

## A TEAM PRODUCTION APPROACH TO CORPORATE LAW AND BOARD COMPOSITION

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In today's world of corporate governance, the board of directors of a publicly held firm<sup>1</sup> (public company) will almost certainly be made up of a majority of independent directors.<sup>2</sup> For example, both the New York Stock Exchange and the NASDAQ require that a public company's board have a majority of independent directors and that the major corporate board committees—audit, compensation, and nominating—be composed entirely of independent members.<sup>3</sup> Moreover, both stock exchanges require that directors meet certain subjective and objective criteria before they can be considered independent.<sup>4</sup> In addition, proxy advisory companies, those companies that help shareholders decide how to vote on company matters, have their own enhanced independence guidelines.<sup>5</sup> This movement toward increased board independence began during the 1990s but was given a big

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<sup>1</sup> A publicly held firm is an economic organization "in which (i) management and residual claimant status (shareholding) are separable and separated functions; (ii) the residual claims (shares) are held by a number of persons; and (iii) the residual claims are freely transferable and neither entry to nor exit from the firm is restricted." Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW 461, 463 n.9 (1992).

<sup>2</sup> Independent directors are defined here as directors whose ties to the corporation are not so significant as to influence their judgment in corporate matters.

<sup>3</sup> See NYSE, Inc., Listed Company Manual, §§ 303A.04–303A.06 (2006), available at [http://www.nyse.com/Frameset.html?nyseref=http%3A//www.nyse.com/regulation/nyse/1182508124422.html&displayPage=/lcm/lcm\\_section.html](http://www.nyse.com/Frameset.html?nyseref=http%3A//www.nyse.com/regulation/nyse/1182508124422.html&displayPage=/lcm/lcm_section.html) (setting out requirements for listed companies' nominating, compensation, and auditing committees) (link); NASDAQ, Inc., Marketplace Rules RR. 4350(c)(4)(A)(ii), 4350(c)(3)(A)(ii), 4350(d)(2)(A) (2006), available at [http://cchwallstreet.com/NASDAQTools/PlatformViewer.asp?selectednode=chp\\_1\\_1\\_4\\_1&manual=%2Fnasdaq%2Fmain%2Fnasdaq-equityrules%2F](http://cchwallstreet.com/NASDAQTools/PlatformViewer.asp?selectednode=chp_1_1_4_1&manual=%2Fnasdaq%2Fmain%2Fnasdaq-equityrules%2F) (setting out requirements for listed companies' nominating, compensation, and auditing committees) (link).

<sup>4</sup> See NYSE, Inc., Listed Company Manual, *supra* note 3, §§ 303A.02 (setting out both subjective and objective tests for establishing director independence); NASDAQ, Inc., Marketplace Rules, *supra* note 3, RR. 4200(a)(15), 4350(c)(4)(A)(ii), 4350(c)(3)(A)(ii) (setting out both subjective and objective tests for establishing director independence).

<sup>5</sup> See, e.g., RiskMetrics Group, *ISS Governance Services U.S. Corporate Governance Policy: 2008 Updates*, at 7–9 (2007), available at [http://www.riskmetrics.com/sites/default/files/2008ISS\\_USPolicyUpdates.pdf](http://www.riskmetrics.com/sites/default/files/2008ISS_USPolicyUpdates.pdf) (link).

boost by the Enron scandal.<sup>6</sup> It is also a reflection of society's evolving understanding of how a public company is to be governed. As so well expressed by Professors Margaret Blair and Lynn Stout, "[t]he notion that responsibility for governing a publicly held corporation ultimately rests in the hands of its directors is a defining feature of American corporate law; indeed, in a sense, an independent board is what makes a public corporation a public corporation."<sup>7</sup> As discussed below, it allows the board of a public company to act as a "mediating hierarchy;" that is, as an arbiter of disputes between the various stakeholders that constitutes a public company.<sup>8</sup> Moreover, many believe that independent boards can better monitor managerial opportunism and enhance firm performance relative to management dominated boards.<sup>9</sup>

If independence is critical, then one option to ensure board independence is to require that a board be composed solely of independent directors. However, this is problematic because an all independent board would lack the insights, knowledge, and understanding of those who know the company best. This would cause more harm than good in board decision-making. Therefore, a corporate board composed of a majority but not entirely of independent directors appears preferable.

