Today’s readings consider another aspect of the US public corporation – its tendency to have boards composed of like-minded corporate executives, rather a more representative set of people. This aspect of the US public corporation is not necessarily part of the legal design, but is fostered by legal rules (and the cost calculus they create) that place in the hands of corporate boards the decision of who is nominated to the board.

The first reading from the student book (that you’ve already read) describes the nomination process in the US public corporation, which as a practical matter is almost exclusively in the hands of the board. A company’s shareholder can nominate his own slate of directors, but must bear the costs of sending proxy materials to fellow shareholders – in a public corporation at usually prohibitive cost. The reading describes a proposal for shareholders to have access to the company’s proxy materials to nominate directors – and the curious history of “proxy access.”

The next reading is a finance article that describes the close connections between directors in US public corporations. Director interlocks are regulated by antitrust law, but only for directors in the same industry, not when directors are in different industries. You’ll read that when directors serve on interlocked boards, they tend to “go along to get along.” Shareholder interests are disserved. What about the interests of other constituents?

Then you’ll find a journalist’s story of how executives in the food industry, though recognizing how junk food has led to an obesity epidemic in the United States, have been unable to take effective action because of the corporate culture of “making profits.”

Finally, you’ll read how the courts accept that corporate boards can be composed of like-minded people. Even when directors are friends, the courts in Delaware accept that directors can be “independent” and thus objective in the face of conflicts of interest. That is, corporate judges in Delaware seem to accept that the “structural bias” prevalent on US corporate boards is a way of life.

Readings:
- Beam v. Stewart (Del. 2004)
C. Shareholder Activism

5. Case Study: Shareholder Access to Nomination of Directors

Under corporate law, management controls the nomination process for board candidates in public corporations. Unless a shareholder insurgent proposes its own directors through a proxy contest at its own expense (a rare event), the only candidates are those nominated by the incumbent board.

Over the past decade U.S. corporate governance saw a movement to open the board nomination process in public corporations so that shareholder nominees could be placed in the company's proxy materials at company expense – so-called proxy access. As of 2013, "proxy access" ended up more or less where it had started ten years before, with shareholders having the ability to propose bylaw amendments creating proxy access on a company-by-company basis, but without a general SEC rule on the subject.

The history of "proxy access" has been convoluted and has brought on stage nearly all of the actors in modern corporate governance: activist and institutional shareholders, corporate management, the SEC, the federal courts, the Congress, the Delaware legislature, the Delaware courts, and even corporate law professors. In short, it offers a telling portrait of shareholder activism and corporate governance in the United States.

SEC proposes Rule 14a-11. Our story of "proxy access" begins in 2003 when the SEC proposed a new rule giving shareholders greater access to the director nomination process. Proposed Rule 14a-11 envisioned a two-stage process that would permit large (that is, institutional) shareholders to submit their nominees for inclusion in the company's proxy materials once a significant number of shareholders had shown their dissatisfaction with the incumbent board. Under the proposal, any shareholder or group holding 5% of a company's stock for more than two years could nominate 1–3 directors to the board (depending on the board's size) if at the previous year's annual meeting either: (1) more than 35% of the votes had been withheld from a management nominee, (2) 50% of the votes had been cast for a direct access resolution (submitted by a 1% shareholder), or (3) the company had failed to implement a majority-approved shareholder proposal. See Exchange Act Rel. No. 48,626 (2003) (proposing release).

The SEC's "proxy access" proposal met a firestorm of opposition from corporate management. Management groups claimed the SEC was interfering with a matter of corporate governance beyond its authority and argued that shareholder-nominated board members would disrupt the collegial working relationships on corporate boards. At first the SEC dithered, and then eventually the agency decided not to pursue its rulemaking.

Shareholder activists propose bylaw amendments. In response, a group of activist union and state pension funds (supported by corporate law professors) began a company-by-company movement proposing amendments to company bylaws modeled on the abandoned SEC "proxy access" rule. Thus, the proponents sought to create a process for shareholders to nominate "short slates" to the board constituting fewer than a majority of directors. At first the SEC staff accepted such proposals as proper under the shareholder proposal rule, but later reversed course and allowed their exclusion under the rule's then-existing exclusion (8): proposals that "relate to a nomination or an election for membership on the company's board of directors." Rule 14a-8(i)(8).
Disappointed by the SEC’s flip-flop, one of the institutional proponents – the pension fund for the labor union American Federation of State, County & Municipal Employees (AFSCME) – brought a lawsuit in federal district court against the American International Group to require that the Delaware-incorporated insurance company include a shareholder-submitted “proxy access” proposal in the company’s proxy statement. The district court concluded that neither Rule 14a-8 nor state law required inclusion of the proposal, suggesting that the litigants (and the law professors who had filed an amicus brief in the case) look to the regulatory and legislative processes for their reform initiative. “Publicly-held corporations, and their shareholders, are entitled to be guided by regulations which are drafted after public notice and comment, which apply uniformly and predictably, and have consistent definitions and standards.”

TAKE NOTE

Yep. AIG is the insurance company that nearly brought down the world financial system. In 2008, the U.S. government injected more than $150 billion into AIG so it could meet its obligations under “credit default swaps,” under which AIG had insured the viability of other financial companies and trillions of dollars in financial instruments. Would an AIG board composed of directors nominated by shareholders have resulted in better board oversight and better risk management – perhaps averting the financial crisis? Who knows.

On appeal, the Second Circuit reversed and held that Rule 14a-8 (as then worded) permitted shareholders to propose bylaw amendments to create “proxy access.” See AFSCME v. AIG, Inc., 462 F.3d 121 (2d. Cir. 2006). The court concluded that such proposals “establish a procedure by which shareholder-nominated candidates may be included on the corporate ballot [and thus do] not relate to an election within the meaning of the Rule 14a-8.” The case turned on the phrase “relates to an election,” which the court interpreted (based on prior SEC interpretations) to mean that proposals were excludable when related to a specific election for a particular director seat – but not to proposals creating general guidelines or procedures for director election. On the question whether company-by-company “proxy access” procedures would conflict with the generic Rule 14a-11 proposed (and not acted on) by the SEC, the court laid down a gauntlet for the SEC:

Accordingly, we deem it appropriate to defer to the [SEC’s prior statements about the includability of shareholder proposals that relate to the process of director elections]. We therefore interpret the election exclusion as applying to shareholder proposals that relate to a particular election and not to proposals that, like AFSCME’s, would establish the procedural rules governing elections generally.

In deeming proxy access bylaw proposals non-excludable under Rule 14a-8(i) (8), we take no side in the policy debate regarding shareholder access to the corporate ballot. There might be perfectly good reasons for permitting companies to exclude proposals like AFSCME’s, just as there may well be valid policy reasons for rendering them non-excludable. However, Congress has determined that such issues are appropriately the province of the SEC, not the judiciary.

In response to the AIG decision, the SEC revised Rule 14a-8 to broaden the “election” exclusion to specifically cover proposals relating to procedures for nominating directors. Exchange Act Rel. No. 56,914
The SEC said it saw the rule change as temporary while it sought a permanent resolution of the basic tension between board control of director nominations and shareholder voting rights.

