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Chapter 3

The Board of Directors: Role and Composition

3.1 The Board's Responsibilities: The Legal Framework

From a legal perspective, the board of a public corporation is charged with setting a corporation's policy and direction, electing and appointing officers and agents to act on behalf of the corporation, and acting on other major matters affecting the corporation. In this context, individual directors' duties and responsibilities are described in the American Bar Association's *Corporate Director's Guidebook, Fourth Edition* (2004) with language, such as the following:

- *in good faith*. Acting honestly and dealing fairly. In contrast, a lack of good faith would be evidenced by acting, or causing the corporation to act, for the director's personal benefit or for some purpose other than to advance the welfare of the corporation and its economic interests and may also include acting on a corporate matter without making a reasonable effort to be appropriately informed.
- *reasonably believes*. Although the director's honest belief is subjective, the qualification that it must be reasonable (i.e., based upon a rational analysis of the situation understandable to others) makes the standard of conduct also objective, not just subjective.
- *best interests of the corporation*. Emphasizing the director's primary allegiance to the corporate entity.
- *care*. Expressing the need to pay attention, to ask questions, to act diligently to become and remain generally informed, and, when appropriate, to bring relevant information to the attention of the other directors. In particular, these activities include reading materials and engaging in other preparation in advance of meetings, asking questions of management until satisfied that all information significant to a decision is available to the board and has been considered, and requesting legal or other expert advice when appropriate to a board decision.
- *person in a like position*. Avoiding the implication of special qualifications and incorporating the basic attributes of common sense, practical wisdom, and informed judgment generally associated with the position of corporate director.
- *under similar circumstances*. Recognizing that the nature and extent of the preparation for and deliberations leading up to decision making and the level of oversight will vary, depending on the corporation concerned, its particular situation, and the nature of the decision to be made. See the *Corporate Director's Guidebook* (4th ed., 2004), the American Bar Association.

This language provides guidance about how directors should comply with the underlying duty of care, the business judgment rule, and the duty of loyalty, briefly introduced in [Chapter 2 "Governance and Accountability"](#), which I restate here more formally: This book focuses on the most important laws aimed at guiding directors' behavior. The reader should be aware that the law includes additional duties for directors such as "the duty not to entrench" and "the duty of supervision."

- *Duty of Care.* The Duty of Care is the most important duty owed by a director to a corporation. A typical (state) corporation statute defining a director's Duty of Care provides that a director's duties must be performed "with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances." This Duty of Care is very broad and requires directors to diligently perform their obligations.
- *Business Judgment Rule.* The Business Judgment Rule works in conjunction with the director's Duty of Care. Under this rule, a director will not be held liable for mere negligence if exercising his or her Duty of Care. The rule can be stated as, "A director who exercises reasonable diligence and who, in good faith, makes an honest, unbiased decision will not be held liable for mere mistakes and errors in business judgment." The rule protects directors from decisions that turn out badly for their corporation, even when the directors acted diligently and in good faith in authorizing the decision.
- *Duty of Loyalty.* The Duty of Loyalty exists as a result of the fiduciary relationship between directors and the corporation. A fiduciary relationship is defined as a relationship of trust and confidence, such as between a doctor and patient, or attorney and client. The nature of the relationship includes the concepts that neither party may take selfish advantage of the other's trust and may not deal with the subject of the relationship in a way that benefits one party to the disadvantage of the other. A director must perform his or her duties in good faith and in a manner in which the director believes is in the best interests of the corporation and its shareholders. Essentially, this duty means that while serving a corporation, the director must give the corporation the first opportunity to take advantage of any business opportunities that he or she becomes aware of and that are within the scope of the corporation's business. If the board of directors chooses not to take advantage of a business opportunity brought to its attention by a director, the director may then go forward without violating his or her duty.

Liability¹ can exist for officers and directors when they cause financial harm to the corporation, act solely on their own behalf and to the detriment of the corporation, or commit a crime or wrongful act. Certain acts may subject an officer or director to personal liability, and other acts, although they would otherwise subject them to liability, may be either indemnified by or insured against by the corporation. Indemnification of officers and directors means that the corporation will reimburse them for expenses incurred and amounts paid in defending claims brought against them for actions taken on behalf of the corporation. Insurance policies can cover matters that cannot be indemnified under state law or in instances where the corporation does not have the financial resources to pay for the indemnification. Most state corporation statutes allow corporations to purchase insurance to cover matters resulting from acts taken by officers and directors. The goal of directors and officers insurance is to protect directors and officers of a corporation from liability in the event of a claim or lawsuit against them asserting wrongdoing in connection with the company's business.

