A Modest Proposal for Improved Corporate Governance

*By Martin Lipton and Jay W. Lorsch**

THE IMPORTANCE OF EFFECTIVE BOARDS

Corporate governance in the United States is not working the way it should. The problem is not the system of laws, regulations, and judicial decisions which are the framework of corporate governance. It is the failure by too many boards of directors to make the system work the way it should. The most obvious sign of this failure is in the gradual decline of many once great American companies. If boards of directors cannot find the solutions to these difficulties, the only realistic avenue for shareholders to voice their disapproval is to sell their shares. Directors eventually may act, as they recently did at General Motors[1], but their actions often are late, after the shareholders have lost value, employees jobs, and the corporation its competitive market position.

During the 1980s, it was argued by many academics and financiers that the "disciplines of the capital markets," through the threats or actualities of takeovers, would cause managers to take corrective action to improve performance.[2] We leave it to historians to decide whether this argument

*Mr. Lipton is a partner of Wachtell, Lipton, Rosen & Katz in New York City. Mr. Lorsch is Senior Associate Dean, Chairman of Executive Education Programs, and Louis E. Kirstein Professor of Human Relations at The Graduate School of Business Administration of Harvard University.

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1. Joseph B. White & Paul Ingrassia, *Board Ousts Managers At GM, Takes Control of Crucial Committee*, Wall St. J., Apr. 7, 1992, at A1.

2. *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 Harv. L. Rev. 1161, 1169 (1981) ("tender bidding process polices managers whether or not a tender offer occurs"); Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 Stan. L. Rev. 819 (1981).

was valid.[3] What is clear today is that this era of highly leveraged takeovers and buyouts is behind us. This nation needs effective means to improve performance by publicly owned companies. We believe that these means should be developed and adopted by corporations on their own initiative and should not be imposed by legislation, regulation, court decisions overruling settled principles of corporate law, or bylaw amendments originated by institutional investors.

The difficulties we face today were presaged by Berle and Means in 1932 in their seminal work.[4] They argued that a clear separation had developed between shareholders and management, with shareholders no longer having any real voice in how the corporation is run and with management only theoretically accountable to the board of directors. The shareholders to which Berle and Means were referring were primarily individual investors. When the historian Alfred Chandler declared in 1977 that America had created a system of "Managerial Capitalism" in which management, not shareholders, controlled the corporation, he too was thinking mostly about individual investors.[5]

Since Chandler's work was completed there has been a rapid rise in the proportion of total U.S. equity owned by institutional investors. This especially has been true in the last decade. The most reliable estimates indicate that the equity ownership by all types of public and private institutions is between 50% and 60% of the total value of stock-exchange-listed companies.[6] In the case of some corporations, especially large ones, this proportion is even higher.[7]

The current difficulty is that these institutional investors, like their individual counterparts, find it difficult to act as owners. They cannot follow the fortunes of specific companies in detail because their portfolios are so large and diverse. This also means that a given institution never owns a sufficiently large proportion of any one company to warrant a board

3. *See, e.g.*, Melvin A. Eisenberg, *The Structure of Corporation Law*, 89 Colum. L. Rev. 1461, 1497-99 (1989) (threat of a takeover may make some managers more efficient, but "the takeover market neither adequately aligns the interests of managers and shareholders, nor adequately addresses the problem of managerial inefficiency"); John C. Coffee, Jr., *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 Colum. L. Rev. 1145, 1192-95 (1984) (capital market is only an effective monitor in cases of massive managerial failure); Michael L. Dertouzos et al., Made in America: Regaining the Productive Edge 39 (1989) ("Only an extraordinary optimist could believe, for example, that the current wave of takeover activity is an efficient way to deal with the organizational deficiencies of American industries.").

4. *See* Adolf A. Berle & Gardiner C. Means, The Modern Corporation and Private Property (Harcourt, Brace & World rev. ed. 1968).

5. Alfred D. Chandler, Jr., The Visible Hand: The Managerial Revolution in American Business (1977).

6. *See* Carolyn Brancato, Columbia University Center for Law and Economic Studies, Institutional Investors and Capital Markets: 1991 Update 8 (1991) (institutional ownership of the total U.S. equity market increased from 33.1 percent in 1980 to 53.3 percent in 1990).

7. *Id.* at 16.

seat. All of this is complicated by "indexing,"[8] which means that a large proportion of a particular portfolio is managed by following the market average rather than focusing on individual companies. Finally, institutional investors may face real conflicts of interest between their fiduciary responsibility to beneficiaries and any role as active owner. Institutions as owners have been able to do little more than to focus public attention on a few companies that have been singled out for especially poor financial performance or other reasons.[9]

Certain institutional investors actively are seeking ways to communicate more easily with each other and jointly to elect directors. To be successful in a meaningful way, such efforts, however, would require changes in Securities and Exchange Commission (SEC) regulations beyond the changes recently adopted by the SEC,[10] as well as in the attitudes of incumbent managers and directors. In addition, direct participation by institutional investors in corporate governance might give rise to insider-trading restrictions and other legal and practical problems.[11] Despite the problems confronting institutional investors that seek greater participation in corporate governance, it is clear that they are in the corporate governance business to stay. They will not just go away.[12] As the owners of more than a majority of the shares of most major public companies, they will continue to insist on accountability for poor performance.[13]

This state of affairs suggests clearly to us that more effective corporate governance depends vitally on strengthening the role of the board of directors. This point was reinforced in a recent speech by Chancellor

8. *See generally id.* at 9-10.

