GROUPTHINK AND CORPORATE GOVERNANCE REFORM: CHANGING THE FORMAL AND INFORMAL DECISIONMAKING PROCESSES OF CORPORATE BOARDS

ANDREW HOWARD*

Our job is to set a tone at the top to incent people to do the right thing and to set up safety nets to catch people who make mistakes or do the wrong thing and correct those as quickly as possible. And it is working. It is working.
—Charles O. Prince III, Citigroup's chief executive, in 2006[1]

I. INTRODUCTION

The current mortgage crisis has led to drastically increasing foreclosure rates, corporate bankruptcies, and job layoffs.[2] In response to the real estate "boom" and government deregulation of the banking industry,[3] lenders took a more "creative" approach by offering high-interest subprime mortgage loans.[4] In addition, many lenders relied solely on third-party credit ratings in determining loan eligibility, as opposed to a more complete loan qualification procedure.[5] When the bubble burst, real estate prices dropped, homeowners with adjustable rate mortgages were unable to make payments, foreclosures drastically increased, and a lack of buyers caused monumental losses for lenders.[6] The United States has seen bubbles burst in its recent past, yet people were still surprised by the most recent crisis

* Class of 2011, University of Southern California Gould School of Law; B.S. Psychology 2006, University of Arizona. Special thanks to Professor Gillian Hadfield for her helpful guidance.

1 Eric Dash & Julie Creswell, *Citigroup Pays for a Rush to Risk*, N.Y. TIMES, Nov. 23, 2008, at A1.

2 *See e.g.*, *Testimony of John C. Dugan, Comptroller of the Currency, Before the S. Comm. on Banking, Hous., and Urban Affairs*, 110th Cong. 8–12 (2008); *Statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation, on the State of the Banking Industry Before the S. Comm. on Banking, Hous., and Urban Affairs*, 110th Cong. 5–6 (2008).

3 *See* Dash & Creswell, *supra* note 1.

4 The Securities and Exchange Commission described a subprime mortgage loan as "a mortgage loan that does not conform to the underwriting standards required for sale to the government sponsored enterprises (non-conforming loans) and are made to borrowers who: (1) have weakened credit histories such as payment delinquencies, charge-offs, judgments, and bankruptcies; (2) have reduced repayment capacity as measured by credit scores (e.g., FICO), debt-to-income ratios, loan-to-value rations, or other criteria; (3) have not provided documentation to verify all or some of the information, particularly financial information, in their loan applications; or (4) have any combination of these factors." *17 CFR Parts 240 & 249(b), Proposed Rules for Nationally Recognized Statistical Rating Organizations*, SECURITIES AND EXCHANGE COMMISSION 3 (2008), http://www.sec.gov/rules/proposed/2008/34-57967.pdf (emphasis omitted).

5 *See* Kurt Eggert, *The Great Collapse: How Securitization Caused the Great Subprime Meltdown*, 41 CONN. L. REV. 1257, 1285 (2009).

6 *See* Gary Klein & Shennan Kavanagh, *Causes of the Subprime Foreclosure Crisis and the Availability of Class Action Responses*, 2 NE. U. L.J. 137, 137–38 (2010).

because government regulations were supposed to prevent a crisis of that magnitude.

In the aftermath of the collapse of Enron and the dot-com and telecommunications ("telecom") bubbles, the government acted swiftly to pass a corporate governance regulatory statute: the Sarbanes-Oxley Act.[7] While the Act may have been created with good intentions, it was passed without much debate, and ultimately it was criticized because it is a "sparsely worded law [that] is both poorly written and hastily put together so there's little to go on when it comes to interpreting some of its murkier provisions."[8] During and following the passage of the Sarbanes-Oxley Act, a new real estate bubble began to grow and the risks associated with past bubbles began to rear their ugly heads. Management and the board of directors of the biggest and most successful financial institutions ignored increasing risks and waged forward, overlooking many warning signs.[9] When the bubble finally burst, the ensuing crisis was similar to crises in the past, except that the failing companies were so large that they drastically affected the entire economy, causing a widespread crisis felt by the majority of the country.

Politicians, scholars, and the public were left asking the same questions: How could this happen and how do we make sure it never happens again? Why did the executives and directors of financial institutions let this happen? Why were the risk management procedures insufficient? Could the government have stepped in to regulate this high-risk situation before it came crashing down?

The psychological phenomenon of "groupthink" may provide answers to these questions. Groupthink refers to "the mode of thinking that persons engage in when *concurrence-seeking* becomes so dominant in a cohesive ingroup that it tends to override realistic appraisal of alternative courses of action."[10] This Note will analyze how groupthink negatively affects corporate directors' risk-taking decisions and the shortcomings of current corporate governance regulations and suggest possible regulations that would insulate corporate directors' informal decisionmaking processes from being hindered by groupthink.

Part II will explain Janis's basic conception of groupthink, the antecedent conditions that give rise to groupthink, and the symptoms that negatively affect group decisionmaking under the influence of groupthink. Part III will consider the dot-com and telecom failures, the Enron scandal, and the role groupthink played among the decisionmakers of each. Next, Part IV will discuss the government's response to the burst bubbles and corporate scandals of the 1990s and early 2000s—the Sarbanes-Oxley Act. This part will focus primarily on the Act's major deficiencies: its failure to address the formal and informal decisionmaking processes shared among directors of large corporations, as well as its failure to recognize the

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[7] *See* Ken Fireman et al., *Taking It to Wall Street: Bush Vows Tougher Penalties Against Corporate Fraud, but Dems Unimpressed*, NEWSDAY, July 10, 2002, at A03.
[8] Renee Deger, *New Law Has Corporate Lawyers Scrambling*, THE RECORDER, Aug. 13, 2002, at 1.
[9] *See* Dash & Creswell, *supra* note 1, at A1.
[10] Irving L. Janis, *Groupthink*, PSYCHOL. TODAY MAG., Nov. 1971, 84.

directors' susceptibility to groupthink. Part V will discuss the current financial crisis and highlight the groupthink that took place within one of the largest failed financial institutions in the country, Citigroup. The prevalence of groupthink among Citigroup decisionmakers highlights the Sarbanes-Oxley Act's failure to deter poor decisionmaking among corporate directors. Part VI will suggest a new form of corporate governance reform that affects the formal structure of boards of directors and their informal decisionmaking processes.

II. GROUPTHINK

Irving Janis developed the theory of groupthink in the early 1970s to help explain how the United States' decisionmakers led the country into major fiascos, such as the Bay of Pigs, the "failure to be prepared for the attack on Pearl Harbor, the Korean War stalemate, and the escalation of the Vietnam War."[11] At its core, groupthink is the phenomenon that occurs when a cohesive group that lacks a consistent and deliberate decisionmaking process must make important decisions under stressful circumstances.[12] Janis uses the term to "refer to the mode of thinking that persons engage in when *concurrence-seeking* becomes so dominant in a cohesive ingroup that it tends to override realistic appraisal of alternative courses of action."[13] After these major fiascos in the United States, many people wondered how such intelligent people could allow such horrible disasters to occur and make such terrible decisions. By looking at each fiasco as a case study, Janis found that each group shared a moderate to high level of cohesiveness.[14] According to Janis, cohesiveness is the first and most important antecedent condition of groupthink.[15] The probability of groupthink occurring is augmented if cohesiveness is combined with one of the following two antecedent conditions: (1) structural faults in the organization, including insulation of the policymaking group, a lack of a tradition of impartial leadership, and a lack of norms requiring methodical procedures for dealing with the decisionmaking tasks or (2) a provocative situational context, including high stress, recent group failures, high difficulty level of decision, and strong moral dilemmas.[16]

A. ANTECEDENT CONDITIONS

1. *Cohesiveness*

The first group characteristic of groupthink is cohesiveness.[17] Cohesiveness involves inclusive feelings that typically promote well-being and happiness within a group.[18] When there is too much cohesiveness

[11] *Id.*
[12] *Id.*
[13] *Id.*
[14] IRVING L. JANIS, GROUPTHINK 176–77 (2d ed. 1982).
[15] *Id.*
[16] *See id.*
[17] It should be noted that cohesiveness does not automatically lead to poor group decisionmaking. With the proper group structure, decisionmaking procedures can benefit from cohesiveness.
[18] *See* JANIS, *supra* note 14, at 3–5.

within a group, however, it can have a detrimental impact on decisionmaking.[19] When groups foster an environment of camaraderie, cohesiveness may cause a group to avoid facing hard questions and avoid conflict so it quickly reaches a consensus. Cohesiveness typically arises due to strong relationships among members involving an emotional tie.[20] Group cohesion also may occur in the absence of each member liking each other if they all share a common goal or strong ties to one leader or a small subset of the group.[21] For example, President Nixon's inner circle of advisors competed with each other and generally did not get along. This group was still cohesive because they were bound together through loyalty to Nixon.[22] Considering the many forms that cohesiveness can take in a group, it is no surprise that the directors of Fortune 500 companies exhibit high levels of cohesiveness.[23]

Directors enjoy associating with other successful people[24] and being granted access to prestigious social networks.[25] In addition, boards are typically considered an elite group of people with an abundance of power.[26] These factors encourage a feeling among board members of belonging to a powerful protective group, which fosters cohesiveness. Boards are also largely homogenous, made up of similar ideologies and social and cultural backgrounds, which also increases cohesiveness.[27] People tend to verify their self-worth by attaching themselves to a high-prestige group,[28] and this tendency, combined with the reasons above, may provide an explanation for the recent trend in corporate governance reform to force corporations to have a majority of board members be independent.[29] Even if the board members are not associated with the corporation, or do not have common business enterprises, they still share the common reasons for seeking a board position and the prestige that is attached to that position. This element is sufficient to create a level of cohesiveness among independent board members, and the board at large, which puts the entire board at risk of succumbing to the pitfalls of groupthink.

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[19] For a cohesive group to suffer from groupthink, it does not have to have any specific level of cohesiveness. A moderately cohesive group may still experience the same symptoms of groupthink that a group of highly cohesive members would experience. *Id.*
[20] *Id.* at 211–13.
[21] *Id.*
[22] *Id.*
[23] *See* Lynne L. Dallas, *The Relational Board: Three Theories of Corporate Boards of Directors*, 22 IOWA J. CORP. L. 1, 6 (1996).
[24] James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 LAW & CONTEMP. PROBS. 83, 94 (1985).
[25] Lynne L. Dallas, *Proposals for Reform of Corporate Boards of Directors: The Dual Board and Board Ombudsperson*, 54 WASH. & LEE L. REV. 91, 109 (1997). *See also* Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 799 (2001).
[26] *See, e.g.*, Barry Baysinger & Robert E. Hokisson, *The Composition of Boards of Directors and Strategic Control: Effects on Corporate Strategy*, 15 ACAD. MGMT. REV.72, 72–73 (1990).
[27] Cox & Munsinger, *supra* note 24, at 105.
[28] *Id.* at 98.
[29] *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §§ 301–302, 116 Stat. 745, 775–78 (2002).

