

# State Intervention in Corporate Governance: National Interest and Board Composition

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*This Article analyzes the composition of the board of directors as a vehicle for state intervention in corporate governance. Such intervention is ubiquitous and often motivated by goals that stray from shareholder wealth maximization, or corporate governance more generally, to promote other national interests such as diversity. Regulating board composition thus is merely the continuation of politics by other means. After briefly discussing direct state ownership in business firms as a way to advance policy goals, the Article explicates the tensions between boards' dual responsibilities of monitoring and strategy-setting. These oftentimes conflicting missions curb the law's ability to guide board members' conduct through the conventional legal duties of loyalty and care or other injunctions. Although the two roles also may entail conflicting implications for board composition, regulation of board composition nonetheless may prove a superior means for promoting policy goals, especially with regard to the objective of the corporation. Composition regulation harnesses board members' personal attributes — specifically, their values — to facilitate the attainment of these goals. Instead of telling board members what to do, the state may fare better by regulating who they are.*

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## INTRODUCTION

September 14, 2008, was not a good day for financial markets, yet it was an interesting one for corporate governance. A few days earlier, the U.S. Treasury had taken over Fannie Mae and Freddie Mac, after American Insurance Group (AIG) had already requested financial support from the U.S. government to keep it solvent.<sup>1</sup> In the early afternoon of September 14, Lehman Brothers, until then a highly profitable investment bank and one of Wall Street's most venerable brands, filed for bankruptcy. Lehman's collapse — which many consider to be a major trigger of the Great Recession — came after earlier on in the day, a Treasury official had indicated that the government would not support Lehman financially.<sup>2</sup> During the 2009 World Economic Forum in Davos, an intriguing question was raised: Would we be in this mess today if it had been Lehman Sisters — that is, if women had been at the helm?<sup>3</sup>

Meanwhile, on the same day, Bank of America announced its impending purchase of Merrill Lynch, another financial powerhouse that was now essentially bankrupt as well. New information, however, indicated that Merrill Lynch could have even bigger losses, leading to the bank contemplating calling off the deal. Ken Lewis, Bank of America's CEO, had become so concerned that he went to DC in December to meet with Ben Bernanke, the Chairman of the Federal Reserve, and James Paulson, then-Treasury Secretary, for guidance. Both of them, Lewis said, were “firmly of the view that terminating or delaying the closing . . . could result in serious systemic harm.”<sup>4</sup> Bank of America ended up buying Merrill Lynch but without full disclosure to its shareholders about its condition. Larry Ribstein, among others, wondered whether that omission — which may also be a breach of basic fiduciary duties — could be justified due to a “national interest” that may supersede shareholders’ best interests and right to full disclosure.<sup>5</sup>

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- 1 Charles Duhigg, Stephen Labaton & Andrew Ross Sorkin, *As Crisis Grew, One Option Remained*, N.Y. TIMES, Sept. 8, 2008, at A1, available at [http://www.nytimes.com/2008/09/08/business/08takeover.html?\\_r=2&hp=&pagewanted=all&oref=slogin](http://www.nytimes.com/2008/09/08/business/08takeover.html?_r=2&hp=&pagewanted=all&oref=slogin); *Credit and Blame: A Must-Read on the Origins of the Crisis*, ECONOMIST, Sept. 11, 2008, <http://www.economist.com/node/12209655>.
  - 2 Andrew Ross Sorkin, *Lehman’s Last Hours*, N.Y. TIMES, Sept. 6, 2010, at B1, available at <http://www.nytimes.com/2010/09/07/business/07sorkin.html>.
  - 3 Katrin Bennhold, *Talking Banks and Sex*, DEALBOOK (Jan. 31, 2009, 12:10 PM), <http://dealbook.nytimes.com/2009/01/31/talking-banks-and-sex/>.
  - 4 Dennis Berman, *BofA’s Merrill Deal Exposes Myth of Transparency*, WALL ST. J., Jan. 20, 2009, at C3, available at <http://online.wsj.com/article/SB123241223885296179.html>.
  - 5 Larry Ribstein, *Is There a “National Interest” Exception to the Securities*

As is often the case, situations of crisis or extreme stress — which the Fall of 2008 offered in abundance — provide an opportunity to observe and assess the critical features of corporate governance systems. This Article focuses on the different modes of state intervention in corporate governance. Should the state — be it through the executive branch or legislative branch — seek to intervene in corporate governance with a view to steering it in particular policy directions, several avenues are available for achieving this goal. The government could invest in a control block and use its dominant position to appoint a board of directors that will pursue strategies in line with its policy. Alternatively, the legislature may enshrine certain strategic goals in law, so that board members will be legally obligated to pursue those goals. Finally, the state could regulate the personal composition of the boards of directors so that board members would be more likely to pursue goals the state considers desirable.

This Article presents a critical review of these three modes of state intervention. Part I argues that barring an extreme crisis (of the sort that took place in 2008), state control through investment in a control block of major business firms is generally undesirable. Part II then shows that the second alternative, dictating corporate governance strategies through legal injunction, may be futile due to its inevitably high degree of generality. Finally, Part III argues that board composition could be a viable vehicle for implementing policies that extend beyond the immediate goal of increasing board diversity. The regulation of board composition relates to the personal attributes of board members not only with regard to salient features (e.g., gender diversity) or economic incentives (e.g., for independent directors). Rather, a more potent — and thus far under-recognized — factor affected by board composition is the members' individual motivational goals as reflected in their value preferences. By regulating the makeup of the board, firms and countries can channel its conduct toward goals they hold desirable, especially in terms of the corporation's objectives. Instead of telling board members what to do, the state may fare better by regulating who they are.

## I. THE SIMPLE CASE AGAINST STATE INVESTMENT

Of the three alternative approaches for involving the state in corporate governance in order to achieve particular policy goals, state investment in

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*Laws?*, IDEOBLOG (Jan. 21, 2009, 07:19 AM), <http://busmovie.typepad.com/ideoblog/2009/01/is-there-a-national-interest-exception-to-the-securities-laws.html> (citing Berman, *supra* note 4).

business corporations is probably the least desirable. A substantial body of literature, mostly from the 1990s, suggests that state officials have no relative advantage in running business firms.<sup>6</sup> Ample anecdotal evidence documents magnificent failures of business enterprises run by state-controlled companies across the world.<sup>7</sup> This evidence indicates, among other things, that state-controlled firms compete with the private sector over resources and may skew resource allocation in the economy; that state-controlled firms are less efficient; and that they tend to pollute more.<sup>8</sup> Consequently, the sole policy question that arose during that decade was not whether to privatize state-controlled economic activity, but how to do so.<sup>9</sup>

When the state controls a business corporation, its managers do not have genuine shareholders. The economic, property interests in the firm are widely diffused among the entire populace. The state officials responsible for a particular firm do not have the kinds of incentives that shareholders have to monitor the company's management. In more egregious cases, the consequences include outright looting of corporate assets ("tunneling").<sup>10</sup> And even in less blatant instances of the agency problem, the personal interests of the government officials may lead them to focus on promoting their (sometimes political) careers more than the public interest.<sup>11</sup>

Israeli law on state-controlled companies stipulates unequivocally that the fiduciary duties in the framework of these companies entail a duty to act in the best interest of the corporation to the exclusion of any external

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6 See, e.g., WORLD BANK, BUREAUCRATS IN BUSINESS: THE ECONOMICS AND POLITICS OF GOVERNMENT OWNERSHIP — SUMMARY 6 (Mary Shirley et al. eds., 1995); Bernardo Bortolotti & Enrico Perotti, *From Government to Regulatory Governance: Privatization and the Residual Role of the State*, 22 WORLD BANK RES. OBSERVER 53 (2007); Andrei Shleifer & Robert Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737, 767 (1997).

7 See, e.g., WORLD BANK, *supra* note 6. For a literature review, see Maxim Boycko, Andrei Shleifer & Robert W. Vishny, *A Theory of Privatization*, 106 ECON. J. 309 (1996).