9. *See, e.g.*, Press Release by California Public Employees Retirement System (CalPERS), 24 Sec. Reg. & L. Rep. (BNA) 420 (Mar. 20, 1992) (announcing the names of twelve poorly performing U.S. companies that CalPERS identified as "ripe for improved shareholder accountability").

10. Regulation of Communications Among Shareholders, Exchange Act Release No. 31, 326, 1992 SEC LEXIS 2470 (Oct. 16, 1992).

11. To the extent that an institutional investor acquires material nonpublic information, it could be held civilly or criminally liable for violation of rule 10b-5 under the Securities Exchange Act of 1934, 15 U.S.C. § 78a-78*ll* (1988 & Supp. II 1990). *See generally* 2 Thomas L. Hazen, The Law of Securities Regulation § 13.9 (2d ed. 1990). For a discussion of other potential liabilities of institutional investors, see Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 Colum. L. Rev. 10, 26-27 (1991) (SEC rules pursuant to §§ 13(d) and 14(a) of the Securities Exchange Act impede activism by large shareholders or groups thereof; § 16(b) of the Securities Exchange Act discourages the assembling of large blocks of stock through the imposition of liability for short-swing profits).

12. The Korn/Ferry 1992 survey shows that the majority of CEOs "anticipate an increase in the involvement of institutional investors in board decisions" and only 6% of CEOs expect influence of institutional investors to diminish in the future. Korn/Ferry, Board of Directors Nineteenth Annual Study 1992 14 [hereinafter, *Korn/Ferry 1992*]. *See also* Kevin G. Salwen, *Institutions Are Poised to Increase Clout in Boardroom*, Wall St. J., Sept. 21, 1992, at B1.

13. *See, e.g.*, Press Release by New York State Comptroller Edward V. Regan (March 18, 1992); Press Release by CalPERS, *supra* note 9.

William Allen of the Delaware Court of Chancery, one of the leading judicial scholars on corporate law. Chancellor Allen said:

> The conventional perception is that boards should select senior management, create incentive compensation schemes and then step back and watch the organization prosper. In addition, board members should be available to act as advisors to the CEO when called upon and they should be prepared to act during a crisis: an emergency succession problem, threatened insolvency or an MBO proposal, for example.
>
> This view of the responsibilities of membership on the board of directors of a public company is, in my opinion, badly deficient. It ignores a most basic responsibility: the duty to monitor the performance of senior management in an informed way. Outside directors should function as active monitors of corporate management, not just in crisis, but continually; they should have an active role in the formulation of the long-term strategic, financial, and organizational goals of the corporation and should approve plans to achieve those goals; they should as well engage in the periodic review of short and long-term performance according to plan and be prepared to press for correction when in their judgment there is need.[14]

Because Chancellor Allen's view may well adumbrate what the courts would hold are the legal duties of independent directors, it is possible to discern an alignment between practical reality and an emerging legal perspective on that which is necessary to improve corporate governance.

If directors perform well the duties Chancellor Allen has outlined, they may prevent a significant portion of the long-term erosion of corporate performance that has plagued many once successful U.S. corporations.[15] By acting early and effectively, directors may prevent small problems from growing into a major crisis. Chairman Richard Breeden of the SEC recently made the same point cogently and succinctly:

> By every measure, the board of directors is the linchpin of our system of corporate governance, and the foundation for the legitimacy of actions taken by management in the name of the shareholders. The board has the access to information and the power to provide meaningful oversight of management's performance in running the busi-

14. Chancellor William T. Allen, Delaware Court of Chancery, *Redefining the Role of Outside Directors In an Age of Global Competition*, presented at Ray Garrett Jr., Corporate and Securities Law Institute, Northwestern University, Chicago (Apr. 1992).

15. *But cf.* Donald S. Perkins, *Twenty Questions of Corporate Governance*, presented at 1992 CEO Forum on Corporate Governance at the Wharton School—The University of Pennsylvania (Sept. 1992) ("Corporate governance improvement, though important, is likely to make only a modest contribution to corporate bottom lines in relation to external factors which challenge our corporations today.").