2. *Structural Faults Within the Organization*

Another antecedent condition of groupthink is an organization's failure to develop a proper structure for decisionmaking within the group.[30] By failing to create a proper structure at the outset of the group's deliberations, a group drastically increases its chances of suffering from the symptoms of groupthink.[31] One common structural fault is the practice of insulating the decisionmaking group from "outsiders."[32] Many times, outsiders are not permitted to know about the new policies being discussed until the decision has already been made.[33] Another common fault of group structure is impartial or biased leadership.[34] In this context, the leader strongly states his or her views to the group at the onset of meetings and discourages dissent within the group.[35] This causes discomfort among members and discourages actual debate when a group is going through the decisionmaking process.[36] A third structural problem of decisionmaking groups is that the organization to which the cohesive decisionmaking group is responsible toward does not have established, methodical procedures for gathering information and evaluating different resolutions.[37] The last structural fault of a decisionmaking group is a lack of social, cultural, and ideological diversity among its members.[38] As a result of this homogeneity there is a risk of unchallenged concurrence among members and "decreases [in] the likelihood of disparate views being presented and productively debated within the group."[39]

3. *Provocative Situational Context*

The final antecedent condition of groupthink focuses on the decisionmaking group's need to make significant policy decisions during a provocative situational context.[40] These types of contexts can be broken down into two categories: outside threats and internal threats.[41] The most vulnerable context a decisionmaking group can encounter is when outside threats increase the group's stress to high levels.[42] When a group with a strong leader experiences this high stress, the tendency will be for members to quickly concur with whatever solution the leader proposes because they are desperate for a solution to alleviate their stress and they are under such

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[30] JANIS, *supra* note 14, at 177.
[31] *Id.* at 249.
[32] *Id.*
[33] *Id.*
[34] *Id.* at 176.
[35] *Id.*
[36] *Id.* It is here that Janis first suggests that group leaders should actually refrain from giving their opinion on policy decisions and instead encourage others to put forth their opinions. This allows for the discussion of more ideas and opinions on how to make a decision, as opposed to one dominate opinion of the leader putting pressure on the other group members to agree with that opinion.
[37] One suggested methodical procedure is creating pros and cons lists for each available option. *Id.* at 176–77.
[38] *Id.* at 250.
[39] Janis also claims that a moderate (not extreme) degree of heterogeneity is sufficient for a group to engage in a more deliberate decisionmaking process that explores the pros and cons of two or more alternative solutions. *Id.*
[40] *Id.* at 258–59.
[41] *Id.*
[42] *Id.* at 250.

pressure that they cannot think of alternative solutions.[43] This tendency results in little debate and analysis during the decisionmaking process and can lead to poor decisions.[44]

The other category of provocative situational contexts, internal threats, generally includes a temporary lowering of self-esteem.[45] Internal threats include: (1) the recent failures of the group that cause the individual members to feel personally responsible, (2) a problem or decision that is highly complex and surpasses the competence of the decisionmaker(s) within a group, and (3) when a necessary decision poses a moral dilemma for the group and all solutions appear to contradict the ethical standards that the decisionmakers hold.[46] When presented with these conflicts, decisionmakers consciously and subconsciously perceive two strong threats affecting their decisions: social condemnation and self-disapproval.[47] Each group member may suffer from lower self-esteem due to feelings of shame and guilt.[48] To avoid these negative thoughts, each member will turn to the others for rationalization and to avert the potential loss of self-esteem.[49] Ultimately, groupthink is a defensive mechanism for coping with stressful decisions within a group.[50] To avoid lowered self-esteem when confronted with difficult moral decisions, group members quickly move toward a group consensus as a form of social support.[51]

To promote this rationalization process, members turn to group consensus to ease worry or doubt stemming from breaking ethical standards.[52] By relying on the mechanism of group consensus, each member is able to believe that he or she and the group made the correct and moral decision.[53] This is how a member avoids raising ethical concerns that imply his or her group could in fact be making an incorrect, immoral decision, which would cast doubt on the entire group's ethics and morals. Members also reassure themselves with the idea that some measure of questionable behavior is necessary because "you can't make an omelet without breaking some eggs."[54] Thus, cohesiveness can cause callous and unemotional actions by caring, ethical people.

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[43] "[This pair] specifies the prime conditions that foster defensive avoidance. After a leader lets it be known that he favors a particular policy alternative, . . . a better solution (because advocating a different alternative will evoke the disapproval of the most esteemed person in the group and of all those who uncritically support him). They will be motivated to reduce the high stress of their decisional conflict by collectively bolstering the choice made by the leader." *Id.*

[44] This should not be taken as a suggestion that no group decision under high stress is sound or can lead to a good outcome. It merely increases the likelihood of cohesive groups to succumb to the leader's opinions if the individual members of the group do not feel they can come up with a better solution. If a leader retained an impartial and unbiased decisionmaking approach, groupthink can be drastically reduced.

[45] *Id.* at 255.

[46] *Id.*

[47] *Id.*

[48] *Id.*

[49] *Id.* at 256.

[50] *Id.*

[51] *Id.*

[52] *Id.*

[53] *Id.*

[54] *Id.*

B. SYMPTOMS OF GROUPTHINK

1. *Illusion of Invulnerability*

The first symptom of groupthink is the group's illusion of invulnerability.[55] This illusion leads typically intelligent and sensible individuals to become overly optimistic, take extraordinary risks, and ignore clear warning signs.[56] "Essentially, the notion is that 'If our leader and everyone else in our group decides that it is okay, the plan is bound to succeed. Even if it is quite risky, luck will be on our side.'"[57] When under this illusion, group decisionmakers may begin to believe that they are infallible and will ultimately always make the best decision; this symptom increases as the power level of the group increases, as well as when the group has achieved success in the past. The group begins to make its decisions on the sole basis that the leader and members believe a plan is appropriate and bound to succeed.[58] Even if the plan is high-risk, the group still will go ahead with the decision based on past success and the perception that the members and leader are lucky.[59]

2. *Belief in Inherent Morality of the Group*

The next symptom of groupthink is the belief in a group's inherent morality.[60] This belief typically causes decisionmakers to ignore the ethical or moral consequences of their decisions because they perceive that they control the moral compass, know what everyone's best interests are, and are acting to the benefit of all.[61]

3. *Collective Rationalization*

The third symptom of groupthink is the group's rationalization of any warning signs that would usually lead members to second-guess, if not completely change, their positions.[62] Collective rationalization explains how individuals can claim to perceive nothing wrong within their group while it is making very risky decisions.[63] Warning signs indicate the need for change, but people are predisposed to "preserve the status quo in order to reduce stress under the 'illusion of normalcy.'"[64] Thus, groups can interpret negative information in a way that supports the preservation of

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[55] Janis, *supra* note 10, at 85.
[56] A prime example of this symptom is the Kennedy administration's acceptance of the Central Intelligence Agency's Bay of Pigs plan. Even after specifics of the plan leaked out through the press, the Kennedy administration still believed it could hide the fact that the United States was responsible for the invasion of Cuba. In addition, the administration did not even consider the international disapproval of the United States' actions. *Id.* This symptom has been present in many other case studies: Korean War, Pearl Harbor, Vietnam War, Marshal Plan, Cuban Missile Crisis, Watergate, Ford's Edsel failure, price-fixing in the electrical industry, the hostage rescue attempt in Iran, and the DeLorean trial.
[57] JANIS, *supra* note 14, at 35.
[58] *Id.* at 36.
[59] *Id.*
[60] *Id.* at 244.
[61] *See id.* at 178.
[62] Janis, *supra* note 10, at 86.
[63] *Id.*
[64] Marleen A. O'Connor, *The Enron Board: The Perils of Groupthink*, 71 U. CIN. L. REV. 1233, 1278 (2003) (citing Donald C. Langevoort, *Taking Myths Seriously: An Essay for Lawyers*, 74 CHG.-KENT L. REV. 1569, 1575 (2000)).

previously agreed-upon policies through "cognitive conservatism."[65] In order to avoid facing the situation and to "save face," groups will not only stay the course, but also increase their invested resources to convince themselves they are making the right decision.[66]

4. *Out-Group Stereotypes*

The fourth symptom of groupthink is the group's stereotyping of adversaries both outside and within the group itself.[67] Members will use negative stereotypes to promote the belief that either someone is with them or against them, leaving no middle ground.[68] Through this negative stereotyping, the group is lead to view all those opposing its decision, outside and within, as weak-minded and unenlightened.[69]

When deviants are within the group, they face intense social disapproval and typically become outcasts.[70] The advisors in President Kennedy's inner circle used this negative stereotyping behavior when they planned the Bay of Pigs.[71] They supported a forceful military strategy and insinuated that Kennedy's supporters within the group were soft and weak idealists.[72] When questioned about their decision afterward, some members stated that they did not voice their reservations on the decision to invade Cuba during planning sessions because they feared seeming unmasculine in front of the military advisors.[73]

When viewed in a similar light, it is understandable how intelligent, experienced directors who monitor firms and are responsible for risk-assessment on a part-time basis may be hesitant to, or completely refrain from, challenging management's business expertise. Independent professionals, particularly, do not want to risk public embarrassment by displaying their ignorance in front of the group.[74] They pretend to understand the complicated issues at hand, but in reality they are relying on the judgment of their fellow directors.[75] This can result in independent directors not asking questions or speaking their mind because they fear appearing unintelligent or misinformed when it comes to discussing complex financial matters in front of management.[76] Astute chief executive officers ("CEO") and senior managers recognize this weakness and use it to manipulate lower-level independent directors into faking an understanding

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[65] Janis, *supra* note 10, at 86.
[66] *See* Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 CALIF. L. REV. 627, 645 (1996). An example of this phenomenon is the Johnson administration's failure to recognize that the United States was failing in its attempt to win the Vietnam War. Through a series of decisions, Johnson's advisors responded by continuing to escalate the United States' commitment by employing more troops and resources. JANIS, *supra* note 14, at 97.
[67] Janis, *supra* note 10, at 86.
[68] *See id.*
[69] *Id.*
[70] JANIS, *supra* note 14, at 257.
[71] *Id.* at 38.
[72] *Id.*
[73] *Id.* at 39.
[74] Langevoort, *supra* note 66, at 653–54.
[75] *See id.* at 655.
[76] *See id.* at 657.

and accepting proposals that the CEOs and senior managers know are risky.[77]

5. *Illusion of Unanimity*

An illusion of a unanimous group consensus that pressures members to accept decisions is the fifth symptom of groupthink.[78] When a group member believes a sufficient number of other members favor a proposal, that member wants to avoid being the last to get on board and adopt the perceived consensus view.[79] A perceptive and manipulative group leader can accelerate this phenomenon by publicly stating that the group has come to a consensus, even when it has not.[80] This enforces the illusion that silence actually means consent and may lead to situations where members within an organization know that there are problems, but are too afraid to openly discuss them.[81]

6. *Self-Censorship*

The sixth symptom of groupthink is self-censorship by members within the group.[82] Self-censorship illustrates members' psychological desires for excessive concurrence seeking. Members that disagree with the group will stay quiet and internally play down or obscure their disagreement when the group appears to favor a decision.[83] By standing out as the sole objector and a road block for the rest of the group, a member believes he or she will suffer embarrassment and upset his or her fellow group members.[84] It is difficult to be a part of a group if everyone else in the group is against you, and most members would rather censor their own concerns than turn the group against themselves.[85] Therefore, members publicly agree or remain silent during group decisionmaking, even though they privately disagree. This symptom seems very relevant when analyzed in the context of the pressures of a boardroom. Boards function in a hierarchical structure, which serves as an easy avenue for this pressure to permeate the relationships between directors and CEOs. Because of self-censorship, it is difficult to know whether an individual director is complying with a decision as a form of obedience to his or her appointer, or that the director truly agrees and supports the decision.

