

# AMERICA'S CHANGING CORPORATE BOARDROOMS: THE LAST TWENTY-FIVE YEARS

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*Since 1987 there have been many significant, positive changes in the manner in which boards of American public companies conduct themselves. In our first book published in 1989, *Pawns or Potentates: The Reality of America's Corporate Boards*, Elizabeth McIver and I found that boards were acting more like pawns and not so much as the potentates they were legally intended to be. By 2001, Colin Carter and I concluded in *Back to the Drawing Board: Designing Boards for a Complex World* that many, if not most boards of public corporations had adopted new "best practices" and were trying to live up to their legal obligation to be potentates. Many boards, however, in the United States and other countries, were still struggling to meet these legal expectations. Despite all of the progress that has been made, boards still face many difficulties, especially oversight of complex multinational corporations and companies that operate several lines of business.*

*In this Article, I outline several significant changes in corporate boardrooms over the past twenty-five years and use those lessons to propose a thought experiment about how boards can be shaped in the future. I argue that the major problems in the last twenty-five years have been the negative, unintended consequences of reforms and the inability to balance the interests of the various stakeholders. Future policymakers should turn their attention to resolving these issues, because they have the potential to thwart other attempts at progress.*

## TABLE OF CONTENTS

INTRODUCTION . . . . .	119
I. CHANGE IN THE NINETIES . . . . .	120
II. CRISES AT THE DAWN OF THE TWENTY-FIRST CENTURY . . . . .	126
III. THE FINANCIAL MELTDOWN . . . . .	129
IV. TWENTY FIVE YEARS OF PROGRESS? . . . . .	130
CONCLUSION . . . . .	133

## INTRODUCTION

Since I began systematically studying corporate boards in 1987 there have been many significant, positive changes in the manner in which boards of American public companies conduct themselves. In our first book published in 1989, *Pawns or Potentates: The Reality of America's Corporate Boards*, my co-author Elizabeth McIver and I asked a basic question: were America's corporate boards acting as the potentates that Delaware and other states' laws required them to be, or were they operating as the pawns of

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CEOs?<sup>1</sup> The answer, derived from questionnaires and interviews with a large sample of directors of public companies, was that boards were acting more like pawns than the potentates they were legally intended to be.<sup>2</sup> By 2001, when Colin Carter and I were writing *Back to the Drawing Board: Designing Boards for a Complex World*, we concluded that many, if not most, boards of public corporations had adopted new “best practices” and were trying to live up to their legal obligation to be potentates.<sup>3</sup> However, many boards, in the U.S. and other countries, were still struggling to meet these legal expectations. In another book I edited and published in the summer of 2012, my colleagues at Harvard Business School and I recognized that while progress has been made in the last decade, boards still face difficulties in overseeing their companies, especially complex multinationals and firms operating several lines of business.<sup>4</sup>

At the time of writing, my Harvard Business School colleagues and I are still engaged in gathering systematic data about the state of America’s boards, as seen by their members. Even with this survey still in progress, in this Article I will share some preliminary data which strongly suggest that corporate boards have made significant progress over the last twenty five years. This is not to deny that some boards are still struggling to perform at a higher level.

## I. CHANGE IN THE NINETIES

In 1989, the major conclusion of *Pawns or Potentates* was that boards had a serious problem because they faced an imbalance of power in relation to the management they were intended to oversee.<sup>5</sup> Top management, especially CEOs, had more real power over corporate affairs and major decisions than did the board. In that book, we identified three important factors that could contribute to boards’ real power to govern.<sup>6</sup> The first factor was the boards’ legal authority. For example, the law in Delaware indicated that boards were in charge, but that they could delegate their authority to manage the company to its officers.<sup>7</sup> As a practical matter boards always did, and still do, make such delegations. This is clearly evident in Delaware, the state in which most public American companies are incorporated. Directors recognized that only full-time executives had the time and knowledge to manage a company. Boards uniformly made the only judgment that was realistic:

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<sup>1</sup> JAY W. LORSCH & ELIZABETH MACIVER, *PAWNS OR POTENTATES: THE REALITY OF AMERICA’S CORPORATE BOARD* (1989).

<sup>2</sup> *Id.*

<sup>3</sup> COLIN B. CARTER & JAY W. LORSCH, *BACK TO THE DRAWING BOARD: DESIGNING CORPORATE BOARDS FOR A COMPLEX WORLD* (2004).

<sup>4</sup> JAY W. LORSCH, *INTRODUCTION TO THE FUTURE OF BOARDS: MEETING THE GOVERNANCE CHALLENGES OF THE TWENTY-FIRST CENTURY* 3 (Jay W. Lorsch ed., 2012).

<sup>5</sup> See LORSCH & MACIVER, *supra* note 1.

<sup>6</sup> *Id.* at 13.

<sup>7</sup> *Cf.* DEL. CODE ANN. tit. 8 §§ 141, 142 (2010).

to oversee management, as the managers ran the company. However, effective oversight requires that boards have the power to influence their CEOs. The legal power of a board was of limited value in this regard unless it was willing to threaten termination or to reduce compensation each time the CEO disagreed with the board. These are not very practical options. The second and most practical source of a board's power was its solidarity as a group. If the entire board supported a decision, it was unlikely that even the most intransigent CEO would resist for long. Finally, the more open the CEO was to the board's ideas, the more opportunity the board had to influence corporate decision-making, another real source of power.

