black, *supra* note 4, at 233 (explaining that eleven of Enron's fourteen directors were independent at the time of its fiasco).

[6] *See, e.g.*, NEW YORK STOCK EXCHANGE LISTED COMPANY MANUAL § 303A.02(a)-(b) (2010), *available at* http://nysemanual.nyse.com/LCMTools/PlatformViewer.asp?selectednode=chp_1_4&manual=%2Flcm%2Fsections%2Flcm-sections%2F [hereinafter NYSE LISTED COMPANY MANUAL] (listing "independence tests" that determine whether a director qualifies as independent).

[7] *See, e.g.*, Claire A. Hill & Brett H. McDonnell, *Disney, Good Faith, and Structural Bias*, 32 J. CORP. L. 833, 845-46 (2007) (detailing the relationships between Disney CEO Michael Eisner and nominally independent Disney directors that rendered "the bulk of the Disney board . . . not independent in any common sense use of the term").

pendent boards may add value at some firms but not others. An emerging theoretical literature argues, for example, that firms' information environments matter.[8] Outside directors will always suffer informational disadvantages relative to insiders, and this disadvantage will be greater in firms where outsiders have greater difficulty acquiring information about the firm. Independent directors at more opaque firms—those with high information costs—will therefore be less effective monitors or advisers than independent directors at more transparent (low information cost) firms.

Monitors' incentives and information are central to constraining agency costs. Happily, two recent empirical studies tackle these important issues. Byoung-Hyoun Hwang and Seoyoung Kim study the incentives of nominally independent directors. They ask whether the existence of common backgrounds between CEOs and their nominally independent directors may affect directors' monitoring.[9] They find that it does: on a number of metrics, independent directors who share important background with their CEOs (what they call "socially dependent directors") do worse as monitors than socially independent directors.[10] Another recent study focuses on directors' costs of acquiring information about their firms. Professors Ran Duchin, John Matsusaka, and Oguzhan Ozbas study the effect of firms' information costs on independent directors' efficacy in improving firm performance.[11] They find that adding independent directors adds value for firms with low information costs, but diminishes value for firms where information costs are high.[12]

These studies suggest that the independent director's place in corporate governance may be more complicated than we thought. Formal independence without social independence may be insufficient to assure the effectiveness of independent directors. And independent directors may be beneficial for some firms but not others, depending on firms' transparency. If these claims are correct, then our current thinking on independent directors may be too blunt. We may need to refine our trust in independent directors or tailor our expectations about their efficacy. Part I discusses the Hwang and Kim study, which raises important questions concerning current definitions of director independence.

[8] Renée B. Adams & Daniel Ferreira, *A Theory of Friendly Boards*, 62 J. FIN. 217, 218 (2007); Milton Harris & Artur Raviv, *A Theory of Board Control and Size*, 21 REV. FIN. STUD. 1797, 1798-99 (2008); Benjamin E. Hermalin & Michael S. Weisbach, *Endogenously Chosen Boards of Directors and Their Monitoring of the CEO*, 88 AM. ECON. REV. 96, 96 (1998); *see also* 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, 1541 (2007) (discussing the effect of the increasing informativeness of stock prices on the systemic value of independent directors).

[9] Byoung-Hyoun Hwang & Seoyoung Kim, *It Pays to Have Friends*, 93 J. FIN. ECON. 138, 139 (2009).

[10] *Id.*

[11] Ran Duchin, John G. Matsusaka & Oguzhan Ozbas, *When Are Outside Directors Effective?*, 96 J. FIN. ECON. 195, 196 (2010).

[12] *Id.*

Part II discusses the study by Duchin, Matsusaka, and Oguzhan, which offers an information-based roadmap for tailoring our expectations for the governance benefits of independent directors.

I. INCENTIVES: SHARED BACKGROUND AND FORMAL INDEPENDENCE

Individuals are no doubt motivated by more than economic incentives. Social influences may be especially important for folks like corporate directors, who work with insiders and with each other in small groups, with every expectation of repeated interaction in the course of long-term professional and personal relationships.[13] Ideally, social ties and social influences could be incorporated into our thinking on director independence. But social incentives are messy; they are hard to measure or analyze rigorously. Perhaps that explains why social influences on nominally independent directors have only recently begun to draw scholarly attention. Hwang and Kim's study offers a rigorous empirical analysis of the effects of a particular type of social influence on independent directors' monitoring efficacy.