1. The state of being legally responsible for causing harm.

3.2 A Board's Role: A Governance Perspective

What does the phrase “direct the affairs of the company” really mean? To provide greater clarity, numerous individuals and organizations have developed more specific descriptions in recent years. One frequently cited description was developed by the Business Roundtable:

- First, the paramount duty of the board of directors of a public corporation is to select the chief executive officer (CEO) and to oversee the CEO and senior management in the competent and ethical operation of the corporation on a day-to-day basis
- Second, it is the responsibility of management to operate the corporation in an effective and ethical manner to produce value for shareholders. Senior management is expected to know how the corporation earns its income and what risks the corporation is undertaking in the course of carrying out its business. The CEO and board of directors should set a “tone at the top” that establishes a culture of legal compliance and integrity. Management and directors should never put personal interests ahead of or in conflict with the interests of the corporation
- Third, it is the responsibility of management, under the oversight of the audit committee and the board, to produce financial statements that fairly present the financial condition and results of operations of the corporation and to make the timely disclosures investors need to assess the financial and business soundness and risks of the corporation
- Fourth, it is the responsibility of the board, through its audit committee, to engage an independent accounting firm to audit the financial statements prepared by management, issue an opinion that those statements are fairly stated in accordance with Generally Accepted Accounting Principles and oversee the corporation's relationship with the outside auditor
- Fifth, it is the responsibility of the board, through its corporate governance committee, to play a leadership role in shaping the corporate governance of the corporation. The corporate governance committee also should select and recommend to the board qualified director candidates for election by the corporation's shareholders
- Sixth, it is the responsibility of the board, through its compensation committee, to adopt and oversee the implementation of compensation policies, establish goals for performance-based compensation, and determine the compensation of the CEO and senior management

- Seventh, it is the responsibility of the board to respond appropriately to shareholders' concerns
- Eighth, it is the responsibility of the corporation to deal with its employees, customers, suppliers and other constituencies in a fair and equitable manner. Business Roundtable (2005), p. 2.

Milstein, Gregory, and Grapsas (2006) take a somewhat broader perspective. First, they note, the board needs to take charge of its own focus, agenda, and information flow. This enables a board to provide management with meaningful guidance and support. It also helps the board focus its attention appropriately, determine its own agenda, and obtain the information it needs to make objective judgments. Second, the board must ensure that management not only performs but performs with integrity. Selecting, monitoring, and compensating management and, when necessary, replacing management, therefore continue to lie at the heart of board activity. Third, the board must set expectations about the tone and culture of the company. The standards of ethics and business conduct that are followed—or not followed—throughout a company impact the bottom line in many ways. “Tone at the top” should be a priority throughout the company and not viewed simply as a compliance matter. Fourth, the board should work with management to formulate corporate strategy. After agreeing to a strategic course with management through an iterative process, the board should determine the benchmarks that will evidence success or failure in achieving strategic objectives and then regularly monitor performance against those objectives. Fifth, it is the board’s duty to ensure that the corporate culture, the agreed strategy, management incentive compensation, and the company’s approach to audit and accounting, internal controls, and disclosure are consistent and aligned. And sixth, it is the board’s duty to help management understand the expectations of shareholders and regulators. Boards can help management recognize that shareholders have a legitimate interest in more meaningful input into the board selection process, in terms of both nominating procedures and voting methods. Similarly, boards can help management recognize and address the concerns that excessive compensation raises among shareholders, regulators, rating agencies, and others. Milstein, Holly, and Grapsas (2006, January).

Both descriptions are useful for developing a basic understanding of a board’s responsibilities. In broad terms, they fall into three categories: (a) to make decisions, (b) to monitor corporate activity, and (c) to advise management. The key issue here is deciding which board posture is appropriate at what time. While the law, corporate bylaws, and other documents frame many of the decisions a board must make, such as appointing a CEO or approving the financials, they do not provide much guidance with respect to the most important decision a board must make—when must board oversight become active intervention? For example, when should a board step in and remove the current CEO? When should directors veto a major capital appropriation or strategic move?

