THE ELUSIVE MONITORING FUNCTION OF INDEPENDENT DIRECTORS

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Abstract: Federal law mandates that audit and compensation committees of public companies be comprised entirely of independent directors. The assumption underlying these legal requirements is that independent directors are more likely to act as monitors of the company’s top management. In this paper, we test this assumption. We conduct our tests by examining the level, direction, and profitability of independent directors’ insider trades and compare these to the trades of other members of top management in firms defending class-action lawsuits. Our evidence indicates that there are no differences between the trading activity of independent directors and other insiders during the class period. Our findings cast doubt on the effectiveness of independent directors’ monitoring role.

Keywords: Independent Directors, Corporate Governance, Corporate Fraud, Gatekeepers

JEL Codes: G34, G38, K22, K41, K42 (Corporate Governance, Corporate Regulation, Business and Securities Law, Litigation Process, Illegal Behavior and Enforcement of Law).

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The Elusive Monitoring Function of Independent Directors

American corporate law has long relied on independent directors as a panacea to many challenging issues of corporate governance. One of the most important functions of independent board members is monitoring a company’s top management, to effectively protect shareholder interests. Generally, boards consist of independent directors as well as insiders, including the CEO who typically serves as the Chairman. Often, there are existing professional or social ties between the management and independent directors. But the extent to which these relationships might impair a director’s judgment is difficult to assess. Therefore, regulatory efforts tend to focus on the number of independent directors and their direct ties to the company. What is not obvious is whether lack of an explicit tie to management is sufficient for the independent directors to act in the best interest of the shareholders instead of their own best interests.

Testing whether the independent directors protect shareholder interests against other top management is a difficult task because the individual voting records of directors are private. We finesse this difficulty by focusing on the purchase and sales of stock by all insiders (instead of their votes), including the independent directors, in their own firms and comparing these patterns to each other. We also focus on firms involved in class action lawsuits to refine our tests.

This article thus seeks to examine these issues by empirically measuring the effectiveness of independent directors on company boards. Specifically, we test two mutually exclusive hypotheses: (1) independent directors act in favor of shareholders rather than in their self-interest and (2) independent directors have been co-opted by management. We test these hypotheses by examining the number and profitability of insider trades of top executives and independent directors. We also compare insider trades in firms that have settled class action litigation with the trades in firms that were not involved in class action litigation.

We analyze trades in firms involved in class action lawsuits that have resulted in large settlements because these events represent periods when the conflict of interest between top management and the shareholders is especially acute. In effect, class-action litigation means that top management is alleged to have engaged in fraud to enhance their own narrow self-interest at the expense of their shareholders. That top management has agreed to pay large sums to settle these cases also means that it is likely that plaintiffs could have won these cases upon trial. Thus, the settlement requirement reduces the likelihood of frivolous cases. Consequently, class periods in settlement cases represent times when shareholders are in special need of protection from decisions of top management. Therefore, it is important to know if independent directors live up to their monitoring responsibility when they matter most.

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1 See Adam C. Pritchard, Monitoring of Corporate Groups by Independent Directors, 9 J. KOREAN L. 1, 1-3 (2009).
4 Id. at 279-80.
5 See Sharpe, supra note 2, at 1436.
If independent directors are effective at monitoring other executives, we would expect that they would not be heavy sellers of company stock during the class action period. If however, independent directors are co-opted by management, we would expect their behaviors with respect to selling their shares of company stock to coincide with the behavior of other top management – that is, that they would trade (sell) as heavily as the other insiders during the class action period and make similar abnormal trading profits as other top executives. As analyzed in Part III, the evidence indicates that independent directors, along with management, trade (sell) intensely and earn large abnormal profits on material non-public information during the class period, supporting the hypothesis that they have been co-opted by management. Thus, a corporate governance system that in theory relies on the capability of independent directors to effectively monitor management behavior is seriously flawed in practice. Our evidence indicates that simply requiring certain number of independent directors has not resulted in an effective system of monitoring, but rather created of an illusion of it.

To address these issues, this manuscript is organized as follows. Part I begins with a discussion of the development of the monitoring role of corporate boards and addresses the myriad of contexts in which the law relies on the independence of independent directors to monitor management. Part II then examines empirical studies that have attempted to discern the effectiveness of independent board members in corporate governance. Parts III and IV describe and analyze our empirical study and implications for improving corporate governance. Our recommendations and concluding remarks follow.

I. The Monitoring Role of Corporate Boards

Up until the 1970s, company boards were dominantly comprised of company executives.6 Inside directors are uniformly defined as directors who are currently employed by the corporation.7 Two events, however, triggered reform and called for the inclusion of independent board members—corporate scandals and academic publications.8 With the rise of the shareholder primacy model,9 academic research examined managerial behavior, ownership structure, and agency costs, with a focus on the costs of dereliction in managerial behavior on shareholder value.10 As a result, these studies seem to suggest that managers should be monitored to

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maximize shareholder wealth. Insiders have been presumed to be biased and lacking in objectivity with respect to decisions made by other managers, and thus, cannot be trusted. In contrast, at least in theory, independent directors should be capable of impartially assessing the actions and decisions of the company, making them better suited to monitor the organization, than even external regulators. In addition, the introduction of calls for corporations to examine their social responsibilities in the 1970s conceptualized the corporate board as an independent and objective decision-making authority. To protect shareholder value, more independent board members were needed on company boards.

The 1978 Corporate Director’s Guidebook was the first (advisory) attempt to distinguish between outsiders and insiders on the board. In addition, in 1994 the American Law Institute published its highly influential Principles of Corporate Governance, recommending rules for the composition of the boards. The trend for increasing the number of independent members on the board of directors grew gradually in the ensuing decades—the ratio of independent directors on company boards increased to 75% in the mid-2000s from 20% in 1950s. As of 2017, independent members share increased up to 84% of all board members, with the CEO serving as the only insider on the boards in the majority of the S&P 500 companies.

The primary purpose of having outsiders on company boards is to monitor the CEO and other insiders in the C-suite. Shareholders want to minimize executive perquisites to maximize firm value. The beliefs that outsiders are well-equipped to monitor insiders and that independent supervision is the best way to increase the company’s performance became so strong in the past decades that researchers have called for increasing the number of outsiders on company boards.

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11 See, e.g., Jensen, supra note 10, at 309-310 (noting that most of the literature in this area focuses on how “to provide appropriate incentives for the agent [defined broadly] to make choices which will maximize the principal’s welfare given that uncertainty and imperfect monitoring exist”).

12 Fairfax, supra note 7, at 139.

13 Id. at 141.


15 Id.


17 BAUM, supra note 8.

18 See Gordon, supra note 14, at 1471.


20 Kelli A. Alces, Beyond the Board of Directors, 46 Wake Forest L. Rev. 783, 789 (2011).

the board; for example, Lipton and Lorsch recommend at least two thirds of the membership of the board be comprised of independent directors.22

Massive takeover activities in the 1980s emphasized the importance of independent directors in the context of evaluating the business judgment of the board.23 This trend continued through 1990s with markets concentrating on executive rights and compensation.24 Corporate financial responsibility scandals in 2000s and the collapse of such giants as Enron and WorldCom stimulated the Congress to act against corporate fraud. The Sarbanes-Oxley Act (SOX)25 mandated complete audit committee independence.26 In the wake of the 2008 financial crisis, the Dodd-Frank Act27 established the requirement of independence of the compensation committee of the board.28

The concept of independence is not statutorily defined in Delaware. Instead, courts have judicially developed the doctrine and emphasized the role of independent directors in many corporate governance challenges. The next section examines these contexts.

A. Self-Dealing Transactions

In the self-dealing context, to receive the protection of the business judgment rule (BJR), a director must be, among other qualifications, disinterested and independent.29 The business judgment rule provides a presumption that the director acted in good faith and in the best interest of the corporation.30 Where the BJR applies, courts do not second-guess the business decision in the absence of gross negligence, conflict of interest or intentional misconduct.31 The Delaware legislature provided further protection for transactions where the director has a conflict of interest in Section 144(a)(1) of the Delaware Code.32 This statute provides that a transaction between a corporation and an interested director or officer is void or voidable solely for this reason unless the interest is disclosed to the board of directors or the committee, and the board or committee in good faith authorizes the transaction by the affirmative votes of a majority of the disinterested directors.33 Thus, in a conflicted transaction, a director often seeks ratification by majority of independent directors to receive the BJR protection. According the court in Cooke v.

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23 BAUM, supra note 8.
24 Id.
26 SOX § 301.
28 Dodd-Frank Act § 952.
32 DEL. CODE ANN. tit. 8, § 144(1)(a) (West 2010).
33 § 144(1)(a).
Oolie, under § 144(a)(1), the business judgment rule applies to the “actions of an interested director, who is not the majority shareholder, if the interested director fully discloses his or her interest and a majority of the disinterested directors ratify the interested transaction.” Thus, ratification by disinterested directors resolves the conflict in the director’s favor.

Judicial deference to ratification by independent directors is explained further in Cooke, where the court emphasized, that “the disinterested directors’ ratification cleanses the taint of interest because the disinterested directors have no incentive to act disloyally and should be only concerned with advancing the interests of the corporation.” The court thus presumes “that the vote of a disinterested director signals that participation in the interested transaction is in the best interests of the corporation despite the interest of one or more directors.” Moreover, according to Cooke, the disinterested directors’ vote in favor of proposal supports that the conflicted directors acted in good faith and in the interests of the corporation and its shareholders. Thus, if the deal was to the detriment of other shareholders, the independent directors in question would not have voted in favor of it. Similarly, in Cede & Co. v. Technicolor, Inc., the Delaware court previously held that one director's interest in a challenged transaction is not sufficient, without more, to deprive a board of the protection of the business judgment rule presumption when the transaction was ratified by independent directors.

B. Controlling Shareholder Transactions

Independent board member ratification plays an important role in the context of transactions instituted by controlling shareholders. In Rosenblatt v. Getty Oil, the court pointed out that an independent bargaining structure is powerful evidence of the fairness of a merger transaction. The case-by-case judicial review of these transactions focuses on factual evidence of whether the special committee appointed to evaluate the transaction was truly independent, fully informed, and had the freedom to negotiate at arm's length. Under Delaware law, the business judgment rule, as opposed to entire fairness, is the standard of review that governs going-private mergers “between a controlling stockholder and its corporate subsidiary, where the merger is conditioned ab initio upon both the approval of an independent, adequately-empowered Special Committee that fulfills its duty of care; and the uncoerced, informed vote of a majority of the minority stockholders.”

34 § 144.
36 Id.
37 Id.
38 Id.
39 Id.
41 Rosenblatt v. Getty Oil Co., 493 A.2d 929, 938 n.7 (Del. 1985).
42 Id. at 938-39.
In *In re Pure Res., Inc., Shareholders Litigation*, a case involving a tender offer, the court pointed out that:

the majority stockholder owes a duty to permit the independent directors on the target board both free rein and adequate time to react to the tender offer, by (at the very least) hiring their own advisors, providing the minority with a recommendation as to the advisability of the offer, and disclosing adequate information for the minority to make an informed judgment.\(^{44}\)

As the court further notes, in a non-coercive tender offer context, independent directors of the target firm “are permitted to make an informed recommendation and provide fair disclosure,” and the law should be reluctant to impose the entire fairness standard of review.\(^{45}\)

Likewise, *In re John Q. Hammons Hotels Inc. Shareholder Litigation*,\(^{46}\) the court also expressly declined to extend the entire fairness review to the case involving an interested cash-out merger and the protection of minority shareholders.\(^{47}\) According to the court, the business judgment rule would be the applicable standard of review “if the transaction were (1) recommended by a disinterested and independent special committee, and (2) approved by stockholders in a non-waivable vote of the majority of all the minority stockholders.”\(^{48}\) Another court stated that in controlling shareholder buyouts, the business judgment rule will be applied only when:

(i) the controller conditions the procession of the transaction on the approval of both a Special Committee and a majority of the minority stockholders; (ii) the Special Committee is independent; (iii) the Special Committee is empowered to freely select its own advisors and to say no definitively; (iv) the Special Committee meets its duty of care in negotiating a fair price; (v) the vote of the minority is informed; and (vi) there is no coercion of the minority.\(^{49}\)

C. **Special Litigation Committees**

The issue of independence of corporate directors has attracted much of the Delaware courts’ attention in the context of special litigation committees (SLCs) appointed to evaluate whether shareholder derivative suits should proceed. The Delaware courts have recognized the effectiveness of derivative suits as an intra-corporate means of policing boards of directors.\(^{50}\) Derivative suits involve a corporate claim for wrongdoing against an officer with an injury to the corporation, as opposed to the suing shareholder. Thus, the injury is indirect to the plaintiff, and the compensation for the harm is paid to the company.


\(^{45}\) Id.


\(^{47}\) See *In re John Q. Hammons Hotels Inc.*, 2009 WL 3165613, at *2 (explaining, however, that the procedures used in this case were not sufficient to invoke business judgment review).