7. *Direct Pressure on Dissenters*

The seventh symptom of groupthink involves group members who struggle with their own doubts over a decision and how groups use

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[77] *See id.*
[78] JANIS, *supra* note 14, at 37.
[79] *See* Robert J. Haft, *Business Decisions by the New Board: Behavioral Science and Corporate Law*, 80 MICH. L. REV. 1, 37–39 (1981).
[80] *See* JANIS, *supra* note 14, at 37–38.
[81] *Id.*
[82] Janis, *supra* note 10, at 87.
[83] *Id.*
[84] Many would rather blend in and not suffer these costs. *See* Candice Prendergast, *A Theory of "Yes Men*,*"* 83 AM. ECON. REV. 757, 769 (1993) (stating that lower-level officers and employees simply tell superiors what they want to hear).
[85] Ronald Sims, *Linking Groupthink to Unethical Behavior in Organizations*, 11 J. BUS. ETHICS 651, 654 (1992).

common forms of social pressure against members who actually stand up and question the group's judgment.[86] They do this in order to assuage their own doubts about the dubious decision the group has made.[87] The more extreme the pressure a member puts on dissenters, the quicker a culture of fear is created within the group, which transforms the lower-level, less powerful members into "yes men."[88]

The inner circle of President Johnson's Administration serves as an ideal example of this symptom.[89] They constantly pressured dissenters who questioned the escalation of the Vietnam War.[90] The dissenter within the group was belittled in an effort to persuade others in the administration that he had lost his "effectiveness" and was a "has been" who would ultimately lose all of his power.[91]

8. *Self-Appointed Mindguards*

The final symptom of groupthink is the emergence of self-appointed "mindguards."[92] These are individual group members who, on their own initiative, decide to protect the group from any adverse information that could influence the group's decisions.[93] The mindguard performs many self-assigned tasks, which include informing others in the group that the leader is not open to criticism and notifying the leader any time there is a whiff of dissent from a group member.[94]

III. PREVIOUS FINANCIAL CRISES AND GROUPTHINK

A. DOT-COM BUBBLE

Although the dot-com bubble disappeared more quietly than the telecom bubble and the Enron scandal, it was the first sign of reality hitting these industries based on astronomical projections.[95] The concept for the dot-coms was simple: create internet businesses to compete directly with traditional brick-and-mortar businesses. The dot-com businesses failed for multiple reasons: lacking a tangible business model, relying solely on selling advertisement space online for revenue, and neglecting to account for consumer reluctance to purchase certain goods or services sight-unseen.[96] Seeking to cash in on this industry, venture capitalists flocked to

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[86] Janis, *supra* note 10, at 87.
[87] "Because each member wants to stay in the group, the others have sanctioning power over deviants. For example, group members place direct pressure on a dissenter by labeling the person as 'not a good team player.' Additionally, the group leader can downplay criticism through power statements such as, 'I'm sure that the dissenter isn't trying to upset the apple cart.'" O'Connor, *supra* note 64, at 1290 (quoting JANIS, *supra* note 14, at 56, 87).
[88] *See* JANIS, *supra* note 14, at 246.
[89] Janis, *supra* note 10, at 87.
[90] *Id.*
[91] JANIS, *supra* note 14, at 114–15.
[92] Janis, *supra* note 10, at 88.
[93] *Id.*
[94] *Id.*
[95] *See* William W. Bratton, *Venture Capital on the Downside: Preferred Stock and Corporate Control*, 100 MICH. L. REV. 891 (2002).
[96] *See, e.g.*, David P. Hamilton & Mylene Mangalindan, *Angels of Death: Reality Bites Hard as String of Dot-Coms Sees Funding Dry Up*, WALL ST. J., May 25, 2000, at A1; Jonathan Weil, *"Going*

dot-com businesses and infused the industry with massive sums of capital that lead to a rapid expansion.[97] Ultimately, the vast majority of dot-coms fell by the wayside in 2000 due to heightened competition, the exhaustion of funds, and the lack of venture capital assistance.[98] Although there have not been many studies involving groupthink and the dot-com industry, some analysts have pointed to groupthink as a contributing factor to the high-risk investments during this time.

B. GROUPTHINK WITHIN THE DOT-COM INDUSTRY

While there have been many studies on the decisionmaking process of investors made during stable markets,[99] Dave Valliere and Rein Peterson developed a study to investigate investors' decisionmaking processes during a rising bubble.[100] Their results uncovered a widespread suffering of groupthink among venture capital firms that were financing and propping up most dot-com companies. The study was conducted by direct interviews with fifty-seven technology investors that had direct involvement in making investments in early stage, technology-based firms during the dot-com bubble.[101] The results showed that the investors suffered from many of the symptoms and consequences of groupthink. Most investors showed a belief in their inherent morality,[102] the illusion of invulnerability,[103] collective rationalization,[104] and an illusion of unanimity.[105] Furthermore, these symptoms lead to the typical consequences of groupthink: the investor groups failed to reexamine their investment plan after failures and

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Concerns": Did Accountants Fail to Flag Problems at Dot-Com Casualties?, WALL ST. J., Feb. 9, 2001, at C1.

[97] *See* Stephanie N. Mehta, *Drop in Returns is Expected for Venture-Capital Firms*, WALL ST. J., Nov. 19, 1996, at B2.

[98] *See* Lisa Bransten, *Deals and Deal Makers: Venture-Capital Investors Look for Exit Signs*, WALL ST. J., Aug. 7, 2002, at C1.

[99] During this time, investors had several strategies to mitigate the typical high risks that come with venture capital investment. These strategies include: imposition of high hurdle rates, use of convertible securities, use of formal screening criteria, staging of investments into separate tranches, and close monitoring of investee companies and mentoring of their management. *See, e.g.*, Andreas Bascha & Uwe Walz, *Convertible Securities and Optimal Exit Decisions in Venture Capital Finance*, 7 J. CORP. FIN. 285, 285–306 (2001); Vance H. Fried & Robert D. Hisrich, *Toward a Model of Venture Capital Investment Decision Making*, 23 FIN. MGMT. 28, 28–37 (1994); Paul A. Gompers, *Optimal Investment, Monitoring, and the Staging of Venture Capital*, 50 J. FIN. 1461, 1461–1489 (1995); Josh Lerner, *Venture Capitalists and the Oversight of Private Firms*, 50 J. FIN. 301, 301–08 (1995); Ian C. MacMillan, Lauriann Zemann & P. N. Subbanarasimha, *Criteria Distinguishing Unsuccessful Ventures in the Venture Screening Process*, 2 J. BUS. VENTURING 123, 123–137 (1987); Ian C. MacMillan, Robin Siegel & P. N. Subba Narasimha, *Criteria Used by Venture Capitalists to Evaluate New Venture Proposals*, 1 J. BUS. VENTURING 119, 119–28 (1985); Darwin V. Neher, *Staged Financing: An Agency Perspective*, 66 REV. ECON. STUD. 255, 255–74 (1999); Dean A. Shepherd, *Venture Capitalists' Introspection: A Comparison of 'In Use' and 'Espoused' Decision Policies*, 37 J. SMALL BUS. MGMT. 76, 76–87 (1999); Andrew L. Zacharakis & G. Dale Meyer, *A Lack of Insight: Do Venture Capitalists Really Understand Their Own Decision Process?*, 13 J. BUS. VENTURING 57, 57–76 (1998).

[100] Dave Valliere & Rein Peterson, *Inflating the Bubble: Examining Dot-Com Investor Behaviour*, 6 VENTURE CAP. 1, at 1 (2004).

[101] *Id.* at 4.

[102] *See id.* at 9 (finding that most investors felt they had a duty to build strong and growing or enduring companies).

[103] When an investment firm had a success, it was hailed by the media and fellow investors, reaffirming the firm's decision and building a belief within the firm that they won their bet and would win more. *See id.* at 17.

[104] *Id.* (discussing investment firms' rationalization process when an investment failed).

[105] *Id.*

new risks arose;[106] investors failed to look for alternative industries to invest in, and instead continued to increase funds into dot-com companies until they dominated venture capital firms' portfolios;[107] investment firms relied heavily on media and investor hype to support their investments;[108] and by allowing their portfolios to be dominated by dot-com companies, investment firms failed to establish contingency plans for a drastic change in the market.[109]

C. TELECOMMUNICATIONS INDUSTRY

Although questionable accounting and fraud contributed to the burst of the telecom bubble,[110] it was the unreasonable and illogical belief in continuous, unprecedented growth that lead to billions of dollars worth of overdevelopment and the bursting of the telecom bubble.[111] By 1996, the telecom industry was drastically deregulated,[112] leading to massive amounts of money pouring into telecom companies to develop and install high-speed, fiber-optic networks that would be able to handle the predicted growth in electronic communication.[113] Investors and companies that were already within the industry relied heavily on one statistic that was heralded by newspapers, financial insiders, and the government: internet traffic doubles every one hundred days.[114] Based on this statistic, dozens of companies spent billions of dollars during the 1990s to bury millions of miles of fiber-optic lines beneath streets and oceans worldwide.[115]

Unfortunately, internet traffic did not increase at the drastic rate claimed in the reports. The actual growth rate was closer to 100 percent a year.[116] This should have been a sufficient growth rate for success, but telecom companies expanded far too fast and at too great an expense for a 100 percent a year growth rate to be sufficient.[117] Thus, most of the infrastructure built during the 1990s has never been utilized.[118] As of 2002, only 2.7 percent of the installed fiber-optic lines were actually being

