Restoring Trust in American Business

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Chapter 5

The Professionalization of Corporate Directors

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Unlike the other "professions" on which these papers focus, corporate directors in the United States do not meet the traditional standards to be considered a profession. There is no specific education required and no formal examination that must be passed in order to serve on a corporate board. Other than the fundamental legal standard of conduct encompassed in the business judgment rule, there is no formally adopted or widely accepted code of professional conduct for directors. (At least one of these factors is present in the other professions we have been discussing.) Yet in some other countries (e.g., Australia and the United Kingdom), there have been initiatives to professionalize corporate board members.

Kraakman and Gilson (1991) have argued that a set of professional directors is needed in the U.S.[1] Their definition of "professional" does not require education, exams or standards. Rather, it defines professional directors as persons whose full-time occupation is serving on corporate boards—the implication being that full-time work as a corporate board member makes one a professional. Whether or not one agrees that this definition is adequate, it does highlight another problem with treating directors as professionals. Unlike the other professions, directors—especially independent ones—are almost always part-timers who have, or have had, another full-time career. Given that fact, we want to address two questions: What would be

[1] See Reinier Kraakman and Ronald J. Gilson, "Reinventing the Outside Director: An Agenda for Institutional Investors," *Stanford Law Review* 43 (1991): 863.

gained if directors considered themselves, and were considered by society to be, professionals? What would it take to create directors who are truly professionals?

THE CURRENT STATE OF BOARDS

To understand the potential advantages of professionalizing corporate directors, we first need to assess the conduct of boards in the past decade. The news here is both good and bad.

The good news is that most evidence, both anecdotal and from surveys of directors, indicates that during the last decade of the twentieth century, corporate boards became more active and powerful in exercising their responsibilities. Many boards adopted all, or part, of a set of "best practices," such as explicitly approving company strategy and reviewing its effect on corporate performance; evaluating the performance of their CEO; and taking responsibility for assuring management succession. Board committees (especially audit, compensation and corporate governance) became more active in their respective domains. A key assumption underlying these practices was that a significant majority of the directors of a company should be independent. These directors were to have their own leader (in addition to the chair/CEO) and were to meet alone periodically. One result of this was that boards were much less beholden to their CEOs in 2000 than they had been in 1990. One concrete piece of evidence of this was, as the decade progressed, the increasing ease and frequency with which boards removed CEOs for poor performance.

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In spite of this progress, the bad news was the series of corporate scandals that started with Enron in the fall of 2001 and has continued to the present. Many who had been active in encouraging boardroom reform, including a lot of directors themselves, were shocked by the fact that such scandals could

take place at a time in which boards seemed to be increasingly diligent and effective.

Of course, on reflection it is clear that all this malfeasance cannot, and should not, be blamed on boards alone. Audit firms, some consultants, Wall Street banks, and even some law firms and regulatory agencies played a part in shaping these events. Nevertheless, it has become clear that further improvement in the functioning of boards is required.

Calls for such reform have come from the media, Washington, the stock exchanges and the investment community, among others. Many suggestions and ideas have been put forth. At this writing, the two initiatives that are certain to have the greatest consequences are the Sarbanes-Oxley Act of 2002 and the new listing requirements of the stock exchanges. Without going into too much detail, there are two major themes in these laws and regulations. The first is a continuing, but increased, reliance on the critical importance of having independent directors on the board and on key committees. The second is an emphasis on what might be called "design" improvements for boards. The emphasis is not only on who should serve on boards, but also on their leadership structure, on their various committees and their duties (especially those of the audit committee), and on the processes that boards should use to monitor performance, make critical decisions, and offer advice.

While there is a new requirement that each company develop a code of conduct for its management and employees, these two initiatives focus limited attention on the values directors are expected to hold and the goals they are expected to pursue. In essence, the emphasis is on getting directors to do things in an effective manner, rather than explicitly focusing on what they are supposed to achieve. This is not surprising since, historically, the aims of boards have been broad and even somewhat vague. For example, the Delaware corporations statute, and various court decisions there, indicate that directors are responsible for the interests of shareholders *and* the corporation. Within such a broad statement there is a great deal of latitude for boards to choose the ends they are seeking.

Shareholders are a diverse and dynamic population. Some, like hedge funds, are involved in "playing" the market and may be only short-term holders. Others, like public pension funds, use indexing and hold the same stocks year after year. Furthermore, it is not unusual for public companies to see other investors, such as mutual funds, take a large position in their stock for months or years and then disappear almost overnight. One indicator of the dynamic quality of share ownership is that, according to the New York Stock Exchange (NYSE), the mean holding period for shares of its listed companies is now less than a year.[2]

The matter of the goals that boards should seek is further complicated by two other factors. The first is the fact that, in the absence of any compelling legal (or other) standard, directors are free to make their own determinations of the goals they should be seeking. Some believe that their goal should be to build a healthy enterprise for the long term, while others are committed to the proposition that quarter-to-quarter increases in earnings per share (EPS) and share price is the goal. To make all this even more complex, boards rarely, if ever, discuss such goals. It is not an exaggeration to say that directors operate in a vacuum as to the purposes boards ought to be pursuing.

