

Reconceptualizing Corporate Boards

Should board members have to be “natural persons”?

BY M. TODD HENDERSON

Corporations play a central role in our capitalist society and therefore corporate governance is a matter of vital public debate. Reformers argue that governance could be improved by requiring different types of executive compensation, changing election procedures, increasing independence requirements, or the like. Defenders of the status quo, on the other hand, counter that these reforms are unnecessary or even harmful and mistrust any one-size-fits-all solution.

Both sides have produced volumes of empirical and doctrinal analysis, but little convincing has been done. It seems like only politics matter in setting public policy. For instance, some of the reform proposals found their way into the 2002 Sarbanes-Oxley Act and the 2010 Dodd-Frank Act. But making broad corporate governance reforms at the federal level and only in response to corporate catastrophe has been labeled “quack corporate governance,” in the words of Yale law professor Roberta Romano. So is there a better way to improve corporate governance? By putting an unstated assumption about corporate boards to scrutiny, the answer is “yes.”

The Modern American Board

The locus of modern corporate governance is the board of directors. State corporate law, for instance, requires corporations to be “managed under the direction of a board of direc-

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tors.” In practice, however, managers—not directors—run American businesses. Nevertheless, managers’ ultimate authority comes from the board, and boards are called on to make “fundamental” decisions. They hire and fire the chief executive officer, set managers’ incentives, and sign off on large transactions like whether to engage in mergers or acquisitions. Boards also provide a monitoring function designed to limit potential divergence between the interests of managers and shareholders or other corporate stakeholders.

This vital job (for both companies and society writ large) is typically entrusted to a group of 10 individuals who are not experts in governance or business, have no affiliation with the firm they serve, work only part time, and are effectively chosen by the CEO. For instance, the board of directors of the Walt Disney Co., which infamously paid its former president Michael Ovitz about \$150 million for little more than one-year’s work, once included several personal friends of then-CEO Michael Eisner, including actor Sydney Poitier, the principal of an elementary school Eisner’s children attended, and the architect who designed one of Eisner’s homes.

The Disney board may be an extreme example, but the problem exists broadly. While most boards are composed of smart and experienced individuals with diverse experience and significant reputations, they are simply outgunned in terms of information and incentives relative to the managers they are supposed to control. Nothing about having a board of powerful and talented individuals prevented the various corporate meltdowns of the dot.com and mortgage crisis eras. The boards of Enron, World-

Com, AIG, Lehman Brothers, Fannie Mae, and so on were stacked with industry and social luminaries, and yet they did not prevent excessive risk taking and their firms' ultimate meltdowns.

Boards fail for a variety of reasons. These include the fact that directors are part-time employees with weak incentives (e.g., a trivial amount of equity ownership) and an inherent informational disadvantage vis-à-vis management. Directors also are generalists, meaning the average board is unlikely to have all the experts it needs at any given time. (A risk management expert might be needed at one time while a finance jock might be needed at another, and a board is unlikely to be comprised of all the various experts needed over a corporation's life.) Finally, the "market" for director talent is not transparent and is not characterized by vigorous competition. CEOs pick directors based on an unknown set of factors; elections for directors are almost always irrelevant; shareholders have no information about how decisions are made or how individual directors perform; and the costs of the board process are completely opaque.

In short, shareholders and society rely on board members to provide a crucial oversight role in corporate America, but the process for choosing directors should give us little faith that board services are provided efficiently. It strains the imagination to believe that a group of 10 outsiders to a firm, chosen by the CEO and given only the information the CEO chooses to give them, could possibly be an effective check on CEO hubris, myopia, mistake, or any number of other potential decisionmaking shortcomings.

Reforms

These potential pathologies are not news and the proposed reforms to remedy them are legion. As noted above, legislation (from both states and the federal government) and private rules from stock exchanges focus on optimizing corporate governance through attempts to perfect the board and optimally define its position in the corporate decisionmaking hierarchy. For instance, in response to numerous corporate scandals during the late 1990s, the Sarbanes-Oxley Act required (among other things) that all listed companies have audit committees composed entirely of independent directors. Similarly, the Dodd-Frank Act implemented numerous corporate governance reforms, including new disclosures about consultants working for boards and about compensation of directors, as well as new independence standards for board compensation committees.

