THE CORPORATE IMMUNE SYSTEM: GOVERNANCE FROM THE INSIDE OUT

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The "Corporate Immune System" (CIS) is an outgrowth of an evolutionary trend reflecting firms' adaptation to challenges including growing corporate complexity, threats to corporate value, and political compromise. Similar to biological immune systems, corporations have adopted a range of internal mechanisms to ward off threats. The CIS performs an internal regulatory function that lowers monitoring costs for government regulators through internal mechanisms such as a monitoring board, compliance and risk management systems, compensation, and an enhanced chief legal officer (CLO) role. It complements external corporate governance strategies: shareholder empowerment, markets, litigation, gatekeepers, and top-down public regulation. Today's corporate boards are much more informed, organized, skilled, and accountable than their historical antecedents. Although far from perfect, they continue to evolve and improve. The CIS, recognizing the potential of collaborative inside-out reforms in the corporate arena is, on balance, a promising development. But this trend also raises concerns that merit further discussion.

I. INTRODUCTION

Recent corporate scandals and their role in the present economic crisis have helped illustrate the need to ensure greater corporate accountability. The collapse of Lehman Brothers, British Petroleum's Deepwater Horizon disaster in the Gulf of Mexico, Toyota Motor Corporation's massive product recalls, the spying scandal at News Corp., and short-termism at Countrywide Financial Corp. are demonstrative of contemporary corporate dysfunction.[1] Such failures are often attributed to

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1. Neil Irwin, *Questionable Accounting at Lehman Brothers Unnoticed, Testimony Shows*, WASH. POST (Apr. 20, 2010), http://www.washingtonpost.com/wp-dyn/content/article/2010/04/19/AR

failures of governance irrespective of the actual cause.[2] The predictable, and perhaps natural, remedy often prescribed following such events is an expansion of external government regulation for corporate firms.[3] Calls for expanded regulation, however, do not answer the question of what shape, if any, should these reforms take among the range of regulatory options? This Article proffers an alternative approach, one that looks inward for solutions to corporate dysfunction. This is a balanced approach; it is not predicated on the traditional reliance on top-down government regulation such as one-off sanctions and fines, shareholder empowerment, or market forces. It emphasizes the importance of building a corporation's internal governance mechanisms—the monitoring board, compliance and risk management systems, compensation, and an enhanced chief legal officer (CLO) role—collectively known as the "Corporate Immune System" (CIS).[4] In recent years, however, scholars have focused on the efficacy of external mechanisms such as shareholder activism and gatekeepers to limit corporate malfeasance. This approach, although well intentioned, is flawed because it overlooks internal opera-

2010041904938.html ("Lehman, which went bankrupt in September 2008, triggering a broad financial panic, hid the degree of its indebtedness by shifting money around right before the end of each quarter, according to a bankruptcy examiner's report."); *The Oil Well and the Damage Done*, ECONOMIST, June 19, 2010, at 65 ("Some in the American oil industry think this reflects a poor corporate culture at BP, in which personal advancement has depended more on cutting costs than on technical proficiency."); Bernard Simon et al., *Pressure Mounts over Toyota Recalls*, FIN. TIMES (Feb. 3, 2010, 9:55 PM), http://www.ft.com/intl/cms/s/0/089c2cec-10f1-11df-9a9e-00144feab49a.html ("Toyota had enjoyed a shining reputation for quality and reliability, helping it to overtake General Motors in 2008 as the world's biggest carmaker. But its image has been hit by mass recalls involving the defective accelerator pedals and out-of-position floor mats, which can jam accelerators and have been linked to several fatal accidents."); Cassell Bryan-Low et al., *Scandal Grows at News Corp.—Former Senior Executive Is Arrested in Hacking Probe*, WALL ST. J., July 18, 2011, at A1 (discussing News Corp. scandal involving the "illegal intercepting of phone voice mails and the alleged bribery of police officials"); Dick Armey, Op-Ed., *Congress and the Countrywide Scandal*, WALL ST. J. (June 18, 2008), http://online.wsj.com/article/SB121375337067183049.html (discussing that Countrywide's mortgage portfolio included very risky loans known as "payment-option ARMs" which were anticipated "to cause a wave of delinquencies").

2. *See* STEPHEN M. BAINBRIDGE, CORPORATE GOVERNANCE AFTER THE FINANCIAL CRISIS 16 (2012); Brian R. Cheffins, *Did Corporate Governance "Fail" During the 2008 Stock Market Meltdown? The Case of the S&P 500*, 65 BUS. LAW. 1, 3–4 (2009) (asserting how market meltdown could also be attributed to the winner-take-all atmosphere of the twenty-first-century corporation); *see also* DAVID SKEEL, THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD-FRANK ACT AND ITS (UNINTENDED) CONSEQUENCES (2011); DAVID SKEEL, ICARUS IN THE BOARDROOM: THE FUNDAMENTAL FLAWS IN CORPORATE AMERICA AND WHERE THEY CAME FROM 182 (2005) [hereinafter SKEEL, ICARUS]; Christopher M. Bruner, *Corporate Governance Reform in a Time of Crisis*, 36 J. CORP. L. 309 (2011).

3. Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1, 26–27 (2003); Lawrence A. Cunningham & David Zaring, *The Three or Four Approaches to Financial Regulation: A Cautionary Analysis Against Exuberance in Crisis Response*, 78 GEO. WASH. L. REV. 39, 55 (2009) ("Many observers cite Sarbanes-Oxley as illustrating the kind of dangerous overreaction that crisis-driven legislative and regulatory reform can pose.").

4. The "corporate immune system" moniker is not new. It has been used in the business school literature in a narrower context to discuss corporate culture. This Article, however, equates the term more generally with internal governance mechanisms that could include corporate culture. *See generally* ARIE DE GEUS, THE LIVING COMPANY: HABITS FOR SURVIVAL IN A TURBULENT BUSINESS ENVIRONMENT 159–68 (1997).

tional determinants of corporate governance that are important for long-term value creation.[5]

The CIS is an outgrowth reflective of the evolutionary trend toward firms proactively adapting to growing corporate complexity and threats to corporate value as well as political compromise. Similar to biological immune systems, corporations develop a range of internal mechanisms to ward off threats. Functionally, the CIS performs an internal regulatory function that lowers monitoring costs for government regulators.[6] It complements external corporate governance mechanisms such as shareholder empowerment, markets, courts, gatekeepers, and top-down public regulation.[7] The CIS promotes information flow concerning risks and performance issues, provides greater flexibility in recognition of corporate complexity, and encourages private ordering.

In the absence of effective internal governance mechanisms (e.g., board oversight, compliance and risk management systems, compensation, and an enhanced CLO role), external regulation, functioning like drugs and antibiotics, will not have its intended impact on corporate opportunism and malfeasance. Similar to antibiotics and other medicines, corporate regulations are an external treatment to an already-infected system. Normally, the immune system can fend off infections, but sometimes antibiotics are needed when the immune system is overloaded. External regulations, in a similar fashion, complement the CIS; they do not replace it. Actually, the overemphasis on external regulations, as with antibiotics, can bring about negative consequences. The long history of scandal and corporate collapses illustrates that top-down regulatory schemes and external mechanisms generally have a limited impact on human behavior, particularly with regard to short-termism, excessive risk-taking, and so-called "Icaran" tendencies.[8] A well-established CIS, especially when complemented by engaged regulators and external gatekeepers, is an essential feature of healthy corporate governance in large, publicly traded companies.

5. In the context of business lawyers, value creation stands for the proposition that "if what a business lawyer does has value, a transaction must be worth more, net of legal fees, as a result of the lawyer's participation." Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239, 243 (1984); *see also* Ronald J. Gilson & Robert H. Mnookin, *Foreword: Business Lawyers and Value Creation for Clients*, 74 OR. L. REV. 1, 8 (1995) ("Economic theory provides a useful framework for understanding the basic sources . . . from which value can potentially be created by transaction cost engineers. These sources relate to: (1) differences; (2) non-competitive similarities; (3) economies of scale and scope; and (4) developing structures for dampening strategic opportunism and reducing transaction costs."); Omari Scott Simmons & James D. Dinnage, *Innkeepers: A Unifying Theory of the In-House Counsel Role*, 41 SETON HALL L. REV. 77, 110–11, 115 (2011) (discussing the underlying issues with regard to in-house counsel and their role in value creation).

6. IAN AYRES & JOHN BRAITHWAITE, RESPONSIVE REGULATION: TRANSCENDING THE DEREGULATION DEBATE 110–16 (1992) (discussing the benefits of internal firm regulation).

7. *Id.* at 128–29.

8. Leo E. Strine, Jr., *Our Continuing Struggle with the Idea That For-Profit Corporations Seek Profit*, 47 WAKE FOREST L. REV. 135, 136 (2012); *see* SKEEL, ICARUS, *supra* note 2, at 4–5.

To be clear, this Article is neither a rigid call for corporate self-regulation nor a blind affirmation of market discipline. Top-down, prescriptive regulation can be beneficial and contributes to corporate value. Prescriptive regulations and accompanying sanctions are often needed to protect an obedient majority against the opportunistic tendencies of a small minority.[9] They also establish minimum standards of conduct for corporate actors, benefitting firms and their multiple stakeholders alike. As Edward Rubin observes, industry pushback, backlash, and lack of receptiveness to regulation are inevitable.[10] Such resistance is simply part of the "regulatizing" process and will generally subside over time.[11] The threat of top-down regulation and punitive sanctions, in certain instances, may be necessary both to discipline corporate actors and to force recalcitrant firms to obey established rules intended to provide systemic benefits to a broader range of market participants.[12] These systemic benefits, which are difficult to measure, are all too often dismissed.

Notwithstanding the potential benefits of top-down prescriptive regulations, there are limits to their efficacy.[13] Despite major reforms such as Dodd-Frank and Sarbanes-Oxley, past scandals and market instability underscore the reality that corporate regulators often lack intimate knowledge of operational practices across industry sectors and adequate resources to fulfill their mandates. Information asymmetries, in conjunction with limited expertise and experience gaps between regulators and internal corporate actors, further constrain the effectiveness of government reforms. Out of necessity, regulators and other "outsiders," such as institutional investors, often rely on readily available heuristics—aggregated information and procedures—that may fail to identify problems at an operational level.

In light of these constraints, state and federal lawmakers have attempted to harness internal corporate machinery, access institutional expertise and information, and "deputize" internal actors. These internal mechanisms perform the basic functions of a regulatory regime: standard setting, compliance monitoring, and enforcement.[14] This cooperative ap-

9. *See* H.L.A. HART, THE CONCEPT OF LAW 193 (1961); Oliver E. Williamson, *Opportunism and Its Critics*, 14 MANAGERIAL & DECISION ECON. 97, 97–98 (1993); *see also* Joseph W. Singer, *Things That We Would Like to Take for Granted: Minimum Standards for the Legal Framework of a Free and Democratic Society*, 2 HARV. L. & POL'Y REV. 139, 141–42 (2008).

10. Edward Rubin, *The Regulatizing Process and the Boundaries of New Public Governance,* 2010 WIS. L. REV. 535, 545–47; *see also* Mark J. Roe, *The Inevitable Instability of American Corporate Governance*, *in* RESTORING TRUST IN AMERICAN BUSINESS 9, 10 (Jay W. Lorsch et al. eds., 2005).

11. Rubin, *supra* note 10, at 548–49.

12. *Id.* at 553–54 (discussing the appropriate use of government power to discipline firms and encourage obedience).

13. *See* discussion *infra* Part III; *see also* Miriam H. Baer, *Choosing Punishment*, 92 B.U. L. REV. 577, 631–39 (2012) (discussing the disadvantages of punitive reforms on improving corporate governance).

14. Jason M. Solomon, *New Governance, Preemptive Self-Regulation, and the Blurring of Boundaries in Regulatory Theory and Practice*, 2010 WIS. L. REV. 591, 596 (describing the basic functions of a regulatory regime).

proach is not synonymous with "agency capture," marked by industry exertion of undue influence over its public regulator.[15] Instead, it resembles a type of so-called "industry capture," best understood as a public-private collaboration that blurs the roles of private and public actors.[16] Researchers contend this cooperative approach between regulators and industry provides greater flexibility and adaptability in the face of novel or complex problems.[17] The Federal Sentencing Guidelines for Organizations, *Caremark* duties under state law, certain aspects of Sarbanes-Oxley, and Dodd-Frank all follow this pattern, which has led to an expansion of board oversight responsibilities under federal and state law.[18] This trend finds significant support in multiple theoretical perspectives, especially the "organizational" and "new governance" literature.[19] In practice, this "collaborative" or "outsourcing" trend brings benefits, but it also raises some concerns that merit further discussion.

This Article asserts that an overemphasis on external governance mechanisms—regulators and courts, shareholder empowerment, market signals as reflected in share price, and third-party gatekeepers—without a concurrent focus on internal governance mechanisms yields a false sense of security; that is, it constructs a "regulatory safe house" made of sticks. The longstanding "outsider" versus "insider" debate among legal scholars understates the operational, evolutionary, and political realities that determine the efficacy of corporate reform.[20] The debate often presents a rigid, false dichotomy that understates insider advantages such as expertise, experience, consistent engagement with corporate operations, and private ordering. To be effective, future corporate reform will require leveraging the CIS, which is ultimately predicated upon attaining a clearer understanding of the complementary advantages provided by internal governance mechanisms.