But having a majority of independent directors means nothing unless these independent directors also exercise "independence of mind."<sup>10</sup> They must be able to make independent judgments without being overly influenced by inside directors and executive management. This, of course, is easier said than done. Moreover, "independence does not consider how the directors will contribute to the board's understanding of the firm's core capabilities" and thereby help optimize firm performance.<sup>11</sup> Thus, independence in itself provides little in the way of guidance on how independent board members are to be selected.

The most important criterion for selecting independent board members is to choose members who enhance the efficiency of board decision-making. For that to occur, we must have an understanding of how the corporate board of a public corporation operates in an efficient manner. Professors Blair and Lynn propose that in order for the corporate board of a public corporation to operate efficiently, it must operate as a mediating hie-

<sup>6</sup> See Allan Kaufman & Ernie Englander, *A Team Production Model of Corporate Governance*, ACAD. MGMT. EXECUTIVE, Aug. 2009, at 9, 10, available at <http://www.gwu.edu/~business/smp/Faculty/Englander/AME%20Team%20Production%20in%20Journal.pdf> (link).

<sup>7</sup> Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 251 (1999).

<sup>8</sup> See *id.* at 276–78.

<sup>9</sup> See Kaufman & Englander, *supra* note 6, at 10.

<sup>10</sup> John Roberts, Terry McNulty & Philip Stiles, *Beyond Agency Conceptions of the Work of the Non-Executive Director: Creating Accountability in the Boardroom*, 16 BRITISH J. MGT. S5, S19 (2005).

<sup>11</sup> Kaufman & Englander, *supra* note 6, at 20.

rarchy, consistent with their team production approach to corporate law.<sup>12</sup> Given this understanding, this Essay proposes that a team production approach should also be used in board composition so that the board of a public company can have the best chance of effectively carrying out its role as a mediating hierarchy.

For guidance on how we should select board members using a team production approach, we rely on a model outlined by Professors Allan Kaufman and Ernie Englander.<sup>13</sup> One of their major recommendations is that the former and current Chief Executive Officers of other companies (outside CEOs) should be forbidden from participating in key board committees—the audit, nominating, and compensation committees, for example—in order to significantly reduce their influence.<sup>14</sup> Even though we cannot yet recommend that outside CEOs be totally eliminated from participation in these key board committees, this recommendation does find support in our prior work on board composition.<sup>15</sup>

In that work, we posited that having a board dominated or heavily influenced by outside CEOs may lead to what we referred to as “dysfunctional deference,” a regard for the recommendations of board insiders and executive management so pronounced that it stifles deliberation of a corporate board’s most important decisions.<sup>16</sup> Therefore, it is our position that corporate boards of public corporations—as well as their audit, compensation, and nominating committees—would be better off and less prone to error if they were composed of no more than a minority of current or retired outside CEOs.

Part I of this paper discusses Blair and Stout’s team production model of corporate law and how it leads to understanding the board as a mediating hierarchy. Part II discusses Kaufman and Englander’s team production model of corporate governance and its implication for board member selection. Part III focuses on how a team production approach, reinforced by our understanding of small group decision-making, leads to the recommendation that the influence of outside CEOs should be significantly reduced. We conclude with a summary of how a team production approach should be applied to board composition.

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<sup>12</sup> See Blair & Stout, *supra* note 7.

<sup>13</sup> See Kaufman & Englander, *supra* note 6.

<sup>14</sup> *Id.* at 19. However, we do not feel comfortable going that far in our recommendations for board composition without additional empirical information.

<sup>15</sup> See Bernard S. Sharfman & Steven J. Toll, *Dysfunctional Deference and Board Composition: Lessons from Enron*, 103 NW. U. L. REV. COLLOQUY 153, 158 (2008), <http://www.law.northwestern.edu/lawreview/colloquy/2008/38/> (link).

<sup>16</sup> *Id.* at 156–59.