Lists never can fully capture the complexity and intricacies of the governance function because they do not consider the specific challenges associated with different governance scenarios. In particular, the precise role of a board will vary depending on the nature of the company, industry, and competitive situation and the presence or absence of special circumstances, such as a hostile takeover bid or a corporate crisis, among other factors.

The Nature of the Company, Industry, and Competitive Situation

It seems self-evident that a board's role depends largely on the nature and the strategic challenges of the company and the industry. The challenges faced by small, private, or closely held companies are not the same as those of larger, public corporations. In addition to their traditional fiduciary role, directors in small companies often are key advisers in strategic planning, raising, and allocating capital, human resources planning, and sometimes even performance appraisal. In large public corporations, directors are focused more on exercising oversight than on planning, on capital allocation and control rather than on the raising of capital, and on management development and succession activities rather than on broader human resources responsibilities.

Public company ownership patterns are not homogeneous either, and different ownership structures may call for different governance approaches. The first, and most common, board situation is one in which a corporation has no controlling shareholder. In that case, directors should behave as if there is a single absentee owner whose long-term interests they serve. A primary responsibility for the board in this scenario is to appoint and, if necessary, change management, just as an intelligent owner would do if he were present. Commenting on individual director's responsibilities in these circumstances, Buffett (1993) writes,

In this plain-vanilla case, a director who sees something he doesn't like should attempt to persuade the other directors of his views. If he is successful, the board will have the muscle to make the appropriate change. Suppose, though, that the unhappy director can't get other directors to agree with him. He should then feel free to make his views known to the absentee owners. Directors seldom do that, of course. The temperament of many directors would in fact be incompatible with critical behavior of that sort. But I see nothing improper in such actions, assuming the issues are serious. Naturally, the complaining director can expect a vigorous rebuttal from the unpersuaded directors, a prospect that should discourage the dissenter from pursuing trivial or non-rational causes. Buffett, annual letter to Berkshire Hathaway shareholders (1993).

The second situation occurs when the controlling owner is also the manager. At some companies, such as Google, this arrangement is facilitated by the existence of two classes of stock endowed with disproportionate voting power. In these situations, the board does not act as an agent between owners and management, and directors cannot affect change except through persuasion. Therefore, if the owner or manager is mediocre—or worse, is overreaching—there is little a director can do about it except object. And if there is no change and the matter is sufficiently serious, the outside directors should resign. Their resignation will signal their doubts about management, and it will emphasize that no outsider is in a position to correct the owner or manager's shortcomings. Buffett (1993).

The third public corporation governance situation occurs when there is a controlling owner who is not involved in management. This case, examples of which are Hershey Foods and Dow Jones, puts the outside directors in a potentially value-creating position. If they become unhappy with either the competence or integrity of the manager, they can go directly to the owner (who may also be on the board) and make their views known. This situation helps an outside director, since he need make his case only to a single, presumably interested owner who can immediately make a change if the argument is persuasive. Even so, the dissatisfied director has only that single course of action. If he remains unsatisfied about a critical matter, he has no choice but to resign. Buffett (1993).

It will also be readily apparent that the role of the board will vary depending on the size of the company, the industries it serves, and the competitive challenges it faces. Global corporations face different challenges from domestic ones; the issues in regulated industries are different from those in technology or service industries, and high growth scenarios make different demands on boards than more mature ones. Finally, in times of turbulence or rapid change in the industry, boards often are called on to play a more active, strategic role than in calmer times. Special events or opportunities, such as takeovers, mergers, and acquisitions, fall into this category.

The Presence or Absence of Special Circumstances, Such as a Hostile Takeover Bid or a Corporate Crisis

Company crises can take on many different forms—defective products, hostile takeovers, executive misconduct, natural disasters that threaten operations, and many more. But, as boards know very well, they all have one thing in common: They threaten the stock price and sometimes the continued existence of the company. Some examples follow:

- In June 2008, with encouragement from federal regulators, JP Morgan executed a takeover bid for Wall Street giant Bear Stearns to prevent the bank's collapse as a consequence of the U.S. mortgage debt crisis. The \$240 million acquisition price represented a substantial discount on its share price at the end of trading the week before, which valued the bank at around \$3.5 billion.
- In 2002, when allegations of insider trading against Martha Stewart were reported, the stock price of Martha Stewart Omnimedia fell some 40% in just 3 weeks.
- In 1993, an allegation of *E. coli* contamination in the beef served by the Jack in the Box hamburger chain caused the company's share price to plummet from \$14 to about \$3 in a matter of hours.
- In 1985, A. H. Robins, the maker of the Dalkon Shield, an intrauterine device, was forced to declare bankruptcy, after collapsing under a wave of personal injury lawsuits.