> ness, and it needs to use them cooperatively but firmly. This is particularly vital when a company is in a downward spiral, since the cost of waiting for a takeover or bankruptcy to make management changes will be far higher than through board action.[16]

Chancellor Allen and Chairman Breeden are not alone in their view of the role of the board. In 1979, Donald S. Perkins, then Chairman and CEO of Jewel Companies, described the role of the board as follows:

> A board of directors can contribute minimally if it acts only as a necessary legal entity tolerated by the chairman. On the other hand, a board can contribute a great deal if it acts as a truly diverse group of informed and interested counsellors, advisors and directors of management.[17]

WHY A "MODEST" PROPOSAL

If effective boards are so important, one may well ask why put forth only a "modest" proposal. The answer rests in our definition of *modest.* We propose that changes in board practices be implemented by individual boards, with no changes in laws, stock exchange rules, SEC regulations, or new court decisions. Trying to change regulations or laws will be politically difficult and at best very time consuming.[18]

There are, of course, differences in opinion and ideas among business leaders, institutional investors, lawyers, and academics as to what changes (if any) in regulations and laws would be desirable.[19] If we wait for this debate to be completed, we risk another decade (or more) of a continuation of governance difficulties which have contributed to the decline of our national competitiveness. We also risk the imposition of ill-considered or politically motivated governance requirements that could cause serious harm, rather than improve corporate performance.

Our proposal for changes in the boardroom is based on our experience and that of others. We believe it will be acceptable to those concerned with corporate governance, especially institutional investors, senior man-

16. Richard C. Breeden, Chairman, Securities and Exchange Commission, Corporate Governance and Compensation, presented at Town Hall of California, Los Angeles, California (June 1992).

17. Donald S. Perkins, *What the CEO and the Board Expect of Each Other*, 57 Harv. Bus. Rev., Mar.-Apr. 1979, at 32.

18. Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. Chi. L. Rev. 187, 249 (1991).

19. *See generally* Michael Cassell, *Blueprint for Good Boardroom Practice*, Fin. Times, Oct. 28, 1991, at Sec. I, p.17 (summarizing various viewpoints concerning desirable changes in regulation of corporate governance); The Business Roundtable, *Corporate Governance and American Competitiveness* (Mar. 1990), *reprinted in* 46 Bus. Law. 241 (1990) [hereinafter Business Roundtable] (setting forth The Business Roundtable's suggestions for corporate governance).

agement and of course directors themselves. Our proposal does not require major changes in what well-advised companies are already doing; indeed, our view of the role and function of the board of directors is not significantly different from that of The Business Roundtable.[20] It would not require any changes in laws or regulations because it deals primarily with the way boards actually perform their duties and not the legal context in which they function. Nor does it require correlative or compensatory action by institutional investors. Specifically, it does not ask them to be patient, long-term investors, to participate in corporate governance activities, or to modify their investment policies. Our proposal is for action by corporations to be taken unilaterally in their self interest and not as part of a "deal" with institutional investors.

We do not argue that good corporate governance produces good corporate performance. Some of the most successful companies are managed by entrepreneurs who disdain what we view as good corporate governance. Nevertheless, we are convinced that if a company is underperforming due to poor management or persisting with a failed strategy, good corporate governance is the safety valve that can provide the means to deal with the problem and improve performance.

LIMITS ON BOARD EFFECTIVENESS

To understand the rationale behind our proposal, it is necessary to comprehend the factors that we believe make it difficult for many boards to carry out the monitoring function to which Chancellor Allen points (and with which we agree) as their critical role. We say "many companies" because we recognize that some boards are doing a better job than others of monitoring management and company performance, and we also believe the limits on board effectiveness which concern us exist in varying degrees and combinations in different boardrooms.

LACK OF TIME AND BOARD SIZE

Based on our experience, the most widely shared problem directors have is a lack of time to carry out their duties. The typical board meets less than eight times annually.[21] Even with committee meetings and informal gatherings before or after the formal board meeting, directors rarely spend as much as a working day together in and around each meeting. Further, in many boardrooms too much of this limited time is occupied with reports from management and various formalities. In essence, the limited time outside directors have together is not used in a meaningful exchange of ideas among themselves or with management/inside directors.

20. *See* Business Roundtable, *supra* note 19, at 7.
21. *Korn/Ferry 1992*, *supra* note 12, at 12.

Another related reason for the lack of meaningful dialogue is the size of many boards. When a board has more than ten members, it becomes more difficult for them all to express their ideas and opinions in the limited time available. This contributes to the expectation, discussed below,[22] that directors are not supposed to voice their opinions freely and frequently.

COMPLEXITY OF INFORMATION

A related difficulty is the complexity of the matters directors must understand, discuss, and decide upon in their limited time. The concern most independent directors have is not with a lack of information, but with the amount and complexity of the data they receive. Part of the problem is that too little attention is given by management and directors themselves to the problem of how best to organize and conceptualize the data. It is also true that too much emphasis is placed on information about short-term financial performance and not enough attention is devoted to data about longer-term trends, not just those trends that are of a financial nature, but also those that are apropos of competitive position and organizational health.

