“Why the Board is Broken”

Joseph Anton and Tamar Frankel

Boards of Directors (“Boards”) are anachronistic to major companies in the 21st century. Boards had their origin in an era when oversight was easily executed. The Board directors of many companies were the owners of significant amounts of stock, or their direct delegates. At a later stage the directors were chosen by the Chief Operating Officers, and served as their advisers. In a period of rapid growth, companies needed the resources of outsiders to lend their collective genius in an era when outside knowledge, data and experience were expensive to collect.

As businesses grew larger, the Boards’ responsibility as “watchdogs” representing the shareholders’ interests, became more important. In law, directors were always the fiduciaries of their corporations, and indirectly of their shareholders. But their advisory and supervisory roles were not always distinguished or evaluated. Today, the supervisory role of the directors has become far more important.

The current “Board” model fails for three reasons:

Physics:

An average Board member probably does not spend more than 60 hours per year (and that’s generous) attending to his duties on the Board—(assume 6 Board meetings per year at 6 hours per meeting, with 4 hours in preparation. The reality is that they probably spend less than 30 hours per year!)

[*] Joseph Anton (JAnton@antoninc.com) is President of Anton Lucas, Incorporated, a private investment banking firm that specializes in mergers and acquisitions of privately held companies. Tamar Frankel (tfrankel@bu.edu) is a Professor of Law at Boston University School of Law.

The volume of data that they must review is so large that it is humanly impossible to verify to assure its accuracy or validity. Their review is perfunctory. You can't consume that much data in that little time unless you suspend the rule of physics.

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A current example is helpful. The CFO of Boeing sat on the Board of Sprint (he resigned recently because of other issues.) I can't think of two companies in the world more complicated than Boeing and Sprint. Boeing produces a product that contains over 300,000 parts, is manufactured in multiple countries, and employs over 150,000 people. Sprint provides a global service that you can't even "see" and is required by government regulation to provide accounting on tariffs that exceeds 30,000 pages monthly!

The Boeing CFO probably works more than 2,000 hours per year; in fact most top executives work long hours. How much effective time can he really spend on Sprint business given his day job? If you are a Boeing shareholder, you hope not much. If you are a Sprint shareholder, you wish the opposite. This asymmetry can't work in a country where most of the population has become shareholders of American business by virtue of the revolution in ERISSA, wealth accumulation and the explosion in financial assets.

Financial Risk:

Rarely is there a requirement to invest a substantial stake in the company's stock when you are invited to sit on a Board. Quite to the contrary. Many Board members are given stock options as a reward for serving. They have no risk and invest nothing. If the company performs well and the public markets treat the stock kindly, then the Board member has a gain. If the markets don't take kindly to the stock or the company performs badly, then the Board member has neither a gain nor a loss. There is no incentive when they are playing "with the houses" money.

Legal Risk:

The Business Judgment Rule is a rule granting directors of public companies immunity from liability if their actions were executed in good faith, using sound business judgment and executed with reasonable care. Director's and Officer's Insurance further insulate the Board and provides a fair amount of "wiggle room".

Solutions:

The vast majority of Boards operate effectively not because the model works, but because the people involved, management and Board members, are honest. It is only the very few which need oversight. But in a world where so much damage can be done by so few individuals it is incumbent upon us to change the system. Shareholders can suffer, investors can suffer and the lives of many long-term employees can be devastated by the misdeeds of just a few. The new model should include three simple revisions:

Professional Boards:

Each public company should have a minimum number of professional Board members
who dedicate at least 500 hours per year to that company and are restricted from sitting on more than three other Boards. They would be able to devote enough time to render a sufficient review of the business. Each company could continue to maintain a diversified Board encompassing other talents but is required to have at least, say, two " full time" professional members. This solves the "physics" problem.

The professional directors, who are more responsible for oversight and understanding the more intimate details of the business, may bear a greater burden for which they are compensated. This higher level of liability should relate only to their added responsibility. Otherwise, their duties do not differ from those of the other directors, and neither should their liabilities.

It is time to rethink the role of directors—given access to data, adequate time to evaluate it and the proper set of incentives to lead them, Adlephia, Enron, Tyco, Worldcom— should become events of the past.

Financial incentive:

Compensation could be a combination of a base salary with an incentive based upon operating performance of the company-- not increases in shareholder wealth. The Board member would be free to own as much stock in the company as they choose and would be subject to the normal restrictions relating to "insiders" when trading that stock. This is a topic that is gaining greater attention and there are some suggestions for change, for example, to link the management's pay to financial performance.[1].

Accountability

Finally, it should be recognized that some large shareholders (i.e. pension funds) have an on-going stake in corporate accountability. They have used their large stock position to informally influence the behavior of management. However, there are suggestions for formalizing this relationship.[2] At the end of the day, board member should serve at the discretion, and for the benefit, of the shareholders.

Deterrent:

A strict enforcement policy with the SEC and Judiciary working in harmony and punishing those who violate the law would go a long way to regulating bad behavior. There is nothing like going to jail, accounting for their profits, and disqualification from membership in management as incentives to being good.

[1] See Siebel, W.S.J. January 21, 2005; Lucian Bebchuk and Jesse Fried, Pay Without Performance (2004).
[2] Security Holder Director Nominations, Exchange Act, Release No. 48,626 (Oct. 14, 2003), 68 Fed. Reg. 60,784 (Oct. 23, 2003).

Self-regulation

Large corporations and mutual funds can affect the economies and currencies of countries around the globe. But in the 1990s their responsibility did not catch up with their power. The reaction to this failure was the Sarbanes-Oxley Act and tougher securities and accounting regulation. The Act raises the management's awareness, but compliance with the Act is costly, and could be reduced if corporations self-supervise.

Apply to Mutual Funds:

The proposal to have at least two committed directors is especially suitable for mutual funds boards of directors. New recent rules increased the number of independent directors to 75%, and required the chairperson of the board to be an independent director. The boards' responsibilities have expanded as well.

Mutual funds are an ideal ground for testing the effect and cost of two committed directors. Mutual funds have served as an experiment for corporate governance before (e.g., the idea of independent directors).

Why should the mutual fund industry and its investors agree to increase its expenses and pay for such committed directors? Why should the Advisers (equivalent to a CEO) agree? They would agree if the proposed change replaced the duties under the Sarbanes-Oxley Act. The costs of committed directors need not be higher than the cost of complying with the Act. The Advisers may prefer stricter accounting to the independent directors than to the personal burdens of the Act. The investors may not object to the experiment.

Most importantly is the effect of this proposal on governance culture, leading to stronger internal self-regulation. Yet, release from the Sarbanes-Oxley Act should be conditional. Sarbanes-Oxley Act should be re-imposed if the directors were ineffective in preventing or uncovering securities violations. Let this experiment apply to mutual funds governance. Corporate governance should follow.