8 WORLD BANK, *supra* note 6.

9 See William Megginson, *Think Again: Privatization*, 118 FOREIGN POL'Y 14 (2000); William L. Megginson & Jeffry M. Netter, *From State to Market: A Survey of Empirical Studies on Privatization*, 39 J. ECON. LITERATURE 321 (2001).

10 Simon Johnson, Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Tunneling*, 90 AM. ECON. REV. 22 (2000).

11 Cf. Stavros Gadinis, *Can Company Disclosures Discipline State-Appointed Managers? Evidence from Greek Privatizations*, 13 THEORETICAL INQUIRIES L. 525 (2012).

interest.<sup>12</sup> The Israeli State Comptroller found, however, that “although a government company is supposed to operate in light of business considerations like a company in the private sector, the state as owner does not pressure a government company to maximize its profits as owners in the private sector do. This is true mainly in wholly-owned government companies.”<sup>13</sup> In companies that are not fully state-controlled, the state’s partners in ownership strive to maximize return, but their interests often do not coincide with those of the state.<sup>14</sup> In fact, board decisions advancing the company’s interests may actually harm the state as owner. Some directors interpret their duties as allowing, if not requiring, them to take action notwithstanding the state’s position.<sup>15</sup> Such situations are bound to breed frustration for all parties involved. Hence, it is generally advisable for the state to abstain from directly investing in business corporations.<sup>16</sup>

The events surrounding the 2008 global financial crisis put this general advice to the test. The federal government’s extension of financial support to business firms constituted a bold policy shift given the deep-rooted aversion to government involvement in business in the United States.<sup>17</sup> The Government developed a general “reluctant shareholder” policy regarding these investments<sup>18</sup> and strived to avoid taking control over supported firms.<sup>19</sup> Under this policy, the federal government sees itself as a reluctant owner of these firms due to the financial crisis and current recession and intends to dispose of its investments as soon as is practicable.<sup>20</sup> In the meantime, the

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- 12 REPORT OF THE COMMITTEE FOR THE PREPARATION OF A GOVERNMENT CORPORATIONS BILL (BARAK COMMITTEE) (1970) (Isr.) (“When they [the directors] face a conflict between the interest of the company and an external interest, including an interest of the state, they should resolve the conflict for the benefit of what they consider in good faith to be the interest of the government company”).
- 13 OFFICE OF THE STATE COMPTROLLER, ANNUAL REPORT 52B FOR YEAR 2001 AND ACCOUNTS FOR FISCAL YEAR 2000, at 329 (2002) (Isr.).
- 14 *Id.* at 331.
- 15 *Id.*
- 16 I avoid discussion of privatizing public sector tasks, which raises thornier issues.
- 17 See Joshua Brockman, *Is the U.S. “Nationalizing” Banks?*, NAT’L PUB. RADIO (last updated Oct. 14, 2008), <http://www.npr.org/templates/story/story.php?storyId=95700786>; see also OFFICE OF FIN. STABILITY, U.S. DEP’T OF THE TREASURY, AGENCY FINANCIAL REPORT: FISCAL YEAR 2009, at 12 (2009).
- 18 OFFICE OF FIN. STABILITY, *supra* note 17, at 42.
- 19 See OFFICE OF FIN. STABILITY, U.S. DEP’T OF THE TREASURY, AGENCY FINANCIAL REPORT: FISCAL YEAR 2010, at 24 (2010).
- 20 *Id.*; see Gerard Hertig, *Governments as Investors of Last Resort: Comparative Credit Crisis Case-Studies*, 13 THEORETICAL INQUIRIES L. 385 (2012).

Treasury refrains from interfering in the day-to-day management decisions of a company in which it is an investor, strives for a strong board of directors, and exercises its voting rights only with respect to core shareholder matters.<sup>21</sup>

The Bank of America's acquisition of Merrill Lynch and the Treasury's general policy objective to ensure the overall stability and liquidity of the U.S. financial system represent a familiar corporate governance conundrum regarding the power of the board to consider interests that are unrelated or even detrimental to the well-being of the firm and its shareholders. The national interest in stabilizing the financial system may have led Bernanke and Paulson, in light of their official roles, to pressure Bank of America's CEO, Ken Lewis, to proceed with the acquisition. But should Lewis have indeed gone forth with the transaction and perhaps even withheld material information from his shareholders? The answer would be an unequivocal yes were Bank of America in need of government financial assistance regardless of the Merrill Lynch deal, but it would be less straightforward were the motivation to assist the country in preventing systemic risk and a financial sector meltdown.<sup>22</sup>

In its capacity as a dominant investor in business firms, the U.S. government arguably could have done more to guide business strategy in ways that are consistent with the overall stability of the financial system. It could have directly instructed supported firms (or at least financial institutions) on what level of risk to assume, or it could have appointed Office of Financial Stability employees to sit on the boards of those firms. That the government has opted not to do so reflects the general policy described above: that it is preferable for the state to avoid any direct investment in business corporations.

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21 For further analysis, see Marcel Kahan & Edward B. Rock, *When the Government Is the Controlling Shareholder*, 89 TEX. L. REV. 1293 (2011).

22 Such multiple considerations might have been present in the actual circumstances. Alternatively, the government might have promised Bank of America financial assistance in order to hold it harmless with respect to the Merrill Lynch acquisition. In any event, Lewis did not deny that the national interest was a factor in the transaction. For a conference call with Lewis, see Heidi N. Moore, *Highlights and Lowlights of BofA's Earnings Call*, WALL ST. D. BLOG (Jan. 16, 2009, 11:06 AM), <http://blogs.wsj.com/deals/2009/01/16/highlights-and-lowlights-of-bofas-earnings-call/>.

## II. WHAT BOARDS (SHOULD) DO

### A. Board Responsibilities: The Legal Framework

Historically, companies were incorporated under individual charters that specified the objectives they were allowed to pursue. The ability to use the corporate form for any legal business came with the liberalization of corporation laws in the mid-nineteenth century. Companies have invariably had a board of directors since (and even before) the 1600 charter granted to the East India Company.<sup>23</sup> The early predecessors of the modern board were remarkably similar to their contemporary counterparts. These boards constituted an intermediate-level body of some two-dozen men appointed by the members (shareholders) for a limited period of time (usually one year) and vested with the power to appoint the company's primary executive, often from among themselves.

Doctrinally, the modern board of directors holds the power to manage or direct the management of the company's business. With mainly technical variations, this is the law in virtually all common law jurisdictions<sup>24</sup> as well as in other legal systems.<sup>25</sup> Principle VI of the *Principles of Corporate Governance* promulgated by the OECD provides a modern version of the board's mission: "The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders."<sup>26</sup>

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23 See Franklin A. Gevurtz, *The Historical and Political Origins of the Corporate Board of Directors*, 33 HOFSTRA L. REV. 89 (2004) [hereinafter Gevurtz, *Historical Origins*]; see also Franklin A. Gevurtz, *The European Origins and the Spread of the Corporate Board of Directors*, 33 STETSON L. REV. 925 (2004).

24 For the law in the United States, see, for example, MODEL BUS. CORP. ACT § 8.01 (2002); DEL. GEN. CORP. LAW § 141(a) (2012). For the law in the United Kingdom and jurisdictions influenced by it such as Australia and New Zealand, see PAUL L. DAVIES, GOWER AND DAVIES' PRINCIPLES OF MODERN COMPANY LAW 366 (8th ed. 2008); ROBERT R. PENNINGTON, PENNINGTON'S COMPANY LAW 696 (8th ed. 2001); see also Susan Watson, *The Significance of the Source of the Powers of Boards of Directors in UK Company Law*, 6 J. BUS. L. 597 (2011). In line with other common law systems, Israeli law provides that the board of directors shall set the company's policy and monitor the performance of the CEO's actions. Companies Law, 5759-1999, SH No. 2281 p. 390 § 92(a) (Isr.). The Israeli statute is therefore also in line with the OECD Principles discussed below.