Even if the data provided were comprehensive, well organized, and cogently presented, independent directors still would face difficulties. The principal would seem to be comprehending the past and likely future state of a company's affairs in a very limited time without a depth of experience and background in industry and company matters. Such knowledge is the critical context in which directors, like managers, need to consider their evaluations and choices. The more time directors spend on the affairs of a given company and the more they have an open exchange of ideas, the more they will develop this important knowledge base.

LACK OF COHESIVENESS

A board is essentially a group of individuals working together. If any group is to be effective, the members need to share a common purpose, be able to communicate with each other clearly, and ultimately reach a consensus that builds on the differing points of view among members. Because boards are often large, spend such a limited amount of time together, and spend even less time in open discussion of ideas, these qualities are in unacceptably short supply in most boardrooms. Further, independent directors are very busy, and often are involved with more than one board. As a result, a particular board may not be an especially important group to a given outside director. Thus, most boards are not a cohesive group able to work well together toward a common purpose.

22. *See infra* note 23 and accompanying text.

In fact, the norms of behavior in most boardrooms are dysfunctional.[23] They discourage directors from speaking out, especially if they are going to be critical of management, and they inhibit independent directors from asserting leadership among their peers. Clearly, if independent directors are to be more effective monitors, we need to find a means to strengthen the cohesiveness of boards and the process by which directors work together.

POWER OF TOP MANAGEMENT

In America the term *power* is often considered a "dirty" word, a phrase to be avoided. Yet, in any discussion of governance, power is a key concept. No one can govern without the power to do so. In U.S. boardrooms, the most influential person is the CEO/chairman.[24] That this is so is not surprising, nor is it usually because the CEO/chairman deliberately or willfully tries to control the board. It is simply because the CEO/chairman is the most knowledgeable and experienced person about his or her company in the boardroom, and has the most time to devote to the company's affairs. By custom and necessity the CEO/chairman controls the flow of information, sets agendas, and runs meetings. The CEO/chairman is truly the leader of the board.

In fact, when boards develop innovative leading-edge practices, it is the CEO/chairman who usually initiates them.[25] The difficulty, however, is that the influence of the CEO and the esteem in which he or she is held by the independent directors can make it difficult for the latter to carry out their monitoring function. As pointed out in the Cadbury Committee recommendations to improve corporate governance in Great Britain, the acid test is whether the board provides an effective check and balance to the CEO.[26]

CONFUSED ACCOUNTABILITIES

The final limiting factor which warrants mention is the directors' understanding of their ultimate accountability. There is confusion about this in most boardrooms, and this is another important reason directors often lack a clear sense of purpose.[27] Certainly the historical idea that directors are responsible for "enhancing shareholder value" has permeated all

23. Jay W. Lorsch, Pawns or Potentates: The Reality of American Corporate Boards 91-95 (1989).

24. Eighty percent of the companies in the 1992 Korn/Ferry survey report that their CEO is also their chairman. *Korn/Ferry 1992, supra* note 12, at 7.

25. *See, e.g.*, Perkins, *supra* note 15, at 5 (the CEO controls the "climate" of the relationship between management and the board of directors).

26. Cadbury Committee, *Committee on Financial Aspects of Corporate Governance* 12 (Draft Report, May 27, 1992); *see also* Perkins, *supra* note 17.

27. Lorsch, *supra* note 23, at 118-21.

boardrooms. But this objective is narrower than many directors personally would prefer, since they are committed to a broader ideal of long-term corporate health. Directors also are not clear about the impact of the broad constituency statutes, adopted in about half the states, which authorize or mandate concern for employees, customers, suppliers, and communities, along with shareholders.[28] Further, they seem not to understand yet the broader definition of their responsibility as stated by Chancellor Allen. To be effective monitors of management and the corporation, independent directors must have a clear, shared understanding of the criteria they should use in judging performance. Such criteria must include a concern for the long-term value of the shareholder's investment as well as a broad range of related corporate performance criteria.

PROPOSED CHANGES

The innovations which we propose are intended to reduce these constraints on the board's role as an effective monitor in a fashion that does not blur the distinction between the executives who manage the company and the directors who monitor its performance. We subscribe to Donald Perkins' view of the need to recognize "the very distinct differences between the daily responsibility of management and the periodic responsibility of directors to evaluate plans and results. Directors simply cannot and should not try to manage the daily affairs of the business."[29]

BOARD SIZE AND COMPOSITION

We believe that the size of a board should be limited to a maximum of ten directors (indeed, we would favor boards of eight or nine)[30] with a ratio of at least two independent directors to any director who has a connection with the company, either as management or substantial customer or supplier of goods or services. In addition, we would not view as independent an executive of another company on the board of which an

28. *See, e.g.*, Ind. Code Ann. § 23-1-35-1(d) (Burns 1991); Me. Rev. Stat. Ann. tit. 13-A, § 716 (West Supp. 1991); Ohio Rev. Code Ann. § 1701.59 (Anderson 1992); Pa. Stat. Ann. tit. 15, § 515 (1990).