A. *Sociology Meets the Board of Directors*

In general, current rules deem a director independent provided she has no significant financial or familial ties to executive officers of the firm or to the firm itself.[14] However, this filter may not be sufficiently discriminating. A major concern is that it ignores social influence. It assumes away social norms and social pressures that we know affect behavior.[15]

1. Small-Group Dynamics

Scholars in psychology, sociology, and law have identified board social dynamics that might affect a director's nominally independent judgment. Small-group dynamics operate within boards of directors no less than in other group decisionmaking contexts. Studies have adduced evidence, for example, that social influence and norms of reciprocity affect board decisions. CEO pay tends to be higher when the CEO enjoys social influence over independent directors,[16] for example, when the CEO also chairs the board or serves on the compensation committee.[17] Demographic similarity also enhances social in-

[13] *See* MARVIN E. SHAW, GROUP DYNAMICS: THE PSYCHOLOGY OF SMALL GROUP BEHAVIOR (1981); James S. Coleman, *Constructed Organization: First Principles*, 7 J. L. ECON. & ORG. 7, 11-12 (Special Issue 1991).

[14] *See supra* note 6 and accompanying text.

[15] Whether this weakness is remediable, though, is another issue. *See infra* Part I.D.

[16] Charles A. O'Reilly III & Brian G. M. Main, *Economic and Psychological Perspectives on CEO Compensation: A Review and Synthesis*, 19 INDUS. & CORP. CHANGE 675, 686-87 (2010).

[17] *Id.* at 15. Other measures of social influence include the number of board committees on which the CEO serves and whether she is older than the compensation committee chair. *Id.*

fluence.[18] One study shows that when the CEO and members of the compensation committee are closer in age, CEO compensation is higher.[19] CEO pay is also higher when independent directors feel reciprocity obligations toward the CEO.[20] Reciprocity norms may be at work for example, when the CEO serves on the nominating committee that nominated a particular director, when the compensation committee chair enjoys high fees, or when the CEO precedes the compensation committee chair on the board.[21]

2. Thick Social Ties

In addition to group dynamics, nominally independent directors may share thick social ties with the CEO or other officers outside of their involvement with the firm. They may belong to the same social clubs or share deep involvement in the same civic organizations. They may simply be friends. Social ties imply shared qualities and experiences among individuals. These shared qualities and experiences facilitate interaction, understanding, and personal connections. For purposes of independent director monitoring, these influences may be especially important. A social relationship "disposes one to interpret favorably another's intentions and actions."[22] In discharging her monitoring function, a nominally independent director with social ties to the CEO might naturally be predisposed to generally giving the CEO the benefit of the doubt. The famous decision in *In re Oracle Corp. Derivative Litigation* posed just this scenario.

In *Oracle*, Vice Chancellor Strine rejected claims of independence for a special litigation committee (SLC) comprised of two Stanford University professors. The SLC was tasked with deciding the fate of a derivative suit against Oracle Corporation, whose board had deep ties to Stanford.[23] Among Oracle's director defendants in the suit were (1) another Stanford professor who had taught one of the SLC members and served with the same SLC member on the steering committee for a Stanford policy institute, the Stanford Institute for

[18] Anne S. Tsui & Charles A. O'Reilly III, *Beyond Simple Demographic Effects: The Importance of Relational Demography in Superior-Subordinate Dyads*, 32 ACAD. MGMT. J. 402, 404-05 (1989).

[19] Brian G. M. Main, Charles A. O'Reilly III & James Wade, *The CEO, the Board of Directors and Executive Compensation: Economic and Psychological Perspectives*, 4 INDUS. & CORP. CHANGE 293, 319-20 (1995).

[20] O'Reilly & Main, *supra* note 16, at 3.

[21] *Id.* These cozy relationships that do not involve direct financial interests of directors are often referred to as "structural bias" in the legal literature. *See* Claire A. Hill & Brett H. McDonnell, *Disney, Good Faith, and Structural Bias*, 32 J. CORP. L. 833, 848 (2007) (noting that "[w]e would be hard pressed to better depict structural bias" than with the Disney board involved in Michael Ovitz's hiring and then unceremonious firing as Disney's president).