### FYI

To give you a sense for the details of “proxy access,” here is the proposal submitted by AFSCME in the AIG case:

**RESOLVED, pursuant to Section 6.9 of the By-laws (the “Bylaws”) of American International Group Inc. (“AIG”) and section 109(a) of the Delaware General Corporation Law, stockholders hereby amend the Bylaws to add section 6.10:**

“The Corporation shall include in its proxy materials for a meeting of stockholders the name, together with the Disclosure and Statement (both defined below), of any person nominated for election to the Board of Directors by a stockholder or group thereof that satisfies the requirements of this section 6.10 (the “Nominator”), and allow stockholders to vote with respect to such nominee on the Corporation’s proxy card. Each Nominator may nominate one candidate for election at a meeting. To be eligible to make a nomination, a Nominator must:

(a) have beneficially owned 3 or more of the Corporation’s outstanding common stock (the “Required Shares”) for at least one year;

(b) provide written notice received by the Corporation’s Secretary within the time period specified in section 1.11 of the Bylaws containing (i) with respect to the nominee, (A) the information required by items 7(a), (b) and (c) of SEC Schedule 14A (such information is referred to herein as the “Disclosure”) and (B) such nominee’s consent to being named in the proxy statement and to serving as a director if elected; and (ii) with respect to the Nominator, proof of ownership of the Required Shares; and

(c) execute an undertaking that it agrees (i) to assume all liability of any violation of law or regulation arising out of the Nominator’s communications with stockholders, including the Disclosure (ii) to the extent it uses soliciting material other than the Corporation’s proxy materials, comply with all laws and regulations relating thereto.

The Nominator shall have the option to furnish a statement, not to exceed 500 words, in support of the nominee’s candidacy (the “Statement”), at the time the Disclosure is submitted to the Corporation’s Secretary. The Board of Directors shall adopt a procedure for timely resolving disputes over whether notice of a nomination was timely given and whether the Disclosure and Statement comply with this section 6.10 and SEC Rules.”

**Dodd-Frank Act authorizes “proxy access” rule.** Without a “proxy access” rule and faced with a revised Rule 14a-8 that specifically limited shareholder-initiated “proxy access,” institutional shareholders turned to Congress. In 2010 Congress put proxy access back on the corporate governance agenda when the Dodd-Frank Act specifically authorized the SEC to promulgate a proxy access rule. Dodd-Frank §971. Within months of the law’s enactment, the SEC accepted the Dodd-Frank invitation and repromulgated Rule 14a-11 in an even stronger form than before. Exchange Act Rel. No. 62,674 (2010) (permitting nomination of directors constituting at most one-fourth of the board by shareholders, or groups of shareholders, that had held 1, 3, or 5 percent of company’s voting shares for at least three years, the percentage varying with company size).

**Court upholds challenge to Rule 14a-11.** The plot thickened, however, when corporate management (through the Business Roundtable and U.S. Chamber of Commerce) brought a challenge in federal court to the reincarnated Rule 14a-11, claiming the SEC’s rulemaking failed to adequately consider the costs and benefits
of the new governance rights granted to activist shareholders. The D.C. Circuit agreed and held that the SEC had failed to consider the rule’s effect on “efficiency, competition and capital formation.” Business Roundtable v. SEC, 647 F.3d 1144 (D.C. Cir. 2011) (vacating rule). Even though Dodd-Frank seemed to have authorized the SEC to make this cost-benefit determination, the SEC decided not to appeal the decision to the Supreme Court and not to propose the rule again, apparently worried it could not meet the (unusually) high standard of review set by the D.C. Circuit.

**Activists return to company-by-company proxy access.** Despite the failure of the SEC’s proxy access rule, many shareholder activists decided to take matters into their own hands and returned to the company-by-company approach. Shareholder-proposed proxy access bylaw amendments had again become viable when the SEC reopened this door in 2010 by revising Rule 14a-8 as part of its Rule 14a-11 rulemaking. Under the new exclusion (8), proposals related to particular director elections are excludable, but shareholders can propose general procedures, including by proposing bylaw amendments, to establish procedures for nominating directors in the company’s proxy materials.

<table>
<thead>
<tr>
<th>FYI</th>
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<tbody>
<tr>
<td>The shareholder proposal rule, as amended in 2010, specifically excludes proposals that would interfere with the board’s nomination authority. Rule 14a–8(i)(8) (providing for exclusion of proposals that “(i) would disqualify a nominee who is standing for election; (ii) would remove a director from office before his or her term expired; (iii) questions the competence, business judgment, or character of one or more nominees or directors; (iv) seeks to include a specific individual in the company’s proxy materials for election to the board of directors; or (v) otherwise could affect the outcome of the upcoming election of directors relate to a nomination or an election for membership on the company’s board of directors.”</td>
</tr>
</tbody>
</table>

Shareholder activists were further emboldened by changes to the Delaware corporate statute, added by the Delaware legislature in 2009, which made clear that shareholders can amend company bylaws to provide for proxy access as well as mandatory reimbursement of proxy expenses incurred by shareholders in director elections. See Del. GCL §§112, 113; see also MBCA §2.06(c). Under these revised corporate statutes, the bylaws can address such matters as ownership requirements for nominating shareholders, disclosure by the nominating shareholder, and caps on the number of shareholder-nominated directors.

**Points for Discussion**

1. **Company-by-company access vs. SEC rule.**

   So, as you see, proxy access is back to where it began – with shareholders holding the power to submit proxy access bylaw amendments for shareholder approval – with the question of whether this is “proper” largely resolved under state law. Under the approach, proxy access thus can vary from company to company. What are the pros and cons of shareholder access varying in this way, compared to a single uniform standard set by the SEC?

   In fact, given that state law (at least in Delaware and the MBCA) now addresses shareholder-access bylaws, is it appropriate or even legal for the SEC to promulgate a rule establishing procedures for shareholders to nominate directors in public corporations? Doesn’t the story of proxy access make clear that it’s really a matter of substantive state law?
2. Just restrict shareholder proposals?

And by the way, if the SEC shareholder proposal rule depends on state-created shareholder rights, what’s to keep corporations from preventing nettlesome shareholders from interfering with board-centric corporate governance? Could shareholders in a particular corporation choose, through an amendment to the articles or the bylaws, not to permit any company-financed shareholder proposals at all or to fully permit such proposals, or to permit certain proposals, but not others? Is Rule 14a-8 mandatory? That is, could corporations opt out of the rule – by establishing either more or less shareholder democracy?

3. The power struggle over proxy access.

You might wonder what all the fuss is about. At most, proxy access gives shareholders (after two annual voting cycles) a chance to create proxy access and then to nominate and place a handful, but not a majority, of directors on the board. Why would shareholder activists be so anxious to be able to put minority directors on the board? Can’t these activists, as hedge funds currently do, simply approach the board with their thoughts or plans?