\(^{48}\) Id. at *12.

\(^{49}\) *Kahn*, A.3d 635 at 645.

\(^{50}\) *Zapata Corp. v. Maldonado*, 430 A.2d 779, 784 (Del. 1981).
To bring a derivative action, among other standing prerequisites, plaintiff must first demand that the board of directors pursue the cause of action on behalf of the company, unless demand is futile.51 The reasoning behind the pleading rule, as noted in Levine v. Smith, is to strike a balance between a right to assert such a claim and a board of directors' duty to decide whether they should invest the resources of the company for this purpose.52 To demonstrate the futility of the demand, the court must answer affirmatively the questions of “(1) whether threshold presumptions of director disinterest or independence are rebutted by well-pleaded facts; and, if not, (2) whether the complaint pleads particularized facts sufficient to create a reasonable doubt that the challenged transaction was the product of a valid exercise of business judgment.”53 When lack of independence is charged in the latter context, “a plaintiff must show that the board is either dominated by an officer or director who is the proponent of the challenged transaction or that the board is so under his influence that its discretion is ‘sterilize[d].’”54

In general, in a demand futility context, if no special litigation committee exists, directors are “presumed to be independent.”55 A claim of lack of independence must be supported by a reasonable inference that the director is “beholden to a controlling person or ‘so under their influence that their discretion would be sterilized.’”56 Thus, a non-interested director is not independent if particularized allegations support the inference that he or she “would be more willing to risk his or her reputation than risk the relationship with the interested [person].”57

The court answered affirmatively, however, in Zapata v. Maldando,58 the question of whether the board, after it has been tainted by the self-interest most of the members, can legally delegate the authority to determine whether a derivative suit should proceed to a special litigation committee (SLC) that consists of two disinterested directors.59 The court further pointed out that “at le[a]st by analogy to our statutory section on interested directors, it seems clear that the Delaware statute is designed to permit disinterested directors to act for the board.”60

51 Fed. R. Civ. P. 23(1). Plaintiff must state with particularity: “(A) any effort by the plaintiff to obtain the desired action from the directors or comparable authority and, if necessary, from the shareholders or members; and (B) the reasons for not obtaining the action or not making the effort.” Id.
53 Id. at 205.
54 Id. (citation omitted).
57 Stewart, 845 A.2d at 1052.
59 Id. at 786.
60 Id.
committee, therefore, may, on the corporation’s behalf, to move to dismiss derivative litigation that may be believed as detrimental to the corporation.\textsuperscript{61}

The independence of special litigation committees plays a crucial role in this context because of the risk to the effectiveness of derivative suits as a corporate monitoring mechanism. Thus, to find the right balance, the Zapata court declined to accept the view that business judgment of special litigation committees is not subject to judicial review even if the committee acted independently, in good faith, and conducted a reasonable investigation.\textsuperscript{62}

In addition, the SLC in Zapata was formed four years after the litigation started and demand had been excused.\textsuperscript{63} In this context, the court noted that “we must be mindful that directors are passing judgment on fellow directors in the same corporation and fellow directors, in this instance, who designated them to serve both as directors and committee members.”\textsuperscript{64} The question, as the court noted, naturally arises, “whether a ‘there but for the grace of God go I’ empathy might not play a role.\textsuperscript{65} And the further question arises whether inquiry as to independence, good faith and reasonable investigation is sufficient safeguard against abuse, perhaps subconscious abuse.”\textsuperscript{66}

The Zapata court answered the latter question negatively in the context of the case, and thus, created a two-step test in deciding a motion to dismiss a derivative suit based on the judgment of the SLC. For the first step, a court must look into the independence, as well as the good faith, of the committee, and a court should inquire into the bases that support the committee’s conclusions with the burden of proof on corporation.\textsuperscript{67} Second, it is upmost importance to balance legitimate claims addressed in a derivative stockholder suit, with the corporation’s best interests in pursuing those claims, as judged by an independent investigating committee.\textsuperscript{68} Recognizing the danger of judicial overreaching, it held that courts should determine, in their own independent business judgment, whether the motion should be granted.\textsuperscript{69}

D. The Sarbanes Oxley Act

Federal securities laws did not directly address issues of corporate governance, especially issues regarding board structure, size, and independence of directors before the Sarbanes Oxley Act was enacted.\textsuperscript{70} SOX was controversial, in part, because corporate governance had been

\textsuperscript{61}Id.
\textsuperscript{62}Id. at 787.
\textsuperscript{63}Id.
\textsuperscript{64}Id.
\textsuperscript{65}Id.
\textsuperscript{66}Id.
\textsuperscript{67}Id. at 788.
\textsuperscript{68}Id. at 789.
\textsuperscript{69}Id. at 788-89.
\textsuperscript{70}See James S. Linck et al., The Determinants of Board Structure, 87 J. FIN. ECON. 308, 310 (2008) (“Prior to SOX, the securities laws did not directly address board composition, board size, and director qualifications”).
primarily the province of state law. Furthermore, courts were reluctant to dictate a board structure. The importance of the participation of independent members, especially in the merger context, began to arise even before SOX, however. Commentators have thus suggested that because there is a well-functioning market for directors, direct regulation, i.e., SOX, might be unnecessary and counter-productive.

Though the need for independent board members and auditors gained importance after the Enron scandal, independence was already an important issue in sensitive industries. An example is investment companies or funds. Because the board of directors plays a critical role in operations of funds and protecting interests of shareholders, the Securities and Exchange Commission (SEC) imposed an at least 40% independence requirement on board of directors of investment companies in 1999. Later, with the rash of financial scandals, independence became a more important issue.

After the Enron, WorldCom, Global Crossing and Adelphia scandals, as well as many other company failures at the beginning of 2000s, the SEC and members of the U.S. Congress began to address auditing and corporate governance principles. The major outcome of this

72 See Roberta S. Karmel, The Independent Corporate Board: A Means to What End? 52 GEO. WASH. L. REV. 534, 548 (1984) (“Board structure, however, is not a matter that has been, or . . . can be dictated by judicial decisions. . . . Thus, the board structure sections fall squarely into the grey area . . . .”).
73 See Jill E. Fisch, Taking Boards Seriously, 1205 U. PA. L. REV. 265, 273 (1997) (“This is most apparent in the merger context, in which the courts have required active participation by the board and have held independent directors accountable. . . . Particularly when independent directors serve on special committees, courts appear to take for granted active participation extending well beyond the monitoring function”).
75 See The Lessons from Enron, THE ECONOMIST (Feb. 7, 2002), https://www.economist.com/node/976011/print (“Companies need stronger non-executive directors, paid enough to devote proper attention to the job; genuinely independent audit and remuneration committees; more powerful internal auditors; and a separation of the jobs of chairman and chief executive”).
77 Id.
78 Id.
80 ROBERT R. MOELLER, COSO ENTERPRISE RISK MANAGEMENT: ESTABLISHING EFFECTIVE GOVERNANCE, RISK, AND COMPLIANCE (2nd ed. 2011).
process was the Sarbanes Oxley Act. SOX codified certain standards for corporate executives, board of directors, and audit committees. Section 301 of SOX regulates audit committee independence and requires all committee members to be independent directors. Moreover, under SOX, the board of directors may not hire company managers for consulting services.

The legislative history of SOX shows that Mr. Oxley, a member of the Committee on Financial Services, had a number of concerns with the bill. Among other things, Mr. Oxley was concerned with: (1) whether the rules, standards and practices relating to determining whether independent directors are in fact independent are adequate; (2) whether rules relating to the independence of directors serving on audit committees are adequate to protect investors and are uniformly applied; (3) whether the duties and responsibilities of audit committees should be established by the SEC; and (4) what further or additional practices or standards might best protect investors and promote the interests of shareholders.

According to Mr. Oxley, the bill lacked provisions to ensure that independent directors are truly independent. Explaining further, he stated that the bill should have eliminated the practice of compensating independent directors as “consultants” while they are members of the board. Lynn Turner, former Chief Accountant of the SEC, among others, argued that paying directors as consultants is “back door compensation that fundamentally undermines their independence.” Significant consulting compensation, thus, disincentives an otherwise independent director from challenging the same management that is paying for their consulting services. The thinking is that a provision prohibiting directors from providing consulting services would help ensure that directors act in the best interests of shareholders, devoid of conflicts of interest. But the amendment, prohibiting independent directors from serving as consultants, did not pass. The vote was 20 yeas and 38 nays.
In addition, Mr. Oxley advocated for shareholder approval of compensation in the form of stock option plans. But according to SEC Chairman Pitt, stock options fail to align the interests of management with those of shareholder. He proposed specific measures to fix the stock option arrangements requiring, in addition to shareholder approval, a committee of independent directors to make the decisions granting options to senior management.

Joseph V. Del Raso, a partner at Pepper Hamilton LLP, testified at a hearing of the House Financial Services Committee, emphasizing that the majority of boards of directors take their responsibilities very seriously, especially in the post-Enron and post-Global Crossing world, and that independent directors “have become increasingly aggressive in acting as watchdogs over their respective shareholders interests.” Del Raso then concluded that any additional regulation may “further dampen the enthusiasm of qualified people to serve as independent directors.” Thus, he expressed concern that further initiatives, including personal liability expenses “except in the most egregious cases of willful, wanton misconduct and onerous regulatory sanctions,” are likely to discourage these individuals from serving as independent directors.

Other testimony included that of Mr. Philip Livingston, President and CEO of Financial Executives International, advocating that companies be required to provide a report of key corporate governance practices. Further, he said that the current best practice was to have a governance and nominating committee composed of independent directors.

Mr. Jerry J. Jasinowski, President National Association of Manufacturers argued that the audit committee should be composed of members who are well-informed on matters of corporate accounting and finance as well as experienced in management of corporate affairs. He further contended that the audit committee needs to work closely with management and the outside auditors yet maintain necessary independence in order operate sufficiently in its supervisory review function. He concluded that the independence of outside auditors and audit committees

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92 Id. at 53.
93 Id. at 52.
94 Id.
95 Testimony Concerning the Corporate and Auditing Accountability, Responsibility, and Transparency Act: Hearing on H.R. 3763 Before the H. Sec. & Exchange Comm., 107th Cong. 102 (Statement of Joseph V. Del Raso, Partner, Pepper Hamilton LLP).
96 Id.
97 Id. at 362.
98 Id. (“They are keenly aware of the realities of shareholder litigation, the parameters surrounding appropriate indemnities, and the finite limits of directors’ and officers’ liability coverage if the corporate indemnity is insufficient”).
99 Id. at 371 (Statement of Philip Livingston, President & CEO, Financial Executives International).
100 Id. at 392 (Statement of Jerry J. Jasinowski, President, National Association of Manufacturers).
101 Id.
must be preserved in “the quest for providing complete and accurate information about the enterprise’s operational and financial status.”

Also testifying before the Financial Services Committee, Mr. Damon Silvers, Associate General Counsel at the American Federation of Labor and Congress of Industrial Organizations, pointed out that corporate governance begins with the board, and companies need directors who are both strong and independent. He explained that part of the problem at Enron was that Enron “touted directors as independent who really had significant ties to Enron management, ties that Enron did not have to disclose.” Therefore, boards should disclose all ties between board members, the company and company management to investors. Also, in agreement with these sentiments, Mr. Silvers further testified that corporate governance is in need of more effective boards and audit committees. For example, requiring independence of a number of board members in general and audit committee members in particular and along with finance and financial reporting skills should lead to more effective monitoring of management.

E. Stock Exchanges

In 1998, the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) sponsored a so-called Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (the Committee). The Committee issued a report with ten recommendations to improve the effectiveness of audit committees. The NYSE, NASD and other exchanges revised their listing standards to comply these recommendations. However, in 2002, in light of high profile corporate failures, the NYSE and NASD filed further corporate governance reform proposals. In addition, pursuant to SOX, the SEC proposed Rule 10A-3 under the Exchange Act. This rule requires audit committees of public companies to be independent as well as other substantive rules, regulating operations of the committees. New NYSE and NASD and other exchange listing requirements were formed based on the new rule.