Over the past thirty years, corporate governance, despite occasional bumps, has undoubtedly improved. Today's corporate boards are much more informed, organized, skilled, and accountable than their historical predecessors.[21] Board monitoring responsibilities, in particular, have expanded. Despite the ongoing challenge of balancing both strategic and monitoring responsibilities in the face of time and knowledge constraints,

15. *Id.* at 624.

16. *Id.* (distinguishing "agency capture" from "industry capture").

17. *Id.*

18. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of 7, 12, 15, 18, 22 and 45 U.S.C.); Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15 and 18 U.S.C.); *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 970 (Del. Ch. 1996); U.S. SENTENCING GUIDELINES MANUAL § 8 (2011) ("Sentencing of Organizations").

19. *See* discussion *infra* Part III.

20. *See generally* Lucian A. Bebchuk & Assaf Hamdani, *Federal Corporate Law: Lessons from History*, 106 COLUM. L. REV. 1793 (2006).

21. *See, e.g.*, Stone v. Ritter, 911 A.2d 362, 367–70 (Del. 2006); Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963).

corporate boards continue to evolve and improve. The CIS, representing the potential of inside-out reforms in the corporate arena, helps advance this positive trend.

Part II of this Article defines the corporate immune system, in addition to discussing its benefits and origins. This Part next discusses key elements of the CIS: the monitoring board, compliance and risk management systems, compensation, and an enhanced CLO role. Part III explores the theoretical underpinnings of the CIS, namely new governance and organizational theory. Part IV illustrates how the CIS functions within the current legal framework at the state and federal levels. Finally, Part V examines the CIS's corporate governance implications by exploring three questions: (1) Does the CIS detract from the board's primary goal to advance corporate strategy? (2) Does the CIS contribute to unrealistic expectations and a false sense of security concerning its effectiveness against various forms of corporate malfeasance? (3) Does the CIS reflect political expediency resulting in suboptimal corporate reform?

II. THE CORPORATE IMMUNE SYSTEM: DEFINITION AND ORIGINS

A. Definitions

The CIS, similar to the human immune system,[22] is a collection of internal processes and mechanisms that have been developed to protect corporations by identifying and eradicating threats to their economic value, such as corporate opportunism.[23] Elements of the corporate immune system often include, inter alia, board oversight, compliance and risk management systems, remuneration, and an enhanced CLO role.[24] Such elements are valuable in isolation but are especially useful as a system of interconnected mechanisms providing layered protection of corporate value. The CIS performs an internal regulatory function that lowers monitoring costs for the government while remaining less adver-

22. The human immune system has two cooperative defense systems: a nonspecific, innate immunity and an adaptive, specific immunity. Innate immune responses function in the same manner no matter how many times they encounter a threat. For example, in response to infection the human body may respond by releasing proteins that raise the body's temperature, creating a fever to help kill infectious bacteria. On the other hand, adaptive responses generally improve upon repeated exposure to a threat, such as a virus. *See generally* Peter J. Delves & Ivan M. Roitt, *The Immune System: Second of Two Parts*, 343 NEW ENG. J. MED. 108 (2000); *Immune System*, ENCYCLOPAEDIA BRITANNICA, http://search.eb.com/eb/article-9109569 (last visited Mar. 25, 2013). Similarly, an effective CIS also has both innate and adaptive defense capabilities.

23. *See* Oliver E. Williamson, *Strategy Research: Governance and Competence Perspectives*, 20 STRATEGIC MGMT. J. 1087, 1099 (1999) (describing opportunism in broad terms capturing "moral hazard, adverse selection, shirking, filtering, undisclosed subgoal pursuit, distortions, and all other strategic deceits").

24. *See, e.g.*, Lawrence A. Hamermesh, *Who Let You into the House?*, 2012 WIS. L. REV. 359 (discussing paradigms and practices through which a CLO can adopt an enhanced role in governance while remaining within the confines of attorney-client privilege).

sarial than traditional regulatory regimes.[25] Internal governance mechanisms may be cheaper and more effective means of regulating employee conduct when compared to external regulators who face resource, expertise, and information restraints.[26]

Flaws in firms' internal operational practices are a recurring theme in corporate mishaps over the past decade.[27] Ironically, legal scholars often take internal corporate operations for granted.[28] Corporate operations are the sum of various internal processes such as manufacturing, sales, marketing, finance, accounting, research and development, and information technology.[29] Ultimately, these operational processes, in conjunction with internal cultural dynamics and external environmental forces, determine the profitability and sustainability of any business enterprise.[30]

Past corporate scandals and failures, such as the recent financial crisis and the BP Deepwater Horizon oil spill, illustrate how regulators may often lack intimate knowledge of operational practices across industry sectors, as well as how information asymmetries between regulators and internal corporate actors inevitably constrain the effectiveness of government reform efforts. Directors, based upon recent surveys, further acknowledge the importance of internal governance mechanisms and corporate operations. Whereas much legal literature often downplays the role played by operational aspects of business enterprise, the CIS concept articulated herein recognizes the routine functioning of business operations and context as a critical feature of corporate governance.

Notwithstanding the benefits of external government regulation, legal observers and the business community must consider the related issue of whether, and how, corporations themselves are evolving from an operational perspective. Reforms that fail to appreciate potential operational implications are insufficient and unlikely to have a meaningful impact on corporate governance. The complexity of the modern corporation, characterized by multiple levels of management, different product lines, and an expansive geographic scope, cannot be understated. External actors such as institutional shareholders are theoretically and

25. *See* Rubin, *supra* note 10, at 537.

26. *See* Simmons & Dinnage, *supra* note 5, at 138–39.

27. *See id.*

28. For example, corporate finance, although important, is usually a means to achieving operational ends. And similarly, mergers are often conducted for the operational benefits such as achieving economies of scale, expanding research and development, and boosting sales capabilities. *See generally* Alan A. Fisher & Robert H. Lande, *Efficiency Considerations in Merger Enforcement*, 71 CAL. L. REV. 1580, 1599–1600 (1983) ("[O]perating efficiencies such as those derived from economies of scale, resource allocation, technological complementarities . . . and various kinds of transaction-cost economies . . . [are likely to arise] from horizontal or vertical mergers . . . .").

29. *See* MICHAEL E. PORTER, COMPETITIVE ADVANTAGE: CREATING AND SUSTAINING SUPERIOR PERFORMANCE 38–43 (1985).

30. Omari Scott Simmons, *Corporate Reform As a Credence Service*, 5 J. BUS. & TECH. L. 113, 115 (2010) [hereinafter Simmons, *Corporate Reform*].

practically unable to control corporate machinery on a day-to-day basis.[31] Collective action problems among institutional shareholders, as well as the formulaic prescriptive box-ticking style approaches of proxy advisory firms, are not an adequate substitute for board discretion. There is no unified theory of corporate governance. The ideal mix of board authority and accountability is difficult to discern and differs across contexts. A more complete articulation of corporate governance and corporate law, however, recognizes the vices of agency costs, created by the separation of ownership and control, as well as the virtues associated with board authority such as more efficient decision making and internal advantages.[32]

B. Benefits

The CIS reflects the emerging paradigm of collaborative new governance strategies and reforms that, on balance, offer significant public and private benefits.[33] The appeal of cooperative governance-based approaches, like the CIS, stems from their blurriness, flexibility, and neutrality.[34] Through harnessing internal expertise and knowledge in the design of corporate reforms, the CIS generates benefits including: (1) creating a symmetrical de-biasing mechanism offsetting or countering predictable outsider biases;[35] (2) preventing unintended consequences and promoting more pragmatic, flexible, current, and forward-looking solutions; (3) enhancing the legitimacy of resulting reforms; (4) providing balance that may deter hasty decisions that are otherwise inconsistent with internal corporate norms and would dampen productivity, risk taking, and entrepreneurship; (5) incentivizing desired conduct, even in the absence of legal liability, using the internal corporate machinery to promote action; and (6) assisting regulators in the early identification of risky business practices and fraud, as well as promoting self-reporting.[36]

Achieving these benefits requires ongoing interaction between lawmakers and internal corporate actors that, on balance, is more cooperative and discursive than what generally occurs when companies rigidly

31. BAINBRIDGE, *supra* note 2, at 242–43.

32. *Id.* at 238–40.

33. *See* Lisa Blomgren Bingham, *The Next Generation of Administrative Law: Building the Legal Infrastructure for Collaborative Governance*, 2010 WIS. L. REV. 297; Gráinne de Búrca, *New Governance and Experimentalism: An Introduction*, 2010 WIS. L. REV. 227; Orly Lobel, *The Renew Deal: The Fall of Regulation and the Rise of Governance in Contemporary Legal Thought*, 89 MINN. L. REV. 342 (2004).

34. Solomon, *supra* note 14, at 624.

35. Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 807 (2001).

36. *See* Miriam Hechler Baer, *Corporate Policing and Corporate Governance: What Can We Learn From Hewlett-Packard's Pretexting Scandal?*, 77 U. CIN. L. REV. 523, 525 (2008); *see also* Pamela H. Bucy, *Information As a Commodity in the Regulatory World*, 39 HOUS. L. REV. 905, 941 (2002) ("Knowledgeable insiders can identify abuses that public regulators do not even know to look for.").

pursue their narrow political and economic interests.[37] Boosting the internal capabilities of corporations and the industry-specific expertise of regulators are not synonymous with regulatory capture or rigid self-regulation; they are pragmatic steps to enhancing lawmaker effectiveness. The CIS envisions a strong external regulatory presence while recognizing the limits of external mechanisms and outsiders to adequately subdue corporate opportunism and malfeasance.[38] In comparison to more prescriptive, top-down approaches such as one-off sanctions and fines, the CIS is more participatory and continuous. The CIS serves as a first line of defense against corporate malfeasance, with regulators stepping in secondarily in response to failures within the CIS. The CIS also encourages endogenous learning, cultivates cooperative firm "buy-in" that better influences corporate culture, and generates multiple information streams for decision makers.[39]

C. Origins

The CIS's origins reflect two interwoven narratives: organizational adaptation and political compromise. Organizational adaptation to internal and external threats significantly influenced the current corporate regulatory regime structure. Corporate scandals and collapses, along with the evolution of modern corporations in terms of size, complexity, and global reach, brought about greater interest in internal governance mechanisms.[40] These trends generated a panoply of global, national, and local regulations influencing business enterprise that, in turn, necessitated parallel organizational adaption to the shifting legal and business climate. These adaptive corporate responses include an enhanced focus on managerial monitoring responsibilities and capabilities. In some instances, regulators operate in a coercive manner and mandate specific changes to corporate operations.[41] In other instances, regulators give companies flexibility that they often use to replicate internal mechanisms adopted by reputable industry players or develop their own unique organizational response to the regulatory environment.[42] Irrespective of the type of or-

37. *See, e.g.*, Citizens United v. FEC, 558 U.S. 310 (2010) (holding section 203 of the Bipartisan Campaign Reform Act, prohibiting the use of general corporate treasuries to fund "electioneering communications" within thirty days of a primary election or sixty days of the general election, unconstitutional on a challenge by a corporate litigant).

38. Regarding the limited efficacy of external regulators in preventing corporate malfeasance, see Stephen M. Bainbridge, *Dodd-Frank: Quack Federal Corporate Governance Round II*, 95 MINN. L. REV. 1779 (2011).

39. Cristie Ford, *New Governance in the Teeth of Human Frailty: Lessons from Financial Regulation*, 2010 WIS. L. REV. 441, 450.

40. Simmons & Dinnage, *supra* note 5, at 99.

41. *See* Paul J. DiMaggio & Walter W. Powell, *The Iron Cage Revisited: Institutional Isomorphism and Collective Rationality in Organizational Fields*, 48 AM. SOC. REV. 147 (1983).

42. *See id.*; *see also* Chris Goldspink & Robert Kay, *Organizations as Self-Organizing and Sustaining Systems: A Complex and Autopoietic Systems Perspective*, 32 INT'L J. GEN. SYS. 459 (2003); Rubin, *supra* note 10.

ganizational adaptation, the central concern is consistent across all contexts: Does the corporation's particular adaptive response actually improve corporate governance?

1. The Questionable Payments Era

In the 1970s, the Securities and Exchange Commission (SEC) investigated questionable payment and foreign bribery practices in which a number of U.S. companies had engaged. In a 1976 report to Congress, the SEC acknowledged a breakdown in corporate accountability at these companies.[43] The report further acknowledged that, in the overwhelming majority of cases involving misconduct, the companies either did not have audit committees, their audit committees were inoperative, or their audit committees were not sufficiently independent from senior management.[44] In response to these scandals, Congress enacted the Foreign Corrupt Practices Act of 1977 (FCPA).[45] Notably, the FCPA, in addition to its anti-bribery provisions, included corporate governance provisions that required companies to devise and maintain an adequate system of internal accounting controls, as well as to keep accurate books and records.[46] Foreign bribery and questionable payments scandals during the 1970s helped generate more comprehensive business regulations, greater interest in internal controls, and more engaged corporate monitoring.[47]

2. The Federal Sentencing Guidelines

Dramatic changes to the landscape of federal corporate criminal law by the mid-1990s precipitated changes to corporations' internal practices.[48] The risks associated with criminal violations were expanded through a range of criminal regulations targeting business practices in diverse areas such as consumer and employee safety, as well as international trade and corruption.[49] The Federal Sentencing Guidelines for Organizations

43. *See* SEC. & EXCH. COMM'N, REPORT ON QUESTIONABLE AND ILLEGAL CORPORATE PAYMENTS AND PRACTICES, S. COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, 94TH CONG., 2D SESS. (Comm. Print 1976); SEC. & EXCH. COMM'N, STAFF REPORT ON CORPORATE ACCOUNTABILITY, S. COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, 96TH CONG., 2D SESS. (Comm. Print 1980).