29. Perkins, *supra* note 17.

30. We recognize that in some companies a larger board functions very well and that such companies should not abruptly reduce the size of their boards. In such situations we suggest that the reduction take place through attrition by retirement over a period of time.

The companies in the 1992 Korn/Ferry survey have an average of twelve directors, with larger companies and banks and financial institutions reporting an average of thirteen and sixteen, respectively. *See Korn/Ferry 1992, supra* note 12, at 7.

executive of the company serves.[31] A smaller board will be most likely to allow directors to get to know each other well, to have more effective discussions with all directors contributing, and to reach a true consensus from their deliberations.

Some may argue that boards of this size will limit the range of viewpoints and ignore the need of our society for diversity in the boardroom. Our rejoinder is that five or six independent directors, who are carefully selected, should provide the breadth of perspective and diversity required. In this connection we recommend that each board establish, and update annually, the criteria to be followed in selecting candidates for nomination as a director of that company.[32] We approve and adopt the proposal by Donald Perkins and a number of other thoughtful directors of major companies that each board should establish a term limit for the independent directors.[33] As a practical matter this is the only way in which a board can replace a director who no longer meets his or her responsibilities. Each board should also establish a mandatory retirement age for the independent directors.

We endorse the now widely accepted view that a corporation should have an audit committee, a compensation committee, and a nominating

31. We recognize that our definition of independent is different from that of the New York Stock Exchange and from that generally applied by the courts. Our definition is similar to that of the SEC with respect to compensation committees. Executive Compensation Disclosure, Exchange Act Release No. 31,327, 1992 SEC LEXIS 2468 (Oct. 16, 1992). We proffer our definition only for the purpose of our proposal and not for legal or rulemaking purposes.

32. *See* Kenneth A. Macke, *The Board and Management: A New Partnership*, Directorship, July-Aug. 1992, at 8:

> [T]he composition of the board is critical to how well it functions. We like to make sure that everything is geared toward making the board as independent and active as possible. By tradition, we look for board members who are successful in their careers so that they do not rely heavily on their Dayton Hudson position for income or prestige. It is no accident that the board is relatively young, with an average age of 56 and that all 13 members are at the top of their professions. That way, Dayton Hudson benefits from their experience as well as their fresh ideas.
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> We are not looking for "professional" directors; hence, there are limits to how long directors may serve. They must rotate off the board after 15 years, or at the mandatory retirement age of 65. . . . As a national corporation, we seek out directors with varied backgrounds. We also look for geographic diversity so that there is no hometown clique. But perhaps most important, board members must be forward-thinking individuals who take their commitment to our board seriously.

Id.

33. "The average tenure for directors was reported at 10 years, the same as last year. Forty-two percent of the respondents believe there should be a limit to a director's term of service, up from 29 percent in 1990. Those who favor a limit believe it should be 12 years." *Korn/Ferry 1992*, *supra* note 12, at 14; *see also supra* note 32.

committee.[34] Each of these committees should consist only of independent directors, one of whom should be the chair. Each independent director should serve on at least one of these committees.

We believe that given the time requirements for directors and the responsibilities they have, except in special situations a person should not serve on more than three boards.

FREQUENCY AND DURATION OF MEETINGS

Boards should meet at least bimonthly and each meeting should take a full day, including committee sessions and other related activities.[35] One meeting each year should be a two or three day strategy session. Directors should also spend the equivalent of another day preparing for each meeting by reviewing reports and other materials sent to them in advance. This would mean that directors would be expected to spend more than 100 hours annually on each board, not counting special meetings and not counting travel time.[36] We believe this much time is essential to allow directors properly to carry out their monitoring function. The additional meeting time will also have the salutary effect of strengthening the cohesive bonds among the independent directors.

Directors' compensation should be raised commensurate with the increased amount of time they will be required to spend. While financial remuneration may not be an important reward for most independent directors,[37] we believe a director should be compensated adequately for the responsibilities he or she assumes in accepting a directorship.[38] We approve the growing trend toward stock options or restricted stock being used as a significant portion of director compensation.[39]

Because the limited time available is such an important issue, we believe that within each board it is essential to consider the manner in which scarce meeting time is used. The agenda should focus the vast majority of the board's time on activities connected to its monitoring role. In fact, if boards were to focus on the three issues that directors themselves[40] identified as their key tasks—selecting, evaluating and rewarding the CEO, approving corporate strategy, and assuring compliance with the laws and

34. According to the Korn/Ferry 1992 survey, 98% of the responding companies have an audit committee, 95% have a compensation committee, and 67% have a nominating committee. *Korn/Ferry 1992, supra* note 12, at 9.

35. It may be desirable for the boards of major corporations to meet more often, perhaps 8 to 12 times per year.

36. According to the Korn/Ferry 1992 survey, the average time spent on "board-related business (including time for preparation, meetings and travel)" was 94 hours. *Korn/Ferry 1992, supra* note 12, at 12.

37. *See* Lorsch, *supra* note 23, at 26-30.

38. *See Korn/Ferry 1992, supra* note 12, at 10-11.

