Why Executives Should be Barred from the Board

John Hendry

For the past fifteen years, corporate governance has been the subject of quite extraordinary attention. Literally thousands of academic articles and scores of books have now been published on the subject. It has been debated endlessly in the press and in legal, financial and political circles. On the back of this debate, whole waves of regulation and legislation have been imposed to try and ensure that corporate managers act ethically and in the interests of their shareholders. Despite all this attention, however, it is hard to avoid the conclusion that corporate governance has failed. On one hand, capable and responsible executives find themselves drowning in a sea of regulation and reporting requirements and distracted from their primary task of delivering value. On the other hand, in other corporations, incompetence, irresponsibility and even fraud continue to go effectively unchecked.

When continued attempts to solve a problem repeatedly fail, it is generally a good idea to ask why and, in the process of doing that, to go back to the beginning and question some of the assumptions underlying the failed attempts. This is what I shall attempt in this article. I shall conclude that while the core problems of corporate governance stem partly, as is generally assumed, from the separation of ownership and control, they are also rooted in a failure to recognize this separation in the legal structure of the corporation, i.e. in a *confusion* of ownership and control. One way of removing this confusion would be to adopt something like the two tier board structure of German or Dutch companies. A simpler and, in the American context, more effective way would be simply to bar executives, both present and past, from formal membership of the board.

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The conventional wisdom is that the core problems of corporate governance derive from the separation of ownership and control that arises when corporations move from having highly concentrated to having highly diversified shareholdings. Historically this move is associated with two developments: the late nineteenth century creation of large corporations through the merger of many smaller, family-owned concerns, and the twentieth century diversification of share ownership as corporations in need of capital for growth raised this through public stock market placings. In today's world it is best thought of in the latter terms. As recent events at the Italian firm

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Parmalat have vividly demonstrated, privately controlled companies are not without their governance problems, but in the American context the main focus of concern is on listed companies with diversified shareholdings. Here "control" is in the hands of management, while "ownership" is divided between a wide range of parties, including both individuals and institutional investors, many of whom are themselves investing on behalf of clients or beneficiaries.

In this context, the core problem of corporate governance is how to ensure that managers exercise their control in a way that corresponds to their fiduciary responsibility to the shareowners. A secondary problem is how to ensure that they act ethically, and fulfill the duties of the corporation to society, to the communities in which it operates, and to other stakeholders. The potential clash between these two sets of obligations is itself a significant area of both academic and public interest, but it is not the primary concern of corporate governance regulation: by and large, behavior that is unethical or acts against societal interests is also likely to lessen the value of the corporation and is therefore against the interests of the shareholders.

Most of the time, there are in fact no major problems. Most corporate executives are diligent and dutiful servants of the corporation and its shareholders. Most senior executives are indeed extraordinarily committed, devoting themselves 24 hours a day seven days a week to the success of their companies. Some are, inevitably, more successful than others, but that is the nature of free competition. In business as in sport, or any other competitive arena, not everybody can come first. Moreover, not even the best executives can call every play perfectly. Business is by its very nature uncertain, and it is far more complex than any ball game. You cannot succeed in business without continually taking risks, and you cannot keep taking risks without sometimes losing. It is easy for those with no experience of management to criticize the way it is done, but the fact is that shareholders are, on the whole, well served by those who manage their corporations.

Not always, though. Sometimes there *are* problems. Sometimes CEOs get arrogant. Sometimes they get greedy. Sometimes they get lazy, or neglectful of their responsibilities. Sometimes they try too hard and overstep the mark. And sometimes they are just not as competent as they need to be.

Arrogance is always a risk in a CEO. Nobody reaches the top corporate job without being exceptionally self-confident and assured, and once in that job it is all too easy for a healthy self-confidence to slip over into a far from healthy arrogance and hubris. In American culture the CEO is unambiguously the top dog. The media spotlight is on him and him alone and everyone inside the corporation looks to him (or very exceptionally to her) for decisions. Everything tends to isolate him in his office and feed his sense of self-importance. But in the complex environments and global competition that characterizes business today, no large corporation can be run effectively by one person alone. It takes teamwork, and CEOs need to listen as well as to talk They need to recognize that two heads are better than one, and to accept that while they have to take the decisions they will often be wise to base these on the judgments of others. Arrogance is rarely in the interests of shareholders, and because it feeds on itself its effects can spiral, as executives get locked into vicious cycles of escalating commitment to unsound policies.