44. *See* sources cited *supra* note 43.

45. Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, 91 Stat. 1494 (codified at 15 U.S.C. §§ 78dd-1–78dd-3 (2006)).

46. *Id.* (codified at § 78m(b)(2)).

47. Lawrence A. Cunningham, *The Appeal and Limits of Internal Controls to Fight Fraud, Terrorism, Other Ills*, 29 J. CORP. L. 267, 278–79 (2004).

48. Jennifer Arlen & Reinier Kraakman, *Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes*, 72 N.Y.U. L. REV. 687, 690 (1997) (The guidelines changed "the traditional rule imposing strict vicarious liability on the firm for its agents' wrongdoing with a 'composite' regime in which the firm incurs a reduced penalty if it has discharged certain compliance-related duties.").

49. *See, e.g.*, 15 U.S.C. §§ 78m(b), (d)(1), (g)–(h), 78dd-1–3, 78ff; Occupational Safety and Health Act of 1970, Pub. L. No. 91-596, 84 Stat. 1590 (codified as amended in scattered sections of 29 and 42 U.S.C.).

(FSGOs) were designed to reduce criminal fines for convicted corporations with effective compliance programs, providing strong incentives for companies to adopt compliance programs.[50] The FSGOs also provided guidance concerning the specific criteria for effective compliance programs.[51] In theory, the benefits of compliance programs are twofold: they have a deterrent effect by preventing violations before they arise, and they have a mitigating impact by reducing criminal penalties in the event of a crime.[52] The FSGOs, when compared to other regulations, have arguably had the largest impact on the development of sophisticated corporate compliance programs, which are an important element of the CIS.[53]

3. *Evolving Expectations of Board Oversight:* Caremark*'s Legacy*

The judicial response to the 1960s Allis-Chalmers antitrust scandal illustrates the monitoring responsibilities and expectations for directors approximately fifty years ago. In *Graham v. Allis-Chalmers Manufacturing Co.*, the Delaware Supreme Court held:

> On the contrary, it appears that directors are entitled to rely on the honesty and integrity of their subordinates until something occurs to put them on suspicion that something is wrong. If such occurs and goes unheeded, then liability of the directors might well follow, *but absent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists.*[54]

Over thirty years later, the Delaware Court of Chancery, in its 1996 *Caremark* decision, recognized that boards of directors held an enhanced duty of oversight. The *Caremark* court, influenced in part by changes in federal sentencing laws concerning corporate compliance programs and evolving expectations for boards of directors, recognized that a director's duty to monitor included the implementation of internal compliance controls.[55] Specifically, the court asserted:

> [I]t is important that the board exercise a good faith judgment that the corporation's information and reporting system is in concept and design *adequate to assure the board that appropriate infor-*

50. Jay M. Cohen, *Compliance and the Code of Conduct*, *in* CORPORATE GOVERNANCE: LAW AND PRACTICE § 13.02[2][b][ii] (Bart Schwartz & Amy L. Goodman eds., 2010).

51. *Id.* § 13.02[2][b][iii].

52. *See* Arlen & Kraakman, *supra* note 48, at 690.

53. Cohen, *supra* note 50, at § 13.02[2][b][i] ("The FSGO . . . gave companies a very good reason to [develop and enforce written codes of conduct]. . . . In 1987, the Sentencing Commission issued the first binding sentencing guidelines applicable to individual defendants.").

54. 188 A.2d 125, 130 (Del. 1963) (emphasis added).

55. *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 970 (Del. Ch. 1996) ("[A] director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system . . . exists, and that failure to do so . . . may . . . render a director liable for losses incurred by non-compliance with applicable legal standards.").

> *mation will come to its attention in a timely manner as a matter of ordinary operations, so that it may satisfy its responsibility.*[56]

Director liability, however, was limited to knowing violations rather than violations stemming from inadvertent neglect.[57]

In contrast to other board decisions, corporate legal compliance decisions have a strong operational component. They involve a wide variety of intertemporal decisions made by corporate actors throughout the firm.[58] *Caremark* made clear that compliance systems were the responsibility of directors in modern corporations, while also establishing a high bar for plaintiffs' claims.[59] In 2006, the Delaware Supreme Court's holding in *Stone v. Ritter* clarified the scope of directorial oversight duties while affirming the central premise of *Caremark*:

> We hold that *Caremark* articulates the necessary conditions predicate for director oversight liability: (a) the directors utterly failed to implement any reporting or information system or controls; *or* (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention. In either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations. Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith.[60]

The evolution of directorial oversight duties for legal compliance between *Allis-Chalmers* and *Stone v. Ritter* is instructive and reveals the rising expectations placed upon today's directors, despite the minimal prospect of liability.[61]

4. Sarbanes-Oxley and Dodd-Frank

Corporate collapses and scandals at companies including Enron, WorldCom, and Tyco precipitated the speedy passage of the Sarbanes-

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56. *Id.* (emphasis added).

57. *Id.* at 971. The court said in *Caremark*:

> Generally where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation . . . only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system [exists]—will establish the lack of good faith that is a necessary condition to liability.

Id.

58. Omari Scott Simmons, *Branding the Small Wonder: Delaware's Dominance and the Market for Corporate Law*, 42 U. RICH. L. REV. 1129, 1162 (2008) [hereinafter Simmons, *Branding*].

59. 698 A.2d at 971.

60. *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006) (footnotes omitted).

61. *See In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 139 (Del. Ch. 2009) (refusing to extend liability for risk-related failures).

Oxley Act of 2002 (SOX).[62] In general, SOX formalized auditing requirements within publicly traded companies.[63] Although SOX received a mixed response from commentators,[64] the Act unquestionably led corporate boards to place a more intense emphasis on internal controls and corporate compliance.[65] It also marked a directional shift in the scope of federal corporate governance legislation. SOX addressed corporate internal affairs—that is, the relationship between the directors and shareholders, an area normally falling within the ambit of state law.[66]

In the wake of the financial crisis of 2008–2010, Congress responded to the well-grounded perception that excessive risk-taking, especially at financial firms, contributed to the crisis.[67] The existing corporate govern-

62. Joseph Kay, *Tyco: US Conglomerate Falls Amid Revelations of Greed and Corruption*, WORLD SOCIALIST WEB SITE (June 18, 2002), http://www.wsws.org/articles/2002/jun2002/tyco-j18.shtml ("In many ways the company exemplifie[d] the current state of American business. Tyco [had] registered huge profits over the past decade largely by means of acquisitions and financial manipulations. Its booming earnings reports and escalating stock value . . . were not the products of growing productive capacity, but were instead achieved through accounting tricks and outright fraud. Given the parasitic character of its economic operations, it quite naturally promoted the most unscrupulous elements into the highest ranks of management."); Richard A. Oppel Jr. & Andrew Ross Sorkin, *Enron Collapses as Suitor Cancels Plans for Merger*, N.Y. TIMES, Nov. 29, 2001, at A1 ("[Enron] had shifted billions of dollars in debt off its balance sheet and into an array of complex partnerships. The [SEC] began an investigation, and Enron restated five years of earnings, wiping out nearly $600 million in profit."); Simon Romero & Riva D. Atlas, *WorldCom Files for Bankruptcy; Largest U.S. Case*, N.Y. TIMES, July 22, 2002, at A1 ("WorldCom, plagued by the rapid erosion of its profits and an accounting scandal that created billions in illusory earnings . . . submitted the largest bankruptcy filing in United States history [at that time].").

63. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15 and 18 U.S.C.).

64. *Compare* David D. Aufhauser, *Overall, Sarbanes-Oxley Is Good for U.S. Competitiveness*, 12 TEX. REV. L. & POL. 433, 435–37 (2008) (arguing that Sarbanes-Oxley has many positive aspects), *with* Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (and It Just Might Work)*, 35 CONN. L. REV. 915, 977–78 (2003) ("On the merits, the Sarbanes-Oxley Act deserves a B-, respectable, but surprisingly low given the attention showered on it by the press, law firms, executive suites, investor groups, and the public. . . . It is impossible to prove that the enactments would or would not deter or prevent repetition of the scandals they are designed to deter or prevent."); *compare* Donald C. Langevoort, *The Social Construction of Sarbanes-Oxley*, 105 MICH. L. REV. 1817, 1820 (2007) (concluding that "there is no clear-cut answer to the question of how much SOX benefits investors"), *with* Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L. J. 1521, 1528 (2005) (finding that SOX "will not provide much in the way of benefit to investors").

65. *See, e.g.*, Carole Basri et al., *From a Corporate Governance and Compliance Viewpoint: A Practical Guide to the Sarbanes-Oxley Act of 2002*, *in* CORPORATE LEGAL DEPARTMENTS 2003, at 11–45 (Practising Law Inst. 2003) ("Many of the provisions of [Sarbanes-Oxley] are aimed at corporate governance and corporate compliance conduct. These areas include the responsibility of the board of directors and its audit committee in connection with accounting irregularities, conflicts of interest, whistle blowing complaints, insider trading and 'oversight responsibility' for corporate compliance programs.").

66. E. NORMAN VEASEY & CHRISTINE T. DI GUGLIELMO, INDISPENSABLE COUNSEL: THE CHIEF LEGAL OFFICER IN THE NEW REALITY 17 (2012).

67. David M. Herszenhorn, *Bush Signs Bill*, N.Y. TIMES, Oct. 4, 2008, at A1 ("After the House reversed course and gave final approval to the $700 billion economic bailout package, President Bush quickly signed it into law on Friday, authorizing the Treasury to undertake what could become the most expensive government intervention in history."); *see also* Sewell Chan, *Financial Crisis Was Avoidable, Inquiry Finds*, N.Y. TIMES, Jan. 26, 2011, at A1 ("The 2008 financial crisis was an 'avoida-

ance regime also came under fire.[68] Amid record economic turmoil and the resulting public outrage, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) was passed into law.[69] Although Dodd-Frank primarily regulates the activities of financial firms, it also contains corporate governance provisions that apply to all public companies.[70] Whereas SOX enhanced the focus on corporate compliance and auditing, Dodd-Frank ushered in a renewed emphasis on corporate risk management. Similar to SOX's prescriptive approach to regulating audit committees, Dodd-Frank prescribes governance structures and practices that traditionally had fallen into the state-regulatory column.[71]

D. CIS Elements

The CIS has a number of elements that perform an embedded internal regulatory function that both lowers monitoring costs and is less adversarial. Examples of these elements include: a monitoring board, compliance and risk management systems, compensation, and an enhanced (CLO) role.

1. The Monitoring Board

A "cardinal precept" of the Delaware General Corporation Law (DGCL) statutory scheme is that "directors, rather than shareholders, manage the business affairs of the corporation."[72] Undoubtedly, the responsibilities of boards of directors have increased significantly over time, especially related to their monitoring and oversight roles.[73] According to recent board surveys, the amount of time boards spend on internal monitoring has increased significantly, especially with regard to compliance, risk management, and executive compensation.[74] Today, the monitoring model of corporate governance—emphasizing procedures,

ble' disaster caused by widespread failures in government regulation, corporate mismanagement and heedless risk-taking by Wall Street, according to the conclusions of a federal inquiry.").

68. *See, e.g.*, Bruner, *supra* note 2.

69. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of 7, 12, 15, 18, 22 and 45 U.S.C.).

70. VEASEY & DI GUGLIELMO, *supra* note 66, at 15–20.

71. *Id.* at 16–17.

72. Solomon v. Armstrong, 747 A.2d 1098, 1111 (Del. Ch. 1999) (quoting another case and citing DEL. CODE ANN. tit. 8, § 141(a) (2010)).

73. *See* E. Norman Veasey & Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance from 1992–2004? A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399, 1405 (2005).

74. HEIDRICK & STRUGGLES, 2011 BOARD OF DIRECTORS SURVEY 15–16 (2011); HEIDRICK & STRUGGLES, 2010 BOARD OF DIRECTORS SURVEY 11 (2010); KORN/FERRY INT'L, THE KORN/FERRY MARKET CAP 100: NEW DIRECTORS AND NEW DIRECTIONS AT AMERICA'S MOST VALUABLE PUBLIC COMPANIES 14–15 (2011) (discussing how companies took government experience into account when selecting new directors); PRICEWATERHOUSE COOPERS, INSIGHTS FROM THE BOARDROOM 2012, at 12 (2012) (annual survey of corporate directors).

internal controls, compliance, and risk management—has become the favored policy response to contemporary scandals and economic turmoil. The monitoring model envisions internal mechanisms as tools to address agency costs, particularly problems of asymmetric information and managerial opportunism. Board structures and practices are designed to ensure decision makers receive information to fulfill their strategy and oversight roles. Accordingly, most public companies have at least three committees: an audit committee, a compensation committee, and a governance committee composed of independent directors. The mere existence of these structural features alone, however, is not a sufficient response to corporate governance issues affecting the complex modern corporation.

2. *Compliance and Risk Management Systems*

a. Compliance

Corporate Legal Compliance (CLC) is integral to the daily operations of large companies.[75] It often involves thousands of decisions made by various firm employees, located in different regions of the world, throughout the course of a fiscal year. Delaware jurisprudence, federal laws addressing corporate liability, and recent corporate scandals have all raised the profile of directorial oversight in CLC. Director and senior executive officer oversight of legal compliance is distinguishable from other forms of oversight that may occur on a more infrequent basis.[76] The fluidity of corporate operations and business context figure prominently into the CLC discussion. Compliance systems are designed to bring important information to the attention of management.[77] Information networks and the flow of information are vital to effective governance, a principle illustrated by the duty to implement a system of controls recognized in *Caremark*.[78] Common features of compliance programs include a code of conduct, monitoring systems, training, reporting, and investigative capabilities. Compliance programs create a paper trail that should, in theory, flag improper conduct.[79] The systems neces-

75. *See* Simmons & Dinnage, *Innkeepers*, *supra* note 5, at 118.