102 Id.
103 Id. at 494 (Statement of Mr. Damon Silvers, Associate General Counsel, American Federation of Labor & Congress of Industrial Organizations).
104 Id.
105 Id.
106 Id.
107 Id. at 495-97.
108 Id.
111 AUDIT COMM. DISCLOSURE, RELEASE NO. 42266 (Dec. 22, 1999).
112 17 C.F.R. § 240.10A-3 (West 2018).
113 Id.
After SOX imposed independence requirements on audit committees, the NYSE and NASDAQ put more emphasis on regulation of director independence. New market listing standards required more independence than the Securities Exchange Act of 1934 (the Exchange Act)\(^{114}\) or SOX. The NYSE mandates that the boards of listed companies be comprised of a majority of independent board members,\(^{115}\) and that the audit and compensation committees be comprised of all independent directors.\(^{116}\) To be independent, the director must not have a material relationship with the company directly or as a partner, shareholder or officer of an organization that has a relationship with the company.\(^{117}\) The determination whether a particular relationship qualifies as a material is left to the board to decide, leaving a significant gray zone in the definition.\(^{118}\) The determinations are also left uncontested by the stock exchanges or the SEC, leading to the lack of proactive enforcement of their own requirements.\(^{119}\)

In addition, the NYSE manual provides a non-exhaustive list of relevant factors for determining independence of members of the compensation committee, evaluating that director's ability to be independent from management.\(^{120}\) The NASDAQ Listing Manual utilizes a similar framework.\(^{121}\) It follows that according to SOX and the exchange rules, independence is tied to the outsider status, as someone who lacks certain ties to those in control of the corporation.\(^{122}\)

Interestingly, in *M & F Worldwide Corp.*, the Delaware Supreme Court stated that satisfaction of the NYSE standards of independence may serve as an illustrative and informative factor for the Delaware Court but is not conclusive.\(^{123}\) The *Sandys v. Pincus* court also found that


\(^{116}\) Id.


\(^{118}\) Nili, *supra* note 19, at 40.

\(^{119}\) Id. at 40.

\(^{120}\) Id. These factors include the source of compensation, whether such director is affiliated with the listed company, or its employee (or has been within the last three years,) or an immediate family member is an executive officer of the listed company. In addition, if the director has received, or has an immediate family member who has received, during any twelve-month period within the last three years, more than $120,000 in direct compensation from the listed company, other than director and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service), then such member is not independent. Id. at 51-52, 51 n.91.


\(^{123}\) See Kahn v. M & F Worldwide Corp., 88 A.3d 635, 649 n.26 (Del. 2014). The Court stated that “record does not support the Appellants’ contention that that the Court of Chancery “relied heavily” on New York Stock Exchange (“NYSE”) rules in assessing the independence of the Special Committee, and that the application of such rules “goes against longstanding Delaware precedent.” The Court of Chancery explicitly acknowledged that directors’ compliance with NYSE independence standards “does not mean that they are necessarily independent under
a company’s determination under the NASDAQ rules that a director as independent is also relevant under Delaware law. Professor Langevoort, however, argues that to be independent, a lack of financial or material connections to management must be supplemented with “a willingness to bring a high degree of rigor and skeptical objectivity to the evaluation of company management and its plans and proposals.”

F. Challenges to Independence of the Board Committee Members

Delaware builds the notion of independence on a situational approach, thus shifting the focus of concern and evaluating specific conflict of interest based on its context. In M&F Worldwide Corp., plaintiffs challenged the independence of the members of the Special Litigation Committee selected to evaluate a merger. As to the first committee member challenged, the court concluded that although that the member had engaged in business dealings with a conflicted director nine years earlier, this relationship did not undermine his ability to evaluate the merger impartially. Another member of the special committee received $200,000 as the head of a law firm, prior to serving on the committee. The member's law firm advised the defendant corporation and another company there M & F owned a 37.6% stake, and earned the amount in legal fees. The court held that $200,000 compensation was not material to the member of the special committee, “in the sense that it would have influenced his decision-making with respect to the M & F proposal. The member was also a law professor at Georgetown. The plaintiff alleged a possible influence on the committee member’s position at Georgetown Law based on his decision regarding the merger because and another conflicted and

[Delaware] law in particular circumstances.” The record reflects that the Court of Chancery discussed NYSE standards on director independence for illustrative purposes.” Id.

See Sandy v. Pincus, 152 A.3d 124, 132–33 (Del. 2016). The court reasoned that:

"The bottom line under the NASDAQ rules is that a director is not independent if she has a “relationship which, in the opinion of the Company's board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director."

Id. Further:

The NASDAQ rules’ focus on whether directors can act independently of the company or its managers has important relevance to whether they are independent for purposes of Delaware law. Our law is based on the sensible intuition that deference ought to be given to the business judgment of directors whose interests are aligned with those of the company's stockholders. Precisely because of that deference, if our law is to have integrity, Delaware must be cautious about according deference to directors unable to act with objectivity. To consider directors independent on a Rule 23.1 motion generates understandable skepticism in a high-salience context where that determination can short-circuit a merits determination of a fiduciary duty claim.

Id.


M & F Worldwide Corp., 88 A.3d at 647.

Id.

Id.

Id.
influential member was on the Georgetown Board of Visitors. But because the member was tenured before he met the conflicted director, the court rejected the argument that there was influence on his independent decision-making.

That the member was also invited a few months after the approval to join the board of directors of Revlon, Inc., a company at which one of the defendants served on the board, That fact did not raise a triable issue, according to the court, because there was no evidence that the committee member expected to be asked to join Revlon's board at the time he served on the Special Committee. And finally, the evidence of prior business relationships prior to 1996 had no bearing because there was no evidence that the committee member had an ongoing economic relationship after 1996 with Perelman (who owned 43.4% of M & F stock and was member of the board) that was material to her in any way.

According to the $M & F$ Worldwide court:

to show that a director is not independent, a plaintiff must demonstrate that the director is “beholden” to the controlling party. Bare allegations that directors are friendly with, travel in the same social circles as, or have past business relationships with the proponent of a transaction or the person they are investigating are not enough to rebut the presumption of independence.

In addition, a plaintiff who is attempting to demonstrate that a director was not independent must meet a materiality standard — ties must be sufficiently substantial that a member’s ability to objectively discharge his or her fiduciary duties would be impaired. The court also held that the presence of some financial ties between the interested party and the director, with nothing more of concern, is not sufficient to disqualify a director. “The inquiry must be whether, applying a subjective standard, those ties were material, in the sense that the alleged ties could have affected the impartiality of the individual director.”

Another court, however, found the compensation at issue as disqualifying in *In re Emerging Communications, Inc. Shareholders Litigation*. This court questioned the independence of the special committee member because of his prior significant consultant fees, received from the defendant company. In contrast, in *Citron v. Fairchild Camera &
Instrument Corp., the Delaware Supreme Court held that an independent director who was elected by and represented one of the company’s largest shareholders, was nonetheless a disinterested director. The shareholder owned approximately 11.5% shares of the company. Yet, in the current era of increasing institutional activism, such a large stake may defacto be controlling. Whether the independent director would be able to be impartial irrespective of the large shareholder’s interests is unclear, especially, because this director’s position is a result of the shareholder’s selection. Thus, there is a great likelihood that minority shareholders’ interests might not be adequately represented by this director.

The court went further in tightening requirements of the independence of a SLC members in In re Oracle Corp. Derivative Litigation. The issue in Oracle involved whether to grant the motion to dismiss the derivative suit based on the recommendation of the SLC. It noted that the question of independence “turns on whether a director is, for any substantial reason, incapable of making a decision with only the best interests of the corporation in mind,” ultimately focusing on impartiality and objectivity.

The Oracle court’s findings were striking. The two SLC members—both of whom are professors at Stanford University—served on the SLC which investigated other Oracle directors. The directors under investigation maintained significant ties to Stanford.

Among the directors who [were] accused by the derivative plaintiffs of insider trading are: (1) another Stanford professor, who had taught one of the SLC members when the SLC member was a Ph.D. candidate and who served as a senior fellow and a steering committee member alongside that SLC member at the Stanford Institute for Economic Policy Research “SIEPR”; (2) a Stanford alumnus who ha[d] directed millions of dollars of contributions to Stanford during recent years, serve[d] as Chair of SIEPR's Advisory Board, was an ha[d] a conference center named for him at SIEPR's facility, and ha[d] contributed nearly $600,000 to SIEPR and the Stanford Law School, both parts of Stanford with which one of the SLC members [was] closely affiliated; and (3) Oracle's CEO, who ha[d] donated millions of dollars to in donations to Stanford through a

defendant company and its affiliates] were the largest single client of [the defendant’s] firm. In 1998, [the member] became “of counsel” at his firm and was put on a retainer arrangement wherein [the defendant’s company] paid compensation of $25,000 per month to [the member], and $5,000 per month to his firm. That amount represented all of [the member's] compensation for 1998.

141 Id. at 56.
143 Id. at 920 (quoting Parfi Holding AB v. Mirror Image Internet, Inc., 794 A.2d 1211, 1232 (Del.Ch.2001) (emphasis in original)).
144 Id.
145 Id.
personal foundation and large donations indirectly through Oracle, and who was considering making further donations of his $100 million house and $170 million for a scholarship program [at around the same time period the SLC members were added to the Oracle board].

As the Oracle court pointed out that “it is no easy task to decide whether to accuse a fellow director of insider trading.” The SLC members were required to decide whether to accuse a fellow professor and two large benefactors of their university of a crime which is inconsistent, according to the court, with the concept of independence. The court admitted that both SLC members were distinguished in their fields, highly respected and have tenure. In addition, the plaintiffs presented no evidence that SLC members had fundraising responsibilities at Stanford. Thus, the court acknowledged and focused its attention on the question “whether the ties would be of a material concern to two distinguished, tenured faculty members whose current jobs would not be threatened by whatever good faith decision they made as SLC members.”

The Oracle court stated that the recognized “domination and control” ground should not serve as the basis of the independence inquiry. The court explained:

Delaware law should not be based on a reductionist view of human nature that simplifies human motivations on the lines of the least sophisticated notions of the law and economics movement. Homo sapiens is not merely homo economicus. We may be thankful that an array of other motivations exist that influence human behavior; not all are any better than greed or avarice, think of envy, to name just one. But also think of motives like love, friendship, and collegiality, think of those among us who direct their behavior as best they can on a guiding creed or set of moral values.

Explaining further, the court stated:

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146 In re Oracle Corp. Derivative Litig., 824 A.2d at 920–21.  
147 Id. at 921.  
148 Id.  
149 Id. at 929–30.  
150 Id.  
151 Id. at 930.  
152 Id. at 937–38. The court provides an example:   Imagine if two brothers were on a corporate board, each successful in different businesses and not dependent in any way on the other's beneficence in order to be wealthy. The brothers are brothers, they stay in touch and consider each other family, but each is opinionated and strong-willed. A derivative action is filed targeting a transaction involving one of the brothers. The other brother is put on a special litigation committee to investigate the case. If the test is domination and control, then one brother could investigate the other. Does any sensible person think that is our law? I do not think it is.  
153 Id.  
154 Id. at 938.
Nor should our law ignore the social nature of humans. To be direct, corporate directors are generally the sort of people deeply enmeshed in social institutions. Such institutions have norms, expectations that, explicitly and implicitly, influence and channel the behavior of those who participate in their operation. Some things are “just not done,” or only at a cost, which might not be so severe as a loss of position, but may involve a loss of standing in the institution. In being appropriately sensitive to this factor, our law also cannot assume - absent some proof of the point - that corporate directors are, as a general matter, persons of unusual social bravery, who operate heedless to the inhibitions that social norms generate for ordinary folk.  

The self-interest of a director may flow from “personal or other relationships,” in addition to a financial stake. As the court acknowledged, “it is, I daresay, easier to say no to a friend, relative, colleague, or boss who seeks assent for an act (e.g., a transaction) that has not yet occurred than it would be to cause a corporation to sue that person” and thus, “denying a fellow director the ability to proceed on a matter important to him may not be easy, but it must, as a general matter, be less difficult than finding that there is reason to believe that the fellow director has committed serious wrongdoing and that a derivative suit should proceed against him.” An affirmative answer by the SLC could potentially have big negative consequences for the defendants, exposing them to the possibility of a large damage award in addition to greatly harming their reputation. Therefore, the court adhered to the view that Delaware law requires courts to consider the independence of directors based on the facts known to the court about them specifically, the so-called “subjective ‘actual person’ standard.”

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154 Id.
155 See id. at 938–39 (quoting Orman v. Cullman, 794 A.2d 5, 24 (Del.Ch.2002)).
156 Id. at 940.
157 Id. at 940–41. Emphasizing human nature, the court also pointed out that:

The importance and special sensitivity of the SLC’s task is also relevant for another obvious reason: investigations do not follow a scientific process like an old-fashioned assembly line. The investigators’ mindset and talent influence, for good or ill, the course of an investigation. Just as there are obvious dangers from investigators suffering from too much zeal, so too are dangers posed by investigators who harbor reasons not to pursue the investigation’s targets with full vigor….

The nature of the investigation is important, too. Here, for example, the SLC was required to undertake an investigation that could not avoid a consideration of the subjective state of mind of the Trading Defendants. Their credibility was important, and the SLC could not escape making judgments about that, no matter how objective the criteria the SLC attempted to use.