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If the top job is isolating it is also very lucrative, and in some respects very comfortable. Not all executives are motivated by their pay packets and many find it quite hard to spend anything like they earn, but money can be addictive. For people who are motivated above all else by winning, it is also the most obvious measure of success. Earning another million, ten million or hundred million dollars can be a powerful driving force that does not always act in shareholders interests. So can preserving the symbols of success, the comforts and kudos of a chief executive's office. Statistically, CEOs are more inclined to policies that will enhance their own earnings (for example by growth or diversification), or protect their jobs from the threat of takeover, than they would be if the interests of shareholders prevailed. And since there are many CEOs who evidently guard carefully against such a bias, there must be many others whose greed costs their shareholders dear. Laziness too is a potential problem. Most CEOs are workaholics, constitutionally incapable of sitting back on the job and enjoying the comforts it brings, but there are always a few who, having reached the top job, just settle back and enjoy it, neglectful of their duties but hopeful that this neglect will not bear fruit until they are safely in retirement.

At the other end of the scale, some CEOs are so determined to succeed for their shareholders that they try *too* hard, pushing and ultimately breaching the boundaries of what is acceptable. While some fraud, for example, stems from greed, some stems from desperation. Many other ethical problems arise in response to performance pressures as managers striving hard for results in highly competitive markets cut corners, bend the rules, or take risks that are far greater than they realize. These effects can also spiral. A well-intentioned bending of the rules leads inevitably to obfuscation and cover up. Small risks, if they do not achieve the desired results, lead to greater risks, and those to still greater, in increasingly desperate attempts to salvage the situation.

Another danger, closely connected to the danger of greed, yet in some respects diametrically opposed to it, is that of CEOs acting to protect the interests of their staff or colleagues, to protect the company when it is in the shareholders' interests to break it up, to retain a senior executive whose contract should really be terminated, or to hold back from redundancies when the competitive situation demands them. Actions like these are often based on the very best of intentions, but they can do as much damage to the company and its shareholders as can excessive self-interest.

All of these factors can lead to corporate governance problems. The most common source of such problems, however, is much more mundane: it is simply that some executives are just not up to the jobs to which they are appointed. In some cases this arises from what agency theorists term adverse selection: a self-seeking executive misrepresents his abilities or, more frequently, an outgoing CEO or incumbent chair misrepresents those of a favored successor. In many cases, however, it is a product of the uniqueness of the top job. A new CEO may be appointed through an open competition, on the basis of a good track record, and after careful consideration of the candidates. But the CEO's job is like nothing else and appointment to it leaves anyone in unknown territory. Moreover, circumstances change. A great finance, marketing or operations executive may fall short in the CEO position. A person who has been a successful CEO in one corporation may be out of his depth in another, especially if it is larger and more complex, or in a different industry. A person who was great at

managing growth may be hopeless in recession, or vice-versa. For all sorts of reasons people may be dutiful, hardworking and committed – and responsibly appointed – but simply not good enough for the job in hand. When this happens in an appointment to a second tier job, the CEO can quickly spot it and act. But if it's the CEO who falls short, there is a real problem.

In corporate governance theory, all these problems are normally rolled into one – the classic agency problem of CEOs' acting in their own interests rather than in the interests of their shareholders. Apart from being rather unfair to those executives who err out of good intentions, this is a gross simplification – and, as we shall see, one that has some implications for corporate governance policy. In some ways, however, it is not unreasonable. What matters to the shareholders, after all, is that a CEO is not performing. Why he is not performing is of secondary importance, and may anyway never be known.

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Attempted solutions to the problems of corporate governance, conceived of as an agency problem, have focused on four different approaches: the market for corporate control, incentive pay, shareholder activism, and regulatory controls, such as reporting requirements. None of these, however, can be called a success.

In theory, the takeover market, or market for corporate control, combined with the requirement for regular financial reporting, should act so as to remove a CEO or management team who are failing for almost any of the reasons discussed above. In the absence of fraudulent accounting, management failure should be reflected in the performance of the corporation. Poor performance should be reflected in a falling share price and at some stage it should become an attractive proposition for a rival corporation or group of investors to take over the company, replace the failing managers and reap the rewards of good management.