76. *See* E. Norman Veasey, *Separate and Continuing Counsel for Independent Directors: An Idea Whose Time Has Not Come As a General Practice*, 59 BUS. LAW. 1413, 1416–17 (2004) (describing categories of corporate decisions).

77. Donald C. Langevoort, *Internal Controls After Sarbanes-Oxley: Revisiting* Corporate Law*'s "Duty of Care As Responsibility for Systems*," 31 J. CORP. L. 949, 958 (2006) ("[T]here are two separate but related objectives built into the internal controls requirement. One is to bring material information to management's attention, the other to permit monitors like auditors or board audit committees to verify the quality of the information flow and processing by management.").

78. *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 970 (Del. Ch. 1996). The Federal Sentencing Guidelines for Organizations also underscore the importance of compliance systems. U.S. SENTENCING GUIDELINES MANUAL § 8 (2011).

79. At times, this may appear at odds with companies seeking to limit litigation risk. Langevoort, *supra* note 77, at 958; Donald C. Langevoort, *Getting (Too) Comfortable: In-House Lawyers,*

sary for compliance, however, are not uniform. They may differ according to jurisdiction, industry, company, and operational context. In certain instances, jurisdictional laws on the same issue may be inconsistent or provide minimal guidance to companies.[80] This scenario inevitably places corporations into challenging gray areas concerning legal compliance. Consequently, many business decisions are made in the absence of absolute legal certainty.

b. Risk Management

The aforementioned developments in corporate governance coincided with business efforts to integrate legal compliance under the broader strategy umbrella known as Enterprise Risk Management (ERM).[81] Generally, ERM is an enterprise-wide attempt to ensure that corporations address risks in the business process.[82] It often involves the identification and analysis of risks, as well as managing those risks via internal controls.[83] Legal risks, however, are just one subset of risks that should be incorporated into business decisions.[84] Other types of risk include financial risk, reputational risk, human resource risk, operational risk, and brand equity risk. In the wake of the financial crisis, regulators sought to control excessive risk taking at major financial institutions. Dodd-Frank has focused greater attention on ERM.[85] Similar to CLC, ERM engenders a strong operational nexus. Courts remain reluctant, however, to treat risk management the same as compliance.[86] In *In re*

Enterprise Risk, and the Financial Crisis, 2012 WIS. L. REV. 495, 515 ("The legal rules with which in-house counsel struggle are varied, of course. Some are quite familiar and intuitive to the well-trained lawyer and readily routinized. But in many situations—especially in financial services—the lines separating law, accounting, business, and finance blur in ways that pose vexing challenges to the lawyer. The most obvious illustration here relates to financial risk management, both in terms of prudential regulation (rules restricting risk-taking) and disclosure regulation (disclosure of whatever level of risk was assumed).").

80. Privacy regulation is an example. *See* Robert Gellman, *Conflict and Overlap in Privacy Regulation: National, International and Private*, *in* BORDERS IN CYBERSPACE: INFORMATION POLICY AND THE GLOBAL INFORMATION INFRASTRUCTURE 255, 255–56 (Brian Kahin & Charles Nesson eds., 1997) ("As national, international, and privately promulgated privacy rules expand, there is a real prospect of overlapping rules and direct conflict. . . . It becomes increasingly difficult to determine what rules apply to what institutions at any given time or for any set of transactions.").

81. *See generally* MATTEO TONELLO, CONFERENCE BD., EMERGING GOVERNANCE PRACTICES IN ENTERPRISE RISK MANAGEMENT (2007) (outlining elements of ERM).

82. *See In re* Citigroup, Inc. S'holder Derivative Litig., 964 A.2d 106, 127–28 (Del. Ch. 2009); Stephen M. Bainbridge, Caremark *and Enterprise Risk Management*, 34 J. CORP. L. 967, 969 (2009).

83. CAROLYN KAY BRANCATO ET AL., CONFERENCE BD., THE ROLE OF U.S. CORPORATE BOARDS IN ENTERPRISE RISK MANAGEMENT 10 (2006).

84. *See id.* at 11 fig.1.

85. *See* Kristin N. Johnson, *Addressing Gaps in the Dodd-Frank Act: Directors' Risk Management Oversight Obligations*, 45 U. MICH. J.L. REFORM 55, 59 (2011) ("In the absence of rigorous ERM obligations under state corporate law and in the wake of the recent financial crisis, Congress has taken steps to impose federal regulation on risk management oversight. In July of 2010, Congress adopted the [Dodd-Frank Act].").

86. *See In re Citigroup*, 964 A.2d 106 (shareholder suit alleging directors breached fiduciary duties pursuing excessively risky strategies).

Citigroup, Inc. Shareholder Derivative Litigation, the Delaware Court of Chancery refused to extend liability to directors for failure to properly evaluate and consider business risks. The court asserted that "[o]versight duties under Delaware law are not designed to subject directors . . . to *personal liability* for failure to predict the future and to properly evaluate business risk."[87]

3. Compensation

Executive compensation and compensation throughout an organization are operational decisions. Their purpose is to encourage conduct from directors, senior officers, middle managers, low level employees—and even prospective employees—that is consistent with corporate goals and objectives.[88] Most of the topical legal literature focuses on the alignment of executive pay with firm objectives in order to reduce agency costs.[89] Firm performance objectives often fall into two broad categories: financial and operational.[90] Financial objectives include net income; earnings before interest, taxes, depreciation, and amortization (EBITDA); earnings per share; and share price. Operational performance metrics include customer service, product development, and environmental stewardship. As part of an internal reward system, remuneration can inculcate a corporate culture and, even when it fails to do so, it may still align interests within the firm, reducing agency costs. Remuneration provides the requisite tangible incentives that do not depend on the impossible task of verifying whether someone has truly internalized the firm's corporate values.

Executive compensation, however, is often viewed from two perspectives: a pay-for-performance, shareholder-wealth-maximization perspective and a broader, public accountability perspective that considers fairness to nonshareholder constituencies, such as employees.[91] The former perspective is most relevant to the CIS. The latter perspective is mostly a political construction and largely addresses external interests.[92] Compensation is an intimate issue with a strong link to corporate operations and internal norms.

Recent say-on-pay[93] efforts empower shareholders through nonbinding votes.[94] Indeed, a non-binding "no" vote might catch the atten-

87. *Id*. at 131. Here, it is worth mentioning that Citigroup had a risk management program in place.

88. *See, e.g.*, R. Franklin Balotti et al., *Equity Ownership and the Duty of Care: Convergence, Revolution, or Evolution?*, 55 BUS. LAW. 661, 665 (2000).

89. *See, e.g.*, Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

90. Omari Scott Simmons, *Taking the Blue Pill: The Imponderable Impact of Executive Compensation Reform*, 62 S.M.U. L. REV. 299, 311–12 (2009) [hereinafter Simmons, *Blue Pill*].

91. *See id.* at 313–16 (discussing different theories of executive compensation).

92. *See id*. at 304–06.

93. *See infra* note 189 and accompanying text.

tion of directors who wish to avoid being voted out. These votes may also impact companies in ways one might not suspect. A recent board survey found that sixty-four percent of respondents indicated that "their companies' compensation practices changed in response to their 'say-on-pay' vote."[95] Common company responses included: strengthening the link between pay and performance, increasing communications with proxy advisory firms, and enhancing proxy statement disclosures. Notably, only two percent of board respondents indicated that overall compensation levels decreased in response to say-on-pay votes.[96] Institutional investors may not have the expertise or incentives to monitor compensation. For example, a mutual fund company with hundreds of holdings may not be in the position or have the desire to monitor compensation at all of its portfolio companies. Institutional investors like mutual funds may primarily focus on short-term returns. Moreover, cost and coordination issues make close monitoring of compensation unlikely. In the executive compensation context, proxy advisory reforms play an important role through the coordination of information and ability to withhold votes. This may lead to standardization of pay practices to satisfy external proxy advisory firm requirements.

Say-on-pay votes may generate greater accountability and alignment with shareholders on pay issues as well as encourage more formal (e.g., managerial statements in proxy filings) and informal communication with shareholders (e.g., road shows). These developments, however, do not adequately ameliorate concerns regarding compensation. The prospect of outsiders—institutional shareholders with dispersed holdings or, more likely, proxy advisory firms—influencing operational decisions raises additional issues.[97] Disclosure is one of many important governance tools. Recent compensation disclosure reforms in the wake of the financial crisis, however, will have a limited impact on improving corporate governance so long as managers, shareholders, compensation consultants, and lawmakers hold the same flawed assumptions concerning the efficacy of the shareholder wealth maximization perspective. Past attempts at realignment, such as the use of stock options and enhanced disclosures, have actually led to the unintended consequence of exponential growth in compensation.[98] For similar reasons, enhanced executive compensation disclosures, in conjunction with an overemphasis on short-term

94. Companies are required to provide their shareholders, at least once every three years, with the ability to approve or disapprove of the compensation paid to top executives, as disclosed under Item 402 of Regulation S-K (including the CD&A, compensation tables, and related disclosures). The say-on-pay vote is nonbinding. 15 U.S.C. § 78n-1 (2012); *see also* 17 C.F.R. § 229.402 (Item 402) (2011).

95. PRICEWATERHOUSECOOPERS, *supra* note 74, at 3.

96. *Id.*

97. *See generally* LYNN STOUT, THE SHAREHOLDER VALUE MYTH: HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS, AND THE PUBLIC (2012).

98. *See* Simmons, *Blue Pill*, *supra* note 90, at 304; Steven M. Davidoff & Claire A. Hill, *Limits of Disclosure*, 36 SEATTLE U. L. REV. 599 (2013).

shareholder wealth maximization, may not lead to optimal pay structures or better long-term governance. Disclosure is a politically acceptable response that generates the impression that regulators are responding to a problem.[99] Its impact on sound decision making, however, is overstated. Although shareholder wealth maximization is an attractive, important, and easily measurable goal, it is too narrow to address corporate complexity and the current environment facing boards of directors.[100] Executive compensation decisions are still best left to boards who in theory can take a broader perspective rather than externally positioned shareholders.

4. An Enhanced Chief Legal Officer Role

Just as collaborative governance-type reforms blurred the roles of private and public institutions, they also contributed to a transformation in the legal profession, particularly with regard to the emergence of in-house counsel.[101] The multifaceted, hybridized incarnation of today's corporate in-house legal department raises important questions concerning the enhanced role of lawyers and other gatekeepers in firm governance.[102] In-house counsel, equipped with a "dual consciousness" characterized by organizational knowledge and legal acumen, are a vital part of the CIS. These so-called "innkeepers" are uniquely positioned to provide monitoring and strategic guidance to corporate managers.[103] This capacity enables the corporation to reduce transaction costs and enhance its creation of value.[104] Recent regulations such as SOX and Dodd-Frank have signaled a "new reality," one in which in-house counsel play a more prominent role in firm governance.[105]

The most prevalent critique of in-house counsel in the legal literature asserts their lack of independence or that capture makes them less effective gatekeepers.[106] John Coffee, in his book *Gatekeepers*, embraces this critique:

> While the outside attorney has been increasingly relegated to a specialist's role and is seldom sought for statesman-like advice, the in-

99. Davidoff & Hill, *supra* note 98; Simmons, *Blue Pill*, *supra* note 90, at 328.

100. Some scholars such as Lynn Stout contend that the extensive use of stock-based compensation may create a dangerous synergy between activist institutional shareholders (RiskMetrics-advised mutual funds and hedge funds) who move in and out of stocks, and executives whose compensation scheme makes them focus on short-term shareholder returns. STOUT, *supra* note 97, at 72.

101. *See* Lisa T. Alexander, *Part III: Reflections on Success and Failure in New Governance and the Role of the Lawyer*, 2010 WIS. L. REV. 737, 741–42 (discussing transformation of lawyers' roles in new governance regimes); Larry E. Ribstein, *Delawyering the Corporation*, 2012 WIS. L. REV 305, 309–11.

102. *See* COFFEE, *infra* note 114, at 195 (asserting in-house counsel are not adequate gatekeepers due to lack of independence).

103. Simmons & Dinnage, *supra* note 5, at 83, 121.

104. *See id.* at 84, 138.