And why has corporate management fought this? Why would incumbent directors be so bothered about having co-directors on the board who were nominated by a sizeable group of shareholders and then elected by a majority of shareholders? What’s the danger? Such minority directors would not have to be put on any important committees, and they could always be outvoted?

In short, activist shareholders don’t seem to have much to gain from proxy access, and corporate management doesn’t seem to have much to lose.

4. The results, please.

So how has company-by-company proxy access done at the corporate ballot box? Based on the results of the 2012 and 2013 – the two proxy seasons after the SEC rule was invalidated -- it’s mostly been a fizzle. In 2012 no proxy access proposals appeared on corporate ballots; and in 2013 there were six such proposals, with only two receiving majority support. As of 2013, no shareholder-nominated directors have been seated under the procedure.

5. Who runs the show?

Perhaps the most important lesson from the proxy access story is the enduring power of state corporate law – and the subsidiary role of the federal SEC rules -- in U.S. corporate governance. Do you agree?
**TIES THAT BIND**

Eliezer M Fich & Lawrence J. White
Stern Business
Spring/Summer 2004

*When corporate directors serve together on multiple boards, the chief executive officers tend to earn more money and enjoy longer tenures. Such mutual interlocks are plainly good for the bosses. But are they good for shareholders? Not necessarily.*

***

In the recent wave of corporate scandals, from Enron to Tyco, poor corporate governance structures have clearly been a contributing factor. The tales of excess compensation, poor capital allocation, and, occasionally, outright theft, have shone a harsh spotlight on the relationships between chief executive officers and the boards of directors. Too frequently, directors – who are supposed to represent the shareholders – have acted in ways that enrich CEOs and other favored executives while impoverishing common shareholders.

On many boards, two (or more) directors serve together on a different company's board. For example, General Motors Corp.'s April 2002 proxy revealed that the GM board had two mutual interlocks: CEO John F. Smith, Jr., and Director George M.C. Fisher were also directors on the board of Delta Air Lines, Inc.; and Smith and Director Alan G. Lafley were also on the board of the Proctor & Gamble Co. (where Lafley is the CEO). We dub these associations "mutual interlocks." And in a sample of 366 large companies, 87 percent had at least one mutual interlock in 1991.

Director interlocks have clear consequences for shareholders. Our empirical analyses show that CEO compensation tends to increase and CEO turnover tends to decrease when the CEO's board has one or more pairs of board members who are mutually interlocked with another company's board. Why? On the one hand, mutual interlocks could be an indication of and a contributor to CEO entrenchment, from which higher compensation and lower turnover naturally follow. On the other hand, mutual interlocks may indicate the strengthening of important and valuable strategic alliances. And the higher CEO compensation and lower turnover may be a just reward for orchestrating such alliances. We believe that the first interpretation is more accurate.

**Director Interlocks**

Researchers from several disciplines have been looking into interlocks for several decades. And at first it appeared that interlocks were a sign of weakness. In one of the earliest such U.S. studies, economist Peter Dooley in 1969 found that less-solvent firms were likely to be director-interlocked with banks. Later studies also reported that firms with high debt-to-equity ratios, or that had an increased demand for capital were likely to have interlocks. The reason: Financially stressed firms may seek to add bank officers to their boards to receive more favorable consideration. Or banks may demand board seats so they can monitor firms more closely.
Organizational behavior experts have examined the extent to which a board is an instrument of management interests. Some have argued that companies use board interlocks as a mechanism to improve contracting relationships, or to reduce the information uncertainties created by resource dependencies between firms. This stream of research suggests that the composition of boards, including interlocks is largely determined by the efforts of CEOs to influence the selection of new directors so that they are responsive to that particular CEO’s interests.

Financial economists have examined interlocks as well. Kevin Hallock of the University of Illinois found that CEOs serving in employee-interlocked firms earn higher salaries than they otherwise would. Nevertheless, existing research has not documented a connection between director interlocks and total CEO compensation. And in our survey of previous studies, we did not find any associations between interlocks of various kinds and firm performance. That leads us to believe that interlocks aren’t designed to serve a firm’s strategic goals, and don’t serve them in practice.

**Compensation and Turnover**

Several recent studies have examined the relation between top executive compensation and board composition. And they report mixed results. For example, some authors have found a positive association between CEO compensation and the percentage of outside directors on the board. Other studies have found no relation between a board majority of outside directors and top management compensation. The level of incentive-based executive compensation appears to be positively connected with firm performance, and incentive-based compensation appears to be used more extensively by outsider-dominated boards.

Other scholars have found an inverse relation between the probability of a top management change and prior stock price performance. After poor firm performance, CEOs are more likely to be dismissed if the board of directors has a majority of outsiders. Empirical analyses indicate that the probability of top management turnover is reduced if the top executives are members of the founding family or if they own higher levels of stock. Executive turnover is also negatively related to the ownership stake of officers and directors in the firm and positively related to the presence of an outside blockholder. However, thus far, no study has considered the possible effects that boards with mutual director interlocks have on CEOs’ total compensation and turnover.

**The Data**

We looked at CEO compensation and CEO turnover for 452 industrial firms, first compiled by NYU Stern professor David Yermack. These firms were drawn from Forbes magazine’s lists of the largest 500 U.S. companies in categories such as total assets, market capitalization, sales, or net income. The data set includes all companies meeting this criterion at least four times during the 1984-1991 period. Compensation data were collected from the corporation’s SEC filings. Directors who were full-time company employees were designated as “inside” directors. Individuals closely associated with the firm – for example, relatives of corporate officers, or former employees, lawyers, or consultants, or people with substantial business relationships with the company – were designated as “gray” directors. All the rest were designated “outside” directors. We also drew on the
data assembled by Kevin Hallock, who analyzed 9,804 director seats held by 7,519 individuals in 1992. We took as our final data set the 366 industrial firms for the 1991 proxy season that appeared in both the Yermack and the Hallock data sets. (Utility and financial firms were excluded from the study because government regulation may lead to a different role for directors.)

In order to examine how director interlocks may affect CEO compensation, we used a measure of total remuneration that included salary and bonus, other compensation, and the value of option awards when granted. We believe that this sum is a more accurate measure of what boards intended to pay, which could be different from what CEOs earn, since CEOs often exercise options early, thereby sacrificing a significant portion of the award’s value.

As an estimate for CEO turnover, we used a dependent variable that was set equal to one if a CEO leaves office during the last six months of the current fiscal year or the first six months of the subsequent period. In order to control for retirement-related voluntary departures, we included in the analysis the CEO’s age. Turnover events occurred in 9.0 percent of the sample (thirty-three firms).

**Considering Interlocks**

The key explanatory variable of this study was the number of mutual interlocks on the firm’s board. While two boards can be interlocked if they share one director, they are mutually interlocked if they share at least two directors. For any given board, a director could be part of more than one pair of mutual interlocks, so it is quite possible that a board may have a greater number of mutual interlocks than directors. In our sample of industrial firms, board sizes ranged from four to 26, with an average of 12.18. The number of mutual interlocks ranged from zero to 42, with an average of 12.15.