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[106] *Id.* (stating that failed investments were only attributable to an uncertain market and that failures actually meant there would be an increased upside on the successful investments).
[107] *Id.* (stating that even without understanding how it would occur, investment firms increased dot-com funding with no regard to other industries because of its "home-run" potential).
[108] *See id.* at 16.
[109] *See id.* at 17.
[110] J. Gregory Sidak, *The Failure of Good Intentions: The WorldCom Fraud and the Collapse of American Telecommunications After Deregulation*, 20 YALE J. ON REG. 207 (2003).
[111] *See* Rebecca Blumenstein, *Lives on Hold: As It Deepens, Telecom Bust Is Taking a Heavy Human Toll*, WALL ST. J., Aug. 19, 2002, at A1.
[112] Shawn Young, Yochi J. Dreazen & Rebecca Blumenstein, *Familiar Ring: How Effort to Open Local Phone Markets Helped the Baby Bells*, WALL ST. J., Feb. 11, 2002, at A1.
[113] Blumenstein, *supra* note 111, at A1.
[114] Yochi J. Dreazen, *Behind the Fiber Glut—Telecom Carriers Were Driven by Wildly Optimistic Data on Internet's Growth Rate*, WALL ST. J., Sept. 26, 2002, at B1. As late as 1999, credible sources continued to cite the "doubles every 100 days" statistic as evidence that the industry was still a gold mine and would continue to drastically expand. William Sterling, *Global Telecommunications: The Revolution Has Just Begun*, STERLING'S WORLD REP., April 1999, at 1 (predicting the growth rate of internet usage doubling every 100 days was, if anything, conservative and investors should expect even greater return on their investments).
[115] Dreazen, *supra* note 114.
[116] *Id.*
[117] *Id.*
[118] *Id.*

used.[119] The remaining fiber, called dark fiber, lay dormant, possibly forever due to advances in technology.[120] Never before had technology exceeded demand by so much; the surplus of fiber-optic lines drove bandwidth prices down 65 percent in 2000 and 2001.[121] This led to most of the telecom companies filing for Chapter 11 bankruptcy and the official "popping" of the telecom bubble.[122] The bulk of the funds invested into the telecom industry are not likely to ever be recovered,[123] and thousands of highly skilled and technically trained workers were left jobless, with very few opportunities to find equivalent employment.[124]As telecom companies began to realize that they would never recoup this money, many resorted to accounting fraud to hide losses and company failures.[125]

D. GROUPTHINK WITHIN THE TELECOMMUNICATIONS INDUSTRY

The decision to resort to accounting fraud was due, at least in part, to groupthink. M. M. Scharff conducted a case study of WorldCom based on a Securities and Exchange Commission ("SEC") report.[126] He concluded that WorldCom's organizational structure, group processes, and culture led to groupthink, which contributed to the company's fraud and the length of time over which it occurred.[127]

As WorldCom's stock rose during the telecom bubble, so did its illusion of invulnerability. Some of the honors awarded included its chief financial officer ("CFO"), Scott Sullivan, being called a "37-year-old whiz kid" and being awarded the CFO Excellence Award in 1998.[128] Furthermore, e-mail chains between accounting employees and managers showed a tendency to mock and ignore the typical auditing procedures, most likely because they did not fear getting caught for these transgressions.[129]

The SEC report also illuminated a common practice within WorldCom to rationalize its accounting fraud. Sullivan had the reputation of having impeccable integrity, so many finance and accounting employees who were aware of the accounting irregularities, rationalized them by assuming

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[119] *Id.*
[120] *Id.*
[121] *Id. See also* Dennis K. Berman, *Behind the Fiber Glut—Innovation Outpaced the Marketplace*, WALL ST. J., Sept. 26, 2002, at B1. (explaining that Telegeography, Inc. estimates that the gap between the capacity of the long-distance fiber-optic networks and demand are now so great that even if all of the internet traffic used by the top twenty United States cities were routed through Chicago, only 25 percent of Chicago's available capacity would be used).
[122] Dreazen, *supra* note 114.
[123] Some estimate that losses attributed to the telecom industry were as high as two trillion dollars as of mid-2002. Steven Rosenbush et al., *Inside the Telecom Game: How a Small Group of Insiders Made Billions as the Industry Collapsed*, BUS. WK., Aug. 5, 2002, at 34.
[124] Yuki Noguchi, *Ready to Work, Nowhere to Go; Laid-Off Telecom Workers Stranded by Industry's Fall*, WASH. POST, Nov. 4, 2002, at E01.
[125] *See* Penelope Patsuris, *The Corporate Scandal Sheet*, FORBES (Aug. 26, 2002), http://www.forbes.com/2002/07/25/accountingtracker.html.
[126] DENNIS R. BERESFORD, NICHOLAS DEB. KATZENBACH & C.B. ROGERS, JR., REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF WORLDCOM, INC. (2003).
[127] M. M. Scharff, *"Understanding WorldCom's Accounting Fraud: Did Groupthink Play a Role?,"* 11 J. OF LEADERSHIP & ORG. STUD. 109 (2005).
[128] *Id.* at 111.
[129] *See id.* at 111–12.

Sullivan had discovered a new methodology or loophole in the Generally Accepted Accounting Principles because they could not fathom him committing fraud.[130] Employees also used Arthur Andersen, LLP, the company's external auditor, and its clean audit reports to rationalize the discrepancies they uncovered.[131] This rationalization affected many employees' decision not to challenge the executives and the company's fraudulent accounting practices.[132]

Scharff also suggests that WorldCom's executives suffered from a belief in their inherent morality, which is another symptom of groupthink.[133] WorldCom executives were highly focused on the ends, not the means, and would do just about anything to reach their ultimate financial goal for each quarter.[134] The best example of this belief in the group's morality occurred when there was a suggestion from within the team of executives to establish a corporate Code of Conduct. Bernie Ebbers, WorldCom's CEO at the time, scoffed at the idea of a Code of Conduct, calling it a "colossal waste of time."[135] To Ebbers, the board did not need anything to hold itself to moral or ethical standards; they decided what was ethical and believed that they were always in control of the moral compass.[136]

One of the most obvious symptoms of groupthink that occurred within WorldCom was the pressure put on dissenters within the management and accounting teams who should have served as a check on accounting fraud. The SEC Report came to the conclusion that "Ebbers created the pressure that led to the fraud. He demanded the results he had promised, and he appeared to scorn the procedures (and people) that should have been a check on misreporting."[137] CFO Sullivan and Director of General Accounting Buford Yates claimed they felt intense pressure to make incorrect accounting entries and were too afraid of the repercussions of stopping the fraud.[138] This pressure trickled down through them to other, lower-level accountants, who feared losing their jobs if they questioned their superiors.[139]

WorldCom's executives and accountants also engaged in self-censorship. Many employees and executives were fully aware of the illegal accounting practices taking place within the company, yet there was little to no dissent among employees.[140] Almost all employees that could have done something chose not to because they did not want to break the consensus within the company.[141] The SEC Report concluded that:

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130 *Id.* at 112.
131 Even after Sullivan was indicted, many employees initially believe he was incapable of such crimes and assumed he must have been setup or made into a scapegoat. *Id.*
132 *See id.* at 112–13.
133 *See id.* at 113.
134 *Id.*
135 *Id.*
136 *See id.*
137 BERESFORD, KATZENBACH & ROGERS, *supra* note 126, at 19.
138 Scharff, *supra* note 127, at 114.
139 *Id.*
140 *Id.* at 115.
141 *Id.*

> The answer seems to lie partly in a culture emanating from corporate headquarters that emphasized making the numbers above all else; kept financial information hidden from those who needed to know; blindly trusted senior officers even in the face of evidence that they were acting improperly; discouraged dissent; and left few, if any, outlets through which employees believed they could safely raise their objections.[142]

Finally, the last symptom WorldCom decisionmakers suffered from was the illusion of unanimity. Many within the corporation interpreted the silence of other employees in response to the accounting fraud as concurrence, thereby mistakenly believing that there was unanimous support within the organization to continue the fraud.[143] An example of this symptom was an interaction between Ron Beaumont, the ex-CEO, and Sullivan.[144] Beaumont asked Sullivan to explain some of the accounting practices, but he never received a response.[145] Instead of reiterating his concerns, Beaumont dropped his inquiry, which Sullivan perceived as Beaumont's concurring with the accounting practices.[146]

While WorldCom's accounting fraud was taking place, another scandal was occurring. At its height, Enron was considered one of the biggest American success stories and a beacon of capitalism. But even Enron succumbed to fraud, and like WorldCom, groupthink played a major role in the crimes committed by Enron's head decisionmakers.

E. ENRON SCANDAL

While Enron was once deemed the personification of the United States' economic superiority, it abruptly became the epitome of greed and a source of American outrage. Enron grew from its humble beginnings as a merger of two interstate pipeline companies[147] into a lean "virtual" company that actively created markets and traded in natural gas, electricity, broadband services, and other energy-related products.[148] It received accolade after accolade, including "most innovative firm" six times[149] and ranked the twenty-second best company to work for in America[150] as it grew to the seventh largest American corporation in terms of revenue.[151]

Although Enron's economic collapse into bankruptcy near the end of 2001 came as a surprise to many, there were many warning signals of financial problems to come. Enron's accountant, Arthur Andersen,[152] classified Enron as a maximum risk client because it used the most

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[142] BERESFORD, KATZENBACH & ROGERS, *supra* note 126, at 18.
[143] Scharff, *supra* note 127, at 115.
[144] *Id.*
[145] *Id.*
[146] *Id.*
[147] Mitchell Pacelle, *Enron's Lay Resigns as Chairman, CEO*, WALL ST. J., Jan. 24, 2002, at A3.
[148] William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275, 1288 (2002).
[149] *Id.* at 1276.
[150] Robert Levering & Milton Moskowitz, *The 100 Best Companies to Work For*, FORTUNE, Jan. 8, 2001, at 148, 152.
[151] *The Five Hundred Largest U.S. Corporations*, FORTUNE, Apr. 16, 2001, at F-1.
[152] This is the same accountant used by WorldCom, Inc.

aggressive permissible accounting principles that ultimately crossed the line to illegal.[153] Enron had created more than two thousand separate business entities,[154] many of which were special purpose entities ("SPEs"), which were created to hold Enron's liabilities but were not to be included in Enron's financial statements.[155] In addition, many Enron executives were the sole owners of the SPEs and Enron diverted some of its profits directly to the executives through these SPEs.[156]

In October 2001, Enron finally had to return all of the liabilities hidden in its SPEs to its own account and restate its earnings,[157] which resulted in a $500 million accounting loss and a $1.2 billion reduction in shareholder equity.[158] The company could not survive in its present state and filed for bankruptcy reorganization.[159] Just before Enron filed for bankruptcy, its board made the decision to pay out $681 million in cash payments to senior officers and executives,[160] while capping employee severance packages at $13,500 per employee.[161] Shortly after the court-appointed examiner in Enron's bankruptcy case filed his initial report, in which he concluded that the "executives at Enron worked to disguise the company's true condition in filings with the [SEC] through complex financing deals involving the partnerships and banks,"[162] Enron's ex-CFO was indicted on fraud, money laundering, and conspiracy charges.[163] Can the decisions made by Enron board members and top executives be attributed solely to greed, or was groupthink playing a role, yet again, in another American economic debacle? Marleen O'Connor argued the latter in her case study of Enron.[164]

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[153] *See* S. PERMANENT SUBCOMM. ON INVESTIGATIONS OF THE COMM. ON GOVERNMENTAL AFF., 107TH CONG., THE ROLE OF THE BD. OF DIRS. IN ENRON'S COLLAPSE (Comm. Print 2002) [hereinafter THE ROLE OF THE BD. OF DIRECTORS IN ENRON'S COLLAPSE].