25 See Gevurtz, *Historical Origins*, *supra* note 23, at 92.

26 OECD, OECD PRINCIPLES OF CORPORATE GOVERNANCE 24 (2004), available at <http://www.oecd.org/dataoecd/32/18/31557724.pdf>.

The OECD Principles obviously do not have the binding force of law, and they might not reflect the precise state of affairs in the corporate law of all countries. Nevertheless, the Principles do reflect a universal consensus on the proper structure of the board's responsibilities. Since their original promulgation in 1999, the Principles have had a tremendous impact on corporate governance legal reforms, especially in emerging economies, as well as on the contents of codes of corporate governance. The World Bank, for example, uses the OECD Principles as a benchmark for assessing the content and implementation of particular corporate governance codes around the world.<sup>27</sup> In light of their broad acceptance, these Principles, then, can be treated as a sort of universal declaration of board responsibilities.<sup>28</sup>

## B. Board Responsibilities and Structure

OECD Principle VI sets forth two separate responsibilities as well as an additional accountability provision. Under this Principle, the board in a well-functioning corporate governance framework is responsible for the strategic guidance of the company and the effective monitoring of management. There are fundamental tensions between the board's dual responsibilities, however. Indeed, to a degree, these responsibilities are incompatible with one another. They are grounded on different theoretical accounts and entail different, often conflicting, implications for policy and practice. To complicate things further, the predominant view in the literature is that the board of directors

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27 See *Reports of the Observance of Standards and Codes (ROSC)*, WORLD BANK GROUP, [http://www.worldbank.org/ifa/rosc\\_cg.html](http://www.worldbank.org/ifa/rosc_cg.html) (last visited Sept. 12, 2011):

The World Bank conducts corporate governance country assessments under the ROSC initiative at the invitation of country authorities. The World Bank uses a diagnostic tool — a Template — that it has developed to gather pertinent information for preparing the Corporate Governance ROSC. The Template has five sections that are based on the OECD Principles.

28 See ROSC, WORLD BANK GROUP, [http://www.worldbank.org/ifa/rosc\\_more.html](http://www.worldbank.org/ifa/rosc_more.html) (last visited Sept. 12, 2011):

The OECD Principles of Corporate Governance were agreed upon by a large number of countries of varied legal, economic and cultural traditions and after extensive consultation with the World Bank, the IMF, the Bank of International Settlements, and representatives of the business community from Japan, Germany, France, UK and the U.S., as well as emerging market governments, international investors, trade unions and other interested parties. As such, the OECD Principles represent the minimum standard that countries with different traditions could agree upon, without being unduly prescriptive. They are equally applicable to countries with civil and common law traditions, different levels of ownership concentration, and various models of board representation.

is an endogenous institution. That is, what the board in fact does and how it is structured in a particular firm may be both a cause and an outcome of other factors, including the firm's industry, its stage of development, its financial needs, the actual individuals on the top management team and the board itself, and so forth.<sup>29</sup> The tensions between the dual responsibilities have been brought to the forefront in the more recent literature and warrant some elaboration.<sup>30</sup> This Section discusses these tensions, which are closely intertwined with one another and, thus, may hinder direct state intervention with a view to promoting particular corporate governance goals, including shareholder protection through better monitoring by the board.

### *1. Tensions Between Monitoring and Strategy-Setting*

Positive law (at least in common law jurisdictions) and the academic literature have lately been focusing on monitoring, while showing less concern about strategy-setting. Apparently, the agency problem, alongside the concomitant monitoring responsibility contending with it, looms larger as a corporate governance challenge.<sup>31</sup> Such opportunistic behavior could take the form of extracting value from the company and its shareholders beyond previously agreed levels ("looting") or failing to exert one's best efforts in the interest of the company ("shirking").

The theoretical underpinnings of the board's strategy-setting responsibility are less well-developed. The advisory role account conceives of board members as counselors to management. In a survey of board members in

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29 See Benjamin E. Hermalin & Michael S. Weisbach, *Endogenously Chosen Boards of Directors and Their Monitoring of the CEO*, 88 AM. ECON. REV. 96 (1998).

30 See Renée B. Adams & Daniel Ferreira, *A Theory of Friendly Boards*, 62 J. FIN. 217 (2007). For a general survey, see Renée B. Adams et al., *The Role of Boards of Directors in Corporate Governance: A Conceptual Framework and Survey*, 48 J. ECON. LITERATURE 58, 74-80 (2010); see also Donald C. Langevoort, *Commentary: Puzzles About Corporate Boards and Board Diversity*, 89 N.C. L. REV. 841 (2011); Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797 (2001); James D. Westphal, *Collaboration in the Boardroom: Behavioral and Performance Consequences of CEO-Board Social Ties*, 42 ACAD. MGMT. J. 7 (1999).

31 Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

Fortune 400 firms, one director provided a good description of this advisory role:

I would say that the role of a director is to keep extremely well informed and just advise the management to the best of his ability. He can't do much more than that. Directors are sounding boards for management. They contribute their opinions as to general policy, and their judgment whenever a problem comes up.<sup>32</sup>

Partially overlapping with the advisory role view, the resource dependency theory holds that board members provide valuable resources to the firm. These resources include chiefly advice and counsel, legitimacy (e.g., due to board members' social status or reputation), channels of communication between the firm and external organizations (e.g., through board members' positions in other firms and organizations), and preferential access to important entities outside the firm (e.g., due to members' political connections).<sup>33</sup> Management scholars have marshaled evidence supporting these theories.<sup>34</sup>

The monitoring and strategy-setting roles have different ramifications for the relations between the board and the CEO. In its monitoring capacity, the board must adopt an adversarial mode of operation, whereas the strategy/advisory role has been characterized as "friendly."<sup>35</sup> To thwart the risk of managerial opportunism, a monitoring board must require accountability and transparency from the management. Psychological research shows, however, that accountability and transparency can create an unpleasant experience. Such situations may encourage the accountee to adopt various techniques for cutting discussions short, avoid decisions that are complex or hard to justify,

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32 JAY W. LORSCH WITH ELIZABETH MACIVER, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS 64-65 (1989).

33 JEFFREY PFEFFER & GERALD SALANCIK, THE EXTERNAL CONTROL OF ORGANIZATIONS: A RESOURCE-DEPENDENCE PERSPECTIVE 163 (1978).

34 See Barry Baysinger & Robert E. Hoskisson, *The Composition of Boards of Directors and Strategic Control: Effects on Corporate Strategy*, 15 ACAD. MGMT. REV. 72, 84 (1990) (regarding provision of information); Amy J. Hillman, Gerald D. Keim & Rebecca A. Luce, *Board Composition and Stakeholder Performance: Do Stakeholder Directors Make a Difference?*, 40 BUS. & SOC'Y 295 (2001) (regarding connections to stakeholders); Mark S. Mizruchi & Linda Brewster Stearns, *A Longitudinal Study of the Formation of Interlocking Directorates*, 33 ADMIN. SCI. Q. 194 (1988) (regarding connections to capital providers). For a survey, see Amy L. Hillman & Thomas Dalziel, *Boards of Directors and Firm Performance: Integrating Agency and Resource Dependence Perspectives*, 28 ACAD. MGMT. REV. 383 (2003).

35 Adams & Ferreira, *supra* note 30.

and tend towards seemingly simple solutions.<sup>36</sup> A closely-monitored CEO may thus prefer to keep her views to herself, avoid bringing up problems or difficulties in the boardroom, and stick to well-rehearsed scripts in board meetings.

The advisory role, in contrast, is premised on the notion of the board and CEO having supportive and mutually favorable opinions of one another. Ideal-type board meetings of the advisory kind are open, receptive to different vantage points — including critical views — and, on the whole, more tolerant of uncertainty, conflicting information, and ambiguity. But the friendly board is not a conglomeration of the CEO's buddies or people beholden to her. Rather, it is a non-adversarial board, whose members collectively seek to perform a task in cooperation with the top management team.