[22] Brian Uzzi, *The Sources and Consequences of Embeddedness for the Economic Performance of Organizations: The Network Effect*, 61 AM. SOC. REV. 674, 678 (1996).

[23] *In re* Oracle Corp. Derivative Litig., 824 A.2d 917, 945-46 (Del. Ch. 2003).

Economic Policy Research (SIEPR); (2) a Stanford alumnus who had directed millions of dollars in donations to Stanford, chaired SIEPR's advisory board, and had endowed a conference center at SIEPR; and (3) Oracle's CEO, who had also made multimillion-dollar donations to Stanford and was considering additional donations at the time the SLC was formed.[24] These thick social ties left the court doubtful about the impartiality of the SLC directors.[25] The court therefore denied the SLC's motion to dismiss the derivative suit.[26]

B. *It Pays to Have Friends*

Hwang and Kim's study goes beyond the existing literature on group dynamics and thick social ties among directors. They identify relatively weak social ties – more in the nature of shared backgrounds and not direct social connections – and demonstrate that affinity based on shared backgrounds may also affect director decisionmaking. While the existing structural bias and social influence literature focuses on thick social connections and group dynamics, Hwang and Kim focus on much thinner connections, which makes their study novel and important.

Hwang and Kim identify potentially important shared background between nominally independent directors and CEOs and introduce evidence that these elements of shared background affect board monitoring.[27] While acknowledging that boards may play an advisory role, for which social affinity might be beneficial, their focus is on monitoring, so they look primarily at CEO compensation issues, which trigger greater monitoring concerns than advising issues.[28] They look at Fortune 100 CEOs and boards of directors from 1996-2005, assessing the strength of shared background (what they call "social ties")

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[24] *Id.* at 920-21.

[25] *Id.*

[26] *Id.* Somewhat surprisingly, though, Oracle's SLC members could still qualify as independent directors under some definitions. Independence requirements for companies listed on the New York Stock Exchange, for example, do not specifically prohibit the troubling relationships described in *Oracle*. Contributions to tax exempt organizations, regardless of amount, are not enumerated as an objective disqualification from independence. Such contributions need only be disclosed, and only if an independent director serves as an *executive officer* of the tax exempt organization and contributions to the organization exceed the *greater* of $1 million and 2% of the organization's consolidated gross revenues in any of the most recent three fiscal years. NYSE LISTED COMPANY MANUAL, *supra* note 6, § 303A.02(b)(v) (disclosure requirement). The *Listed Company Manual* does include a somewhat subjective catch-all provision regarding director independence determinations: "No director qualifies as 'independent' unless the board of directors affirmatively determines that the director 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)." *Id.* § 303A.02(a).

[27] Hwang & Kim, *supra* note 9, at 139 (finding evidence that social ties matter by evaluating executive compensation packages).

[28] *Id.*

between the CEO and each conventionally independent director of the firm.[29] They find that the presence of social ties on the board has a number of significant effects on CEO compensation, CEO turnover, and firm performance.[30]

1. Identifying Social Ties

Relying on economics and sociology literature, Hwang and Kim identify five types of shared background that might matter: mutual alma mater, military service, regional origin, academic discipline, and industry.[31]

Mutual alma mater. Graduates from the same university share a bond in terms of shared traditions and experiences, as well as a sense of group belonging. For purposes of this study, a social tie exists if the CEO and the director graduated from the same university *and* were born within three years of each other.[32] This latter condition assures that the CEO and director overlapped in their years of attendance, which increases the similarity of their experiences as well as the likelihood that they knew each other before their shared tenure with the firm.[33]

Military service. Veterans share a common experience insofar as the structure and function of the military and its demands have no parallel in civilian working environments.[34]

Regional origin. Hwang and Kim cite to studies showing cultural and lifestyle similarities within geographical regions of the United States.[35] Americans view themselves as sharing certain traits based on geography, and evidence suggests they make social choices based on regional homophily. Hwang and Kim use birthplace as a proxy for regional affiliation, categorizing by U.S. region or non-U.S. country of birth.[36]

Academic discipline and industry. A shared academic discipline or industry captures shared interests and common experiences between the CEO and director.[37]

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[29] *Id.* at 143 tbl.1.