## I. TEAM PRODUCTION AND THE BOARD'S ROLE AS A MEDIATING HIERARCHY

According to Professors Hansmann and Kraakman, “[t]here is no longer any serious competitor to the view that corporate law should principally strive to increase long-term shareholder value.”<sup>17</sup> In this worldview of corporate law, shareholders indirectly sit on top of the corporate pyramid, as corporate managers have an obligation to manage according to shareholder interests.<sup>18</sup> The economic rationale for utilizing this “shareholder primacy norm” is that this is the best way for our society to maximize “aggregate social welfare.”<sup>19</sup>

Yet, logic, experience, and the law tell us something different. As discussed below, a review of statutory corporate law shows us that corporate governance is clearly not structured to achieve shareholder primacy. Moreover, the courts very rarely look to such a norm when deciding corporate law cases.

### A. Shareholders and the Structure of Corporate Law

The biggest hurdle in understanding corporate law is accepting the reality that the law does not provide ownership rights to shareholders. Although shareholders do own interests in the corporation by owning company stock, they do not have ownership of the corporate entity. For example, title to corporate assets is in the name of the corporation, not its shareholders.<sup>20</sup> Perhaps most importantly, corporate assets are controlled by the corporation’s board of directors, not its shareholders.<sup>21</sup> Without control, shareholders become merely the “recipient[s] of the wages of capital.”<sup>22</sup>

Furthermore, while shareholders do have potential claims to the residual profits of the corporation, it is the board of directors that decides if a dividend will be paid, and how much the dividend will be. Moreover, corporate law clearly does not require the corporate board to follow the commands of its shareholders.<sup>23</sup> Shareholders may ratify a board’s action, but the board must first approve the action.<sup>24</sup> Even if shareholders pass a un-

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<sup>17</sup> Henry Hansmann & Reiner Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439 (2001).

<sup>18</sup> *See id.* at 440–41.

<sup>19</sup> *Id.* at 441.

<sup>20</sup> Blair & Stout, *supra* note 7, at 269.

<sup>21</sup> “If ‘control’ is the economically important feature of ‘ownership,’ then to build a theory of corporations on the premise that ownership (and, hence, control) lies with shareholders grossly mischaracterizes the legal realities of most public corporations.” *Id.* at 260–61.

<sup>22</sup> *Id.* at 265 n.32 (citing ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 3 (1932)).

<sup>23</sup> *See id.* at 291.

<sup>24</sup> *See* Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461, 468 (1992).

animous resolution requesting the board to act in some specific matter, the board has the legal right to ignore such a resolution.<sup>25</sup>

Finally, courts adjudicating corporate law cases prefer to disregard shareholder primacy in their decisions. Courts demonstrate this preference by applying the business judgment rule; requiring shareholders to make demands before filing a derivative suit or demonstrating demand futility; making it clear that directors owe fiduciaries to the corporation, not just to shareholders; limiting the requirement of shareholder wealth maximization to unusual situations such as when Revlon duties are to be applied;<sup>26</sup> and rarely finding directors financially liable for the decisions they make as a board.<sup>27</sup> Therefore, it is clear that corporate boards, not shareholders, sit at the top of a public company's hierarchical pyramid.<sup>28</sup>

### B. *The Board as a Mediating Hierarchy*

Corporate law protects the value of centralized authority as embodied in the board of directors. But why does corporate law have such high regard for corporate board authority? Professors Blair and Stout's team production theory of corporate law provides a cogent explanation.

According to Professors Blair and Stout's innovative stakeholder approach,<sup>29</sup> it is more realistic to think of a public corporation as a team of members who make firm-specific investments in the corporation with the goal of producing goods and services as a team (team production)<sup>30</sup> with the

<sup>25</sup> See Blair & Stout, *supra* note 7, at 291 ("American law in fact grants directors tremendous discretion to sacrifice shareholders' interests in favor of management, employees, and creditors, in deciding what is best for 'the firm.'").

<sup>26</sup> Margaret M. Blair & Lynn A. Stout, *Corporate Accountability: Director Accountability and the Mediating Role of the Corporate Board*, 79 WASH. U. L.Q. 403, 406 (2001) (link).