Other independent variables used in the study were based on their likely relevance and effects on CEO compensation and CEO turnover, as established by other authors. As in numerous other studies, Tobin’s Q (the market value of assets divided by the replacement cost of assets) was used as a proxy for the growth opportunities of the firm.

Table 1 presents descriptive statistics of the key variables in this study and their correlation with the number of board director interlocks. As seen, the mean number of directors who are CEOs of other firms is 1.94. This result is similar to that reported by James Booth and Daniel Deli, who found the mean to be 1.87 for 1989-90 data. The mean number of outside directors serving on the board was 6.94, which is also consistent with the previous literature.
TABLE 1: DESCRIPTIVE STATISTICS FOR KEY VARIABLES

<table>
<thead>
<tr>
<th>Variable</th>
<th>Mean</th>
<th>Standard deviation</th>
<th>Correlation with number of interlocks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of mutually paired director interlocks</td>
<td>12.152</td>
<td>8.652</td>
<td>1.00</td>
</tr>
<tr>
<td>Board Composition</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Board size</td>
<td>12.177</td>
<td>3.075</td>
<td>0.537***</td>
</tr>
<tr>
<td>Inside directors</td>
<td>3.943</td>
<td>1.989</td>
<td>-0.039</td>
</tr>
<tr>
<td>Outside directors</td>
<td>6.940</td>
<td>3.012</td>
<td>0.660***</td>
</tr>
<tr>
<td>Gray directors</td>
<td>1.294</td>
<td>1.501</td>
<td>-0.175***</td>
</tr>
<tr>
<td>Directors who are CEOs of other firms</td>
<td>1.943</td>
<td>1.687</td>
<td>0.565***</td>
</tr>
<tr>
<td>CEO Characteristics and Compensation</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>CEO’s age</td>
<td>58.269</td>
<td>6.612</td>
<td>0.016</td>
</tr>
<tr>
<td>CEO’s percentage of stock owned</td>
<td>0.023</td>
<td>0.063</td>
<td>-0.295***</td>
</tr>
<tr>
<td>CEO’s salary + bonus (in thousands of dollars)</td>
<td>1099.000</td>
<td>662.323</td>
<td>0.156***</td>
</tr>
<tr>
<td>CEO’s other compensation (in thousands of dollars)</td>
<td>388.354</td>
<td>803.518</td>
<td>0.193***</td>
</tr>
<tr>
<td>Value of options when granted (thousands of dollars)</td>
<td>775.313</td>
<td>1739.000</td>
<td>0.197***</td>
</tr>
<tr>
<td>Tenure as CEO (in years)</td>
<td>9.103</td>
<td>8.533</td>
<td>-0.187***</td>
</tr>
<tr>
<td>Tenure in the firm (in years)</td>
<td>26.000</td>
<td>12.027</td>
<td>0.134***</td>
</tr>
</tbody>
</table>

*** Significant at the 1% level.

Two Hypotheses

If the CEO dominates the selection process of directors to the board, and if the CEO is in fact filling the director positions with sympathetic members, then we would expect a positive association between the fraction of these favorable board members and the compensation of the CEO. In other words, our first hypothesis stipulates that boards with a larger number of mutual director interlocks will pay a higher compensation package to the CEO. Our second hypothesis states that there is an inverse association between the presence of mutual interlocks and the likelihood of CEO departure.

What do the results show? The correlations reported in Table 1 suggest the existence of a relationship between the number of mutual director interlocks and the compensation of the CEO. It is not surprising that larger boards have more interlocks and that a preponderance of interlocks appears to be positively connected with outside directors and with directors who are CEOs of other organizations. Mutual director interlocks appear to be curtailed by close ownership and
governance structures. Our results show a negative and significant correlation between this variable and the indicators for CEO-as-founder and for non-CEO chairman.

Since director interlocks could just be indicators of strategic power relationships between firms at the highest level, it cannot be automatically concluded that CEOs and interlocked directors exploit networks of board memberships for their personal gain simply because these multiple board affiliations exist. In fact, CEOs could be rewarded with additional compensation and long job durations for successfully establishing mutual interlocks that serve the strategic goals of the firm.

But the data show a significant negative relationship between the number of mutual interlocks and the number of “gray” directors, many of whom could represent companies that have supplier or customer relationships with the company. This negative relationship reinforces our skepticism as to the likelihood that the mutual interlocks serve the strategic goals of the firm.

**Extra Compensation**

To test our first hypothesis, we ran an ordinary least square regression to estimate the effect that mutually interlocking boards have on the total compensation of the CEO. These calculations took into account factors such as interlocks, firm size, tenure of the CEO, firm performance, and stock ownership of the CEO. The results of this estimation are presented in Table 2. As expected, the number of mutual director interlocks is found to be significant and positively associated with total compensation. This finding suggests that the links created by the mutual interlocking relations between boards actively benefit the CEO. In other words, with the aid of mutual interlocks, CEOs are able to extract significantly larger compensation packages from their firms. The robustness of this result is upheld through further investigations of the components of the CEO’s pay package.

When we repeated the analysis using the natural log of only the sum of the CEO’s salary and bonus as the dependent variable, the coefficient for mutual directors was positive and significant. That suggests that even just the sum of the CEO’s basic salary and bonus tends to increase as a consequence of the mutual director interlocks. In fact, we found that a mutual interlock adds an average of $143,000 (approximately 13 percent) to the average CEO salary and bonus.

The evidence presented in Table 2 is in line with the view that mutual interlocks may indeed assist the CEO in extracting lucrative remuneration packages from the firm. The networks and traffic of influences created by mutual interlocking directorships have probably been utilized by CEOs in exerting control over the majority of board members. This finding suggests that directors may not be making decisions that benefit the firm’s shareholders the most. Mutually interlocking directorships could be weakening the control mechanisms put in place to ensure that directors fulfill their fiduciary duty and act in the best interest of the shareholders.
TABLE 2: EFFECT OF INTERLOCKS ON CEO COMPENSATION

<table>
<thead>
<tr>
<th>Variable</th>
<th>Estimate</th>
<th>Std. Error</th>
<th>p-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>INTERCEPT</td>
<td>4.956</td>
<td>0.304</td>
<td>0.0001</td>
</tr>
<tr>
<td>Natural log of total assets</td>
<td>0.288</td>
<td>0.038</td>
<td>0.0001</td>
</tr>
<tr>
<td>CEO tenure as CEO</td>
<td>0.019</td>
<td>0.005</td>
<td>0.0001</td>
</tr>
<tr>
<td>1991 stock return</td>
<td>0.428</td>
<td>0.107</td>
<td>0.0001</td>
</tr>
<tr>
<td>Stock ownership by CEO or family</td>
<td>-3.000</td>
<td>0.641</td>
<td>0.0001</td>
</tr>
<tr>
<td>Tobin’s Q</td>
<td>0.170</td>
<td>0.047</td>
<td>0.003</td>
</tr>
</tbody>
</table>

When we ran other regressions with these data we found that stock option compensation appears not to be judiciously used by boards in compensating their CEOs in the presence of mutual interlocks. We believe this reflects cronyism and weakens the board’s monitoring function. This interpretation is consistent with the view of academics and corporate governance activists who perceive interlocks generally as corrupt. Thus, although other studies find that markets react favorably to the adoption of stock option plans to compensate top executives, we find that stock options can be misused if the board’s monitoring activities are weakened by interlocks.

