The Nominating Process for Corporate Boards of Directors: A Decision-Making Analysis

Michael E. Murphy

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Michael E. Murphy

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The Nominating Process for Corporate Boards of Directors: A Decision-Making Analysis

I. INTRODUCTION

The nominating procedure for electing directors to the corporate board has turned the formal legal structure of corporate governance on its head. The shareholders may be equity owners of the corporation, but when they are presented with an unopposed slate of directorial candidates, without having practical means of nominating their own candidates, it is clear that management effectively controls the corporate ballot.

The dominance of management over the electoral process may be justified as an inevitable adaptation to the pattern of diffuse share ownership in the large publicly traded corporation, but the anomaly of a system that inverts formal legal structure and defies democratic sensibilities by presenting shareholders with a one-party slate has generated unease leading to two avenues of reform. The first reform approach, based on the authority of section 14 of the Securities Exchange Act of 1934 (Exchange Act), is the concept of direct shareholder access to the management proxy. The Securities and Exchange Commission (SEC) proposed this reform in 1942 and 2003, and came very close to doing so in again 1980 following a three-year investigation. The opposing reform is the establishment of a nominating committee, which first became popular as an alternative to the SEC’s threatened reform in the late 1970s and evolved to become an active and important corporate institution, guided by a broad consensus as to best practices.

The nominating process, like other aspects of corporate governance, affects corporate decision making—indeed corporate governance is a sub-system of decision making within the corporation—but the two avenues of reform have been pursued without reference to the remarkable scientific progress in understanding the processes of human decision making during the past 40 years. Behavioral research, in general, has made few inroads into the scholarship of corporate governance and has not reached the important sphere of the nominating process. Scholarly studies of corporate governance and scientific progress in understanding decision making have existed in separate worlds.

The purpose of this article is to view the two approaches to the nominating process from the perspective of decision-making research. I will first trace the history of the idea of direct shareholder access to the management proxy, leading to the SEC’s elaborate 2003 proposal. We will see that the public comment to this proposal in fact stressed a number of decision-making considerations, which can be placed under the headings of collegiality,
diversity, and independent monitoring, but it did not draw directly from scientific research. Next I will review the brief history of the nominating committee, which spans a period of only 30-years as a widespread and significant institution.

After completing these historical accounts, I will briefly survey the salient findings of descriptive decision-making research that fall within the matters of public concern revealed in the SEC comments. I will then critique the alternative reforms from the perspective of empirical knowledge of decision making. I contend that the two approaches are both defective, though each has certain positive aspects. The 2003 SEC proposal, which effectively sought to institutionalize the concept of an insurgent director, would have a disruptive impact on board proceedings, but it would arguably strengthen the benign influence of institutional investors on the environment of corporate decision making. The nominating committee preserves the vital value of cooperation but it runs afoul of other reefs and shoals revealed by modern decision-making research.

Lastly, I will discuss alternatives to the two traditional reforms that might be authorized with federal legislation under the Commerce Clause. I limit myself to four options: modification of the two traditional reforms, the idea of reserved shareholder seats on the board, direct shareholder intervention in the nominating committee, and experimentation with a compound board of directors.

II. DIRECT SHAREHOLDER ACCESS TO MANAGEMENT PROXY

A. Fair Corporate Suffrage

The proxy solicitation process, regulated by section 14(a) of the Exchange Act, forms the context for our analysis of the nomination procedures for corporate directors. The landmark New Deal legislation on securities law began with the Securities Act of 1933 (Securities Act), which dealt with the initial distribution of securities. The Exchange Act, passed the next year, represented an ambitious effort to regulate the secondary trading of securities; it prohibited certain fraudulent and manipulative practices, established a system of self-regulation of the securities exchanges, and, in section 14, conferred regulatory power on the SEC to reform the proxy solicitation process.

Before the New Deal years, proxy solicitation provided no more than a transparent façade of legitimacy to self-perpetuating management groups. In a cautious understatement, the Senate Report observed: “Too often proxies are

solicited without explanation to the stockholder of the real nature of the matters for which authority to cast his vote is sought. In fact, the proxy commonly consisted of a postcard that the shareholder was urged to sign and return, which gave management authority to vote on certain vaguely described matters and take other action it considered “desirable.” Berle and Means commented, “For the most part the stockholder is able to play only the part of the rubber stamp.”

As the Supreme Court has noted, the “broad remedial purposes” of section 14 are evidenced in the statutory language, which makes it “unlawful for any person . . . to solicit . . . any proxy or consent or authorization in respect of any security . . . registered on any national securities exchange in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.”

The House Report explains that section 14 has the objective of assuring “fair corporate suffrage”:

Fair corporate suffrage is an important right that should attach to every equity security bought on a public exchange. Managements of properties owned by the investing public should not be permitted to perpetuate themselves by the misuse of corporate proxies . . . . Inasmuch as only the exchanges make it possible for securities to be widely distributed among the investing public, it follows as a corollary that the use of the exchanges should involve a corresponding duty of according to shareholders fair suffrage. For this reason the proposed bill gives the Federal Trade Commission power to control the conditions under which proxies may be solicited with a view to preventing the recurrence of abuses which have frustrated the free exercise of the voting rights of stockholders.

Some commentators have cautioned against placing too much reliance on a single phrase in the legislative history, but the Senate Report contains similar

language. It notes that proxy regulation will "render it impossible for brokers having no beneficial interest in a security to usurp the franchise power of their customers and thereby deprive the latter of their voice in the control of the corporations in which they hold securities." And, most decisively, the Supreme Court has cited the House Report as reflecting legislative intent. The decision in *J. I. Case Co v. Borak* states that section 14 "stemmed from the congressional belief that "[f]air corporate suffrage is an important right that should attach to every equity security bought on a public exchange.""

Though drawn from the language of political discourse, the legislative intent to assure "fair corporate suffrage" is plainly limited to those specific powers granted to shareholders by statute. In an article subtitled, *A Program for Fair Corporate Suffrage*, Mortimer Caplin, who served as Commissioner of Internal Revenue under two presidents, wrote that the essential element of corporate democracy is "the untrammeled right of recall, at least on an annual basis, over those managers whose records are not found to be satisfactory." This right of recall, he argued, forms part of a "system of checks and balances against possible managerial abuse." In the sense employed by Caplin, fair corporate suffrage merges with the more general concept of self-regulation, i.e., the capacity of an organization to detect deviations from a desired standard and to adopt needed corrections. Shareholders exercising their right of suffrage are a vehicle for corporate self-regulation.

**B. The Proxy System**

The regulations promulgated by the SEC under section 14 of the Exchange Act soon established the contours of the proxy system that exists today. In general, all proxy solicitations must be accompanied by a proxy statement, meeting certain detailed requirements, which must be filed with the SEC before being disseminated to shareholders. Pursuing the mandate of fair corporate...
suffrage, the Commission issued regulations on shareholder mailing privileges and the inclusion of shareholder proposals in the management proxy statement. In 1942, the Commission considered, and then backed away from, a more significant measure: the inclusion of shareholder nominees for director in management proxy materials.

As initially proposed by the SEC staff, the 1942 regulations provided that, if a shareholder notified management of an intention to nominate a candidate for the board of directors at the annual meeting, the management was required to set forth the shareholder nomination in its proxy materials together with the nominees proposed by the management itself. In the event shareholders should nominate more than twice as many nominees as there were directors of the company, the management could "select, on any equitable basis, name and furnish the required information concerning only twice as many nominees as there are directors." The regulation ultimately adopted further codified the shareholder proposal regulation and shareholder options for mailing proxy materials, but the Commission raised objections to the idea of allowing shareholder nominations in the management proxy materials, and it was not pursued further. Five years later, apparently fearing that the shareholder proposal rule could be used as a vehicle to introduce shareholder nominations, the Commission closed this avenue for shareholder suffrage by prohibiting shareholder proposals applying to "elections to office."

The effect of the proxy rules under the Exchange Act was to shift the locus of decision making from the annual shareholder meeting to the proxy solicitation process. The annual meeting served merely to record voting that had already taken place in response to proxy solicitation. Very few shareholders went to the trouble to attend the meetings, which might be held in small rooms in distant locations, and the theoretical right of shareholders to nominate corporate directors or introduce proposals at the meeting became wholly meaningless. By the time the shareholder meeting was held, the votes were already cast and a shareholder would gain nothing by appealing to the

18. See Hearings Before Committee on Interstate and Foreign Commerce on H.R. 1493, H.R. 1821 and H.R. 2019, 78th Cong. at 17-19, 34-36, 161 (rule X-14a-2(b)).
20. For an analysis of the Commission's objections, so far as they appear on the record, see Seligman, supra note 10, at 13-14.
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insignificant number of shareholders in attendance.22

The SEC regulations did enable shareholders to solicit proxies at their own expense. Upon a shareholder’s request, management was required to choose between producing a shareholder list sufficient to allow the shareholder to mail its soliciting materials or mailing the materials itself and charging the shareholder for the cost.23 But the salutary intention of this regulation was subverted by the advantages of incumbency possessed by management—many shareholders could be expected, out of inertia or a conservative reflex, to always support management’s positions. Moreover, the high cost of proxy solicitation effectively deterred shareholder solicitations, except in contests for control.24 State courts liberally upheld the right of management to expend corporate funds on behalf of its candidates for director but gave a shareholder only the right to apply for a discretionary reimbursement of the costs of proxy solicitation if it succeeded in securing a position of influence or control of the board.25 If a shareholder sought control of a corporation the potential economic benefits might be enough to justify the cost of a proxy contest. In the ordinary course of corporate governance, however, the cost equation alone was enough to assure management domination of the proxy process; it gave management virtually unlimited access to funds to promote its candidates while affording other shareholders only a “slim possibility of reimbursement if they should triumph over shareholder inertia and concerted management opposition to win a seat on the board.”26

A decade after passage of the Exchange Act, the rules governing the proxy system enabled shareholders to make informed decisions in certain matters subject to shareholder approval, such as corporate reorganizations, contests for control, and shareholder proposals, but they gave shareholders no voice in the central function of the corporation: the selection of directors to the governing board of the corporation. Apart from an occasional contest for control, the shareholders, deprived of access to the proxy machinery, were presented with a single slate of management-nominated candidates for approval.27Shareholders

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24. Id. at 1917; Eisenberg, supra note 22, at 1499.


27. See 40TH ANNUAL REPORT OF THE SECURITIES EXCHANGE COMMISSION 33 (1974). During the fiscal year ended June 30, 1974, the SEC received proxy statements for 6,615 annual meetings for election of directors. Only 15 companies were engaged in proxy contests for election of directors. Of
did not even have the option of voting against the candidates since state law generally permitted election of directors by a plurality of votes cast.\textsuperscript{28} As in the days of Berle and Means, shareholders were "able to play only the part of the rubber stamp," at least with respect to selection of directors.\textsuperscript{29}

\textbf{C. The 1977 SEC Proceedings}

In 1977 the Securities and Exchange Commission announced that it would conduct a re-examination of the impact of proxy rules on corporate governance.\textsuperscript{30} It posed a series of questions for public comment and scheduled hearings in four cities. The Commission placed particular emphasis on the subject of shareholder participation in the corporate electoral process and specifically asked:

Should shareholders have access to management's proxy soliciting materials for the purpose of nominating persons of their choice to serve on the board of directors? What criteria, if any, should be applied to shareholders who wish to have access to management proxy soliciting materials for purpose of making nominations?\textsuperscript{31}

In a timely article, Professor Seligman called on the Commission to give shareholders access to the management proxy for purpose of nominating directors, but he acknowledged that there were problems in "designing a system of access to the corporate proxy," which would insure "(1) that outside shareholders have the opportunity to make nominations; and (2) the proxy is not overloaded with so many nominees that rational selection of directors becomes difficult."\textsuperscript{32} He proposed detailed rules to overcome these difficulties.\textsuperscript{33} Among other things, he recommended that only shareholders with a certain minimum share ownership should be allowed access to the corporate proxy and that the total number of shareholder nominations be limited to two for each board vacancy.\textsuperscript{34}

The problems raised by Seligman were a central focus of public comment.

\footnotesize

\textsuperscript{28} Thirty five jurisdictions, including Delaware, provide expressly that directors are elected by plurality vote. See \textit{MODEL BUS. CORP. ACT ANNOTATED}, at 7191-92 (3d ed. 2000).

\textsuperscript{29} See BERLE & MEANS, \textit{supra} note 6, at 89.


\textsuperscript{32} Seligman, \textit{supra} note 10, at 13.


\textsuperscript{34} Seligman, \textit{supra} note 10, at 14.
Advocates of shareholder participation in the electoral process proposed a variety of restrictions on the shareholder nomination privileges intended to avoid confusion in the corporate electoral process, but they varied widely on specific ideas. For example, the proposed standing requirements for shareholder nominations to be included in the corporate proxy varied from ten percent of share ownership to 0.1 percent. Corporate commentators saw no solution to practical difficulties; any formula for shareholder access to management proxy was likely to "politicize" the board and engender "hostility." As an alternative, they pointed to the new, but rapidly growing, practice of establishing nominating committees of the board.

After conducting the hearings, the Commission issued certain disclosure rules but deferred consideration of "more complex matters," until preparation of a comprehensive staff report. The report, issued in 1980, again suggested further study prior to regulatory action, recommending investigation of 1980 proxy data to determine the extent to which corporate nominating committees were actually considering shareholder nominations. If corporations were not displaying progress in processing shareholder nominations, the report recommended that the Commission authorize the staff to develop an appropriate rule to this end.

With the change to a Republican administration in 1980, the Commission's interest in experimentation waned; it would not return for 23 years to the controversy of nomination procedures for the corporate board. But the anomalies of the corporate electoral process were not ignored by legal scholars and, in the preface to its 1992 reform of proxy rules, the Commission acknowledged that it had received comments highlighting "the difficulty experienced by shareholders in gaining a voice in determining the composition of the board of directors." It described as "appealing" proposals

35. SEC & EXC. COMM'N, STAFF REPORT ON CORPORATE ACCOUNTABILITY 110-13, printed for Senate Committee on Banking, Housing and Urban Affairs, 96th Cong. 2d Sess. at 110-113 (1980) (hereafter "SEC CORPORATE ACCOUNTABILITY REPORT").
36. Id. at 100, 117.
37. Id. at 101, 115, 117.
40. SEC CORPORATE ACCOUNTABILITY REPORT, supra note 35, at 125-27, 131.
to require the corporate proxy statement to include shareholder nominees, but elected to address only "a more limited problem" pertaining to certain directorial nominations.

Shareholder proposals to place shareholder nominations in the corporate proxy materials enjoyed some success in the early 1980s, despite the rule excluding shareholder proposals relating to an election. Proponents needed to make the difficult argument that the exclusionary rule concerned only the election of particular persons to the corporate board and did not apply to procedural rules applying prospectively to future elections to the board. At first appearing to accept the argument, the SEC staff denied several requests for no-action letters, but in 1990 the staff took a harder line, issuing four no-action letters that allowed management to exclude such proposals from its proxy statement. In the next decade, no proposal for shareholder access to the management proxy appears in the record of shareholder proposals actually voted upon in large public corporations.

