



HOW BOARDROOM HISTORY
IS WRITING ITS FUTURE

Recommendations to Meet Future Governance Challenges

By JAY W. LORSCH

Boardroom: the word alone conjures up grand visions of power, wealth and privilege. The boardroom's core – the symbol of its power – is a massive, highly polished table around which the directors are supposed to make the decisions that govern corporations, impacting the livelihoods of many. It is the throne room of the corporate world's potentates.

At least, that's what people think. A quarter century ago, in the book *Pawns or Potentates*:

The Reality of America's Corporate Boards, my coauthor Elizabeth MacIver and I found that boards were acting more like pawns and not so much as the potentates they were legally intended to be. More often than not, real power over corporate affairs and major decision-making was being wielded by the CEOs, posing serious problems for the boards that were ostensibly meant to oversee them.

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some extent because of the periodic crises that have occurred during this time, boards are now more seriously engaged and working harder to fulfill their duties. That's the good news.

The other news is that there is still work to do. This article outlines the major problems that boards have faced over the past quarter century and solutions proposed to overcome them. I warn about the negative, unintended consequences of some of these "solutions." And I offer my views on how to meet future governance challenges within the wider context of business.

How We Got to Where We Are Today: The Norms of the 1990s

To begin, I should note that in the United States – the geographic focus of my studies – it is the boards that have the legal authority, as enshrined in Delaware law. In other words, the boards are in charge. They can then choose to delegate their authority to manage the com-

pany to its officers. In practice, boards always did, and still do, make such delegations. Full-time employees with the time and knowledge to manage are the ones who run the company.

That being said, boards need to retain enough power to question and oversee CEO decisions. Board solidarity and building a strong relationship with the CEO are two sources of board influence. However, these sources of power were limited by the culture and norms of the 1990s. In the United States, these limitations included:

LIMITED TIME. Most board members had other full-time jobs and some served on several different boards at a time.

LIMITED KNOWLEDGE & INFORMATION. To an important extent, boards' limited knowledge and information was due to the sheer size and pace of the businesses under their charge, in addition to the limited time mentioned above.

LIMITED EXPERIENCE. Independent directors usually had limited experience in the company's specific line of business, which forced them to learn on the job.

INFORMATION ASYMMETRY. In most boardrooms, the management teams not only had greater knowledge of the issues but they also controlled the information that the directors received.

LACK OF CLARITY ABOUT BOARD GOALS. Certain directors believed that the primary purpose of a company was to create value for shareholders; others believed that companies should have broader goals, serving not only shareholders but also customers, employees and their communities. Because such important distinctions were never clarified, decisions wound up being based on fundamentally divergent premises within the same board.

EXECUTIVE SUMMARY

There have been significant, positive changes in boardroom practices over the past 25 years. However, there is still work to do, says the author, whose expertise in corporate governance matters was tapped for lawsuits involving the Tyco and Enron fiascos at the dawn of this new century. Drawing on decades of research and experience, the author outlines the major problems that boards have faced over the past quarter century and the solutions proposed to overcome them.

He warns of the negative, unintended consequences of some of these solutions, many of which were not thought through carefully and may be based on false premises. Finally, he offers four recommendations for directors, CEOs, shareholders and other stakeholders on how to meet future governance challenges within the wider context of business. Put simply, there needs to be open communication between all parties and a consensus on the ultimate purpose of the firm.



The diagnoses of the boardroom problems of the '90s led to a set of agreed best practices. Yet even adopting best practices did not solve all boardroom problems. Far from it.

STRONG NORMS. The presence of a strong coalition of board members to counter the power of the CEO was not the norm at the time. Directors subscribed to the notion that it was inappropriate to criticize the CEO in board meetings or to have discussions without the CEO present.

COUNTERVAILING POWER OF THE CEO. The CEO and the executives reporting to the CEO served as the board's primary sources of information. Since the board chair and the CEO were normally one and the same, it was usually the CEO who set the agenda and controlled the discussions of board meetings.

A New Paradigm Is Born?

The diagnoses of these boardroom problems of the '90s found willing listeners, leading to calls for change. Among the changes developed in the United States and the United Kingdom were a set of agreed best practices, which included:

- Smaller boards to facilitate group discussion.
- A majority of independent directors.
- Meetings without the CEO present. Directors were encouraged to hold executive sessions. They also began to feel comfortable speaking to each other informally between meetings.
- Board leaders who were not also the CEO.
- Independents controlling the selection of new directors.
- Audit, compensation and corporate governance committees in which directors met without the CEO or the top management present.
- A sharpened focus: The board focused on the approval and oversight of corporate strategy, CEO performance and management development to assure a supply of future executives. Boards also evaluated their own performance and were supposed to ensure

that the company complied with applicable laws.

Granted, not all boards adopted these practices simultaneously or quickly, and some in the United States did not do so until laws and regulations required them many years later.

Conversely, in the United Kingdom, the adoption of recommendations made by the Cadbury Report – such as having a board chair who was not the CEO, adding independent and nonexecutive members, and establishing audit committees – was swift and dramatic.

Yet even adopting best practices such as these did not solve all boardroom problems. Far from it.

Crises at the Dawn of the 21st Century

At the beginning of the new century, two different governance-related crises struck. The first was the bursting of the dot-com bubble in 2000. Many early-stage, newly listed public companies had yet to prove they had sustainable business models. Although their subsequent failures were blamed mostly on reckless entrepreneurs and venture capitalists, in hindsight such failures were at least partially the fault of boards who wanted to attract public investors even before their companies had earnings.

A second governance failure was the wave of fraud and misleading accounting that occurred at companies such as Enron, Tyco and WorldCom. While the specifics of each scandal were different, all featured improper or fraudulent accounting practices and inflation of the compensation packages of senior managers. In the case of Tyco, a so-called “independent” director was receiving questionable payments from the company. Notably, all these boards had a majority of independent directors, and they also had audit, compensation and corporate governance committees. So what went wrong?