COMPANY DIRECTORS - WHOM DO THEY SERVE?

"Dance with the one who brought you"

"So long as owners remained in charge and hired managers to help run the business, salaries were ample but not extravagant. J.P. Morgan, for example, made it a point never to pay an executive more than twenty times the earnings of the lowliest employee in the organization. As late as 1900, salaries of $5,000 -$6,000 (or $80,000 - $95,000 in today's currency) were not uncommon for presidents of substantial manufacturing companies, and the average compensation for top managers of large firms prior to World War I was slightly below $10,000. - less than the pay of a university president. ***Not until owners relinquished power, and managers were accountable only to thousands of shareholders, was the way clear to granting emoluments on the lavish scale we know today.'"***[a]

It is a part of the worldwide definition of the corporation that the shareholders elect the members of the board of directors and that the directors will be responsible for the conduct of the business, including the selection of executive officers.[i] And yet in reality shareholders do not elect the directors and directors are not responsible for the conduct of the business, and this gulf between myth and reality seems acceptable, even preferred. Shareholders do not elect directors; the Chief Executive Officer selects the board members; they are routinely "nominated" by a committee comprised of incumbent directors; theirs are the only names that appear on the company proxy which is distributed at corporate expense to all shareholders; management counts the votes and calls those who cast a vote against to try to persuade them to change their minds, and it is virtually impossible for anyone other than management to get a name on the company proxy, so challengers must bear all the expenses of providing alternate candidates while the management slate uses corporate funds. The result is that the "election" of the management slate is as safely guaranteed as that of the Chief Executive of Albania during the half century following World War II.

We persist in this pernicious pattern, only because it is plainly in the interest of those who have power and because those who do not have no cost-effective way to object. The idea that the system has some real accountability gives the CEO the best of both worlds; a legitimating theory for the exercise of power and no real restrictions on its exercise in reality. In a democratic society, the conferral of power on an unelected official like a corporate CEO properly raises much concern [Lingbloom]. Using vocabulary like "elect", "vote" and "proxy" appropriates the sense of accountability in the democratic political system and tends to diminish popular concern. Likewise, directors are not displeased to be considered as being more powerful than in fact they usually are - in addition to reputational advantages, it tends to justify what otherwise seems an unconscionably high pay level. The public and the shareholders are left out - we'll get back to them later.

The current mode of director selection is tainted, inherently self-perpetuating. Unsurprisingly, the performance of boards of directors raises substantial question as to the utility of the institution. The celebrated guru Peter Drucker concluded many years ago: "Whenever an institution malfunctions as consistently as boards of directors have in nearly every major fiasco of the last forty or fifty years it is futile to blame men. It is the institution that malfunctions."[ii] Can a group of extremely busy individuals committed to the establishment, who meet no more than a dozen times a year and who receive their information only from the management, be expected to monitor the same management that "brought them" to the dance?

American Express is one of the great names in American business history. It is one of the stocks comprising the widely publicized Dow (Jones) Index. For fifteen years, starting in the late 1970s, James Robinson III, was the energetic and imaginative CEO who took many

risks in trying to transform the traditional franchise. He was hand picked by the autocratic Howard Clark from the background of an aristocratic Atlanta banking family, Harvard Business School and J.P. Morgan. He was an influential participant in the highest business councils such as the Business Roundtable, as well as being a director of Coca Cola and General Motors. Robinson was a lot more than all this -- he was a "player". In the late 1970s, he failed in making his first two acquisitions that in hindsight seem hubristic -- of Walt Disney and of McGraw Hill. The latter transaction was scarred with acrimony. The number two person at Amexco had to resign, but like Ronald Reagan, Robinson was a "teflon president." This only warmed him up for the "swinging 80s". There have been several books written about his various roles -- Barbarians at the Gates is the best known and is an exhaustive and entertaining account of the maneuvering behind the largest leveraged buyout of modern times, RJR Nabisco. He was also involved, again controversially, with Edmund Safra (Vendetta), Sandy Weil, Peter Cohen and the whole cacophony of "business glitterati" of the late 1980s. American Express shareholders had a great deal of excitement but little profit. By the end of this period of time, Jim had been very prominent for a long time. As the popular expression goes, "he had ducked a lot of bullets." Although he was barely 50, there was a substantial sentiment for his early retirement. This culminated in a private dinner before a late summer directors' meeting in 1992 at which Robinson told a group of senior members of his intention to chair a committee looking to select the next management of American Express.