<sup>27</sup> See Bernard S. Sharfman, *Being Informed Does Matter: Fine Tuning Gross Negligence Twenty Plus Years After Van Gorkom*, 62 BUS. LAW. 135, 147 (2006), available at [http://works.bepress.com/bernard\\_sharfman/4/](http://works.bepress.com/bernard_sharfman/4/) (link). Moreover, because of indemnification and D&O insurance, it is even rarer to find a case where the outside directors actually had to use their own money to pay off a claim. Bernard S. Black, Brian R. Cheffins & Michael D. Klausner, *Outside Director Liability*, 58 STAN. L. REV. 1055 (2006) (link).

<sup>28</sup> See Blair & Stout, *supra* note 7, at 279. A key element in making this arrangement work is trust. The duty of loyalty is a means for creating trust in the board to do the right thing for all team members, including shareholders. Such a duty deters directors from using their corporate authority to line their own pockets to the detriment of all the other team members. *Id.* at 316.

<sup>29</sup> The team production approach to corporate law is a particular type of stakeholder model. Hansmann & Kraakman, *supra* note 17, at 447. Hansmann and Kraakman refer to this particular form of stakeholder model as a "'fiduciary' model of the corporation, in which the board of directors functions as a neutral coordinator of the contributions and returns of all stakeholders in the firm." *Id.* This is in contrast to another type of stakeholder model which they describe as a "'representative' model of the corporation," where "two or more stakeholder constituencies appoint representatives to the board of directors, which then elaborates policies that maximize the joint welfare of all stakeholders, subject to the bargaining leverage that each group brings to the boardroom table." *Id.* at 448.

<sup>30</sup> For the seminal work on team production as a theory of economic organization, see Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972). According to Alchian and Demsetz, "[W]ith team production it is difficult, solely by

board of directors acting as a “mediating hierarchy.”<sup>31</sup> These board members serve the interests of the corporation.<sup>32</sup> Moreover, “the interests of the corporation, in turn, can be understood as a joint welfare function of *all* the individuals who make firm-specific investments and agree to participate in the extracontractual, internal mediation process within the firm.”<sup>33</sup> Team members are primarily made up of executives, rank-and-file employees, and equity investors, but can also include researchers, creditors, the local community, marketers, and vendors who provide specialized products and services to the firm and shareholders, among others.<sup>34</sup> Any person or entity that makes a firm-specific investment is a member of the team. The result is “that no one team member is a ‘principal’ who enjoys a right of control over the team.”<sup>35</sup>

In this innovative approach to understanding the public company, the board of directors, composed primarily of outside members who are also independent of the firm, provides a unique mediating function. Not only does it have the final authority on hiring and firing corporate officers, approving corporate policy, recommending major transactions for shareholder approval, approving executive compensation packages and the like, but it also acts “as an internal ‘court of appeals’ to resolve disputes that may arise among the team members.”<sup>36</sup> In this role, board members are “mediating hierarchs whose job is to balance team members’ competing interests in a fashion that keeps everyone happy enough that the productive coalition stays together.”<sup>37</sup>

As stated by Professors Blair and Stout, “[i]n essence, the mediating hierarchy solution requires team members to give up important rights (including property rights over the team’s joint output and over team inputs such as financial capital and firm-specific human capital) to a legal entity created by the act of incorporation.”<sup>38</sup> Consistent with this approach, corporate law requires boards to act primarily as legal agents of their respective corporations, not the shareholders.<sup>39</sup> This does not mean that corporate

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observing total output, to either define or determine *each* individual’s contribution to this output of the cooperating inputs. The output is yielded by a team, by definition, and it is not a *sum* of separable outputs of each of its members.” *Id.* at 779.

<sup>31</sup> Blair & Stout, *supra* note 7, at 271–76. The mediating hierarchy model of the firm does not work where the firm is subject to the control of one shareholder or a group of shareholders. Under those conditions, the lack of independence impedes the ability of directors to act as mediating hierarchs. *Id.* at 309.

<sup>32</sup> *Id.* at 288.

<sup>33</sup> *Id.*

<sup>34</sup> *Id.* at 271–76 & n.61.