105. VEASEY & DI GUGLIELMO, *supra* note 66, at 14–15.

106. Simmons & Dinnage, *supra* note 5, at 90.

> house general counsel seems even less suited to play a gatekeeping role. First, the in-house counsel is less an independent professional—indeed he is far more exposed to pressure and reprisals than even the outside audit partner. Second, the in-house counsel is seldom a reputational intermediary (as law and accounting firms that serve multiple clients are) because the in-house counsel cannot easily develop reputational capital that is personal and independent from the corporate client.[107]

The assertion that in-house counsel cannot serve as adequate gatekeepers due to a lack of independence or due to capture is overly broad. Such criticism is unduly dismissive of the key advantages in-house counsel possess, which potentially outweigh the advantages of independence in a range of circumstances.[108] In-house counsel perform an integrated strategic function as opposed to the largely tactical role of the outside law firm. This strategic role involves consistent interaction with corporate operations and internal actors such as management and other employees. With insider status or "a seat at the table," in-house counsel often possess the power to promote internal action, access to information and institutional knowledge, the capacity to engage in preventive law, and the primary responsibility for outside counsel and other service providers.[109] Corporations require legal support to manage ongoing threats to corporate value. These threats include failure to comply with federal regulations, a mishandled product liability lawsuit, or even a poorly written contract. Effective corporate managers "cannot wait until such threats materialize; they require a type of consistent and strategic guidance that in-house counsel are uniquely positioned to provide."[110]

III. CIS AND LEGAL THEORY

Broadly defined, corporate governance is the "structure, relationships, norms, control mechanisms, and objectives of the corporate enterprise."[111] Corporations' primary objectives are to create value, maximize profitability, and promote long-term growth for the benefit of shareholders.[112] Pursuit of these objectives involves multiple actors throughout the corporation. Corporate governance literature, however, is generally characterized by a director-shareholder dualism that overlooks the impact of a range of internal actors and activities.[113] Legal scholarship often

107. COFFEE, *infra* note 114, at 195.

108. *See id.*; Simmons & Dinnage, *supra* note 5, at 91–92.

109. Simmons & Dinnage, *supra* note 5, at 113–15.

110. *Id.* at 83. In-house counsel can play an important role through advising boards and officers of both their fiduciary duties under state law and responsibilities under federal statutes (e.g., SOX and Dodd-Frank).

111. VEASEY & DI GUGLIELMO, *supra* note 66, at 132–33.

112. *Id.* at 133; *see also* Strine, *supra* note 8, at 135.

113. Omari Scott Simmons, *The Under-Examination of In-House Counsel*, 11 TRANSACTIONS: TENN. J. BUS. L. 145, 147–48 (2009) [hereinafter Simmons, *Under-Examination*].

vacillates between shareholder and director primacy with occasional detours, such as the gatekeeper discussion.[114] But, a "corporation is much more than directors and shareholders; it is a complex bureaucracy composed of multiple layers of management, where decision-making occurs at all levels of the firm on an intertemporal basis."[115] Notwithstanding the director-shareholder dualism that predominates within the legal literature, the CIS paradigm finds significant support in an array of diverse, and even rival, theoretical perspectives. Theoretical perspectives—including transaction cost economics, behavioral economics, new governance, organizational theory, and stakeholder theories of corporate governance—all implicitly, if not explicitly, recognize the importance of internal governance mechanisms. Notwithstanding, "organizational" and "new governance" theories offer the greatest explanatory power with their inside-out, bottom-up, adaptive, and micro-level implications.[116]

A. Organizational Theory

The complexity of the modern corporation can largely be explained as organizational adaptations intended to minimize transaction costs.[117] In theory and as a matter of law, the board of directors manages the modern corporation, but delegates its management authority to the CEO and senior salaried executives.[118] Delegation to senior management was necessary to address transaction costs created by the complexities inherent in modern, multidivision, publicly traded companies.[119] Yet the sepa-

114. *See, e.g.*, STEPHEN BAINBRIDGE, THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE 8–12 (2008) (discussing shareholder primacy, director primacy, managerialism, and stakeholder theoretical approaches); *see also* JOHN C. COFFEE JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE 6 (2006) (discussing reasons for gatekeeper failure); Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 253 (1999) (acknowledging directors, within their discretion, may consider non-shareholder interests in order to maximize the joint welfare of all firm stakeholders); Lisa M. Fairfax, *The Rhetoric of Corporate Law: The Impact of Stakeholder Rhetoric on Corporate Norms*, 31 J. CORP. L. 675, 698–711 (2006) (describing the impact of stakeholder rhetoric); Marleen O'Connor, *Labor's Role in the American Corporate Governance Structure*, 22 COMP. LAB. L. & POL'Y J. 97, 99–102 (2000) (discussing why American employees lack corporate governance rights).

115. Simmons, *Under-Examination*, *supra* note 113, at 148.

116. *See generally* Lobel, *supra* note 33, at 344 (describing the new governance model); Williamson, *Strategy*, *supra* note 23, at 1087 (comparing and contrasting the governance perspective and competence perspective, which involves organization theory).

117. *See, e.g.*, R. H. Coase, *The Nature of the Firm,* 4 ECONOMICA 386 (1937) (asserting that in order to minimize transaction costs, it may be optimal to bring various labor functions within the firm to prevent costly "spot" labor market transactions); Oliver E. Williamson, *The Modern Corporation: Origins, Evolutions, Attributes*, 19 J. ECON. LITERATURE 1537, 1537 (1981) ("While I recognize that there have been numerous contributing factors, I submit that the modern corporation is mainly to be understood as the product of a series of organizational innovations that have had the purpose and effect of economizing on transaction costs."). *See generally* ALFRED D. CHANDLER, JR., STRATEGY AND STRUCTURE: CHAPTERS IN THE HISTORY OF THE AMERICAN INDUSTRIAL ENTERPRISE (1962) (discussing strategic divisionalization of the modern corporation).

118. DEL. CODE ANN. tit. 8, § 141(a) (2010).

119. S*ee generally* ALFRED D. CHANDLER, JR., THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS (1977) (examining the way in which management of U.S. companies has become increasingly systematic).

ration of ownership and control between managers and shareholders, as Adolf Berle and Gardiner Means identified, created a different set of transaction or "agency" costs.[120] This agency cost discussion predominates in the legal literature.[121] Managers, however, must address a wider range of transaction costs to improve firm operations, strategy, productivity, and innovation.

General systems theory, a branch of organizational theory characterized by a loose analogy between social and biological systems, provides an instructive view of firm responses to regulation.[122] Presented with external threats in the form of regulation or sanctions, a firm will respond to minimize the stress from the external threat and to restore its internal equilibrium. This response often involves resistance that, over time, yields to adaptation. Over the medium-and long-term, the normal firm response is to develop internal mechanisms that minimize the impact of stress to the firm's operations and value.[123] This internalization and threat response may take different forms: a self-produced, coadaptive, and self-referencing autopoietic response, where the firm creates an internal substructure that conforms to and perpetuates existing firm structures; or institutional isomorphism, where the firm develops internal structures that resemble an external force.[124] In the former scenario, although the external regulatory environment may influence structural changes, it does not actually drive them. Here, a regulated firm might develop mechanisms, patterned on existing company structures, to monitor and eradicate legal threats to business operations and the company's economic value. Such responses might take the form of a separate functional unit, such as a compliance or risk management department; positions such as Chief Compliance Officer (CCO) and Chief Risk Officer (CRO); or the establishment of additional board committees. In the latter scenario, a company might reorganize and implement an entirely different internal structure in response to external forces. This change may be initiated by a mandate from regulators, may be patterned on the threat itself, or may mimic structures from those reputable firms who have won regulatory approval.[125] The particular type of response often depends upon, *inter alia*, the comprehensiveness of the regulation and

120. *See generally* ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 128–31 (1932) (arguing that shareholders who own the company do not actually control it).

121. *See, e.g.*, Jensen & Meckling, *supra* note 89, at 305.

122. Rubin, *supra* note 10, at 551–52; *see also* Langevoort, *supra* note 79, at 515 ("Where a loyalty to the corporate mission comes to color the [employee's] thinking, it becomes easy to start thinking of regulators and the courts as rivals—anachronistic, inexpert policy-makers who mindlessly burden entrepreneurial innovation. Once this kind of cynicism and disdain takes root, there is little to restrain the [employee's] encouragement of legal risk-taking except for their sense of the probability of detection and magnitude of possible sanction—which, as we have seen, can diminish for extended periods of time.").

123. Rubin, *supra* note 10, at 552.

124. *Id.*; *see* Goldspink & Kay, *supra* note 42.

125. Rubin, *supra* note 10, at 552.

business context.[126] The emergence and expansion of the CIS—director oversight, compliance, risk-management, and in-house legal functions—reflect these processes.

These adaptations to external and internal threats, in theory, benefit both firms and their regulators. Admittedly, the efficacy of these adaptations may vary. Organizational theorists such as Oliver Williamson tout the advantages of internal governance mechanisms, such as access to internal machinery and information economies.[127] With access to internal control mechanisms, as well as ongoing internal relationships, internal actors can gather information more efficiently, accurately, and at a lower cost, allowing them to conduct more precise *ex ante* and *ex post* evaluations of corporate performance. Leveraging firms' internal advantages figures prominently into the organizational adaptation discussion.

B. New Governance Theoretical Perspectives

Although there are multiple definitions for new governance or collaborative governance strategies in the legal literature, these differing definitions reflect a number of common conceptual threads: public-private collaboration wherein stakeholders work together to create and implement reforms; experimentation with local program design, including the ability to evaluate and test such programs; government regulators acting as facilitators rather than centralized rule makers; a preference for incrementalism and the utilization of flexible legal principles rather than rigid prescriptive rules; and decentralizing, bottom-up, and inside-out regulation strategies that promote active participation of affected groups within the governance structure.[128]

Under the new governance paradigm, the principle of subsidiarity is instructive. It maintains that "all governmental tasks are best carried out at the level closest to those affected by them" and government "authorities should leave the widest scope possible for local discretion to fill in the details of broadly defined policies."[129] Regulators have difficulty matching the capabilities of regulated entities and keeping up with industry trends and transformations. New governance approaches can help address this gap by providing balance, harnessing internal industry expertise, allowing for greater flexibility, and encouraging private ordering.[130]

126. *Id.*

127. *See generally* Oliver E. Williamson, *The Vertical Integration of Production: Market Failure Considerations*, 61 AM. ECON. REV. 112, 113–14 (1971) (discussing positive aspects of internal organization); Williamson, *Strategy*, *supra* note 23.

128. Wendy A. Bach, *Governance, Accountability, and the New Poverty Agenda*, 2010 WIS. L. REV. 239, 256; Ford, *supra* note 39, at 445 (describing "regulation based on an iterative process between private-party experience and a regulator that serves variously as clearinghouse, catalyst, monitor, prod, and coordinator.").

129. Lobel, *supra* note 33, at 382.

130. *See* Jill E. Fisch, *The Destructive Ambiguity of Federal Proxy Access*, 61 EMORY L. J. 435, 486 (2012) ("The . . . challenge in evaluating governance mechanisms is that their effectiveness depends on

Notwithstanding the multiple benefits of new governance approaches, it would be naïve to assert that these approaches to corporate regulation are a panacea to all forms of corporate malfeasance and corporate governance concerns.[131] Rather, they should be understood as operating in concert with existing regulatory regimes. Simply stated, new governance approaches represent one of the multiple ways to influence firm behavior rather than "a full-blown alternative" to existing regulatory structures.[132] Adversarial, command-and-control, and rule-based regulation methods still have an important role to play in corporate governance due to their increased efficacy relative to collaborative approaches in certain contexts. For example, prophylactic rule-based regulation may be more appropriate where a public regulator is incapable of providing meaningful oversight due to resource constraints or complexity.[133] Such rules may help "conserve[] regulatory resources" and assist in "keeping essential systems functioning."[134] Even where new governance strategies may be optimal, they may not be able to be practically implemented. Timing can also determine the efficacy of various regulation types. When implementing new regulations, particularly a novel regulatory regime, regulators tasked with imposing the new rules often face an adversarial climate and corporate resistance. In the short-term, command-and-control regulation and punitive tactics may be more efficient and effective addressing disobedience from corporate firms.[135] But, as the regime is established, new governance strategies become more effective and face less resistance from industry over time. At this stage, Edward Rubin asserts, new governance strategies become optimal.[136] On balance, new governance strategies provide better long-term responses to complexities in the corporate context.[137]

New governance strategies may prove less effective, however, where firms are subject to numerous regulators and dispersed regulations. Arguably, new governance strategies work best where firms buy in due to a number of factors. When firms face more comprehensive regulation from an agency or regulator, the firms share an intimate relationship with

firm-specific characteristics, including the firm's existing management team, its shareholder base, and its life-cycle stage. . . . The very governance mechanisms that are valuable for some firms impose excessive costs upon others. In particular, increasing board accountability by enhancing shareholder power is likely to be valuable for poorly managed firms and wasteful, at best, for well run issuers.").

131. Ford, *supra* note 39, at 486; *see* Kenneth A. Bamberger, *Regulation As Delegation: Private Firms, Decisionmaking, and Accountability in the Administrative State*, 56 DUKE L.J. 377, 378 (2006) (noting that corporate self-regulation may "in a subset of cases, systematically blind decision-makers to the types of risk and change in which regulation is interested, and lead to unaccountable regulatory decisions").

132. Ford, *supra* note 34, at 441–42.

133. *Id.* at 479–83.

134. *Id.* at 482.

135. *Compare* Rubin, *supra* note 10, at 553–54, *with* Baer, *supra* note 13, at 627 (asserting that punitive measures, in general, are not effective corporate governance tools).