Robinson had chosen virtually all of the members of the Amexco board. Although his friend and board member Ross Johnson, the former CEO of RJR, is commonly thought to have set the world standard for making corporate resources conveniently available to board members, Robinson was no slouch. Henry Kissinger received a $500,000. annual consulting fee on top of the normal (not bad!) emoluments for the part time job; Beverly Sills' operatic interests were generously supported by American Express; Robinson and Drew Lewis sat on each other's compensation committees; and so forth. He was attentiveness itself to the sensitivities of board members. It can be said that the Amexco board was "Jim Robinson's board" with the conspicuous exception of former Mobil CEO Rawleigh Warner, Joe Williams and ultimately the elder Howard Clark, who served in an emeritus position, without a vote. As Warner put it: "As I think back over the last months of 1992 and January of 1993, it's quite obvious that a number of the American Express board members could not be called independent and **that a majority of them was beholden to Mr. Robinson in one form or another.**"[iii] Robinson's attentiveness to the realities of perpetuating power had extended to the creation of a senior position for Howard Clark, Jr. Nevertheless, the non-voting senior Howard Clark appeared to be discontented with his protégé.

Robinson guided the board during the fall of 1993 to the selection of Harvey Golub to be his successor as CEO. Let's follow Raleigh Warner's account; "A committee of the board was set to work with Mr. Robinson to find his successor. We had no board meeting in October. In November the committee made a progress report on its search. It was going slowly. In January the committee, which by a quirk of fate at the last minute found itself unable to hold a most satisfactory and willing successor, announced that it wanted to extend its search. Mr. Robinson, **who had other plans and who had moved a majority of directors to his side,** called in two counselors he had used over the years: Joseph Flom and Felix Rohatyn. They persuaded the committee to abandon its search...."[iv] This was presented through the financial press as splendid statesmanship led by Robinson in overcoming the anti-Semitism of the old line company. Robinson, himself, was to stay on as Chairman. Only Warner (who had reached the mandatory retirement age of 72) and Joe Williams objected.

At this point, real life departed from the careful script. Golub went to a meeting of institutional investors simply to introduce himself, only to encounter a "fire storm" of outrage from the shareholders. They demanded Robinson's head in no uncertain terms and within a couple of days they had it.

There is one matter about which all observers of boards of directors agree -- its most important task is the selection of top executives. Now that the American Express board had

demonstrated in full public its absolute incapacity to perform this function, one might have expected some contrition -- not necessarily a Japanese style mass resignation, but something! This board had abandoned an orderly search for a new CEO largely because of the persuasiveness of Robinson's hirelings. Their solution was immediately and unceremoniously repudiated by the highest quality of institutional owners, an event virtually without precedent in American corporate history. Did the board's nominating committee believe that this utter public disgrace was reason not to renominate the despised slate? No single director failed to be renominated and in the Spring of 1993, the same gang was dutifully reelected for further service.

This tale is a bit long in the telling -- but there is purpose in illustrating three often times ignored realities:

No board ever - indeed, no individual board member in my cognizance - has been held accountable for the most egregious of failures - whether it is the Robinson succession, the greenmailing of the Bass brothers by the Texaco board, the hostile takeover and subsequent destruction of National Cash Register by the AT&T board, the destruction of value at IBM or Westinghouse, or the somnolence of the Champion Paper board;
Today, when something important needs to be done, the shareholders do it directly and can't be bothered even to participate in the reform of the board;
Neither shareholders, nor bankers, nor employees - indeed, nobody - thinks it important to take even symbolic steps to replace individual directors who are public disgraces. This is the ultimate epitaph for today's American board of directors.