158 Id. at 941.

Id. at 942. In this inquiry:

a court must often apply to the known facts about a specific director a consideration of how a reasonable person similarly situated to that director would behave, given the limited ability of a judge to look into a particular director's heart and mind. This is especially so when a special litigation committee chooses, as was the case here, to eschew any live witness testimony, a decision that is, of course, sensible lest special
In re eBay, Inc. Shareholders Litigation\(^{159}\) is another case where plaintiffs successfully challenged the objectivity and impartiality of the independent directors participating on the SLC. The shareholders sued the directors for violation of their fiduciary duty because they usurped the opportunity from eBay of participating in the IPOs.\(^{160}\) eBay had hired Goldman Sachs to underwrite its IPO. eBay’s board of directors consisted of seven members,\(^{161}\) including three defendant-directors and one former director who had all received initial public offering (IPO) allocations from Goldman.\(^{162}\)

The court concluded that directors who received IPO allocations were obviously interested in the transactions.\(^{163}\) The other four directors of eBay did not participate in the “spinning” and served on the SLC formed to determine whether the case against the defendant directors should proceed.\(^{164}\) Plaintiffs alleged that non-participating directors all had “close business and personal ties with the individual defendants” and could not exercise necessary independent judgment in order to determine whether eBay should bring a breach of fiduciary duty action against these individual defendants.\(^{165}\)

The court noted that defendant directors (and their affiliates) owned about one-half of eBay’s outstanding common stock, and thus they had the ability to control eBay and to direct business and affairs, including electing directors and approving significant corporate transactions.\(^{166}\) The SLC members were awarded stock options with the alleged value potentially running into the millions of dollars.\(^{167}\) Many of the options awarded to the independent directors had not yet vested at the moment of transaction approval and would never vest so long as the independent directors remained.\(^{168}\) Thus, the court held that one could not conclude realistically that the SLC members “would be able to objectively and impartially consider a demand to bring litigation against those to whom [they were] beholden for [their] current position and future position on eBay’s board.”\(^{169}\)

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\(^{159}\) Id. at 940 (quoting Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1167 (Del. 1995)).

\(^{160}\) Id. at *1-2.

\(^{161}\) Id.

\(^{162}\) Id.

\(^{163}\) Id.

\(^{164}\) Id. at *2.

\(^{165}\) Id.

\(^{166}\) Id. at *3.

\(^{167}\) Id.

\(^{168}\) Id. at 3.

\(^{169}\) Id.
Courts have also found certain business and social relationships adversely affect the impartiality of independent directors. For example, shareholders successfully showed that a board member could not act independently of the company's chairman, “where the board member had a close friendship of over half a century with the interested party [and] the director’s primary employment (and that of his brother) was as an executive of a company over which the interested party had substantial influence.”

Deep friendship ties have also been found to impact the determination of independence. In Sandy, a director and her husband co-owned private airplane with the board chairman, who was also controlling stockholder and was interested the transaction at issue. According to the court, it created reasonable doubt about the director’s independence because “plane ownership was not common and involved partnership in an expensive personal asset that required close cooperation in use, which was suggestive of detailed planning indicative of continuing, close personal friendship.”

II. Effects of Independence on Corporate Governance - Empirical Studies

Scholars have been attempting to empirically discern the effect of independent board on corporate governance issues. This Part provides a summary of key findings.

A. Board Composition and Firm Performance

Empirical evidence on the relation between independent directors and firm performance is mixed. There is a significant body of literature finding a positive relation between shareholder wealth or firm performance and boards with outside independent directors. Two studies

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171 Sandy, 152 A.3d at 128, 130.
172 Id. at 124.
focused solely on tender offers. These studies found a positive relation between independent members and returns to shareholders during tender offers. On the other hand, other scholars could not find any relationship between number of independent members on company boards and performance. Hermalin and Weisbach, for example, claim that even if their results are due to a measurement error, the relationship between these two variables, if any, must be weak at best. Nikos Vafeas, could not find a relationship between board composition and earnings-return relation.

Some studies find that director independence is conditionally effective. One study found that if cost of acquiring information is low, the addition of independent directors enhances financial performance. On the other hand, a high cost of information acquisition causes independent directors to worsen financial performance. The same relationships were suggested to exist between earnings management and board independence. Monitoring quality was also found to improve if a majority of independent directors serve on multiple monitoring committees in a company. In addition, firms with independent directors serve on multiple monitoring committees were found to exhibit more sensitivity to CEO compensation, CEO turnover, and earnings management.

Boone et al. find a positive relation between the firms’ board independence and the firms’ growth and diversification while also negatively related to CEO influence on board decisions.

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RES. 235, 246 (1988) (noting that their study weakens arguments that a manager-dominated board increases a firm’s financial performance).

174 Byrd and Hickman, supra note 173; Cotter, supra note 173.

175 Id.


177 Hermalin & Weisbach, supra note 176, at 111.


179 Ran Duchin et al., When are Outside Directors Effective? 96 J. FIN. ECON. 195, 212-13 (2010).

180 See Xia Chen et al., Does Increased Board Independence Reduce Earnings Management? Evidence from Recent Regulatory Reforms, 20 REV. ACC. STUD. 899, 925 (2015) (finding that “the reduction in [discretionary accruals], as explained by the change in board independence and information acquisition cost, is associated with better firm performance”).


182 Id. at 170.

183 Boone et al., supra note 173, at 69, 87.
Fich and Shivdasani find that the busyness of independent directors is associated with weak governance.¹⁸⁴ Busy independent directors are also likely to quit boards after poor performance.¹⁸⁵ Weisbach finds that independent directors are positively associated with resignations of CEOs after bad performance.¹⁸⁶

B. Board Composition and Monitoring

Some authors suggest that there are significant trade-offs between board composition and monitoring. Independent directors provide advice and counsel to executives, while at the same time they monitor them.¹⁸⁷ As independent directors monitor more, executives tend to reveal less information to them.¹⁸⁸ These studies thus suggest that management-friendly boards can be optimal depending on conditions.¹⁸⁹ Another study attempted to address optimal board size and board composition and found that these depend on the characteristics of the firm and the particular directors.¹⁹⁰

Furthermore, transparency is another important issue in corporate governance. One study shows that transparency has a positive relation with the percentage of independent directors.¹⁹¹

C. Board Composition and CEO Role

A positive relationship has been found between separation of CEO positions from that of the chair of board and subsequent operating performance.¹⁹² The drafters of the Commonsense Corporate Governance Principles (the Principles) argue that a board’s independent directors should analyze and decide whether the roles of chairman and CEO should be separate or combined.¹⁹³ If the board chooses a combined role, the Principles point out that a strong lead

¹⁸⁵ Id. at 711-12.
¹⁸⁷ Adams & Ferreira, supra note 21, at 218.
¹⁸⁸ Id.
¹⁸⁹ Id. at 219.
¹⁹¹ See Christopher S. Armstrong, et al., Do Independent Directors Cause Improvements in Firm Transparency?, 113 J. FIN. ECON. 383, 402 (2014) (“We present results that are generally consistent with the interpretation than an exogenous (required) increase in the proportion of independent directors results in an increase in corporate transparency”).
independent director with clearly defined authorities and responsibilities is vital for the board.\textsuperscript{194} In addition, the *Principles* encourage boards to explain the choice to shareholders.\textsuperscript{195}

Studies have also found a negative relation between CEO compensation and the level of control from board of directors.\textsuperscript{196} Similarly, equity ownership of board members has a negative relationship with CEO compensation.\textsuperscript{197} Equity ownership of board members was found be even more important than percentage of independent directors on the board in affecting CEO pay.\textsuperscript{198} Steven Kaplan finds that CEOs are indeed monitored by boards: CEO pay levels are not significantly higher than other top-income groups in 2012 compared to the levels in early 1990s and CEOs are rewarded for high performance and penalized for low performance upon examination of listed companies within the U.S.\textsuperscript{199}

Shivdesani and Yermack studied the CEO’s role in selecting directors, such as his or her presence on nominating committees.\textsuperscript{200} They found that a CEO on the nominating committee results in fewer independent outside directors, and more gray outsiders (those who have conflict of interests) on company boards.\textsuperscript{201} They claim that CEOs reduce the pressure of active monitoring by using this mechanism.\textsuperscript{202} Responding to similar criticism, the NYSE manual mandates complete independence of members of the governance committee of listed companies.\textsuperscript{203} Nonetheless, CEOs are still heavily involved in appointments of new directors.

D. Connections between the CEO and Board Members

Academics are generally in agreement about the relationship between connectedness of CEO with directors as well as other top executives and corporate fraud.\textsuperscript{204} Professor Khanna

\textsuperscript{194} Id.
\textsuperscript{195} Id.
\textsuperscript{197} Id. at 340.
\textsuperscript{201} Id.
\textsuperscript{202} Id. at 1852.
\textsuperscript{203} NYSE LISTED COMPANY MANUAL § 303A.04(a) (2013). “Listed companies must have a nominating/corporate governance committee composed entirely of independent directors.” Id.
\textsuperscript{204} See Vikramaditya Khanna et al., *CEO Connectedness and Corporate Fraud*, 70 J. FIN. 1203, 1204-05 (2015); see also Cesare Fracassi & Geoffrey Tate, *External Networking and Internal Firm Governance*, 67 J. FIN. 153, 187-88 (2012); N. K. Chidambaran et al., *CEO-Director
finds that connectedness through past employment, education, and social organizations significantly affects the incidence of corporate fraud.\textsuperscript{205} N. K. Chidambaran and colleagues argue that nonprofessional connections, such as alma mater, increase the likelihood of fraud while professional connections from employment overlaps lower the probability of fraud.\textsuperscript{206} In addition, these authors argue that independence is only a necessary, but not a sufficient element to stop corporate crime.\textsuperscript{207} Randall Morck introduced social psychology theories to the analysis and claims that related literature indeed lacks evidence of the relationship between board independence and corporate performance, potentially due to hidden deep personal ties between independent directors and CEOs.\textsuperscript{208}

Jeffrey Coles et al. introduces the term “co-option” to redefine independence of boards.\textsuperscript{209} Co-option is the fraction of the board comprised of directors appointed after the CEO assumed office, making them likelier to side with the CEO.\textsuperscript{210} The authors argue that co-option reduces the board’s monitoring, negatively impacts the connection between CEO turnover and firm performance, but increases CEO pay and investments.\textsuperscript{211} Based on the data, they conclude that co-opted independent directors are not associated with the effective monitoring.\textsuperscript{212}

A positive relationship has been also found between stock ownership of independent board members and the probability of disciplinary actions toward management in case of poor performance.\textsuperscript{213} These findings may suggest that stock ownership provides additional incentives for the board members to monitor management actions.

\textbf{E. Insider Trading}

Professors Ravina and Sapienza analyze insider trading of independent directors and other executives.\textsuperscript{214} Their results show that there is very little difference between the insider trading profits of independent directors and executives; the profits for both groups are also higher in companies with weaker corporate governance.\textsuperscript{215} Another study analyzes insider trading of

\textsuperscript{205} Khanna, \textit{supra} note 204, at 1240.
\textsuperscript{206} Chidambaran, \textit{supra} note 204, at 1.
\textsuperscript{207} \textit{Id.}
\textsuperscript{210} \textit{Id.}
\textsuperscript{211} \textit{Id.} at 1753.
\textsuperscript{212} \textit{Id.} at 1754.
\textsuperscript{213} Bhagat & Bolton, \textit{supra} note 173, at 257.
\textsuperscript{215} \textit{Id.}
independent directors who serve on multiple boards.\textsuperscript{216} Cook and Wang find that audit and compensation committee memberships increase trading performance.\textsuperscript{217} Moreover, multi-firm directors outperform single-firm directors in their insider trading profitability.\textsuperscript{218}

F. Earnings Fraud

A number of studies have found that firms are less likely to commit earnings management tactics or financial statement fraud if they have boards or audit committees with independent directors.\textsuperscript{219} On the other hand, Ferris’ and Yan’s study leads to the opposite conclusion, claiming no significant relationship between board independence and financial statement fraud.\textsuperscript{220} Another study found that family affiliations may also play a role in the likelihood of financial fraud—firms with CEOs from the founding family are more likely to restate financial statements.\textsuperscript{221}

III. Our Empirical Study

As described above, independent directors have been relied upon to monitor management and to thus maximize shareholder wealth.\textsuperscript{222} Where there is a conflict of interest between managers and shareholders, independent directors are thought to be able to prohibit managers from acting in their self-interest.\textsuperscript{223}

Some studies find a positive relationship between directors’ compensation and directors’ monitoring of the executives.\textsuperscript{224} Yet other studies reveal that independent directors are not as efficient as in protecting shareholder wealth as projected.\textsuperscript{225}

\begin{flushleft}
\textsuperscript{217} Id. at 120-21
\textsuperscript{218} Id.
\textsuperscript{219} See Patricia M. Dechow et al., Causes and Consequences of Earnings Manipulation: An Analysis of Firms Subject to Enforcement Actions by the SEC, 13 CONTEM. ACC. RES. 1, 3 (1996); see also Anup Agrawal & Sahiba Chadha, Corporate Governance and Accounting Scandals, 48 J. LAW & ECON. 371, 374 (2005); Mark S. Beasley, An Empirical Analysis of the Relation Between the Board of Director Composition and Financial Statement Fraud, 71 ACC. REV. 443, 463 (1996).
\textsuperscript{220} Ferris & Yan, supra note 176, at 393.
\textsuperscript{221} Agrawal & Chadha, supra note 219, at 371.
\textsuperscript{222} Alces, supra note 20, at 789.
\textsuperscript{223} Id.
\textsuperscript{224} Shin Rong Shiah Hou & Chin Wei Cheng, Outside Director Experience, Compensation, and Performance, 38 MANAGERIAL FIN. 914, 932 (2012).
\textsuperscript{225} See Hermalin & Weisbach, supra note 176, at 111 (discovering no apparent connection between firm performance and board composition); see also Ferris & Yan, supra note 176, at 393 (finding no connection between director independence and reduction in fraud).
\end{flushleft}
We test two mutually exclusive hypotheses to measure the effectiveness of independent directors on company boards. The first hypothesis is that independent directors act in favor of shareholders. That is, they act in the corporate interest and do not seek to personally profit when doing so.