136. Rubin, *supra* note 10, at 554.

137. Ford, *supra* note 39, at 482.

their regulator where their ability to operate depends on the cooperative relationship, and they internalize regulator norms due to ongoing relationships.[138] Several of these favorable background conditions exist in the corporate governance context between publicly traded companies, the SEC, and the State of Delaware. The symbiotic relationship between state and federal regulators strengthens the appeal of new governance strategies provided that the internal affairs doctrine is respected.[139]

New governance strategies, however, do not operate in a vacuum. Countervailing forces—political, economic, and otherwise—challenge the efficacy of these strategies. As a result, regulators are tasked with addressing foreseeable flaws in the implementation process including: power asymmetries creating biased reforms, bounded rationality of private actors pursuing their short-term self-interest, and public regulators' limited capacity to oversee complex arrangements.[140]

C. Insiders Versus Outsiders Debate

The insider-outsider debate is at the center of longstanding deliberations among legal scholars. Independence, particularly among directors, is often touted, without empirical validation, as a sacred corporate virtue and the solution to various forms of corporate malfeasance.[141]

1. Board Independence

A growing number of scholars now recognize the overstated impact of independence-infused reforms. Usha Rodrigues captures this overreliance in the board context:

> [I]ndependent directors are useful only [or most useful] in situations where a conflict exists. An independent director—a part-timer whose contact with the corporation is necessarily limited—is not inherently better suited to further the interests of shareholders than an inside director. Current rules thus over-rely on independence, transforming an essentially negative quality—lack of ties to the corporation—into an end in itself, and thereby fetishizing independence.[142]

138. Rubin, *supra* note 10, at 554.

139. *See* Marcel Kahan & Edward Rock, *Symbiotic Federalism and the Structure of Corporate Law*, 58 VAND. L. REV. 1573 (2005).

140. Ford, *supra* note 39, at 470–83.

141. Lisa M. Fairfax, *The Uneasy Case for the Inside Director*, 96 IOWA L. REV. 127, 130 (2010) ("This virtual elimination of inside directors' role on corporate boards is inextricably linked to the overwhelming consensus that boards should be dominated by 'independent' directors. Such consensus stems from a belief that independent directors are better equipped to monitor the corporation, detect fraud, and protect shareholders' interests.").

142. Usha Rodrigues, *The Fetishization of Independence,* 33 J. CORP. L. 447, 447 (2008); *see also* Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921, 921–22 (1999); Langevoort, *supra* note 35, at 799 ("Current policy-making initiatives show an increasing tendency to assume the benefits of director independence and

The weight of available evidence shows, at best, a nominal correlation between board independence and corporate performance.[143] Similarly, this research also shows little correlation between board independence and CEO compensation.[144] Internal corporate actors, such as senior management, may certainly be prone to provincialism, remaining too close to problems to exercise independent critical judgment about them. Yet on the other hand, outsiders such as lawmakers, institutional investors, gatekeepers and independent directors may rely on crude, readily available heuristics, such as share price, that do not provide adequate insight into the health of a corporate organization.[145] An understanding that both insiders and outsiders are subject to varying degrees of bias makes clear that they must play complementary roles.

A common critique of this heightened emphasis on board independence is that it subordinates expertise in the governance discussion.[146] As a consequence of these gaps in information and expertise, the appropriate degree of managerial discretion and deference to internal expertise is a subject of considerable debate among scholars.[147] The trade-offs between independence and expertise, however, are more nuanced than the regulatory regime suggests. Despite research illustrating the limited benefits of independence requirements at an individual firm level, independence may nonetheless provide systemic benefits such as improved financial reporting, enhanced monitoring, and more accurate share prices.[148] Directorial independence also does not necessitate a concomitant lack of expertise. A director can be both independent and qualify as an expert, where the director's knowledge is rooted in a substantive discipline such as accounting. This, however, is not the case where expertise itself develops from insider status.[149]

2. *Institutional Shareholders*

Beyond independent directors, legal scholars tout the corporate governance advantages of involving institutional shareholders in firm

accountability, and hence the self-evident desirability of legal reforms to promote them."); Simmons, *Blue Pill*, *supra* note 90, at 341–42, 359–60.

143. Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1468 (2007).

144. *Id.* at 1503–04.

145. Simmons & Dinnage, *supra* note 5, at 152; *see also* Langevoort, *supra* note 35, at 807.

146. Langevoort, *supra* note 35, at 807.

147. For example, the Delaware-corporate-law-versus-federalization debate focuses on the degree and type of constraints placed on corporate insiders in order to protect investors. Delaware corporate law is often described as embodying "enabling" standards rather than "prescriptive" rules that some observers contend characterizes the federal approach to regulation. Peter Ferola, *The Role of Audit Committees in the Wake of Corporate Federalism: Sarbanes-Oxley's Creep into State Corporate Law*, 7 J. BUS. & SEC. L. 143, 157 (2007); Fisch, *supra* note 130, at 487–90.

148. *See* Gordon, *supra* note 143, at 1508–09.

149. Lawrence A. Cunningham, *Rediscovering Board Expertise: Legal Implications of the Empirical Literature*, 77 U. CIN. L. REV. 465, 467 (2008).

governance. Shareholder empowerment is an important aspect of the insider-outsider debate. The classic recitation of the agency cost problem presupposes diffuse rationally apathetic shareholders with collective action issues. Institutional investors and the strengthened hand of proxy advisory firms such as RiskMetrics and Glass Lewis present a challenge to the traditional view, yet they do not eliminate all the problems and create additional concerns.[150] Simply asking "What would a shareholder do?" is a not an adequate response to the varied types of transaction costs that threaten corporate value. The monolithic shareholder does not exist.[151] Recent legislation such as Dodd-Frank empowers shareholders and proxy advisory firms. These new reforms do not adequately address the costs that accompany greater shareholder empowerment such as short-termism.[152] Ironically, legal scholars such as William Bratton and Michael Wachter argue that the overemphasis on shareholder interests contributed significantly to the 2008 financial crisis.[153] The results of enhancing shareholder power and increasing board accountability are likely mixed, as "increasing board accountability by enhancing shareholder power is likely to be valuable for poorly managed firms and wasteful, at best, for well run issuers."[154]

IV. THE CORPORATE IMMUNE SYSTEM IN THE LEGAL FRAMEWORK

The aspects of contemporary regulatory architecture that impact corporate governance are the by-product of the symbiotic relationship between state and federal regulators, namely Delaware and the SEC.[155] Historically, corporate lawmakers have been reluctant to advocate policies that shift the internal power dynamics between management and shareholders or to introduce policies addressing firms' operational details.[156] Instead lawmakers have (i) outsourced such reform to third-party gatekeepers, reputational intermediaries, and the market;[157] (ii) emphasized democratically symbolic procedures reflecting values such as inde-

150. *See* Stephen Choi et al., *The Power of Proxy Advisors: Myth or Reality?*, 59 EMORY L.J. 869 (2010); *see also* Fisch, *supra* note 130.

151. Margaret M. Blair, *Corporate Law and the Team Production Problem*, *in* RESEARCH HANDBOOK ON THE ECONOMICS OF CORPORATE LAW, 33, 45–49 (Claire A. Hill & Brett H. McDonnell eds., 2012).

152. *Id.*; *see also* William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653 (2010).

153. *See* Bratton & Wachter, *supra* note 152, at 720–22.

154. Fisch, *supra* note 130, at 486.

155. *See* Kahan & Rock, *supra* note 139.

156. *See* Lyman Johnson & Dennis Garvis, *Are Corporate Officers Advised About Fiduciary Duties?*, 64 BUS. LAW. 1105, 1106–09 (2009).

157. *See* COFFEE, *supra* note 114, at 223; Sidney A. Shapiro, *Outsourcing Government Regulation*, 53 DUKE L.J. 389, 389–90 (2003) (highlighting situations where government regulators have outsourced not only services but the origination and implementation of regulatory policy).

pendence, participation, and transparency;[158] and (iii) regulated business activity indirectly or outside of the traditional corporate law context (e.g., tax, antitrust, environmental, banking, international trade, and labor laws).[159]

A. State Corporate Law

State corporate law addresses the internal affairs of the corporation, primarily the relationship between shareholders and managers (e.g., directors and senior officers).[160] The content of state corporate law, especially Delaware law, is schematically conservative, lacks a degree of contextual specificity, and provides substantial managerial discretion.[161] This reality is not coincidental. State corporate laws function like bookends; they do not address a broad range of corporate activity, thereby leaving it to managers to fill gaps in most cases.[162] There are multiple new governance analogs embedded in the dominant Delaware corporate law framework.[163] Delaware corporate law is often described as embodying "enabling" standards and encouraging "private ordering" in contrast to the "prescriptive" rules that some observers contend characterizes the federal approach to regulation.[164]

158. *See* Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 395 (1983); Lawrence Mitchell, *Protect Industry from Predatory Speculators*, FIN. TIMES (London), July 9, 2009, at 9.

159. *See* ROBERT CHARLES CLARK, CORPORATE LAW § 1.4, 30–32 (1986). There are, however, numerous laws and regulations affecting business enterprise that should not be overlooked. *See id.*

160. CTS Corp. v. Dynamics Corp. of Am., 481 U.S. 69, 89–91 (1987); VantagePoint Venture Partners 1996 v. Examen, Inc., 871 A.2d 1108, 1112–13 (Del. 2005); Randy J. Holland, *An Introduction to Delaware Corporation Law Directors' Fiduciary Duties*, 19 CIV. & COM. L.J. 92, 94–95 (2008) (Taiwan).

161. Here, the use of the word "conservative" is value neutral.

162. *See* CLARK, *supra* note 159, at 30–32. Ownership decisions involve ownership changes, such as mergers, acquisitions, and corporate takeovers. Oversight decisions concern managers' monitoring role, such as ensuring employees execute their responsibilities in compliance with the law. *See id.*; E. Norman Veasey, *The Defining Tension in Corporate Governance in America*, 52 BUS. LAW. 393, 394 (1997).

163. *See generally* Simmons, *Branding*, *supra* note 58 (providing extensive discussion and rationale for Delaware's dominance).

164. *See* VEASEY & DI GUGLIELMO, *supra* note 66, at 132–35; William B. Chandler III & Leo E. Strine, Jr., *Views from the Bench: The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953, 960 (2003); Fisch, *supra* note 130, at 435 ("The core of the problem, as illustrated by the SEC's experience with proxy access, is that federal regulation is poorly suited for regulating corporate governance. Private ordering offers a more flexible mechanism for maintaining equilibrium in the allocation of power between shareholders and managers"); Lawrence A. Hamermesh, *The Policy Foundations of Delaware Corporate Law*, 106 COLUM. L. REV. 1749, 1752 (2006).

1. *Business Judgment Rule*

Most routine operational decisions,[165] such as the decision to build a foreign production plant or what products to produce, are protected under state law through the business judgment rule. The business judgment rule vests directors with the authority and protection to make numerous corporate decisions, often relying on skilled managers and advisors, without the prospect of being second-guessed through judicial intervention.[166] The reluctance to permit judicial second-guessing of management decisions made by directors and officers is embodied in the Delaware Court of Chancery's decision in *In re Citigroup, Inc. Shareholder Derivative Litigation*, in which the Court of Chancery held that managers' decisions to invest in mortgage-backed securities, resulting in significant losses, were protected by the business judgment rule.[167] Justification for a robust business judgment rule does not entail antipathy for top-down regulation, but rather is an acknowledgment of the principle of subsidiarity, the effects of hindsight bias, the need for balancing among complex contextual variables, and the lack of effective alternatives.[168]

2. *Fiduciary Duties*

a. Origins and Functions

The core of corporate law is judge made, through case-by-case common-law formulations of fiduciary duties.[169] The DGCL is merely a skeletal framework of mandatory requirements that leaves ample room for private ordering and common-law decisions regarding fiduciary duties. As Justice Randy Holland of the Delaware Supreme Court observes, fiduciary duties, including loyalty and care, "are an equitable response to the power that is conferred upon directors as a matter of

165. *See generally* Veasey, *supra* note 162, at 394 (discussing the types of decisions Delaware courts address, which include enterprise, ownership, and oversight decisions).

166. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984). Robert Clark describes the business judgment rule as follows:

> The rule is simply that the business judgment of the directors will not be challenged or overturned by courts or shareholders, and the directors will not be held liable for the consequences of their exercise of business judgment—even for judgments that appear to have been clear mistakes—unless certain exceptions apply.

CLARK, *supra* note 159, at § 3.4, 123; *see also* FRANKLIN A. GEVURTZ, CORPORATION LAW 279 (2000) ("After all, business decisions typically involve taking calculated risks."); Lyman P.Q. Johnson, *Corporate Officers and the Business Judgment Rule*, 60 BUS. LAW. 439, 440 (2005) (arguing that the business judgment rule should not extend to corporate officers in the same way as to directors); Lawrence A. Hamermesh & A. Gilchrist Sparks III, *Corporate Officers and the Business Judgment Rule: A Reply to Professor Johnson*, 60. BUS. LAW. 865, 866 (2005) (critiquing Johnson's argument for a liability scheme holding officers liable for negligence). In Delaware and many other states, directors receive an additional layer of legal protection from exculpation statutes that cover violations of fiduciary duty, but not breaches of the duty of loyalty and good faith. DEL. CODE ANN. tit. 8, § 102(b)(7) (2010).

167. *In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 126 (Del. Ch. 2009).

168. *See* sources cited *supra* note 9.