D. The 2003 SEC Proposal

The Enron bankruptcy and the ensuing corporate scandals prompted the SEC to undertake its most ambitious review of the proxy rules affecting nominations for corporate director. The catalyst was a series of proposals of the American Federation of State, County, and Municipal Employees (AFSCME) Pension Fund for binding bylaw amendments giving shareholders defined rights of access to the corporate proxy directorial nominations. The proposals were submitted to six companies, which all refused to include them in their proxy statement. The SEC staff upheld the refusals on the ground that the proposals related to "an election for membership on the company's board of directors . . ." When the AFSCME appealed, the Commission let the no-

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43. Id.
44. The problem involves a revision of rule 14a-4, which provided a procedure for a shareholder to solicita "short slate" of shareholder nominees contesting less than all of the positions on the board. See 17 C.F.R. § 240.14aa-14a-4(d)(4) (2007).
45. 17 C.F.R. § 240.14a-8(i)(8).
46. See LOSS & SELIGMAN, supra note 16, at 2045.
49. The most accessible record of shareholder proposals in these years may be found in the Annual Corporate Review of Georgeson, Inc. See http://www.georgeosonshareholder.com (research and press releases).
action letters stand but directed the Division of Corporate Finance to consider possible changes in the proxy rules under section 14(a) of the Exchange Act. A press release issued May 1, 2003, solicited public input on the Division’s review of proxy rules relating to the nomination and election of directors.  

After receiving almost 700 comments, the Division of Corporate Finance proposed an intricate and lengthy regulation, denominated rule 14(a)-11, resting on a concept without precedent in earlier SEC proceedings or scholarly commentary: the shareholder right of access to the corporate proxy materials would be activated by a “triggering event” justifying shareholder intervention in the nominating process for a limited period. Upon the occurrence of a triggering event, certain large shareholders could invoke a highly circumscribed privilege of access to the corporate proxy materials to nominate directors who would be more attentive to their concerns. In effect, the Commission proposed an “insurgent director” model of shareholder access to the nominating process.

The regulation proposed two triggering events: (1) a management nominee for director received “withhold” votes from more than thirty-five percent of the votes cast at the previous annual shareholder meeting; or (2) a shareholder proposal calling for the company to be subject to the new rule 14(a)-11, submitted by a shareholder or group of shareholders, with more than one percent of the company’s voting stock, received fifty percent of the votes cast at the shareholder meeting. For the two annual meetings immediately following a triggering event, shareholders would have a limited right of access to management proxy materials in nominating directors.

The nominating right under the proposed regulation was restricted to a shareholder or group of shareholders owning five percent of the company’s voting securities continuously for the two previous years. The right was further restricted to shareholders reporting their ownership on Exchange Act Schedule 13G, that is, to institutional investors acquiring their five percent ownership “in the ordinary course of business and not with the purpose nor the effect of changing or influencing the control of the issuer . . .” Thus, the shareholder’s right to actively engage in the nomination process was paradoxically limited to passive institutional investors.

To make a nomination qualifying for inclusion in the management proxy materials, the shareholder was required to give the company requisite notice

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53. Id. at 59 (proposed § 240.14a-11(a)(2)).
54. Id. at 9, 59.
55. Id. at 61 (proposed § 240.14a-11(b)(1) and (2)).
56. Id. (proposed § 240.14-11(b)(3) and (4)).
containing elaborate representations designed to assure, among other things, that the shareholder nominees would be free of conflict of interest and would satisfy the standards of independence established by an applicable national security exchange.58 The shareholder or shareholder group could nominate up to two candidates for the typical board of 9 to 20 members. For a smaller board, it could nominate only one candidate and for a larger board it could nominate three candidates. The shareholder or shareholder group could not exercise this right, however, if the board already had the prescribed number of shareholder-nominated directors, i.e., two directors for a nine-member board.59 Where more than one shareholder group gave notice of intent to nominate directorial candidates, the company would be required to include in its proxy materials only the nominees of the group with the largest beneficial ownership of its securities.60

The shareholder nomination procedure was available only to the extent permitted by state law. Also it could not be invoked if the law of the company’s state of incorporation permitted corporations to adopt a bylaw or provision in articles of incorporation prohibiting shareholders from nominating candidates.

Despite its very limited scope, the proposal aroused an intense controversy that can now be reviewed in the SEC Comments file.61 Among both opponents, led by the Business Roundtable, and proponents, with a strong base in pension funds, an important focus of attention was on the decision-making processes of the corporate board. Both offered widely varying scenarios of the effect of the proposed procedure on (a) relations of collegiality among board members, (b) the presence of diverse perspectives (or agendas) in board deliberations, and (c) the board’s capacity to exercise effective oversight of management.

Stressing the value of collegiality, the Business Roundtable noted that board members “must function as a team, within a culture of trust and candor, if the board is to be effective.”62 The election of shareholder-nominated directors, it feared, would “disrupt board dynamics and balkanize boards.”63 Echoing this concern, a spokesman of The Boeing Company maintained that “the nomination and election of ‘special interest directors’ who further the agendas of the shareholders who nominated them . . . could lead to the creation of divisive boards that have difficulty functioning as a team.”64 The American Society of Corporate Secretaries was concerned that the proposed nomination

58. See supra note 52, at 61-64 (proposed § 240.14a-11(c)).
59. Id. at 65 (proposed § 240.14a-11(d)(1) and (2)).
60. Id. at 65-66 (proposed § 240.14a-11(d)(3)).
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system would also “make the relationship between investors more adversarial because the system culminates in a contested election.”65 Seconding this concern, the Association of Corporate Counsel predicted that the proposal would “result in a more confrontational and adversarial relationship between directors and shareholders.”66

In contrast, the Council of Institution Investors, an organization of more than 140 pension funds, saw a benefit in introducing “‘outside’ directors with new viewpoints. Groups, such as boards of directors,” it argued, “benefit from members’ diverse perspectives and different experiences.”67 The Social Investment Forum, another investor organization, added that “most investors believe creative tension on a board is not a bad thing.”68 All proponents saw potential gains in board accountability and independence from management.69

A coalition of 12 large public employees pension funds argued that the corporate scandals of recent years revealed a need for “effective oversight of the corporate managers who nominate th[e] directors” as part of a system of “greater checks and balances on company executives.”70 In a particularly sophisticated comment, the president of the AFSCME suggested that “the access right would be used sparingly” but would “promote meaningful communication between shareholders and boards of directors.”71

E. Impasse

In the face of opposition from the business community, the SEC took no action on the proposed rule 14(a)-11, but the question remained whether shareholders could still secure access to the management proxy by a shareholder proposal for a binding bylaw amendment. It was soon answered. In 2004, the AFSCME Employees Pension Fund submitted a shareholder proposal with The Walt Disney Company that would allow shareholder nominations pursuant to the guidelines of the proposed SEC rule. The SEC staff allowed the company to exclude the proposal from the management proxy in a no-action letter.72 Undeterred, the AFSCME initiated another similar shareholder

proposal for the 2007 annual meeting of Hewlett-Packard Co. To defeat the measure, Hewlett-Packard simply relied on a bylaw requiring a two-thirds vote for bylaw amendments, and let it go to a shareholder vote. The measure received only thirty-nine percent of the votes cast—far short of the number needed for passage. The supra-majority requirement was one of several potential defenses that management might have employed; it might also have imposed inconvenient notice requirements, stringent shareholder qualification rules, or restrictions mirroring the conditions of SEC rule 14a-8. If these barriers should prove insufficient, management might have pursued counter initiatives; it is an open question in Delaware and certain other states whether the board of directors has the power to repeal a shareholder-initiated bylaw by adopting a superseding bylaw amendment.

In short, the lack of support from the SEC and the array of potential defensive measures available to management effectively ruled out shareholder-initiated bylaws as an alternative route for reform of the proxy process.

III. THE NOMINATING COMMITTEE

The business associations and corporate executives opposing direct shareholder access to the management proxy, from The Business Roundtable to Hewlett-Packard, point to the corporate nominating committee as a preferred alternative. These committees, according to one executive, "are uniquely situated to determine the variety of skills and backgrounds that are necessary for a particular company’s board.” The proposed shareholder-access rule, it is argued, would undercut the important functions of the nominating committee by failing to assign it any role in screening or approving shareholder nominations. A spokesman for the Business Roundtable reports that almost three-fourths of nominating committees “have a process in place to accept and

weeks later reversed its position.

76. Shareholder-initiated bylaw amendments to bar use of shareholder rights plans as an anti-takeover device (i.e., poison pills) present different practical and legal issues, which may encourage use of the binding bylaw amendment in this area. Compare Teamsters v. Fleming, 975 P.2d 907 (Okla. 1999), with Invacare Corp. v. Healthdyne Tech., Inc., 968 F. Supp. 1578 (N.D. Ga. 1997).
79. E.g., Carol Ward, Corporate Secretary, CIGNA Corporation Jan. 2, 2004, supra note 61; B. Kenneth West, Chairman, National Association of Corporate Directors, Mar. 26, 2004, supra note 61; Johnson, supra note 64; McKinnell, supra note 64, at 49; Wolf, supra note 65, at 2.
respond to shareholder nominations for director positions.”  

Since the corporate nominating committee reflects existing practice, with its strengths and weaknesses, it does indeed deserve close examination.

Until the late 1970s, relatively few companies had any formal procedures for selecting candidates for boards of directors. While directorial elections were subject to elaborate procedures mandated by the SEC and state laws, the nomination of the slate of candidates was regarded as a personal prerogative of the CEO. On the basis of interviews in the late 1960s, Mace observed, “Most executives interviewed confirmed that the selection of new directors was controlled and decided by the president.” The prevailing theory was that the CEO needed to form an effective team and the choice of directors formed part of that task. Twenty years later, Lorsch and Maclver still found many CEOs referring to the corporate board as “my directors.”

The nominating committee emerged as a common feature of corporate governance in the late 1970s largely in response to the SEC investigation of shareholder participation in the corporate electoral process. Regulations issued in 1978 called for disclosure of whether a company had a nominating committee, whether its members were independent of management, and whether the committee considered shareholder recommendations for director and, if so, the procedures to be followed in making such recommendations. In proposing these regulations, the Commission stated that it believed “that the institution of nominating committees can represent a significant step in increasing shareholder participation in the corporate electoral process.”

According to Conference Board surveys, the percentage of companies with nominating committees stood at only eight percent in 1971, rose to fifteen percent by 1977, and roughly doubled in the next two years. By 1980, thirty-two percent of surveyed corporations reported having a nominating committee. The Conference Board study noted that management saw the nominating committee as being far preferable to the alternative of direct shareholder access to the proxy machinery. For its part, the SEC saw “the use of nominating committees as a vehicle for shareholder participation” in the

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80. Odland, supra note 63, at 14.
82. Id. at 94-101.
87. Id. at 12.
nomination of directors.\textsuperscript{88} As we have seen, the 1980 staff report on shareholder participation in the corporate electoral process deferred consideration of direct shareholder nominations for directors pending a study of "the extent to which these [nominating] committees are considering shareholder nominations"\textsuperscript{89}—a study that never came to fruition.

A Corporate Director's Guidebook issued in 1976 by the ABA Committee on Corporate Laws described the nominating committee as "potentially the most significant channel for improved corporate governance."\textsuperscript{90} By providing a forum for shareholders to submit recommendations for directors, the nominating committee would offer "a more effective and workable method of affording access to the nominating process to individual shareholders than a direct 'right' of nominating in the corporation's proxy material."\textsuperscript{91} The American Law Institute (ALI) issued in 1982 Tentative Draft No. 1 of Principles of Corporate Governance, which seconded the ABA call for nominating committees composed exclusively of directors who are not officers in large public corporations. Using political terminology, an ALI consultant, Joseph Hinsey, saw the nominating committee as a screening mechanism comparable to the electoral college as originally envisioned by the founding fathers. He argued "that the independent nominating committee concept provides an effective response to the claimed erosion of so-called shareholder democracy that has been long bemoaned by corporate reformers."\textsuperscript{92} The committee "provides the essential link to both the effective yet practical participation of the shareholders in the corporate electoral process and the effective independent review function that is at the forefront of the board's monitoring role."\textsuperscript{93}

The nominating committee gained popularity in the 1980s, though it lagged behind the vision reflected in the ABA and ALI statements. By 1992, sixty-four percent of companies surveyed by the Conference Board possessed a nominating committee,\textsuperscript{94} but the committee met median average of only two times a year in large companies and often only once in smaller companies.\textsuperscript{95} The committees were increasingly composed of independent directors, though

\textsuperscript{88} SEC CORPORATE ACCOUNTABILITY REPORT, supra note 35, at 119.

\textsuperscript{89} Id. at 125.

\textsuperscript{90} Comm. on Corp. Laws, A.B.A., Corporate Director's Guidebook, 32 BUS. LAW. 5, 35 (1976).

\textsuperscript{91} Id.; see also Comm. on Corp. Laws, A.B.A., The Overview Committees of the Board of Directors, 35 BUS. LAW. 1335, 1341-1342 (1980); The Bus. Roundtable, The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation, 33 BUS. LAW 2083, 2110 (1978).


\textsuperscript{93} Id. at 69.

\textsuperscript{94} JEREMY BACON, THE CONFERENCE BD., CORPORATE BOARDS AND CORPORATE I1, Research Report No. 1036 (1993).

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the CEO or another officer was sometimes a committee member. In any event, as one executive remarked, the CEO’s membership on the committee was largely a “cosmetic” matter since he worked closely with committee members in identifying and approving candidates whether or not formally a member.

But the vision of the nominating committee as a vehicle for shareholder participation in the nominating process never became a reality. Institutional investors were rarely represented on corporate boards in the 1980s. The Conference Board’s 1992 survey reported that only three percent of the firms had received suggestions concerning directorial nominees from institutional investors, and “just one company stated that it had acceded to the demand of a large shareholder that an outside director be placed on the board.” After conducting some 80 interviews of corporate directors in the late 1980s, Lorsch and MacIver concluded that “shareholders are obviously not involved [in selecting directors] until the election phase, and even at this point, their impact is negligible.”

The spread of the nominating committee did not change the CEO’s dominant role in the nomination process. The committee was unlikely to propose a candidate to the board over the CEO’s opposition, and by most credible accounts, the CEO remained the principal source of ideas for nominees to directorships throughout the 1980s. Lorsch and Maclver reported, “In spite of these changes [involving the nominating committee], the directors’ influence is still limited in comparison to the CEO’s. For the most part, there is a division in responsibility between the CEO, who identifies new candidates, and the nominating committee or full board, which evaluates and formally nominates candidates.”

More recently, at some point in the last 10 or 15 years, the nominating committee seems to have made a quantum shift to become a bona fide working unit of the board. In 2006, it was found in ninety-nine percent of S & P 500 companies, according to a Spencer Stuart survey. The committee met an

96. See BACON, supra note 86, at 28 (in 1981, a corporate officer, usually the CEO, sat in almost half of the committees); BACON, supra note 95, at 10-11.
97. Id.
98. BACON, supra note 95, at 6-8; see also id. at 12 (“Today, however, shareholder participation in the nominating process has been modest and has had little impact on the membership of the boards (with exception of situations such as proxy fights).”). Compare BACON, supra note 87, at 25, 30.
99. BACON, supra note 95, at 16; see also MICHAEL USEEM, INVESTOR CAPITALISM: HOW MONEY MANAGERS ARE CHANGING THE FACE OF CORPORATE AMERICA 132 (1996) (In a survey of 375 firms in 1992, only six percent “had received even a single director nomination from an institutional investor.”).
100. LORSCH & MACIVER, supra note 83, at 22.
101. BACON, supra note 86, at 24; BACON, supra note 95, at 16; LORSCH & MACIVER, supra note 83, at 20.
102. Id. at 21-22.
average of 3.9 times a year and meetings typically lasted almost two hours; it nearly always operated under a written charter defining its responsibilities; and the committee members usually elected their own chairman.104 Today, a commentary in the Listing Company Manual of the New York Stock Exchange (NYSE) describes the nominating committee as "central to the effective functioning of the board."