To some extent this mechanism works. Indeed it almost works too well, as the evidence shows that the shareholders of a target firm typically receive not merely what the firm is worth in its existing, damaged state at the time of the takeover, but its full recovery value, assuming improved management (implying, of course, that the shareholders of the acquiring company are not being so well served). The mechanism does, however, have a number of weaknesses. In the first place, it is slow. Allowing for the lead times of management decisions, and for all the other factors in play, it can take a long time for poor management to be clearly visible in reported results. By the time it is, the damage to shareholder interests may be irreparable. In the second place, its effectiveness has been blunted by anti-takeover measures such as poison pills introduced by entrenched management on the back of management-promoted legislation. In recent years, in response to shareholder and public pressure, many of these have been withdrawn, but many still remain in place. Unlike Britain, where anti-takeover measures are almost unknown, the United States cannot be said to have a free takeover market. In the third place, while the mechanism may sometimes provide

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shareholders with a defense against innocent management incompetence, it is almost powerless to counter management greed, laziness, or wanton irresponsibility. Quite apart from anti-takeover devices, executives have considerable control over the information process, including the spin put on events and the way in which activities are posted to the reported accounts. An entrenched management can turn what is always a slow process into one far too slow to be of any value to shareholders.

Since the early 1990s, the most favored mechanism of corporate governance has been incentive pay. The theory here is that the interests of self-interested managers can be tied to those of shareholders by an appropriate compensation package, and in particular by the award of stock options, the value of which mirrors (often in a leveraged form) that of the stock itself. As a result of incentive pay policies, a vast slice of American corporate stock has effectively been taken away from shareholders and given instead to managers, all in the name of shareholder interests, and all to little or no avail. Despite hundreds and hundreds of empirical studies, academics have yet to find any significant impact of incentive pay on corporate performance.

One of the core problems with incentive pay in practice, if not in theory, is that it has no downside. The theory suggests that shareholders will benefit by *replacing* executive salaries by stock-based incentives, but in practice stock options have always been *added* to salary, so that while there has been an incentive for raising the share price there has been no corresponding disincentive for lowering it.[1] The core problem with the theory is that it assumes that the most desirable outcomes can be accurately specified in advance, that because executives are self-interested their discretion should be minimized, and that while they are self-interested enough to be incentivized by their pay they are not self-interested enough to manipulate the financial results accordingly. In reality, in business, circumstances are always changing and the most desirable outcomes (market share versus margin, risk versus security) cannot be specified in advance. What shareholders need from a CEO is someone who will use his judgment and discretion to the maximum, to advance their interests through these changing circumstances. And anyone who is really motivated by the money will manipulate the results so as to maximize his pay, regardless of whether this is best for the company: as academic studies have shown, what you measure is what you get.

Until incentive pay came along, most chief executives were probably not motivated primarily by their pay packets. They were motivated either by competitive success and the status and kudos that brought with it, or by a commitment to the corporation. The problems for shareholders arose when their attachment to the status and perks of the job made them neglectful of their duties or encouraged them to entrench themselves in it; when commitment became distorted by arrogance and a false sense of possessiveness – a belief that only they could run the company properly, leading again to a desire for entrenchment; and when their abilities simply fell shorted of those needed. Incentive pay solved none of these problems, but it added to them the problem of pecuniary greed and the problem of misplaced competitiveness, as

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[1] [Note added in 2012] The situation has been improved somewhat as some corporations now require that their chief executives hold a significant portion of their wealth in the company's shares, ensuring that they suffer materially from fall in the share price. In most cases, however, the incentives remain lop-sided.

executives sought to compete against rivals not in the product market place but in terms of what became the clearest indicator of success, the published pay packet.

Partly in response to the failures of incentive pay and the market for corporate control, a third mechanism of corporate governance, shareholder activism, has found increasing favor in recent years. The central idea here is to control executive behavior by careful monitoring and direct involvement, replicating some of the effects of a more concentrated shareholding system. The main drawback to this approach has been that shareholders typically have neither the incentive to become involved in this way nor the access to management information on which effective involvement would need to be based. In terms of incentives, shareholder activism suffers from two drawbacks. First, most investors, including the fund managers who dominate institutional investment, see themselves as financial speculators, not as committed owners. They value corporations and buy and sell on the basis of their valuations. They have no desire whatsoever to act as responsible share *owners*. Secondly, a free rider problem puts the basic economics against activism. The costs of activism are born by the activist individual or institution, but the benefits are shared amongst all shareholders, so it is economically rational for everybody to leave the activism to others.