There are also stark differences between the legal rules underlying the board's monitoring role and the rules grounding its advisory/strategy-setting role. In a nutshell, the common law typically responds to agency (power) situations by imposing a duty of loyalty on agents, the core of which comprises a proscription on acting when in a conflict of interests and a duty of full disclosure of material information.<sup>37</sup> Although these are the characteristic features of trust relations, in their very essence, these legal doctrines reflect suspicion and anything but blind trust; trust hinges on accountability and transparency. In the corporation, these duties apply to both managers and their monitors — the directors. Courts have gone to great lengths to stress the stringency of the duty of loyalty. In contrast, the duty of care governs mostly board and managerial decisions untainted by concerns of disloyalty. Subject to rare exceptions, such decisions enjoy full deference, if not immunity, under the U.S. business judgment rule and equivalent rules of reasonableness in other legal systems.

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36 See generally Jennifer S. Lerner & Philip E. Tetlock, *Accounting for the Effects of Accountability*, 125 PSYCHOLOGICAL BULL. 255 (1999); Stefan T. Trautmann, Ferdinand M. Vieider & Peter P. Wakker, *Causes of Ambiguity Aversion: Known Versus Unknown Preferences*, 36 J. RISK & UNCERTAINTY 225 (2008) (showing that fear of negative evaluation may invoke ambiguity aversion).

37 Here, too, the sources are too numerous to cite in full. See generally MATTHEW CONAGLEN, *FIDUCIARY LOYALTY: PROTECTING THE DUE PERFORMANCE OF NON-FIDUCIARY DUTIES* (2011); Robert C. Clark, *Agency Costs Versus Fiduciary Duties*, in *PRINCIPALS AND AGENTS* 55 (John W. Pratt & Richard J. Zeckhauser eds., 1985); Robert Flannigan, *The Fiduciary Obligation*, 9 O.J.L.S. 285 (1989); Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795 (1983).

## *2. Independence on the Board*

The different implications of the board's monitoring and strategy roles for its composition and dynamics arise also in the context of two mechanisms commonly used to improve monitoring — namely, independent directors and separating the positions of chair and CEO.<sup>38</sup> It is quite apparent that a monitoring board could be meaningless if it is staffed by company insiders. How many tough questions can a CEO expect from board members who, in the regular course of business, report to her and are promoted (or demoted) by her? As Upton Sinclair famously quipped, “[i]t is difficult to get a man to understand something when his salary depends upon his not understanding it.”<sup>39</sup> This basic insight has motivated a major transformation in the composition of boards in many countries, toward having more independent directors on the board and fewer, if any, insiders. To a considerable extent, this trend represents a reaction (perhaps over-reaction) to the wave of scandals in the United States and Europe in the early 2000s. The details of this phenomenon vary from place to place, and thus, the definition of independent directors may not be identical everywhere. Some countries (such as the United States) require a majority of independents on the boards of public listed companies, whereas other countries make do with a recommendation via a corporate governance code backed by a comply-or-explain requirement. In yet other countries, the issue remains up to the shareholders to decide. As of yet, however, there is no conclusive evidence that majority independent boards are superior, which is consistent with the board as an endogenous institution in the corporation.<sup>40</sup>

Yet regardless of the definition of independence of a board member, whatever her workload beyond the particular directorship duties and whatever her background, she will be at an informational disadvantage regarding the firm relative to insiders sitting on the board. The latter by necessity know more about the firm, the reality of its labor relations, the difficulties and challenges of its operations, and so forth. The fewer insiders on the board, the more its deliberations could tend to neglect advising the CEO. Stated otherwise, the trend toward board independence may provide a sounder basis for the board's monitoring task and enhance its performance in this regard, but at the same time, this may also deplete the board of essential resources necessary for its strategy role.<sup>41</sup>

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38 The next Part deals with more general factors in board composition, including diversity and general personal attributes. The issues are intertwined, obviously.

39 UPTON SINCLAIR, I, CANDIDATE FOR GOVERNOR: AND HOW I GOT LICKED 109 (University of California Press, 1994) (1935).

40 See Adams et al., *supra* note 30.

41 Cf. Westphal, *supra* note 30.

Moreover, the more pronounced the distinction between inside and outside directors, the greater the likelihood of camps forming within the board. Even without romanticizing the functioning of the board as a team, it can be expected that interpersonal interactions will be smoother and more collaborative in a setting that does not place absolute priority on monitoring insiders as the “usual suspects.” This is an extension of the idea that the relations between the board and CEO can be friendlier or more adversarial, but not both at the same time. The nature of the board as an endogenous institution reflecting an equilibrium, compounded by casual observation of human nature, suggests that it would be difficult for a board to shift freely between “monitoring mode” and “strategy mode.”

A similar analysis applies to separating the positions of CEO and chairman of the board. This separation has become a shibboleth regarding good corporate governance. The underlying logic is straightforward. If monitoring is the board’s primary mission, what point is there to appointing the monitored entity at the head of the monitoring body? Suppose, however, that in a particular firm, for whatever reason, strategy-setting takes precedence over monitoring in terms of its potential contribution to firm value. This may be the case, for instance, if the firm is still at an entrepreneurial stage and or led by its founder (consider Steve Jobs, for example). In such cases, too, there is no unequivocal empirical evidence as to the desirability of separating the CEO and chairman positions.<sup>42</sup>

### *3. Board Responsibilities in Controlled Firms*

Much of the literature on the roles of the board and its structural features deals with widely dispersed companies, in which the agency relations and monitoring necessary to contend with this apply to management. However, in most countries, public firms have controlling or dominant shareholders.<sup>43</sup> In such firms, the board’s monitoring and strategy roles can both differ dramatically from the situation in widely dispersed firms. The economic literature on this subject is under-developed.<sup>44</sup> OECD Principle VI<sup>45</sup> does not refer to different ownership structures as a relevant factor that may

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42 See Adams et al., *supra* note 30.

43 See Stijn Claessens, Simeon Djankov & Larry H.P. Lang, *The Separation of Ownership and Control in East Asian Corporations*, 58 J. FIN. ECON. 81 (2000); Mara Faccio & Larry H.P. Lang, *The Ultimate Ownership of Western European Corporations*, 65 J. FIN. ECON. 365 (2002); Rafael La Porta et al., *Corporate Ownership Around the World*, 54 J. FIN. 471 (1999).

44 See Adams et al., *supra* note 30, at 101.

45 OECD, *supra* note 26.

affect the board's responsibilities, which remain strategic guidance and monitoring. Indeed, the World Bank asserts that the OECD Principles are equally applicable in different ownership concentrations.<sup>46</sup> However, there are fewer agency concerns about the top management team in controlled firms because the dominant shareholder has both sufficient incentives and the means to replace under-performing or opportunistic managers. Power relations and agency problems arise instead between the dominant shareholder and minority public shareholders, since the former can exert private benefits of control at the expense of the latter. Pyramidal holding structures, which are also quite common,<sup>47</sup> exacerbate this agency problem, as they bolster the dominant shareholder's power.<sup>48</sup>

Since the power to appoint the board of directors is vested in the general meeting, which is controlled by the dominant shareholder, the board may fulfill the latter's explicit requests and implicit expectations, including in regard to affiliated-party transactions and other forms of extracting private benefits. Various mechanisms to contend with this problem could rest on independent directors, or non-tainted shareholders, or both.<sup>49</sup> Be that as it may, it should be acknowledged that the board's ability to discharge its monitoring responsibility is weaker in controlled companies. The strategy role, however, is not necessarily weaker. Granted, strategic decisions in controlled companies likely reflect policies and guidance emanating from the dominant shareholder. But this fact need not diminish the importance of strategic advice at the particular firm level in support of the CEO and even of the dominant shareholder. In relative terms, therefore, in controlled firms, the board's strategy and advisory role could be more important than its monitoring role.