As these examples attest, there are few situations in which directors' fiduciary duties to shareholders are so clearly on view as in times of crisis. Jones (2007).

3.3 The Board's Role: Governance, Not Management

Beyond implementing reforms and **best practices**², boards are being counseled to become more involved. See, for example, Felton and Pamela Fritz (2005); and *The State of the Corporate Board, 2007—A McKinsey Global Survey* (2007, April). Rubber-stamping decisions, populating boards with friends of the CEO, and convening board meetings on the golf course are out; engagement, transparency, independence, knowing the company inside and out, and adding value are in. This all sounds good. There is a real danger, however, that the rise in shareholder activism, the new regulatory environment, and related social factors are pushing boards toward micromanagement and meddling.

This issue is troubling, and clear evidence that the important differences that separate *governance from management*—critical to effective governance—are still not sufficiently well understood by directors, executives, regulators, and the popular press alike. And regrettably, faced with the need to be more involved, the most obvious opportunity (and danger) is for boards to expand their involvement into—or, more accurately, intrude into—management's territory.

The key issues are how and to whom boards add value. Carver (2007, November), pp. 1030–1037. Specifically, the potential of directors to add value is all too often framed in terms of their ability to add value to management by giving advice on issues such as strategy, choice of markets, and other factors of corporate success. While this may be valuable, *it obscures the primary role of the board to govern, the purpose of which is to add value to shareholders and other stakeholders*. John Carver, well-known governance consultant and author, does not mince words:

Governance is an extension of ownership, not of operations. Directors must be more allied with shareholders than with managers. Their mentality, their language, their concerns, their skills, their choice of interactions are subsets of ownership, not of management. As long as we view governance as übermanagement—focusing on management methods, strategies and planning—finding a new balance between micromanagement and detachment... will be hard to come by. Carver (2007, November), p. 1035.

A greater arms-length relationship between management and the board, therefore, is both desirable and unavoidable. Recent governance reforms focused on creating greater independence and minimizing managerial excess while enhancing executive accountability have already created greater tension in the relationship between management and the board. The Sarbanes-Oxley Act, for example,

2. Methods or techniques of running a corporation or business to realize superior results.

effectively asks boards to substitute verification for trust. Section 404 of the act requires management at all levels to “sign off” on key financial statements.

This is not necessarily bad because trust and verification are not necessarily incompatible. In fact, we need both. But we should also realize that effective governance is about striking a reasonable accommodation between verification and trust—not about elevating one over the other. The history of human nature shows that adversarial relationships can create their own pathologies of miscommunication and mismanaged expectations with respect to risk and reward. This makes defining the trade-offs that shape effective governance so difficult. Is better governance defined primarily by the active prevention of abuse? Or by the active promotion of risk taking and profitability? The quick and easy answer is that it should mean all of those things. However, as recurrent crises in corporate governance around the world have shown, it is hard to do even one of those things consistently well. What is more, a board trying to do all of these things well is not merely an active board; it is a board actively running the company. This is not overseeing management or holding management accountable—it is management. Therefore, the corporate governance reform agenda risks becoming an initiative that effectively dissolves most of the critical, traditional distinctions between the chief executive and the board. Macavoy and Milstein (2003).

3.4 Governance Guidelines

As part of the recent wave of governance reforms, the NYSE adopted new rules that require companies to adopt and publicly disclose their corporate governance policies. Specifically, the following subjects must be addressed in the guidelines:

- *Director qualification standards.* These standards, in addition to requiring independence, may also address other substantive qualification requirements, including policies limiting the number of boards on which a director may sit and director tenure, retirement, and succession.
- *Director responsibilities.* These responsibilities should clearly articulate what is expected from a director, including basic duties and responsibilities with respect to attendance at board meetings and advance review of meeting materials.
- *Director access to management and, as necessary and appropriate, to an independent advisor.* Clear policies should be adopted that define protocols for director access to corporate managers and identify situations when the board should retain external advisors.
- *Director compensation.* Director compensation guidelines should include general principles for determining the form and amount of director compensation (and for reviewing those principles, as appropriate).
- *Director orientation and continuing education.* Director orientation and continuing education should be the responsibility of the governance committee, if one exists. If the board does not have a separate governance committee, the full board, the nominating committee, or both, should have this responsibility.
- *Management succession.* Succession planning should include policies and principles for CEO selection and performance review, as well as policies regarding succession in the event of an emergency or the retirement of the CEO.
- *Annual performance evaluation of the board.* The board should conduct a self-evaluation at least annually to determine whether it and its committees and their individual directors are functioning effectively.