The second hypothesis is that directors, when presented with certain circumstances and have the same opportunities to act in their self-interest as executives, behave the same as the executives acting in their own self-interest.

If the first hypothesis is true, then independent directors act good faith, and including them on corporate boards creates value for shareholders. However, if instead the second hypothesis is true, then reliance of independent directors as effective corporate monitors should be questioned.

We test these hypotheses by examining the insider trading by top executives, independent directors and all officers excluding outsiders in the presence of a class-action lawsuit that resulted in a settlement. We also compare securities class actions (SCAs) of firms that settled class action claims with the firms that were not involved in SCAs. If independent directors are a good monitor of executive behavior, we would expect independent directors to refrain from trading company stock during the class action period. If the second hypothesis is correct, we would expect independent directors to behave similar to insiders and sell company stock during the class action period.

A. Data

This study analyzes the insider trading activities of top executives, officers, dependent directors, and independent directors of the companies listed in the Stanford Law School Securities Class Action Clearinghouse (SCAC). SCAC keeps track of more than 4,000 class action lawsuits filed in Federal Court since the enactment of the Private Securities Litigation Reform Act of 1995.226

A Securities Class Action (SCA) is a claim filed on behalf of a group of shareholders. The complaint contains allegations that the company or its managers violated at least one federal or state securities law, but most are brought under federal law.227 Commonality of interest is

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required to certify a class and plaintiffs must demonstrate that the claims of the representatives of
class are typical of every class member.  

The analysis period of the study is 1996–2016, our data set contains 4,041 filed cases. Law firms often file a class action lawsuit if any large negative shock occurs in share prices, thus it is not likely that any large class-action lawsuit would be excluded from this data set. After obtaining data from the SCAC, we applied filters to account for frivolous cases. We eliminated dismissed and ongoing cases, private company cases, and cases with settlement amounts lower than $25 million. We set a minimum settlement amount to ensure that damages are sufficiently large for injured parties, and insiders can predict the effect of drop in share prices. We are left with 131 companies after the filters.

We collected insider trading data from Thomson Reuters (TFN) from 1996 to 2017. Between 1975 and 1995, we have obtained insider trading data from the National Archives. We combine these two datasets to create a continuous record of insider trading covering the period from 1975 to 2017. Our database consists of legally-mandated reporting of the universe of all insider transactions; it contains the date, volume and the amount of purchases and sales of insider trading, names and titles of insiders, as well name and CUSIP number of the firm, and other information. We use the information on insider trading of top executives, independent directors, dependent directors, and other officers. Top executives, dependent directors, and other officers, and independent directors are classified using role codes in the TFN database. Top executives are limited to officer and director (OD), officer, director, and beneficial owner (H), chairman of the board (CB), CEO (CEO), CFO (CFO), controlling person (CP), general partner (GP), and president (P). Independent directors are coded with (D). Inside directors and other officers are defined as all other officers. We include any large shareholder with any officer title. We exclude outside large shareholders (SH) and outside beneficial owner of more than 10% of a

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228 Rules 23(a) and (b) of the Federal Rules of Civil Procedure govern the requirements for class certification. There are four threshold requirements for class certification, each of which must be met: (1) the class is so numerous that joinder of class members is impracticable (numerosity); (2) there are questions of law or fact common to the class (commonality); (3) the claims or defenses of the class representatives are typical of those of the class (typicality); and (4) the class representatives will fairly and adequately protect the interests of the class (adequacy). Fed. R. Civ. P. 23(a). Courts have added additional requirements: (1) that a definable class exists, (2) the named representatives are members of that class, and (3) the claim of the class is live, rather than moot. Shriver Center, 7.2 Rule 23 Class Certification Requirements, FED. PRAC. MANUAL FOR LEGAL AID ATTY’S, http://www.federalpracticemanual.org/node/42 (last updated 2017).


These outside groups are typically harmed by corporate fraud and thus they are not likely to be aware of any ongoing corporate fraud.

Next, we combine the SCAC and insider trading information and we are left with the trading activities of insiders from companies that were involved in fraud settlements after enactment of the Private Securities Litigation Reform Act of 1995.\footnote{Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.).} We construct pre-class and post-class periods as control periods. The pre-class, class, and post-class periods have the same number of days. For example, if class period is 100 days, so are the pre-class and post-class periods. The pre-class period starts from 100 days before the class period begins and ends the day before the class action starts. Similarly, the post-class period starts the day after the class period ends and lasts 100 days. We test the timing of insider trading activities for the pre-class period before the class action period, during the class action period, and for the post-class period.

### B. Methodology: Measuring Insiders’ Abnormal Stock Profits

We use a standard event study model to measure abnormal returns of insiders around trade dates. The event date, day 0, is the insider trade day for each transaction. We measure cumulative abnormal returns around event days by using market-adjusted daily returns as follows:

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CAR_{i,T} = \sum_{t=1}^{T} H_{i,t} (r_{i,t} - r_{m,t})
\]

where \(H_{i,t}\) takes value 1 for insider purchases and -1 for insider sales. The variable \(r_{i,t}\) is the return to stock \(i\) on day \(t\). \(r_{m,t}\) is the market return, which is with-dividend return to the CRSP equally-weighted portfolio of the New York Stock Exchange, American Stock Exchange, and NASDAQ stocks for day \(t\). An insider purchase is profitable if the stock return outperforms market return, and an insider sale is profitable if stock return is less than market return for day \(t\). Next, we cumulate all abnormal returns for 10, 20, 50, 100, 150, 200, and 250 days after the event to compute abnormal profits gained from insider trades.

### C. Overall Comparisons

Table 1 displays the sample characteristics of insider trading in all public firms between 1996 and 2017. This table provides information about trades of officers and directors, top executives, and independent directors. Purchases and sales are reported separately. We also classify companies into three categories. Small-cap firms are firms with less than $1 billion market capitalization. Midcap firms are defined by market capitalization between $1 billion and $5 billion. Large cap firms have higher than $5 billion in market capitalization.
The table shows that the number of firms involved in insider trading and the number of trades are decreasing with market capitalization, while the average trade size is increasing with market capitalization. The number of sales are more frequent than the number of purchases. Insider sales to purchase ratio numbers are slightly more than 3-1. The ratio of purchases to sales is highest for large-cap firms (17-1); lower for mid-cap firm (9-1) and lowest for small firms (1.7-1) and it follows similar patterns for officers, directors, top executives, and independent directors. This pattern shows that independent directors behave like other insider traders.

Next we compare the overall profitability for independent directors and other insiders. Table 2 shows insiders’ abnormal profits computed in all publicly listed firms between 1975 and 2017. Our evidence shows that all officers, top executives and independent directors trade profitably. Following these transactions, all officers earn about 4.0% in abnormal returns, top executives earn around 4.9% and independent directors earn around 4.1%. Overall, our evidence indicates that for the 43-year period from 1975 to 2017, independent directors trade in a similar fashion and earn comparable profits as other insiders. There is no evidence of any “independent” behavior by independent directors.

D. Class-Action Subsample Comparisons

Table 3 displays the sample characteristics of insiders in firms that settled securities fraud class actions during the same period (1996 through 2017). Once again, insider sales are more than insider purchases. Insider sales to purchase ratio now numbers more than 10-1. Thus, firms involved in class action lawsuits are three times more likely to experience insider selling than the overall sample. The number of firms and the number of trades are higher for firms with higher market capitalization, indicating higher insider trading activity in large SCA-settled firms. The average class period is around 612 calendar days. The class period generally increases along with market capitalization.

The average settlement amount is increasing monotonically with market capitalization. The average settlement amount is around $60-$90 million for small-cap stocks. This amount grows to about $250-275 million for large-cap stocks. This finding indicates that larger firms with deeper pockets tend to settle for larger amounts.

Next, we turn our attention to profitability of insider trading in SCA-settled firms. Table 4 displays insiders’ abnormal profits in firms subject to securities fraud lawsuits between 1996 and 2017 and settled at least for $25 million. We examine insider trading separately before the class period, during the class period, and after the class period. The first column shows the number of observations in each column. The number of insider trading by officers and top executives are comparable while number independent directors have engaged in about half as many insider trading transactions as officers or top executives.

The number of insider trades is numerous during the class period as compared to pre- and post-class periods even though the length of the periods is the same. This indicates that the class period involves more information asymmetry and thus more profitability from insider trading.
than pre- and post-class periods. This fact is valid for all insider groups; however, it is more pronounced for top executives and independent directors.

The first three lines of Table 4 show the abnormal returns of insider trading to officers (except independent directors) in pre-class, class, and post-class periods. Pre-class period abnormal returns are statistically not different from 0 for 4,656 observations. The number of insider trading transactions increase to 6,747 in the class period. The abnormal returns of all officers reach up to 35% during the 250 days after insider trading transaction. Moreover, abnormal profitability for 20 to 250 days is statistically significant for this insider trading group. This finding shows that officers use their material nonpublic information to make profits in the class period. There are 1,424 insider trading transactions in the post-class period, which do not show profitability for the first 50 days after insider trading. We observe significant profits after 100-, 150-, 200- and 250-day event periods, the profitability reaches up to 31% for the 250-day period.

The profitability of top executives is shown in the next three lines. There is no significant profitability in the pre-class period for 3,464 observations. Top executives increase number of transactions to 6,485 during the class period. Abnormal profitability of top executives rise up to 23% after 250 days of insider trading. Further, top executives’ transactions display statistically significant abnormal returns immediately after the insider trading day. This finding indicates that top executives do not refrain from trading based on material non-public information like other officers. During the post-class period, top executives engage in 2,295 insider trading transactions. Profitability of insider trading to top executives continue in the post-event period and reaches up to 44% 250 days after insider trading. Once again, top executives’ transactions display profitability immediately after the insider trading day.

Finally, we can see independent directors’ insider trading in the last three rows. There are 1,903 pre-class period insider trading transactions and their abnormal returns are not statistically different from 0. Hence, independent directors do not profit in the pre-class period. The number of transactions increase up to 3,700 in the class period. Abnormal returns to independent directors reach up to 16% in the 250-day event period. However, independent directors do not attain any significant profitability until about 200 days after the insider trading day. This evidence indicates that independent directors trade intensely based on material non-public information. Independent directors conduct 1,670 transactions in the post-class period. Profitability is fluctuating, yet always positive in this period. Profitability after 200 days is about 9%, after 250 days is about 5%. Moreover, the independent directors’ profits display statistically significant results immediately after the insider trading days. This evidence shows that abnormal profits continue with breaks even after the class period.

Next, we analyze whether the adoption of SOX impacted the trading behavior of the insiders of SCA-settled firms. Table 5A shows abnormal returns from insider trading before enactment of SOX. Hence the analysis period is January 1996 to September 2002 for this table. The number of transactions among insider groups varies from 173 to 1,817. For all three groups, insiders always display profitable trading during the Class Period. All officers earn 33%, top executives earn 48%, while the independent directors earn 23%. All officers and top executives continue to trade during the post Class Periods, while independent directors’ transactions during
the post Class period do not attain statistical significance. This evidence confirms that once again all three groups behave similarly, and earn abnormal trading profits using the inside information regarding the class action lawsuits.

Next we test whether the enactment of SOX made any difference in the behavior of independent directors. Table 5B displays the abnormal returns in the post-SOX period, between September 2002 and December 2017. First we notice that for all three groups of insiders, they all trade the greatest number of transactions during the Class period. For all three groups, the number of transactions during the Class Period, doubles or trebles compared to pre- and post-Class Periods. This evidence indicates that if anything all three groups of insiders have become more aggressive in exploiting their securities-lawsuit related information during the Class Period after the enactment of SOX.

Table 5B shows that abnormal profitability of insider trading continues at high levels even after the passage of SOX. All officers earn 36%, top executives earn 19% while independent directors earn 15% from insider trading during the Class Period after the passage of SOX. Once again, both the abnormal profitability of trading as well as the number of transactions by independent directors follow very similar patterns as those for all officers and top executives. Independent directors behave very similarly to all other top management groups both before and after the passage of SOX. This evidence is consistent with the conclusion that independent directors’ interests continue to appear to be aligned with other members of top management and not with shareholders.

