

Corporate Board Member [March/April 2004](#)

Feature Story

An Outside-the-Box Idea: Go Inside for Directors
by William T. Allen

Governance reformers have demanded that companies hire more outside directors as a way to ensure better governance. The former head of Delaware's Chancery Court thinks this solution can be overdone.

For more than 50 years, the standard criticism of corporate boards has been that they are pawns of the CEO. The popular remedy for this condition—which has appealed to the courts, Congress, and institutional investors alike—is to place heavier reliance on directors who are independent of the company and its management. That penchant reached full bloom in the reforms that followed the shock of the Enron-WorldCom scandals. The Sarbanes-Oxley Act, as well as the proposed new-listing standards of the New York Stock Exchange, rely heavily on safeguards that rest on the independence of corporate directors. When those reforms become fully operative, each company traded on the NYSE will have to have all of its audit, governance, and compensation committees staffed wholly by outside directors who meet enhanced standards for independence.

This is a good thing. But what has not been very much noticed is that there are already very few inside directors on public-company boards. Indeed, for some time now it has been the style for boards to shuck their senior management members in favor of outsiders. At many, if not most, public companies today, the only insider is the CEO.

Of course, independence of judgment is an essential characteristic of an effective director, but it's equally clear that independence alone is not sufficient to produce effective governance. To protect investors' long-term financial interests, directors must exercise informed judgment. This requires information about the current condition of the company, its markets, and its technology, as well as information concerning challenges that are on the horizon. And in most cases directors get plenty of information, maybe too much. The skill, or the luck, may lie in focusing on the right information at the right time.

The 20-year trend of removing inside directors from corporate boards has deprived modern boards of a subtle source of important information. Provided we maintain a majority of outside directors on our boards, I suggest that it may often be possible to improve the quality of a board's performance by increasing the number of senior managers who serve on it. First, such a step would improve the quality of the information that independent directors consider in their deliberations. Second, it would act as a constraint

on the imperial-CEO phenomenon, but would do so with less risk than is entailed in stripping the CEO of the chairmanship role, which some propose. Third, and most important, it would improve the quality

of the board's judgment with respect to the vital job of succession planning. Here is a closer look at each of those benefits:

Improving the quality of information and deliberations

Legally, board members have full access to any information in the company's custody, but as a practical matter even conscientious board members have control over only certain summary information. Moreover, the Sarbanes-Oxley reforms have skewed the information that directors are apt to be focusing on more toward issues relating to legal-compliance needs, disclosure, and the integrity of financial statements. Obviously those are important topics, but this emphasis may incline boards to skimp on other vital aspects of their mandate: strategic planning and management development and succession. That tendency heightens the board's need for members who are deeply informed (as an insider is) about issues concerning the organizational function of the company as a business.

One may suppose that this change is unnecessary; senior managers will be in the boardroom if they are wanted. Since they are fully available, it may be argued, there is no need for them to sit at the table or have a vote. But this view underestimates the psychological and legal effect of formal board membership. The formal and informal relations between senior management and members of the board will inevitably be different when the senior managers are also directors.

Balancing the power of the board and ceo

I would suggest that sharply reducing the number of senior managers on the board reduces the likelihood that the board meeting will be a valuable forum. Without other senior management people feeling the legal responsibility of a director, the CEO will, in effect, be the only deeply informed member of the board on issues of strategy and performance. By modifying the nature of the relationship between outside directors and members of senior management, board membership for top managers will tend to increase the opportunities for outside directors to learn material information and to hear views that might not otherwise be considered. This may occur at formal board meetings and, just as important, in other ways once the relationship is altered.

Improving succession planning

Every well-run enterprise strives to manage succession internally, and great companies have a record of succeeding. When the process works right, the board comes to know a cadre of officers that the CEO has selected. That means exposure over a significant period and under varying circumstances. While periodic presentations to the board, formal review of performance, and even social contacts will be helpful, actual service on a board is the best way for directors to make an assessment of the strengths and weaknesses of the next generation of leadership. Effective corporate governance is not a simple thing, and no one set of standards or practices will fit all companies. But governance arrangements can only function with effect if they are operating on good information. We have answered the perceived problem of CEO domination with enhanced board independence, but in doing so we may have deprived

the outside majority of the best source of information and judgment by which they may accomplish their important task.

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