[154] *See* Enron Corp., Annual Report (Form 10-K) (Apr. 2, 2001).

[155] Bratton, *supra* note 148, at 1306–08.

[156] Kurt Eichenwald, *Secret Deal Part of Tangle in Enron Case*, N.Y. TIMES, Oct. 1 2002, at C1. To find more specific studies regarding Enron's accounting practices and the structure of its SPEs, see THE ROLE OF THE BD. OF DIRECTORS IN ENRON'S COLLAPSE, *supra* note 153; WILLIAM C. POWERS, JR., RAYMOND S. TROUBH & HERBERT S. WINOKUR, JR, REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BD OF DIRS. OF ENRON CORP., REPORT OF INVESTIGATIONS (2002); Bratton, *supra* note 148; Lawrence A. Cunningham, *Sharing Accounting's Burden: Business Lawyers in Enron's Dark Shadows*, 57 BUS. LAW. 1421 (2002); Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233 (2002); Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critque of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1 (2002).

[157] Bratton, *supra* note 148, at 1308–09.

[158] Ribstein, *supra* note 156, at 4.

[159] Bratton, *supra* note 148, at 1276.

[160] Kathryn Kranhold & Mitchell Pacelle, *Enron Paid Top Managers $681 Million, Even as Stock Slid*, WALL ST. J., June 17, 2002, at B1.

[161] David Barboza, *Enron Agrees to Increase Severance by $30 Million*, N. Y. TIMES, June 12, 2002, at C11.

[162] Kurt Eichenwald, *The Findings Against Enron*, N.Y. TIMES, Sept. 23, 2002, at C1.

[163] Superseding Indictment, United States v. Fastow, 300 F. Supp. 2d 479 (S.D. Tex. 2003) (No. H-02-0665), *available at* http://news.findlaw.com/hdocs/docs/enron/usafstw43003sind.pdf.; Alexei Barrionuevo, Jonathan Weil & John R. Wilke, *Leading the News: Enron's Fastow Charged with Fraud*, WALL ST. J., Oct. 3, 2002, at A3.

[164] O'Connor, *supra* note 64, at 1238–39.

F. GROUPTHINK WITHIN ENRON

Although O'Connor could not find much direct evidence to suggest Enron directors suffered from an illusion of invulnerability,[165] she did point to several indirect sources from journalists' accounts of Enron's corporate culture that revealed this groupthink symptom. O'Connor found four factors that indicated Enron's corporate culture permeated an illusion of invulnerability: (1) Enron was endowed with multiple awards and promoted the belief that these were earned solely as a result of talent, rather than any luck; (2) Enron executives believed that they were "above everyone else"; (3) executives believed that the company was untouchable due to vast political power; and (4) the culture of hubris encouraged breaking rules and taking extreme risks.[166]

O'Connor was able to find direct evidence that the Enron board exhibited a belief in its own inherent morality.[167] She cited the belief held by the board that Enron would improve the world,[168] and noted the public's hero-like reverence of top Enron executives as evidence to support the presence of this symptom of groupthink.[169] One director even testified that the reason the board approved many of the illegal or questionable deals was that Enron executives were "some of the most creative and talented people in business" and that the board believed all of the publications lauding the Enron executives for their intelligence, leadership, and creativity.[170] This evidence suggests that Enron's board did indeed believe in the inherent morality of the company and its decisions.

The Enron board also used collective rationalization to ignore the many red flags. The Senate Subcommittee on Oversight & Investigations of the Committee on Energy and Commerce Report included multiple red flags over the years that should have served as a warning to Enron and its board.[171] O'Connor highlights several rationalizations used by the board to ignore the red flags.[172] One example is the refusal by many board directors to admit that they waived the Enron Code of Conduct. Many claimed their actions were ratifications of the Office of the Chairman.[173] The board also ignored the accounting reports that classified several transactions as "H," or high-risk, and claimed that they believed the classification meant the

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[165] O'Connor notes that the overall strategic plans of Enron's directors were extraordinarily ambitious and quotes a senator's statement that "The [Enron] Board . . . succumbed to the Enron ether of invincibility, superiority and gamesmanship in manipulating Enron's financial statements to keep the Enron stock price soaring," indicating that the board did suffer from the illusion of invulnerability. *Id.* at 1271.

[166] *Id.* at 1272–73.

[167] *Id.* at 1274.

[168] Enron's former CEO, Jeffery Skilling stated, "[W]e're the good guys," and "[W]e're on the side of the angels." *OnLine Extra: Q & A with Enron's Skilling*, BUS. WK. ONLINE (Feb. 12, 2001), http://www.businessweek.com/2001/01_07/b3719010.htm.

[169] O'Connor, *supra* note 64, at 1276 (citing Jennier G. Hill, *Deconstructing Sunbeam-Contemporary Issues in Corporate Governance*, 67 U. CIN. L. REV. 1099 (1999); Michael Maccoby, *Narcissistic Leaders: The Incredible Pros, The Inevitable Cons*, 78 HARV. BUS. REV. 69 (2002)).

[170] *Id.* at 1277 (citing *The Financial Collapse of Enron–Part 2: Hearing Before the Subcomm. on Oversight & Investigations of the Comm. on Energy & Commerce*, 107th Cong. 7 (2002)).

[171] *The Financial Collapse of Enron—Part 4: Hearing Before the Subcomm. on Oversight & Investigations of the Comm. on Energy & Commerce*, 107th Cong. (2002) [hereinafter *Enron Hearings*].

[172] This Note will review five of the red flags and rationalizations for each one.

[173] THE ROLE OF THE BD. OF DIRECTORS IN ENRON'S COLLAPSE, *supra* note 153, at 25 n. 59.

transaction was important.[174] In addition, the Audit Committee of the board treated SPE transactions with "cursory" review and as "brief item[s] on the agenda";[175] this was an attempt at "see-no-evil" rationalization.[176] Another red flag that the board ignored was an employee letter warning them of company wrongdoing.[177] The board justified ignoring the letter by claiming that investigating the employee's claims would show that they distrusted outside counsel and the CEO.[178] Finally, the board ignored an $800 million earnings charge from its SPEs and justified this by claiming it was a "one-time" occurrence.[179] O'Connor concluded that all of these rationalizations are direct evidence that the Enron board suffered from the collective rationalization symptom of groupthink.[180]

The Enron board and executives also suffered from the out-group stereotyping symptom of groupthink. This practice was directed at both outsiders, typically journalists, and insiders, typically older board members or employees breaking "rank."[181] Enron executives believed that any outsider who did not understand their business model or accounting practices "just didn't get it" and was ignorant.[182] Enron's former CEO told reporters who questioned how Enron made any money that they were "unethical"[183] and even called a journalist an "asshole" for questioning the whereabouts of a missing financial statement.[184] In addition, the board and executives negatively stereotyped any members within the board who misunderstood or questioned a transaction.[185] O'Connor argued that Enron directors were afraid of being stereotyped as "'soft' on risk-taking or like 'old-time dinosaurs' who could not adapt to 'new economy' thinking."[186] These stereotypes caused several directors to remain silent while the board made poor decisions.

According to O'Connor, the illusion of unanimity also ran rampant within Enron.[187] The Senate Report noted that over the course of the two years in question, almost every board vote was unanimous.[188] Even more telling was the fact that some directors were losing millions of dollars from stock investments in the company, but still withheld any reservations about the company's decisions because of the appearance of unanimity.[189] O'Connor also points to remarks from Enron executives claiming that "you

[174] O'Connor, *supra* note 64, at 1281 (citing *Enron Hearings*, *supra* note 171, at 14, 23, 53).
[175] POWERS, TROUBH & WINOKUR, *supra* note 156, at 148, 162.
[176] O'Connor, *supra* note 64, at 1281–82 (defining "see-no-evil" rationalization as the act of purposely avoiding reading details that may call in to question the appropriateness of a past decision).
[177] THE ROLE OF THE BD. OF DIRECTORS IN ENRON'S COLLAPSE, *supra* note 153, at 12.
[178] O'Connor, *supra* note 64, at 1282.
[179] *Id.* at 1283.
[180] *Id.*
[181] *Id.* at 1285.
[182] Bethany McLean, *Why Enron Went Bust*, FORTUNE, Dec. 24, 2001, at 33.
[183] Felicity Barringer, *Enron's Many Strands: Early Scrutiny; 10 Months Ago, Questions on Enron Came and Went With Little Notice*, N.Y. TIMES, Jan. 28, 2002, at A11.
[184] *See The Amazing Disintegrating Firm—Enron*, ECONOMIST, Dec. 8, 2001, at 61.
[185] O'Connor, *supra* note 64, at 1285.
[186] *Id.* at 1286.
[187] *Id.* at 1287.
[188] THE ROLE OF THE BD. OF DIRECTORS IN ENRON'S COLLAPSE, *supra* note 153, at 8.
[189] *See* Carrie Johnson, *Enron Director Robert Belfer Gave Away Millions*, LINCOLN J. STAR, May 9, 2002, at 3.

had to keep drinking the Enron water" and "drink the Kool-Aid" as evidence of Enron's board suffering from an illusion of unanimity.[190]

O'Connor also provides evidence that the Enron board suffered from self-censorship. She points out one instance where the Compensation Committee within the board was told to review the CEO's income from the SPE transactions, but when the Committee did not receive a response from the CEO, the matter was completely dropped.[191] Furthermore, O'Connor highlights three quotes from employees and executives that exhibit a self-censorship culture within Enron: (1) "You don't object to anything, [t]he whole culture at the vice-president level and above just became a yes-man culture";[192] (2) "People perpetuated th[e] myth that there were never [] mistakes. It was astounding to me";[193] and (3) "[P]eople went from being geniuses to idiots overnight" if they questioned superiors.[194]

O'Connor's case study of Enron and its decisionmakers is the most extensive study of the group psychological factors at work within Enron's board of directors. This study, along with the data regarding the venture capital firms during the dot-com bubble and WorldCom during the telecommunications bubble, provides extensive evidence that groupthink is a major factor in poor decisionmaking habits among decisionmakers of large corporations. The next section will explore the general prevalence of corporate fraud in the early twenty-first century and the government's response to Enron: a law rushed through Congress that failed to address groupthink.[195]

IV. SARBANES-OXLEY ACT

In response to reports of corporate fraud and to a lesser extent the burst financial bubbles of the dot-com and telecommunications industries, Congress pushed through the Sarbanes-Oxley Act. The reaction among legal and academic commentators was not very favorable. The Act was called "a nightmare for company executives"[196] and was described as "a telling example of a law of unintended consequences. It will have wide-ranging effects on securities, derivatives and other shareholder lawsuits."[197] Professor Cunningham was slightly more optimistic when he wrote:

> [A]ll changes made by the Act had been discussed among corporate governance and accounting devotees for years. Many were already in effect due to requirements imposed by stock exchanges, regulators, state law, or other provisions of federal law . . . . In this view, the changes may be "sweeping" or "far-

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190 O'Connor, *supra* note 64, at 1288.
191 *Id.* at 1289.
192 John Byrne, *At Enron, "The Environment Was Ripe for Abuse*,*"* BUS. WK. ONLINE, Feb. 25, 2002.
193 McLean, *supra* note 182, at 362.
194 O'Connor, *supra* note 64, at 1290.
195 This Note does not mean to argue that the Sarbanes-Oxley Act was useless. Rather it needs to be re-evaluated and more reform is necessary to avoid a repeat of the past.
196 Deger, *supra* note 8.
197 Gregory P. Joseph, *Corporate Fraud Act*, NAT'L L. J., Aug. 5, 2002, at B9.

reaching," but they are hardly "reforms."[198]

This part will examine the subsequent clauses and regulations that affect executives and directors of publicly traded companies and whether they do an adequate job of combating groupthink among this group of decisionmakers.