The significance of nominating committee is now closely linked to the role of independent directors. Following passage of the Sarbanes-Oxley Act,106 both the New York Stock Exchange and the NASDAQ Exchange required listed companies to appoint independent directors, as defined by the Exchange rules, to a majority of positions on their boards.107 An average seventy-four percent of board members in companies with over $10 billion in revenues were independent directors in a 2004 survey.108 Strengthening these requirements, the Exchanges extended the policy of directorial independence to nominating committees. NYSE rules now require the nominating committee to be composed entirely of independent directors.109 The NASDAQ Exchange adopted a rule with much the same effect, though it contains exceptions of minor significance.110

The contemporary influence of the CEO in the nominating process is difficult to assess in the absence of studies comparable to those conducted in the late 1980s, but it is clear that CEO's may have the dominant voice in the nominating process even if not included in the membership of a nominating committees composed of independent directors.111 The ALI Principles of Corporate Governance, adopted in 1994, note that "the chief executive officer, can be expected to be highly active in recommending to and discussing candidates with the committee and in recruiting candidates for the board," and adds that such participation of the CEO in the nominating process can be

105. NYSE, INC., LISTED COMPANY MANUAL, Commentary, § 303A.04.
107. See NYSE, INC., supra note 105, at §§ 303A.01, 303A.02; NASDAQ, INC., MANUAL § 4350(c)(1). The Sarbanes-Oxley Act of 2002, Public L. No 107-204, § 301, 116 Stat at 776, established standards of independence for directors on the audit committee requiring changes in SEC regulations and Exchange Rules. The Exchanges, however, went well beyond compliance with the Act and issued more extensive regulation of directorial independence on the board itself.
109. NYSE, INC., supra note 105, at § 303A.04.
110. NASDAQ, INC., supra note 107, at § 4350(c)(4). As an alternative to creating a nominating committee, a company may nominate directors by a majority vote of independent directors on the board. A single non-independent director may sit on the nominating committee under "exceptional and limited" circumstances, and the board must recognize a legally enforceable right of third parties to nominate directors.
111. John C. Bogle, the founder of Vanguard mutual funds, offers the skeptical opinion: "Even when there is a theoretically independent nominating committee, the CEO is apt to control the slate." John C. Bogle, Democracy in Corporate America, 33 DAEDALUS (Summer 2007).
achieved "without making the CEO a member of the committee." A handbook of the National Association of Corporate Directors (NACD) suggests that these practices continue to be widespread. "Most directors," the handbook reports, "recognize the need to have the CEO closely aligned with the new director selection process. Some companies have found from personal experience that providing the CEO with veto power may be a reasonable middle ground." A sample committee charter attached to the handbook states explicitly that committee should select nominees "with direct input from the CEO."

In a minority of companies, the slowly growing movement to separate the position of CEO and Chairman of the Board may have introduced more complex patterns of interaction between the nominating committee and management, and the now common practice of appointing a "lead director" to preside over executive sessions of the independent directors may have had somewhat the same effect. Empirical evidence, however, is lacking on how these practices affect the nominating process.

For all practical purposes, institutional investors and other shareholders continue to be excluded from the nominating process. Surveys reveal that representatives of institutional investors do not figure among the populations from which directors are drawn. According to the executive director of the Council of Institutional Investors, "[O]ur members' sense is that shareowner-suggested candidates—whether or not submitted to all-independent nominating committees—are rarely given serious consideration." To the same effect, the 2003 SEC staff report on the nominating process observed, "[A]lthough shareholders generally may recommend candidates to a company's nominating committee or group of directors fulfilling this role, shareholders have indicated that this is not effective, as companies rarely nominate candidates recommended by shareholders."

Nevertheless, the SEC adopted still more elaborate disclosure rules in 2003.
with the objective of encouraging nominating committees to consider shareholder recommendations. The revised rules require, among other things: disclosure of the committee’s policy regarding shareholder recommendations for directorial candidates, a description of procedures to be followed by shareholders in submitting such recommendations, whether the committee has received a recommended candidate from a shareholder or group of shareholder holding five percent of the stock of the company within 120 days of the date of the proxy statement, and whether the committee chose to nominate such candidate.119 A 2006 survey of Spencer Stuart, however, records no shareholder nominations three years after the effective date of the disclosure rules.120

As it exists today, the original purpose of the nominating committee as an avenue for shareholder participation in the selection of directors remains unfulfilled, but the committee figures in a set of “best practices,” enunciated by authoritative voices in U.S. industry. “The Corporate Handbook 2005” of the Conference Board, under the heading “Setting a New Standard for Corporate Governance,” notes that “[t]he Enron Bankruptcy, accompanied by other corporate scandals and the resulting regulatory response, has caused a sea change in the attention given corporate governance and in how directors are viewed by the public, shareholders, employees, and the courts.”121 The functions of the nominating committee forms one of the principal chapters in the Handbook’s description of best corporate governance practices.122 Similarly, in its “Principles of Corporate Governance,” the Business Roundtable states “that the United States has the best corporate governance, financial reporting and securities market systems in the world. These systems work because of the adoption of best practices by public companies within a framework of laws and regulations.”123 A separate statement of principles sets forth recommended practices for nominating committees.124

The nominating committee practices advocated by The Conference Board and the Business Roundtable are notable in two respects: they respond to public criticism of corporations by calling on the nominating committees to follow desirable practices in selecting independent and qualified members of the board, and, in addition, they advocate a broad charter of responsibilities for these committees, which are now often designated corporate governance committees. In addition to identifying and evaluating candidates to the board,

120. STUART, supra note 103, at 14.
121. BRANCATO & PLATH, supra note 108, at 7.
122. Id. at 36-47.
the associations recommend that nominating committees should review committee structure, recommend candidates for membership of committees, oversee efficient functioning of the board, annually evaluate performance of the board and committees, propose corporate principles, and oversee succession planning for the CEO and other senior management positions.¹²⁵

IV. THE RELEVANCE OF DECISION-MAKING RESEARCH

A. Introduction

Corporate boards, as recently as the 1980s, defined their roles narrowly, limiting their responsibilities to hiring and firing the CEO and performing the essentially ceremonial function of approving the CEO’s decisions during his tenure. But for more than a decade there has been a strong trend toward more active participation of the board in corporate decision making, stimulated by the expectations of institutional investors, the scandals of the Enron period, and the pressures of the Sarbanes-Oxley legislation.¹²⁶ Corporate boards are now generally held accountable for approving strategic plans, financial policies, and material transactions, as well as for monitoring management performance.¹²⁷

In view of its evolving role, a necessary and fundamental criterion for evaluating any proposed reform affecting the corporate board is the impact of the reform on decision making. The two historical approaches to reform of the nominating process that we have reviewed—direct shareholder access to the management proxy and an active nominating committee—were in fact both intended to improve the corporate decision-making process and must be evaluated in terms of how they accomplish (or might accomplish) this end. As noted earlier, the public comments on the 2003 SEC proposal for shareholder access in fact repeatedly raised decision-making considerations relating to collegiality, diversity, and independent monitoring.¹²⁸ These same considerations will guide our analysis here.

To properly address the issues, however, we must first traverse a complex body of basic research in the fields of management science, social psychology and the behavioral school of law and economics.¹²⁹ My limited purpose is to

¹²⁵ See id.; The Business Roundtable, supra note 123, at 21-23; BRANCATO & PLATH, supra note 108, at 36; STUART, supra note 103, at 6 (Responsibility for succession planning generally falls to the compensation committee (forty-four percent), the nominating committee (thirty-six percent), or a combination of both.).


¹²⁸ See supra note 61-71 and accompanying text.

¹²⁹ See, e.g., Donald Langevoort, Behavioral Theories of Judgment and Decision Making in Legal Scholarship: A Literature Overview, 51 VAND. L. REV. 1499 (1998); Christine Jolls et al., A Behavioral
provide some general orientation to salient features of these fields that will inform later discussion. (Readers familiar with this behavioral research may skip to page 40.) The research on point concerns the descriptive study of decision making, i.e., the study of how human decisions are actually made, and will not involve the related field of prescriptive decision making, which provides methodologies for analysis of complex decisions.  

B. Background

Within the field of economics, the descriptive study of human decision-making processes can be traced to the concept of bounded rationality, introduced by Simon and March, which draws attention to the inevitable human tendency to make suboptimum decisions based on incomplete information. Building on this concept, a generation of behavioral economists, led by Kahneman and Tversky, explored specific cognitive biases in decision making. These biases, it became clear, represent simplified decision-making strategies, or heuristics, that commonly work but can harden into irrational assumptions. A prevalent heuristic, for example, is that of anchoring and adjustment by which people predict outcomes by adjusting from an original baseline. This approach may be quite reasonable but it becomes an irrational bias when the original value is arbitrary or the decision-makers make insufficient adjustments from this value. In an experiment, subjects were asked to give the last four digits in their social security numbers and then were asked to estimate the number of physicians in Manhattan. The estimates bore an empirical relationship to the value of the social security numbers. The tendency to engage in anchoring and adjustment cannot be easily overcome by professional training. Real estate brokers disclaim the relevance of the seller’s list price to the appraisal of market value, but experiments how that their appraised values are influenced by the list price to a similar degree as those of nonprofessionals.

By the 1980s, the study of decision-making heuristics had developed into a coherent and enduring body of knowledge. Bazerman finds 13 categories of heuristics employed in business decision making, each with a predictable

130. See MAX H. BAZERMAN, JUDGMENT IN MANAGERIAL DECISION MAKING 6-7 (6th ed. 2006) (an authoritative text on the cognitive biases in human decision making with a principal focus on issues relevant to business management).


132. See BAZERMAN, supra note 130, at 6-10.

133. Id. at 29-31.


135. BAZERMAN, supra note 130, at 162-63.
potential for error.\textsuperscript{136} In an article entitled \textit{From Homo Economicus to Homo Sapiens}, Thaler predicts that economists will increasingly incorporate such behavioral findings in more complex "models of quasi-rational emotional human beings."\textsuperscript{137} Pursuing this challenge, Camerer et al have mapped out an research agenda to better inform economic analysis by incorporating data from neuroscience on behavioral regularities in human behavior.\textsuperscript{138}

Approaching the subject from an entirely different direction, neurologists discovered in the 1990s an unsuspected link between feeling and decision making.\textsuperscript{139} It is within common experience that emotions can interfere with sound judgment, but studies of brain-damaged patients revealed that, without a neurological capacity to have feelings, people can not make reasonable decisions. It turns out that the biological capacity of the brain to map the well being of the body, yielding feelings of happiness, sadness, embarrassment, humiliation, etc., is also used to scan possible outcomes in light of past experience in the process of making decisions. Patients who have lost the neurological capacity to experience feelings are unable to navigate their way through life and are fully disabled by an inability to make ordinary daily decisions.

This discovery of the neurological link between feelings and decision making parallels recent psychological research on non-cognitive biases in decision making, such as egocentrism, ingroup favoritism, and bounded awareness (i.e., the ways in which people fail to see what is immediately before them).\textsuperscript{140} These biases again are compelling tendencies that are found among the most intelligent and professional decision makers. Before the Enron debacle, behavioral theorists argued that it was psychologically impossible for auditors, who were placed in a position of conflict of interest, to exercise independent judgment.\textsuperscript{141} Loewenstein notes extensive empirical evidence that "people tend to conflate what is personally beneficial with what is fair or

\begin{itemize}
\item \textsuperscript{136} \textit{Id.} at 13-40.
\item \textsuperscript{137} Richard H. Thaler, \textit{From Homo Economicus to Homo Sapiens}, 14 \textit{J. ECON. PERSPS.} 133-141 (Winter 2000).
\item \textsuperscript{138} Colin Camerer et al., \textit{Neuroeconomics: How Neuroscience Can Inform Economics}, 43 \textit{J. ECON. LITERATURE} 9 (2005).
\item \textsuperscript{139} Two widely acclaimed books by Antonio Damasio, a leading neurological researcher, provide a non-technical survey of recent research findings. See ANTONIO R. DAMASION, DESCARTES' ERROR: EMOTION, REASON AND THE HUMAN BRAIN (1994); ANTONIO R. DAMASION, LOOKING FOR SPINOZA: JOY, SORROW AND THE FEELING BRAIN (2003).
\end{itemize}
moral." Not being exempt from this universal human tendency, auditors will inevitably engage in rationalizations in favor of clients so long as it is personally beneficial for them to do so. Auditor independence, he maintains, cannot be achieved by codes of conduct or external controls but rather by altering the business setting that "virtually guarantee[s] unethical behavior."143

A further dimension of research involving the influence of groups on individual decision making has a classic formulation in an ambitious study of worker productivity at a large General Electric plant in the late 1920s. The investigators found that the most significant factor was one that lay outside their original research aims—the tendency of groups to create norms regulating their behavior.144 From this auspicious beginning, a large body of empirical knowledge has emerged dealing with group influence on individuals in organizations, which was admirably reviewed by Hackman 15 years ago.145 Corporate boards, which have clear boundaries and strong self-identities, are good examples of small groups falling within this body of research, but, as Khurana points out, the boards must also be viewed in a larger social context. Directors belong to a larger community of corporate directors, and the institutional environment of the board involves interaction with other groups and decision-making bodies.146

C. Collegiality: Pertinent Research

It should be immediately apparent that groups have the potential of improving the decision-making process. Business organizations in fact rely pervasively on small groups, such as project teams, task forces, budget and strategy review committees, and boards of directors. These groups bring together employees with different areas of expertise necessary for particular decisions and can also help the organization transcend the effect of cognitive biases. Thus, the potential effect of anchoring and adjustment can be neutralized when participants enter the group with different preliminary assessments.147 But groups frequently fail to achieve their potential. Research has documented a surprisingly strong tendency of group members to discuss

142. Loewenstein, supra note 140, at 221.
143. Id. at 226.
shared information and to value most highly the information that is already most widely disseminated, rather than to learn from the unique expertise and perspectives of individual participants.\textsuperscript{148} Worse, groups have sometimes been found to magnify individual biases, giving them an amplified effect.\textsuperscript{149} For example, where a cognitive bias operates to induce an underestimate of risks, groups have been shown to be still more willing than individuals to incur the unwarranted risk.\textsuperscript{150}

The kind of internal interaction that enables groups to surpass the individual capabilities of their members is marked by the behavior that has permitted the survival and flourishing of the human species—cooperation.\textsuperscript{151} An important motive for cooperation at work is a need for affiliation with other workers.\textsuperscript{152} People are better able to engage in cooperative problem solving with team members with whom they have some personal acquaintance;\textsuperscript{153} they work well with friends\textsuperscript{154} and, more generally, seek working relationships with others who support their personal self-identity.\textsuperscript{155} Cooperative working relationships in turn lead to an increase in group cohesion by strengthening existing feelings of affiliation among members.\textsuperscript{156}

A prerequisite for effective cooperation within a group is trust, based on a faith in the good will of others.\textsuperscript{157} In the absence of trust, knowledge workers (e.g., technicians, professionals, executives and directors) may refrain from asking questions or sharing information, fearing to expose gaps in their own understanding of complex problems or to risk the possibility that others will use