169. VEASEY & DI GUGLIELMO, *supra* note 66, at 133.

statutory law."[170] These fiduciary duty precepts date back to *Charitable Corp. v. Sutton*, a 1742 decision by the Lord Chancellor of England. *Charitable Corp. v. Sutton* explained that corporate directors were both agents and trustees who must act with "fidelity [loyalty] and reasonable diligence [care]."[171] Delaware courts recognize that maximizing shareholder wealth necessitates directors exercising their discretion in good faith to weigh business risk and rewards.[172] The courts have also recognized that personal monetary liability for directors could likewise inhibit directors from pursuing a risky, but rational, strategy to enhance shareholder wealth.[173] In this fashion, Delaware courts have tempered law. According to Ed Rock, Delaware corporate law is analogous to a series of folktales about good and bad managers.[174] These tales, as manifested in judicial opinions, collectively describe the roles of directors and "over time they yield reasonably determinate guidelines."[175] Similarly, fiduciary duty principles evolve incrementally from the common-law process and also in response to changing business norms.[176]

Although Delaware fiduciary duty jurisprudence provides broad discretion to managers and remote possibilities for personal liability, it acknowledges the importance of internal governance mechanisms and corporate complexity. The expansion of oversight duties under *Caremark* is a prime illustration. As a result of *Caremark*, federal regulations under SOX and Dodd-Frank indirectly expanded directorial oversight responsibilities under state law.[177] Companies, however, still have considerable discretion in designing compliance programs.[178]

b. Fiduciary Duties for Nondirector Officers

Whereas a corporate board meets periodically—roughly six to ten times a year—senior officer engagement with the corporation is continuous. From a practical perspective, a board's ability to effectively monitor is contingent upon adequate information flow, usually from senior officers functioning in a nondirectorial capacity. Monitoring and strategy are

170. Randy J. Holland, *Delaware Directors' Fiduciary Duties: The Focus on Loyalty*, 11 U. PA. J. BUS. L. 675, 678 (2009).

171. Charitable Corp. v. Sutton, (1742) 26 Eng. Rep. 642 (Ch.) 645; 2 Atk. 400, 406; Marcia M. McMurray, *An Historical Perspective on the Duty of Care, the Duty of Loyalty, and the Business Judgment Rule*, 40 VAND. L. REV. 605, 605 nn.1–2 (1987).

172. Holland, *supra* note 160, at 97.

173. *Id.*

174. Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1016 (1997).

175. *Id.* at 1017. *But see* Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908, 1913–14 (1998) (arguing that Delaware law is indeterminate).

176. VEASEY & DI GUGLIELMO, *supra* note 66, at 135–37.

177. *See supra* Part II.C.3–4.

178. Donald C. Langevoort, *Internal Controls After Sarbanes-Oxley: Revisiting* Corporate Law*'s "Duty of Care As Responsibility for Systems,"* 31 J. CORP. L. 949, 953 (2006) (explaining that the threat of liability "is restrained enough to leave ample room for business judgment on the specifics of compliance design").

not exclusively the dominion of the board. Actually, nondirector officers may have a greater capacity to make oversight and strategic decisions on a day-to-day basis. Recently, fiduciary duty law evolved to address this reality of corporate governance. In *Gantler v. Stephens*, the Delaware Supreme Court ruled that officers of Delaware corporations owe the same fiduciary duties—the duties of loyalty and care—as directors.[179] This decision is important because corporate officers, unlike corporate directors, are thoroughly immersed in the day-to-day affairs of the corporation and do not receive protection from section 102(b)(7) of DGCL.[180] As a consequence, officers—general counsels, CIOs, CFOs, COOs, and other senior officers—are generally not exculpated for breaches of their fiduciary duties of care. Although the decision raises additional questions concerning the application of the business judgment rule to nondirector officers, it acknowledges the important day-to-day impact of senior officers on corporate governance and firm operations. Although the issue remains unresolved as a matter of law, the business judgment rule, theoretically and pragmatically, should apply to nondirector officer decisions in some form.[181] The rationale for extending business judgment protection is perhaps even stronger for nondirector senior officers.[182]

B. Federal Securities Law

1. Origins and Functions

The federal government, to a large extent through the SEC, regulates the external trading of securities and disclosure without addressing the internal affairs of the corporations it regulates.[183] Prior to the stock market crash of 1929, a substantive federal role in the regulation of the securities markets seemed a remote possibility. The crash coincided with a crisis of confidence in the capital markets. Congress passed the Securities Act of 1933 and the Securities Exchange Act of 1934 to restore investor confidence and the markets. The SEC's mandate is largely accom-

179. Gantler v. Stephens, 965 A.2d 695, 708–09 (Del. 2009). In *Gantler*, the Court found that two First Niles officers could have breached their fiduciary duty of loyalty. *Id.* at 709.

180. DEL. CODE ANN. tit. 8, § 102(b)(7) (2010) (applies only to directors).

181. Lyman P.Q. Johnson & David Millon, *Recalling Why Corporate Officers Are Fiduciaries*, 46 WM. & MARY L. REV. 1597, 1599–601, 1642–43 (2005); Lyman P.Q. Johnson and Robert V. Ricca, *(Not) Advising Corporate Officers About Fiduciary Duties*, 42 WAKE FOREST L. REV. 663, 665–66 (2007); *see* Hamermesh & Sparks, *supra* note 166.

182. *See* Gregory Scott Crespi, *Should the Business Judgment Rule Apply to Corporate Officers, and Does It Matter?*, 31 OKLA. CITY U. L. REV. 237 (2006). *But see* Johnson, *supra* note 166.

183. Simmons, *Blue Pill*, *supra* note 90, at 327–29; Leo E. Strine, Jr., *The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (and Europe) Face*, 30 DEL. J. CORP. L. 673, 674–79 (2005). *But see* Robert B. Thompson & Hillary A. Sale, *Securities Fraud As Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859, 872–73, 878 (2003) (asserting that federal securities laws indirectly impose fiduciary duties on officers via disclosure and certification).

plished through a disclosure regime.[184] Disclosure requirements, as a general matter, are less intrusive than prescriptive rules and are consistent with market-based theories. Better information ostensibly contributes to healthier markets and presupposes that the greater the disclosure, the lesser the need for judicial and regulatory intervention. Notwithstanding its tangible benefits, disclosure has limits and its impact is overstated.[185]

2. *New Directions*

Some researchers argue that federal securities laws have attempted to fill voids in state law by imposing liability on nondirector officers, thereby exerting more influence on corporate internal affairs.[186] These researchers consider SOX and Dodd-Frank attempts to influence internal affairs of corporations and to encroach upon what has historically been the territory of state law.[187] SOX federalizes certain aspects of corporate law, including: the composition of the corporation's audit committee, separation of accounting and audit services, forfeiture of executive pay, and prohibitions on loans to executives.[188] Similarly, Dodd-Frank mandates structures and practices that historically have been regulated by state law, such as: proxy access, compensation committee composition and committee advisor independence, "say-on-pay" and "golden parachute" advisory votes, whistleblower provisions, "clawback" policies for incentive compensation, and special requirements for financial companies.[189] Dodd-Frank also mandates externally focused public policy-related disclosures that arguably fall outside the ambit of investor protection.[190] These controversial disclosures include: CEO pay ratios, mine safety, payments to governments by issuers engaged in resource extraction activities, and the use of conflict materials in manufacturing activities.[191]

Although these measures strengthen the positions of shareholders and other stakeholders in the corporate governance sphere, as a whole

184. *See* Bainbridge, *supra* note 38, at 1797–1801.

185. *See* Davidoff & Hill, *supra* note 98, at 6 ("The admittedly nebulous bottom line is this: disclosure is too often a convenient path for policymakers and many others looking to take action and hold onto comforting beliefs in the face of a bad outcome. Disclosure's limits reveal yet again the need for a nuanced view of human nature that can better inform policy decisions.").

186. *See* Thompson & Sale, *supra* note 183, at 878.

187. E. Norman Veasey, Address, *The Challenges for Directors in Piloting Through State and Federal Standards in the Maelstrom of Risk Management*, 34 SEATTLE U. L. REV. 1, 7 (2010).

188. *Id.* at 3, 6; *see* Ferola, *supra* note 147, at 150–54.

189. Katherine Addleman, *The Impact of Dodd-Frank on Public Companies*, 38 SEC. REG. L.J., no. 3, 2010 at 1.

190. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, 2212 (2010) (codified as amended in scattered sections of 7, 12, 15, 18, 22 and 45 U.S.C.).

191. For a discussion of the provisions of Dodd-Frank pertaining to mandatory disclosures by corporations involved with conflict minerals, mine safety, and extractive industries, see Sarah A. Altschuller et al., *Corporate Social Responsibility*, 45 INT'L LAW. 179, 183–84 (2011); for a discussion of compensation and board disclosure requirements, see Bainbridge, *supra* note 38, at 1797–1801.

they are moderate and ultimately do not "alter or eliminate the protections traditionally provided to directors by the business judgment rule."[192] SOX and Dodd-Frank reflect a more prescriptive, one-size-fits-all approach to corporate regulation in comparison with state law. The different state and federal approaches taken with regard to proxy access illustrate this point. Under Dodd-Frank, Congress attempted to strengthen the hand of shareholders by providing for proxy access for the nomination of directors.[193] A federal appeals court, however, struck down the SEC's proxy access rule.[194] Instead of mandating proxy access, Delaware, by contrast, adopted section 112 of the DGCL, which authorizes corporations to voluntarily adopt bylaws providing for proxy access.[195]

V. IMPLICATIONS OF THE CIS

The CIS is a balanced regulatory philosophy falling between market forces and top-down regulation. It is an evolutionary trend adaptive to both increasing corporate complexity and is also a pragmatic political compromise made by regulators. Well established internal governance mechanisms (of the CIS), especially when complemented by engaged regulators and effective external gatekeepers, are an essential feature of healthy corporate governance in large publicly traded corporate firms.[196] Without an effective CIS, threats to corporate value may remain unresolved, lying dormant until the political or regulatory environment changes. This Article adopts a cautiously optimistic perspective concerning the potential of internal mechanisms to improve corporate governance. The emergence of the CIS and the appeal of internal controls, auditing, compliance, and risk management as preferred reform measures reflect the descriptive power of cooperative governance theories. There are, however, important questions that merit further exploration, namely: (1) Does the CIS detract from the board's goal to advance corporate strategy? (2) Does the CIS contribute to unrealistic expectations from corporate constituents? (3) Does the CIS reflect political expediency resulting in suboptimal corporate reform? The answers to all of these questions are both "yes" and "no." Yet the relevant inquiry concerns the degree to which these confounding factors detract from the CIS's overall efficacy. On balance, the CIS is a positive development that must be evaluated in light of the available, effective, and politically feasible governance alternatives that are in short supply.

192. Veasey, *supra* note 187, at 2.

193. Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56,668 (Sept. 16, 2010) (to be codified at 17 C.F.R. pts. 200, 232, 240, 249).

194. Business Roundtable v. SEC, 647 F.3d 1144, 1148 (D.C. Cir. 2011) (vacating 75 Fed. Reg. 56,668 as "arbitrary and capricious").

195. DEL. CODE ANN. tit. 8, § 112 (2012).

196. *See* Williamson, *Strategy*, *supra* note 23, at 1090 ("The efficacy of governance is thus jointly determined by local efforts (self-help to craft mechanisms) and as a function of the institutional environment (polity; judiciary; laws of property and contract).").

A. Does the CIS Detract from the Board's Goal to Advance Corporate Strategy?

Experts acknowledge that "during the last decade of the twentieth century, corporate boards became more active and powerful in exercising their responsibilities."[197] In the exercise of their responsibilities, boards play important strategic and monitoring roles. While the corporate legal architecture provides minimal guidance on director monitoring responsibilities, there is a much greater degree of opacity with respect to the board's strategic role.[198] Visions of the board's strategic role are not uniform: Do directors simply approve the strategy management sets and then monitor its execution? Or rather, are boards more proactive and collaborative with senior management in shaping strategy? A particular board's approach to strategy may differ according to a host of contextual factors such as the particular industry as well as the directors' level of experience and industry knowledge.[199] Certainly, the CEO and senior management have the primary role in setting and implementing corporate strategy; however, collaborative engagement with the board is optimal, if for no other reason than to allow the board to better understand corporate operations and render informed business judgment concerning strategies before approving them.[200] Moreover, without some knowledge of corporate strategy the board cannot fulfill perhaps its most important function: the hiring and firing of the CEO. Even if a board may lack expertise, it can still engage in corporate strategy by asking questions to understand the assumptions underlying proposed strategies and debate implications.[201] Realistically, however, asking questions alone may not be enough. Board members must have access to strategic information in order fulfill their role. Recent board surveys highlight the lack of knowledge of company strategy as a significant concern among directors.[202] Due to the lack of role clarity and informational deficits surrounding strategy, the board's strategic value will likely depend on the board's relationship with senior management and the strategy-setting process.[203]

Although recognizing the importance of board monitoring responsibilities, some commentators question whether directorial attention to

197. Martin Lipton & Jay W. Lorsch, *The Professionalization of Corporate Directors*, *in* RESTORING TRUST IN AMERICAN BUSINESS 71, 72 (Jay W. Lorsch et al. eds., 2005).

198. Jay W. Lorsch, *Boardroom Challenges: Lessons from the Financial Crisis and Beyond*, *in* THE FUTURE OF BOARDS: MEETING THE GOVERNANCE CHALLENGES OF THE TWENTY-FIRST CENTURY 7, 13–14 (Jay W. Lorsch ed., 2012).

199. *Id.* at 26–28.

200. Krishna Palepu, *Focusing on Strategy to Govern Effectively*, *in* THE FUTURE OF BOARDS, *supra* note 198, at 37, 42–43.

201. *Id.* at 42.

202. *See* PRICEWATERHOUSECOOPERS, *supra* note 74, at 23–26.