In contrast to these few sources of power, boards faced numerous limitations on their ability to carry out their duties. First, directors had limited time to conduct their affairs. Most had other full-time jobs in addition to their board duties, and some served on several boards.<sup>8</sup> These facts limited their time to meet and to prepare for meetings. The typical board at this time met six times a year for about a day at each meeting.<sup>9</sup> This is still true today. A single day is not a lot of time to understand and debate issues facing directors and their company.<sup>10</sup>

Most directors also had limited knowledge and information about their company and its business. To an important extent this was because of the size and pace of the relevant businesses, and the limited time mentioned above. Another issue was that most directors, even in the 1990s, were independent.<sup>11</sup> Independent directors usually had limited experience in their company's business, and thus had to learn on the job. The longer a director served the less problematic the situation was, but many experienced directors indicated that it took them a year or more to understand their company's business.<sup>12</sup> Even then, they lacked the depth and breadth of knowledge of their full-time CEO.

Information asymmetry between a board and its management was also an issue. In most boardrooms, management not only had greater knowledge of the issues, but also controlled the information directors received. This is not to suggest that managers were intentionally withholding information, but merely that the situation affected the balance of power in boardrooms.

Another constraint on the power of boards was a lack of clarity about the goals of boards in general. Many directors had adopted the notion propagated by Michael Jensen and William Meckling that the primary purpose of a company was to create value for its shareholders.<sup>13</sup> Other board members

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<sup>8</sup> LORSCH & MACIVER, *supra* note 1, at 18–19.

<sup>9</sup> *Id.* at 55–56, 87.

<sup>10</sup> Jay W. Lorsch, *Boardroom Challenges: Lessons from the Financial Crisis and Beyond*, in *THE FUTURE OF BOARDS* 18 (Jay W. Lorsch ed., 2012).

<sup>11</sup> CARTER & LORSCH, *supra* note 3, at 87.

<sup>12</sup> *Id.* at 45.

<sup>13</sup> Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 306–07 (1976).

accepted the more traditional view that companies should have broader goals, serving not only shareholders, but also customers, employees, and their communities.<sup>14</sup> Directors seldom discussed such fundamental matters as the purpose of the company or the board's and management's objectives. As a result, different directors were making management decisions on the basis of fundamentally divergent premises. Not surprisingly, such uncertainty could limit a board's capacity to reach decisions.

As stated earlier, a key source of any board's power was the ability of the directors to act in concert in any disagreement with the CEO. Unfortunately, a strong set of norms in most boardrooms in the early 1990s inhibited directors from forming such a strong coalition. In essence, directors believed that it was inappropriate to criticize their CEO in board meetings.<sup>15</sup> An obvious way around this norm was private discussions among directors, but there was also a belief that it was inappropriate for directors to have discussions without the CEO being present.<sup>16</sup>

A final constraint on board power was the countervailing power of the CEO, who had intimate and detailed knowledge of the company and its strategy, people, and operations. Executives reporting to the CEO were the board's primary source of information. Further, the fact that in almost all companies at this time the CEO was also the board chair<sup>17</sup> afforded the CEO control over the agenda and discussions in board meetings. The CEO's position as board chair also allowed her to encourage directors to speak or not or allocate time to different topics. Finally, the CEO was often the most important voice in deciding who should fill any vacant seats on the board.<sup>18</sup> Thus, new directors often felt beholden to the CEO.

On account of these factors, Elizabeth MacIver and I concluded that directors were not so much the potentates they were legally intended to be, but were more likely to be the pawns of the company's CEO. When *Pawns and Potentates* was first published, there were mixed reactions to our conclusions. On the one hand, CEOs and their lobbying organization, the Business Roundtable, argued that the research must be flawed because CEOs indeed recognized the legitimacy of their board's right to rule.<sup>19</sup> On the other hand, institutional investors like CalPERS, who already believed that top managers had too much power, agreed with the book's conclusions.<sup>20</sup> Such investors, often index funds holding the whole market, could not communi-

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<sup>14</sup> LORSCH & MACIVER, *supra* note 1, at 41–44.

<sup>15</sup> *Id.* at 93.

<sup>16</sup> *See id.* at 93–94.

<sup>17</sup> *Id.* at 2 n.1.

<sup>18</sup> *Id.* at 20.

<sup>19</sup> *See* Bus. Roundtable, *Corporate Governance and American Competitiveness*, 46 BUS. LAW. 241, 246 (1990).

<sup>20</sup> *See* CAL. PUB. EMPLOYEES' RET. SYS., U.S. CORPORATE GOVERNANCE PRINCIPLES 3 (1998), available at <http://www.boardoptions.com/governance.htm>.

cate their disapproval of company performance or governance by selling shares and so sought other means to voice their concerns.<sup>21</sup>

Perhaps the most important audience for the book was the directors themselves. When the book was first published, there was no evident reaction from them. However, as expressed in questionnaires and interviews, it is clear that many directors were uncomfortable with their ambiguous position.<sup>22</sup> They were supposed to be potentates, but they did not have the real power to carry out this mandate.