\textsuperscript{149} See supra note 146, at 24-27 (in an experiment, groups were more accurate but displayed extreme overconfidence); Cass Sunstein, \textit{Deliberative Trouble? Why Groups Go to Extremes}, 110 YALE L.J. 71, 77-96 (2000) (discussing polarization phenomenon in which groups enhance the prevailing opinion within the group).
\textsuperscript{151} For advice on how to improve corporate decision making, which emphasizes cooperative interaction within groups, see Ram Charan, \textit{Conquering a Culture of Indecision}, HARV. BUS. REV., Jan. 2006, at 108.
\textsuperscript{152} MICHAEL ARGYLE, \textit{COOPERATION: THE BASIS OF SOCIABILITY} 118-129 (1991); see also Ken G. Smith et al., \textit{Intra- and Interorganizational Cooperation: Toward a Research Agenda}, 38 ACAD. MGMT. J. 7 (1995).
\textsuperscript{154} ARGYLE, supra note 152, at 119.
\textsuperscript{156} See ARGYLE, supra note 152, at 125.
\textsuperscript{157} For a discussion of the concept of trust in group decision making, see Roger Mayer et al., \textit{An Integrative Model of Organizational Trust}, 20 ACAD. MGMT. REV. 709 (1995); Peter S. Ring & Andrew H. Van de Ven, \textit{Developmental Processes of Cooperative Interorganizational Relationships}, 19 ACAD. MGMT. REV. 90 (1994).
shared information to their own advantage.158 Dialogue involving a true exchange of expertise inevitably involves an element of personal vulnerability because it exposes the questioner’s need for better understanding of a problem to the scrutiny of others.159

Again, cooperative working relationships thrive where group members share interdependent goals, which cause them to associate their own success with the success of the group.160 Conversely, cooperative problem solving fails when individuals possess, or are perceived as possessing, goals that are not shared by others in the group. In such cases, groups may display the common propensity of dividing among advocates of particular agendas or organizational constituencies.161 As Maier observes: “Persuasion activity includes the selling of opinions already formed, defending a position held, either not listening at all or listening in order to be able to refute, talking dominated by a few members, unfavorable reactions to disagreement, and a lack of involvement of some members.”162 The struggle of dominance resulting from conflicting efforts at persuasion often prompts the group to rush prematurely to a decision without adequately considering all alternatives.163

D. Diversity: Pertinent Research

In a masterful literature review, Hackman notes that group influence over the individual is more complex that commonly thought. Groups regulate the behavior of their members to assure the smooth functioning of the group, but individuals also seek ways of benefiting from group membership.164 Group regulation takes the form of pressures for uniformity among members and the creation of distinct roles for particular members;165 both uniformity and structured diversity are necessary “to maintain the viability of a group as a social system.”166 At the same time, individuals use groups as a vehicle to gain information and to serve a variety of personal needs. The effect of informal communications between the individual and group members is often to enhance the incentive for uniformity in behavior.167 Individuals may learn that they are

162. Id. at 244.
163. Garvin & Roberto, supra note 161, at 110.
164. Hackman, supra note 145, at 217.
165. Id. at 213-15
166. Id. at 215.
167. Leon Festinger, Informal Social Communication, 57 PSYCHOL. REV. 271, 272-73 (1950);
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"expected to see things the same way [as other group members] and to behave accordingly."\(^6\)

Group influence over the individual has its most profound impact through the operation of behavioral norms. Norms are social structures that serve "to regulate and regularize member behavior."\(^6\) They develop gradually and usually apply "only to those behaviors that are viewed as important by group members."\(^7\) Such behaviors include those that "ensure group survival, increase the predictability of group members' behavior, [or] avoid embarrassing interpersonal situations."\(^8\) Hackman observes that "[n]orms are powerful, efficient, and so pervasive that one commentator has suggested that 'it is only in imagination that we can talk about a human group apart from norms.'"\(^9\)

Group members may willingly comply with norms or decide to go along after weighing the rewards of compliance or sanctions for noncompliance.\(^10\) When an individual persists in violating a group norm, other group members commonly are reluctant to expel or ostracize the member, though that may occur.\(^11\) An easier tactic is to assign the non-complying member the role of an institutional deviant, which relieves other group members of the need to take seriously the possibility that his or her views have merit.\(^12\) In this way, the deviant member may actually strengthen group norms; by his or her loss of influence, the deviant member marks the bounds of acceptable behavior and reveals the consequences of violating group norms.\(^13\)

In general, groups are good for an organization and for the individual,\(^14\) but group cohesiveness, which is often a measure of a group's effectiveness, can present costs in the process of decision making. Majority influence dominates in highly cohesive groups.\(^15\) An unfortunate consequence is a frequent tendency of cohesive groups to suppress innovative ideas and dissenting views.\(^16\) Janis coined the term "groupthink" to describe the tendency of highly cohesive groups to abandon critical thinking in favor of preferred majority views.\(^17\) In his study of foreign policy making groups he

Maier, supra note 161, at 241.

168. Hackman, supra note 145, at 220.
169. Id. at 235.
170. Id. at 235-36.
171. Id. at 236.
172. Id. at 235.
173. Id. at 239, 241.
174. Festinger, supra note 167, at 275-78.
175. Hackman, supra note 145, at 245.
176. Id. at 244-45.
177. Id. at 200.
178. Id. at 241 (members of cohesive groups adhere closely to group norms because they "care a great deal about being together and about continuing their mutually satisfying social interaction.").
179. Id. at 251.
180. IRVING L. JANIS, VICTIMS OF GROUPTHINK: A PSYCHOLOGICAL STUDY OF FOREIGN POLICY
found that the phenomenon of groupthink caused group members "to maintain esprit de corps by unconsciously developing a number of shared illusions" and to censor thoughts that deviated from majority thinking.\textsuperscript{181}

The exposure of a group to minority views, which put strains on group cohesion, can improve group performance in problem solving situations. Building on Nemeth's earlier work, Peterson and Nemeth show that minority dissent, \textit{even if it is wrong}, stimulates the consideration of numerous alternatives.\textsuperscript{182} Precisely because they carry no presumption of correctness, minority views "unfreeze current opinions and thereby open the possibility of alternative solutions."\textsuperscript{183}

While individuals value the strong relationships found in cohesive groups, they are most likely to find new ideas in social links that put them in contact with other social worlds or ways of thinking.\textsuperscript{184} Paradoxically, weak social ties are those that best stimulate creativity because they "are more likely to connect people with diverse perspectives, different outlooks, varying interests, and diverse approaches to problems."\textsuperscript{185} According to Perry-Smith and Shalley, "[t]he type of diversity particularly relevant to creativity includes differences in terms of background, areas of specialization, and work responsibilities."\textsuperscript{186}

In practical terms, these considerations lead to a question rather than an answer. As Hackman asks: "Is it possible to have, simultaneously, effective normative control of member behavior and support for . . . processes that

\textsuperscript{181} JANIS, supra note 180, at 35-36.


\textsuperscript{183} Peterson & Nemeth, supra note 182, at 15.

\textsuperscript{184} Creativity research reveals the significant role of social processes in innovation. Cameron F. Ford, \textit{A Theory of Individual Creative Action in Multiple Social Domains}, 21 ACAD. MGMT. REV. 1112 (1996); Richard W. Woodman et al., \textit{Toward a Theory of Organizational Creativity}, 18 ACAD. MGMT. REV. 293 (1993); Teresa M. Amabile, \textit{A Model of Creativity and Innovation in Organizations}, 10 RES. IN ORGANIZATIONAL BEHAV. 123 (1988).


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promote originality of thought and openness to alternative perspectives?\textsuperscript{187} While there is no definitive answer,\textsuperscript{188} the question cannot be evaded by opting for simple answers favoring one horn of the dilemma or the other.

\textit{E. Independent Monitoring: Pertinent Research}

Decision-making research also raises the distinct question of the need for institutional checks on the influence of cognitive biases. The question might be explored from many perspectives, but I will limit the discussion here to three pervasive and persistent cognitive biases: over-optimism, ingroup favoritism, and irrationally extended commitments.

1. Over-optimism

Psychologists traditionally regarded mental health as a capacity to see things as they are, but, in a landmark work, Taylor shows that healthy persons in fact maintain mild and benignly positive illusions about their personal attributes, control over events, and prospects for the future. She argues that:

[T]he normal human mind is oriented toward mental health and that at every turn it construes events in a manner that promotes benign fictions about the self, the world, and the future. The mind is, with some significant exceptions, intrinsically adaptive, oriented toward overcoming rather than succumbing to the adverse events of life. In many ways, the healthy mind is a self-deceptive one. . . . \textsuperscript{189}

In other words, it is optimism, not realism, which is the identifying mark of a healthy person. Such positive illusions generate thought patterns essential for creativity and assist people in overcoming adversity. Unlike the defense of denial, they do not distort reality but rather "enable people to impose their own interpretations on events and to give themselves the benefit of the doubt, framing events in ways that promote hope and positive self-appraisal."\textsuperscript{190}

Small groups are as likely as individuals to have illusory confidence in their judgments.\textsuperscript{191} Indeed, positive illusions may be especially evident in a creative and productive organization. Taylor describes her experience as a visiting scholar at a laboratory of a prominent psychologist:

\textsuperscript{187} Hackman, \textit{supra} note 145, at 253.

\textsuperscript{188} Hackman suggests that group dynamics conducive to creativity and productive dissent may more easily be found where "the basis for cohesiveness is shared commitment to the group task rather than the maintenance of interpersonal harmony." \textit{Id.} at 254. See also Donald C. Hambrick, \textit{Top Management Groups: A Conceptual Integration and Reconsideration of the 'Team' Label}, 16 RES. IN ORGANIZATIONAL BEHAV. 171, 203 (1994) (favors moderate "paradigm homogeneity").


\textsuperscript{190} \textit{Id.} at 126.

\textsuperscript{191} Sniezek & Henry, \textit{supra} note 147, at 2-27.
I was struck by how he and his students seemed to feel that the center of psychology was right there in their research investigations. Assistants reported empirical developments almost hourly. . . . The level of excitement, energy, and enthusiasm was infectious and clearly contributed to the long hours everyone put in. I almost began to believe that psychology was entered in their lab. 192

Nevertheless, the human penchant for positive illusions has a downside, sometimes prompting individuals and organizations to take foolish risks or overrate their abilities. 193 Bazerman advises that, in important decisions, one should “invite an outsider to share his or her insight.” 194 The outsider perspective, even if less informed, may be more accurate than one’s own insider view. Lovallo and Kahneman counsel executives to avoid constructing their own scenarios of progress and instead to take an “outside view” by examining the experience of a similar class of projects. 195

2. Ingroup Favoritism

A phenomenon closely related to over-optimism is the cognitive bias of ingroup favoritism. People’s tendency to view themselves positively also characterizes their attitudes towards groups to which they belong. An abundant body of research, representing over 100 studies in the past 50 years, reveals that, when people find themselves within a group, they have both a cognitive bias and an affective bias favoring the group and its members. 196 The bias exists even when the group is arbitrarily formed, as by a flip of the coin. 197 Experiments show that the bias is easily activated, 198 but the strength of the bias tends to be directly related to the clarity of the group’s self-identify, that is, by the “salience of the distinction” between the group and others. 199

Because people wish to feel good about themselves, they particularly value membership in relatively successful groups. 200 Consequently, ingroup

192. TAYLOR, supra note 189, at 59.
194. BAZERMAN, supra note 130, at 199.
195. Id. at 61.
200. Moreland, supra note 196, at 1173.
favoritism typically is stronger in privileged or advantaged groups. In her exhaustive review of the literature, Dasgupta explains:

The data suggests that people's implicit attitudes about ingroups . . . are influenced by two different forces—the tendency to prefer groups associated with the self as a confirmation of their positive self-esteem, and the tendency to prefer groups valued by the mainstream culture as a confirmation of the sociopolitical order in society.201

Ingroup favoritism is commonly associated by a devaluation of outgroups—sometimes by overt antipathy toward them202—but this association between positive ingroup attitudes and negative feelings toward others is still complex and variable. Ingroup favoritism may exist without any explicit competition with an outgroup.203 Nevertheless, the effect of ingroup favoritism may be discriminatory, even when people are unaware of any discriminatory motives. Mortgage lenders may disclaim in good faith any intent to discriminate against minorities, but after treating favorably applications from people with their own personal characteristics, they may have fewer resources to distribute among others.204

There should be nothing invidious in pointing out the presence of ingroup favoritism, or even a tendency to devalue outgroups. These are pervasive and universal human frailties that may be found at times in everyone's behavior. Few people would deny that they identify more easily with people like themselves or that they tend to think well of groups or organizations to which they belong.205

3. Irrationally Extended Commitments

When people make a series of related choices, rather than an isolated decision, they are prone to follow the commitments implied in the initial decision. A determination to persevere in an endeavor is often admirable, but it becomes harmful when it causes people to apply an earlier decision to changed circumstances or to persist in a failing course of action.206 The explanations for misdirected persistence in business strategies turn out to be exceedingly complex; the persistence may be linked to economic, social, institutional, or psychological factors. The psychological determinants in turn involve a convergence of distinct biases.207 Aronson notes that these biases have a kind

201. Dasgupta, supra note 196, at 163.
202. Rabbie & Horwitz, supra note 197 ("What is striking in the present experiment is how little it evidently takes to move two randomly formed groups of strangers into mutual antipathy.").
203. See generally Dasgupta, supra note 196; Brewer, supra note 199.
205. Id. at 16 ("Everyone is ethnocentric to some degree.").
206. Id. at 81-91.
207. See Barry M. Staw & Jerry Ross, Behavior in Escalation Situations: Antecedents, Prototypes,
of "cognitive conservatism" as a common factor: "The first information received is always the most influential." The result is a "tendency to preserve that which is already established—to maintain our preexisting knowledge, beliefs, attitudes and hypotheses."

A fundamental, pervasive, and obvious factor in irrational persistence is self-justification. People sometimes throw good money after bad to prove their initial decision was right. But self-justification also operates in unintended and unnoticed ways. Schoorman investigated performance reviews by supervisors of clerical employees in a large public sector organization and compared the job ratings of supervisors who had influenced the hiring of the employees with those who were not involved in the hiring decision. He found that a bias attributable to the previous choice accounted for six percent of the variance in performance appraisal rating—a modest effect perhaps, but still more significant than any other variable studied and entirely unintended.

Self-justification is related to the phenomenon of self-serving attributions. As Bazerman remarks, "[W]e tend to take a disproportionately large share of the credit for collective successes and to accept too little responsibility for collective failures." Self-serving attributions of success or failure, reflecting an attempt to justify past decisions, will tend to distort the accurate interpretation of events needed to monitor the success of strategic decisions.

The tendency toward self-justification is reinforced by two distinct cognitive biases that often have the same effect. First, research discloses that once people have a certain level of commitment to an alternative course of action, they prefer information that supports the alternative rather than information that questions it. Accordingly, they actively seek out confirming information or simply tend to notice or remember such information. After deciding to buy a hybrid car, a prospective purchaser will more readily absorb information about rated fuel economy than information regarding the

209. Staw & Ross, supra note 207, at 50-51.
211. For a survey of attribution theory in social psychology, see Frank Fincham & Miles Hewstone, Attribution Theory and Research: From Basic to Applied, in INTRODUCTION TO SOCIAL PSYCHOLOGY 198, 214-217 (3d ed. 2001).
212. BAZERMAN, supra note 130, at 71.
213. See Vincent L. Barker & Pamela S. Barr, Linking Top Manager Attributions to Strategic Reorientation in Declining Firms Attempting Turnarounds, 55 J. BUS. RES. 963, 976 (2002).
215. See BAZERMAN, supra note 130, at 35-36, 88; BAZERMAN & WATKINS, supra note 192, at 81; Staw & Ross, supra note 207, at 53-54.
replacement cost of batteries. A second tendency goes by the technical name of self-inference but is well understood and exploited by salesmen. People rely on the fact that they have taken previous steps in a course of action to justify taking a further step ("this venture must be good if I am so committed to it.") After embarking on a course of action they are less likely to reevaluate their reasons for doing so and are more amenable to persuasion. This is, of course, the psychological dynamic that explains the efficacy of foot-in-the-door sales techniques.