<sup>35</sup> *Id.* at 277 (emphasis omitted).

<sup>36</sup> *Id.* at 276–77.

<sup>37</sup> Blair & Stout, *supra* note 7, at 281.

<sup>38</sup> *Id.* at 250.

<sup>39</sup> *Id.* at 290. Of course, there are exceptions to this general rule. For example, the *Van Gorkom* court also found that the directors’ breached their fiduciary duty of candor to shareholders by not dis-

boards will not act in the interests of shareholders when they make decisions, but it does mean that they are not required to give shareholder interests first priority.

### C. *The Interests of Shareholders*

The rationale for why shareholders would accept such an arrangement is that team members, including shareholders, “understand they would be far less likely to elicit the full cooperation and firm-specific investment of other members [for fear of shirking and rent-seeking] if they did not [all agree to] give up control rights” to a mediating hierarchy (the board of directors), which has the responsibility of allocating “duties and rewards.”<sup>40</sup> Moreover, the team production theory of corporate law suggests that “a legal rule requiring corporate directors to maximize shareholder wealth ex post might well have the perverse effect of reducing shareholder wealth over time by discouraging non-shareholder groups from making specific investments in corporations *ex ante*.”<sup>41</sup>

Furthermore, shareholders can utilize the political clout they have with the corporate board and the legal tools that they have at their disposal to *advocate* that the board give priority to their interests.<sup>42</sup> Direct engagement through communication with the board, shareholder proposals, proxy contests, class actions under state corporate or federal securities law, and derivative suits are all tools that shareholders can use to encourage corporate boards to address shareholder interests.

Thus, even though corporate law gives shareholders certain unique rights and remedies, it is clear that corporate law is structured not to support shareholder primacy but to support the corporate board as a mediating hierarchy.<sup>43</sup> By protecting the ability of the corporate board to act as a mediating hierarchy, corporate law encourages the firm-specific investment of team members, making incorporation a desirable means for establishing the rights and remedies of a public company’s team members.

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closing all material information necessary to make an informed decision on the merger transaction. *Smith v. Van Gorkom*, 488 A.2d 858, 893 (Del. 1985).

<sup>40</sup> Blair & Stout, *supra* note 7, at 277–78.

<sup>41</sup> Lynn A. Stout, *Why We Should Stop Teaching Dodge v. Ford*, 3 VA. L. & BUS. REV. 163, 173–74 (2008) (link).

<sup>42</sup> Blair & Stout, *supra* note 7, at 257.

<sup>43</sup> Another reason for protecting the centralized authority of the corporate board derives from the advantages the board has in efficiently filtering information in its decision-making process versus shareholders, other interested parties, and the courts. *See* Sharfman, *supra* note 27 (arguing that corporate law needs to protect the decision-making authority of the board based on both the board’s ability to act as a mediating authority and efficiently filter corporate information).

## II. TEAM PRODUCTION AND BOARD COMPOSITION: MAXIMIZING THE ABILITY OF THE BOARD TO ACT AS A MEDIATING HIERARCHY

As we have just discussed, corporate law is structured to promote the ability of the board to function as a mediating hierarchy. With this understanding, board composition can be utilized to promote this value of centralized authority, making the board a more efficient decision-making body. To do so requires a team production approach to board member selection, not just stacking the board with current or former CEOs of other companies. The key is making sure that the board is composed of members who can best understand how the company functions from a team production perspective.

Professors Kaufman and Englander provide a team production approach to board selection that is consistent with our goal: “the team production model asks that the board replicate team members, both within and connected to the firm, who add value, assume unique risks, and possess strategic information in the corporation.”<sup>44</sup> Those characteristics may manifest in a variety of potential board members:

1. *Value Contribution*—Those employees who add critical value to team production often include engineers or scientists and outside suppliers of research and development such as universities.

2. *Unique Risk*—Stakeholders assuming unique risks may include vendors who have customized their production of goods and services to meet the particular demands of the company, employees and executives of the company who have invested in the learning of non-transferrable skills, those that provide unique sources of funding, and the communities where company employment is concentrated and have made infrastructure investments to support this employment.