[30] *Id.* at 155.

[31] *Id.* at 140-41 (explaining how these social ties produce enhanced interaction, shared experiences, and common interests).

[32] *Id.* at 141-42.

[33] *Id.* at 141.

[34] *Id.* ("[V]eterans are in an environment that depends on a highly structured, organized force . . . [with] a demand not paralleled in any other work environment, suggesting that this unique shared experience contributes to a steadfast bond among veterans." (internal quotations omitted)).

[35] *Id.* at 140.

[36] *Id.* Though admittedly birthplace is not a perfect proxy, it is objectively identifiable and less malleable than the more vague notion of where someone is "from." *Id.* The authors use the United States Census Bureau's regional classifications: South, Northeast, Midwest, Mountain, Pacific, and Territories. *Id.*

[37] *Id.* at 141.

2. Comparing Boards

Hwang and Kim distinguish between conventionally independent boards and socially independent boards. Conventionally independent boards are comprised of a majority of conventionally independent directors – those with no familial or material financial relationship with the firm or any of its executive officers.[38] A socially independent board, by contrast, has a majority of directors that are both conventionally *and* socially independent. The authors deem a director socially dependent if she has two or more social ties with the firm's CEO.[39]

C. *Do Social Ties Matter?*

The study first looks at CEO compensation. Hwang and Kim find that conventionally independent boards show no statistically significant effect on CEO compensation, as compared to nonindependent boards. But the presence of a socially independent board has a statistically significant effect in reducing CEO compensation, as measured by both salary plus bonus and total compensation.[40] The effect is also economically significant: the average drop in total compensation is $3.3 million, while average total compensation for the sample is $12.8 million.[41] Hwang and Kim also find a statistically significant difference in compensation when comparing conventionally versus socially independent boards.[42]

By itself, this difference in compensation may not tell us all we need to know. Possible explanations exist that are unrelated to agency costs and monitoring effectiveness. For example, when the CEO's job is more complex or

[38] A director is classified as independent if he or she is not a current or former employee of the firm (or of a subsidiary of the firm), a relative of an executive officer, a customer of or a supplier to the company, a provider of professional services, a recipient of charitable funds, a designee under a documented agreement by a significant shareholder or group, or interlocked with an executive of the firm.

Id. at 142. This tracks the IRRC definition. *Id.*

[39] In addition to the five types of social ties described above, a director is also credited with a social tie to the CEO if that director and the CEO each share two of the above-specified social ties with another director:

> For example, suppose that the CEO is a 55-year-old, Stanford-educated, business major who served in the military and was born in the Northeast, and director A is a 55-year-old, Stanford-educated, electrical engineering major born in the South. Although the director and CEO share only one direct tie (i.e., through mutual alma mater), if there is third-party director B who is a 57-year-old Stanford graduate who studied electrical engineering and served in the military, then we consider director A socially dependent to the CEO (because in addition to their mutual alma mater connection, the two are socially connected to a mutual third party with whom each shares two direct ties).

Id.

[40] *Id.* at 145.

[41] *Id.* at 146.

[42] *Id.* at 148.

difficult, she may need an advisory board more than a monitoring board. She may therefore rely on a more collaborative board, whose value is enhanced by social ties.

To address this concern, the study also compares firm operating performance for conventionally independent boards versus socially independent boards.[43] The study calculates CEOs' predicted excess compensation from having boards that are conventionally but not socially independent,[44] and then regresses operating performance on this predicted excess compensation. A positive correlation would suggest that a CEO's compensation premium from having a socially dependent board could be explained by the need for a strong advisory board to run a more complex firm. The results, however, show a significant negative relation between predicted excess compensation and subsequent operating performance.[45] So the advisory needs of a complex firm cannot explain the social ties, because the excess compensation attributed to social ties correlates with worse subsequent operating performance. Instead, it appears that socially dependent boards are simply weaker monitors.[46]