Other results in these regressions are consistent with the previous literature. We found that CEO pay is inversely related to the fraction of equity held by the CEO. And as economists Sherwin Rosen, Clifford W. Smith, Jr., and Ross L. Watts have found in other studies, we find that large companies and firms with greater growth opportunities pay more to their CEOs. A company’s net-of-market stock return was found to have a positive and significant association with total CEO compensation, consistent with previous studies.

CEO Turnover

To test our second hypothesis, we investigated whether the presence of mutual interlocking directorships decreases the board’s ability to monitor the CEO, thereby decreasing the likelihood that the CEO will depart. We analyzed the data, including CEO and company characteristics that should be associated with the probability of turnover. Michael Jensen and Kevin Murphy have suggested that one obvious CEO feature likely to affect the turnover process is age. To control for this influence we included the CEO’s age in the estimation. And to control for firm performance, we included the firm’s current and previous year stock returns net-of-market as well as the current period return on assets. Further control variables included proxies for growth opportunities (the ratio of research and development {R&D} over sales), the ratio of long-term debt to total assets, company size, and the fraction of common stock held by the CEO or his immediate family.

Table 3 presents coefficient estimates for the CEO turnover model. And the results are as hypothesized: The coefficient on the mutual interlock variable is negative and significant.
as predicted, implying that the presence of mutual board interlocks is inversely associated with the probability of CEO turnover. We interpret this result to indicate that mutually interlocking directorships weaken the monitoring power that the board has over the chief executive. Further, mutual interlocks contribute to the possible entrenchment objectives of the CEO. This result is in agreement with the notion that boards are ineffective in controlling the CEO, who is likely to control the domination and selection process of the directors.

**TABLE 3: PROBIT COEFFICIENT ESTIMATES: CEO TURNOVER**

<table>
<thead>
<tr>
<th>Variable</th>
<th>Estimate</th>
<th>Std. Error</th>
<th>p-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>INTERCEPT</td>
<td>-6.83</td>
<td>1.531</td>
<td>0.0001</td>
</tr>
<tr>
<td>Mutual director interlock indicator</td>
<td>-0.98</td>
<td>0.512</td>
<td>0.0548</td>
</tr>
<tr>
<td>% of board directors who are CEOs of other firms</td>
<td>0.72</td>
<td>0.891</td>
<td>0.4191</td>
</tr>
<tr>
<td>CEO's age (in years)</td>
<td>0.09</td>
<td>0.024</td>
<td>0.0001</td>
</tr>
<tr>
<td>Option compensation/ (salary + bonus)</td>
<td>0.01</td>
<td>0.054</td>
<td>0.8344</td>
</tr>
<tr>
<td>Stock return net-of-market</td>
<td>-0.60</td>
<td>0.364</td>
<td>0.1000</td>
</tr>
<tr>
<td>Stock return net-of-market (lagged one year)</td>
<td>-0.30</td>
<td>0.351</td>
<td>0.3937</td>
</tr>
<tr>
<td>R&amp;D expense/sales</td>
<td>3.35</td>
<td>2.374</td>
<td>0.1587</td>
</tr>
<tr>
<td>Firm size (natural log of total assets)</td>
<td>0.04</td>
<td>0.102</td>
<td>0.6819</td>
</tr>
<tr>
<td>% of equity held by CEO through direct stock ownership</td>
<td>-47.49</td>
<td>26.806</td>
<td>0.0764</td>
</tr>
<tr>
<td>Tenure as CEO (years)</td>
<td>0.01</td>
<td>0.016</td>
<td>0.3516</td>
</tr>
<tr>
<td>Leverage (long term debt/total assets)</td>
<td>0.39</td>
<td>0.705</td>
<td>0.5824</td>
</tr>
<tr>
<td>Return on assets (ROA)</td>
<td>1.52</td>
<td>1.788</td>
<td>0.3951</td>
</tr>
<tr>
<td>CEO is member of founding family</td>
<td>0.06</td>
<td>0.498</td>
<td>0.8972</td>
</tr>
</tbody>
</table>

These results are consistent with other theories and research on CEO turnover. As previous studies have noted, we found that CEOs are less likely to leave office if they own a large fraction of equity in the firm or if company performance is strong. And we found that age is positively associated with the probability of CEO turnover. Firm size, as proxied by the natural log of the firm assets, does not appear to play a role in the likelihood that the CEO leaves office.

**Conclusion**

Academics and the popular press have suggested that corporate boards are ineffective in monitoring CEOs, since CEOs frequently dominate the director selection process. Boards filled with CEO-sympathetic director appointees are likely to overcompensate and undermonitor the chief executive. Our view is that the mutually interlocking directorships that are prevalent among
firms are responsible for the production of sympathetic directors. These directors have the opportunity to pay and re-pay each other favors because of their multiple board memberships and may well be doing so in league with the CEOs who nominated them.

Our results indicate that the power alliances created by directors with multiple memberships are used by self-serving CEOs to extract handsome remuneration packages from firms and to strengthen their entrenchment. Boards that overcompensate and undermonitor the CEO are not fulfilling their fiduciary duties to the shareholders. As a result, board mutual interlocks weaken the firm’s governance structure, promote cronyism, and exacerbate the firm’s agency problems.

The results reported here indicate that it is at least plausible that mutual director interlocking relationships between different corporate boards might affect the voting patterns and decisions that these boards make on other matters besides CEO compensation and turnover.

Overall, our research suggests that inter-board relationships should be more closely scrutinized to determine whether these relationships encourage decisions that enhance shareholder wealth or instead facilitate empire building by self-serving CEOs. If, as we suspect, the latter is the case, then closer monitoring – private and/or public – of boards is needed.

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THE EXTRAORDINARY SCIENCE OF ADDICTIVE JUNK FOOD
Michael Moss

On the evening of April 8, 1999, a long line of Town Cars and taxis pulled up to the Minneapolis headquarters of Pillsbury and discharged 11 men who controlled America’s largest food companies. Nestlé was in attendance, as were Kraft and Nabisco, General Mills and Procter & Gamble, Coca-Cola and Mars. Rivals any other day, the CEOs and company presidents had come together for a rare, private meeting. On the agenda was one item: the emerging obesity epidemic and how to deal with it. While the atmosphere was cordial, the men assembled were hardly friends. Their stature was defined by their skill in fighting one another for what they called “stomach share” — the amount of digestive space that any one company’s brand can grab from the competition.