Decision-making groups generally display the same tendency as individuals to engage in misguided persistence, but studies reveal certain exceptions. Self-serving attributions afflict only those corporate officers who had personal responsibility for earlier decisions; the newly hired executives are more open to new strategies for a declining business. Moreover, a large-scale experiment found that confirmation bias (i.e., the tendency to seek information supporting earlier decisions) occurred in groups of five members who possessed homogeneous opinions but was weaker in groups with a single dissenting member, and was absent from groups with two dissenting members.

V. TRADITIONAL REFORMS: A DECISION-MAKING PERSPECTIVE

Viewed from the perspective of descriptive decision-making research, the two traditional approaches to reform the nominating process — shareholder access to the management proxy and nominating committees dedicated to best practices — both present defects as well as strengths. Turning first to the issue of shareholder access, I will look only at the general model reflected in the SEC's 2003 proposal and will reserve, until later, a discussion of how it might be modified. The proposal, as noted earlier, would institutionalize the phenomenon of an insurgent director by giving shareholders the opportunity to gain limited representation on corporate boards under restricted circumstances, following 'triggering events.'

A. The Insurgent Director Model

In their social analysis of corporate boards, Khurana and Pick observe that, besides being members of a particular board, directors are also members of a larger population of directors with an identity of its own:

216. Id. at 52.
217. Id. at 52-53.
This population is densely connected through interlocks, with most directors serving on several boards at the same time. The changing environment for corporate has made this community even tighter as it becomes more bounded by opposition to external parties that scrutinize and attempt to exert influence. The broader population of directors now has a visible and distinct out-group, comprised of legislators, shareholders activists, and various other critics, against which to position itself. 

The management community has long resisted admission of institutional shareholder representatives into the circles of corporate decision making. Useem observes,

"[T]he outward acceptance of investor sovereignty coexists with private rejection of investor advice. In management's view, investor ownership does not carry with it the right to give direction as to how to enhance shareholder value. It remains management's right to set strategy, acquire divisions, market products, promote executives, and fix salaries."

The deep roots of this resistance are dramatically illustrated by nominating committee's action in declining to select candidates from the community of institutional investors, despite SEC efforts to encourage their candidacy by disclosure rules. Surveys confirm management's low opinion of institutional shareholders engaged in corporate initiatives. The comments of corporate representatives in the 2003 SEC proceedings were at times colored by unmistakable indications of outgroup devaluation. For example, the Business Roundtable placed great emphasis on the empirically tenuous argument that the investment objectives of highly diversified pension funds reflect special interests and narrow agendas.

A director elected through the proposed SEC procedure would consequently enter upon his or her duties with the burden of overcoming the latent antipathy of at least some other directors. This social barrier might disappear with person-to-person contact, giving way to a sense of affiliation and cooperative relationships, but there are reasons to expect that an element of distrust would stand in the way of such a happy outcome. First, since

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222. USEEM, supra note 99, at 70. Useem gives an insightful analysis of the management's "cultural resistance" to shareholder advice. Id. at 70-106.
223. See supra notes 97-99 and 115-17 and accompanying text.
224. E.g., NAT'L ASSOC. OF CORPORATE DIRECTORS, supra note 104, at 31 ("Shareholder activists received low scores on taking responsible actions, with only nine percent of respondents indicating favorable agreement.").
225. See, e.g., McKinnell, supra note 61, at 2; Detailed Comments, supra note 61, at 31-32; Odland, supra note 61, at 19-35. On the empirical basis for this argument, see generally Michael E. Murphy, Pension Plans and the Prospects of Corporate Self-Regulation, 5 DEPAUL BUS. & COM. L.J. 503, 538-39 (2007).
226. See supra notes 150-55 and accompanying text.
institutional investors own stock in competing firms, a director sponsored by such investors would inevitably be subject to scrutiny to prove his or her ability to maintain confidentiality and avoid conflicts of interest. The 2003 proposal addressed this problem by imposing qualification requirements on shareholder nominees, requiring their freedom from any financial ties with institutional investors, and boards themselves can seek to enforce appropriate codes of conduct. Nevertheless, shareholder-nominated directors would need to dispel suspicions as to their loyalty, arising from the stock ownership of their shareholder supporters, thereby adding to their burden in gaining a cooperative working relationship with other directors.

Secondly, a shareholder-nominated director, if drawn from the community of institutional investors, would lack expertise in the core business functions of the firm. The same, of course, can be said others who are commonly found on corporate boards (e.g., attorneys, bankers, academics, government executives), and the director’s experience with capital markets and financial reporting would be distinctly relevant to corporate strategy and financial management. Still, without expertise in the core functions of the business, a shareholder-sponsored director might lack traction in gaining an equal role in boardroom dialogue.

Thirdly, by their method of selection, shareholder directors would be set apart from other directors. Under the SEC proposal, a majority of the board would be recruited and screened by the nominating committee and elected with management’s recommendation. Since shareholder-nominated directors would achieve their position by directly challenging management in the proxy process, they could not fail to be regarded, at least initially, as coming into office with a separate agenda and answerable to a separate constituency. They would, in short, be stamped with an identity different from that of other directors. Bearing the stigma of an unwelcome outsider, they might find it difficult to achieve a cooperative working relationship with other directors, based on a sense of interdependence and dedication to a common task. The perception of a separate agenda can harden, even if it is unfounded, as accounts of Walter Hewlett’s fate on the Hewlett-Packard board suggest.

228. See Security Holder Director Nominations, supra note 52, at 61-62 (proposed rule § 41a-11(c)(3)).
229. See BACON, supra note 95, at tbls. 3-5; NAT’L ASSOC. OF CORPORATE DIRECTORS, supra note 104, at 12-13.
230. See supra notes 157-58 and accompanying text.
231. See supra notes 160-62 and accompanying text.
Drawing on his extensive experience as an advisor to corporate boards, Charan warns against the disruptive impact of an "unwanted" director:

Unfortunately, some boards realize that there are times in which they have to deal with directors who hijack dialogue and poison the group’s interactions. Occasionally, a director doesn’t pick up on the signals that this kind of behavior is detracting from the group dynamics. An ‘unwanted’ director can single-handedly derail the board’s group dynamics and create an enormous time sink for a board and a CEO.233

A shareholder-nominated director has the potential of being an unwanted director on steroids. Management’s fear of the disruptive presence of such a director could indeed be self-fulfilling. But we have seen that another outcome is more likely—the board would assign the shareholder-nominated director to the role of an institutional deviant. To best serve the group’s need for smooth functioning, the board would develop norms graciously according the shareholder-nominated director a place at the table and assuring that he or she would be ignored. As an institutional deviant, the director’s opinions would be regarded as being a priori without merit.234

Whether a pariah or an institutional deviant, the shareholder-nominated director would be powerless to monitor corporate decisions by a process of dialogue with other directors and management. Lacking the kind of affiliation needed for cooperative relations with the board, the director would face an inevitable handicap in securing the information needed for monitoring as the information the board needs must necessarily come from management.235 CEO’s have been shown to share information most freely with friends on the board;236 a share-nominated director would be outside the circle of such informal circulation of information. Directors may sometimes be able to detect obfuscation or noncompliance on the part of top executives through contacts with a lower tier of executives, but the transmission of sensitive information again implies trust. A director, quoted by Charan, explains, “[o]n compliance, when you think about how a board member uncovers noncompliance, you realize that you have to rely on people who observe it, the management, to tell you. They’ll only tell you if they trust you.”237

One is tempted to conclude that the insurgent-director model reflected in the SEC’s proposal would be an exercise in futility for shareholders and a time sink for management, but Gerald McEntee, the president of the AFSCME, the original proponent of the 2003 proposal, offers an argument that avoids this conclusion. He anticipates that the shareholder right of access to the

233. Charan, supra notes 126, at 45.
234. See supra notes 174-75 and accompanying text.
236. Westphal, supra note 159, at 12-14.
237. Charan, supra note 126, at 50.
management proxy "would be used sparingly, at companies with most persistent and severe problems," but it would effectively encourage dialogue between shareholders and the board:

In the vast majority of cases, shareholders and boards would engage in dialogue as a way to understand one another's perspectives and arrive at mutually agreeable solutions. The existence of an access right would form part of the background to these discussions, and would require resistant, entrenched boards and managements to come to the table or face shareholder nominated board candidates in the future. At a recent conference, Peter Chapman, who heads TIAA-CREF's corporate governance program — know for its 'quiet diplomacy' — stated that his efforts would be aided by negotiation in the shadow of a shareholder access right."\(^\text{238}\)

Similarly, a letter signed by six professors of the Harvard Law School and nine professors at the Harvard Business School, argued that the proposed SEC rule would give shareholders "more voice in the selection of candidates that the board itself nominates." Even if shareholder nominations were "rare in practice," an expanded right to pursue such nominations "would create a more productive behind-the-scenes negotiation between long-term shareholders and the board in the selection of candidates."\(^\text{239}\)

In short, these proponents of the proposed SEC rule do not really seek shareholder admission into the decision-making circles of corporate—the problems likely to attend an insurgent director are beside the point—they hope only to use the proposed SEC rule to change the environment in which corporate boards function.\(^\text{240}\) We have noted that the wave of corporate governance reforms in the past 15 years was stimulated in part by pressure from institutional shareholders. The shareholder access rule, in this view, would give shareholders more clout to seek another round of reforms, involving such issues as majority election of directors and separation of the CEO and Chairman positions. It might sometimes enable major shareholders to go over the head of shareholder relations departments and enter into discussions with directors and top executives about subjects that matter to them, including selection of directorial candidates.\(^\text{241}\) If the shareholder right of access to the management proxy should prove to be a blunt and disruptive instrument, it would not matter because it would be used rarely and only against dysfunctional boards, which might benefit from anything calling attention to their failures.

The objective of changing the environment of corporate governance may be

\(^{238}\) McEntee, supra note 71.


\(^{240}\) See supra note 145 and accompanying text.

\(^{241}\) For a discussion of the policies of shareholder relations departments, see USEEM, supra note 99, at 168-207.
a realistic one, with genuine benefits, but it falls short of significant systemic reform. Shareholders would remain outside the portals of corporate power, empowered only to rattle the gates more loudly to secure attention. As such, it is doubtful if the proposed SEC rule meets the mandate of the Exchange Act to ensure fair corporate suffrage. This legislative goal, as we have seen, appears to imply an effective shareholder power to remove directors for incompetence or abuse of power. The proposed SEC rule relegates this power to exceptional cases, to be seldom exercised and chiefly serves only to amplify somewhat the shareholder voice in the existing system.

B. The Active Nominating Committee Model

The great virtue of the nominating committee, as a means of selecting directorial candidates, is that it can assemble a group of individuals who are predisposed to work cooperatively together. Since all directors are "hand picked" by the same process, they join the board as colleagues of other "very smart, highly influential and experienced people" who have met the same demanding criteria of selection. While factions and distrust may occasionally erupt later on, the strong prevailing tendency of boards is to develop into highly cohesive groups. Such group cohesion, as we have seen, is an excellent quality for groups to have in the performance of many tasks, but it is often (though not always) associated with a degree of conformity to group norms that has adverse consequences for decision making. Corporate boards clearly evidence these adverse consequences.

I will touch briefly on the phenomenon of group cohesion in corporate boards and then discuss the systemic defects in decision making arising from the effects of group cohesion — a loss of diversity in intellectual perspectives and in a capacity for independent monitoring. In either case, the nominating committee, which serves the board well in selecting competent candidates and promoting cooperative relationships, fails to address the causes of these systemic decision-making failures.

1. Group Cohesion in Corporate Boards

It is a familiar observation that boards of directors are "characterized by a


243. See supra notes 13-14 and accompanying text.

244. See supra notes 150-55 and accompanying text.

245. Khurana & Pick, supra note 146, at 1275.

246. See supra notes 177-80 and accompanying text.
high degree of internal cohesion," and certain structural characteristics plainly appear to contribute to the phenomenon. Boards are small and possess "high group distinctiveness, meaning that their membership is readily identifiable both to insiders and outsiders." Moreover, boards tend to be very homogenous in terms of social and cultural background. Khurana and Pick explain,

Although this is beginning to change with respect to gender and race, boards continue to be homogenous with respect to age, occupation, class, and status position. This gives boards the likelihood of shared mental models attitudes, beliefs, and experiences that contribute to group cohesion.

Westphal has found empirical support for another factor: directors commonly hope not only to secure re-nomination (a likely event) but to secure other directorial appointments. They are most likely to realize the benefits of board membership, as a vehicle for future advancement, by conforming to the behavior favored by other board members.

These explanations still seem inadequate to explain the degree of cohesion in corporate boards. We may well share Sonnenfeld’s surprise on the strength of this tendency:

I’m always amazed at how common groupthink is in corporate boardrooms. Directors are, almost without exception, intelligent, accomplished, and comfortable with power. But if you put them into a group that discourages dissent, they nearly always start to conform. The ones that don’t often select out.

Drawing on Hackman’s authoritative text, Khurana and Pick suggest that a full explanation has to do with the social dynamics of the board. They note that the nature of the board’s work tends to fortify the motivation, found in all groups, for individuals to rely on other group members for information. First, group members tend to rely on the group for information when faced with uncertain outcomes and ambiguous goals. The issues directors face “are unusually complex and subject to interpretation,” and their decisions “often

247. RAKESH KHURANA, SEARCHING FOR A CORPORATE SAVIOR 83 (2002). See also MACE, supra note 81, at 52-61; LORSCH & MACIVER, supra note 83, at 80-95.
249. Id.
250. J. D. Westphal & I. Stern, Flattery Will Get You Everywhere, 50 ACAD. MGMT. J. 207, 281-84 (2007); J.D. Westphal & P. Khanna, Keeping Directors in Line: Social Distancing as a Control Mechanism in the Corporate Elite, 42 ADMIN. SCI. Q. 361, 391-95 (2003). See also Sonnenfeld, supra note 232, at 111 (concern for renomination); CHARAN, supra note 126, at 156 (candidates screened for past board behavior).
251. See Hackman, supra note 145, at 219 (description of the behavior of individuals seeking benefits of group membership).
252. Sonnenfeld, supra note 232, at 111.
253. See supra notes 166-67 and accompanying text.
254. Hackman, supra note 145, at 222.
must be based on incomplete, complex, and subjective information." Perhaps most important, they are accountable to shareholders for performance of the conflicting tasks of assisting management and monitoring management's performance. With such an ambiguous target, it is understandable that they display the general tendency of group members to rely on each other in shaping their beliefs and judgments.

Secondly, members tend "to rely heavily on the group for information" when they "feel poorly qualified personally to assess the environment." This factor may seem to have little application to the elite membership of corporate boards, but Khurana and Pick explain,

Despite the fact that directors are generally highly qualified individuals, the flood of information with which they must work likely leaves them never feeling completely informed. Directors are often inundated with pages of information prior to board meetings. Given time constraints, director are unusually unable to process this information and it is likely that this could make a director feel as though he or she is not entirely 'qualified' to respond and/or act.