Hwang and Kim make a number of additional findings consistent with this interpretation. CEO pay is less sensitive to stock performance with socially dependent boards.[47] This result is economically significant: with a 20% stock loss, the CEO's total compensation decreases on average by 10.2% less if the board is socially dependent.[48] CEO turnover is also significantly less likely with a socially dependent board. All else equal, the probability decreases by 3.7%.[49] There is also some evidence – though not statistically significant – that the probability of CEO turnover is less sensitive to firm performance with a socially dependent board.[50]

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[43] *Id.* The study uses three accounting measures for subsequent operating performance – return on assets, return on sales, and return on equity. It measures subsequent operating performance for one-, two-, and three-year periods. *Id.*

[44] *Id.* Essentially, after accounting for standard economic determinants of compensation, any excess is attributed to board structure and other governance variables. *See* John E. Core, Robert W. Holthausen & David F. Larcker, *Corporate Governance, Chief Executive Officer Compensation, and Firm Performance*, 51 J. FIN. ECON. 371, 390-91 (1999).

[45] Hwang & Kim, *supra* note 9, at 149.

[46] *Id.* The effect is also economically significant. Taking three-year measures of operating performance, a one standard deviation increase in predicted excess compensation is associated with average annual decreases of 0.4% for return on assets, 0.5% for return on sales, and 0.7% in return on equity. *Id.*

[47] *Id.* at 150.

[48] *Id.*

[49] *Id.* at 151.

[50] *Id.* These CEO turnover findings are interesting because prior studies have shown significant differences in CEO turnover probability following poor firm performance, as between conventionally independent boards and non-independent boards. *See* Michael S. Weisbach, *Outside Directors and CEO Turnover*, 20 J. FIN. ECON. 431, 453-55 (1988) (demonstrating the much higher rate of CEO retirements following poor performance when the

Hwang and Kim also look at audit committee composition and its relation to CEO bonuses.[51] Evidence exists that managers sometimes attempt to manipulate earnings to maximize their bonuses, and that the level of manipulation is a function of firm governance structures. Firms with independent audit committees engage in less earnings management.[52] Hwang and Kim find that, among firms with independent audit committees, CEOs receive higher bonuses when at least one committee member is socially dependent. This effect is economically as well as statistically significant. On average, the bonus is $0.734 million greater, while the average bonus over the sample is $2.6 million.[53]

D. *Caveats and Implications*

Hwang and Kim's interesting findings should be qualified with one small caveat. While they do include a standard battery of controls for firm, governance, and CEO characteristics, they ironically do not control for the more commonly identified social influences within boards that have been shown to affect board decisionmaking and CEO pay.[54] For example, as earlier noted, researchers in both finance and organizational behavior have found a positive correlation between CEO pay and (i) the proportion of outside directors appointed after the CEO took office,[55] (ii) whether the CEO was appointed before the compensation committee chair became a director,[56] and (iii) whether the CEO was a member of a formal nominating committee of the board.[57] Each of these factors is consistent with the operation of reciprocity norms that enable the CEO to influence directors' decisions about the CEO's pay.[58] Perhaps accounting for these other social influences would not have much affected their results, but inclusion of additional controls or tests for interactive effects between their shared background factors and these previously identified social influences might have enabled Hwang and Kim to more cleanly distinguish the effects of the shared background factors on which their study focuses.

company's board of directors had 60% or more independent directors). Hwang's and Kim's findings add another important piece to the puzzle. Hwang & Kim, *supra* note 9, at 151.

[51] Hwang & Kim, *supra* note 9, at 151-52.

[52] *Id.*

[53] *Id.* at 152. The analysis controls for total CEO compensation and a number of measures of firm performance. *Id.*

[54] Hwang and Kim do control for whether the CEO also chairs the board, *id*. at 156, a factor that likely confers social influence on the CEO and has been shown to correlate with higher CEO pay, John E. Core, Robert W. Holthausen & David F. Larcker, *Corporate Governance, Chief Executive Officer Compensation, and Firm Performance*, 51 J. FIN. ECON. 371, 385-88 (1999).

[55] *Id.*; s*ee also* James Wade, Charles A. O'Reilly, III, & Ike Chandratat, 35 ADMIN. SCI. Q. 587, 598 (1990) (relating to golden parachutes).

