Photograph by Bruce Weller

What's a Director to Do?

From governance guru Ira Millstein and others, complex counsel on blending oversight and intervention.

Knowledge Review
by Michael Schrage

By far the most important responsibility of a board of directors, says super-investor Warren Buffett, is to fire CEOs who just aren't good enough. What makes a board's job particularly tough, he observed at a CEO workshop on corporate governance earlier this year, is when the CEO rates only "a six or seven" on a scale of 10. The CEOs didn't like hearing that.

Although Mr. Buffett's boardroom priority reflects neither the spirit nor the letter of the Sarbanes-Oxley Act, it does capture the core conflict haunting corporate governance worldwide: When should board oversight — when *must* board oversight — become active intervention? As directors become more accountable to shareholders, regulators, and the courts, how much more accountability does the board demand of its C-level executives?

Multibillion-dollar governance debacles have understandably created new demands for radical reform. A "zero-tolerance" environment is evolving for both directors as individuals and boards as fiduciary institutions. The days when "independent" directors could

Michael Schrage
(schrage@media.mit.edu), a contributing editor to *strategy+business*, is the codirector of the MIT Media Lab's e-Markets Initiative and a senior advisor to the MIT Security Studies program. Mr. Schrage is the author of *Serious Play: How the World's Best Companies Simulate to Innovate* (Harvard Business School Press, 1999) and served on the board of Ticketmaster.

receive hundreds of thousands of dollars in "fees" for marginal investments of time and effort are over.

Yet although the current sense of urgency and accountability may be new, the underlying problems of corporate governance are not, as Yale economist Paul W. MacAvoy and attorney and governance guru Ira M. Millstein point out in their quirky but compelling collaboration, *The Recurrent Crisis in Corporate Governance*, which explains why boards consistently, persistently, and predictably fail in their fiduciary duties.

Despite legislation as onerous as Sarbanes-Oxley, and despite ongoing threats of public and private litigation, Professor MacAvoy and Mr. Millstein maintain that the governance conundrum will get worse unless further reforms are undertaken. In a pithy, provocative 160 pages, they not only synthesize and summarize the best academic research on the economic importance of governance; they persuasively argue that boards need to be institutionally reconstituted and redesigned.

They are blunt: The authors want the American era of the combined chairman/CEO to come to an end. Now. They believe that boards should be far more independent. Now. They expect that making boards more accountable will make them more productively proactive. Directors should be investors. Managerial capitalism is dead; long live the return of investor capitalism.

"The major element of [board] self-help, as suggested throughout this book," they write, "requires boards to own up and recognize a basic truth: a board needs a leader, separate and independent from management, whose primary function is to help the board design and carry out its processes and thereby obtain the information that it needs to adequately protect against the misuse of resources and the squandering of investors' capital."

Professor MacAvoy and Mr. Millstein sport impeccable credentials and employ rigorous analysis, but the governance conflicts they identify may prove even more intractable than they fear. Rather than creating a rational mechanism for corporate checks and balances, the ongoing rise in governance legislation, litigation, and regulation instead may be creating unrealistic expectations for effective oversight.

That's worrisome news for directors. Look at a recent white paper from the American Insurance Group (AIG) on the future of directors and officers (D&O) insurance, and the California Public Employees' Retirement System (CalPERS) Web site on corporate governance. AIG is one of the largest underwriters of D&O insurance. CalPERS is the largest U.S. public pension fund, with more than $160 billion in holdings, and has championed the limiting of investments to those companies that use "best practice" governance principles. What becomes disconcertingly clear is that the public market for directorial transparency, accountability, and responsibility is becoming as overheated as the market for Internet stocks was in 1999.

"New litigation trends continue to indicate that D&O liability will become greater and greater," begins AIG's 2004 white paper. "Trends point to increases in derivative litigation against directors; a rise in securities claims against smaller companies; and new vulnerabilities, including expensive pension fund litigation against directors and officers. There is also the specter of unforeseen litigation arising out of new accounting pronouncements and regulatory changes." Just for context, AIG's paper points out that the number of companies sued in securities litigation nearly doubled from 1996 to 2003, while the average settlement for non-accounting-related cases more than tripled, to $24.8 million. In other words, says AIG, you ain't seen nothin' yet.

Or how about the CalPERS governance Web site? Among the warning shots delivered is this one: "In the past, CalPERS encouraged the independent directors as a group to act as catalysts on the board and to heighten their oversight of management. In future campaigns, CalPERS may call directors to account for their *individual* [emphasis in the original] performance. It may urge directors to devote more time to fewer boards, avoiding the problem of 'multiple directorships.' Or, it may encourage boards to restructure for optimum size, diversity, and independence."