3. *Strategic Information*—Employees able to provide strategic information that adds significantly to board deliberations often include executive management or employees with special skills—such as those with expertise in accounting, finance, and marketing.<sup>45</sup>

Board members could come from inside or outside the company, as long as they are representative of the team.<sup>46</sup> For example, the engineers or scientists representative of the critical technologies that are part of the company’s production function can be from either inside or outside the corporation.<sup>47</sup> Given the ability to substitute outside expertise for inside expertise, members of the board that come from outside the firm essentially serve as proxies for the various components of the firm’s team production, thereby allowing the board to meet its independence requirements.

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<sup>44</sup> Kaufman & Englander. *supra* note 6, at 12.

<sup>45</sup> *Id.*

<sup>46</sup> *Id.* at 13. Of course, the utilization of firm employees to make up the board is constrained by the need to have a majority of independent directors.

<sup>47</sup> *Id.*

Implementing a team production approach to board composition would not require any change in the way board members are selected, as selection would still occur primarily through the board nominating committee process. The key would be making sure the board nominating committee buys into this approach. Of course, if a public company also has a mechanism for shareholder nominated directors, that process should also consider how these nominees would blend with in the other board members based on a team production approach.

### III. BOARD COMPOSITION AND OUTSIDE CEOs

For a public company's board to operate effectively as a mediating hierarchy, it must be composed of members who can best implement that function of the board. As discussed below, both Kaufman and Englander's team production approach to board composition and our understanding of small group decisionmaking lead us to conclude that a board will be better off executing its role as a mediating hierarchy by constraining the number and influence of current or former CEOs in their positions as outside directors.

#### A. *Team Production and Outside CEOs*

The composition of corporate boards of public companies with a majority of independent directors have traditionally been composed of a large number of current or former CEOs as outside directors.<sup>48</sup> In 2007, 47% of all newly hired independent directors at S&P 500 companies were either active (33%) or retired (14%) CEOs, even though that is down from 52% in 2002 (41% active, 11% retired).<sup>49</sup> However, a team production approach to board composition supports a limitation on the seating of outside CEOs as board members. By having a significant number of current or former CEOs as outside directors you potentially overweigh the board with proxies for the current CEO who is already on the board. Of course, each outside CEO on the board will bring to the table different attributes and strategic information than the company's current CEO, but still the risk is that by having too many outside CEOs on the board, the board will not be representative of the company from a team production perspective. Thus, a board composed of too many current or former CEOs may not be able to act effectively as a mediating hierarchy.

#### B. *Group Polarization and Outside CEOs*

Our understanding of small group decisionmaking also supports a limitation on the number of current or former CEOs on the corporate board. Because there is much greater potential for relevant information to be

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<sup>48</sup> SPENCER STUART, SPENCER STUART BOARD INDEX 11 (2007), available at [http://content.spencerstuart.com/sswebsite/pdf/lib/SSBI\\_FINAL.pdf](http://content.spencerstuart.com/sswebsite/pdf/lib/SSBI_FINAL.pdf) (link).

<sup>49</sup> *Id.*

shared in the decisionmaking process, it makes sense that small groups will make better decisions than individual decisionmakers.<sup>50</sup> Even so, behavioral scientists have been saying for years that small deliberative groups are prone to error in their decisionmaking if these groups are made up of a majority of members who are similar *in position on an issue* prior to deliberations.<sup>51</sup> When they are, such groups can fall victim to what is referred to as “group polarization,” the tendency of a small deliberative group with an initial tendency to move in a given direction to move to even more extreme positions in that direction following group deliberations.<sup>52</sup> This problem is especially relevant for groups who are like-minded and possess a shared identity.<sup>53</sup> The corporate board is no exception to this problem.