1995 was an "annus horibilus" for the CEOs of badly functioning companies. The mess that was W.R. Grace virtually came apart at the same time as its long time dominator Peter Grace died in early spring. For the first time, the large U.S. private teachers' pension fund TIAA/CREF (holding some 8% of the stock) became active, forced out many directors and selected several new ones. Morrison Knudson appears in hindsight to have been an atrocity. The compliant board ignored every possible warning signal, including the fact that this Boise Idaho company was being run - at vast expense to the company - out of the CEO's home on the golf links at Pebble Beach, California. The CEO, himself, was virtually a "Robert Maxwell" in his inappropriateness to direct a public company, based on the disasters he left behind at two previous companies; it is no surprise that his hand-picked board was riddled with conflicting interests. The shareholders of Kmart were so persistent in forcing change, including the removal of the CEO, that the respected outside director Don Perkins[v] took on the position of temporary Chairman. He recounted being in a room where over 35% of the total shareholding was represented by a handful of people who demanded certain corporate changes - some of which appear appropriate for shareholders' determination, but others were clearly not. This was the American shareholder in full glory.

Let's turn briefly to look at some recent developments in the United Kingdom. The public pension funds in the U.S. have increasingly large holdings in UK securities, and - unlike UK institutions[vi] - they are intent on using their voting power. When a Chicago investment firm Harris Associates took the lead in pushing for the resignation of Maurice Saatchi from the company that he had founded and named, there was substantial institutional support. Saatchi was duly forced out - with, however, only problematic effects for the surviving shareholders. Sir Adrian Cadbury is not only a splendid human being, he is a bit of genius, having managed in his widely publicized report - known as the Cadbury Commission Report - to have antagonized both those who wanted a higher level of governance and those who wished for less to a virtually equal extent. He found that precise place where equilibrium existed. We are told that the successor commission - maybe The Hampel Committee (after its chairman Sir Ronald Hampel, chairman of ICI) - will rethink some of the Cadbury conclusions. "If you go down the road of making non-executives solely responsible for the vetting of executives - and some things are going that way, then you destroy the unity of the board."[vii] We are not yet told why board "unity" is a transcending normative virtue; nor are we told - if not the non execs, who ***is*** to vet the

executives? Lord Rees-Mogg wrote an editorial in the *Times* in mid summer deploring the fractious spirit invading boards through the requirement of monitoring by non-execs. It is hard to be certain about what happens behind the famous Establishment scenes (rude Americans tend to think - very little indeed) and the dynamics of UK boards are materially different than those in the U.S. When a board member complained publicly about the process of finding a successor to the septuagenarian Lord Weinstock at GEC, the process was not accelerated, a successor was not designated...and the board member was forced to resign.

Turning to the southern Hemisphere, the celebrated brouhaha at Coles/Myer appears to have been resolved not so much by the board as by concerned shareholders, an increasingly professionalized governance community and the press.