Thirdly, group members tend to accept group information when they regard the group to be a credible source of information. Accordingly, it is not surprising that the talented directors, whom Sonnenfeld describes, rely on other board members for guidance. It is precisely because the board is composed of similarly talented individuals that it is a credible source of information. In his classic study of groupthink, Janis described the how the brilliant entourage of President Kennedy led him into the Bay of Pigs fiasco. Board members are similarly disposed to accept group-supplied information to the extent that they perceive other directors to be expert and experienced.

2. Diverse Intellectual Perspectives

The process of decision making, we have seen, can benefit by bringing diverse intellectual perspectives to bear on complex problems. Such intellectual diversity may be sought by selecting group members with different functional backgrounds in business and different career paths in industries. Research reveals that executives tend to diagnose organizational weaknesses in terms of their own expertise and to adopt strategic orientations widely shared in an

255. Id.
256. See infra notes 353-60 and accompanying text. Khurana and Pick do not mention this element of ambiguity, though it is consistent with their analysis.
257. Hackman, supra note 145, at 222.
258. Khurana & Pick, supra note 146, at 1276.
259. Hackman, supra note 145, at 222.
261. See supra notes 179-80 and accompanying text.
industry. The nominating committees of U.S. corporations, however, exclude without exception an important pool of talent — candidates with backgrounds in the fields of investment management and financial analysis. The committee’s behavior in rejecting this category of qualified candidates can only be explained by compliance with a group norm strongly sanctioned by a majority of directors in corporate boards throughout the United States.

A further filtering process is the inevitable product of ingroup favoritism. We have seen that this universal human behavior operates most strongly in privileged and advantaged groups where people view their membership as a confirmation of positive self-esteem. Corporate boards are, of course, a perfect example of the kind of group most predisposed to engage in ingroup favoritism. The characteristic of such a privileged group also extends to the larger community of directors formed by numerous interlocking directorships. The result of ingroup favoritism is a marked tendency of nominating committees to replicate the homogeneity of beliefs and attitudes found in their own board and the larger community of directors.

This lack of intellectual diversity leaves corporate boards exposed to the formation of group norms which suppress innovation and dissent — the phenomenon commonly described as groupthink that often takes root in highly cohesive groups with a highly qualified membership. The phenomenon of groupthink has unquestionably been a factor in the chain of scandals beginning with the Enron collapse. Indeed, Ramirez argues that a fundamental flaw in the Sarbanes-Oxley legislation is a failure to address this critical source of corporate irresponsibility. In addition, the loss of intellectual diversity in the selection of directors deprives the board of a source of creativity and the kind of constructive dissent that leads to more thorough consideration of strategic alternatives.

As presently organized, nominating committees are subordinate units of highly cohesive boards. The committee members are selected by these boards and meet to offer recommendations for board approval. While the committees may do a good job in selecting smart and experienced candidates with a certain

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263. See supra notes 116-119 and accompanying text.

264. See supra notes 199-200 and accompanying text.

265. KHURANA, supra note 247, at 84-85; USEEM, supra note 221, at 56.

266. See supra notes 258-60 and accompanying text.


268. Id. at 842-44.
range of complementary abilities, they function according to the same norms as the board itself and inevitably manifest the unseen and unintended effects of ingroup favoritism. These failures cannot be remedied by codes of best practice, holding the committees to high standards of diligence and propriety. The failures rather are based in human behavioral tendencies, which are fated to continue so long as the committees continue to operate in their present form.

3. Independent Monitoring

Two provocative articles in the Harvard Business Review point to pervasive flaws in corporate decision making that demand continual monitoring. Lovallo and Kahneman observe “a strong tendency toward overoptimism” among executives and entrepreneurs. They note:

Most large capital investment projects come in late and over budget, never living up to expectations. More than seventy percent of new manufacturing plants in North America, for example, close within their first decade of operation. Approximately three-quarters of mergers and acquisitions never pay off—the acquiring firm’s shareholders lose more than the acquired firm’s shareholders gain. . . . [Moreover,] an analysis of start-up ventures in a wide range of industries found . . . that more than eighty percent failed to achieve their market-share target.”

They recognize that one might attribute this high failure rate to rational decisions on the theory that “in the long run the gains from a few successes will outweigh the losses from many failures.” But they do not think that it can be adequately “explained as the result of rational choices gone wrong,” but rather “as a consequence of flawed decision making.” A central cause of the failure rate is the cognitive bias of over-optimism, which leads to delusions of success.

In a 1995 article, John Pound points to a complementary defect in corporate decision making that may compound the effects of over optimism and other management errors. “[M]ost performance crises,” he contends, “are the result of errors that arise not from incompetence but from failures of judgment” that go uncorrected. “[F]ailures usually result,” he argues, “from a few well intentioned but flawed management decisions that are not challenged in an

269. These standards, however, appear to have led to some modest increase in the representation of women and minorities. For current statistics on representation of women and minorities on corporate boards, see STUART, supra note 103, at 17-18.
270. Lovallo & Kahneman, supra note 134, at 57, 59.
271. Id. at 58-59.
272. Id. at 58.
273. The authors explain that this bias can be reinforced by organizational pressures and the biases of anchoring and competitor neglect.
efficient, effective manner." He continues:

Errors arise from the simple realities of human decision making and organizational behavior. People make mistakes. Individuals tend to be biased toward decisions and strategies that favor their own personal strengths. People also have a difficult time confronting past failures. . . . Managers who stick with failed policies in the face of dismal performance, and directors who stick with failed policies in the face of shareholder discomfort, are both displaying a well-documented pathology of judgment and behavior."

As we have seen, these systemic flaws in decision making are rooted in cognitive biases in human behavior. The point can be easily made in the case of over optimism: the healthy human mind tends to harbor positive illusions. These serve people well in most situations but are often damaging in the context of business decisions. The phenomenon of misguided persistence in a course of action is more complex, but it clearly has an important psychological component arising from such psychological factors as cognitive conservatism, self-justification, self-serving attributions, confirmation bias, and self-reference. The effects of over optimism, as described by Lovallo and Kahneman, rest on the intuitive judgment and experience of these distinguished scholars. They are inherently difficult to prove, but the recurrent tendency of business leaders to respond slowly or not at all to failing strategies is reinforced by an abundant literature.

Lovallo and Kahneman urge managers to cultivate an "outside" view as a means of making more accurate forecasts. Pound carries the point further by arguing that the design of corporate governance systems "should seek ways to create and maintain an efficient decision-making process," which will help "prevent significant mistakes in corporate strategy and . . . ensure that the mistakes that do occur can be corrected quickly." As a feature of such a system, he advocates improved communication with "[l]arge outside shareholders," who "are in an ideal position to render an outside second

275. Id. at 90.
276. Id. at 91-92.
277. See supra notes 188-94 and accompanying text.
278. See supra notes 207-16 and accompanying text.
279. Daniel Kahneman was the Nobel Prize winner in economics in 2002. Dan Lovallo, a former strategy advisor at McKinsey & Company, is an associate professor at the Australian Graduate School of Management at the University of New South Wales.
281. Pound, supra note 274, at 90.
opinion on corporate policy." Corporate boards and managers, he contends, "need to hear that opinion directly as a check on insularity." The corporate reforms of the past 15 years have pursued a different approach to assuring independent monitoring — the selection of directors according to criteria of independence contained in the listing requirements of the NASDAQ Stock Exchange and New York Stock Exchange. This approach, however, excludes a shareholder role. In general, the selection criteria require an absence of employment, consulting contracts, or other business relationships with the company or family relationships with persons who have such company connections. Large corporations have willingly adopted these guidelines for directorial independence and generally exceed them by a wide margin. In 2006, eighty-one percent of directors in S&P 500 companies qualified as independent, and in thirty-nine percent of these companies the CEO was the only non-independent director.

Empirical investigations reveal that the selection of directors according to formula in listing requirements has turned out to be a weak remedy in improving the monitoring function of corporate. Anecdotal reports and some studies suggest that boards with a high proportion of independent directors may sometimes adopt a more proactive monitoring role. Beneficial effects on firm performance do not appear in all corporations or all situations however, and the overall statistical evidence is inconclusive and disputed. There are a number of reasons why one might expect this formulaic approach to have modest results. The most important arise from limitations in the criteria of independence, disparity in access to information, and the dynamics of the board as a highly cohesive social system.

The criteria for directorial independence relate only to financial ties, employment, and family relationship; they do not prevent the CEO, or the nominating committee working in tandem, from nominating directors who are

282. Id. at 95.
283. Id.
284. See supra notes 108-09 and accompanying text.
286. CHARAN, supra note 126, at 7-9; Khurana & Pick, supra note 146, at 1269-70.
288. For a somewhat different analysis, see O’Connor, supra note 267, at 1244-47.
social friends, fellow members of a club, association or charitable endeavor, or from taking into account a candidate’s probable conduct as a team player on the board. Conard observes, “[e]xecutives can easily find directors who are neither subordinates, relatives, nor suppliers, who will support almost anything that the executives propose.” The most sought-after category of directorial candidates are the CEO’s of other companies; these CEO directors may have needed experience and independent judgment, but they are likely to share many of the values and sympathies of the company’s own CEO, particularly with respect to issues of compensation. In recent years, top executives have been under pressure to serve on fewer boards, shrinking the pool of CEO candidates; in 2006, only twenty-nine percent of directors in S & P 500 companies were CEO’s of other firms. But their place has been taken by another growing category—the younger executive who is a likely heir to the top position another companies. These rising executives have a strong incentive to use their membership on the board for their own advancement by conforming to the group’s positive expectations.

In their famous study of corporate boards in the late 1980s, Lorsch and Mclver found that the most important source of the CEO’s power in the boardroom rested in “a comprehensive knowledge of company affairs.” The board receives most of its information through the filter of the CEO’s selection and interpretation, and directors may be reluctant to pursue questions in areas where management has the best access information. This source of management power has not changed with the appointment of directors satisfying formal standards of independence and may sometimes have actually increased. To the extent that directors come from backgrounds removed from the business, they may be more inclined to defer to the CEO’s superior firm-specific expertise. Charan observes, “[m]any independent directors fall silent when facing strong CEOs; their lack of knowledge of the company and of its

291. STUART, supra note 103, at 12.
292. Id. at 4-5, 7-8.
293. Hackman, supra note 145, at 220, 241. See also USEEM, supra note 221, at 48 (“Executives who are being groomed to rise up to the most senior company positions are encouraged to take on outside directorships as a means of enhancing their awareness of the company’s business environment. . . . A blemished reputation for this kind of external service weighs against a candidate aspiring to the apex of the company hierarchy.”).
294. LORSCH & MACIVER, supra note 83, at 80.
295. Id. at 84-88.
296. See James D. Westphal, Board Games: How CEOs Adapt to Increases in Structural Board Independence from Management, 43 ADMIN. SCI. Q. 511, 514 (1998).
officers works against their ability to provide oversight."

The most important factors arise from the marked tendency of corporate boards to form highly cohesive groups. First, we have seen that majority influence is always dominant in cohesive groups, and the more cohesive the group, the more members adhere to group norms reflecting this influence. In light of the presence of a diverse group of compliant members (friends, team players, CEO’s, heirs apparent, etc) ordinarily constituting a board majority and the board’s dependence on management for information, these norms are likely to have an orientation that is distinctly deferential to management and unsuited for effective monitoring. Secondly, any outsider perspective that a director brings with him or her upon accepting a board appointment will tend to be subverted by his or her participation in decisions that demand future monitoring. After approving strategic plans, material transactions, and financial policies, the directors acquire a personal stake in the decisions, which will dilute their outsider perspective and make them prey to the cognitive biases that prompt decision makers to adhere unreasonably to their initial perceptions. These tendencies are inevitably accentuated by the cohesive nature of the board, which assures group responsibility for decisions, and by the long tenure of directors, averaging almost ten years, which permits an insider perspective to solidify over time.

Writing twelve years ago, Pound viewed director nominations as "[a] promising area for direct communication among shareholders, management and the board," which could infuse the reality check of the shareholder’s outside perspective into corporate decision making. Nominating committees have evolved rapidly since that time, with a number of good results, but, contrary to Pound’s hopes, they do not serve as a vehicle for introducing the shareholder’s outside perspective. The committees actively recruit qualified candidates but, as we have seen, the individual competence of a director does nothing to ensure an outside perspective needed to counteract cognitive biases in decision making. Talented and untalented directors may be equally prey to over-optimism and the behavioral tendencies causing people to adhere unreasonably to their initial perceptions. Again, the committees are now composed of independent directors and operate at a greater distance from direct CEO influence, but they still remain subordinate to the board, inevitably reflecting the composition and norms of the board itself. They do not inject any element of independence beyond that provided by the listing requirements.

297. CHARAN, supra note 126, at 25.
298. Hackman, supra note 145, at 252.
299. See supra notes 125-26 and accompanying text regarding decision-making role.
300. NAT’L ASSOC. OF CORPORATE DIRECTORS, supra note 105, at 16 (when participants in survey were asked average tenure of director, the most frequent response was 10 years and the average was 8.5 years).
301. See supra notes 115-19 and accompanying text.
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The potential of a shareholder voice providing a “check on insularity,” to use Pound’s felicitous phrase, remains unfulfilled. Instead, nominating committees serve to maintain corporate boards as self-perpetuating elites, which respond at times to shareholder pressures but exclude shareholders from the circle of influence in selecting the board’s own members.

VI. ALTERNATIVE APPROACHES

The two approaches to reform of the nominating process, which we have considered — direct shareholder access to the management proxy and the nominating committee — by no means exhaust the universe of possibilities. Both approaches have emerged from a history that could have taken a different course. The SEC’s thrice-repeated proposals for direct shareholder access represent attempts to fulfill the mandate of “fair corporate suffrage” under section 14 of the Exchange Act with the limited means afforded by that section, i.e., the regulation of proxies. The nominating committee received much of its initial impetus as an alternative to direct shareholder access and later evolved as part of a business-sponsored movement offering a set of best practices linked to preservation of the status quo.

Both approaches have been proposed and debated in the past thirty years with virtually no consideration of the scientific research which has greatly expanded our knowledge of the processes of human decision making during this period. Both present grave defects if examined in light of this research.

One may then ask: what other alternatives might be pursued to reform the nominating process? The question, in general, assumes the necessity of new federal legislation. The SEC may seek new ways to exercise its broad authority under section 14 of the Exchange Act, but innovative ideas for reform, attuned to the realities of the decision-making process, will take us beyond existing legislative authority. There is no constitutional impediment to legislation affecting internal governance of large corporations. The Commerce Clause offers ample constitutional authority, which Congress has exercised most recently in enacting portions of the Sarbanes-Oxley Act.


304. See Sarbanes-Oxley Act of 2002, supra note 106. For a description of the Act’s incursion into
I will limit myself to discussing four alternatives: (1) modification of the two traditional approaches, (2) the idea of reserved shareholder seats on the corporate board, as advocated by Caplin and Lowenstein, (3) an Italian improvisation (my preferred option), and (4) experimentation with a compound board.305

A. Modification of Traditional Approaches

1. Proposed Direct Shareholder Access Rule

The SEC’s concept — that a triggering event gives rise to a limited right of shareholder access to the management proxy — seems guaranteed to confer on a shareholder nominee the opprobrium of an unwanted director, selected under circumstances of perceived unfairness. Perversely, it would aggravate the most undesirable feature of a direct access rule — the effect of disrupting cooperative relationships on the board. The intention of the SEC staff, as explained in the introduction to the 2003 proposal, was to craft a rule that “would apply only in those instances where criteria suggest that the company has been unresponsive to security holder concerns as they relate to the proxy process.”306 But, in fact, corporations are uniformly unresponsive to shareholder efforts to intervene in the sphere of decision making,307 and, in particular, resist shareholder participation in the nominating process.308 Communications between shareholders and the corporation are normally relegated to a shareholder relations department well removed from the centers of decision making.309

The growing scientific understanding of cognitive biases underscores the need for systemic reform affecting all large corporations. The cognitive biases associated with over-optimism and irrationally extended commitments are universal features of human decision making, and therefore they must always be taken into account in designing corporate governance structures with an effective monitoring capacity. Shareholders, in theory, can offer an outsider’s perspective as an antidote to these biases. That which is not clear is whether a

areas formerly left to state law, see Mark J. Roe, Delaware’s Competition, 117 HARV. L. REV. 590, 633-34 (2003).