While not shown, we also explore insiders’ purchase and sales transactions separately. Our evidence indicates that overwhelming the majority of insider trading in class-action involved firms come from sales, and not purchases. Furthermore, abnormal profits from insiders’ purchase transactions never attain positive statistical significance for firms involved in class action lawsuits. Instead, all abnormal profitability is restricted to insiders’ sales only. Thus, our evidence indicates that insiders exclusively exploit their negative information regarding the potential lawsuits, sell their own firms’ stock and earn abnormal profits from these sales. Earning abnormal profits from their sales transactions represents a further conflict of interest between shareholders and top management.

As a sensitivity test, we analyze the profitability of insider trading for smaller settlements. Table 6 presents the abnormal profitability of insider trading for settlements between $3 million and $25 million. The evidence shows that profitability is continuing even for smaller settlements. Abnormal profitability of insiders with smaller settlement in the class period is 36%, 19%, and 15% for all officers, top executives, and independent directors, respectively. Comparing abnormal returns of insiders from companies with larger settlements, we observe that profitability of insider trading is somewhat higher for smaller settlement cases. One possible explanation for these results is that insiders may be viewing the costs of profitable trading to be smaller in smaller settlement cases. Consequently, all three groups of insiders are taking more aggressive trading positions to exploit their asymmetric information advantage.
IV. Implications for Improving Corporate Governance

The presence of independent directors on the board has advantages and disadvantages. Some commentators argue that insiders also play a vital role, even considering their lack of independence because they act as a source of important firm-specific information for the board.233 Insider members advise the CEO, and therefore they are the main source of increasing company value. They know activities of company very well and therefore they can increase the company performance. Insiders also have the information, knowledge, and resources that may allow them to more accurately monitor their fellow insiders.234 On the other hand, dependent members are directly involved with daily operational management and related decision-making, and therefore may lack objectivity or worse. The following Part discusses various critiques of the role of independent boards, including the infrequency of judicial findings of liability for failure of oversight, with implications for improving corporate governance.

A. Critiques of Independent Boards

Heavy reliance by independent board members on the insider’s financial analysis is a weakness of the current monitoring model, making supervision more problematic. For example, independent members are less informed than insiders about the firm’s constraints and opportunities.235 The fix is not easy—as independent board members increase their involvement into the operations of a firm, costs will likely increase, eventually making monitoring infeasible. Whether American boards need more independent members, thus, remains unclear.

The CEO’s informal influence over board appointments provides another challenge for board independence. Agency theory claims that as long as CEO is the leader of the board, his or her influence remains high.236 On the other hand, management theory advocates for a single strong leader of the company to assure unity of command at the top.237 Regulatory efforts, such as mandating independent nominating committees, majority voting, and certain changes of proxy access, may reduce the tension between board members and CEO. As mentioned above, both the NYSE and NASDAQ require either firms to appoint a nominating committee or employ a process under which nominations are made by independent members of the boards.238

There is evidence that the number of outsiders on the board increases as the CEO’s influence increases over top management.239 Independent members of the board are also

233 Linck, et al., supra note 70, at 310.
234 Lisa M. Fairfax, supra note 7, at 132.
235 Linck, et al., supra note 70, at 310.
237 Id. at 1083.
238 NYSE LISTED COMPANY MANUAL § 303A.04 (2013).
239 Linck, et al., supra note 70, at 312.
encouraged to meet without managerial members in order to keep managerial influence at minimum.\textsuperscript{240}

Professor Bebchuk, contends that to enhance monitoring of the CEO, it is important to decrease the degree of the CEO’s informal influence over board appointments and make these directors accountable to public investors through improved elections.\textsuperscript{241} Furthermore, in the controlled firms, there are a slightly different set of issues.\textsuperscript{242} Bebchuk further argues that the manner of electing board members decreases the effectiveness of independent director oversight\textsuperscript{243}—because controllers have a strong influence on selection of board candidates, independent members have weighty incentives to support the controller, undermining their strength in conflicted decisions.\textsuperscript{244}

The assumption that independent outside directors will monitor the actions of management to minimize agency costs and maximize shareholder value may find its roots in public perception rather than facts.\textsuperscript{245} The underlying logic behind that notion presupposes that because independent members are less committed to company operations and management, they are not subject to agency problems, and thus they are expected to monitor dependent members.\textsuperscript{246} On the other hand, as the practice demonstrates, they can be passive and ineffective when they lack enough information about company activities\textsuperscript{247} and further, they may hinder efficient operation of board of directors.\textsuperscript{248}

\section*{B. Liability of Independent Directors for Failure of Oversight}

Independent directors are rarely found liable for violation of their oversight duties in either civil or criminal contexts.\textsuperscript{249} And even if independent board members are charged with a violation, because of insurance, indemnification, and statutory protections, their liability rarely leads to out-of-pocket damages.\textsuperscript{250} Given the infrequency of the independent director’s liability, which seems to be a primary motivation for a proper oversight, effectiveness of their monitoring

\begin{thebibliography}{99}
\bibitem{240} Gordon, \textit{supra} note 14, at 1497.
\bibitem{242} NYSE defines a controlled company as a company of which more than 50% of the voting power for the election of its directors is held by a single person, group or another entity. NYSE \textsc{Listed Company Manual} § 303A.00 (2013).
\bibitem{243} Bebchuk & Hamdani, \textit{supra} note 235, at 1274.
\bibitem{244} \textit{Id.}
\bibitem{246} Adams & Ferreira, note 21, at 221-22.
\bibitem{247} See Gordon, \textit{supra} note 14, at 1541 (noting that in one area “[a]s [t]he independents’ information debilities decrease . . . their monitoring advantages become more apparent”).
\bibitem{248} \textit{Id.}
\bibitem{249} See Fairfax, \textit{supra} note 7, at 167-71 (discussing the lack of independent director liability in various contexts).
\bibitem{250} \textit{Id.} at 168.
\end{thebibliography}
activities is questionable. Some authors point out, however, that the threat of increased liability may discourage people from directorships, leading to a lack of well-qualified independent candidates in future. But because government regulators shift significant policing function in hands of independent directors, their least accountable status in corporate law is still concerning.

Potentially, director liability for a breach of the duty to exercise appropriate attention may, in theory, arise in two distinct contexts. As the court in one case explained, “[f]irst, liability may be said to follow from a board decision that results in a loss because that decision was ill advised or ‘negligent.’ Second, liability to the corporation for a loss may be said to arise from an unconsidered failure of the board to act in circumstances in which due attention would, arguably, have prevented the loss.” But the business judgment rule applies to the first group of cases, effectively eviscerating the risk of liability, if the decision made was from a process that was deliberately considered in good faith or rational. Thus, stupid to egregious or irrational decisions provide no ground for director liability under the business judgment rule. The “business judgment rule is process oriented and informed by a deep respect for all good faith board decisions.”

Thus, where a director exercises a good faith effort, in fact, to be both informed and enable them to exercise appropriate judgment, this satisfies the duty of care. If shareholders are not satisfied with the judgment, as the court in In re Caremark International Inc. Derivative Litigation noted, that is a past problem; they “should have elect other directors.” Thus, the “core element” of any corporate law duty of care inquiry is whether a good faith effort was made to be informed and exercise appropriate judgment.

The court went on to note that the “second class of cases in which director liability for inattention is theoretically possible entail circumstances in which a loss arises not from a decision but, from unconsidered inaction.” In this case, the court held that without some reason to suspect deceit, corporate boards and senior officers cannot be charged with any wrongdoings only because they assumed the integrity and honesty of employees that were acting on the company’s behalf. The court, at the same time, declined to accept the view that a corporate board does not have any responsibility to assure that appropriate information and reporting systems are put in place by management.

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253 Id.
254 Id.
255 Id.
256 Id. at 967-68.
257 Id. 968.
258 Id.
259 Id.
260 Id.
261 Id. at 969.
262 Id. at 969-70.
The level of detail appropriate for these information system is analyzed as business judgment decision, as the court noted. And the court held further that “no rationally designed information and reporting system will remove the possibility that the corporation will violate laws or regulations, or that senior officers or directors may nevertheless sometimes be misled or otherwise fail reasonably to detect acts material to the corporation's compliance with the law.” The board must, therefore, “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 information will come to its attention in a timely manner as a matter of ordinary operations, so that it may satisfy its responsibility.”

In In re Walt Disney Co. Derivative Litigation, the court noted that the presumptions that:

“[I]n making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company” can be rebutted if the plaintiff shows that the directors breached their fiduciary of loyalty or acted in bad faith. If that is shown, the burden then shifts to the director defendants to demonstrate that the challenged act or transaction was entirely fair to the corporation and its shareholders.

Later, in Stone v. Ritter, the court noted that the phrase in case law, which describes an absence of good faith as a “necessary condition to liability,” is intentional. The court further explained:

[the purpose of that formulation is to communicate that a failure to act in good faith is not conduct that results, ipso facto, in the direct imposition of fiduciary liability. The failure to act in good faith may result in liability because the requirement to act in good faith “is a subsidiary element” i.e., a condition, “of the fundamental duty of loyalty.”] It follows that because a showing of bad faith conduct, in the sense described in Disney and Caremark, is essential to establish director oversight liability, the fiduciary duty violated by that conduct is the duty of loyalty.

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263 Id. at 970.
264 Id.
265 Id. at 970.
266 In re Walt Disney, 906 A.2d 27, 52 (Del. 2006).
268 911 A.2d 362 (Del. 2006).
269 Id. at 364 (quoting In re Caremark Int'l Inc. Deriv. Litig., 698 A.2d 959 (Del.Ch.1996)).
270 Id. at 369.
271 Id. at 369-70.
Thus, the duty to act in good faith does not result in separate fiduciary duty.\textsuperscript{272} Only violations of duties of care and loyalty may lead directly to liability; an absence of good faith may do so as well, but more indirectly.\textsuperscript{273}

Therefore, the \textit{Ritter} court concluded, that the necessary conditions for director oversight liability include the following: “(a) the directors utterly failed to implement any reporting or information system or controls; \textit{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.”\textsuperscript{274} For both of these tests, imposing liability requires showing directors knew that they failing to meet their fiduciary duties.\textsuperscript{275} If directors do not act when they know they have a duty to do so, \textit{they} fail to discharge their fiduciary obligations in good faith and thus breach their duty of loyalty.\textsuperscript{276}

In \textit{Horman v. Abney},\textsuperscript{277} also known as the \textit{UPS} case, shareholders brought a derivative action against board members of UPS, alleging that UPS breached their duty of loyalty by knowing failure of monitoring and managing UPS's compliance with state and federal laws concerning delivery and transportation of cigarettes, seeking to recover losses borne by the company from pending enforcement action that arose out of this breach of duty.\textsuperscript{278} The court explained that the \textit{Caremark} liability standard for violating a duty to actively monitor corporate affairs is very much related to a director’s failure to act in good faith.\textsuperscript{279} Therefore, the court held to plead a claim under \textit{Caremark}, the facts pled by the plaintiff must give rise to, or at least allow, a reasonable inference that a director acted in contradiction to his or her fiduciary duties, and knew he or she was acting in contradiction to such duties.\textsuperscript{280}

The \textit{UPS} court further stated, however, that even if directors their oversight responsibilities in good faith, this does not mean that employees will not commit crimes, or that employees will not cause the corporation to sustain substantial financial liability.\textsuperscript{281} Accordingly, Delaware courts routinely reject the argument just that because there was an incident of illegal behavior, internal controls must have been insufficient, and the board must have had knowledge of this.\textsuperscript{282} Rather, a plaintiff must “plead with particularity” about how the illegal corporate conduct is related to the board’s actions.\textsuperscript{283}

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{272} \textit{Id.} at 370.
\item \textsuperscript{273} \textit{Id.}
\item \textsuperscript{274} \textit{Id.}
\item \textsuperscript{275} \textit{Id.}
\item \textsuperscript{276} \textit{Id.}
\item \textsuperscript{277} No. CV 12290-VCS, 2017 WL 242571, at *1 (Del. Ch. Jan. 19, 2017).
\item \textsuperscript{278} \textit{Id.}
\item \textsuperscript{279} \textit{Id.} at *7 (quoting Stone ex rel. AmSouth Bancorporation v. Ritter, 911 A.2d 362, 369-70 (Del. 2006)).
\item \textsuperscript{280} \textit{Id.} (quoting \textit{In re Massey Energy Co.}, 2011 WL 2176479, at *22 (Del. Ch. May 31, 2011)).
\item \textsuperscript{281} \textit{Id.} (quoting Stone, 911 A.2d at 373).
\item \textsuperscript{282} \textit{Id.} (quoting Desimone v. Barrows, 924 A.2d 908, 939, 940 (Del. Ch. 2007)).
\item \textsuperscript{283} \textit{Id.} (quoting 38 La. Mun. Police Empls.’ Ret. Sys. v. Pyott, 46 A.3d 313, 340 (Del. Ch. 2012), rev’d on other grounds, 74 A.3d 612 (Del. 2013)).
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Explaining the first Caremark prong, the court held that “the board cannot be held liable for breaching its duty, under the first prong of Caremark, unless it can be proven that its members ‘utterly failed to implement any reporting or information systems or controls.’”\(^\text{284}\) It is not a Caremark claim to show that a system that was implemented with care and seemed to be working well just failed to detect some fraud that occurred.\(^\text{285}\) In this case, as the court stated, “[a]t best, the [c]omplaint might support an inference that employees charged with the responsibility to implement UPS's oversight systems failed to report issues to the board. That is not enough to sustain a Caremark claim.”\(^\text{286}\)

The only way liability could be established in such a case is if the plaintiff shows that the board knew of corporate misconduct but consciously disregarded its duty to address this misconduct, thereby acting in bad faith.\(^\text{287}\) In this context, “bad faith means ‘the directors were conscious of the fact that they were not doing their jobs, and that they ignored red flags indicating misconduct in defiance of their duties.’”\(^\text{288}\) However, typically:

\[^{289}\]The red flag analogy depicts events or reports that serve as warning signs to the Board of corporate wrongdoing after a system of reporting and compliance is in place. These red flags put the board on notice that the system is not working properly. If the members of the board become aware of the red flags and do nothing in response, and thereby consciously disregard their fiduciary duties, then they are individually subject to liability for a failure of oversight.