The problem with this new governance ideal is that boards of

Today's market for board accountability is as overheated as the market for Internet stocks in 1999.

directors are effectively being asked to develop fiduciary split personalities. On one hand, boards are asked to ensure that management actively seeks to "maximize shareholder value." On the other, hostile legal and ethical climates compel directors to be conservative in ensuring compliance with complex and conflicting accounting rules and regulations. (Consider the huge battles over expensing stock options.)

Where Sarbanes-Oxley demands that directors devote disproportionate effort to overseeing compliance processes to preclude any chance of fraud, misrepresentation, or financial malfeasance, the markets rightly demand that directors push for strategic value creation. Powerful institutional investors who once pressured a company's top management to perform better — or else — now tell boards of directors to get top management to perform better — or else.

In other words, directors, particularly the truly independent directors now required by law to populate the boardrooms of publicly traded companies, must be bolder yet more risk-averse. Maximize shareholder value, but be certain to dot every legal *i* and cross every compliance *t*. Practice "Hippocratic governance" (first, do no harm!), but also deliver the "high-performance governance" that pushes management to greater results.

Resolving these tensions is difficult in the best of times. As the MacAvoy–Millstein book, the AIG paper, and the CalPERS Web site attest, these are not the best of times. Regulatory redesigns, in fact, complicate the governance challenge because they promote institutional distrust between the company management and the board. Sarbanes-Oxley, for example, effectively calls for boards consistently to substitute verification for trust. Section 404 of the act requires management at all levels to "sign off" on the financials. Top managers can't be trusted either to police or to compensate themselves, so audit and compensation committees must consist solely of independent directors.

Is that all bad? Of course not. Trust and verification are not incompatible. Skeptical inquiry typically yields better operational decisions than passive acquiescence. But effective governance is about striking a reasonable accommodation between verification and trust — not about elevating one over the other.

If you accept that governance reforms are intended to minimize managerial excess and indulgence while boosting executive accountability, then honesty compels acknowledgment that reforms must also encourage a more contentious relationship between management and the board. The history of human nature reveals that adversarial relationships create their own pathologies of miscommunication and mismanaged expectations with respect to risk and reward. That's why defining the trade-offs that shape effective governance is so hard.

So is better governance defined primarily by the active prevention of abuse? Or by the active promotion of profits? Or, to "Buffett-ize" the issue, is better governance defined primarily by making sure the right people are in the top jobs — the board as C-level human resources department?

"Better governance" champions, including Mr. Millstein, Professor MacAvoy, and the CalPERS board, argue that it should mean all of those things. Good luck. As recurrent crises in global corporate governance affirm, it's difficult to do even one of those things consistently well. No wonder D&O insurance rates are rising.

The problem emerging in the governance debate is straightforward: A board trying to do all of these things well is not merely an active board; it is a board actively running the company. This is not overseeing management or supervising management or holding management accountable — it *is* management. So the corporate governance reform agenda risks becoming an initiative effectively to dissolve most of the critical, traditional distinctions between the chief executive and the board.

That's not hyperbole. Consider this observation by Mr. Millstein and Professor MacAvoy: "There has been growing boardroom interest in assuming a more active role in the strategic process. If the board is to determine the merits of management's strategic and business plans, including the likelihood of realizing the intended results, then it should determine for itself the capacity of specific operations to generate the returns expected to be in keeping with the strategy."

How might a board do this? Imagine that management presents the board with a bold plan for spinning off or acquiring strategic assets worldwide. The logic is consistent; the plan makes sense; the numbers look good; and management honorably answers every hard question put to it by skeptical outside directors. But is that really enough? At the very least, shouldn't the board get an opinion from an independent advisor or consultant to "audit" the strategic assumptions made by management and its own consultants? After all, independent outside directors have hardly had the equivalent time and resources to review the merits of such strategic plans.

Corporate Governance Resources

Works mentioned in this review.

Paul W. MacAvoy and Ira M. Millstein, *The Recurrent Crisis in Corporate Governance* (Palgrave Macmillan, 2004), 160 pages, $65.00

American Insurance Group's White Paper on D&O Insurance: www.aig.com/boardmember/aig_do_white_paper.pdf

The California Public Employees' Retirement System governance Web site, "CalPERS Shareowner Forum": www.calpers-governance.org

A decent case could be made that independent directors who feel compelled to retain outside experts to review corporate strategy have lost confidence in the CEO and should simply fire him or her. Conversely, one could argue that hiring outside experts is the most cost-effective way for independent directors to prove their independence and positively challenge, rather than undermine, top management. So which is it?