Although many CEOs at first resisted this diagnosis of boardroom problems, there were other influential voices in the business community who recognized its validity and began the search for solutions. A number of similar ideas for improving board functionality emerged at this time. Martin Lipton and I wrote an article laying out proposals we believed would enable boards to improve their governance.<sup>23</sup> Ira Millstein, working as a counsel to the General Motors board, urged the adoption of similar ideas.<sup>24</sup> William Allen, Chancellor of the Delaware Court of Chancery, delivered a speech at Northwestern Law School, in which he urged outside directors to be more proactive.<sup>25</sup> Over the balance of the 1990s many boards adopted similar ideas.<sup>26</sup> These changes developed into a set of widely-recognized best practices, among which were: smaller boards; a majority of independent directors; meetings for the independent directors without the CEO present; a leader for the board who is not the CEO; independent directors controlling the process of selecting new directors; audit, compensation, and corporate governance committees; a focus on approval of company strategy, evaluating the performance of the CEO, oversight of management development, and evaluation of the board's own activities; and compensation structured to motivate the directors.

In essence, these best practices enhanced the power of boards in relation to management and other top executives. These practices provided the board with a legitimate leader who was not the CEO. The practices encouraged directors to hold "executive sessions," thus breaking away from the old norm which had discouraged directors from talking to each other in the CEO's absence. Once directors recognized the benefits of having conversations without the CEO, they also began to feel comfortable speaking to

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<sup>21</sup> Ira M. Millstein & Paul W. MacAvoy, *The Active Board of Directors and Performance of the Large Publicly Traded Corporation*, 98 COLUM. L. REV. 1283, 1290 (1998).

<sup>22</sup> See, e.g., LORSCH & MACIVER, *supra* note 1, at 77–80.

<sup>23</sup> See generally Martin Lipton & Jay W. Lorsch, *A Modest Proposal for Improved Corporate Governance*, 48 BUS. LAW. 59 (1992).

<sup>24</sup> Michael Schrage, *Ira Millstein: The Thought Leader Interview*, STRATEGY & BUS. (Mar. 1, 2005), <http://www.strategy-business.com/article/05109?gko=37d1b>.

<sup>25</sup> William T. Allen, *Redefining the Role of Outside Directors in an Age of Global Competition*, Address before the Ray Garrett Jr. Corporate and Securities Law Institute, Northwestern University (Apr. 30, 1992), in ROBERT A.G. MONKS & NELL MINOW, *CORPORATE GOVERNANCE* 487–95 (1995).

<sup>26</sup> CARTER & LORSCH, *supra* note 3, at 16–18.

each other informally between meetings. Such dialogue was also encouraged by the formation of three committees—Audit, Compensation, and Governance—in which directors met regularly without management present. These best practices also emphasized the desirability of smaller boards to facilitate group discussion. Finally these new ideas also provided boards with a more precise view of their role than just “managing the affairs of the corporation.” They were supposed to ensure company compliance with applicable laws, approve major strategic decisions and assure a supply of future top executives.

A most intriguing question is why so many directors were willing to try these new ideas. The oft-repeated idea in organization theory that individuals resist change was clearly not true in many boardrooms. In fact, the directors who embraced these new ideas saw them as solutions to the problems that they felt existed (and that they had revealed as we collected data for *Pawns or Potentates*).

To be clear, not all boards adopted these practices simultaneously or quickly, and some did not do so until regulations and laws required the new practices many years later.<sup>27</sup> Nor did such best practices solve all board problems. As Colin Carter and I wrote in 2004, “[o]ur position from the start was that while boards had been improving in many countries over the previous decade, too many were still unable to carry out their mandate effectively.”<sup>28</sup> Nonetheless, the voluntary acceptance of these practices in so many boardrooms during a period of about eight years was a remarkable change. Although still insecure in their relationship with CEOs, many board members ultimately resolved to adopt these best practices, seeing them as both feasible and as sources of ultimate benefit for their corporations.

While in many cases the impetus for adopting these best practices came from directors themselves, institutional investors also pressed for these changes. Often these shareholder initiatives were quiet—a private meeting or an unpublicized letter—but carried the implicit support of other institutional investors. Although SEC rules at the time limited direct coordination among shareholders,<sup>29</sup> these shareholders all belonged to the Council of Institutional Investors,<sup>30</sup> which provided an easy venue for informal communication.

When such a “quiet approach” to remedying corporate governance sins did not bring results, institutional investors sometimes used a public ap-

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<sup>27</sup> See, e.g., Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 *BUS. LAW.* 921, 921–22 (1999) (reporting that 2% of S&P 500 firms maintained a majority of inside directors on their boards in 1997).

<sup>28</sup> CARTER & LORSCH, *supra* note 3, at ix.

<sup>29</sup> See, e.g., Regulation of Communications Among Shareholders, 57 *Fed. Reg.* 48276 (Oct. 22, 1992) (stating the SEC’s “determination that the federal proxy rules have created unnecessary regulatory impediments to communication among shareholders and others . . .” by imposing strict requirements on communications between large groups of shareholders).