It is easy to see how corporate boards could become victims of group polarization. Insider board members and executive management in general will have a greater degree of knowledge and understanding regarding the true state of the company than the independent directors. Given this understanding, it is only rational for outside independent board members to enter board deliberations with the initial tendency to presume that the business judgments of insiders and executive management are correct, creating a group of like-minded people.<sup>54</sup> Moreover, this initial tendency may be supported by a significant number of outside board members who have a shared identity, such as members who are current or former CEOs. These board members form a dominant “in-group”<sup>55</sup> whose positions may polarize in order to conform to what they believe is the typical position of the other in-group members.<sup>56</sup> Such a scenario promotes the dominant initial position in discussion, limiting the argument pool and proceeds to an extreme, as in-

<sup>50</sup> See Stephen M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1, 3 (2002) (“A wealth of experimental data suggests that groups often make better decisions than individuals.”).

<sup>51</sup> No one in the legal community has done more to sound the alarm about the problems of small group decision making than Professor Cass Sunstein. See, e.g., Cass R. Sunstein, *Group Judgments: Statistical Means, Deliberation, and Information Markets*, 80 N.Y.U. L. REV. 962 (2005) (link); Cass R. Sunstein, *Deliberative Trouble? Why Groups Go to Extremes*, 110 YALE L.J. 71 (2000) [hereinafter Sunstein, *Deliberative Trouble*] (link).

<sup>52</sup> Sunstein, *Deliberative Trouble*, *supra* note 51, at 74. Professor Sunstein notes that the term “group polarization” is misleading, as it can be mistakenly interpreted to mean that group members move toward opposite positions. *Id.* at 85.

<sup>53</sup> Cass R. Sunstein & Reid Hastie, *Four Failures of Deliberating Groups* 18, 21 (John M. Olin Working Paper No. 401 (2d Series) and Public Law and Legal Theory Working Paper No. 215, Apr. 2008), available at <https://www.law.uchicago.edu/files/401.pdf> (link).

<sup>54</sup> Group polarization is sometimes a product of cascade effects. Based on the prior description of informational cascades, it is also easy to see how an informational cascade can be the mechanism by which group polarization is facilitated in board deliberations. See Sunstein, *Deliberative Trouble*, *supra* note 51, at 81.

<sup>55</sup> Sunstein & Hastie, *supra* note 53, at 21.

<sup>56</sup> See *id.*

group members hear their peer group voice similar positions and become more confident in their beliefs.<sup>57</sup>

### C. *Dysfunctional Deference and Outside CEOs*

In a previous essay, we described in detail how we thought a phenomenon called “dysfunctional deference” applied to certain critical decisions made by the board of Enron prior to the company’s fall.<sup>58</sup> These decisions, made in 1999 and 2000, allowed Enron’s Chief Financial Officer (CFO), Andrew Fastow, to establish and operate the now infamous LJM private equity funds. The funds were set-up to acquire Enron assets with the purpose of reducing the size of the company’s balance sheet.<sup>59</sup> Such an arrangement gave Fastow immense opportunities to engage in self-dealing transactions at the expense of Enron and its shareholders.<sup>60</sup> Unfortunately, that is exactly what happened.<sup>61</sup> Ken Lay, Enron’s CEO at the time the funds were created, knew of the controversial nature of this arrangement, and therefore sought board ratification despite the fact that he had full authority to approve the waiver on his own.<sup>62</sup> That in itself should have led to long and intense board deliberations, yet very little in the way of deliberations were reported prior to board approval, evidencing an incredible and surprising deference to the recommendations of management.<sup>63</sup>

Deference by independent board members to the opinion of insiders and executive management is understandable and most likely beneficial to corporate board decision-making. This asymmetric distribution of information should be beneficial to board decision-making assuming board insiders honestly share information about the pros and cons of a prospective decision with the other board members during deliberations. However, this deference to board insiders and executive management can also lead to serious errors in decision-making if the deference is so pronounced that it stifles deliberation of a corporate board’s most controversial decisions. Without deliberation, there is no opportunity for board members to share potentially valuable information they may individually have regarding the decision, making the board as a whole less informed. When such extreme deference

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<sup>57</sup> *See id.* at 21–22.

<sup>58</sup> Sharfman & Toll, *supra* note 15.

<sup>59</sup> S. REP. NO. 107-70, at 7–8 (2002). The purpose of establishing these entities was to help maintain the Company’s investment grade credit rating based on the criteria established by rating agencies such as Moody’s and Standard & Poor’s. *Id.* at 7.