39. *See id.* at 12.

40. *See* Lorsch, *supra* note 23, at 63-71.

ethical standards—they would be doing what Chancellor Allen suggests. One way to assure that board time is well spent is to develop a board calendar, which specifies at which meeting the board will carry out various duties and reviews. A concrete sample of what we have in mind, which is from the Dayton Hudson Corporation, is attached as Exhibit 1. As shown in this exhibit, Dayton Hudson divides the areas to be monitored by the board into five principal segments: (1) strategic planning; (2) capital allocation; (3) long range goals; (4) performance appraisal; and (5) manpower planning. Each segment is further divided into its main components. If board agendas were planned in this careful manner and if meetings and preparation time were expanded, we believe that there would be major progress in improving the effectiveness of America's corporate boards.

THE LEAD DIRECTOR

Over the years, whenever there is a resurgence of interest in U.S. corporate governance, one idea which resurfaces is to separate the job of chairman from that of CEO.[41] This is a key point in the Cadbury Committee's recommendations.[42] While this idea works well in many European companies, and even in a few in the U.S., we recognize that it is strongly resisted by top management in most U.S. companies.

Nevertheless, if independent directors are to be effective, they need some form of leadership from among their own number. While this is true in normal times, it is especially valid if the CEO is incapacitated or is failing in his or her duties. We therefore propose (as does the Cadbury Committee for those British companies that do not have a nonexecutive chairman) that each board select a leader from among the independent directors. The person in this role could be rotated on an annual or biannual basis. What this person is called is not important, but his or her duties are important. We believe that the CEO/chairman should consult with this lead director on the following matters: the selection of board committee members and chairpersons; the board's meeting agendas; the adequacy of information directors receive; and the effectiveness of the board meeting process. Additionally, this director would play a leading role in the CEO evaluation described below. Finally, if the independent directors should face a crisis because of the incapacity of the CEO/chairman, or a failure in top management performance, they would have a designated leader in

41. *See, e.g.*, Winthrop Knowlton & Ira Millstein, *Can the Board of Directors Help the American Corporation Earn the Immortality It Holds So Dear?*, *in* The U.S. Business Corporation: An Institute in Transition 169-191 (1988); Harold Williams, *Corporate Accountability and Corporate Power*, *in* Power and Accountability: The Changing Role of the Corporate Board 18 (1979); Mary L. Schapiro, Commissioner, Securities and Exchange Commission, Address before the Council of Institutional Investors (Apr. 9, 1992).

42. Cadbury Committee, *Committee on Financial Aspects of Corporate Governance* 13 (Draft Report, May 27, 1992).

advance. This could be key to their ability to act promptly if the need arose.

While some top managers' immediate emotional reaction to this idea will be negative, we believe it is a critical factor in making boards more effective. In fact, we believe that in many boardrooms today such a leader is already recognized by management and independent directors alike. He or she may be a particular committee chairperson, the director with the most seniority, or the one who is most respected. Our proposal would simply legitimate this role, without compromising the leadership prerogatives of the CEO/chairman. We recognize the possibility that a lead director might attempt to usurp some of the functions of the CEO or otherwise interfere improperly in the management of the company. On balance we believe that this risk should be accepted. We think this risk is reduced by the smaller board with all directors encouraged to participate fully. In addition, term limits, mandatory retirement age, and careful selection provide further protection.

IMPROVED INFORMATION

Even when directors spend more time preparing and discussing corporate issues, they still will need information that is superior to that which they now receive, in two senses. First, to carry out the monitoring of the corporation's performance in relation to its long-term strategic, financial, and organizational goals, directors need a broader array of data than the financial reports they typically now receive. That financial reports alone are inadequate for assessing corporate performance is not a new idea. As Eccles and Nohria point out,[43] as far back as 1951, Ralph Cordiner, then CEO of General Electric, asked McKinsey and Company to develop a broader set of measures for business performance. Several different classes of measures were recommended: profitability; market position; productivity; product leadership; personnel development; employee attitudes; public responsibility; and balance between short- and long-range goals. Earlier this year Cyrus Friedheim, Jr., Vice Chairman of Booz, Allen & Hamilton, proposed a similar list of measures as the basis upon which CEO performance should be judged in relation to compensation.[44] Following this recommendation would also be of considerable value in enabling companies to comply with the new SEC requirement that compensation committees report in the annual proxy statement the factors they considered in setting executive compensation.[45]

43. Robert G. Eccles & Nitin Nohria, Beyond the Hype: Rediscovering the Essence of Management (1992).

44. Cyrus Friedheim, Jr., *Measuring Executive Performance*, presented at Corporate Governance Conference, Kellogg Graduate School of Management, Chicago (Jan. 1992).

45. Executive Compensation Disclosure, Exchange Act Release No. 31,327, 1992 SEC LEXIS 2468 (Oct. 16, 1992).

The specifics of the performance data supplied to the directors will vary depending on the company's business(es) and the adequacy of its information systems. We recognize that the amount of this data could be overwhelming to outside directors, even with the increased time we have proposed they devote to their responsibilities. Hence, our second proposal relating to director information is that great care and attention be given to how data is organized and presented, with each board choosing (and reevaluating annually) the format it finds the most useful.