Taking another approach towards understanding the seemingly impenetrable limitations on board effectiveness, we turn to the commitment of corporate resources employed to "protect" boards from those not nominated by the self-perpetuating incumbents. Kirk Kerkorian in his current efforts of trying to have a former director of Chrysler restored to the board is following a path trodden by Carl Icahn at Texaco, Harold Simmons at Lockheed and other holders of billions of dollars worth of a company's equity securities who are unable to achieve board representation. There has been some movement in recent years in the United States to remove the legal and regulatory obstacles to an independent board candidacy - for which I deserve (and am sometimes awarded) substantial credit. This arose out of my candidacy for a seat on the board of Sears, Roebuck in 1991. Even though the Securities & Exchange Commission (the "SEC") has ceased censoring communication between shareholders, they still have not gotten to the point of requiring a ballot that permits a shareholder to vote for an independent candidate as well as some of the company nominees. The process reforms, while incomplete, are welcome, but running as a non-management candidate is still a very expensive and risky undertaking. My Sears effort was definitely a "poor boy" undertaking and it cost me upwards of $500,000. I continue to ask myself - what horrendous risk would I present if I were to join the august board of Sears Roebuck? I couldn't even second my own motions. As I pointed out with some cogency, my educational attainments were not notably inferior to those of the incumbents, I had been appointed by several U.S. Presidents to run responsible Federal Agencies, including service as a director of the $82 billion United States Synthetic Fuels Company, and I had served - without dreadful adverse impact on the management and shareholders - as a director of a dozen public companies. I am not unfamiliar with the practice of certain social clubs of never - *never* - ***NEVER*** admitting an individual so deficient in social sophistication as to have applied for membership. Indeed, I am told that it is a source of some pleasure in certain quarters. At the end of the day, it seems a board of directors is essentially just such a social club, dressed up with:

> some statutory entreaties whose accomplishment is demonstrably beyond the capacity of a group with such a limited time commitment is admittedly very limited;
> theoretical liability - much discussed but virtually never paid for;
> myriad nominal tasks that are passed as a matter of rote.
> What is being protected by maintaining these fictions; what social purpose is being served; what justifies the hugely successful effort to exclude the uninvited?

It has to do with power. If the board admits its incapacity to regulate its own membership, it then becomes an entity that will be judged by what it accomplishes. This is not a test to which a part time group of self-elected members wished to expose itself. The "board myth" is useful to many. Not only to the CEO and the board itself, but also to the government. So long as there is an operative fiction that those holding private power are in fact accountable to someone, there is less pressure on government to deal with such knotty examples of "unfairness" as outrageous executive compensation and the like. Boards seem to be a convenient construct of the legal profession to provide mythology for those all too ready to acquiesce. Myles Mace, a professor at the Harvard Business School, twenty five years ago wrote the definitive account of Directors who do not direct. There has been no shortage of insightful commentary.

Why then has the board myth been permitted to continue? Lawyers keep proposing increasingly more plausible formulations. The ideas of having “lead directors”, of inventing all manner of filter to assure “independence” in the nominees of making compensation transparent and reasonable, all blithely ignore the limitations inherent in any and all self perpetuating organisms. In most countries, the huge public company is merely the traditional private company - writ large. Some of the arrangements in private companies do not “scale up” in an acceptable way - one of the most conspicuous of these is the board formerly comprised of individuals with a significant portion of their own net work being succeeded by an appointed board with only nominal personal commitment to the enterprise.

If we want to stop living in denial about the reality of boards, there are two alternatives:

I. Acknowledge the self-perpetuating nature of the present system and defend it as the time proven best method of achieving corporate objectives; or

II. Make the relatively modest statutory changes so as to enable shareholder participation in the director selection and election process.

Let me turn a minute to the quotation from a recent book by former Harvard President Derek Bok with which I opened these remarks. In his brief account of how top executive salaries have gotten out of control over the course of this century, Bok passes right over boards of directors and turns directly to the dispersion of ownership into small units. Boards then are a fiction - sometimes useful, but fundamentally flawed. The answer lies elsewhere. Our own work supplements Bok’s conclusion. We find that a company having rationally informed and effectively involved owners is worth more than one without. The efforts of the Public Employees’ Retirement System of California (“CalPERS”) to assert ownership concern with the managements of many major U.S. companies have been widely publicized. Hopefully there will be equivalent appreciation for the analysis of Wilshire Associates concluding that the CalPERS effect has been hugely value enhancing. Wilshire has analyzed the price action for those companies “targeted” by CalPERS and has concluded that they significantly outperform the market. There are studies indicating the same results for those companies comprising the annual Council of Institutional Investors’ “hit list”. Indeed, our own experience with the LENS fund over five years is specific and eloquent (in the sense that I am risking my own money - as well as my vocal chords) proof of the value adding characteristics of shareholder activism.