### C. Corporate Objective(s) Redux

The tensions between the monitoring and strategy roles of the board do not exhaust the complexity of the board's mission. Recall that under OECD Principle VI, in addition to strategic guidance and effective monitoring, “[t]he corporate governance framework should ensure . . . the board's accountability

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46 See *ROSC*, *supra* note 28.

47 La Porta et al., *supra* note 43.

48 See Lucian A. Bebchuk, Reinier Kraakman & George Triantis, *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights*, in *CONCENTRATED CORPORATE OWNERSHIP* 20 (Randall Morck ed., 2000).

49 See, e.g., ASIAN CORPORATE GOVERNANCE ASSOCIATION (ACGA), RULES & RECOMMENDATIONS ON THE NUMBER OF INDEPENDENT DIRECTORS IN ASIA (2010).

to the company and the shareholders.”<sup>50</sup> This formula mirrors the traditional legal doctrine in Delaware on the objectives of the corporation, as it was articulated in *Guth v. Loft* and has been reiterated in innumerable cases since 1939: “Corporate officers and directors . . . [w]hile technically not trustees, . . . stand in a fiduciary relation to the corporation and its stockholders.”<sup>51</sup> From this fiduciary relation stems the board’s accountability to the company and its shareholders.<sup>52</sup> As noted, at least the World Bank holds that “the OECD Principles represent the minimum standard that countries with different traditions could agree upon, without being unduly prescriptive. They are equally applicable to countries with civil and common law traditions.”<sup>53</sup>

If only things were so simple. The debate over the objectives of the business corporation is one of the oldest and probably the most fundamental in corporate law. The proposition that shareholders are the primary beneficiaries of the corporation and, hence, that directors’ fiduciary duties run to them is generally interpreted as calling on corporate fiduciaries to maximize (long-term) shareholder value.<sup>54</sup> The literature often refers to this proposition in shorthand as the “shareholder primacy norm” or the “shareholder wealth maximization norm.” Against shareholder primacy stands the “stakeholder approach,” which calls on corporate fiduciaries to take into account, in addition to shareholders’ interests, the interests of other constituencies as well, including employees, creditors, customers, and the community.<sup>55</sup>

Legal doctrine regarding the objectives of the corporation varies among different jurisdictions. Although common law and civil law jurisdictions have often been characterized as, respectively, shareholder-oriented and stakeholder-oriented,<sup>56</sup> even a cursory review refutes such a clear distinction. Thus, the laws of Delaware and of the United Kingdom endorse the shareholder-oriented

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50 OECD, *supra* note 26.

51 *Guth v. Loft*, 5 A.2d 503, 510 (Del. 1939); see also the seminal ruling in *Dodge v. Ford Motor Co.*, 204 Mich. 459, 170 N.W. 668 (Mich. 1919).

52 See *supra* text accompanying note 35; see also Amir N. Licht, *The Maximands of Corporate Governance: A Theory of Values and Cognitive Style*, 29 DEL. J. CORP. L. 649, 690-98 (2004).

53 See ROSC, *supra* note 28.

54 See, e.g., MICHAEL P. DOOLEY, *FUNDAMENTALS OF CORPORATION LAW* 97 (1995); D. Gordon Smith, *The Shareholder Primacy Norm*, 32 IOWA J. CORP. L. 277, 278 (1998).

55 For reviews, see Licht, *supra* note 52; Smith, *supra* note 54; see also Michael Bradley et al., *The Purposes and Accountability of the Corporation in Contemporary Society: Corporate Governance at a Crossroads*, 62 LAW & CONTEMP. PROBS. 9 (1999).

56 See, e.g., Bradley et al., *supra* note 55.

approach. In Delaware, the recent ruling in *Gheewalla*<sup>57</sup> underscored the logic of *Guth* and dispelled any possible ambiguities following *Credit Lyonnais*.<sup>58</sup> In the United Kingdom, section 172 of the Companies Act, 2006,<sup>59</sup> authorizes board members to consider the interests of non-shareholder constituencies but subordinates the latter to the primary objective of promoting “the success of the company for the benefit of its members [shareholders] as a whole.” In Canada, in contrast, the Supreme Court’s ruling in *BCE* endorsed an approach that balances the interests of different (financial) constituencies.<sup>60</sup> In the civil law tradition, German corporate law famously vests the managing board with the responsibility “to manage the corporation as the good of the enterprise and its retinue and the common weal of folk and realm demand.”<sup>61</sup> In China, the 2005 revision of its corporate law requires companies to “observe social morals” and to “assume social responsibility.”<sup>62</sup> Yet in Sweden, notwithstanding its well-known social democratic orientation, the objective of business corporations is to generate profits for shareholders.<sup>63</sup>

In theory, the law should inform board members and top executives on how to discharge their strategy-setting and monitoring duties. If the law prescribes shareholder wealth maximization, then the board should monitor the CEO and dominant shareholder not only for any attempts to illegitimately extract private benefits of control, but also for any illegitimate transfer of corporate value to non-shareholder stakeholders, for instance, by paying employees

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57 N. Am. Catholic Educ. v. Gheewalla, 930 A.2d 92 (Del. 2007).

58 Credit Lyonnais Bank Nederland v. Pathe Communications, 1991 WL 277613 (Del. Ch. 1991).

59 Companies Act, 2006, c. 46, § 172 (Eng.).

60 BCE v. 1976 Debentureholders, [2008] 3 S.C.R. 560 (Can.).

61 Aktiengesetz [AktG] [Stock Corporation Act], Sept. 6, 1965, BGBl. I at 1089, § 70(1) (Ger.) (*translated in Detlev Vagts, Reforming the “Modern” Corporation: Perspectives from the German*, 80 HARV. L. REV. 23, 40 (1966)). For a thorough analysis, see Martin Gelter, *Taming or Protecting the Modern Corporation? Shareholder-Stakeholder Debates in a Comparative Light*, 7 N.Y.U. J.L. & Bus. 641 (2011).

62 Zhonghua Renmin Gongheguo Gongsi Fa [The Company Law of the People’s Republic of China] (promulgated by the Standing Comm. Nat’l People’s Cong., Oct. 27, 2005, effective Jan. 1, 2006) § 5 (China) (for English translation, see *Companies Law of the People’s Republic of China*, THE NATIONAL PEOPLE’S CONGRESS OF THE PEOPLE’S REPUBLIC OF CHINA, [http://www.npc.gov.cn/englishnpc/Law/2007-12/13/content\\_1384124.htm](http://www.npc.gov.cn/englishnpc/Law/2007-12/13/content_1384124.htm) (last visited May 1, 2012)).

63 3 ch. 3 § AKTIEBOLAGSLAGEN [COMPANIES ACT] (Svensk författningsamling [SFS] 2005:551) (Swed.) (requiring companies with a different objective to state this clearly in their articles of association).

more than what they are owed<sup>64</sup> or by foregoing income and profits in order to avoid harm to the community.<sup>65</sup> Similarly, when the board must make strategic decisions, shareholder primacy prescribes a clear hierarchy, or ranking, of lines of action so that shareholders remain the primary beneficiaries.

Yet management scholars have long acknowledged that in order to survive and prosper, firms must strategically manage their relations with all stakeholders. Under R. Edward Freeman's seminal stakeholder theory, "[a] stakeholder in an organization is (by definition) any group or individual who can affect or is affected by the achievement of the organization's objectives."<sup>66</sup> Conceptually, stakeholder theory may imply at least three theoretical approaches — descriptive, instrumental, and normative — that are nested within one another.<sup>67</sup>

Anecdotal evidence suggests that the law notwithstanding, board members find it necessary to balance the interests of all stakeholders for effective strategic management. Jay W. Lorsch and Elizabeth MacIver found in their survey that the majority of board members consider themselves accountable to stakeholders more than to shareholders.<sup>68</sup> In a typical statement, one director asserted, "You have to consider, at all times, all of your stakeholders."<sup>69</sup> Lorsch and MacIver concluded that directors may feel trapped in the traditional legal responsibility towards shareholders and that board discussions "often resemble a charade where directors, working toward the corporation's long-term interests, avoid revealing their standards and criteria or their deep belief in the need for a broad [stakeholder] perspective."<sup>70</sup> Similarly, in a survey of board members in Canadian firms, one director noted, "Nothing

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64 Cf. *Parke v. Daily News*, [1962] Ch. 927 (Eng.).