Thus, under the second prong of Caremark, the question is whether the board knew of these red flags and then whether the board attempted to address these red flags.\(^\text{290}\)

In In re Citigroup, the court held that:

\[^{291}\]There are significant differences between failing to oversee employee fraudulent or criminal conduct and failing to recognize the extent of a company's business risk. Directors should, indeed must under Delaware law, ensure that reasonable information and reporting systems exist that would put them on notice of fraudulent or criminal conduct within the company. Such oversight programs allow directors to intervene and prevent frauds or other wrongdoing that could expose the company to risk of loss as a result of such conduct.

\(^{284}\) Id. at *9 (quoting Stone 911 A.2d at 370).

\(^{285}\) Id. (quoting David B. Shaev Profit Sharing Account v. Armstrong, 2006 WL 391931, at *5 (Del. Ch. Feb. 13, 2006)).

\(^{286}\) Id. at 10.

\(^{287}\) Id. (quoting Reiter v. Fairbank, 2016 WL 6081823, at *8 (Del. Ch. Oct. 18, 2016)).

\(^{288}\) Id. (quoting David B. Shaev Profit Sharing Account v. Armstrong, 2006 WL 391931, at *5 (Del. Ch. Feb. 13, 2006)).

\(^{289}\) Id. at 11 (citing South v. Baker, 62 A.3d 1, 15 (Del. Ch. 2012)).

\(^{290}\) Id. at 14.

More recently, the court in *Reiter v. Fairbank*, held that “imposing Caremark-type duties on directors to monitor business risk is fundamentally different from imposing on directors a duty to monitor fraud and illegal activity.”292 The case here involved an allegation that the “directors breached their fiduciary duty of loyalty by consciously disregarding their responsibility to oversee Capital One’s compliance with the Bank Secrecy Act and other anti-money laundering laws ‘(BSA/AML’).”293 Allegedly, these directors ignored the red flags were related to this compliance, and the plaintiff alleged certain inadequacies in provision of the services which in turn, allegedly exposed the bank to liability for money-laundering activities.294

The court held, however, that directors, while acting in good faith, cannot always prevent employees’ wrongdoings, and therefore, a plaintiff asserting a Caremark claim must demonstrate “a sufficient connection between the corporate trauma and the board.”295 To show such connection, the board must have known the evidence of corporate misconduct, and yet consciously disregarded its duty to address that wrongdoing.296 According to the court, the directors did not violate their fiduciary duties because the evidence involved at best yellow flags, and the plaintiff failed to show that "defendants consciously allowed Capital One to violate the law so as to sustain a finding they acted in bad faith."297

**Recommendations and Conclusion**

Currently, the reliance in corporate law on the role of independent directors to serve as gatekeepers in their monitoring role over management, is flawed. Our empirical study provides new evidence that not only may independent directors be ill-equipped to engage in serious oversight of the activities of management, they may also be easily co-opted when they have the opportunity to personally participate in self-interested transactions to the detriment of the shareholders. Our current study provides evidence that independent directors are not likely immune from the temptation to profit from insider trading and especially insider selling. Our prior research also demonstrated that they are similarly likely to manipulate stock option compensation when the opportunity arose.298 And as described above in Part II, numerous other empirical studies have been critical of the ability of independent directors to effectively serve a monitoring function. Moreover, the current legal doctrines providing deference to independent directors appear not to offer much in the way of a check on their behavior. Finally, even the

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293 *Id.*
294 *Id.*
296 *Id.* at *8.*
297 *Id.* at *14.*
definition of an independent director appears ineffective for avoiding conflicts of interest which arise from personal and social relationships.

Thus, independent status is not a sufficient condition for the proper monitoring. The informed oversight of management may also depend on other characteristics, necessary for the performance of director’s functions, such as experience in the firm’s industry. One should not lean toward the other extreme, however, and mandate the experience as a prerequisite to the directorship. As the drafters of the Principles correctly point out “some of the best ideas, insights and contributions can come from directors whose professional experiences are not directly related to the company’s business.”

But industry background may be particularly helpful in curtailing of corporate fraud, allowing independent members to catch certain red flags or inconsistencies in the company’s performance that may not be apparent to the industry outsider. The director’s experience may also deter management from manipulating and misleading the boards, given the high probability of getting caught.

In addition, the current disclosure model has a significant flaw—companies do not explain in detail their reasoning to their shareholders and the market, nor justify the designation of a director as independent and disclose information they considered during their deliberations. The current disclosure requirements by the SEC about independence designations are incomplete as well. Because of this, Aaron Nili calls for an enhanced disclosure system, mandating the entire set of information that the company relied on in making their judgment about a director’s independence, allowing its shareholders and outsiders to subsequently check their designations. As a 2015 survey of institutional investors found, 62% of respondents read the director independence section of the proxy statement before voting. In conjunction with the severe liability for a director for failure to disclose certain connections that a court later finds to be material, making public all available information, including facts submitted by the board candidate, may lead to a more scrutinized nomination process, reducing a firm’s discretion, and increase shareholders’ awareness of certain nuances, surrounding a candidate’s connectedness to the management, to provide for a fully informed vote.

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299 Principles, supra note 193, at 1.
300 Nili, supra note 19, at 40.
301 Id. at 71. Nili provides the following reasons for the lacking system:
   First, companies are only required to disclose what they considered as potentially material information. Second, companies can escape the need to provide detailed information by adopting categorical standards to assist them in making determinations of independence and then may make only a general disclosure if a director meets these standards. Third, currently a company can report different information about the director in various locations in its filing—making it harder for shareholders to easily review the information. Finally, many companies provide no information to shareholders, potentially violating the current disclosure regime, but these practices are not enforced by the SEC.

302 Id.
303 Id. at 46.
An enhanced disclosure system may, however, create a certain chilling effect of the willingness of future candidates to become directors on the board. But because the disclosures need ask only for facts, revealing the connections to the firm, if directors have something to hide, then as Nili argues, perhaps the chilling effect would be a positive development.\(^\text{304}\)

We also recommend a more nuanced definition of independence of independent directors. A director should be banned from serving as an independent director by the stock exchanges and SEC if a director fails to reveal a relationship, later found to be material by a court. The prospect of liability and reputational risks will provide a director an extra incentive to over-disclosure, particularly one’s social and casual connections to the company and its insiders. In addition, we agree with the eBay and Oracle contextual analyses of independence.\(^\text{305}\) Even if a director passes a general test of independence, independence must be determined, case by case, in the context of the events litigated.

Finally, as proposed in our prior work,\(^\text{306}\) we continue to recommend more power be given to the shareholders to act as corporate monitors. These recommendations include eliminating shareholder multi-class voting structures, making shareholder resolutions binding, eliminating plurality voting for board membership and replacing this with majority voting and requiring companies to set up secure websites to allow shareholders to review corporate issues and vote their choices.\(^\text{307}\) Of course, we realize that many shareholders do not care to participate in corporate governance. Yet, there are institutional and activist shareholders who do care and the current regime does not provide for a full opportunity for their voices to be heard.

\(^{304}\) Id. at 75.

\(^{305}\) See Dana M. Muir & Cindy A. Schipani, Fiduciary Constraints, Correlating Obligations with Liability, 42 Wake Forest L. Rev. 697, 736-38 (2007) (discussing the contextual approach of the Delaware courts in the eBay and Oracle cases).

\(^{306}\) Avci et al., supra note 298.

\(^{307}\) Id.
Table 1
Sample Characteristics of Insider Trading in All Firms (1975 to 2017)

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<td>864,635</td>
<td>596,265</td>
<td>2,893,861</td>
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<tr>
<td>is more than $5 Billion</td>
<td>13,217</td>
<td>14,811</td>
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<tr>
<td>Average Trade Size (Shares)</td>
<td>2,651</td>
<td>521</td>
<td>964</td>
<td>4,136</td>
<td>7,049</td>
<td>5,022</td>
<td>4,142</td>
<td>16,213</td>
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<td>Total Shares Traded by Officers and Directors (Million)</td>
<td>2,891</td>
<td>409</td>
<td>163</td>
<td>3,463</td>
<td>5,712</td>
<td>3,352</td>
<td>4,002</td>
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<td>Total Shares Traded by Top Executives (Million)</td>
<td>5,127</td>
<td>478</td>
<td>236</td>
<td>5,841</td>
<td>5,300</td>
<td>3,786</td>
<td>3,243</td>
<td>12,329</td>
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<td>Total Shares Traded by Independent Directors (Million)</td>
<td>10,669</td>
<td>1,408</td>
<td>1,363</td>
<td>13,340</td>
<td>18,061</td>
<td>12,160</td>
<td>11,387</td>
<td>41,608</td>
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<th>150-days</th>
<th>200-days</th>
<th>250-days</th>
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<tbody>
<tr>
<td>Officers (except Independent Directors)</td>
<td>1,423,271</td>
<td>0.44% (4.41)</td>
<td>0.69% (4.91)</td>
<td>1.50% (6.71)</td>
<td>2.37% (7.49)</td>
<td>2.86% (7.35)</td>
<td>3.35% (7.46)</td>
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<tr>
<td>Top Executives</td>
<td>1,316,440</td>
<td>0.70% (6.78)</td>
<td>1.00% (6.86)</td>
<td>1.80% (7.77)</td>
<td>2.88% (8.79)</td>
<td>3.62% (9.00)</td>
<td>4.20% (8.99)</td>
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<td>Independent Directors</td>
<td>1,091,776</td>
<td>0.65% (6.82)</td>
<td>0.90% (6.64)</td>
<td>1.57% (7.30)</td>
<td>2.34% (7.65)</td>
<td>2.83% (7.51)</td>
<td>3.26% (7.49)</td>
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*Bold are statistically significant at the 5% level or better*
Table 3
Sample Characteristics of Insider Trading in Firms with Securities Fraud Settlements (1996 to 2017)