[56] Main, O'Reilly & Wade, *supra* note 19, at 319.

[57] *Id.*

[58] *Id.*

In any event, Hwang and Kim's study offers important empirical evidence confirming our suspicions that existing definitions of independence may not capture all the potential influences that may affect directors' impartiality. The appropriate policy response, however, is unclear. On the one hand, we might be tempted to expand the list of relationships or shared experiences that in some combination disqualify a director from independent status. On the other hand, the shared experiences that Hwang and Kim identify seem fairly general, such that it may be doubted that any expanded list of disqualifying factors could hope to be comprehensive. Shared regional origin or academic discipline or industry, for example, all seem likely to capture huge numbers of individuals. One might imagine similarly general shared experiences – shared nonprofit backgrounds or religious affiliation, for example – that might possibly combine with others to affect director monitoring. And the list could go on, as new forms of shared experiences are created and/or discovered to affect monitoring incentives.

Rather than driving us to rethink independence requirements, Hwang and Kim's findings may instead cast doubt that a workable definition of independence exists that could possibly capture the variety of shared experiences that might dampen conventionally independent directors' monitoring incentives. Any such attempt at rulemaking would be unavoidably over- and underinclusive.[59]

Perhaps we should acknowledge that there may be limits to our capacity to operationalize independence ex ante. Instead, we may need to rely on the fine-grained ex post analysis of judges, as exemplified by Vice Chancellor Strine in *Oracle*. This is not to suggest that ex ante independence requirements may not be improved along other margins. But as with many features of corporate governance, managing actors' incentives may be tricky, and shared experiences and other social influences may be too numerous and subtle for comprehensive ex ante enumeration.

II. INFORMATION AND INDEPENDENT DIRECTORS

In addition to incentives, information also matters for directors' efficacy.[60] Though the literature notes the importance of information for independent directors and recognizes the information deficit that outside directors suffer compared to insiders, scholars have not, until recently, attempted to measure the effects of information on independent directors' efficacy.

Professors Duchin, Matsusaka, and Ozbas ("DMO") offer such a study.[61] They hypothesize that as the costs of obtaining information vary across firms, so will the efficacy of independent directors' efforts. While DMO confirm,

[59] This is not to suggest that current definitions of director independence could not be improved, *cf. supra* note 26 and accompanying text, but merely that Hwang and Kim's interesting findings may not translate easily to crafting stricter definitions of independence.

[60] *See supra* note 8 and accompanying text.

[61] Duchin, Matsusaka & Ozbas, *supra* note 11, at 196.

consistent with the existing literature, that increasing the percentage of independent directors on a board does not help or hurt firm performance on average, they show that the performance effect of increasing board independence for public companies depends on information costs. For high-information-cost firms, performance suffers with an increase in board independence. Low-information-cost firms, however, benefit from an increase in the percentage of independent directors.[62]

A. *Methodology*

DMO use three different measures for a firm's information costs. First, they count the number of analysts who posted earnings forecasts for the firm in a given year. Greater analyst following typically means more information available to outsiders.[63] DMO's second measure is the dispersion of analyst forecasts. A wider dispersion suggests more difficulty for outsiders to evaluate the firm.[64] Third, DMO measure analyst forecast error – i.e., the absolute difference between the mean analyst forecast and the firm's subsequent quarterly earnings announcement.[65] As with dispersion of forecasts, a larger forecast error indicates greater difficulty for outsiders to become informed about the firm. From these three measures, DMO create an information cost index for each firm.[66]

Perhaps the greatest challenge with studies of board composition is that board composition is endogenous.[67] Attributing causal effect is fraught with peril because of the difficulty of identifying, for example, whether a change in board composition is the cause or the effect of a change in firm performance. Or perhaps changes in board composition and firm performance both covary with some third factor. DMO overcome this difficulty by exploiting changes in board independence rules between 1999 and 2003.[68] Changes in 1999 in NYSE and NASDAQ listing rules, and the Sarbanes-Oxley Act in 2002, all required that audit committees comprise only independent directors.[69] Then, in 2003, NYSE and NASDAQ rule changes mandated majority independent boards. For firms that were not in compliance at the time of these rule

[62] *Id*.