A more active role for the board might well guarantee new fiduciary-driven infrastructures for managerial second-guessing. In the same way finances are audited by outsiders, strategies and operations would be too. In the same way there are board audit committees and compensation committees, there would now logically be board committees for strategy and operations.

To the extent, however, that the board actively collaborates and cooperates with management in the design and development of new strategies and business operations, the board inherently is not performing oversight. Why? Because active collaboration with management means the board is overseeing and reviewing itself. It's almost impossible to see how a group of independent directors intimately collaborating with the CEO, the CFO, and the key business unit heads on a proposed strategic acquisition can honestly be objective about a deal they helped facilitate.

Similarly, we can — and do — look askance at a judge who is a little too helpful to and supportive of a plaintiff's or defendant's attorney. Courts would think twice before allowing members of the jury to conduct cross-examinations to clarify concerns they might have. There are rules, there are roles, and we need to think very carefully about the consequences of expanding the purview of company boards just as we would a judge's discretion or a jury's curiosity in the courtroom.

Yet, as Mr. Millstein and Professor MacAvoy point out, longtime legal principles of corporate governance such as "good faith" continue to expand the boundaries of perceived directorial duty. Indeed, the authors quote Delaware's chief justice as saying good faith is likely to emerge as a central issue of the directors' standard of conduct. "Traditionally," they note, "the duty of good faith has been closely related to that of loyalty, which prohibits self-dealing, self-interest or serving any interest except that of the corporation and its stockholders. [The Chief Justice] has noted, however, that in some cases, 'it may be accurate to consider the duty of good faith as an additional duty beyond the duty of loyalty.'"

In other words, "good faith" may mean adhering to both the letter and the spirit of regulatory compliance. However, it may also mean having the board retain its own outside advisors to scrutinize a strategic initiative recommended by management's outside advisors. Indeed, the securities plaintiff's bar will be eager to conduct discoveries that would examine the differences between the consultants hired by management and those hired by the board to review them. Better yet, if some boards retain outside advisors to review strategic operations and others don't, are the ones that don't in breach of their "good faith" fiduciary obligations, because they didn't subject management to this added level of strategic quality control?

That's precisely the kind of question the courts will ultimately decide. Of course, an insurance company like AIG will have to pay for that legal defense. That is, unless AIG insures only those boards and directors who do in fact seek outside counsel before they vote on strategic management initiatives. Thus new standards of "good faith" are created.

What's fascinating about so many of the governance reformers is not that they are cynical about the role of boards, but that they are so idealistic. The notion that independent directors can, on a part-time basis, simultaneously and successfully formulate strategy, hire and fire senior executives, ensure rigid compliance with myriad global procedures, detect fraud, appropriately incentivize managerial performance, and oversee metrics for organizational performance, all without any actionable conflicts of interest, strikes me as exceedingly optimistic.

The more provocative governance questions might well be: What are the two or three things a board — and its independent directors — must do outstandingly well? And how do we ensure the board does them? In other words, can governance be redefined in ways that sharpen and narrow the focus of the board rather than so dramatically extending its fiduciary obligations and reach?

Perhaps boards will become better vehicles for allowing individual and institutional investors to introduce initiatives for management consideration — the "California-ization" of corporate governance, with propositions and recalls galore defining a new era of shareholder democracy and republicanism. Maybe the board of the future will double down on Warren Buffett's declared governance priority and focus overwhelmingly on supervising and measuring management as its role in maximizing shareholder value.

Conversely, maybe it's time to go back to first principles and redefine the meaning of *oversight* in an era of high-tech transparency. Should the role of the board be, instead, to ensure appropriate levels of transparency so that other stakeholders can work with the firm more cost-effectively?

The point is not that any of these ideas represent a "better" approach to resolving the recurrent crises in governance, but that their underlying vision is more humble and modest. Over the past 20 years, there's been no shortage of best-selling books celebrating entrepreneurial managers and visionary leaders. But who gets hot and bothered about governance? Even three years ago, no one would write, let alone buy, *The One-Minute Director*, *In Search of Governance*, or *Who Moved My Board?* Yet a fundamental reevaluation of what makes governance work — and why — is precisely what business executives need. Management and leadership exist in the context of governance. I think that means governance should be more tightly focused rather than all-encompassing.

Our systems of due diligence and disclosure have proved to be distorted and dysfunctional. But let's not confuse good leadership and good management with good governance. The current generation of business leadership and corporate investment critics risks doing so. The price in both capital and credibility has been enormous. Recapturing credibility is a challenge that calls for greater humility, not greater ambition. ✚

Reprint No. 04310