Title III of the Act, entitled "Corporate Responsibility," imposes new requirements on the audit process.[199] Section 301 requires that a company's board of directors creates an audit committee made up entirely of independent directors.[200] This committee is responsible for the appointment, compensation, and oversight of the public accounting firm and the auditor employed by the corporation.[201]

Section 302 requires that the CEO and CFO certify in each annual or quarterly report the following: (1) the report does not omit or contain any untrue material fact, (2) the report gives an accurate and fair review of the financial condition and the results of operations of the corporation, (3) there have been internal controls established that ensure that the officers receive material information and that the controls have been followed, and (4) the officers have disclosed any significant deficiencies in the internal controls to the auditor and audit committee.[202] Section 305 changes the test for barring unfit officers from "substantial unfitness" to mere "unfitness."[203]

Section 307 applies specifically to attorneys and is highly controversial because historically, bar associations, not federal agencies, have regulated the responsibilities of attorneys.[204] This section requires the SEC to establish minimum standards of "professional conduct" for attorneys practicing before the Commission.[205] Attorneys must also report any violations to the chief legal officer or CEO.[206] If neither officer responds to the violation, the attorney must report to it to the audit committee.[207] Under this section, attorneys will serve as the role of "watchdog."[208]

Title IV of the Act covers financial disclosures of the corporation. Section 404 requires each annual report to include a statement that the management of the corporation is responsible for establishing and maintaining an adequate control structure and procedures for financial reporting, but exempts investment corporations from this responsibility.[209] Section 406 requires the corporation to divulge whether or not it has adopted a code of ethics for executives and directors, or explain why it has

[198] Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (and It Just Might Work)*, 35 CONN. L. REV. 915, 941–42 (2003).
[199] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §§ 301–302, 116 Stat. 745, 775–78 (2002) (codified in scattered sections of 15 U.S.C. and 18 U.S.C.).
[200] *Id.*
[201] *Id.*
[202] Sarbanes-Oxley Act § 302, 116 Stat. at 777.
[203] Sarbanes-Oxley Act § 305(a)(1), 116 Stat. at 745, 779.
[204] Shanon D. Murray, *SEC Chairman: Lawyers to Get Closer Scrutiny*, MIAMI DAILY BUS. REV., Aug. 15, 2002, at 9.
[205] Sarbanes-Oxley Act § 307, 116 Stat. at 784.
[206] *Id.*
[207] *Id.*
[208] Murray, *supra* note 204.
[209] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 404(a), 116 Stat. 745, 789.

not adopted such a code if the corporation has not,[210] and report all changes to the code.[211] Section 407 requires each corporation to have at least one "financial expert" on its audit committee,[212] which means that there must be at least one independent financial expert on the board of directors. Section 408 requires the SEC to review the disclosures made by corporations at least once every three years and gives the SEC the discretion to review the disclosures more often if it deems fit.[213]

Finally, Titles VIII, IX, and XI of the Act either increase the criminal penalty or establish criminal penalties for certain crimes, including: destruction, alteration, or falsification of records in federal investigations, bankruptcy court, or in relation to audits;[214] mail and wire fraud;[215] and violations of the Employee Retirement Income Security Act.[216]

These provisions of the Act affect executives and the board of directors but have very little to no effect on groupthink among these decisionmakers. For example, establishing a code of ethics does not necessarily equate to an ethical or good decisionmaking group. If groupthink is already present within a board, there is a strong chance that the board already has an inherent belief in its own morality. As discussed above in regards to WorldCom and Enron, executives may decide they do not even need a code of ethics because their decisions are already moral and ethical. Directors also may waive any violation of the code of ethics based on a belief in the morality of themselves and the executives, evidenced by Enron's board. Another example is the mandate that directors of the audit committee be independent directors. As discussed previously, independent directors are still at risk of forming a cohesive bond amongst each other and suffering from groupthink. In addition, an external auditor does not always ensure that the decisions made by executives and directors are appropriate. Arthur Andersen is a prime example of this issue. The auditor is still paid a fee by the corporation and may feel a need to comply with powerful executives or directors. Moreover, directors may ignore or rationalize any warnings from an auditor, as Enron's board did.

Finally, many provisions are retroactive as opposed to proactive. For instance, the SEC reviews a corporation's disclosures after completion and there are increased criminal penalties for fraud and other crimes already committed. While these provisions are not irrelevant, they cannot truly be considered reform because they have little effect on a board's actions. If groupthink is already present, all the SEC can hope to do is catch onto it before it does too much damage to shareholders and the economy at large. This does nothing to truly change the decisions and actions of executives and directors before it is too late. Furthermore, stronger criminal penalties may have little to no effect retroactively because many executives and directors do not even realize they are suffering from groupthink. Many

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[210] Sarbanes-Oxley § 406(a), 116 Stat. at 789.
[211] Sarbanes-Oxley § 406(b), 116 Stat. at 789.
[212] Sarbanes-Oxley § 407, 116 Stat. at 790.
[213] Sarbanes-Oxley § 408, 116 Stat. at 790–91.
[214] Sarbanes-Oxley § 802(a), 116 Stat. at 800–05, 807.
[215] Sarbanes-Oxley § 903, 116 Stat. 745, 805.
[216] Sarbanes-Oxley § 904, 116 Stat. at 805.

truly believe that their actions are moral, ethical, and, most importantly, legal.

For these reasons, the Sarbanes-Oxley Act falls short of its goal of true corporate governance reform. The economic crisis that has occurred over the last three years supports this hypothesis. This Note will now explore the current subprime-mortgage crisis and use CitiGroup's executives and board of directors as evidence that groupthink still persists among major corporations' decisionmakers.

V. SUBPRIME MORTGAGE CRISIS AND GROUPTHINK

A. SUBPRIME MORTGAGE CRISIS

The current mortgage crisis has brought about massive corporate bankruptcies, leading to countless job layoffs and foreclosures, devastating the United States economy and pushing it into a recession most have never experienced before.[217] A high home-sale rate coupled with steep rises in home prices created the real estate bubble.[218] Home prices were rising so quickly that many homeowners realized that they could buy and sell a home quickly, make a significant profit, and rapidly move on to acquire another property.[219] This phenomenon is called "flipping a house."[220] At the time, it was a win-win situation for the homeowner.

In order to flip a house, homebuyers needed quick mortgages that were often for amounts far exceeding what they could realistically afford.[221] This temptation led to fraud at every level of the real estate process, from buyers submitting false income data on their mortgage applications at the request of their broker, to small lenders knowingly selling mortgages received via a fraudulent application to larger financial institutions.[222] These poor decisions should have caused the subprime-mortgage crisis to occur sooner but housing prices continued to rise at a rapid pace, prolonging the inevitable crisis.[223]

In order to take advantage of the real estate bubble, most lending institutions exploited the government's deregulation of the mortgage industry[224] by creating a new, more creative approach to lending. They utilized the technique of offering high-interest, adjustable subprime-mortgages to people with poor credit histories.[225] In a world where real estate prices continued to rise quickly, this became a common practice with brokers and lenders, many of whom employed dishonest tactics to deceive

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[217] Klein & Kavanagh, *supra* note 6, at 373–74.
[218] *See* Peter Coy, et al., *Is A Housing Bubble About to Burst?*, BUS. WK. (July 19, 2004), http://www.businessweek.com/magazine/content/04_29/b3892064_mz011.htm.
[219] This is similar to the phenomenon that was occurring with venture capital firms during the dot-com boom.
[220] Noelle Knox, *Soft Market Teaches Flippers an Ever-So-Humble Lesson*, USA TODAY, Sept. 20, 2006, at 1B.
[221] Klein & Kavanagh, *supra* note 6, at 375–77.
[222] David Fiderer, *Alan Greenspan's Financial History for Lobotomy Victims*, THE HUFFINGTON POST, (Mar. 25, 2010, 12:25 AM), http://www.huffingtonpost.com/david-fiderer/alan-greenspans-financial_b_512540.html.
[223] *Id.*
[224] Dash & Creswell, *supra* note 1.
[225] Klein & Kavanagh, *supra* note 6, at 375–77.

buyers about the loans they received.[226] Lending institutions felt insulated from any risk because home prices continued to rise at a record pace, and any foreclosed home could be easily resold for a profit; therefore, it was perceived as a no-risk situation by lenders.[227]

Real estate sales inevitably declined and prices fell drastically; the bubble had burst.[228] This left many homeowners with homes they could not sell and large mortgages, which they were unable to pay.[229] The subprime loans belonging to many homeowners allowed lenders to drastically increase mortgage payments; therefore, homeowners were unable to make their payments and banks could no longer foreclose properties for a profit.[230] The sheer number of these types of loans and the inevitable foreclosures, which lead to massive losses for lenders and a drastic decrease in the value of mortgage-backed securities, jumpstarted the mortgage crisis.

In sum, the current mortgage crisis was caused by unsound financial decisions, government deregulation, and fraud. Every major player in the real estate industry shares some of the responsibility for the crisis. While there were many factors contributing to the recession, one stands out above the rest: lending institutions devoted a disproportionate amount of capital to the subprime-mortgage market without leaving themselves an exit strategy for when the real estate market slowed and the high-risk mortgages no longer could be paid by homeowners.

B. Groupthink Within Citigroup

Lynn Turner, a former chief accountant with the SEC, blamed Citigroup's "balkanized culture and pell-mell management" for its downfall.[231] Turner said "'[i]f you're an entity of this size . . . if you don't have controls, if you don't have the right culture and you don't have people accountable for the risks that they are taking, you're Citigroup.'"[232] Although there has not yet been a full public report of an investigation into Citigroup's decisionmaking and risk-analysis procedures by Congress or a federal agency, this Note will utilize indirect sources, particularly news articles and journalists' opinions, to reveal that Citigroup's decisionmakers suffered from groupthink during the subprime-mortgage bubble.