203. Palepu, *supra* note 200, at 41–43.

the director's primary goal of strategy is being undermined.[204] These commentators fear the heightened focus on compliance, risk management, and executive pay accompanied by the recently strengthened hand of institutional investors in governance matters, pursuant to Dodd-Frank and other legislation, could have unintended negative consequences.[205] They argue that the pendulum has swung too far in the monitoring direction and that boards should strike a more delicate balance between the role of advancing corporate strategy and their responsibility to monitor risk and compliance.[206] Although this tension does exist, the CIS and corporate strategy are not necessarily mutually exclusive. According to the National Association of Corporate Directors (NACD) Blue Ribbon Commission Report on Risk, risk management, compensation, and corporate compliance, for example, have a strong connection to business strategy.[207] Notwithstanding the general resolution of where power and discretion should lie, an unbalanced response that only addresses external pressures undoubtedly detracts from the boards' strategic focus and overall effectiveness.[208] Carter and Lorsch discuss this challenge:

> The best practice initiatives for board improvement are legitimate and well intended. There is, however, a basic problem with them . . . . Many of these ideas for improvement focus only on those matters that can be observed from outside the boardroom. Focusing on what is visible may be the best way to put public pressure on boards to focus on "improvement," but it misses the essential fact that these visible factors have only a limited impact on board effectiveness. The real action is in the boardroom itself—how directors interact among themselves and with management and how they gain knowledge and reach decisions.[209]

Adding to their set of challenges, boards today are attempting to improve their approach to governance amid the enhanced scrutiny from multiple constituencies, particularly externally focused institutional shareholders and proxy-advisory firms. Recent reforms largely ignore how micro-level interactions and decision-making processes operate in context.[210] They do not address perhaps the "central limitation" facing directors: time and knowledge.[211] This scenario raises a fair question: Whether, in light of these constraints, simply too much is being asked of directors? To the extent that reforms fail to address these practical con-

204. *See* COLIN B. CARTER & JAY W. LORSCH, BACK TO THE DRAWING BOARD: DESIGNING CORPORATE BOARDS FOR A COMPLEX WORLD 146 (2004).

205. *See id.* at 42–43.

206. *See id.* at 43.

207. BLUE RIBBON COMM'N, NAT'L ASS'N OF CORPORATE DIRECTORS, RISK GOVERNANCE: BALANCING RISK AND REWARD 20 (2009) (discussing the strong link between risk management and corporate strategy).

208. CARTER & LORSCH, *supra* note 204, at 7.

209. *Id.* at 35–36.

210. *See supra* Part III.

211. CARTER & LORSCH, *supra* note 204, at 29.

straints, board effectiveness will suffer, from both a strategic and monitoring standpoint. Each specific business context may determine the appropriate balance between strategy and monitoring. A company in the midst of crisis or emerging from a crisis, for example, needs more monitoring than a company that is not similarly situated.

B. Does the CIS Contribute to Unrealistic Expectations from Corporate Constituents?

The CIS narrative reflects organizational adaptation and innovation in response to the regulatory environment. Although these adaptations and innovations can add value, it is also possible they may improve firm legitimacy without improving performance. Any particular adaptive response can take multiple forms, and the response of one company may not be suitable for others. In some instances, regulators will mandate a particular internal structure or innovation that a company will adopt. This process is known as coercive isomorphism.[212] In the absence of regulator coercion or mandate, a company may look to other organizations and mimic their approaches, particularly those companies that are perceived as successful and legitimate. This process could lead to homogenized approaches. In certain instances, corporations will respond to reforms, but without reference to other companies or regulation. Instead, these companies will self-reference and create an internal substructure that conforms to and perpetuates existing firm structures.[213] Although these internal mechanisms and procedures can undoubtedly assist in curbing corporate opportunism and malfeasance, their impact may be overstated, leading to unrealistic expectations and a false sense of security among the public and regulators. Understandably, critics of cooperative governance strategies in areas such as corporate compliance might view these efforts as being "cosmetic," wasteful, and as more procedure than substance.[214] The legitimacy of corporate reforms is often judged from a procedural vantage point rather than a substantive one. Procedures and structures often serve as a default heuristic for quality. Corporate constituencies find it easier to coalesce around procedures that, in part, resemble familiar democratic values such as independence, disclosure, and voting.[215] Transplanting these democratic principles to a corporate setting that is more bureaucratic than democratic resonates with the public and some shareholders.[216] But the overall effectiveness of

212. DiMaggio & Powell, *supra* note 41, at 150.

213. *See* Goldspink & Kay, *supra* note 42; Rubin, *supra* note 10, at 552.

214. *See, e.g.*, Kimberly D. Krawiec, *Cosmetic Compliance and the Failure of Negotiated Governance*, 81 WASH. U. L. Q. 487, 487 (2003); *see also* John C. Coffee, Jr. & Hillary A. Sale, *Redesigning the SEC: Does the Treasury Have a Better Idea?*, 95 VA. L. REV. 707, 712 (2009) (criticizing self-regulation).

215. *See* Simmons, *Blue Pill*, *supra* note 90, at 360.

216. LISA M. FAIRFAX, SHAREHOLDER DEMOCRACY: A PRIMER ON SHAREHOLDER ACTIVISM AND PARTICIPATION (2011).

such mechanisms remains a question. For example, current reforms promoting independence and shareholder empowerment in board elections, even if implemented, are unlikely to address the inner workings of individual boards and corporate operations. Nicola Sharpe offers the following critique of existing board reform:

> Current attempts to fix corporate boards are doomed to failure. This is because the conventional approaches to improve corporate boards are based on a dangerously incomplete understanding of board behavior, which looks to structure and composition at the exclusion of process [or internal workings]. . . . Structural and compositional changes insufficiently empower the board to perform its oversight function.[217]

Donald Langevoort's extensive work on the behavioral aspects of corporate governance further illustrates the limitations of reform.[218] Human nature, cognitive biases, and "Icaran" tendencies in the decision-making process still may undermine well-designed internal controls, compliance, and risk management solutions.[219] Indeed, cultural and behavioral factors not unique to corporate actors are impediments to managing risk, complying with the law, and stifling malfeasance.

Empirical studies illustrate that standard corporate governance mechanisms, especially those with which many scholars concern themselves, have an inconclusive or marginal impact on firm performance.[220] For example, the substantial body of empirical findings addressing the impact of independence on corporate performance are inconclusive.[221] One explanation for the disappointing results of independence could be that the benefits of independence and other governance features are systemic and not necessarily recognized at the individual firm level.[222] In other words, independence in the aggregate might contribute to systemic benefits such as more accurate stock pricing and improved financial disclosure that benefits all companies.[223] Another plausible explanation for these results is that "firms' corporate governance behavior has only a

217. Nicola Faith Sharpe, *Process Over Structure: An Organizational Behavior Approach to Improving Corporate Boards*, 85 S. CAL. L. REV. 261, 311 (2012).

218. *E.g.*, Langevoort, *supra* note 35, at 797.

219. Michelle M. Harner, *Barriers to Effective Risk Management*, 40 SETON HALL L. REV. 1323, 1356 (2010); Skeel, *supra* note 2.

220. *See* Bernard Black, *Does Corporate Governance Matter? A Crude Test Using Russian Data*, 149 U. PA. L. REV. 2131, 2131–32 (2001); *see also* Bhagat & Black, *supra* note 142, at 921–22; Marcel Kahan & Edward Rock, *The Insignificance of Proxy Access*, 97 VA. L. REV. 1347, 1352 (2011); Langevoort, *supra* note 35, at 798.

221. Cunningham, *supra* note 149, at 466. For a thorough analytical review of the history of independent directors and their effect on corporate boards, see Gordon, *supra* note 143; *see also* Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231 (2002); Bhagat & Black, *supra* note 142; Robert A. Prentice & David B. Spence, *Sarbanes-Oxley As Quack Corporate Governance: How Wise Is the Received Wisdom?*, 95 GEO. L.J. 1843 (2007).

222. Cunningham, *supra* note 149, at 472.

223. Gordon, *supra* note 143, at 1508–09.

small effect on their market value, compared to other elements such as industry environment, macroeconomic factors, and management skill."[224]

Whether the limited empirical support for an assortment of governance measures illustrates that such reforms and devices have no merit and should be abandoned is a fair question. One response is that these mechanisms perhaps matter at the margins, or in specific contexts. This inconclusive research does suggest, however, that it may be necessary to look beyond structures and aggregated numbers that fail to provide clarity or resolve looming governance questions. This may entail looking inside the corporation's black box to discern how corporate governance matters on the shop floor or operational level. Answers to fundamental questions such as why certain firms are likely to encounter crisis or scandal and how they ultimately respond, whether effectively or ineffectively, to such challenges perhaps rests at the operational, cultural, and behavioral levels of a corporation. This reality must inform the design of reform and corporate constituent expectations.

Admittedly, measuring the effectiveness of the CIS and its various components is difficult.[225] For example, the effectiveness of internal compliance controls against fraud could be measured by comparing the extent of deviation of *ex ante* and *ex post* control environments.[226] But this measure is obviously imprecise, methodologically akin to measuring the effectiveness of antiterrorism efforts. Internal controls, often designed for auditing and verification, do not necessarily address whether specific controls are effective against specific risks.[227] In other words, process may trump efficacy, giving rise to a false impression that internal controls are one-hundred percent effective against risks. But there is neither absolute assurance nor one-hundred percent effectiveness. As Lawrence Cunningham concedes, "[C]ontrols are inherently leaky."[228] Outsiders such as regulators, the public, and some legal scholars confront an expectations gap: what they expect external regulation to achieve and what external regulation can actually accomplish.[229] The CIS can yield important benefits; however, an adjustment to outsiders' expectations regarding its effectiveness may be warranted.

C. Does the CIS Reflect Political Expediency Resulting in Suboptimal Corporate Reform?

The CIS and its cooperative governance origins are rooted in political compromise. The deregulation movement of the 1980s and 1990s made internal governance an appealing compromise approach because it

224. Black, *supra* note 220, at 2135.
225. Cunningham, *supra* note 47, at 320.
226. *Id.* at 270 n.7.
227. *Id.* at 269.
228. *Id.*
229. *Id.* at 305.

allowed states to exert power over the private sector while preserving private autonomy over operations. Interestingly, the evolving, monitoring model of corporate governance also coincided with these trends.[230] Thus, a key concern arises: whether the CIS is a pragmatic compromise promoting shareholder wealth or a Faustian bargain between lawmakers and corporate managers. Fundamentally, there is a crucial question that requires answering: Is the CIS merely a means through which firms, with minimal effort, can insulate themselves from liability?[231] From one perspective, the CIS generates crucial buy-in from corporate firms by preventing more lax self-regulation as well as the potential absence of a legitimate and meaningful public regime.[232] Here, corporate managers may be more willing to adopt more internal monitoring burdens associated with the CIS to prevent greater intrusions by regulators. On the other hand, some observers harbor a more critical perspective, viewing cooperative governance as a guise for neoliberal and deregulatory perspectives that undermine public regulation.[233] Both CIS perspectives, cautiously optimistic and critical, have merits. This Article, however, adopts the cautiously optimistic perspective with the following caveat concerning crisis-related reform.

The expansion of corporate reform often originates in crisis response legislation, and this reactive, episodic approach to reform may not adequately address threats on an ongoing basis if such reforms are not structured properly. The procedural protocols reflected in existing internal governance mechanisms often have limited substantive content. There is too much disagreement among corporate constituents concerning the optimal shape of substantive reforms, and a one-size-fits-all approach may not prove suitable for all entities. For lawmakers seeking to preserve political capital, substantive reforms are often too risky. Such reforms could lead to corporate constituent backlash, expose deficits in lawmaker expertise, or simply render lawmakers blameworthy for the unintended consequences of resulting reforms. Consequently, regulators such as the SEC may develop reforms with limited impact simply to respond to a public outcry.[234] These factors, among others, such as aggressive lobbying efforts, ultimately contribute to moderate reforms.

Admittedly, the strength and weakness of collaborative governance strategies rests with their inherent flexibility. They can be appropriated for multiple purposes and agendas. The CIS is an outgrowth of move-

230. Veasey & Di Guglielmo, *supra* note 73, at 1436.

231. *See* Krawiec, *supra* note 214, at 491.

232. *See* Solomon, *supra* note 14, at 624.

233. Mark Roe highlights a similar concern with respect to the current regulatory regime: "[W]ith our porous [decentralized] system of regulation, the core regulated group—the managers—can induce regulators to weaken the direct oversight that they face, can influence Congress to deny the regulators enough funding to be effective, can deter good regulation, and can thereby render some gatekeepers ineffectual in checking managers." Roe, *supra* note 10, at 11.

234. *See* Fisch, *supra* note 130, at 452–53; *see also* Simmons, *Blue Pill*, *supra* note 90, at 329.

ments toward deregulation and cooperative compliance, resistance to federal preemption of state corporate law, and stakeholder demands on the corporation. Its effectiveness often depends upon ground-level concerns: organizational commitment to effective implementation, requiring compensation for predictable flaws, learning from experience, and ongoing adjustments. Even with effective implementation, however, breakdowns will inevitably occur.

VI. CONCLUSION

The appeals of the CIS are numerous: its capacity to compromise, its inherent adaptability, its grafting from the public and private spheres, and the preservation of private ordering.[235] The CIS originates from the humble insight that "no one [constituency] has a complete solution to what collectively ails them."[236] Realistically, knowledge asymmetries and human participation ensure that no one has a complete solution to corporate governance problems. The CIS nonetheless is an important component of that solution. The CIS, recognizing the potential of collaborative inside-out reforms in the corporate arena is, on balance, a promising development. Overall, there is more evolution occurring in today's boardrooms than devolution.

235. *See* Solomon, *supra* note 14 at 594 n.7.
236. Michael C. Dorf, *After Bureaucracy*, 71 U. CHI. L. REV. 1245, 1269 (2004) (book review).