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<thead>
<tr>
<th></th>
<th>Small-Cap Firms</th>
<th>Mid-Cap Firms</th>
<th>Large-Cap Firms</th>
<th>All Purchase Firms</th>
<th>Small-Cap Firms</th>
<th>Mid-Cap Firms</th>
<th>Large-Cap Firms</th>
<th>All Sale Firms</th>
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<td>Number of Firms</td>
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<td>43</td>
<td>53</td>
<td>115</td>
<td>33</td>
<td>45</td>
<td>54</td>
<td>132</td>
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<td>Length of Class Period (Days)</td>
<td>501</td>
<td>686</td>
<td>591</td>
<td>611</td>
<td>431</td>
<td>654</td>
<td>583</td>
<td>569</td>
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<td>Average Settlement ($Mill.)</td>
<td>65.9</td>
<td>107.1</td>
<td>253.0</td>
<td>167.5</td>
<td>179.7</td>
<td>115.3</td>
<td>275.0</td>
<td>196.7</td>
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<tr>
<td>Number of Insider Trades</td>
<td>927</td>
<td>992</td>
<td>1074</td>
<td>2,993</td>
<td>2,313</td>
<td>14,014</td>
<td>15,393</td>
<td>31,720</td>
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<td>Average Trade Size (Shares)</td>
<td>17,522</td>
<td>25,509</td>
<td>46,875</td>
<td>34,036</td>
<td>11,601</td>
<td>10,654.6</td>
<td>31,565.9</td>
<td>19,445.8</td>
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<td>Total Shares Traded by Officers (Million)</td>
<td>10.2</td>
<td>9.5</td>
<td>19.0</td>
<td>38.7</td>
<td>8.6</td>
<td>65.0</td>
<td>132.0</td>
<td>205.6</td>
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<td>Total Shares Traded by Top Executives (Million)</td>
<td>4.5</td>
<td>8.6</td>
<td>12.1</td>
<td>25.2</td>
<td>9.7</td>
<td>53.0</td>
<td>228.7</td>
<td>291.4</td>
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<tr>
<td>Total Shares Traded by Independent Directors (Million)</td>
<td>1.6</td>
<td>7.2</td>
<td>19.3</td>
<td>28.1</td>
<td>8.4</td>
<td>31.3</td>
<td>125.2</td>
<td>164.9</td>
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<tr>
<td>Total Shares Traded (Million)</td>
<td>16.3</td>
<td>25.3</td>
<td>50.4</td>
<td>92.0</td>
<td>26.7</td>
<td>149.3</td>
<td>485.9</td>
<td>661.9</td>
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<tr>
<td>Market Capitalization is less than $1 Billion</td>
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<tr>
<td>Market Capitalization is between $1 Billion and $5 Billion</td>
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<tr>
<td>Market Capitalization is more than $5 Billion</td>
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<td></td>
<td></td>
</tr>
<tr>
<td></td>
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<td>50-days</td>
<td>100-days</td>
<td>150-days</td>
<td>200-days</td>
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</tr>
<tr>
<td><strong>Officers - Before Class Period</strong></td>
<td>4,656</td>
<td>0.91%</td>
<td>0.45%</td>
<td>0.04%</td>
<td>-1.73%</td>
<td>-1.62%</td>
<td>-3.48%</td>
<td>-1.94%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(1.16)</td>
<td>(0.40)</td>
<td>(0.02)</td>
<td>(-0.70)</td>
<td>(-0.53)</td>
<td>(-0.99)</td>
<td>(-0.50)</td>
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<tr>
<td><strong>Officers - During Class Period</strong></td>
<td>6,747</td>
<td>1.28%</td>
<td><strong>2.19%</strong></td>
<td><strong>5.43%</strong></td>
<td><strong>11.12%</strong></td>
<td><strong>20.58%</strong></td>
<td><strong>28.09%</strong></td>
<td><strong>35.05%</strong></td>
</tr>
<tr>
<td></td>
<td></td>
<td>(1.63)</td>
<td>(1.98)</td>
<td>(3.10)</td>
<td>(4.49)</td>
<td>(6.78)</td>
<td>(8.02)</td>
<td>(8.95)</td>
</tr>
<tr>
<td><strong>Officers - After Class Period</strong></td>
<td>1,424</td>
<td>1.16%</td>
<td>1.35%</td>
<td>2.71%</td>
<td><strong>11.45%</strong></td>
<td><strong>16.48%</strong></td>
<td><strong>23.58%</strong></td>
<td><strong>31.26%</strong></td>
</tr>
<tr>
<td></td>
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<td>(1.66)</td>
<td>(1.37)</td>
<td>(1.75)</td>
<td>(5.20)</td>
<td>(6.11)</td>
<td>(7.57)</td>
<td>(8.97)</td>
</tr>
<tr>
<td><strong>Top Executives - Before Class Period</strong></td>
<td>3,464</td>
<td>-0.01%</td>
<td>-0.97%</td>
<td>-0.15%</td>
<td>0.76%</td>
<td>3.77%</td>
<td>0.32%</td>
<td>4.94%</td>
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<td>(-0.01)</td>
<td>(-0.83)</td>
<td>(-0.08)</td>
<td>(0.29)</td>
<td>(1.18)</td>
<td>(0.09)</td>
<td>(1.20)</td>
</tr>
<tr>
<td><strong>Top Executives - During Class Period</strong></td>
<td>6,485</td>
<td>2.00%</td>
<td><strong>4.41%</strong></td>
<td><strong>7.50%</strong></td>
<td><strong>10.37%</strong></td>
<td><strong>17.64%</strong></td>
<td><strong>21.86%</strong></td>
<td><strong>23.14%</strong></td>
</tr>
<tr>
<td></td>
<td></td>
<td>(1.92)</td>
<td>(3.00)</td>
<td>(3.23)</td>
<td>(3.15)</td>
<td>(4.38)</td>
<td>(4.71)</td>
<td>(4.45)</td>
</tr>
<tr>
<td><strong>Top Executives - After Class Period</strong></td>
<td>2,295</td>
<td><strong>2.63%</strong></td>
<td><strong>1.87%</strong></td>
<td><strong>4.74%</strong></td>
<td><strong>16.04%</strong></td>
<td><strong>23.59%</strong></td>
<td><strong>32.66%</strong></td>
<td><strong>43.77%</strong></td>
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<td>(5.44)</td>
<td>(2.74)</td>
<td>(4.42)</td>
<td>(10.48)</td>
<td>(12.62)</td>
<td>(15.13)</td>
<td>(18.08)</td>
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<tr>
<td><strong>Independent Directors - Before Class Period</strong></td>
<td>1,903</td>
<td>-0.03%</td>
<td>-0.12%</td>
<td>-0.22%</td>
<td>-2.15%</td>
<td>-2.04%</td>
<td>-0.86%</td>
<td>-0.96%</td>
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<td>(-0.35)</td>
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<td><strong>Independent Directors - During Class Period</strong></td>
<td>3,700</td>
<td>1.09%</td>
<td>1.11%</td>
<td>2.19%</td>
<td>3.17%</td>
<td>5.01%</td>
<td><strong>14.45%</strong></td>
<td><strong>16.42%</strong></td>
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<td>(1.18)</td>
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<td>(3.00)</td>
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<td><strong>Independent Directors - After Class Period</strong></td>
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<td><strong>2.93%</strong></td>
<td>1.59%</td>
<td>1.64%</td>
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<td>(0.52)</td>
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<td>(2.17)</td>
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*Bold are statistically significant at the 5% level or better*
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<th>20-days</th>
<th>50-days</th>
<th>100-days</th>
<th>150-days</th>
<th>200-days</th>
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<tbody>
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<td><strong>Officers-Before Class Period</strong></td>
<td>1,817</td>
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<td>(6.74)</td>
<td>(6.86)</td>
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<td>(8.90)</td>
<td>(9.69)</td>
<td>(10.78)</td>
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<td>(2.96)</td>
<td>(2.56)</td>
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<td><strong>Top Executives-Before Class Period</strong></td>
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<td>14.86%</td>
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<td>(5.22)</td>
<td>(8.18)</td>
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<td><strong>Top Executives-After Class Period</strong></td>
<td>524</td>
<td>2.11%</td>
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<td>-0.81%</td>
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<td>(4.35)</td>
<td>(4.97)</td>
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<td><strong>Independent Directors-Before Class Period</strong></td>
<td>887</td>
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<td>(-1.49)</td>
<td>(-1.16)</td>
<td>(-0.73)</td>
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<td><strong>Independent Directors-During Class Period</strong></td>
<td>468</td>
<td>2.56%</td>
<td>4.40%</td>
<td>7.43%</td>
<td>6.63%</td>
<td>13.99%</td>
<td>14.73%</td>
<td>22.84%</td>
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<tr>
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<td>(2.86)</td>
<td>(3.48)</td>
<td>(3.71)</td>
<td>(2.34)</td>
<td>(4.03)</td>
<td>(3.68)</td>
<td>(5.09)</td>
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<td>-15.75%</td>
<td>-7.71%</td>
<td>0.12%</td>
<td>3.96%</td>
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<td>(0.34)</td>
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*Bold are statistically significant at the 5% level or better*
### Table 5B

Inspectors’ Abnormal Profits in Firms Subject to Securities Fraud Lawsuits that Resulted in Settlements Exceeding $25 Million between 2002 and 2017 (Post-SOX)

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<th>150-days</th>
<th>200-days</th>
<th>250-days</th>
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<td><strong>Officers-Before Class Period</strong></td>
<td>2,839</td>
<td>1.12%</td>
<td>1.66%</td>
<td>-0.17%</td>
<td>-4.01%</td>
<td>-5.40%</td>
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<td><strong>Officers-During Class Period</strong></td>
<td>5,212</td>
<td>0.86%</td>
<td>1.14%</td>
<td>4.27%</td>
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<td>20.43%</td>
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<td>(0.86)</td>
<td>(0.81)</td>
<td>(1.92)</td>
<td>(3.24)</td>
<td>(5.29)</td>
<td>(6.40)</td>
<td>(7.16)</td>
<td></td>
</tr>
<tr>
<td><strong>Officers-After Class Period</strong></td>
<td>1,251</td>
<td>0.21%</td>
<td>-0.14%</td>
<td>1.33%</td>
<td>10.77%</td>
<td>16.35%</td>
<td>23.83%</td>
<td>31.59%</td>
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<tr>
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<td>(-0.13)</td>
<td>(0.79)</td>
<td>(4.47)</td>
<td>(5.54)</td>
<td>(6.99)</td>
<td>(8.28)</td>
<td></td>
</tr>
<tr>
<td><strong>Top Executives-Before Class Period</strong></td>
<td>2,245</td>
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<td>-0.18%</td>
<td>-1.02%</td>
<td>-2.72%</td>
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<td>-5.11%</td>
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<td>(-1.12)</td>
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<td>4.01%</td>
<td>7.08%</td>
<td>9.61%</td>
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<td>19.54%</td>
<td>18.97%</td>
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<td>(2.64)</td>
<td>(2.54)</td>
<td>(3.40)</td>
<td>(3.65)</td>
<td>(3.16)</td>
<td></td>
</tr>
<tr>
<td><strong>Top Executives-After Class Period</strong></td>
<td>1,771</td>
<td>2.79%</td>
<td>2.11%</td>
<td>6.37%</td>
<td>18.58%</td>
<td>23.76%</td>
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<td>45.46%</td>
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<tr>
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<td>(3.75)</td>
<td>(2.00)</td>
<td>(3.83)</td>
<td>(7.89)</td>
<td>(8.26)</td>
<td>(10.09)</td>
<td>(12.22)</td>
<td></td>
</tr>
<tr>
<td><strong>Independent Directors-Before Class Period</strong></td>
<td>1,016</td>
<td>0.12%</td>
<td>0.16%</td>
<td>1.05%</td>
<td>-0.41%</td>
<td>0.49%</td>
<td>2.27%</td>
<td>0.94%</td>
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<td>(0.16)</td>
<td>(0.67)</td>
<td>(-0.19)</td>
<td>(0.18)</td>
<td>(0.73)</td>
<td>(0.27)</td>
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</tr>
<tr>
<td><strong>Independent Directors-During Class Period</strong></td>
<td>3,232</td>
<td>0.88%</td>
<td>0.63%</td>
<td>1.42%</td>
<td>2.67%</td>
<td>3.71%</td>
<td>14.40%</td>
<td>15.49%</td>
</tr>
<tr>
<td></td>
<td>(0.70)</td>
<td>(0.35)</td>
<td>(0.51)</td>
<td>(0.68)</td>
<td>(0.77)</td>
<td>(2.58)</td>
<td>(2.48)</td>
<td></td>
</tr>
<tr>
<td><strong>Independent Directors-After Class Period</strong></td>
<td>1,550</td>
<td>2.78%</td>
<td>3.24%</td>
<td>2.47%</td>
<td>2.99%</td>
<td>9.80%</td>
<td>10.32%</td>
<td>5.42%</td>
</tr>
<tr>
<td></td>
<td>(2.67)</td>
<td>(2.20)</td>
<td>(1.06)</td>
<td>(0.90)</td>
<td>(2.43)</td>
<td>(2.22)</td>
<td>(1.04)</td>
<td></td>
</tr>
</tbody>
</table>

*Bold are statistically significant at the 5% level or better*
### Table 6

Insiders' Abnormal Profits in Firms Subject to Securities Fraud Lawsuits that Resulted in Settlements Between $3 Million and $25 Million between 1996 and 2017.

<table>
<thead>
<tr>
<th>Number of Observations</th>
<th>10-days</th>
<th>20-days</th>
<th>50-days</th>
<th>100-days</th>
<th>150-days</th>
<th>200-days</th>
<th>250-days</th>
</tr>
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<tbody>
<tr>
<td>All Officers-Before Class Period</td>
<td>2,839</td>
<td>1.12%</td>
<td>1.66%</td>
<td>-0.17%</td>
<td>-4.01%</td>
<td>-5.40%</td>
<td>-8.29%</td>
</tr>
<tr>
<td></td>
<td>(0.97)</td>
<td>(1.02)</td>
<td>(-0.07)</td>
<td>(-1.10)</td>
<td>(-1.21)</td>
<td>(-1.61)</td>
<td>(-1.29)</td>
</tr>
<tr>
<td>All Officers-During Class Period</td>
<td>5,212</td>
<td>0.86%</td>
<td>1.14%</td>
<td>4.27%</td>
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<td>20.43%</td>
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