Into this void step the analysts, which is the second complication. Because directors have no clear sense of what shareholders really want, the analysts tell them. They do this by demanding "earnings guidance." Basically, what they want is a goal of EPS improvement for the next quarter and the next. The consequence of this pressure—combined with compensation plans for CEOs and other senior executives that reward the same short-term performance—is a focus on delivering short-term earnings that perpetuates what John Cassidy has labeled "the greed cycle."[3] The strong desire to achieve short-term objectives is a principal reason that managers, as well as boards, have so often used aggressive accounting practices.

[2] See the NYSE Quick Reference Sheet, available at http://www.nyse.com/marketinfo/p1020656068262.html?displayPage=%2Fmarketinfo%2F1022221393893.html.
[3] See John Cassidy, "The Greed Cycle," *New Yorker*, September 23, 2002, 64.

BENEFITS OF PROFESSIONALIZATION

Given this state of affairs in America's boardrooms, we believe that a case can be made for treating directors in a manner somewhat similar to the way certain other professionals are treated. However, as we shall point out shortly, a major challenge would be how to achieve this objective.

The professionalization of corporate directors would have two benefits. First, it would lead to a clearer understanding of what the goals of boards should be. Just as doctors are charged with assuring patient health and lawyers with acting in the interests of clients, directors could be charged with the responsibility of achieving clear, but broad, objectives. We would argue that for a large public company, the goal of the professional director should be the long-term success of the company. Such a goal would benefit shareholders while also placing emphasis on the company's responsibility to other parties (employees, customers, and suppliers). It would also entail assuring that the company (including its employees) is behaving in a legal and ethical manner. A code of professional conduct for directors should also include an obligation to the investing public to maintain the integrity and transparency of financial reporting.

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The second benefit is consistent with the first. Over the past decade, the focus of board improvement has been on what boards are expected to do and how they can best be organized to accomplish their work. We believe that there is every reason to continue this focus. The design of how boards are organized needs to be further improved to deal with the growing complexity of their companies, the increased expectations being placed on boards, and the limits that boards face because of their reliance on outside independent directors who do not have the same knowledge and experience as the officers of the companies.

Professionalizing corporate directors would add a complementary focus on the purpose of boards. In place of what are now rather vague objectives, we believe that an explicit professional code for board members would provide clear goals that boards are meant to achieve. Ideally, this could lead to boards that not only function effectively, but do so with clear ends in sight.

CREATING PROFESSIONAL DIRECTORS

Now we come to what may be the toughest question of all. Assuming professionalizing directors is a great idea, how would it be accomplished? At first glance it might not seem too difficult. After all, probably fewer than 10,000 people serve on the boards of publicly listed companies. However, this is quite a diverse set of people, with different backgrounds (including CEOs, ex-government officials, investors, and members of various professions, some active, some retired). Furthermore, they have all had a lot of experience and may hold strong opinions about their duties as directors. Clearly indoctrinating them into a common code of conduct is likely to be much more complicated than educating law or medical students—and the latter are processes that involve years of education and include licensing exams. It would also be necessary to ensure that professionalization would not increase the exposure of directors to litigation. It is clear that the imposition of legal liability—whether it be civil or criminal, and whether it be the pre-Sarbanes-Oxley five years' potential imprisonment, or the post-Sarbanes-Oxley twenty—does not eliminate fraud or malpractice by corporate executives, lawyers, bankers and accountants. To accompany the professionalization of directors with additional legal liability would not improve their performance; it would simply deter good people from serving as directors.

A potential starting point for the professionalization process might be the stock exchanges. For example, if the NYSE were to endorse a statement of professional conduct (which would not be significantly more extensive than the corporate guidelines and

ethics codes mandated by the new NYSE rules) that a director of a listed company must promise to uphold when he or she joins its board, it would be a start. While we would not propose an official certifying educational experience or exam, the professional code could be reinforced by educational efforts through the stock exchanges and various educational programs that already exist for new directors. The NYSE rules requiring "indoctrination" for new directors, as well as the director education programs currently being sponsored by the NYSE, are the types of director education we have in mind.

It would be naive to assume that such steps would immediately focus all directors on a clear set of goals, but they would be a start! At least they would be an improvement over the situation in which so many boards find themselves—becoming more efficient and effective, but without clarity as to their goals and purpose.

The proposal by Robert Monks and Allen Sykes[4] to change the law so that corporations would have two sets of directors (the customary management and independent directors nominated by the board, plus three directors specially nominated by institutional shareholders), and the proposed revision of the SEC proxy rules to provide shareholders access to the annual proxy statement to nominate two or three directors, are *not* what we have in mind. While the adoption of such proposals would likely lead to the development of a cadre of "professional" directors, it would also balkanize boards and render them dysfunctional.

Our recommendation is that directors' commitment to professionalism be established and reinforced by means of thorough indoctrination of new directors, annual two- or three-day comprehensive strategic reviews by the board, and directors' attendance at the type of educational programs mentioned above, combined with adherence to the guidelines, charters, and codes mandated by the stock exchanges.

[4] Robert Monks and Allen Sykes, *Capitalism Without Owners Will Fail: A Policymaker's Guide to Reform* (London: Centre for the Study of Financial Innovation, 2002). The full report is available at http://www.ragm.com/library/topics/ragm_sykesPolicyMakersGuide.html.