This is a beginning. There is much inertia to overcome. Over half of all equities are held by institutional investors. Virtually all of these institutions have business relationships - or would like to - with the companies whose securities they hold in their portfolios. It is not a secret taught at the Harvard Business School that one should avoid directly affronting either present or potential customers. Thus, many private pensions, insurance companies and bank trust departments simply will **never** find it convenient to act as owners with respect to the securities of customers. The fact that so-doing will make money for their beneficiaries may well change the landscape. One awaits the first judicial holding of a trustee to have been negligent in failing to be sufficiently activist. Common law courts would be harsh in circumstances - such as now prevail - where the failure to act arises out a conflict of interest which the institution has consistently resolved to the detriment of its trust beneficiaries.

With all deference to the Hampel Commission’s initial comments, it appears clear that there is need for some structure within the corporate framework to ensure the accountability of management to someone. This is needed both in aid of competitiveness and to enable the corporation to make changes of policy and personnel when such are necessary to enhance the ability to compete and ultimately to survive. One needs to protect against the hazards of self-invigilation. The marking of one’s own examination papers has been a temptation fraught with peril since childhood. It works no better with corporate managers, corporate directors or CEOs.

There is need for someone to whom to be accountable. If boards must retain "collegiality" as their essential organizing principle, then some other element in the corporate cosmos is needed to perform this indispensable responsibility. That today's institutional investors are not the ideal "owners" of the commercial state is not definitive. The institutions can be made into acceptable owners. That is the task to which we should turn ourselves.

Ultimately, these issues will only be resolved when it becomes widely understood that ***we cannot afford to have uninvolved owners.*** Hopefully, we have shed some light on the proposition that it really is not sensible to expect that a board of part-timers is going to be able - in any meaningful way - to monitor the functioning of a huge enterprise. Even if these directors are personally impeccable, the required effort is way beyond what anyone is thinking of committing today. No one is going to take the trouble to be informed - and that involved quintessentially the ability and the willingness to ask difficult questions - unless they have a huge stake in getting the right answers. Ultimately, this ends up with owners - not because they are intrinsically more deserving than customers, citizens, employees or other constituencies affected by corporate functioning, but because - at the end of the day - they are the ones who bear the cost and reap the reward of corporate decisions.

ENDNOTES

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[a] Derek C. Bok, The Cost of Talent How Executives and Professionals are Paid and How It Affects America (Free Press 1993) at p. 33.

[i] It is important to emphasize that I will use the term "director' in the American sense (which approximates the UK "non executive" director classification) of individuals outside the corporation who devote typically a dozen days a year to its direction. One must emphasize that the dynamics of boards in the U.S. where the preponderance of directors are non-executive and the CEO typically acts as board chairman are materially different than in other countries. Thus, some of the conclusions adduced in this paper will surely not be applicable in other countries.

[ii] Peter Drucker, The Bored Board, in *Toward the Next Economics and Other Essays,* Harper & Roe, New York, 1981, at p 110.

[iii] Rawleigh Warner, Jr., *The Lessons from American Express,* Directors & Boards, Spring 1994, 88, 86. (emphasis added)

[iv] *Ibid*, (emphasis added). The involvement of Joe Flom, perhaps America's premier takeover lawyer and Felix Rohatyn, arguably the most prestigious investment banker, all at vast expense to the company, are the "smoking gun" to demonstrate the power of entrenched and determined management to dominate both board and shareholder interests (even if, ironically, in this situation, the "fix" would only last four days!).

[v] Later in the year, he was awarded "director of the year" by the National Association of Corporate Directors.

[vi] A recent study indicated that 35% was a high total of votes for the AGM of a large UK company.

[vii] Norma Cohen and William Lewis, Some Cadbury Reforms May be Reversed, *Financial Times,* 23 November 1995.