65 Cf. *Shlensky v. Wrigley*, 237 N.E.2d 776 (Ill. App. 1968).

66 R. EDWARD FREEMAN, *STRATEGIC MANAGEMENT: A STAKEHOLDER APPROACH* 46 (1984); see also R. Edward Freeman & John McVea, *A Stakeholder Approach to Strategic Management*, in *HANDBOOK OF STRATEGIC MANAGEMENT* 189 (Michael A. Hitt et al. eds., 2001). For a critique, see Michael C. Jensen, *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, 7 EUR. FIN. MGMT. 297 (2001).

67 See Thomas Donaldson & Lee E. Preston, *The Stakeholder Theory of the Corporation: Concepts, Evidence, and Implications*, 20 ACAD. MGMT. REV. 65 (1995); see also Thomas M. Jones, *Instrumental Stakeholder Theory: A Synthesis of Ethics and Economics*, 20 ACAD. MGMT. REV. 404 (1995); Thomas Jones & Andrew Wicks, *Convergent Stakeholder Theory*, 24 ACAD. MGMT. REV. 206 (1999).

68 LORSCH WITH MACIVER, *supra* note 32.

69 *Id.* at 43.

70 *Id.* at 49.

is more important than good corporate governance. It's shareholder value . . . Stakeholder value is also important . . . It's not shareholder value by itself, but includes stakeholder value such as society, communities, etc., who produce dividends for shareholders. You have to weigh these things for good corporate governance.”<sup>71</sup>

### **III. NON-LEGAL FACTORS AFFECTING THE BOARD**

The preceding Parts reviewed several mechanisms that the state can implement in order to steer companies towards certain lines of action, particularly in order to improve corporate governance. The effectiveness of these measures is debatable at best. Suggesting policy measures beyond outright state control or direct legal prescriptions regarding the working of the board requires a broader vantage point that also considers board diversity. Diversity in this context refers to board members' personal attributes, in particular, their individual values, which could be pivotal for directing board members in handling strategic issues. This Part explains how state intervention in board composition, which affects these personal attributes, could provide an alternative — perhaps better — mechanism for attaining corporate governance goals.

#### **A. Diversity and the Board: Three Approaches**

As an entity of individuals, the board of directors can be homogenous in its personal makeup only to a degree. I leverage Thomas Donaldson's and Lee Preston's taxonomy to identify three approaches for analyzing board heterogeneity: descriptive, instrumental, and normative.<sup>72</sup> Accordingly, one could ask descriptively whether the laws in different countries regulate board composition in some way, e.g., by prescribing representation of employees, women, or minorities. Or one could ask whether in the absence of such laws, boards of directors show diversity on such dimensions. These are important questions, to which answers often are not readily available in the form of reliable data.<sup>73</sup> Dealing with diversity on the board from an instrumental perspective means asking whether “diversity works” — namely, if having

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71 RICHARD LEBLANC & JAMES M. GILLIES, INSIDE THE BOARDROOM: HOW BOARDS REALLY WORK AND THE COMING REVOLUTION IN CORPORATE GOVERNANCE 26-27 (2005).

72 Donaldson & Preston, *supra* note 67.

73 For an excellent survey of the empirical literature on diversity and the board that makes even a cursory review here redundant, see Deborah L. Rhode & Amanda K. Packel, *Diversity on Corporate Boards: How Much Difference Does*

more board seats occupied by non-majority individuals is associated with certain outcomes.

Until not too long ago, a typical U.S. board was dominated by white, mid-fifties, wealthy men who were predominantly Protestant and Republican.<sup>74</sup> One should be specific about which attribute is being analyzed: Is it race, age, gender, occupation, and so forth? Discussions of diversity in the abstract, without reference to a particular attribute, presume that there is no diversity in diversity. While diversity could have some general consequences at a high level of generality,<sup>75</sup> a better approach should specify what particular attribute is at bar. Such an approach may be crucial for identifying the mechanisms through which diversity exerts its influence. Having more women on the board, or more ethnic minority members, or more employees may or may not have the same impact on the working of the board and on the company. This is because the mechanism channeling the effect of diversity may be sensitive to these attributes. For example, the resource dependence theory of boards suggests that consumer-oriented firms might benefit from gender and race diversity on the board, as this might improve strategy-setting thanks to the informal knowledge and intuitions about different market segments. Studies of demographic diversity on U.S. boards have found, however, that the effects of diversity may depend on additional conditions, including board members' social ties, CEOs' ingratiation and persuasion tactics toward institutional investors, and ingratatory behavior among peer directors.<sup>76</sup>

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*Difference Make?* 30-32 (Rock Ctr. for Corp. Governance, Working Paper No. 89, 2010), available at <http://ssrn.com/abstract=1685615>.

74 James D. Cox, *Changing Perceptions into Reality: Fiduciary Standards to Match the American Directors' Monitoring Function*, 1 BOND L. REV. 218, 218 (1989); Marleen A. O'Connor, *Women Executives in Gladiator Corporate Cultures: The Behavioral Dynamics of Gender, Ego, and Power*, 65 MD. L. REV. 465, 468 (2006).

75 See SCOTT E. PAGE, *THE DIFFERENCE: HOW THE POWER OF DIVERSITY CREATES BETTER GROUPS, FIRMS, SCHOOLS, AND SOCIETIES* (2007). For a short review of the psychological literature on diversity in general (unrelated to corporate governance), see Jennifer K. Brooke & Tom R. Tyler, *Diversity and Corporate Performance: A Review of the Psychological Literature*, 89 N.C. L. REV. 715 (2011).

76 See Westphal, *supra* note 30; James D. Westphal & Michael K. Bednar, *Pluralistic Ignorance in Corporate Boards and Firms' Strategic Persistence in Response to Low Firm Performance*, 50 ADMIN. SCI. Q. 262 (2005); James D. Westphal & Laurie P. Milton, *How Experience and Network Ties Affect the Influence of Demographic Minorities on Corporate Boards*, 45 ADMIN. SCI. Q. 366, 369 (2000); James D. Westphal & Ithai Stern, *The Other Pathway*

The latter findings also point to the possible outcomes of board diversity. The empirical evidence on these outcomes, especially with regard to financial performance, remains unclear.<sup>77</sup> Individual-level diversity within the board likely also affects the way the board operates as a team. This Article does not deal with this issue, as this would require deploying a separate theoretical framework. A full account of the outcomes of diversity would reveal a nuanced picture. Richer board discussions thanks to additional vantage points could also breed prolonged discussions or a higher likelihood of discord. When diversity is imposed on the company by a state affirmative action policy, the result could be board appointees with lesser relevant qualifications. An instrumental approach analysis of board member diversity should strive to identify all of the possible material outcomes that could arise.

Finally, a normative approach to board member diversity seeks to define which outcomes that can be associated with diversity in a certain attribute could be beneficial or detrimental. For instance, Renée Adams and Daniel Ferreira found that more gender-diverse boards in U.S. firms are tougher monitors, which is associated, *inter alia*, with women's better board meeting attendance and committee participation.<sup>78</sup> The authors also found, however, the average effect of gender diversity on firms' financial performance to be negative, possibly due to over-monitoring in well-governed firms, where shareholders may be sufficiently protected against firm agents.

Adams and Ferreira's analysis focuses on the monitoring role and on financial performance as the corporate objective. This reflects a normative stance (even if not necessarily the authors') endorsing shareholder wealth maximization. In tandem, consider the evidence that firms with a higher share of seats held by women tend to respond to economic downturns with fewer workforce reductions, which may lead to higher employment costs at the immediate expense of shareholders.<sup>79</sup> It could be concluded from

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*to the Boardroom: Interpersonal Influence Behavior as a Substitute for Elite Credentials and Majority Status in Obtaining Board Appointments*, 51 ADMIN. SCI. Q. 169 (2006); James D. Westphal & Edward J. Zajac, *Who Shall Govern? CEO/Board Power, Demographic Similarity, and New Director Selection*, 40 ADMIN. SCI. Q. 60, 77 (1995).