306. Security Holder Director Nominations, supra note 52, at 5.


308. See supra notes 115-17, 119 and accompanying text.

309. USEEM, supra note 99, at 168-207.
shareholder access rule can serve as an appropriate vehicle for introducing this needed check on the decision-making process. The most sophisticated defense of the 2003 proposal, as we have seen, assumes that proxy contests would be infrequent but institutional shareholders would be better positioned to engage management in dialogue on matters of shareholder concern. In other words, the disruptive effects of occasional proxy contests would be offset by the benign effects of improved shareholder/management communication.

One may easily imagine ways of modifying the 2003 proposal to change the impact of shareholder access to the management proxy without resorting to the triggering events concept. The SEC, for example, did not pursue one effective device for discouraging shareholder harassment: shareholders could be limited to one nomination every three or four years. With this restriction, they would have an incentive to proceed cautiously in making nominations by first assembling a coalition of supporters. Such tinkering with the restrictions of the proposed regulation, however, causes a dilemma: if the threat of disruptive shareholder nominations is reduced, the impact of the regulation on the institutional environment of corporate boards will also diminish. The converse is of course also true.

While it is possible that a favorable balance between positive and disruptive effects would emerge over time through an informal process of negotiation and accommodation between shareholders and management, it is not clear that this balance can be achieved by manipulating the proxy access requirements under the authority of section 14 of the Exchange Act. Instead, the desired balance may require some institutional mechanism for defusing the threat of unproductive proxy contests, while preserving a strong shareholder presence in the corporate environment. I will discuss this possibility in connection with the alternative of an Italian improvisation.

2. Nominating Committee

As an avenue for reform of nominating committees, we need not consider the elaboration of additional disclosure requirements. Disclosure has never worked as a means of giving shareholders access to the nominating process, and the SEC's 2003 regulations have taken disclosure to an ultimate (and burdensome) extreme. A different approach is suggested by the American Bar Association Committee on Corporate Laws in its Corporate Director's Guidebook: "the non-executive chair, if there is one, as well as the lead or presiding director or nominating/corporate governance committee chair, should be prominently involved in the recruiting process, in order to reinforce the perception as well as the reality that the nominating decisions are being made

311. See supra notes 83, 97-99, 113-17 and accompanying text.
by the committee, and not by the chief executive officer or other managers. 312

The point implied in the Guidebook’s cautious advice is that an independent nominating committee can gain weight and significance with the emergence of independent board leadership. One can see this development in the United Kingdom. A unique institution, the Financial Reporting Council, has introduced new standards in corporate governance that, in some ways, parallel developments in the United States. 313 The British, however, have placed primary emphasis on separating the offices of chief executive and board chairman. The Combined Code of Corporate Governance, promulgated by the Financial Reporting Council, now bars the same individual from serving as both chief executive and chairman. 314 The nominating process has also undergone a similar change. While the selection of directors was formerly the personal prerogative of the chairman, 315 the responsibility is now placed in a nominating committee, with a majority of non-executive members. Significantly, the committee is to be chaired by the board chairman himself or by an independent non-executive director. 316

In the United States, corporations have been slow to accept the practice of splitting the offices of CEO and board chairman. Where a non-executive chairs the board, it is frequently a former CEO, serving on a transitional basis, or other insider. A chairman, who qualifies as independent by the same standards as applied to directors, was found in only ten percent of large publicly traded companies in a recent survey. 317 On the other hand, the designation of a lead director has quickly gained almost universal acceptance with the adoption of NYSE rules requiring executive sessions of independent directors of the board. 318 The person who chairs these sessions is ipso facto a lead director,

317. STUART, supra note 103, at 20. A total of thirty-three percent of companies in the survey reported separating the positions of CEO and Chairman but many appointed a former CEO or other insider or had not actually filled the chairman position.
318. Id. at 3; BRANCATO & PLATH, supra note 108, at 20; SOCIETY OF CORPORATE SECRETARIES & GOVERNANCE PROFESSIONALS, supra note 113, at 4-5.
though his or her responsibilities may be formally defined and enlarged.

The practice of placing an independent board chairman or a prominent non-executive director in charge of the nominating process would appear to have the potential of significantly altering the social dynamics of the board. The new directors’ expectations of personally benefiting from board membership would then center on their relationship with the chairman or the lead director, and, to this extent, the directors would be likely to assume a position of greater independence from management. A line of business administration scholars have long regarded the CEO’s power to nominate or influence the nomination of directors as an important source of the CEO’s power on the board. By decisively shifting this power to independent board leadership, the effect would be to create a new allocation of power that may be more conducive to effective monitoring of management decisions.

3. Reserved Shareholder Seats on the Board

In 1988, pursuing Mortimer Caplin’s earlier suggestion, Louis Lowenstein, a professor of law and finance at Columbia University, proposed that “shareholders should be allowed to elect a minimum of two directors out of a short but separate list of candidates, appearing in the same proxy statement” as management. In the wake of recent corporate scandals, other prominent figures voiced variations of this idea. Lowenstein envisioned the board as having two seats exclusively reserved for shareholder nominees. To avoid electoral confusion, the number of shareholder nominees would be limited through a nominating process: “The list of candidates would consist of those with the most nominating votes and would contain perhaps two times as many candidates as the number of seats to be filled.” Once elected, the “[s]hareholder nominated directors would have the same duties and rights as the rest.”

“The process,” Lowenstein explains, “is frankly designed to encourage the election of candidates nominated by major institutions,” such as College Retirement Equities Fund. It seeks to create “continuing unconfrontational channels by which the owners of the business communicate with the

320. LOWENSTEIN, supra note 41, at 210; Caplin, supra note 13, at 153.
321. Monks and Sykes suggest that boards should have three seats reserved for shareholder nominees and report that financier, Felix Rohatyn, and Wall Street lawyer, Ira Millstein, have spoken in favor of one reserved seat. See Robert A. G. Monks & Allen Sykes, Capitalism without Owners Will Fail, www.ragm.com/hottopics/2004/ragm_sykesPolicyMakersGuide.pdf
322. LOWENSTEIN, supra note 41, at 210.
323. Id.
324. Id.
managers." By providing a "bridge between owners and managers . . . it just might turn a we-they conflict into a continuing dialogue about how best to satisfy the interests of both." Lowenstein predicted that the institutional managers would acquire a more long-term investment orientation if they had a way to participate in the management of particular companies:

The more the board listens, and the more influence a shareholder nominated director acquires, the less the temptation for an investor to sell the company’s stock. . . . Money managers, able to place their candidates on this or that board, may actually become interested in the companies they own. They may begin to act more as owners of a business . . . because they would begin to develop that better understanding of particular companies that comes only with time and commitment.

He went on to acknowledge the problems of conflict of interest and confidentiality that a shareholder-nominated director might encounter on a corporate board. His position was that the problem could be minimized by professional restraint, procedures to avoid conflicts, and by the nomination of persons, such as business school deans, "who could represent shareholder interests effectively but whose knowledge would not be imputed to the investor."

Lowenstein was most tentative on one point: "whether institutions would respond to the opportunity, whether the carrot is large enough to shake investors out of their apathy." He acknowledged that "[t]he shareholder nominated director proposal is frankly in the nature of an experiment for which there are no precedents," but he offered an optimistic conjecture:

One suspects that groups with common ties would form to assure the nomination of candidates acceptable to the group, sometimes with such substantial support that nomination would be tantamount to election. If investors then begin to act like owners of a business, the managers might then begin to treat them as such, rather than as officious meddlers. . . . The guess is that for appropriate reasons of prestige, power, and peer group pressure, the institutions would slowly but surely take advantage of the opportunity to move from the outside to the inside.

The proposal differs from the SEC’s 2003 proposal in a very important respect. The two shareholder-nominated directors would not enter the board

325. Id. at 211.
326. Id.
327. Id. at 213.
328. LOWENSTEIN, supra note 41, at 216.
329. Id. at 214.
330. Id.
331. Id. at 215 (emphasis added).
after defeating management in a costly and adversarial proxy context. Instead, the shareholder-nominated directors would be an ongoing and predictable feature of the board, and, accordingly, both shareholders and management would have an incentive to make the system work by developing procedures and norms of conduct needed to avoid conflict and foster dialogue. The shareholder-sponsored directors, if backed by stable and well organized shareholder coalitions, would likely receive appropriate deference from other directors. The proposal, however, suffers from the same defects as the SEC's insurgent director proposal; the suspicions of conflict of interest and confidentiality would remain, and the board would be irremediably divided into two parts by the separate processes of election. While many of the benefits Lowenstein envisions might be attainable, it is unclear whether such a divided board would form the sense of interdependence needed to work cooperatively toward common objectives. The reserved seat proposal would unquestionably run into transitional problems, and if unsuccessful, it would be difficult to call the experiment off.

4. An Italian Improvisation

The difficulty in changing complex and specialized institutions, a familiar phenomenon illuminated by modern sociological research, is clearly encountered in the field of corporate governance. It presents a paradox for reform: where the basic structure of a system is defective, there is still no alternative to working with existing institutional forms. The most viable reform strategy may sometimes be an opportunistic improvisation, which responds to current needs while permitting a slower process of systemic change. The 1998 reforms of Italian corporate law illustrate my meaning.

The Italian corporation is characterized by an insider system of ownership and control. Investors holding large blocks of stock actively monitor senior management to protect their holdings. Financial reporting is often formulaic and conclusory, and shareholder derivative actions have not traditionally been allowed. While this system may suit the interest of large blockholders, it presents risks for minority shareholders and impairs the investor confidence needed for efficient capital markets. Seeking to better protect minority interests, a comprehensive legislative reform in 1998 provided minority investors with an unusual privilege — direct representation on the board of


statutory auditors of the corporation — as part of a series of measures intended to improve financial reporting and bolster shareholder remedies. The representation of minority shareholders on the statutory auditing board may be regarded as a kind of provisional remedy ostensibly intended to provide a measure of immediate relief while more comprehensive forms of minority protection based on disclosure and shareholder rights could gain acceptance.

In the United States, patterns of shareholder passivity, linked to dispersed share ownership and high investment turnover, have been reinforced by a century of custom and law. Pension funds, for example, practice a degree of diversification well beyond that dictated by modern portfolio theory and are barred from pursuing concerted action in corporate governance by the broad sweep of securities regulations. With limited power to affect corporate policies, institutional investors have difficulty justifying the time and cost needed for monitoring activity. A more effective shareholder-based system of corporate monitoring calls for complex reforms. These should remove obstacles to shareholder initiatives and reward the monitoring efforts that have genuine influence. One may ask if there is any way to bridge the gap between ownership and control while such complex reforms can be pursued. The emergence in the past decade or so of active oversight committees of the board, mandated by the listing requirements of national stock exchanges, suggests an opportunity having some analogy to the Italian experience: it would be possible, as part of more comprehensive reforms, to give shareholders the right to elect representatives, with full membership status, to positions on the nominating committee.

It is an inelegant idea, perhaps, which would require federal regulation of an institution that has only recently come to maturity as the result of voluntary management reforms, and it would require the design of a novel election procedure. But if combined with a system of direct shareholder access to the management proxy, it would directly serve two compelling objectives. The first would be to minimize the disruptive effects of the direct shareholder access system. A shareholder representative on the nominating committee could defuse the threat of costly proxy contests by negotiating accommodations with...
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major blocs of shareholder. Such accommodations would deprive potential challengers of part of their potential base of support, reducing the likelihood of proxy contests with serious prospects of success. The second objective would be to fulfill the vision, articulated by Hinsey and other commentators in the 1970s, of making the nominating committee a vehicle for shareholder participation on the board. The power of the nominating committee to screen candidates would help assure the selection of qualified directors, disposed to work cooperatively and free of perceived problems of confidentiality and conflict of interest. At the same time, the mediating role of a shareholder representative would exert pressure for greater intellectual diversity on the board and serve to encourage the selection of candidates with an independence of judgment grounded in accountability to the community of shareholders.

But in light of prevailing shareholder passivity, one may ask: would large institutional shareholders or coalitions of shareholders adequately respond to the opportunity of fielding candidate for representatives on corporate nominating committees? The answer may depend in part on response of management. Faced with the reality of living with a direct shareholder access rule, management would appear to have an incentive to encourage the mediating activities of the shareholder representative by providing an appropriate retainer and other administrative assistance. In the end, the corporation could benefit from improved shareholder relations, a matter now deemed important enough to justify a separate department in large publicly traded corporations.

The prospects of success would also be affected by the attractiveness of the carrot offered to potential shareholder participants. Institutional shareholders would have a better incentive to participation if (a) the responsibility of the nominating committee were broadly defined by regulations and (b) the shareholder representative enjoyed an accompanying presence on the other supervisory committees, i.e., the compensation committee and auditing committee. It should be noted that a broad range of responsibilities for the nominating committee is currently recommended by The Conference Board and associations of corporate professionals. And the nominating committee frequently shares with the compensation committee responsibility of planning for management succession. Finally, like the 2003 SEC proposal, the scheme would need to be combined with measures to remove obstacles to shareholder initiatives in corporate governance and to permit concerted action by

338. See supra notes 90-92 and accompanying text.


341. BRANCATO & PLATH, supra note 108, at 34-84; DARAZSDI & STOBAUGH, supra note 113, at 5.
shareholder coalitions in the sphere of activity.\textsuperscript{342}

Such a novel practice would, no doubt, be an experiment with uncertain benefits, but, unlike the idea of reserved shareholder seats on the board, it would have no significant downside risk. Shareholder representatives on the nominating committee would not disrupt board deliberations, and since the nominating committee has a narrowly defined responsibility, well removed from business operations, the problems of confidentiality and conflict of interest would be of minor concern. The reform, moreover, might initially be restricted to the limited number of corporations qualifying as large accelerated filers,\textsuperscript{343} and it need not require that the shareholder position on the nominating committee actually be filled. Election procedures might effectively limit the privilege of naming the shareholder representative to large shareholder blocs, leaving management with the option of directly negotiating with these shareholder coalitions. If its concerns were satisfied, a shareholder bloc might not choose to pursue the actual appointment of a representative on the nominating committee. The system would serve its objective if it did no more than stimulate active and good faith outreach by nominating committees into the shareholder community.

Admittedly, the proposal would be no more than an improvisation — a way to bridge the century-long separation of shareowners and corporate management — which could facilitate the evolution of a more effective system of corporate self-regulation. But it would be open to further change, either by enlarging shareholder representation on oversight committees, or by including employee representatives. The idea of employee participation in corporate governance is seldom discussed today, and in some quarters it stirs antipathies arising from experience with unions or objections to the German system of codetermination. But there is a cogent case for employee participation in those business functions where it would improve firm performance. The nominating process may be such a function.\textsuperscript{344} The presence of employee representatives on the nominating committee could confer the benefits of stability, independence, and productivity.