James Behnke, a 55-year-old executive at Pillsbury, greeted the men as they arrived. He was anxious but also hopeful about the plan that he and a few other food-company executives had devised to engage the CEOs on America’s growing weight problem. “We were very concerned, and rightfully so, that obesity was becoming a major issue,” Behnke recalled. “People were starting to talk about sugar taxes, and there was a lot of pressure on food companies.” Getting the company chiefs in the same room to talk about anything, much less a sensitive issue like this, was a tricky business, so Behnke and his fellow organizers had scripted the meeting carefully, honing the message to its barest essentials. “CEOs in the food industry are typically not technical guys, and they’re uncomfortable going to meetings where technical people talk in technical terms about technical things,” Behnke said. “They don’t want to be embarrassed. They don’t want to make commitments. They want to maintain their aloofness and autonomy.”

A chemist by training with a doctoral degree in food science, Behnke became Pillsbury’s chief technical officer in 1979 and was instrumental in creating a long line of hit products, including microwaveable popcorn. He deeply admired Pillsbury but in recent years had grown troubled by pictures of obese children suffering from diabetes and the earliest signs of hypertension and heart disease. In the months leading up to the CEO meeting, he was engaged in conversation with a group of food-science experts who were painting an increasingly grim picture of the public’s ability to cope with the industry’s formulations — from the body’s fragile controls on overeating to the hidden power of some processed foods to make people feel hungrier still. It was time, he and a handful of others felt, to warn the CEOs that their companies may have gone too far in creating and marketing products that posed the greatest health concerns.

The discussion took place in Pillsbury’s auditorium. The first speaker was a vice president of Kraft named Michael Mudd. “I very much appreciate this opportunity to talk to you about childhood obesity and the growing challenge it presents for us all,” Mudd began. “Let me say right at the start, this is not an easy subject. There are no easy answers — for what the public health community must do to bring this problem under control or for what the industry should do as others seek to hold it accountable for what has happened. But this much is clear: For those of us who’ve looked hard at this issue, whether they’re public health professionals or staff specialists in your own companies, we feel sure that the one thing we shouldn’t do is nothing.”
As he spoke, Mudd clicked through a deck of slides — 114 in all — projected on a large screen behind him. The figures were staggering. More than half of American adults were now considered overweight, with nearly one-quarter of the adult population — 40 million people — clinically defined as obese. Among children, the rates had more than doubled since 1980, and the number of kids considered obese had shot past 12 million. (This was still only 1999; the nation’s obesity rates would climb much higher.) Food manufacturers were now being blamed for the problem from all sides — academia, the Centers for Disease Control and Prevention, the American Heart Association and the American Cancer Society. The secretary of agriculture, over whom the industry had long held sway, had recently called obesity a “national epidemic.”

Mudd then did the unthinkable. He drew a connection to the last thing in the world the CEOs wanted linked to their products: cigarettes. First came a quote from a Yale University professor of psychology and public health, Kelly Brownell, who was an especially vocal proponent of the view that the processed-food industry should be seen as a public health menace: “As a culture, we’ve become upset by the tobacco companies advertising to children, but we sit idly by while the food companies do the very same thing. And we could make a claim that the toll taken on the public health by a poor diet rivals that taken by tobacco.”

“If anyone in the food industry ever doubted there was a slippery slope out there,” Mudd said, “I imagine they are beginning to experience a distinct sliding sensation right about now.”

Mudd then presented the plan he and others had devised to address the obesity problem. Merely getting the executives to acknowledge some culpability was an important first step, he knew, so his plan would start off with a small but crucial move: the industry should use the expertise of scientists — its own and others — to gain a deeper understanding of what was driving Americans to overeat. Once this was achieved, the effort could unfold on several fronts. To be sure, there would be no getting around the role that packaged foods and drinks play in overconsumption. They would have to pull back on their use of salt, sugar and fat, perhaps by imposing industrywide limits. But it wasn’t just a matter of these three ingredients; the schemes they used to advertise and market their products were critical, too. Mudd proposed creating a “code to guide the nutritional aspects of food marketing, especially to children.”

“We are saying that the industry should make a sincere effort to be part of the solution,” Mudd concluded. “And that by doing so, we can help to defuse the criticism that’s building against us.”

What happened next was not written down. But according to three participants, when Mudd stopped talking, the one CEO whose recent exploits in the grocery store had awed the rest of the industry stood up to speak. His name was Stephen Sanger, and he was also the person — as head of General Mills — who had the most to lose when it came to dealing with obesity. Under his leadership, General Mills had overtaken not just the cereal aisle but other sections of the grocery store. The company’s Yoplait brand had transformed traditional unsweetened breakfast yogurt into a veritable dessert. It now had twice as much sugar per serving as General Mills’ marshmallow cereal Lucky Charms. And yet, because of yogurt’s well-tended image as a wholesome snack, sales of Yoplait were soaring, with annual revenue topping $500 million. Emboldened by the success, the company’s development wing pushed even harder, inventing a Yoplait variation that came in a squeezable tube — perfect for kids. They called it Go-Gurt and rolled it out nationally in the weeks before the CEO meeting. (By year’s end, it would hit $100 million in sales.)
According to the sources I spoke with, Sanger began by reminding the group that consumers were “fickle.” (Sanger declined to be interviewed.) Sometimes they worried about sugar, other times fat. General Mills, he said, acted responsibly to both the public and shareholders by offering products to satisfy dieters and other concerned shoppers, from low sugar to added whole grains. But most often, he said, people bought what they liked, and they liked what tasted good. “Don’t talk to me about nutrition,” he reportedly said, taking on the voice of the typical consumer. “Talk to me about taste, and if this stuff tastes better, don’t run around trying to sell stuff that doesn’t taste good.”

To react to the critics, Sanger said, would jeopardize the sanctity of the recipes that had made his products so successful. General Mills would not pull back. He would push his people onward, and he urged his peers to do the same. Sanger’s response effectively ended the meeting.

“What can I say?” James Behnke told me years later. “It didn't work. These guys weren't as receptive as we thought they would be.” Behnke chose his words deliberately. He wanted to be fair. “Sanger was trying to say, 'Look, we’re not going to screw around with the company jewels here and change the formulations because a bunch of guys in white coats are worried about obesity.' ” The meeting was remarkable, first, for the insider admissions of guilt. But I was also struck by how prescient the organizers of the sit-down had been. Today, one in three adults is considered clinically obese, along with one in five kids, and 24 million Americans are afflicted by type 2 diabetes, often caused by poor diet, with another 79 million people having pre-diabetes. Even gout, a painful form of arthritis once known as “the rich man’s disease” for its associations with gluttony, now afflicts eight million Americans.

The public and the food companies have known for decades now — or at the very least since this meeting — that sugary, salty, fatty foods are not good for us in the quantities that we consume them. So why are the diabetes and obesity and hypertension numbers still spiraling out of control? It’s not just a matter of poor willpower on the part of the consumer and a give-the-people-what-they-want attitude on the part of the food manufacturers. What I found, over four years of research and reporting, was a conscious effort — taking place in labs and marketing meetings and grocery-store aisles — to get people hooked on foods that are convenient and inexpensive. I talked to more than 300 people in or formerly employed by the processed-food industry, from scientists to marketers to C.E.O.’s. Some were willing whistle-blowers, while others spoke reluctantly when presented with some of the thousands of pages of secret memos that I obtained from inside the food industry’s operations.