<sup>30</sup> JAY O. LIGHT, JAY W. LORSCH & JAMES E. SAILER, *CALIFORNIA PERS (A) 8* (1991) (Harvard Business School case study) (on file with author).

proach. For example, in 1990, both CalPERS and The New York State Employees' Pension Fund wrote letters to the board of General Motors asking how the directors planned to handle the selection of a successor for CEO Roger Smith. When they did not receive a satisfactory response, the parties publicized the episode in the *New York Times* and *Wall Street Journal*.<sup>31</sup>

Alternating between private communication with boards and management on the one hand and more public embarrassment on the other are tactics that institutional shareholders continue to use—or perhaps misuse—for reforming boards today.<sup>32</sup> They understand that public company directors do not like to be embarrassed and they use that fact to their advantage. Further, these funds and their allies, mainly union pension funds, have used their right to sponsor shareholder proposals, and even proxy contests to produce changes in corporate bylaws, which affect matters like how directors are elected. As Figure 1 demonstrates, these changes have had a continuing impact. There are four particularly salient examples of how institutional investors have enjoyed enhanced influence over boards—efforts which have in large part been influenced by the decisions of the Delaware courts.

While these changes were being accepted in many American boardrooms, similar ideas were being proposed across the Atlantic. Notably, in Britain, the 1992 Cadbury Report, which did not have the force of law,<sup>33</sup> enumerated multiple best practices for boards and asked that companies state in their public reports the extent to which they complied with its recommendations.<sup>34</sup> Among its recommendations were that boards have a chair who was not the CEO, add independent and non-executive members (many U.K. boards at the time were made up largely of management directors<sup>35</sup>), and establish audit committees.<sup>36</sup> Even more than in the U.S., adoption of these recommendations was swift and dramatic. Perhaps it was because the sponsors of the project included the London Stock Exchange.<sup>37</sup> Or perhaps it was because companies were encouraged to publicly state their degree of compliance. Whatever the reason, the Cadbury Report had an important impact not

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<sup>31</sup> Doron P. Levin, *2 Holders Seek Role With G.M.*, N.Y. TIMES, Jan. 8, 1990, at D1; Joseph B. White, *GM Performance Sparks Fund's Concern But Their Letters Draw Tactful Rebuff*, WALL ST. J., Jan. 9, 1990, at A4.

<sup>32</sup> JAY O. LIGHT, JAY W. LORSCH & JAMES E. SAILER, CALIFORNIA PERS (B) 8 (2000) (Harvard Business School case study) (on file with author).

<sup>33</sup> For information on the separation of CEOs from Chairpersons, see SPENCER STUART, 2009 SPENCER STUART BOARD INDEX 4 (2009), available at <http://content.spencerstuart.com/sswebsite/pdf/lib/ssbi2009.pdf>. For information on staggered boards and majority voting, see *id.* at 10. For information on poison pills, see KEVIN M. WELLS, RISKMETRICS GRP., 2009 CORPORATE GOVERNANCE BACKGROUND REPORT: POISON PILLS 9 (2009), [https://www.governanceexchange.com/repository/KnowledgeGateway/pubs/BR\\_Pills\\_Final.PDF](https://www.governanceexchange.com/repository/KnowledgeGateway/pubs/BR_Pills_Final.PDF).

<sup>34</sup> See ADRIAN CADBURY, CORPORATE GOVERNANCE AND CHAIRMANSHIP: A PERSONAL VIEW 15 (2002).

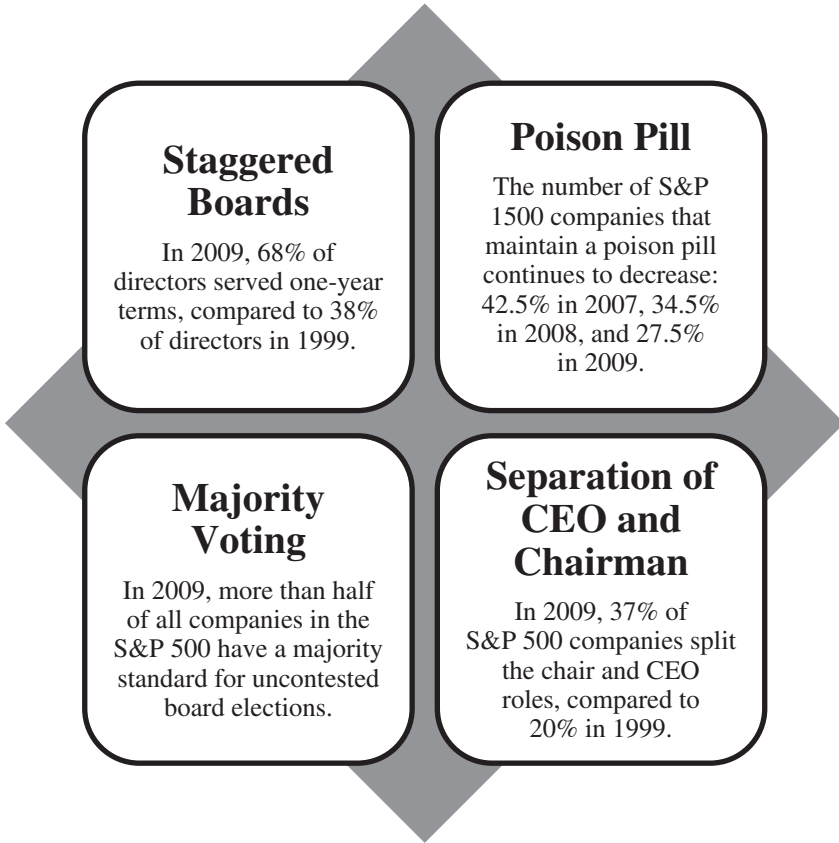
<sup>35</sup> *Id.* at 20.