CORPORATE AND CEO PERFORMANCE EVALUATION

The purpose of this broader data is not only to enable independent directors to be better informed in making decisions, but also to enable them to do a more thorough and meaningful assessment of the performance of their company and of its leadership. We believe the board's performance evaluation should be an explicit annual event. It should consist of three related aspects.

First, there should be an assessment of the company's long-term financial, strategic, and organizational performance in relation to the goals previously established by management and the board. This assessment of company performance also should include an examination of the company's historical trends as well as its performance compared to that of its competitors and/or similar companies. This assessment of company performance would be a critical part of the board's annual evaluation of the CEO's performance, the second aspect of the board's annual review of performance.

The independent directors' review of the CEO's performance is obviously a sensitive and delicate matter, which must be conducted with skill and tact. Many boards profess to do such an assessment, but we know of only a few companies that conduct a thorough and systematic review. According to The Business Roundtable, one of the primary functions of the board of directors is to "select, regularly evaluate and, if necessary, replace the chief executive officer."[46] Because of the sensitivities involved we do not recommend any specific process. What will work in a particular company will depend on its business(es), size, history and culture, and the relationship between the CEO and the independent directors.

Nevertheless, we do have in mind certain broad guidelines which we believe are critical if the process of evaluation is to be helpful both to the CEO and the independent directors:

46. Business Roundtable, *supra* note 19, at 7; *see also* The Working Group on Corporate Governance, *A New Compact for Owners and Directors*, 69 Harv. Bus. Rev., July-Aug. 1991, at 141 (one of the primary functions of directors should be to regularly evaluate the performance of the CEO against established goals and strategies).

1. The assessment should be based on company performance, and the progress the CEO has made toward his or her personal long- and short-range goals. Such personal goals would constitute the major extraordinary initiatives the CEO wanted to achieve, e.g., developing and selecting a successor; expanding into markets internationally; making a major acquisition; creating a significant joint venture. We contemplate that short-term goals will be agreed upon annually among the CEO and the independent directors. The longer-term goals might have a three-to-five-year horizon, but would be reviewed annually and changed as necessary.
2. Each director would make an individual assessment of the CEO's performance. These assessments then would be synthesized to reveal the central tendency, as well as any range of views. This synthesis could be done by the lead director, or by a small group or committee of independent directors.
3. The CEO would receive this synthesized feedback in a confidential manner in which both he or she and the independent directors were comfortable.
4. After the CEO has had time to reflect on it and to develop a response, he or she would then discuss his or her reactions to the assessment with all the independent directors. This discussion also should focus on any changes in goals for the company or the CEO which seem appropriate.

We believe that a careful annual assessment would accomplish several important objectives. For the CEO it would provide concrete data about how the independent directors assessed his or her performance and that of the company. Leaders of large companies rarely get such feedback, but they tell us it can be very helpful to them. For the independent directors such a process would enable them to share their ideas on the company's progress and on the CEO's performance. It would also provide a tangible basis for defining CEO compensation. Finally, this process would improve communication between the CEO and the independent directors as well as among the latter, which in itself is desirable.

We recognize that some companies may be concerned with the litigation implications of the annual CEO evaluation. Nevertheless, we believe that the benefits, both substantively and as demonstrating discharge by the directors of their monitoring responsibilities, outweigh the possible misuse or misinterpretation of the evaluation in a lawsuit.

In order to avoid any misunderstanding or implication that the independent directors are meeting or conferring because of dissatisfaction with management, the CEO evaluation could take place at the same time each year. Some companies have adopted a practice of having the independent directors meet separately as part of several of the regularly scheduled board meetings. This very regularity serves to avoid any implication of a problem with management.

The third aspect of the annual performance evaluation is an assessment of how the board itself is functioning. Questions like the following should be discussed: Is the board satisfied with the information it is receiving? Is the lead director interfering with the management? Is there a director who does not participate fully in the board's activities? What can the board do to improve its own processes and performance?

THE BOARD AND SHAREHOLDERS

Our focus so far largely has been on the relationship between management and the board. We now want to turn to the board's relationship to shareholders. As we noted earlier, shareholders, especially institutional investors, are searching for legitimate means to express their concerns about corporate performance. As we describe this facet of our proposal, we must emphasize that the term "legitimate" to us means that shareholders should focus their attention on the financial and strategic performance of the company, and should not use the corporate governance arena to further social or political ends.[47] Such activity only serves to exacerbate the tensions between shareholders and managers and directors, diverting the latter two groups from focusing on efforts to improve performance.