<sup>60</sup> *Id.* at 24.

<sup>61</sup> *See* Plea Agreement, United States v. Fastow, Cr. No. H-02-0665, (S.D. Tex. Jan. 14, 2004).

<sup>62</sup> S. REP., *supra* note 59, at 25.

<sup>63</sup> While there was no evidence of significant deliberations on the topic of the LJM private equity funds at the three board meetings where they were approved, supposedly there was a vigorous discussion of LJM2 at a board finance committee meeting prior to the approval of LJM2. However, it is not known whether Fastow’s conflict of interest, the economics of the transaction itself, or both, was the subject of discussion. *See id.* at 28.

to insiders and executive management leads to a stifling of board deliberations, we refer to this as dysfunctional deference,<sup>64</sup> a small group phenomenon that is distinguished from group polarization by the lack of deliberation.

#### D. Limiting Outside CEOs

In our essay on dysfunctional deference, we recommended that a limit be put on the number of outside directors who have been or are CEOs of large institutions—public or private—to less than a majority of outside directors in order to reduce the potential for over identification with insiders and executive management.<sup>65</sup> Such a background is conducive to *identifying* with executive management and perhaps viewing his or her role on the board as making sure not to get in the way of what executive management wanted to do. In the context of executive remuneration, Professors Jensen, Murphy, and Wruck have already applied this reasoning in recommending that the number of active CEOs on a public company's board be limited.<sup>66</sup> Indeed, initial statistical evidence has borne this out. While Kaufman, Englander, and Tucci have only found weak statistical evidence that the more CEOs on the board of directors the higher the CEO compensation, they did find a strong statistical association between the number of CEOs on a public company's board compensation committee and the level of CEO pay.<sup>67</sup>

Kaufman and Englander recommend that *no* outside CEO serve on three critical board committees: audit, nominating, and compensation.<sup>68</sup> However, even though we are sympathetic to that recommendation, more research needs to be done before we can give it our full support. Therefore, given the support provided by the team production approach to board composition, it is our current position that corporate boards of public corporations as well as their audit, compensation, and nominating committees would be better off if they were composed of no more than a minority of current or former outside CEOs.

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<sup>64</sup> Sharfman & Toll, *supra* note 15 (where the phrase “dysfunctional deference” was coined in the context of corporate governance).

<sup>65</sup> *Id.*

<sup>66</sup> See Michael C. Jensen, Kevin J. Murphy & Eric G. Wruck, *Remuneration: Where We've Been, How We Got to Here, What are the Problems, and How to Fix Them* 55 (Harvard NOM Working Paper No. 04-28; ECGI-Finance Working Paper No. 44/2004 July 12, 2004), available at <http://ssrn.com/abstract=561305> (link).

<sup>67</sup> See Allen Kaufman, Ernie Englander & Christopher L. Tucci, *The Managerial Thesis Revised: Independent Directors and the CEO “Directorate”* 34 (July 2006) (unpublished manuscript, on file with the Northwestern University Law Review), available at <http://ssrn.com/abstract=1030845> (link).

<sup>68</sup> Kaufman & Englander, *supra* note 6, at 19.

CONCLUSION

As argued by Professors Blair and Stout, corporate law directs a public company's board of directors to act as a mediating hierarchy. Taking a team production approach to board composition can enhance the ability of a public company's board to act as a mediating hierarchy. Based on the work of Kaufman and Englander, the process for implementing such an approach is clear. First, the board nominating committee would create a prototype board identifying the types of individuals that would best represent the way the firm produces its goods and services as a team. Second, whether or not the individuals actually selected for nomination by the board nominating committee would be from inside or outside the company would be driven primarily by the board's independence requirements and whether qualified proxies can be found outside the ranks of the company. If such proxies are not available, the nominating committee would look internally to the extent it can do so without violating its independence constraints. Third, outside CEOs would be selected to serve on the board only so long as they add value in a team production approach and without creating an imbalance of interests. Fourth, the board itself as well as its critical board committees, audit, nominating and compensation, cannot have more than a minority of outside CEOs as members. Thus, by implementing a team production approach to board composition, a public company's board should be less prone to error.