It is clear from many sources that the executives and directors who made up Citigroup's board were a cohesive group. A prime example of this is the cohesive relationship between David C. Bushnell, the senior risk officer, Thomas G. Maheras, who oversaw the bank's mortgage-back securities, and Maheras's trusted deputy, Randolph H. Barker.[233] All three

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[226] *Id.* at 382–84.
[227] This is analogous to the telecommunications industry's faith in the infinite increase of telecommunication expansion.
[228] Klein & Kavanagh, *supra* note 6, at 373.
[229] *Id.*
[230] If lenders could sell foreclosed properties, it was usually for a drastically lower price than the amount owed on the properties, leading to massive losses for lending institutions. *Id.* at 375–76.
[231] Dash & Creswell, *supra* note 1.
[232] *Id.* (quoting Lynn Turner).
[233] *Id.*

men were old friends who climbed the corporate ladder together.[234] The bond between Bushnell and Barker was particularly strong, which should have raised a red flag because Bushnell was in charge of analyzing and limiting risk, while Barker was looking to push the limits of responsible practices in the mortgage-backed securities sector.[235] Another sign of cohesiveness among the decisionmakers within Citigroup was their admiration of Robert E. Rubin.[236] When Rubin came to the corporation, he served as chairman of the executive committee and was seen as a rock star; this admiration bound many executives and directors to each other.[237]

There is also evidence that Citigroup displayed another antecedent condition of groupthink: biased leadership. Charles O. Prince, Citigroup's former CEO, openly put pressure on Maheras and other top executives to increase earnings in the bank's subprime mortgage securities department.[238] Prince, along with his senior advisor, Rubin, made it clear that "[y]ou have to take more risk if you want to earn more" and openly supported vast expansion of this sector of the corporation.[239] Another Citigroup structural flaw was its procedures for risk control. Risk managers lacked clear procedures for reporting and reported to both Maheras and Bushnell.[240] This put Maheras in the position to influence risk analysts who were charged with judging risk on his decisions, another conflict of interest. This evidence strongly suggests that the necessary antecedent conditions existed within Citigroup to foster groupthink and produce its symptoms.

At least five symptoms of groupthink appear to have been present within Citigroup's executives and board of directors: an illusion of invulnerability, an inherent belief in their own morality, collective rationalization, direct pressure on dissenters, and self-censorship. Citigroup's decisionmakers believed that their subprime mortgage securities were a gold mine and that they were invulnerable to any risk. This was likely augmented by the high regard the financial world had for Rubin, one of Citigroup's top advisors. The real estate boom had allowed the management team to make record-breaking earnings, which validated their business decisions in regards to the subprime mortgage securities industry. Many within Citigroup did not consider what would happen if the real estate market declined, and even when the market did begin to decline, they did not believe that they were vulnerable to financial peril.[241] When Bear Stearns was hit by the subprime mortgage crisis, Citigroup's top executives showed very little concern over its own subprime mortgage backed securities when it told the SEC that "the probability of those mortgages defaulting was so tiny that they excluded them from their risk analysis . . . ."[242] These are all signs that Citigroup suffered from an illusion of invulnerability.

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[234] *Id.*
[235] *Id.*
[236] *See* Evan Thomas, *Rubin's Detail Deficit*, NEWSWEEK, Dec. 8, 2008, at 44.
[237] Dash & Creswell, *supra* note 1.
[238] *Id.*
[239] *Id.*
[240] *Id.*
[241] *Id.*
[242] *Id.* (citing an anonymous source).

There is also evidence that suggests Citigroup suffered from an inherent belief in its own morality. Because many of the top executives worked together for many years as they rose through the ranks, they trusted and had the utmost faith in each other. Prince assured analysts in 2005 that "[w]e will run our business in a way where our credibility and our reputation as an institution with the public and with our regulators will be an asset of the company and not a liability."[243] This statement shows a strong belief in the morality of the decisionmakers within Citigroup and their ability to uphold the high reputation and esteem they believed they embodied.

The third symptom of groupthink evident within Citigroup is its collective rationalization among executives and the board of directors. Many red flags should have been noticed, but every time one presented itself, Citigroup downplayed the risk. As the corporation began to increase its subprime mortgage securities portfolio to alarming levels, executives "put blind faith in the passing grades that major credit-rating agencies bestowed on the debt."[244] Even when the credit markets began seizing up and the value of its securities was plummeting, executives used rating agencies to ignore this red flag because the agencies claimed that Citigroup's subprime mortgage securities had an extremely low probability of default.[245] These rationalizations allowed Citigroup to ignore warning signs and remain positive about their business model's inevitable success.

Citigroup also put direct pressure on dissenters who questioned its choice to finance alarming amounts of subprime mortgage securities, another symptom of groupthink. A former Citigroup executive claimed that "Prince started putting pressure on Maheras and others to increase earnings in the bank's trading operations" and, in particular, subprime mortgage securities.[246] The chain of pressure went down through Maheras to the corporation's risk managers. Having risk managers report directly to Maheras allowed him to transfer that pressure to risk analysts. This caused a major conflict between lower-level employees and an executive, which will almost always result in the lower-level employee giving in to any pressure from the executive. Citigroup's directors may have been unaware of the risk it was taking because of the pressure its directors were placing on risk analysts not to dissent; this pressure quieted any hopes the corporation had of getting an early wake up call to the risk it was accumulating.

Finally, Citigroup displayed the groupthink symptoms of self-censorship and an illusion of unanimity. Many employees and even executives had concerns regarding the growing size of the corporation's subprime mortgage securities but kept those concerns to themselves.[247] One person who worked with these securities said, "'as long as you could grow revenues, you could keep your bonus growing.'"[248] This exposes an

[243] Dash & Creswell, *supra* note 1 (quoting Charles O. Prince).
[244] *Id.*
[245] *Id.*
[246] *Id.*
[247] *Id.*
[248] *Id.* (quoting a Citigroup employee).

internal corporate structure that focused solely on short-term goals and dealt out bonuses based on those goals. These bonuses led many to hold their tongue if they had concerns about the corporation's well being. This, paired with the pressure put on risk analysts, led to a culture of self-censorship within Citigroup. Self-censorship also led to the illusion of unanimity among executives. Because no one had warned Prince of the potential risks the corporation was assuming, he never questioned the growing securities portfolio.[249] By not raising concerns, Citigroup executives and directors created the illusion of unanimity for themselves and used this to quell their own concerns.

Although this analysis lacks an abundance of direct evidence, Vikram S. Pandit's, current CEO of Citigroup, recent testimony in front of the Congressional Oversight Panel supports these conclusions. In his prepared testimony, he admits that the company suffered from hubris[250] and needed to rebuild its senior management and board of directors with a better decisionmaking structure.[251] Clearly, there were major issues among Citigroup's decisionmakers, and the indirect evidence suggests groupthink played a significant role in Citigroup's poor and high-risk business decisions.[252] If groupthink is still present among major corporations' decisionmakers, any corporate governance reform must take into account the effects of groupthink and take measures to minimize its negative effects on powerful corporate decisionmakers.

VI. CORPORATE GOVERNANCE REFORM

A. Formal Board Structure Reform

After the subprime mortgage crisis, there has been an abundance of calls for corporate governance reform. Many calls for reform are based on changing the structure of the board of directors and the process of nominating directors. This part concludes that while changing the process of nominating board members can be useful to help prevent groupthink, specifically by increasing heterogeneity, it is not enough to change the decisionmaking process of executives and the board of directors. Transforming powerful psychological processes within a boardroom requires a more significant reform. This reform should include formalizing Janis's conception of the role of the devil's advocate and using skill matrices to test potential board nominees for susceptibility to groupthink.

One of the driving forces behind corporate governance reform is the alarming rate of growth in CEO compensation packages during the crisis. A recent study found that there is a negative correlation between executive

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[249] Dash & Creswell, *supra* note 1.
[250] *See Citigroup and the Troubled Asset Relief Program: Hearing Before the Cong. Oversight Panel*, 111th Cong. 60 (2010) (prepared testimony of Vikram S. Pandit, C. Exec. Officer, Citigroup Inc.).
[251] *See id.* at 7–8.
[252] The conclusions in this Note will be supported as more direct evidence of the decisionmaking process of Citigroup executives and directors is released to the public.

compensation and performance in firms,[253] and the best evidence of this is the increasingly large amounts of money CEOs of struggling corporations were paid, even as the economy and their corporations were spiraling downward.[254] President Obama has responded to the public outcry,[255] but the efforts to reform CEO compensation will not have a significant effect on the psychological forces within a boardroom. Currently, the most popular suggestions for changing CEO compensation are "say on pay" legislation[256] and a new requirement that a significant portion of CEO compensation must come in the form of equity in the company.[257] These reforms will have little to no effect on groupthink within a board of directors. Rather, structural regulations could be created that will increase heterogeneity among the decisionmakers of a corporation.

1. *Institutional Investors' Nomination Rights*

One option to increase heterogeneity within the board of directors is to allow institutional investors the right to nominate directors straight onto the corporation's proxy statement for an annual or special shareholders' meeting.[258] The SEC rejected this proposal,[259] but if enacted appropriately, it could be an important reform that encourages heterogeneity within the board of directors. This reform would significantly reduce the cost of running a proxy contest, which is the main hindrance of competitive elections of board members.[260] A more competitive election should, in theory, create a more diverse pool of nominees.

The main criticism of proxy access is that institutional investors are more concerned with the short-term stock price of a corporation than its overall health.[261] While this is a valid concern, there are requirements that could be placed on proxy access that would limit the nomination power to institutional investors who clearly are concerned with the overall success of the corporation and not short-term returns on their investments. The following restrictions should quiet much of the criticism of this reform: requiring a 5 percent (alone or aggregated together with the holdings of other shareholders seeking to sponsor the same candidate(s)) ownership of

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[253] *See* Lewis A. Kornhauser, Vinay B. Nair & Robert Daines, *The Good, the Bad, and the Lucky: CEO Pay and Skill* (N.Y.U. Sch. of Law, Law & Econ. Working Paper No. 9, 2005), *available at* http://lsr.nellco.org/nyu_lewp/9.

[254] *See* Louise Story, *Wall St. Profits Were a Mirage, but Huge Bonuses Were Real*, N.Y. TIMES, Dec. 18, 2008, at A1 (describing the increasing CEO compensation packages during the current subprime mortgage crisis).

[255] The Emergency Economic Stabilization Act ("EESA") barred any financial institution that received Troubled Asset Relief Program ("TARP") funds from claiming tax deductions for senior executive officers' compensation that exceeds $500,000. Emergency Economic Stabilization Act, Pub. L. No. 110-343, 122 Stat 3766 (2008).

[256] This plan would require each public corporation to hold a non-binding shareholder vote at its annual meeting to approve the corporate executives' compensation packages. Leo E. Strine Jr., *Breaking the Corporate Governance Logjam in Washington: Some Constructive Thoughts on a Responsible Path Forward*, 63 BUS. LAW. 1079, 1103 (2008).

[257] Rebecca A. Crawford, *Corporate Governance Reform: How to Promote the Long-Term Health and Value of U.S. Corporations*, N.Y.U. J. L. & BUS. 905, 923 (2009).

[258] This is referred to as "proxy access." Strine Jr., *supra* note 256, at 1085–86.

[259] *Id.* at 1092.

[260] *Id.* at 1085–86.