Best practice suggests that the board should review the guidelines at least annually. By elaborating on the board's and directors' basic duties, a carefully constructed set of governance guidelines will help both the board and individual directors understand their obligations and the general boundaries within which they will operate.

3.5 Recent Board Trends

Board Size

The optimal size of a board has been the subject of much debate in recent years. As a general proposition, smaller boards have a number of advantages over larger ones: They are easier to convene, require less effort to lead, and often have a more relaxed, informal culture. Research on group decision making supports the contention that smaller groups typically are more effective. The statistics in this chapter are taken from the Spencer Stuart Board Index 2007.

As a practical matter, however, board size should be governed by the skills needed to do the job. Larger corporations with more complex structures, substantial global interests, or multibusiness operations will require larger boards than smaller, mainly domestic, single-business firms. Today, the average Standard & Poor's 500 board has 11 directors, compared to 18 directors about 25 years ago. It is unlikely boards will shrink further, however, as a result of new rules and proposals requiring that the audit, nominating or governance, and compensation committees of boards in publicly held companies be composed of independent directors only, in some cases, with specialized expertise (audit committee).

Board Membership

Fewer CEOs are accepting directorships, for two reasons. First, many boards—in the wake of the recent scandals and the Sarbanes-Oxley legislation—now insist that the chief executive concentrate fully on his or her job and restrict the number of outside boards the CEO can serve or, in some cases, prohibit it altogether. Second, as boards expand their role to areas, such as company strategy, they look for directors who have risen through specific functional areas in which the company must excel in order to compete effectively—sales and marketing, global operations, manufacturing, and others. And, in the aftermath of Sarbanes-Oxley, directors with a background in finance, especially chief financial officers (CFOs), are in strong demand. Heidrick and Struggles (2006).

For a while, it looked as though the reduced availability of CEOs and the growing demand for specialized directors would significantly reduce the talent pool of qualified directors and make it even more difficult for companies to attract new board members. Fortunately, this has not proven to be the case. If anything, the talent pool has become larger as boards are changing the definition of what constitutes a qualified candidate and widening their search. Instead of focusing almost exclusively on CEOs as candidates for the board, companies are increasingly

tapping division presidents and other executives who have experience running large operations or bring specialist expertise. The redefinition of director qualifications has also expanded the talent pool of diversity candidates who may not have risen to chief executive but excel in a critical, functional area.

These changes do not mean that attracting qualified directors has become easier. Although the pool of qualified candidates is larger, many candidates are far more reluctant to serve. More than ever, candidates perform extensive **due diligence**³ about the companies recruiting them and look for ways to mitigate as much as possible the risk of associating themselves with a disaster or incurring personal liability. They are also far more critical and objective about their ability to add value, particularly in complex organizations, such as conglomerates, or industries like financial services and insurance. The overwhelming reason why candidates decline to serve, however, remains a lack of time. Given their already enormous responsibilities, many qualified and desirable director candidates feel that they will be unable to devote adequate attention to the job.

Director Independence

The proposition that boards should “act independently of management, through a thoughtful and diligent decision-making process,” has been a major focus of corporate governance reform in recent years. Macavoy and Milstein (2003), pp. 22–23. In the United States, the Sarbanes-Oxley Act of 2002, as well as the revised NYSE and NASDAQ listing rules, as affirmed by the SEC, are premised on a belief that director independence is essential to effective corporate governance. In the United Kingdom, the Cadbury Commission’s report of 1990—The Code of Best Practice—included a recommendation for having at least three nonexecutive directors on the board. Currently, reflecting this broad consensus, about 10 out of the average 12 directors of a major U.S. public company board are nonexecutives; in the United Kingdom, the corresponding number is a little less than half.