[The remainder of the article describes “case studies ... on how the foods are created and sold to people who, while not powerless, are extremely vulnerable to the intensity of these companies’ industrial formulations and selling campaigns.”]

*This article is adapted from “Salt Sugar Fat: How the Food Giants Hooked Us,” published by Random House in April 2013.*

*Michael Moss is an investigative reporter for The Times. He won a Pulitzer Prize in 2010 for his reporting on the meat industry.*
Beam ex. rel. Martha Stewart Living Omnimedia, Inc. v. Stewart
845 A.2d 1040 (Del. 2004)

[Background information: Independent directors are relevant under Delaware’s review of board decision making in three important contexts:

(1) Pre-suit demand: Delaware courts require that shareholders (before filing a derivative suit) must first make a demand for action by the board; if the board is composed of a majority of independent and disinterested directors, the suit will be dismissed.

(2) Dismissal of shareholder litigation: Delaware courts give deference to a board committee composed of independent and disinterested directors after shareholder derivative litigation has been filed; if the independent and disinterested committee requests dismissal of the litigation on an informed and reasonable basis, the court will (after an independent review) dismiss the litigation.

(3) Takeovers: Delaware courts will defer to a board committee composed of independent directors in negotiating the terms of a merger or other acquisition, even when there are conflicts of interest (such as with a parent company having a controlling interest in the company).

The following case involves the first such case, where the Delaware Supreme Court decided that general allegations of social/professional ties and friendship are not sufficient to question the independence of directors when considering whether demand would be futile.

In the case the plaintiff had alleged that Martha Stewart (a famous TV celebrity and entrepreneur) breached her duties of loyalty and care by selling stock of another company (ImClone) and then making misleading statements to the media. The shareholder plaintiff contended that demand on the board would be futile because social and business connections created a reasonable doubt as to the independence of a majority of the board of directors. The Court of Chancery held that demand was required – and thus dismissed the suit – because the plaintiff had not alleged specific facts to demonstrate a lack of independence, and the Delaware Supreme Court affirmed.]

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The plaintiff, Monica A. Beam, owns shares of Martha Stewart Living Omnimedia, Inc. (MSO). Beam filed a derivative action in the Court of Chancery against Martha Stewart, the five other members of MSO’s board of directors, and former board member L. John Doerr. In four counts, Beam's complaint alleged that Stewart breached her fiduciary duties of loyalty and care by illegally selling ImClone stock in December of 2001 and by mishandling the media attention that followed, thereby jeopardizing the financial future of MSO. The Court of Chancery dismissed the complaint because Beam failed to plead particularized facts demonstrating presuit demand futility.

When Beam filed the complaint in the Court of Chancery, the MSO board of directors consisted of six members: Stewart, Sharon L. Patrick, Arthur C. Martinez, Darla D. Moore, Naomi O. Seligman, and Jeffrey W. Ubben. The Chancellor concluded that the complaint alleged sufficient facts to
support the conclusion that two of the directors, Stewart and Patrick, were not disinterested or independent for purposes of considering a presuit demand.

The Court of Chancery found that Stewart’s potential civil and criminal liability for the acts underlying Beam’s claim rendered Stewart an interested party and therefore unable to consider demand. The Court also found that Patrick’s position as president and chief operating officer of MSO and inside director, together with the substantial compensation she receives from the company, raised a reasonable doubt as to her ability objectively to consider demand. The defendants do not challenge the Court’s conclusions with respect to Patrick and Stewart.

We now address the plaintiff’s allegations concerning the independence of the other board members. We must determine if the following allegations of the complaint, and the reasonable inferences that may flow from them, create a reasonable doubt of the independence of either Martinez, Moore or Seligman:

[The court quotes from the Plaintiffs’ complaint allegations regarding Martinez, Moore and Seligman]

**Decision of the Court of Chancery**

The Chancellor found that Beam had not alleged sufficient facts to support the conclusion that demand was futile because he determined that the complaint failed to raise a reasonable doubt that these outside directors are independent of Stewart. Because Patrick and Stewart herself are not independent for demand purposes, all the plaintiff need show is that one of the remaining directors is not independent, there being only six board members.

Because the parties do not argue and the court below did not address the issue of Ubben’s independence, we do not address it. Thus, we assume for purposes of this appeal that the presumption of Ubben’s independence is unrebutted.

As to the remaining three directors of the six-person board, it is appropriate here to quote the Chancellor’s analysis of the allegations regarding these three directors:

> The factual allegations regarding Stewart’s friendship with Martinez are inadequate to raise a reasonable doubt of his independence. While employed by Sears, Martinez developed business ties to MSO due to Sears’ marketing of a substantial quantity of MSO products. Martinez was recruited to serve on MSO’s board of directors by Beers, who is described as Stewart’s longtime personal friend and confidante and who was at that time an MSO director. Shortly after Martinez joined MSO’s board, Patrick was quoted in a magazine article saying, "Arthur [Martinez] is an old friend to both me and Martha [Stewart]."

> Weighing against these factors, the amended complaint discloses that Martinez has been an executive and director for major corporations since at least 1990. At present he serves as a director for four prominent corporations, including MSO, and is the chairman of the Federal Reserve Bank of Chicago. One might say that Martinez’s reputation for acting as a careful fiduciary is essential to his career – a matter in which he would surely have a material
interest. Furthermore, the complaint does not give a single example of any action by Martinez that might be construed as evidence of even a slight inclination to disregard his duties as a fiduciary for any reason. In this context, I cannot reasonably infer, on the basis of several years of business interactions and a single affirmation of friendship by a third party, that the friendship between Stewart and Martinez raises a reasonable doubt of Martinez's ability to evaluate demand independently of Stewart's personal interests.

The allegations regarding the friendship between Moore and Stewart are somewhat more detailed, yet still fall short of raising a reasonable doubt about Moore's ability properly to consider the demand. In 1995, Stewart's lawyer, Allen Grubman, hosted a wedding reception for his daughter. Among those in attendance at the reception were Moore, Stewart, and Waksal. In addition, Fortune magazine published an article in 1996 that focused on the close personal friendships among Moore, Stewart, and Beers. In September 2001, when Beers resigned from MSO's board of directors, Moore was selected to replace her. Although the amended complaint lists fewer positions of fiduciary responsibility for Moore than were listed for Martinez, it is clear that Moore's professional reputation similarly would be harmed if she failed to fulfill her fiduciary obligations. To my mind, this is quite a close call. Perhaps the balance could have been tipped by additional, more detailed allegations about the closeness or nature of the friendship, details of the business and social interactions between the two, or allegations raising additional considerations that might inappropriately affect Moore's ability to impartially consider pursuit of a lawsuit against Stewart.

On the facts pled, however, I cannot say that I have a reasonable doubt of Moore's ability to properly consider demand.