77 Rhode & Packel, *supra* note 73.

78 Renée B. Adams & Daniel Ferreira, *Women in the Boardroom and Their Impact on Governance and Performance*, 94 J. FIN. ECON. 291 (2009).

79 See Davia A. Matsa & Amalia R. Miller, *A Female Style in Corporate Leadership? Evidence from Quotas* (Working Paper, 2011), available at <http://ssrn.com/abstract=1636047>. For consistent evidence, see Øyvind Bøhren & R. Øystein Strøm, *Aligned, Informed, and Decisive: Characteristics of Value-Creating Boards* (EFA Ljubljana Meetings Paper, 2007), available at <http://ssrn.com/>

this that firms with more gender-diverse boards might be managed with a multiple-stakeholder objective — sacrificing shareholder value in the interest of employees. At the same time, it could also be that retaining a well-trained workforce through an economic downturn is in the shareholders' long-term interest. Again, ascribing a normative judgment to this evidence requires a normative stance on the basic question of the corporation's primary objective.

### **B. Regulation of Board Composition: Politics by Other Means**

In discharging board responsibilities, does it matter that a board member has no significant economic or family affiliation with company insiders — i.e., that he or she is independent? Does it matter that the board member is a woman? A work council member? A CEO of another company? At first blush, the answer seems to be no: All board members should comply with their legal duties to act loyally and in good faith in the best interests of the corporation. The law on the objectives of the corporation may vary across jurisdictions, but within a particular jurisdiction, it applies uniformly and equally to all board members. Under this reasoning, there may be some variation among individuals in how they perform their monitoring or advisory tasks, but these variances should be random and not systematically contingent on personal attributes. Based on this simple view, board members will respond only to incentives due to remuneration, shareholdings, and legal liability and to family ties where applicable. In reality, however, a whole array of objective and subjective personal attributes can systematically affect how board members discharge their director duties. Objective attributes include observable qualities such as gender, race, and occupation. Relational attributes — namely, affiliation or independence — can also be classified as objective. Since a very large body of literature already deals with objective attribute diversity,<sup>80</sup> this Article focuses on subjective ones, particularly individual values.

The endogeneity of board composition makes it difficult to assess the outcomes of the different board features.<sup>81</sup> Consequently, it may also be

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abstract=966407; see also Alfred Yawson, *Evaluating the Characteristics of Corporate Boards Associated with Layoff Decisions*, 14 CORP. GOVERNANCE: INT'L REV. 75 (2006).

80 See Adams et al., *supra* note 30; Hermalin & Weisbach, *supra* note 29; Rhode & Packel, *supra* note 73; see also Malcolm Baker & Paul A. Gompers, *The Determinants of Board Structure at the Initial Public Offering*, 46 J.L. & ECON. 569 (2003); Jeffrey L. Coles et al., *Boards: Does One Size Fit All?*, 87 J. FIN. ECON. 329 (2008); James S. Linck, Jeffry M. Netter & Tina Yang, *The Determinants of Board Structure*, 87 J. FIN. ECON. 308, 316 (2008).

81 Adams et al., *supra* note 30, at 59.

difficult to assess regulatory intervention in board structure. Such intervention may be warranted if it could be shown that the voluntary, market equilibrium is suboptimal due to some market failure. For instance, if a collective action problem were to prevent public shareholders from exercising effective monitoring of management or a dominant shareholder, this could be grounds for requiring a majority of independent directors instead of firm insiders on the board. This reasoning weakens, however, if strategy-setting is a more pressing issue for the firm than monitoring, e.g., in entrepreneurial firms or during crisis.

Assessment of regulatory intervention in board composition may be tricky, moreover, if the purpose of that intervention is precisely to shift firms from the market equilibrium. It may be tempting to label the motivation for such intervention “political” as opposed to efficiency-oriented. An important stream in the corporate governance literature indeed argues that political forces and motives have stood behind major corporate governance reforms in the United States and in many other market economies.<sup>82</sup> There is no need to resort to Maoist rhetoric that “everything is political” to acknowledge that *any* equilibrium with regard to the corporation, and the board’s strategy role more specifically, inevitably has significant political implications simply because it determines the division of power and wealth among various corporate constituencies. The argument that a policy mandating employee representation on the board is “inefficient” because it might erode profits at the expense of shareholders will not have much traction among policy-makers who, for political reasons, place a higher priority on redistributing profits (as long as firms survive) than on maximizing those profits.

### C. Personal Attributes: Individual Values

Values are trans-situational, abstract desirable goals, ordered by importance, that serve as guiding principles in peoples’ lives. Often defined as conceptions of the desirable, values guide the way individuals select actions, evaluate people and events, and explain or justify their actions and evaluations.<sup>83</sup>

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82 See PETER GOUREVITCH & JAMES SHINN, *POLITICAL POWER AND CORPORATE CONTROL: THE NEW GLOBAL POLITICS OF CORPORATE GOVERNANCE* (2005); MARK J. ROE, *POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE* (2003); MARK J. ROE, *STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE* (1994).

83 MILTON ROKEACH, *THE NATURE OF HUMAN VALUES* (1973); Clyde Kluckhohn, *Values and Value Orientations in the Theory of Action, in TOWARD A GENERAL THEORY OF ACTION* 383 (Talcott Parsons & Edward A. Shils eds., 1951); Shalom H. Schwartz, *Universals in the Content and Structure of Values: Theoretical*

Among the numerous psychological factors in which individuals may differ, values emerge as particularly central. Steven Hitlin and Jane Piliavin suggest that values occupy an important place within individuals' social psychology.<sup>84</sup> Shalom Schwartz proposes that the structure of values may point the way toward a unifying theory of human motivation.<sup>85</sup> A growing number of studies link value priorities to behavior and to social roles.<sup>86</sup> Although most of the evidence in this regard is correlational, recent studies have found that activating values *causes* behavior that is conceptually consistent with them.<sup>87</sup>

In a study conducted with Renée Adams and Lilach Sagiv, a quasi-experimental approach was used, where board members and CEOs of public corporations in Sweden were given a set of vignettes based on seminal legal cases such as *Dodge v. Ford*,<sup>88</sup> which dealt with dilemmas between shareholders and other stakeholder constituencies.<sup>89</sup> These top executives exhibited a systematic approach to different dilemmas that mapped onto a single dimension of shareholderism versus stakeholderism stances. Shareholderism thus stands for an ideology-like, principled, motivated stance that gives primacy to shareholder wealth-maximization, whereas stakeholderism is an equally principled position that sees merit in a variety of corporate constituencies. Board members' shareholderism stances were

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*Advances and Empirical Tests in 20 Countries, in ADVANCES IN EXPERIMENTAL SOCIAL PSYCHOLOGY 1* (Mark Zanna ed., 1992).