A large industry of good-governance advocates and advisers of various kinds exists to improve board performance as well. Proxy adviser firms, like Institutional Shareholder Services (ISS) and Glass, Lewis, and Company, spend considerable resources trying to improve corporate governance by giving shareholders information about how they should vote in director elections. For instance, ISS sells institutional shareholders recommendations on how to vote for every director of large publicly traded firms based on firm policies regarding areas ranging from executive

compensation to corporate strategy. While these firms exert some influence, the fact that director elections are not competitive and matter extremely rarely limits their power dramatically.

Academics hoping to improve corporate governance also focus on the role and composition of the board. The typical response to board failures is to tweak the current governance model on the edges. If CEO domination is a problem in a particular case, reformers propose more board independence. If information flows cause a corporate meltdown, reformers propose empowering boards to hire their own experts. If board members are shirking or making decisions not in shareholders' interests, reformers suggest aligning board members' interests through share ownership. And so on.

All of those reforms share several unattractive features. They are reactive, meaning they try to solve the last problem instead of the next one. They are one-size-fits-all, meaning they do not leave open the possibility of locally optimal solutions. While say-on-pay or more independent directors might make sense for some firms, it may actually destroy value for others. In addition, the reforms rely on academics or other "experts" knowing more about what is good for particular firms than the managers and owners of those firms. They also do not take advantage of market processes to develop and test reforms. Finally, they are narrow in scope, meaning they leave open the possibility of significant unintended consequences. Focusing only on fixing one problem in a multi-facet environment risks making other problems worse.

Despite the dollars spent, books written, and articles published, no one seriously doubts there is room for improvement in corporate governance. For instance, a 2008 Towers Perrin survey of chief financial officers suggests boards failed to implement effective risk management, and this was a substantial cause of the recent financial crisis.

So is there a better way forward that recognizes the potential for reform but rejects the idea that academics or other "experts" can divine the optimal form of corporate governance?

"Natural-Person" Requirement

The corporate board as an institution needs to be rethought, not reformed. If we are going to have boards play the crucial role they do in corporate governance, actors operating in a market with robust competition, transparency, and accountability should provide director services. Unfortunately, this is not the state of affairs today. But, optimistically, there is a single legal change that can move us in that direction.

State law requires directors to be "natural persons"—that is, individual human beings. There are similar provisions in federal law pertaining to corporate governance and the listing requirements of stock exchanges. This means that individuals providing director services to firms cannot associate with other individuals in order to provide those services.

To see the absurdity of this legal restriction on corporate governance, imagine there is a state law requiring legal services to be provided by individual sole proprietorships. Companies

would have to hire individual lawyers, who could then contract with others for information, expertise, support, and so on. Such a law might be motivated by a belief that lawyers would be more careful acting alone, or that conflicts of interest arising from pooling legal resources outweigh the gains, or some other reason. But whatever the reason, such a rule would generate widespread opposition from lawyers arguing that by pooling their resources they could offer better services to their clients. Clients would object too. While some clients might prefer to hire lawyers unaffiliated with a large firm, others might prefer the costs and benefits of hiring a firm instead of a single lawyer.

The reason why individual service providers join together to provide services through firms—be they partnerships or corporations—is that the gains from doing so exceed the costs. The benefits of using firms to provide goods and services are well known. Associating with others allows individuals to share risks, obtain gains from economies of scale and scope, optimize the deployment of various resources across space and time, devote time and effort to innovation, and develop large reputational assets that can constrain opportunism. Board members currently have to get expertise from outsiders hired typically by the CEO, which creates conflict-of-interest problems. Allowing these to be under the same roof would reduce this problem, as well as transaction costs.

These benefits obtain in the provision of all products and services, and are as applicable for director services as anything else. Just as legal, accounting, consulting, and other business services are provided by “firms,” so too should director services.