The idea of an independent board is intuitively appealing. **Director independence**⁴, defined as the absence of any conflicts of interest through personal or professional ties with the corporation or its management, suggests objectivity and a capacity to be impartial and decisive and therefore a stronger fiduciary. At times a board needs to discuss issues that involve some or all of the company’s senior executives; this is difficult to do with senior executives on the board. The independence requirement also stops destructive practices, such as “rewarding” former CEOs for their accomplishments by giving them a role on the board. Having the former CEO on the board almost always limits the ability of the new CEO to develop his or her own relationship with the board and put his or her imprint on the organization. There is also limited evidence that outsider-dominated boards are more proactive in firing

3. Reasonable care exercised by an individual or a corporation to prevent harm or as preparation for a business action.

4. The absence of any conflicts of interest through personal or professional ties with a corporation or its management.

underperforming CEOs and less willing to go along with outsized compensation proposals or vote for poison pills.

Director independence should not be viewed as a proxy for good governance, however. At times, not having more insiders on the board actually can reduce a board's effectiveness as an oversight body or as counsel to the CEO. Independent, nonexecutive directors can never be as knowledgeable about a company's business as executive directors or senior managers. CEOs say that some of their most valuable directors are those with experience in the same industry, counter to current independence tests. The higher the proportion of outside directors, therefore, the more difficult it is to foster high-quality, deep board deliberations. Moreover, it is less likely that a CEO can mislead a board, intentionally or otherwise, when some of the directors are insiders who also have intimate knowledge of the company. Carter and Lorsch (2004), p. 93. Boards mostly comprised of independent directors must, at a minimum, therefore, create regular opportunities to interact with senior executives other than the CEO. The more complex a company's business is, the more important such communications are.

The bottom line is that effective corporate governance does not depend on the independence of some particular subset of directors but *on the independent behavior of the board as a whole*. The focus should be on fostering *board independence* as a *behavioral* norm, a psychological quality, rather than on quasi-legal definitions of director independence. Director independence can contribute to but is no guarantee for better governance.

3.6 Board Leadership: Should We Separate the Chairman and CEO Positions?

Few issues in corporate governance are as contentious as the question of whether the roles of chairman and CEO should be separated or combined. In the United Kingdom, about 95% of all Financial Times Stock Exchange (FTSE) 350 companies adhere to the principle that different people should hold each of these roles. In the United States, by contrast, most companies still combine them, although the idea of splitting the two roles is gaining momentum. In the last 2 years, Boeing, Dell, the Walt Disney Company, MCI, Oracle, and Tenet Healthcare all have done so, and a new study finds that roughly one third of U.S. companies have adopted such a split-leadership structure, up from a historical level of about one fifth. This finding is reported in a September 2004 study of more than 2,500 companies across the world by Governance Metrics International, the New York-based corporate governance ratings agency.

Arguments for splitting the two roles, emanating chiefly from the United Kingdom—and other countries that overwhelmingly embrace the idea of separate roles (particularly Germany, the Netherlands, South Africa, Australia, and, to a lesser extent, Canada)—reflect four schools of thought. Coombes and Wong (2004).

The first is that the separation of the chairman and CEO positions is a key component of board independence because of the fundamental differences and potential conflicts between these roles. The CEO runs the company—the argument goes—and the chairman runs the board, one of whose responsibilities it is to monitor the CEO. If the chairman and the CEO are one and the same, it is hard for the board to criticize the CEO or to express independent opinions. A separate chairman, responsible for setting the board's agenda, is more likely to probe and encourage debate at board meetings. Separating the two roles is, therefore, essentially a check on the CEO's power.

A second argument is that a nonexecutive chairman can serve as a valuable sounding board, mentor, and advocate to the CEO. Proponents of this view note that CEOs today face enough challenges without having to run the board and that a relationship with the chairman based on mutual trust and regular contact is good for the CEO, shareholders, and the company. For this to happen, however, it is essential that, from the outset, the two roles be clearly defined to avoid territorial disputes or misunderstandings.

A third reason for supporting the two-role model is that a nonexecutive chairman is ideally placed to assess the CEO's performance, taking into account the views of fellow board directors. Advocates maintain that the presence of a separate, independent chairman can help maintain a longer term perspective and reduce the risk that the CEO will focus too much on shorter term goals, especially when there are powerful incentives and rewards to do so. They add that he is also in a good position to play a helpful role in succession planning. And when a CEO departs, voluntarily or otherwise, the chairman's continued presence in charge of the board can reduce the level of trauma in the business and the investor community.