No particular felicity is alleged to exist between Stewart and Seligman. The amended complaint reports in ominous tones, however, that Seligman, who is a director both for MSO and for JWS, contacted JWS' chief executive officer about an unflattering biography of Stewart slated for publication. From this, the Court is asked to infer that Seligman acted in a way that preferred the protection of Stewart over her fiduciary duties to one or both of these companies. Without details about the nature of the contact, other than Seligman's wish to "express concern," it is impossible reasonably to make this inference. Stewart's public image, as plaintiff persistently asserts, is critical to the fortunes of MSO and its shareholders. As a fiduciary of MSO, Seligman may have felt obligated to express concern and seek additional information about the publication before its release. As a fiduciary of JWS, she could well have anticipated some risk of liability if any of the unflattering characterizations of Stewart proved to be insufficiently researched or made carelessly.

There is no allegation that Seligman made any inappropriate attempt to prevent the publication of the biography. Nor does the amended complaint indicate whether the biography was ultimately published and, if so, whether Seligman's inquiry is believed to have resulted in any changes to the content of the book. As alleged, this matter does not serve to raise a reasonable doubt of Seligman's independence or ability to consider demand on the complaint.
In sum, plaintiff offers various theories to suggest reasons that the outside directors might be inappropriately swayed by Stewart's wishes or interests, but fails to plead sufficient facts that could permit the Court reasonably to infer that one or more of the theories could be accurate.

**Demand Futility and Director Independence**

Under the first prong of Aronson, a stockholder may not pursue a derivative suit to assert a claim of the corporation unless: (a) she has first demanded that the directors pursue the corporate claim and they have wrongfully refused to do so; or (b) such demand is excused because the directors are deemed incapable of making an impartial decision regarding the pursuit of the litigation. The issue in this case is the quantum of doubt about a director's independence that is "reasonable" in order to excuse a presuit demand. The parties argue opposite sides of that issue.

The key principle upon which this area of our jurisprudence is based is that the directors are entitled to a presumption that they were faithful to their fiduciary duties.

A director will be considered unable to act objectively with respect to a presuit demand if he or she is interested in the outcome of the litigation or is otherwise not independent. A director's interest may be shown by demonstrating a potential personal benefit or detriment to the director as a result of the decision. The primary basis upon which a director's independence must be measured is whether the director's decision is based on the corporate merits of the subject before the board, rather than extraneous considerations or influences.

**Independence Is a Contextual Inquiry**

Independence is a fact-specific determination made in the context of a particular case. In order to show lack of independence, the complaint of a stockholder-plaintiff must create a reasonable doubt that a director is not so "beholden" to an interested director (in this case Stewart) that his or her discretion would be sterilized.

**Personal Friendship**

A variety of motivations, including friendship, may influence the demand futility inquiry. But, to render a director unable to consider demand, a relationship must be of a bias-producing nature. Allegations of mere personal friendship or a mere outside business relationship, standing alone, are insufficient to raise a reasonable doubt about a director's independence.

The facts alleged by Beam regarding the relationships between Stewart and these other members of MSO's board of directors largely boil down to a "structural bias" argument, which presupposes that the professional and social relationships that naturally develop among members of a board impede independent decisionmaking.

In the present case, the plaintiff attempted to plead affinity beyond mere friendship between Stewart and the other directors, but her attempt is not sufficient to demonstrate demand futility. Even if the alleged friendships may have preceded the directors' membership on MSO's board and
did not necessarily arise out of that membership, these relationships are of the same nature as those giving rise to the structural bias argument.

Allegations that Stewart and the other directors moved in the same social circles, attended the same weddings, developed business relationships before joining the board, and described each other as "friends," even when coupled with Stewart's 94% voting power, are insufficient, without more, to rebut the presumption of independence. They do not provide a sufficient basis from which reasonably to infer that Martinez, Moore and Seligman may have been beholden to Stewart. Whether they arise before board membership or later as a result of collegial relationships among the board of directors, such affinities – standing alone – will not render presuit demand futile.

That is not to say that personal friendship is always irrelevant to the independence calculus. But, for presuit demand purposes, friendship must be accompanied by substantially more in the nature of serious allegations that would lead to a reasonable doubt as to a director's independence. That a much stronger relationship is necessary to overcome the presumption of independence at the demand futility stage becomes especially compelling when one considers the risks that directors would take by protecting their social acquaintances in the face of allegations that those friends engaged in misconduct.

1. Seligman

Beam's allegations concerning Seligman's lack of independence raise an additional issue not present in the Moore and Martinez relationships. Those allegations are not necessarily based on a purported friendship between Seligman and Stewart. Rather, they are based on a specific past act by Seligman that, Beam claims, indicates Seligman's lack of independence from Stewart. Beam alleges that Seligman called John Wiley & Sons (Wiley) at Stewart's request in order to prevent an unfavorable publication reference to Stewart. The Chancellor concluded, properly in our view, that this allegation does not provide particularized facts from which one may reasonably infer improper influence.

The bare fact that Seligman contacted Wiley, on whose board Seligman also served, to dissuade Wiley from publishing unfavorable references to Stewart, even if done at Stewart's request, is insufficient to create a reasonable doubt that Seligman is capable of considering presuit demand free of Stewart's influence. Although the court should draw all reasonable inferences in Beam's favor, neither improper influence by Stewart over Seligman nor that Seligman was beholden to Stewart is a reasonable inference from these allegations.

Indeed, the reasonable inference is that Seligman's purported intervention on Stewart's behalf was of benefit to MSO and its reputation, which is allegedly tied to Stewart's reputation, as the Chancellor noted. A motivation by Seligman to benefit the company every bit as much as Stewart herself is the only reasonable inference supported by the complaint, when all of its allegations are read in context.

2. Moore
The Court of Chancery concluded that the plaintiff’s allegations with respect to Moore’s social relationship with Stewart presented "quite a close call" and suggested ways that the "balance could have been tipped." Although we agree that there are ways that the balance could be tipped so that mere allegations of social relationships would become allegations casting reasonable doubt on independence, we do not agree that the facts as alleged present a "close call" with respect to Moore’s independence. These allegations center on: (a) Moore’s attendance at a wedding reception for the daughter of Stewart’s lawyer where Stewart and Waksal were also present; (b) a Fortune magazine article focusing on the close personal relationships among Moore, Stewart and Beers; and (c) the fact that Moore replaced Beers on the MSO board. In our view, these bare social relationships clearly do not create a reasonable doubt of independence.

3. Stewart’s 94% Stock Ownership

Beam attempts to bolster her allegations regarding the relationships between Stewart and Seligman and Moore by emphasizing Stewart’s overwhelming voting control of MSO. That attempt also fails to create a reasonable doubt of independence. A stockholder’s control of a corporation does not excuse presuit demand on the board without particularized allegations of relationships between the directors and the controlling stockholder demonstrating that the directors are beholden to the stockholder. As noted earlier, the relationships alleged by Beam do not lead to the inference that the directors were beholden to Stewart and, thus, unable independently to consider demand. Coupling those relationships with Stewart’s overwhelming voting control of MSO does not close that gap.