Board Service Providers

In a forthcoming law review article, University of California, Los Angeles law professor Stephen Bainbridge and I argue for a change in state law that would allow directors to pool together to provide services through a firm, instead of as sole proprietors. This would allow these firms, which we call “board service providers” (BSPs), to offer their services directly to firms in a new market for corporate governance. We envision a corporation, say Microsoft or ExxonMobil, hiring another company, say Boards-R-Us, to provide it with director services, instead of hiring 10 or so separate “companies” to do so. Just as other service firms, like Kirkland and Ellis, McKinsey and Company, or KPMG, are staffed by professionals with large support networks, so too would BSPs bring the various aspects of director services under a single roof. We expect the gains to efficiency from such a move to be quite large.

We argue that hiring a BSP to provide board services instead of a loose group of sole proprietorships will increase board accountability, both from markets and judicial supervision. BSPs traded in public markets will be disciplined to provide quality services at competitive prices, and courts may be more willing to enforce fiduciary duties against firms as opposed to individuals. More transparency about board performance, including better pricing of governance by the market and increased reputational assets at

stake in board decisions, means improved corporate governance, all else being equal.

Currently, there is no real market for corporate director talent. Directors find their way onto boards largely through personal connections or the opaque headhunter process, and because votes are private and decisions are made collectively, the accountability to shareholders is greatly attenuated. Although it is possible for any individual to run for a board seat on any company, the publicity and voting costs are prohibitive. The returns to winning a seat on the board of a very large company are a few hundred thousand dollars per year, while the costs of mounting a proxy battle run in the many millions. Even if sensible economically, the chances of winning such a battle are trivially small. Another alternative is for an investor, such as a private equity firm, to take a large stake in a firm (or take over the entire firm) and use that as leverage to win board seats and thus influence governance. A BSP with a national reputation and the ability to provide all director functions would be able to increase the gains from winning board seats while reducing the per-seat cost of winning them. This could create a market for corporate governance separate and distinct from the market for corporate control.

Another benefit is that a BSP may be an effective means of measuring the value of corporate governance and of those providing director services. For instance, a publicly traded BSP providing board services to many firms would have the quality of its services measured in the market somewhat independently of the operational outcomes of its clients. Partially decoupling governance and operational performance would allow all stakeholders to more readily measure the former.

One way to think about the BSP model of governance is trying to achieve some of the improved governance benefits of the private equity model without the need for investors to stake an economic bet on the entire firm. If there develops a robust market for governance, BSP firms would be a threat to any existing board. The potential for a takeover of the board function, separate from the takeover of the firm, would be a real possibility, and with it the possibility that management could be improved by the intervention of a third party offering a better governance mousetrap. This model could, of course, be coupled with the board taking a greater stake in the economics of the firm than it currently has—a possibility that we discuss further below. The use of higher-powered board incentives would thus create a sliding scale of governance, with the full private equity model on one end and the current approach on the other. The BSP model would fall somewhere in between, depending on the incentives of the board in any particular case.

Objections

To be sure, there are downsides to providing products and services through business associations. Risk sharing creates moral hazard problems, and therefore there may be reduced incentives for individuals providing director services through a BSP to take care. The moral hazard problem and the potential

for risk externalization associated with limited liability are commonly understood problems of business associations.

But those potential problems should be balanced against the potential benefits of BSPs, including the significant potential for the reputation of large-scale organizations to ameliorate this risk. In addition, there are well known ways of reducing this risk, including using the “piercing the corporate veil” doctrine in extreme cases. Given the broad acceptance and use of corporate forms in other areas of providing goods and services, we think the cost-benefit tradeoff for corporations serving as corporate boards is clearly positive in some and perhaps many cases. But our claim is narrower: we merely argue that firms should be permitted to experiment with having corporate entities provide some or all of their director services.