These drawbacks have been partly overcome by the existence of a small number of determined activist institutions, mainly public pension funds; by changes in legislation, making it easier for shareholders to enter proxy contests; by the growing concentration of institutional shareholdings, which gives the larger institutions significant holdings and so a greater voice in the companies in which they invest; and by the associated growth in the size of the major institutional portfolios, which makes it harder to simply sell stock when things go badly. Despite all these developments, however, shareholder activism remains deeply unattractive to the majority of investors, and those who do wish to engage in it still have to do so on the basis of public information or, to put it another way, on the basis of information controlled by the management teams they wish to monitor.

All three corporate governance mechanisms that we have discussed so far rest to some extent on a fourth, the existence of regulatory controls such as accounting regulations, stock exchange listing requirements, and legislation such as Sarbanes-Oxley. As corporate governance has become more and more of a concern, these rules and regulations have proliferated. However, they have brought no obvious benefits and there is a strong argument to the effect that they have done more harm than good.

The key point here is that the regulatory regime seeks to control management through the medium of an image presented by management. To satisfy the regulators, executives have to demonstrate compliance with a variety of requirements. Their demonstration, however, takes the form of written statements and reports that are scrutinized at a distance. This form of accountability, which Cambridge academic John Roberts has called an "individualizing" form of accountability, encourages managers to focus narcissistically on the image they present rather than on the substance of their actions. One of the effects is a focus on short-term share price gains at the expense of the longer-term health of the corporation. Another effect is that despite the appearance of ever increasing information on the corporation, this information becomes more and more carefully crafted and further and further removed from the underlying reality. This

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applies both to the moral realm, where responsible behavior gives way to compliance with ethical codes, and to the economic realm, where management effort is diverted from achieving genuine performance to demonstrating the appearance of performance.

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Roberts contrasts the dominant, “individualizing” forms of accountability with “socializing” forms based on dialogue and interpersonal relationships, and suggests that these are most naturally exercised through the board. The trouble is, of course, that boards are not in fact holding executives accountable, but the distinction serves to make a crucially important point. The focus of corporate governance rhetoric is always upon the failings of management, but the plain fact is that any failure of corporate governance is also a failure of the board. Management failings, whether as a result of incompetence or of self-interest, are a problem for shareholders only because boards fail in their duty to act, and the various mechanisms of corporate governance come into play only because the primary mechanism, control by the board, is so ineffective. Shareholder activism in particular is a substitute for the active engagement that should properly be enacted by boards of directors on their shareholders’ behalf.

Why, then, do boards not do what they are supposed to? Part of the answer is that board members are no more blessed with perfect competence than are CEOs. Business issues are never black and white. They are always gray and even informed directors find it hard to judge the effectiveness of management. There is also a natural tendency to give executives a chance, to give them time to prove themselves rather than jumping on the first signs of failure. A large part of the answer, however, and the largest part in the American context, is that most American corporate boards are dominated either by their chief executives or by ex-CEO chairmen.

There is nothing new in this observation. The problem of executive control over boards has been well documented by critics such as shareholder activists Bob Monks and Nell Minow, and one clear result – arguably the only clear result – to have come out of academic research on corporate governance is that there is a negative correlation between firm performance and executive entrenchment. To address this, people have argued for a separation between the chairman and chief executive offices (a separation that has become the norm in Britain) and for a variety of measures to ensure the independence of nominally independent, non-executive directors. What is rarely addressed, however, is a much more fundamental question. What on earth are executives doing on the board in the first place, given the extreme conflict of interests this so evidently creates?

The simple answer to this question is that corporate law in the United States has never distinguished clearly between the privately controlled and publicly listed corporation. In privately controlled companies it is normal for ownership and control to be united. The CEO is either the dominant shareholder (often the founder of the company) or a representative of controlling shareholder interests. It is perfectly appropriate in such cases for the CEO to sit on and even lead the board. In a family-

controlled firm, the non-executive directors, if any, are there primarily as advisors or as friendly investors, not as shareholder representatives. The situation changes slightly as a firm moves from family control to a situation in which external investors such as venture capitalists take a controlling stake. In such cases, however, the venture capitalists are typically invited in by the CEO, who retains a significant ownership stake. Though there may be a *de facto* separation of ownership and control the spirit of the agreement is, in the initial stages at least, one of partnership. On one side, the venture capitalists are directly represented on the board and have full access to management information. On the other side the continued presence of the CEO and other executives on the board is also part of the deal. A significant factor here is that the ownership stake of the venture capitalists is typically highly concentrated and so potentially threatening to the incumbent CEO. If bringing in venture capitalists meant sacrificing their own places on the board, CEOs might well forego the growth opportunities in favor of keeping control.