A fourth and final argument concerns the time needed to do both jobs and do them well. It can be argued that as companies grow more complex, a strong board is more vital than ever to the health of the company, and this requires a skilled chairman who is not distracted by the daily pull of the business and can devote the required time and energy. This may take one or more days per week and involve such tasks as maintaining contact with directors between meetings, organizing board evaluations, listening to shareholder concerns, acting as an ambassador for the company, and liaising with regulators, thereby allowing the CEO to concentrate on running the business.

Although these arguments increasingly resonate with U.S. directors and shareholders, many CEOs resist the change. Why, they ask, should corporate wrongdoing at a small number of S&P 500 companies be a compelling reason for changing a system that has worked well for so long? Moral and ethical failures are part of the human condition, they note, and no rules or regulations can guarantee the honesty of a leader. Some allow that, at times, a temporary split in roles may be desirable or necessary—when a company is experiencing a crisis, for example, or when a new CEO is appointed who lacks governance and boardroom experience. But they maintain that such instances are infrequent and temporary and do not justify sweeping change. Overall, they argue, the combined model has served the U.S. economy well, and splitting the roles might set up two power centers, which would impair decision making.

Critics of the split-role model also point out that finding the right chairman is difficult and that what works in the United Kingdom does not necessarily work in the United States. Executives in the United Kingdom tend to retire earlier and tend to view the nonexecutive chairman role (often a 6-year commitment) as the pinnacle of a business career. This is not the case in the United States, where the normal retirement age is higher.

5. A nonexecutive who acts as a link between a corporation's chairman-CEO and its outside directors.

To allay concerns that combined leadership compromises a board's independence, opponents of separation have proposed the idea of a "**lead director**"⁵: a

nonexecutive who acts as a link between the chairman–CEO and the outside directors, consults with the chairman–CEO on the agenda of board meetings and performs other independence-enhancing functions. Some 30% of the largest U.S. companies have taken this approach. Its defenders claim that—combined with other measures, such as requiring a majority of independent directors and board meetings without the presence of management—this alternative obviates the need for a separate chairman.

On balance, the arguments for separating the roles of chairman and CEO are persuasive because separation gives boards a structural basis for acting independently. And reducing the power of the CEO in the process may not be bad; compared with other leading Western economies, the United States concentrates corporate authority in a single person to an unusual extent. Coombes and Wong (2004). Furthermore, rather than create confusion about accountability, the separation of roles makes it clear that the board’s principal function is to govern—that is, to oversee the company’s management, and hence to protect the shareholders’ interests—while the CEO’s function is to manage the company well.

Separating the two roles, of course, is no guarantee for board effectiveness. A structurally independent board will not necessarily exercise that independence: Some companies with a separate chairman and CEO have failed miserably in carrying out their oversight functions. What is more, a chairman without a strong commitment to the job can stand in the way of board effectiveness. The separation of roles must therefore be complemented by the right boardroom culture and by a sound process for selecting the chairman. The challenge of finding the right nonexecutive chairman who must not only have the experience, personality, and leadership skills to mesh with the current board and management but also must show that the board is not a rubber stamp for the CEO, should not be underestimated. The ideal candidate must have enough time to devote to the job, strong interpersonal skills, a working knowledge of the industry, and a willingness to play a behind-the-scenes role. The best candidate is often an independent director who has served on the board for several years.

3.7 Board Committees and Director Compensation

A greater and more effective use of committees also stands out as one of the key changes in board functioning over the last 50 years. Committees permit the board to divide up its work among the directors; they also allow board members to develop specialized knowledge about specific issues. The value of having standing committees has been recognized by the NYSE, the NASDAQ, and the Securities and Exchange Commission (SEC), and today public company boards are required to have independent *audit, nominating (and governance), and compensation* committees. In addition, a growing number of companies are creating board committees to better communicate with and stay abreast of the concerns of external stakeholders, referred to as *public responsibility, corporate social responsibility, stakeholder relations, or external affairs* committees.