Another objection is that nothing prevents individual directors from buying the expertise and support they need in the market by entering into contracts with consultants or others with the information or experience desired. This is the practice today, more or less, and appears to work in theory. But it is limited by the fact that directors do not have complete freedom to spend shareholder money and are subject to constraints imposed by the CEO in this regard. In fact, legislation has been required to simply authorize directors to spend money on outside advisers in a limited number of cases. Moreover, it is doubtful that the optimal arrangement is for all director support or specialization to be bought in the market in this way.

In his pioneering work on the theory of the firm, Ronald Coase noted that there is also a choice between bringing expertise together in a firm and buying it in a market, and that the size of the firm will expand until the marginal cost of adding another element to a firm equals the marginal cost of buying that element in the market. The unlikely result that the optimal director services firm size is a single person is evident by the fact that single-person firms are not the norm in any other area of professional services.

Critics might also argue that corporations or partnerships providing board services might serve their own interests instead of those of shareholders or society or wherever one thinks corporate efforts should be directed. But this objection is just as easily leveled against individual directors as associations of directors. Directors like Deepak Chopra (Men’s Warehouse), Chelsea Clinton (IAC), or Al Gore (Apple) may shirk, line their own pockets, or act in ways that serve their own interests above others, just as Boards-R-Us might. Fiduciary duty law (the twin fiduciary duties of care and loyalty) and reputation are the constraints on this behavior by directors today, and these would apply equally to firms as boards. In fact, reputation is likely to be a much more powerful constraint for a firm than an individual. When an individual director acts, the director bets only its reputation on the outcome, whereas when individuals act together in a firm, each act by each director affects the reputation of the entire firm. This means that all else being equal, we should expect less faithlessness from firms than individuals.

A final potential objection is that individuals have always

provided director services, and there may be some hidden logic to this structure. But the history of corporate boards is not instructive on this point. The first corporations used “boards of directors” as a mechanism to resolve a political problem. For instance, the Dutch East India Company (founded in 1602) was created to unite a series of independent firms located in various Dutch cities. The six cities, including Amsterdam, Rotterdam, and Delft, demanded *political* representation on a central board of directors known as the “Gentlemen Seventeen.” Thus the first corporate boards were more akin to the U.S. Senate than to the management of Microsoft or ExxonMobil. Boards today are not political bodies but decisionmaking and oversight ones, and the issues are of sufficient complexity and the stakes sufficiently high that a new approach is warranted.

Finally, the firms-as-boards proposal is consistent with the spirit of state corporate law as a set of default rules that merely enables firms to create their own governance arrangements designed to generate local maxima. Mandatory rules are the exception, not the rule, and should be based on clear and convincing evidence that freedom of contract would be unlikely to lead to social welfare improvements. We believe such a case is not made and, in fact, the opposite is true. In addition, there are a variety of contexts in which law, including state and federal law, already tolerates corporate entities serving in a board or board-like role. Partnerships, for instance, can have any “legal person” serving in the board-like role of general partner. Extending this right to corporations seems like a logical next step.

Conclusion

The reform idea that Professor Bainbridge and I have in mind is not a requirement that firms hire professional director services firms to be their boards, but merely that they should be permitted to do so. We are skeptical of one-size-fits-all arguments generally, and are confident that such a rule here would be hopelessly overbroad. Firms should merely have a choice, subject to the constraints of the market and judicial review for opportunism in the use of corporations, to provide these services.

The BSP idea is one that could be used to achieve a host of governance ends, ranging from increased shareholder power to better director primacy over corporations. In either case, and all those in between, what our proposal does is increase the transparency and competition for board services in a way that should increase confidence that firm choices about the role of the board are ones that are in the interests of shareholders and society in general, rather than based on a hidden agenda. **R**

READINGS

■ “Boards-R-Us: Reconceptualizing Corporate Boards,” by Stephen M. Bainbridge and M. Todd Henderson. Social Science Research Network paper 2291065, July 10, 2013.

■ “Quack Corporate Governance,” by Roberta Romano. *Regulation*, Vol. 28, No. 4 (Winter 2005).

■ “The Nature of the Firm,” by Ronald Coase. *Economica*, Vol. 4, No. 16 (1937).