<sup>36</sup> Jay Dahya & John J. McConnell, *Board Composition, Corporate Performance, and the Cadbury Committee Recommendation*, 42 J. FIN. & QUANTITATIVE ANALYSIS, 539, 540 (2007).

<sup>37</sup> CADBURY, *supra* note 34, at 21, 104.

only in the U.K., but also in the U.S., in that it lent support to changes already in progress on this side of the Atlantic. It is worth mentioning that at this time these ideas were spreading to the Netherlands, France, and Australia.<sup>38</sup> But, nobody was aware of the problems that the new century would bring.

FIGURE 1: RESULTS OF SHAREHOLDER PROPOSALS (1999-2009)<sup>39</sup>



II. CRISES AT THE DAWN OF THE TWENTY-FIRST CENTURY

In the beginning of the new century two different governance-related crises struck the American business scene. The first was the bursting of the “dot com bubble” in 2000. Many early-stage, newly-listed public companies saw the value of their equity drop precipitously. Many of these companies

<sup>38</sup> See *id.* at 29.

<sup>39</sup> CARTER & LORSCH, *supra* note 3, at 12.



had yet to prove that they had sustainable business models, and these failures were blamed mostly on the entrepreneurs and venture capitalists who founded and took the companies public. Nevertheless, in hindsight, it is clear that such failures were at least partially the fault of boards, which made the decisions to attract public investors at share prices which were unrealistic and unsustainable.

The second governance failure was the wave of fraud and misleading accounting that occurred at companies like Enron, Tyco, and WorldCom. While the specifics of each scandal were different, all featured improper or fraudulent accounting practices and inflation of the earnings of senior managers, and in the case of Tyco, even a so-called independent director.<sup>40</sup>

An important question is whether the boards of these companies adopted the best practices described above. Certainly all these boards had a majority of independent directors, and they had the major board committees.<sup>41</sup> But in other respects, these boards mostly followed the traditional approach in which the CEO had great power. None of these companies had a leader of the independent directors besides the CEO.<sup>42</sup> For example, Enron had a board of seventeen members, far beyond the size specified by the best practices, and all these directors expressed great confidence in Enron's Chairman and CEO, Kenneth Lay, and his senior executives.<sup>43</sup> The board of Tyco, a Bermuda corporation, held only informal "huddles" in the U.S., at which no minutes or other records were kept.<sup>44</sup>

I had the dubious distinction of serving as a potential expert witness in lawsuits involving both Tyco and Enron directors, and read hundreds of pages of exhibits and deposition testimony by the directors, senior executives, and their advisors. What struck me as a common theme in all these documents was that the directors in both instances were in thrall to their CEO, whatever lip service they were giving to the new paradigm for boards that was emerging in the 1990s in other firms, in these two companies any innovations had little impact in achieving the goal of increasing the power of the board compared to that of their CEO. However, there was also a striking difference between the situations at the two companies. At Enron the board

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<sup>40</sup> Laurie P. Cohen & Mark Maremont, *Tyco Ex-Director Pleads Guilty*, WALL ST. J., Dec. 18, 2002, at C1.

<sup>41</sup> Jay O. Light & Ashley Robertson, *Restoring Trust at WorldCom 6-7* (2004) (Harvard Business School case study) (on file with author); TYCO, ANNUAL REPORT 2001 (2001), available at [http://media.corporate-ir.net/media\\_files/irol/11/112348/reports/tyc\\_2001ar.pdf](http://media.corporate-ir.net/media_files/irol/11/112348/reports/tyc_2001ar.pdf); ENRON, ANNUAL REPORT 2001 (2001), available at <http://picker.uchicago.edu/Enron/EnronAnnualReport2000.pdf>.

<sup>42</sup> *Id.*

<sup>43</sup> MALCOLM SALTER, *INNOVATION CORRUPTED: THE ORIGINS AND LEGACY OF ENRON'S COLLAPSE* 154-89 (2008).

<sup>44</sup> Alex Berenson, *Pressed at Trial, Ex-Tyco Figure Can't Document Story on Bonuses*, N.Y. TIMES, Feb. 19, 2004, at C1.

was aware of the problematic transactions and actually approved them.<sup>45</sup> Further, Arthur Andersen warned the audit committee that some of the transactions were highly risky.<sup>46</sup> The audit committee ignored this warning and put their trust in their CEO and other senior executives.<sup>47</sup> In contrast, at Tyco the questionable payments to a sitting “independent” director were hidden from the board, only coming to light when another director discovered them in a footnote to the company’s 10K.<sup>48</sup>

There was a huge outcry to this spate of scandals from the public, media, many business leaders, and politicians in Washington from President Bush to members of Congress of both parties. The concern was so strong that the president delivered a speech on Wall Street about the need to restore trust in American capital markets and public companies, and visited the New York Stock Exchange.<sup>49</sup> These concerns quickly led to passage of the bipartisan Sarbanes-Oxley Act, which imposed new requirements on the audit committees of boards and for the certification of financial reports by public-company CEOs and CFOs.<sup>50</sup> The initial reactions to the new law were a series of complaints from business leaders in senior management and in boardrooms.<sup>51</sup> Those complaining argued that the law was too onerous for both audit committees and for the corporate financial and accounting staff.<sup>52</sup> In spite of such complaints, there were no serious attempts to change or repeal the law. In fact, within a few years, most directors and senior executives with whom I spoke admitted that the law had improved accounting and financial reporting for their companies. They also felt that the law gave audit committees clear responsibility for engaging and overseeing the public accounting firms that audited their companies, which they also believed improved governance.