[261] Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187, 206 (1991).

a corporation's shares, requiring that the institutional investor hold that 5 percent share for at least two years before receiving the right to nominate directors, and limiting the number of institutional investor-nominated directors to, at most, one-quarter of the entire board of directors. By having these restrictions, investors will never be able to take control away from a corporation and will have a stronger likelihood of being invested in the long-term health of the corporation. This policy would change the make-up of the board and increase the heterogeneity among directors by bringing in new ideas.

2. *Creditors' Nomination Rights*

Another reform that could significantly increase heterogeneity among directors would be to allow creditors to have proxy access and to grant them the same right to nominate directors as institutional investors have. In addition, there would be the same restrictions on the percentage of board nominees nominated by a creditor as there would be for institutional investors. For a creditor to get its return on its investment in a company, the company must remain solvent, thus the creditor has a fundamental interest in the ongoing success of its debtor corporation.[262] Creditors want their loans repaid in full, with interest, or the ability to sell their debt for present value.[263] Some may argue that creditors are far more risk-averse than shareholders or management of a corporation and only have an interest in the corporation surviving, not thriving.[264] This criticism is misguided because in the big picture, a creditor has a very strong interest in the growth and success of a debtor. If the relationship between creditor and debtor is strong, the creditor will want a continuing relationship with the company and its affiliates.[265] It makes sense that a creditor wants to see its debtors grow and succeed, because that in turn will require more funds for expansion and more profit for the creditor.

By following these two reforms, there will be a more diverse group of nominators and nominees for the board of directors. The different nominating groups—investors, creditors, and the corporation— should help diversify the ideology among directors, while still allowing the corporation to run smoothly because management will still control a significant portion of the directors. This structure allows for a balance between a risk-averse and risk-taking ideology among directors, which should encourage more debate over important decisions. In addition, this structure gives investors and creditors the ability to circumvent the "good old boy" system within board nominations and nominate more minorities and women to boards. A diversified pool of nominating bodies should result in a more diversified pool of nominees and help change the strongly homogenous structure of boards that leads to groupthink. While these reforms should help combat groupthink, more reform on the actual behavior of board members is necessary to combat this strong psychological phenomenon.

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[262] Adam Feibelman, *Commercial Lending and the Separation of Banking and Commerce*, 75 U. CIN. L. REV. 943, 944, 949 (2007).
[263] *Id.* at 944.
[264] Crawford, *supra* note 257, at 933.
[265] Feibelman, *supra* note 262, at 948–49.

B. REFORMING DECISION-MAKING PROCESSES

1. *Formalizing the Position of Devil's Advocate*

The devil's advocate is a term Janis used to refer to the position of one group member who has "an unambiguous assignment to present his arguments as cleverly and convincingly as he can, like a good lawyer, challenging the testimony of those advocating the majority position."[266] The devil's advocate would serve as a discussion leader, asking tough questions and encouraging suggestions, all while withholding his or her own opinion. This process could be too confrontational if not done correctly. Therefore, Janis emphasized that the devil's advocate should raise questions in a low-key style.[267]

Another important aspect of the role of devil's advocate is that it be a rotating position.[268] If the role was designated to one person, it would give that person more power than other directors. If that director knows he or she will never have to sustain questioning on their views, he or she may abuse this power and attempt to embarrass other directors who have opposing views. Conversely, if the devil's advocate is in the vast minority, he or she may not perform the job appropriately and may remain silent for fear of being chastised by the group. Rotating the position ensures that each member will be afforded the opportunity to question his or her colleagues. This should allow for open questioning and a far more complete exploration of the many approaches of each business decision. Studies show that the devil's advocate role improves group performance compared to unstructured debates,[269] but this improvement hinges on how the first group member performs the role. To ensure the devil's advocate role is performed correctly, directors should undergo training on how to perform it properly.[270] Creating this role should help encourage real debate among directors but, alone, may not be enough to ensure real change and avoidance of groupthink. The nominating committee of the board of directors should also use skill matrices when approving nominees on the proxy statement.

2. *Skill Matrices to Evaluate Groupthink*

A skill matrix is a document used to evaluate how a newcomer's skills and characteristics fit the needs of a group.[271] In this context, it would be used to evaluate how the skills and characteristics of a proposed director nominee would fit with the needs of the board of directors of a corporation. Skill matrices can be used to identify gaps in behavioral patterns of existing and potential board members, specifically to look for behavioral patterns that show an ability to avoid groupthink.[272] Richard Leblanc and James

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266 JANIS, *supra* note 14, at 267–68.
267 *Id.*
268 *Id.*
269 *See* Dan N. Stone, Marcos P. Sivitanides & Anne P. Magro, *Formalized Dissent and Cognitive Complexity in Group Processes and Performance*, 25 DECISION SCI. 243 (1994).
270 O'Connor, *supra* note 64, at 1306.
271 Rookmin Maharaj, *Corporate Governance, Groupthink and Bullies in the Bedroom*, 5 INT'L J. DISCLOSURE & GOVERNANCE 69, 78 (2008).
272 *Id.* at 78–79.

Gillies offer a behavior-type model[273] that illuminates the best behavioral characteristics that nominating boards[274] should look for when evaluating nominees who will not be prone to groupthink.

Leblanc and Gillies focused on six behavioral types relating to groupthink that fall into two categories: functional or dysfunctional board members.[275] The first two types are "Change Agents" and "Controllers." Change Agents are considered functional board members because they are there "to ensure that the change is not simply talked about but that it takes place and that they provide the leadership and make tough decisions, unpopular as they may be with management and other directors, to get the change made."[276] On the other hand, Controllers are not open to opposing positions and give no alternatives to the suggestions they reject.[277] A way to evaluate which behavior a nominee possesses is to measure his or her level of engagement—meaning a nominee's proclivity to look for alternatives, question decisions, and welcome debate.[278] They also should evaluate a nominee's motivation to inquire and gain knowledge in an area that they are currently misinformed about, because directors need to show a willingness to understand the management's business decisions if they are going to be able to constructively debate and approve of those decisions.[279]

Another set of behavioral types that a nomination committee should consider is "Challengers" versus "Critics."[280] Challengers are considered the functional board members because they ask the tough questions and are constructively critical, while Critics criticize and complain in a manipulative way.[281] The most important characteristic of a Challenger is his or her open-mindedness.[282] By evaluating a nominee's open-mindedness, a nominating committee can judge whether or not that nominee is likely to be a Challenger or a Critic. Remaining open-minded allows constructive dialogue among board members, which is a very effective method of change according to one senior management executive:

> Adopting this new program at our company prompted a tremendous dialogue. Whereas the philosophy before was to just get a little better than what you did last year, now there is a stake in the ground and you get engaged with creative tension. That is the part driving the change.[283]

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[273] Richard Leblanc & James Gillies, *The Coming Revolution in Corporate Governance*, IVEY BUS. J. ONLINE, Sept.–Oct. 2003, at 1.
[274] The New York Stock Exchange requires that listed firms maintain independent nominating committees. NYSE, INC., LISTED COMPANY MANUAL § 303A, *available at* http://nysemanual.nyse.com/LCMTools/PlatformViewer.asp?selectednode=chp_1_4_3&manual=%2Flcm%2Fsections%2Flcm-sections%2F (last visited Jan 20, 2011).
[275] Leblanc & Gillies, *supra* note 273, at 10.
[276] RICHARD LEBLANC & JAMES M. GILLIES, INSIDE THE BOARDROOM: HOW BOARDS REALLY WORK AND THE COMING REVOLUTION IN CORPORATE GOVERNANCE 174 (2005).
[277] *Id.* at 185–86.
[278] Maharaj, *supra* note 271, at 79.
[279] *Id.* at 80.
[280] *See* LEBLANC & GILLIES, *supra* note 276, at 182, 195.
[281] *See id.*
[282] *See* Maharaj, *supra* note 271, at 80.
[283] *Id.*

The last relevant pair of behavioral types described by Leblanc and Gillies is "Counselors" versus "Cheerleaders."[284] The Counselor is the functional type, while the Cheerleader simply praises all executives on the board and decides to not participate or prepare for meetings.[285] A nominee that fits the Counselor type should "have strong persuasive skills, high credibility and have the ability to work individually with a variety of people, both inside and outside the company."[286] Directors that fit this behavioral type are beneficial to a board of directors because they act as coaches to the other board members and have a good understanding of social change or political developments.[287]

Skill matrices can be adjusted depending on the values of a corporation, but these characteristics should be part of the matrices. They will ensure that a nomination committee can evaluate a nominee's ability to contribute to open dialogue and debate, while increasing the board's motivation to seek the knowledge necessary to make a decision. A nomination committee can also use the matrices to evaluate the make-up of the current board, determine if there is a functional behavior type it is in need of, and then find nominees that will fill that void on the board.

VII. CONCLUSION

It is clear that over the last decade, corporate governance has been insufficient. The common denominator among the most recent economic crises appears to be the unquestioned faith that an exponential growth rate of each respective industry would continue perpetually. These poor decisions put corporations in huge amounts of debt and ultimately led to fraud in many cases. Attributing these poor decisions to greed is too simple. There are many psychological processes occurring within executive teams and boards of directors. This Note has examined groupthink's effect on decisionmakers in major American corporations and has found that many corporations suffer from this psychological phenomenon.

Harsher punishments and increasing the number of independent directors on a board are clearly not enough to release these groups of decisionmakers from the grasp of groupthink. A more comprehensive reform is needed to change both the structure of the board of directors and the informal behaviors of boards. Allowing institutional investors and creditors to nominate directors will lead to an increase in diversity within boards. This will break up the homogeneity among directors, a serious problem in today's corporate world. In addition to this reform, directors have to change how they make decisions. A devil's advocate role will increase discussion, questioning, and debate among directors and lead to more calculated and prudent business decisions. By rotating this position and educating directors on how to be a devil's advocate before starting the practice, any ill effects of the devil's advocate will be negated, and directors will have a far better chance of avoiding groupthink. Finally, once

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[284] Leblanc & Gillies, *supra* note 273, at 10.
[285] *Id.*
[286] LEBLANC & GILLIES, *supra* note 276 at 179.
[287] *Id.* at 179–88.

nominations are suggested to the nominating committee, the committee should use skill matrices to evaluate what type of directors the board needs. These matrices can evaluate the behavioral tendencies of nominated directors and allow the committee to determine if that nominee is susceptible to groupthink. Equally as important, the matrices can be developed to determine what type of functional director the nominee would be and allow the committee to approve nominees that fit the current need of the board.

These are sweeping reforms that may not be enforceable as a mandate. They could, however, be utilized as incentives for corporations. If corporations allow creditors and institutional investors to nominate directors directly on the proxy statement, or require their nomination committee to use skill matrices to determine behavioral types, the government could offer subsidies or tax incentives. With these enticements, decisionmakers within corporations will be far less likely to succumb to groupthink. These reforms will not stop all risk taking, but no reform should aim to stop risk taking in its entirety. Corporations must take risks to progress and grow, but if a group of decisionmakers suffers from groupthink, those risks tend to be irrational and unthinkable in hindsight. With these reforms, corporations will be able to take informed risks that lead to the long-term health of their business and, ultimately, the entire economy.