The Audit Committee

The **audit committee**⁶ is charged with assisting the board in its oversight of (a) the integrity of the company's financial statements and internal controls; (b) compliance with legal and regulatory requirements, as well as the company's ethical standards and policies; (c) the qualifications and independence of the company's independent auditor and the performance of the company's internal audit function and its independent auditors; and (d) preparing the audit committee report for inclusion in the company's annual proxy statement. The committee typically consists of no fewer than three members, all of whom must meet the independence and experience requirements of the NYSE and rule 10A-3 under the Securities Exchange Act of 1934, which hold that each member of the Committee must be financially "literate" and at least one member of the committee must have accounting or related financial management expertise (the so-called audit committee financial expert). Its members, including the committee chair, usually are appointed by the board on the recommendation of the nominating and governance committee.

6. A committee charged with assisting a corporation's board of directors in oversight of various aspects of a corporation's functioning, including the company's financial statements, internal controls, compliance with legal and regulatory requirements, and ethical standards and policies.

7. A committee of three or more independent directors commonly charged with recommending new candidates for the board of directors, recommending director compensation, and implementing succession planning for the CEO.

The Nominating (and Governance) Committee

The **nominating (and governance) committee**⁷ has multifaceted responsibilities and is typically charged with recommending new candidates for the board of directors and determining (a) the eligibility of proposed candidates, (b) reviewing the company's governance principles and practices, (c) establishing and overseeing self-assessment by the board, (d) recommending director compensation, and (e) implementing succession planning for the CEO. The nominating (and governance) committee normally consists of three or more independent directors; its members

and chair are usually appointed by the board on the recommendation of the **chairman of the board**⁸.

The Compensation Committee

The **compensation committee**⁹ is charged with duties related to human resources policies and procedures, employee benefit plans, and compensation. It is also responsible for preparing a report on executive compensation for inclusion in the company's annual proxy statement. It typically consists of three or more independent members; its members are normally appointed by the board on the recommendation of the chairman of the board with the concurrence of the nominating (and governance) committee.

Other Board Committees

In addition to these standing committees, a growing number of companies make use of ad hoc committees to address specific issues—a *strategy* committee to look at different growth options, for example, or a *finance* committee to develop recommendations to recapitalize the company. While ad hoc committees can be useful, they should have clear sunset clauses to prevent their institutionalization or a balkanization of the board on important issues.

Committees can also be used to send specific signals to employees or external stakeholders about what is important to the company. A growing number of boards are creating committees to better communicate with and stay abreast of the concerns of external stakeholders. Names for such committees include the *corporate social responsibility*, *stakeholder relations*, *external affairs*, or *public responsibilities* committees. For example, the board of General Electric has created a public responsibilities committee to review and oversee the company's positions on corporate social responsibilities and public issues of significance that affect investors and other GE key stakeholders.

Finally, most bylaws make provision for an **executive committee**¹⁰, usually consisting of the chair, the CEO and other designated officers of the company, and key directors, such as the chairs of the standing committees. In theory, the executive committee has the power to act for the full board in case of emergencies or when there is no time for the full board to meet and deliberate, although this is fraught with danger. Fortunately, advances in communication technology have made executive committees increasingly redundant, and their use has all but disappeared from the corporate governance landscape.

8. The chief officer of a corporation, typically elected by the corporation's board of directors.
9. A committee charged with overseeing human resources policies and procedures, employee benefit plans, and compensation.
10. A committee of key directors and other designated officers of a company that has the power to act for the full board in case of emergencies. With advances in technology, this committee is rarely used.

Director Compensation

Setting director pay typically is not done by the compensation committee of the board. Rather, director pay decisions normally are made by the nominating committee. The justification for this structure is twofold. First, it provides for a separation of the director and executive compensation decisions. Second, it allows the nominating committee to integrate compensation with board-building strategies.

The job of director has become significantly more challenging in recent years; it demands stronger qualifications, requires more time, and increasingly carries personal financial risk. In this new governance climate, the pool of available independent directors has shrunk and pushed up director pay. Directors are typically paid with a mix of cash and equity, with equity representing about half of the total direct compensation. Nonemployee chair and lead-director pay is generally structured like that of other directors on the board (retainer, meeting fees, and equity), while employee, non-CEO chairs are typically paid like an employee (salary, incentives, and benefits). A majority of companies pay a premium to committee chairs—especially audit and compensation committee chairs—reflecting the increased time commitment and additional responsibility. With respect to the equity component of director compensation, companies have reduced their reliance on stock options and increased the use of full-value awards.