- 84 Steven Hitlin & Jane A. Piliavin, *Values: Reviving a Dormant Concept*, 30 ANN. REV. SOC. 359 (2004).
- 85 Shalom H. Schwartz, *Basic Values: How They Motivate and Inhibit Prosocial Behavior*, in PROSOCIAL MOTIVES, EMOTIONS, AND BEHAVIOR 221 (Mario Mikulincer & Phillip R. Shaver eds., 2009); see also Steven Hitlin, *Values as the Core of Personal Identity: Drawing Links Between Two Theories of Self*, 66 SOC. PSYCHOL. Q. 118 (2003); Meg J. Rohan, *A Rose by Any Name? The Values Construct*, 4 PERSONALITY & SOC. PSYCHOL. REV. 255 (2000).
- 86 A body of large literature on judgment and decision-making, which are outside the scope of this article, analyzes the role of cognitive processes, see, e.g., HEURISTICS AND BIASES: THE PSYCHOLOGY OF INTUITIVE JUDGMENT (Thomas Gilovich et al. eds., 2002); DAN ARIELY, PREDICTABLY IRRATIONAL: THE HIDDEN FORCES THAT SHAPE OUR DECISIONS (2008).
- 87 Bas Verplanken & Rob W. Holland, *Motivated Decision-Making: Effects of Activation and Self-Centrality of Values on Choices and Behavior*, 82 J. PERS. SOC. PSYCHOL. 434 (2002); Lilach Sagiv, Noga Sverdlik & Norbert Schwarz, *To Compete or to Cooperate? Values' Impact on Perception and Action in Social Dilemma Games*, 41 EUR. J. SOC. PSYCHOL. 64 (2011).
- 88 Dodge v. Ford Motor Co., 204 Mich. 459, 170 N.W. 668 (1919).
- 89 Renée B. Adams, Amir N. Licht & Lilach Sagiv, *Shareholders and Stakeholders: How Do Directors Decide*, 32 STRATEGIC MGMT. J. 1331 (2011).

situated along a continuum between these two ideal-type, polar positions. Board members who scored higher on shareholderism tended to emphasize power and achievement and de-emphasize universalism. They also put emphasis on self-direction and de-emphasis on conformity. In regressions that control for other objective attributes, including age, gender, and role, as well as firm-level attributes, such as firm and board size, higher power, achievement, and self-direction and lower universalism robustly predicted stronger shareholderism stances.

Thus, board members will more strongly endorse corporate actions that benefit shareholders the more their values are compatible with the economic interests of equity investors — values that emphasize wealth attainment, competitiveness, and venturing. This value profile reflects a Schumpeterian “entrepreneurial spirit.”<sup>90</sup> Giving primacy to shareholders is consistent with the nature of the business corporation as a vehicle for venturing and entrepreneurship. The evidence reflects substantial variability — that is, diversity — not only in board members’ value profiles but also in the strategies they indicate as desirable in shareholder-stakeholder dilemmas, notwithstanding the clear legal duty to enhance shareholder value. Apparently, this seemingly clear prescription provides ample room for managerial discretion. In other words, board members may make strategic decisions in light of internal subjective injunctions — because of who they are — and not only in line with external injunctions or incentives.

To put the above findings into context, we also examined the diversity of value priorities across different groups. In particular, we compared average value priorities of regular board members as a group to those of employee representative board members. We also compared board members’ values to those of a representative sample of the general population in Sweden. In brief, the value profile of regular directors and CEOs<sup>91</sup> reflects a significantly stronger Schumpeterian “entrepreneurial spirit” than the value profiles of employee representatives and the general population. Employee representatives and the general population attribute lesser importance than do regular directors and CEOs to power, achievement, stimulation, and self-direction as values and greater importance to universalism, benevolence, conformity, and security. The figure below presents a graphic depiction of these differences. Although

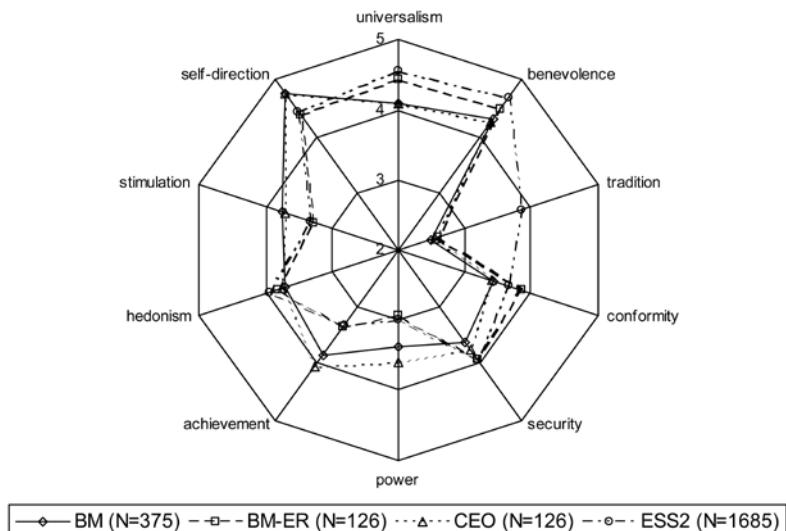
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90 See Amir N. Licht, *The Entrepreneurial Spirit and What the Law Can Do About It*, 28 COMP. LAB. L. & POL’Y J. 817 (2007). For Schumpeter’s classic account, see JOSEPH A. SCHUMPETER, THE THEORY OF ECONOMIC DEVELOPMENT 93-94 (R. Opie trans., Oxford Univ. Press 1961) (1934).

91 Regular board members and CEOs exhibit a very similar value profile, except that, as might be expected, CEOs score somewhat higher on power and achievement.

there are some differences between employee representatives and the general population, overall, the former are rough proxies for the general population in terms of value profile.

### Value Priorities of Regular Board Members, Employee Representatives, CEOs, and the General Population<sup>92</sup>



*Legend:* BM — board members; BM-ER — employee representative board members; CEO — CEOs; ESS2 — Swedish representative sample from the European Social Survey Round 2

In a related analysis, Renée Adams and Patricia Funk looked more closely at differences between male and female directors in Sweden.<sup>93</sup> Two interesting observations emerged: First, in comparison to male board members, female directors are higher on universalism and benevolence and lower on power and higher on stimulation and lower on security and conformity. Thus, one cannot say that female directors are less entrepreneurial than their male counterparts. There is another way to conceptualize these differences, namely, as manifesting a more complexity-oriented value profile. Second, female directors tend to be less shareholderist than their male counterparts regardless

92 Renée B. Adams, Amir N. Licht & Lilach Sagiv, *Shareholderism: Board Members' Values and the Shareholder-Stakeholder Dilemma* (ECGI—Finance, Working Paper No. 204/2008, 2008), available at <http://ssrn.com/abstract=1118664>.

93 Renée B. Adams & Patricia Funk, *Beyond the Glass Ceiling: Does Gender Matter?*, 58 MGMT. SCI. 219 (2012).

of their value priorities. This finding conforms with Davia Matsa's and Amalia Miller's finding that Norwegian firms with more female directors may be more reluctant to respond to economic downturns with workforce reductions.<sup>94</sup>

Further research is needed to confirm the idea that values similarly affect board members' shareholderism in strategic decisions in different national institutional environments. At the same time, it would be wrong to treat this preliminary evidence as unique due to its particular country of origin. The distinctiveness of the ten values and their structural relations have been verified in the vast majority of more than 200 samples from over sixty-five countries. This supports using the Schwartz model as a universal model of human motivations. The vignettes also originate from common law jurisdictions and are not unique to Sweden.

## CONCLUSION

This contribution to the discussion on state intervention in corporate governance has reviewed and considered different modes of intervention. The 2008 financial crisis notwithstanding, direct state control over companies through holding control blocks (as distinguished from financial support) remains inadvisable as a tool for directing corporate conduct toward socially desirable goals. The efficacy of state regulation of corporate governance with regard to board members' conduct in important strategic situations may be considerably limited insofar as it relies on direct legal prescriptions. Corporate law can enshrine certain general duties but can do only little beyond that in terms of conduct regulation intended to promote a particular corporate governance policy. Recent evidence underscores the importance of board composition regulation. If representatives of different corporate constituencies or social subgroups indeed differ in their subjective personal attributes in a way that is systematically linked to corporate governance outcomes, then board composition may offer an effective vehicle for intervention to promote such national policies.

This Article points to a central mechanism that may lead to much broader consequences than the immediate goals of such regulations. Because values are trans-situational motivational goals, they could foster conceptually consistent behavior in contexts that extend beyond these immediate goals. Importantly, to the extent that the results for employee representatives and women generalize to additional objective attributes, the different value profiles that diverse board members bring to the boardroom may wield their influence on strategic decisions above and beyond any effect due to objective attributes.

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94 Matsa & Miller, *supra* note 79.