In response to the large public outcry about these scandals, the New York Stock Exchange and NASDAQ revised their listing requirements. In essence, both exchanges modified their rules to require listed companies to implement most of the best boardroom practices.<sup>53</sup> A significant difference

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<sup>45</sup> See PERMANENT SUBCOMM. ON INVESTIGATIONS, S. COMM. ON GOV'T AFFAIRS, 107TH CONG., THE ROLE OF THE BOARD OF DIRECTORS IN ENRON'S COLLAPSE 8 (Comm. Print 2002) [hereinafter ENRON'S COLLAPSE].

<sup>46</sup> *Id.* at 15–17.

<sup>47</sup> *Id.*

<sup>48</sup> SURAJ SRINAVASAN & ALDO SESIA, THE CRISIS AT TYCO – A DIRECTOR'S PERSPECTIVE 1 (2011) (Harvard Business School case study) (on file with author).

<sup>49</sup> Jim Rutenberg, *Bush Tells Wall St. to Rethink Pay Practices*, N.Y. TIMES, Feb. 1, 2007, at C1.

<sup>50</sup> Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, sec. 301(m)(3), 116 Stat 745 (2002).

<sup>51</sup> See, e.g., Jesse Eisinger, *Long & Short: Corporate Regulation Must Be Working – There's a Backlash*, WALL ST. J., June 16, 2004, at C1 (quoting AIG chief executive Maurice Greenberg calling the Sarbanes-Oxley Act “an enormous burden”).

<sup>52</sup> See, e.g., *The Hot Seat: These Days, All Eyes Are on the Chairman of the Audit Committee*, WALL ST. J., Feb. 24, 2003, at R4; *CFOs Chafe at Burden of Applying Reforms*, CHI. TRIB., Oct. 11, 2003, at C1.

<sup>53</sup> See Raymond Gilmartin, *The Argument for a Lead Director*, in THE FUTURE OF BOARDS 159 (Jay W. Lorsch ed., 2012).

between the listing requirements of the two exchanges was that whereas the NYSE insisted that governance and compensation committees consist entirely of independent directors, NASDAQ did not require compensation and governance committees if those matters were decided upon by a majority of independent board members.<sup>54</sup> The combination of the changed listing requirements and Sarbanes-Oxley created more forward momentum for improving corporate boards.

### III. THE FINANCIAL MELTDOWN

These developments left those interested in corporate governance with a belief that corporate boards were improving. So the financial meltdown in 2008 came as a particular shock. Since the media, politicians, and the public identified those responsible as “bankers” or “Wall Street,” there was little public criticism of boards.<sup>55</sup> As attention focused on managers and the regulators who were supposed to oversee them, few commentators focused on the lack of board oversight. Consistent with this view, the Dodd-Frank Act focused on the regulation of banks and their officers.

One reason for the muted reaction was that top managers themselves were unaware of many of the practices and problems that led to the meltdown. If the CEO and other top leaders were ignorant of the problems being created by their own firms' lending practices (as well as other crisis-inducing behaviors), it seemed unfair to blame directors who were dependent on those leaders for information. Although such arguments have merit, there is ample ammunition to criticize the boards of these financial institutions.<sup>56</sup> An underlying problem was that because of the drive to find independent board members, too few directors had any depth of financial experience.<sup>57</sup> Evidence of this assessment emerged as the Treasury Department became a significant shareholder in major financial institutions, such as Bank of America and Morgan Stanley. As soon as the federal government became a shareholder, several existing directors on each board were replaced by new ones who had deeper financial experience.<sup>58</sup>

Although Dodd-Frank primarily focused on regulating financial institutions, the new law had two wider ramifications for corporate governance. The first was to allow shareholders, under certain conditions, to place nomi-

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<sup>54</sup> NASDAQ STOCK MARKET RULES §§ 5605(d)–(e) (2009).

<sup>55</sup> Neil A. O'Hara, *Asleep at the Switch? Corporate Boards' Culpability in the 2008 Financial Crisis*, 2 THE INVESTMENT PROF. (2009), [http://www.theinvestmentprofessional.com/vol\\_2\\_no\\_3/asleep-at-switch.html](http://www.theinvestmentprofessional.com/vol_2_no_3/asleep-at-switch.html).

<sup>56</sup> See Lorsch, *supra* note 10, at 8.

<sup>57</sup> See, e.g., Robert C. Pozen, *The Big Idea: The Case for Professional Boards*, 88 HARV. BUS. REV. 50, 53 (2010) (discussing lack of expertise among Citigroup directors in 2008).

<sup>58</sup> *Bank Boards in the Aftermath of the Financial Crisis*, MOODY'S INV. SERV. (MAR. 2010), <http://www.directorship.com/media/2010/03/Moodys-Bank-Boards-Mar-2010.pdf>.

nees for board seats on the proxy statement of the company.<sup>59</sup> This was intended to allow shareholders to have more of a voice in nominating directors for board seats. The SEC was to implement this provision, but its rules were struck down by a federal court and the agency postponed further attempts at implementing this provision.<sup>60</sup> While proxy access is still possible in some states, including Delaware, it must be done through changes in company by-laws.<sup>61</sup>

The second aspect of Dodd-Frank that affected governance broadly was the “say-on-pay” provision, which provided shareholders the right to a precatory vote to approve the prior-year compensation of senior executives.<sup>62</sup> The idea, was adapted from a British proposal that had existed for several years, with a few American innovations.<sup>63</sup> One may wonder how such a provision related to executive pay found its way into a law whose purpose was financial regulation. One connection is that there had been a long shareholder and media outcry about executive compensation being too large and unrelated to company performance, and top executive pay in financial service institutions were prime examples of these issues.