[63] *Id.* at 201.

[64] *Id.* at 201-02 ("[The dispersion of analyst forecasts is] measured as the standard deviation of earnings forecasts across analysts prior to a quarterly earnings announcement, normalized by the firm's total book assets and averaged across four quarters in a given year.").

[65] *Id.* at 202 (explaining that both the second and third measures are "normalized by the firm's total book assets and averaged across four quarters for a given year").

[66] *Id.* ("We also construct an information cost index that combines the three separate measures by averaging a firm's percentile rankings in the sample according to each measure . . . . We then scale the index range from zero (low) to one (high).").

[67] *Id.* at 196.

[68] *Id.*

[69] *Id.*

changes, the external mandates, and not endogenous factors, likely drove subsequent appointments of independent directors. This simplifies the investigators' efforts to identify causal effects of independent directors' appointments.[70]

DMO assess the performance of publicly traded firms between 2000 – before the rule changes described above – and 2005, after the rule changes.[71] They compare changes in performance for firms not in compliance with mandatory director independence requirements in 2000 with firms that were in compliance, and therefore not required by rule changes to appoint new independent directors.[72]

B. *Findings*

DMO use three measures of firm performance: return on assets (ROA), Tobin's Q,[73] and annual stock return.[74] When they test the effects of exogenous changes in the percentage of independent directors on these performance measures without accounting for information costs, the results are statistically insignificant, consistent with the prior literature. However, when they interact exogenous changes in the percentage of independent directors with their information cost index, they find that the performance effect of increased board independence depends on firms' information costs, and this effect is both statistically and economically significant for all three performance measures.[75] For firms in the lowest quartile of information costs in their sample, a 10% increase in the percentage of independent directors is associated with 1.3% higher ROA, 8.1% higher Tobin's Q, and 3.8% higher annual stock return.[76] By contrast, for firms in the highest information cost quartile, a 10% increase in the percentage of independent directors is associated with a 1.7% *decrease* in ROA, 15.8% lower Tobin's Q, and 2.4% lower annual stock return.[77] DMO

[70] *Id.* DMO use noncompliance with new board independence rules as an instrument to identify exogenous changes in the percentage of outside directors. Their main results rely on noncompliance with audit committee independence as their instrument. *Id*.

[71] *Id.* at 200-02.

[72] *Id.* at 202.

[73] Tobin's Q is the ratio between the market value and the replacement value of the same physical asset. *See* James Tobin & William R. Brainard, *Asset Markets and the Cost of Capital*, *in* ECONOMIC PROGRESS, PRIVATE VALUES, AND PUBLIC POLICY: ESSAYS IN HONOR OF WILLIAM FELLNER 235, 235 (Bela Balassa & Richard Nelson eds., 1977).

[74] Duchin, Matsusaka & Ozbas, *supra* note 11, at 200. DMO measure ROA and Tobin's Q in 2000 and 2005. They compute average monthly stock returns from the end of 2000 to the end of 2005.

[75] *Id.* at 204. The coefficients on the interaction term are negative and statistically significant, while the coefficients on the changes in board independence variable by itself are positive and significant. *Id*. at 202 tbl.3.

[76] *Id.* at 204.

[77] *Id.*

obtain similar results when they test for changes in board control, instead of changes in the percentage of independent directors on a board.[78]

These data suggest some interesting implications. Before the rules changed, managers in low information cost firms may have been inefficiently limiting the number of independent directors in order to reduce board oversight. In those cases, the rule changes pushed firms toward value-enhancing board compositions by requiring them to add independent directors. On the other hand, high information cost firms may have been optimally constituted with insider-dominated boards before the rule changes, since with high information costs, independent directors are likely to be less effective at both advising and monitoring. The new regulations pushed these high information cost firms into inefficient board structures by mandating more independent directors.

Given DMO's results suggesting the importance of information costs for optimal board composition, one might wonder whether firms account for information costs when they compose their boards. DMO find evidence that firms do. High information cost firms have fewer independent directors than low information cost firms, but the difference is not large.[79] By one estimate, the percentage of independent directors on boards of firms in the highest information cost quartile is only 2.7% lower than for firms in the lowest quartile.[80] This evidence does, however, reinforce the general idea that information costs matter for optimal board composition.