Two extraordinary facts help explain the vehemence of management’s opposition to the SEC’s 2003 shareholder access proposal: institutional investors now own approximately seventy percent of the equity of the 1000 largest corporations,\textsuperscript{345} and the ownership is concentrated in a relatively small

\textsuperscript{342} See Security Holder Director Nominations, supra note 52, at 35-39; Michael E. Murphy, \textit{Dispelling TINA’s Ghost from the Post-Enron Corporate Debate}, 43 SANTA CLARA L. REV. 63, 78-86 (2002); Murphy, supra note 225, at 512-22.

\textsuperscript{343} 17 C.F.R. § 240,12b-2(2).

\textsuperscript{344} Other functions that might benefit from employee participation include pension plan administration and selection of corporate contributions. \textit{See} Murphy, supra note 225, at 530-31, 538 n.188.

\textsuperscript{345} BRANCATO & PLATH, supra note 108, at 6, 35.
number of firms—the top 100 institutional investors own fifty-two percent of all U.S. equities.\textsuperscript{346} One may argue that shareholder input is an essential element of a robust system of self-regulation, but it is quite another thing to entrust the main burden of corporate governance to institutional investors. The short-term oriented community of investment managers is not prepared by training for the task or willing to shoulder the responsibility. The business community may rightly gird themselves to fight government initiatives that threaten the stability of corporate by giving investors more power than they may be expected to exercise responsibly. The question then becomes how a shareholder voice can be contained to provide a "check on insularity" without yielding to misguided solutions that would overextend shareholder's monitoring capacity.\textsuperscript{347} The concept of self-regulation provides an alternative. The employee community is also a potential check on insularity of management, but it is likely to favor management on a broad range of issues. Employee ownership, it may be remembered, was once a popular devise for defending against hostile takeovers.\textsuperscript{348} By placing an employee representative on the nominating community, management would gain a potential ally and a counterweight to shareholder power, confining large institutional shareholders to an appropriate degree of influence.

While employee representatives might generally be well disposed toward management, especially if currently employed by the corporation, the presence of employee representatives on the nominating committee would still confer a degree of additional independence by diluting the effects of ingroup favoritism.\textsuperscript{349} The presence of representatives of both shareholders and employees on the committee would inevitably serve to broaden the scope of recruitment by instilling a new perception of candidate acceptability. Employee representatives might also be expected to cultivate networks of contacts and to side occasionally with the shareholder representative on issues with respect to which management directors were either noncommittal or divided.

A body of empirical research suggests that trust, defined as a tendency to cooperate, "accounts for the superior performance of all institutions in a society, including firms."\textsuperscript{350} Indeed, trust is a universally admired quality in business literature. Business biographies associate trust with successful executive leadership,\textsuperscript{351} and labor relations specialists view it as the key to a

\textsuperscript{346} See BOGLE, supra note 310, at 74.
\textsuperscript{347} The phrase is John Pound's. See Pound, supra note 274, at 95.
\textsuperscript{348} Michael E. Murphy, \textit{The ESOP at Thirty: A Democratic Perspective}, 41 \textit{WILLAMETTE L. REV.} 655, 663-64 (2005).
\textsuperscript{349} See supra notes 195-204 and accompanying text.
\textsuperscript{350} Rafael La Porta et al., \textit{Trust in Large Organizations}, in \textit{SOCIAL CAPITAL} 310 (Partha Dasgupta & Ismail Serageldin eds., 2000).
\textsuperscript{351} KATHY BLOOMGARDEN, \textit{TRUST: THE SECRET WEAPON OF EFFECTIVE BUSINESS LEADERS} (2007); Eleanor Bloxham, \textit{Seeking Trust}, \textit{CHIEF EXECUTIVE} 57, Jan. 1, 2007; MICHAEL S. MALONE, \textit{BILL & DAVE, HOW HEWLETT AND PACKARD BUILT THE WORLD'S GREATEST COMPANY} 123-63, 192,
productive workplace. In a study of small and medium-sized businesses with employee stock ownership plans, Logue and Yates found that the single factor most closely correlated to superior firm performance was the election of non-management employees to the board of directors. A most plausible explanation is that the practice served to confirm relationships of trust between management and the workforce. In the large publicly owned corporation, the participation of employees in the nominating committee can be seen as a similar trust-building practice, calculated to stimulate the virtuous circle of cooperation and higher performance.

But it may be objected that there is no precedent, outside of collective bargaining, for allowing employees to select representatives for such a role. In fact, a model procedure does exist for one aspect of corporate governance — pension plan administration. The British Pension Act 1995 requires that one third of the members of company pension boards be nominated by members of the plan. In July 2006, the regulatory authority issued a Code of Practice offering guidance on methods of selection of member-nominated board members. The Code requires that “nominating and selection procedures comport with the principles of proportionality, fairness and transparency; and it outlines alternative methods of selection that may meet these criteria.” I have argued elsewhere that the fiduciary structure of pension plans is in urgent need of reform and have advocated the British Pension Act 1995 as a compelling model. If procedures for representation of employee could be worked out in this sphere of business activity, the procedures might later be put to other uses, maybe even including the nominating process for the board.

5. The Concept of a Compound Board

At the heart of the dilemmas of corporate governance in the American and British systems is the necessity of reconciling the functions of assisting management in the most vital corporate decisions and monitoring management’s performance based in part on these board-approved decisions. An active role in management can compromise objectivity in monitoring but monitoring draws on information gained by participation in decision making. It is no wonder that recommended practices do not consistently produce effective boards. A balancing act that works well in one corporation may fail in


352. Harvey Leibenstein, Inside the Firm: The Inefficiencies of Hierarchy 48-99 (1987); Robert Levering, A Great Place to Work 259-66 (1988). Levering identifies a series of practices calculated to build trust in the workplace, including openness and transparency and a willingness to go beyond the conventional relationship with employees. Id. at 45.


354. Murphy, supra note 225, at 529-30.

355. Id. at 530.

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another.

Several countries in Continental Europe, including Germany, have avoided this dilemma by separating the functions of management and monitoring: a supervisory board, with broad access to information, is responsible for monitoring and an executive board is given free rein to manage the company.\textsuperscript{357} Though often associated with the German experiment in co-determination,\textsuperscript{358} the idea a compound board takes a different form in France and can in theory take many other forms.\textsuperscript{359} One spectacularly successful U.S. company, TIAA-CREF, has such a two-tiered board but of a very unusual kind. Two Boards of Overseers, each with the same seven members, function at a level above two different boards of trustees responsible for management of the linked companies — Teachers Insurance and Annuity Association (TIAA) and College Retirement Equities Fund (CREF). The Boards of Overseers have exclusive authority to pass by-laws — and thus they can choose their own role — but they have elected to follow the practice of meeting only twice a year to review the corporate mission and, in the case of TIAA, to nominate candidates for its Board of Trustees (CREF has a distinct nominating procedure).\textsuperscript{360}

The compelling logic of separating the monitoring function from active management tends to reappear in corporate governance systems, even when it is not found in the structure of the board. The Japanese keiretsu have a monitoring function somewhat analogous to a supervisory board,\textsuperscript{361} as do the informal decision-making councils of family-owned business,\textsuperscript{362} LBO associations, venture capital groups, and the holders of large blocs of stock in some U.S. corporations. The New York Stock Exchange effectively embraced


\textsuperscript{359} Lauren J. Aste, Reforming French Corporate: A Return to the Two-Tier Board?, 32 GEO. WASH. J. INT'L. L. & ECON. 1 (1999) (The supervisory board is optional in France but is found in a number of large and respected companies).

\textsuperscript{360} TIAA-CREF, GOVERNING TIAA-CREF: AN INTRODUCTION TO THE TIAA-CREF SYSTEM, available at http://www.tiaa-cref.org/.

\textsuperscript{361} See Ronald J. Gilson & Mark J. Roe, Understanding the Japanese Keiretsu: Overlap Between Corporate and Industrial Organization, 102 YALE L.J. 871 (1993) (The authors acknowledge the monitoring function but emphasize other aspects of the keiretsu system.); JONATHAN P. CHARKHAM, KEEPING GOOD COMPANY 74-118 (1994).

\textsuperscript{362} Studies show that S & P 500 corporations with family groups involved in management actually out perform other S & P 500 corporations, but family-owned firms with independent boards do better than those dominated by insiders. See CHARAN, supra note 126, at 26; Ronald C. Anderson & David M. Reed, Board Composition: Balancing Family Influence in S & P 500 Firms, 49 ADMIN. SCI. Q. 209, 231 (2004).}
the logic of a supervisory board by mandating regularly scheduled executive sessions of independent directors "[t]o empower non-management directors to serve as a more effective check on management."

A supervisory board removes significant constraints on the process of selecting board members. Since the board operates at a greater distance from day-to-day operations, it reduces the problems of preserving confidentiality and avoiding conflicts of interest, effectively expanding the range of appropriate directorial candidates. A more clearly defined function of the board has the same effect permitting a broader range of eligible members. First, the duties of evaluating management performance places less demand on specialized expertise and more on qualities of balanced judgment and inter-personal intelligence, which that may be found in leaders in many walks of life. Second, as noted earlier, decision-making research reveals that an ambiguous environment, such as that of U.S. corporate boards, stimulates pressures for conformity, as group members look to each other for normative guidance. In contrast, a group with a simpler and better defined role, such as that of a supervisory board, can more easily remain on-task in face of differing perspectives and backgrounds of members, perhaps relying on the device of majority voting.

Nevertheless, the separation of the corporate board into two distinct bodies will affect the decision-making process in incalculable ways and have profound implications for patterns of corporate leadership. None of the models for a compound board, including TIAA-CREF, can plausibly be transferred to the publicly traded corporation in the United States. One cannot seriously advocate such a fundamental reform in corporate governance without a basis in practical experience. Certain avenues for experimentation, however, appear worthy of serious consideration.

First, Bebchuk and Hamdani have made a strong case for empowering shareholders to initiate changes in the corporation’s state of incorporation, with the option of federal incorporation. If federal corporate law authorized a supervisory board, this form of corporate organization might appeal to shareholders seeking an effective check on management and more direct participation in monitoring activities. The supervisory board would lend itself to changes in the nominating process to meet these shareholder objectives.

Second, Congress has multiplied the number of government-sponsored corporations, without any common plan, in the hope of combining out a public purpose with the advantages of corporate autonomy. The governance

364. See supra notes 252-55 and accompanying text.
problems of these entities have led to opposing solutions. Privatization departs from the original dedication to a public purpose while tighter regulation sacrifices the advantages of autonomy. The field might instead be regarded as a laboratory of new approaches to corporate governance. For example, an advisory board of stakeholders, with specific powers of intervention, might facilitate the task of regulation while preserving management independence. Since some government-sponsored corporations are partially or entirely private owned, experimentation with stakeholder representation might have application to other industries.

Third, the responsibilities given to independent directors in the three principal board committees—nominating, compensation, and auditing—as well as in the newly mandated executive sessions, might evolve further in a direction that would capture the benefits of a supervisory board, while retaining existing organizational forms. The Italian improvisation, suggested earlier, would be a step of this kind.

VII. CONCLUSION

William Allen, the distinguished former Chief Judge of the Delaware Court of Chancery has posed the question of why we should care about corporate governance. He notes that the phrase was almost unheard of fifteen or twenty years ago, but “today it seems to be on everyone’s lips.” Statistical evidence of the link between corporate governance and financial performance is too inconclusive to account for the rise in the level of interest. Judge Allen offers two reasons why we should indeed care: the first is the likelihood that corporate governance can help provide a more efficient economic system. The second, he suggests, “is not economic so much as political in the largest sense of that term.” A well-functioning system of corporate governance helps to legitimate the power over others—“employees, customers, investors and others in the community”—that is entailed in decisions regarding the deployment of corporate assets.
The present essay has sought to respond to both reasons underlying concern about corporate governance. Decision-making research offers a perspective for analyzing the effectiveness of the corporate organization that can complement and enrich other perspectives drawing from economics and the life sciences. This growing body of knowledge figures prominently in the field of management science but received less attention from legal scholars. It provides a useful framework for analyzing the nominating process and proposed reforms thereto.

The subject of the nominating process for the corporate board of directors has a direct bearing on public perceptions of corporate legitimacy. The ritual of presenting shareholders with an uncontested slate of candidates grates against democratic political sensibilities. At a popular level, it stirs up indignation and invites comparisons with the one-party slate in authoritarian governments. More sophisticated commentators struggle to explain the difficulty of devising a practical alternative and the seductive, but misleading, appeal of political models for business enterprises.

The proposed reforms of the nominating process, moreover, touch on matters, linked to Republican and Democratic traditions, which are distinctly relevant to a theory of corporate legitimacy. This article began with the concept of "fair corporate suffrage," found in the legislative history of section 14 of the Exchange Act — a republican concept involving the separation of internal powers in the corporation. Our analysis of decision making research again underscored the need for internal checks on management, and, in addition, this research supported the value of extending the circle of participation in corporate decision making — a democratic value — so as to minimize the hazards of conformity and in-group favoritism and to secure the benefits of intellectual diversity.

A comprehensive theory of corporate legitimacy might perhaps rest on capacity of the corporation to conduct itself according to the standards of a democratic society. Without attempting to sketch such a theory here, I wish to note only that the application of decision-making research to corporate governance favors a departure from the traditional organization of the corporate

374. LORSCH & MACIVER, supra note 83, at 189-91.
376. See supra notes 13-14 and accompanying text.
377. The idea of adapting a republican separation of powers to corporate governance is discussed by Bogle and Braithwaite. See Bogle, supra note 109, at 26-29; John Braithwaite, On Speaking Softly and Carrying Big Sticks: Neglected Dimensions of a Republican Separation of Powers, 47 U. TORONTO L.J. 305 (1990). The idea of designing corporate governance so that the corporation will better comport itself according to the standards of a democratic society seems to entail the concept of corporate self-regulation, which may perhaps be regarded as a specific form of the life principle of self-organization. See John Mathews, Holonic Organisational Architectures, 15 HUM. SYSTEMS MGMT. 27 (1996); Turnbull, supra note 15.
board, which is as a self-perpetuating elite with weak internal checks. This direction of institutional reform has clear implications for such a theory of corporate legitimacy.

This essay first traced the unfulfilled mandate of section 14 of the Exchange Act. The SEC’s failure to device a practical mode for shareholders to select directorial candidates, has preserved the perennial scandal in corporate—the uncontested slate for directors relegating shareholders to the role of a rubber stamp. But the means provided by the Exchange Act to achieve the goal of “fair corporate suffrage”—the regulation of proxies—may be inadequate to carry out the legislative intent. The SEC’s 2003 proposal for shareholder access to the management proxy presents serious defects if judged by the desiderata of decision making.

The institution of the nominating committee has failed to respond to the mandate of shareholder suffrage. Though some commentators and the SEC staff once saw it as a possible vehicle for shareholder influence, it has never served this function. Moreover, as presently constituted, the nominating committee has not helped to remedy the systemic decision-making flaws that afflict the board as a homogeneous and cohesive body. Nevertheless, it has the merit of properly screening candidates and preparing the stage for cooperative relations on the board, and it might strengthen internal checks if it were controlled by independent board leadership.

Both schemes for the selection of directors are, to a large degree, the product of historical accidents and are amenable to reform by federal legislation. I have discussed four avenues of reform—modification of the existing systems, the idea of reserved shareholder seats on the board, shareholder representation in the nominating committee, and experimentation with a compound board. The insights of decision-making research may affect our assessment of the urgency of reform and our choice of these alternatives.