#### IV. TWENTY FIVE YEARS OF PROGRESS?

My purpose in undertaking this historical review is to enable the reader to understand the changes which have taken place in the governance of public companies, and especially in boardrooms, in the last quarter of a century, in order to be able to judge what future steps may be essential for further improvement. That boards are doing a better job of governance in 2012 than they were in 1987 seems indisputable. In spite of and to some extent because of the periodic crises that have occurred, boards are more seriously engaged and working harder to fulfill their duties. Preliminary data from a survey my Harvard Business School colleagues and I have just conducted supports this view. For example, directors report that they understand the role they are expected to play and are focused on the economic performance of their company over the next two years or longer. They also report that they have a high level of comfort with the information they receive.

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<sup>59</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 971, 124 Stat. 1376, 1915 (2010). See also 17 C.F.R. § 240.14a-11 (2011) (implementing this section, prior to being vacated by Court of Appeals for the D.C. Circuit).

<sup>60</sup> Press Release, Mary L. Schapiro, Chairman, U.S. Sec. & Exch. Comm’n, Statement by SEC Chairman Mary L. Schapiro on Proxy Access Litigation (Sept. 6, 2011), available at <http://www.sec.gov/news/press/2011/2011-179.htm>. See also *Bus. Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011) (vacating SEC Rule 14a-11).

<sup>61</sup> Marc Weingarten, *2012 Shareholder Activism Insight Report*, HARV. LAW SCH. FORUM ON CORP. GOVERNANCE AND FIN. REG., (Nov. 26, 2012), <http://blogs.law.harvard.edu/corpgov/2012/11/26/2012-shareholder-activism-insight-report/#more-36656>, accessed December 2012.

<sup>62</sup> Dodd-Frank Act § 951.

<sup>63</sup> JAMES D. COX & THOMAS LEE HAZEN, *TREATISE ON THE LAW OF CORPORATIONS* § 11:7 (3d ed. 2011) (citing L.C.B. GOWER & PAUL L. DAVIES, *THE PRINCIPLES OF MODERN COMPANY LAW* §§ 14-16-14-17, 14-22-14-23 (8th ed. 2008)).

What seems more problematic is the erratic and relatively unpredictable manner by which such improvements have been brought about. Change in such a complex network of institutions is inevitably going to be messy and will lead to unintended negative consequences. Nevertheless, a clearer understanding of the need for change and the forces driving the change can hopefully facilitate future improvements in corporate governance while producing fewer negative side effects.

To illustrate my point, let me return to say-on-pay. The underlying concern that executive pay is too large and insufficiently connected to performance has been expressed in the media for over a decade.<sup>64</sup> In 1993, the Tax Code was amended to eliminate deductions for executive compensation above a million dollars, unless the pay was tied to performance.<sup>65</sup> But compensation committees increased incentive compensation to offset this. Then the SEC came up with a better idea in the form of the Compensation Disclosure and Analysis Section of the 10K, which was to reveal and explain the compensation of senior executives.<sup>66</sup> The theory was that disclosure of this information would curb excessive executive pay. It was not to be. Senior executives used the information on their peers' compensation to argue for more pay for themselves. Experience so far suggests that the current focus on say-on-pay will also have little effect in stemming the rise of executive pay, except in the most egregious cases.

Another example of how changes related to governance have unintended consequences is the requirement that boards have a majority or even a larger proportion of directors who are independent. The intention was to ensure that directors had no conflicts of interest and would always act with complete loyalty to their company, but independence had the unintended consequence of creating a majority or more of board members lacking deep experience in a company's industry and business. Individuals without such experience were unlikely to be truly independent.

A third example of such negative but unintended consequences is the drive by union and public employees' pension funds to eliminate staggered boards.<sup>67</sup> The advocates of this change argue that shorter terms will provide shareholders a greater opportunity to replace directors when they believe it is desirable. What is more important, however, as I have argued earlier, is to have directors with knowledge and experience. Serving longer terms for directors fosters this knowledge and experience in directors, thereby strengthening the argument for retaining staggered boards.

There are two major reasons for such unintended consequences. First, the forces that affect board effectiveness are interrelated and form a complex system. Often those who are proposing a particular change only consider its

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<sup>64</sup> See, e.g., Daniel F. Cuff, *Those Well-Paid Executives*, N.Y. TIMES, May 2, 1984, at D1.

<sup>65</sup> 26 U.S.C. § 162(m) (1993).

<sup>66</sup> 71 Fed. Reg. 53,158 (Sept. 9, 2006).