DMO also find evidence that independent directors' advising function may be less important than their monitoring function.[81] To be sure that director independence drives their results, and not director expertise, DMO control for directors' financial expertise, academic affiliation, and whether a director is an executive officer or consultant for another corporation. Not only do their original results hold, but director expertise turns out to have no statistically significant effect on firm performance.[82] Because special expertise is likely to matter more for directors' advising function than for monitoring, this suggests that independent directors' monitoring role may be more important.

C. *Caveats*

Endogeneity may be a concern with any complex governance study. DMO's study assumes that information costs are exogenous – that whether a firm's information costs for outsiders are high or low does not depend on the firm's governance or other firm features. Other empirical work suggests that a firm's information environment may be endogenous and not static. Todd A. Gormley, Bong Hwan Kim, and Xiumin Martin find, for example, that Indian

[78] *Id.* at 206 tbl.5, 207. To eliminate alternative explanations for their results, DMO control for industry, firm size, and the expertise of individual directors. *Id.* at 207-08.

[79] *Id.* at 211 tbl.9, 212.

[80] *Id.*

[81] *Id.* at 208.

[82] *Id.* at 208 tbl.6.

firms improve their accounting quality as foreign banks enter local markets.[83] They suggest that this improved transparency derives from firms' desire for better financing terms from foreign banks. Improved accounting quality is also positively related to firms' subsequent debt levels.[84]

Especially with DMO's information cost measures, one might justifiably be concerned that firms enjoy significant influence over their own information costs. Two of their three measures – dispersion of analyst forecast errors and mean analyst forecast error – depend to some extent on the quality of earnings guidance that each firm offers to analysts. Individual firms may choose to be more or less open with their earnings forecasts,[85] and they may actively manage analyst opinions in their communications with analysts.[86] So DMO's information cost measures are not exogenously determined; firm managers may influence outsiders' information costs.

Another potential concern with DMO's information costs measures is that independent directors are not outsiders to the firm in the way that analysts are. Independent directors have much greater access to information than analysts. So a firm that is not transparent to analysts may yet be transparent to independent directors. In essence, analysts' difficulties predicting a firm's earnings may be only a very rough proxy for information costs to directors.

In any event, DMO offer a thought-provoking analysis and an early test of the theoretical literature arguing that independent directors' efficacy depends on their information costs.

CONCLUSION

Where do we go from here? The Hwang and Kim and DMO studies improve our understanding of independent directors' incentives and information constraints by suggesting a broader range of considerations for predicting and designing independent director efficacy. These studies offer plausible explanations, consistent with the theoretical literature, for why prior empirical work has been unable to discern an association between board independence and firm value. The analyses offer early guidance for developing a richer framework for assessing directors' independence and refining our expectations about independent directors' capacities.

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[83] Todd A. Gormley, Bong Hwan Kim & Xiumin Martin, Can Firms Adjust Their Opaqueness to Lenders? Evidence from Foreign Bank Entry Into India 4 (June 15, 2010) (unpublished manuscript), *available at* http://ssrn.com/abstract=1265109.

[84] *Id.* at 30-31.

[85] *See generally* Foley & Lardner LLP, *The Art of the Analyst Conference Call and Earnings Forecasts – To Guide or Not Guide*, 2007 NATIONAL DIRECTORS INSTITUTE, http://www.foley.com/files/tbl_s31Publications/FileUpload137/4024/ArtAnalystConference Call.pdf (last visited April 21, 2011) (noting that some high-profile companies have discontinued the common practice of offering earnings guidance).

[86] *Id.* (characterizing a quarterly conference call with analysts as "a valuable opportunity for a company to frame itself and its results in the way it wants investors to view them").

Ultimately, it may be that no affirmative policy response exists for the shared background factors that Hwang and Kim identify. Similarly, assuming firms' information environments affect independent directors' efficacy, regulatory intervention to optimize firm information costs may be difficult, given insiders' inherent ability to influence their firms' information environments.

We may yet hope against hope that director independence could be the magic bullet for corporate governance. But there might be no magic.