We recommend that the board of directors (including its management members) meet annually in an informal setting with five to ten of the larger investors in the company.[48] The primary purposes of the meeting would be to promote understanding between the two groups and provide a convenient and informal opportunity for the investors to tell the directors either as a group or individually of any concerns the investors have. Thus the meeting might avoid much of the letter writing, meeting requests, boardseat requests, and proxy proposals some institutions have been pursuing. If the meeting does nothing more than improve understanding between investors and directors, it will serve a valuable purpose. The meeting will be of little or no value, and likely will fall into disuse, however, if the investors are not represented by knowledgeable, high-level officers. A company with satisfactory performance may find that its large investors prefer to meet once in two or three years rather than annually.

If the company's performance is satisfactory, the informal meeting with the large investors and the customary quarterly and annual reports, plus

47. *See* Richard Y. Roberts, Commissioner, Securities and Exchange Commission, *Shareholder Proposals—Rule 14a-8*, presented at the American Society of Corporate Secretaries—New York Chapter (Oct. 5, 1991).

48. This type of meeting must be conducted carefully to avoid the transmission of material nonpublic information. We believe that such transmission can be readily avoided, because the suggested meetings with large investors do not present any inside information problems beyond those of the customary meetings with security analysts and portfolio managers. *See supra* note 11.

the usual pattern of management's meetings with analysts, should provide adequate information to investors. When the company's performance is not satisfactory, we believe the company should provide investors with more information about the causes of the company's difficulties, and the actions the board and management are taking to correct the situation, than is normally provided in the "Management Discussion and Analysis" section of the company's periodic reports.[49]

Specifically, if in three of the past five years a company has failed to meet its goals or plans, or suffered losses or declines in earnings, or erosions in competitive positions, or has underperformed the market averages or its competitors or peer group of companies, a special section of the annual report should be prepared under the supervision of the independent directors. This special report should describe the causes of the problems and the actions the board and management are taking. This special report should be continued in subsequent annual reports until the problem has been rectified. While this special report may in some situations relate to certain elements of the CEO performance review, we do not intend that such review be published or necessarily referred to in any way in the special report or otherwise.

When a corporation's underperformance triggers these explanations in the annual report, substantial shareholders should be entitled to voice their views through the proxy statement for the annual meeting. To provide this we would adapt the recent proposal made by New York State Comptroller Edward Regan to grant such access to long-term substantial shareholders,[50] and we would provide that the annual meeting be rescheduled so that there is sufficient time after the mailing of the annual report for shareholders to determine if they desire to have their views included in the proxy statement for the meeting. Provided there is no proxy fight, up to three shareholders or groups of shareholders who individually or together have held 1% or more of the shares of the corporation for a year would each be permitted to include a statement of up to 500 words setting forth their views of the corporation's performance.

The performance reviews, annual meeting with large investors, and special report to shareholders for troubled companies are central features of our proposal. We believe that these features will result in better monitoring and higher standards of accountability, and will provide shareholders with adequate information for purposes of communicating with management and the directors and upon which to make proxy decisions. These features

49. *See* 17 C.F.R. § 229.303 (1992) (Item 303 of Regulation S-K of the Securities Exchange Act of 1934); *see also In re* Caterpiller Inc., Exchange Act Release No. 30,532, Fed. Sec. L. Rep. (CCH) ¶ 73,830 (Mar. 31, 1992) (stating that management should have disclosed future uncertainties and their possible adverse effect upon earnings).

50. *See* Press Release by New York State Comptroller Edward V. Regan (Mar. 18, 1992); *see also* Lipton & Rosenblum, *supra* note 18, at 230-32 (discussing the grant of access to proxy machinery to significant shareholders).

put "teeth" into our proposal. A formal annual performance review overcomes the natural reluctance of directors to be critical of the CEO and requires them to focus on deficiencies that human nature might otherwise lead them to overlook. Informal meetings in which large shareholders have the opportunity to communicate directly with directors will do much to promote understanding and most importantly will enable directors to assess better any concerns the shareholders may have. These meetings will also enable the directors to show the shareholders that the directors are aware of and dealing with any problems. Finally, we believe the requirement for a special report and postponement of the annual meeting in the event of persistent underperformance will be a major factor in motivating management and the board to take action to deal with underperformance before it gets to the point of triggering the special report.

CONCLUSION

We believe that our proposal provides an effective means for improving corporate governance and thereby improving performance and the competitive position of U.S. companies. All of our proposals can be adopted by individual boards of directors with no more than changes in bylaws and boardroom procedures. We are convinced that moving in the directions we have proposed will strengthen corporate governance by making management more directly accountable to the board and, in problematic situations, improving shareholder communication with independent directors. Lastly, we believe that our proposal will: reduce the growing tension between activist institutional investors and shareholder advocacy groups and corporations; eliminate much of the proxy resolution activity by institutional investors designed to impose their concepts of governance on companies; arrest the efforts for more federal regulation and legislation; and avoid a judicial shift away from the traditional business-judgment-rule review of board actions.

Exhibit 1
BOARD OF DIRECTORS—DUTIES

RELATIONSHIP TO THE MANAGEMENT PROCESS