<sup>67</sup> See discussion in Section I, *supra*.

benefits for them. They do not anticipate or are unaware of the potential downside to their new proposal. Second, those who are proposing particular changes understand and care about only part of the system. Those who serve as directors believe that what matters most for effective governance is what goes on among directors and between them and their management team. To directors, governance is the result of these very human relationships. For their part, institutional shareholders who have been focused on governance believe that the way to improve governance is to change the rules of the game so that shareholders can gain a greater ability to influence corporate decision-making.<sup>68</sup> The changes in corporate governance that I have described as occurring over the past twenty-five years have come from two places: corporate boardrooms, where directors and their advisors have seen the changes as beneficial and institutional shareholders, who believe that their proposals will enhance their influence and protect their interests.

In my judgment, the most beneficial changes have emanated from boards and their advisors. Directors understood from firsthand experience why boards were having difficulty carrying out their responsibilities and they invented solutions that eliminated or at least minimized these constraints. Many of the ideas that emanated from shareholders were aimed at matters which were specified in laws and corporate legal documents, but which had little or no impact on how boards functioned. For example, Institutional Shareholder Services (ISS) has publicly rated boards on their governance practices.<sup>69</sup> The problem has been that ISS can only rate boards on matters which are publicly available, which often are not truly important to board functioning. In 2008, Robert Clark and I published an article in which we found that directors considered these reform measures to have had little practical impact on the on functioning of boards.<sup>70</sup>

While directors and those who work with them have an intimate understanding of the problems that have stood and still stand in the way of improving board functionality, shareholders and their allies who follow the external path to change operate on different premises. Shareholders question the trustworthiness of directors. They believe that directors have their own interests and do not necessarily concern themselves with shareholders' interests and rights. For them, it follows that shareholders must use whatever means they can to prevent boards from using their power in ways that will not benefit shareholders.

From these two different perspectives we have seen a basic mistrust emerge between these two groups interested in improving governance. Instead of cooperating to find avenues for solutions, those in the boardroom

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<sup>68</sup> RAKESH KHURANA & JAMES WEBER, AFL-CIO: OFFICE OF INVESTMENT AND HOME DEPOT 1 (2007) (Harvard Business School case study) (on file with author).

<sup>69</sup> See, e.g., *Introducing GRID 2.0*, ISS, <http://www.issgovernance.com/grid-info> (last visited Oct. 29, 2012).

<sup>70</sup> Jay W. Lorsch & Robert C. Clark, *Leading From The Boardroom*, 86 HARV. BUS. REV. 86, 105, 109 (2008).

see the initiatives for change from shareholders as hostile acts. Similarly, shareholders interpret resistance to their proposals by boards as veiled attempts to entrench boardroom power. Improving communication and understanding between the two sides could reduce the danger that unintended consequences will impede progress in improving governance reform.

This account of the past and the prognosis for the future cannot be concluded without mentioning the ultimate rule setters, the various state courts and especially the Delaware courts. To the extent there have been legal or regulatory changes, they have come almost exclusively from Congress, the SEC, and the stock exchanges. The Delaware courts' attitude toward these best practices was summed up by Chancellor Chandler in the litigation over Disney's employment of Michael Ovitz, in which Chandler stated that best practices were merely aspirational.<sup>71</sup> In essence, he seemed to be arguing that Delaware law could ignore what business leaders and the stock exchanges were endorsing as governance improvements. Accordingly, it seems to me that the time is now ripe for Delaware to exercise greater leadership in defining boards' best practices.

#### CONCLUSION

Looking to the future, we need an approach to changing corporate governance that reduces unintended consequences and conflict among the interested parties. At the heart of any discussion is a need to agree fundamentally on the role of shareholders in governance. As Justin Fox and I pointed out in our recent *Harvard Business Review* article, there are important questions about how shareholders can be involved in governance in the twenty-first century.<sup>72</sup> Not only have institutions become more prominent than individuals as shareholders, but ideas about shareholders' rights have also evolved. While many shareholders, directors, and executives hold the view that a corporation's responsibility is to its shareholders, new voices challenge this perspective and argue that the purpose of the corporation must be broader;<sup>73</sup> it must consider its own long-term health and the value it adds to the broader society. In this view, shareholders who trade in the stock of a company frequently should not be considered owners and therefore should not have the rights of ownership.<sup>74</sup> As long as this disagreement remains unaddressed it will be hard to reach a consensus on future changes in corporate governance.

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<sup>71</sup> *In Re The Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 697 (Del. Ch. 2005).

<sup>72</sup> Justin Fox & Jay W. Lorsch, *What Good Are Shareholders?*, 90 HARV. BUS. REV. 49, 57 (2012).

<sup>73</sup> See, e.g., LYNN STOUT, *THE SHAREHOLDER VALUE MYTH: HOW PUTTING SHAREHOLDERS FIRST HURTS INVESTORS, CORPORATIONS, AND THE PUBLIC* (2012).

<sup>74</sup> Cf. *id.* at 37–38 (arguing that shareholders do not own corporations, which, instead, own themselves).

The types of changes needed today are to some extent in the eye of the beholder. My own view is that we need a better process for overseeing executive compensation, more directors on boards who are both independent and knowledgeable, improved communications between companies and long-term shareholders, and finally, a re-examination of staggered boards.

There is also the question of who could convene such discussions. There are numerous possibilities, from the stock exchanges to members of the legal community, business leaders, academics, and perhaps, the authorities in the states that are heavily involved in corporate rules, like Delaware. Improving corporate governance more rapidly not only requires a more precise agreement about the purposes of the corporation, but also requires that the major actors involved in governance have a forum in which these issues can be explored and agreed upon.