With an initial public offering, a much more significant change takes place. With share ownership dispersed among investors with no direct access to management, the board members cease to become the representatives of particular interests and become instead the elected representatives of shareholders as a body. Just as politicians elected to the House of Representatives are representatives of communities as a whole and not just of those who voted for them, so the directors of listed corporations are elected to act on behalf of *all* the shareholders of the corporation. They are elected, moreover, to oversee the management of the corporation – at least that is the theory. In practice, of course, the "election" is a sham, the so-called independent directors are nominated by management and the board is run by management with the current or previous CEO in the chair and the current CEO determining the agenda and controlling the information provided. Management, in other words, not only control the way the corporation is run but also control the body charged with representing the interests of ownership and in particular with overseeing their own actions. Ownership and control become quite hopelessly confused.

There is no obvious reason why things need to be arranged this way. Once ownership becomes diversified, the interests of the executive team are no longer threatened, as they might be under private equity control, by special interests. And there is no reason why their own interests as shareowners (substantial shareowners, given the stock options they receive) should need any special treatment as compared with the interests of other investors. Other countries, such as Germany and Holland, have no difficulty in making a clear separation of ownership and control, with supervisory boards on which executives do not sit. And even in America other kinds of institutions feel no need to include managers on their governing bodies.

Of course, every culture is different and every governance system makes compromises of one kind or another. I am emphatically not suggesting here that the German system, in which the supervisory board represents the workers (including both managers and trades unions) as well as shareholder interests, would be appropriate for America. Indeed, while most American boards probably do not meet often enough or for long enough, or get enough exposure to corporate middle management, the basic Anglo-American practice of unitary boards meeting relatively frequently, in the

presence of executives, seems generally fine. My only caveat is that while executives should normally participate fully in board meetings they should not be permitted to be *formally* members of the board. Nor, if conflicts of interest are to be minimized, should former executives.

This small change would not solve all the problems of corporate governance. But it would have certain effects. First, the board could no longer be chaired by a past or present member of the management team. This would not always prevent management from controlling the board through a friendly chair, but it would make it quite clear that the primary purpose of the board was to represent shareholder, not management interests, and to oversee the management of the corporation rather than to do its bidding. Second, it would make it much easier for the board to meet without the executives, either on a regular basis (immediately before or after the main meeting to which executives were invited) or more occasionally. Indeed the legislation might reasonably require that certain types of business, such as those currently carried out by certain board committees, be conducted by the elected board alone. Third, as a consequence of these effects, it would become much easier for boards to seek information of their own choosing, to engage in critical dialogue with and, where necessary, to dismiss failing executives. Fourth, a change in the law that emphasized the role of directors (and chairmen) as shareholders' representatives – and that called, on its enactment, for a raft of new chair appointments – might act as a spur to the involvement of institutional investors. We should not expect every institution to get involved in every appointment, but the change might well lead to the creation of intermediary organizations to advise on, and indeed make nominations for, independent director appointments, much as existing organizations advise on proxy voting.

The fine-tuning of a corporate governance system for listed companies such as I am suggesting here would of course be a matter for debate. One possibility worthy of consideration might be the creation in every listed company of one or more "public interest directors", charged with protecting the interests of societal stakeholders. This would seem quite a reasonable requirement, given what society already gives to the corporation in the form of limited liability, bankruptcy protection, free speech *et cetera*, and would leave the majority of directors free to focus exclusively on the interests of shareholders. Other possibilities might well emerge. The key points, though, are clear: that directors should have as good access as possible to management, so as to be able to engage them in genuine dialogue; and that they should be able to act as independently as possible of management, so as to be able to concentrate on their duties to shareholders. The words "as possible" here signal a recognition that no system will be perfect, and that executive entrenchment will never be removed entirely. But barring executives from boards would be a good start.

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