INSIDE BOARDROOMS: RESTORING CORPORATE GOVERNANCE

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Abstract

Recent bold changes in corporate governance proceedings suggest that business and regulators are ahead of scientists in addressing the role of informal constraints. We argue that economics and management sciences alone are no longer sufficient to advance our understanding of how to make corporate boards effective. Our proposal for a multidisciplinary approach comes with an appeal for a radical rethink of current limits of existing empirical methodology.

Keywords: corporate board, corporate governance

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The business world had run off rails, mistaking wealth for success and image for leadership. We are in danger of weakening the very concept of the corporation Bill George *Why it is hard to do what's right. Fortune; 9/29/2003 Vol. 148(6): 753*

1. Introduction

Corporate governance is essentially about how to *efficiently* compel management to continue to carry out the wishes of the board. In principle, the board governs as they are empowered to hire and fire management and to set policy or at least ratify all major management decisions; management implements. In practice, things are not so clearly cut. This paper argues that economics and management sciences alone are insufficient to advance our understanding of how to make corporate boards more effective in order to improve governance. Our proposal for a multidisciplinary approach comes with an appeal for a radical rethink of the limits of existing empirical methodology; to actively engage corporations as research partners.1

Corporate governance (hereafter, governance) has come a long way since Berle and Means in their seminal book, *The Modern Corporation and Private Property* highlighted the agency problem endemic to such forms of business organization. Long before then, Adam Smith (1776, p.700) had noted the moral hazard problem in a business organization characterized by the separation of ownership and control.2 Chandler Jr. (1980) labels this phenomenon the rise of the managerial enterprise, which he argues has been characterized by a shift in the focus of founding owners and other stakeholders. These owners became "rentiers," focusing instead on income derived from profits rather than being highly concerned about the quality of management; all of which can be considered part the evolution from family and financial capitalism to modern capitalism.

Over time, corporate governance has become a catchall expression for the renewed search for a better way of aligning the interests of the manager and the all stakeholders, not just the owners. In its new form, some of the more important questions include what the owners would want of the manager, and whose interests should matter more or less in managing the firm?

The rest of the paper is organized in five sections. Section 2 briefly reviews contemporary concerns about corporate governance and concurs with the view that there is a crisis of the board. Section 3 describes the crisis in contemporary perspective. Section 4 out5 lines countermeasures to strengthen boards, and Section 5 concludes.

2. How is corporate governance?

Economic history is full of stories (Kindleberger, 2000) of swindles and other financial crises such as mania, bubbles, panics, and their resulting economic

depression. As well, the literature on governance has repeatedly warned of the dangers of abuse by mangers and of documented cases of such continuing abuse. Yet people are shocked, perhaps by the sheer magnitude of modern day occurrences of major swindles, or by the fact that it continues to happen, or perhaps by the sheer audacity of the perpetrators.3

The takeover wave of the 1980s was very controversial, and generated a burst of papers seeking to account for that merger mania. For instance, *The Journal of Economic Perspectives,* Volume 2(1), 1988 carried a symposium on takeovers. In that volume, Shleifer and Vishny examined internal control in firms and found it too weak. Consequently, they called for an active market for corporate control. Subsequently, Jensen (1989, 1993) argued that the United States corporate governance system was "broke" and that a "fix" was necessary whereas Easterbrook and Fischel (1991), and Romano (1993) found it to be otherwise.

Following the call for an active market for corporate control, Ayogu (2002) examined the structure of ownership and corporate control in sub-Saharan Africa.4 The study found that institutions are the majority of the controlling shareholders with concentrated ownership. If concentrated ownership is good for governance, then a priori we should expect good corporate governance in Africa. With regard to the market for corporate control, the study found that contests for corporate control were weak and the market for corporate control very thin. Based on an examination of the few instances of contests and the process (rules of the game in control contests) as they currently exist, the study concludes that "hostile takeovers are a tasking means of enforcing value maximization" (Ayogu, 2002, p.39), and therefore cannot be relied upon presently to deliver good governance in the region (see Dobrzynski, 1988 a,b for similar views).

Elsewhere, concern over the governance of corporations continues to engage academics and stakeholders. The European Corporate Governance Network is an ongoing international research initiative that has begun to provide research data on comparative corporate governance (see, European Economic Review 43, volume 4-6, April 1999). Outside academia is an impressive concentration of interest groups as well. Groups such as the African Capital Markets Forum, the African Development Bank, California Public Employees Retirement System, Center for International Private Enterprise, Commonwealth Association for Corporate Governance, Commonwealth Secretariat, The Institute of Directors, Private Sector Development and Global Corporate Governance Forum at the World Bank, OECD, Private Sector Corporate Governance Trust, United Nations Economic Commission for Africa, and The World Bank.

One lesson from this flurry of activities is the abiding unease about governance of corporations; the conduct of managers appointed to run the firms and the ability of elected directors to "command and control" management.

3. Crisis of governance is of the board

Without any doubt, boards of directors are major agents of the stockholders and surrogates for the rest of the stakeholders.5 Therefore, our focus here is on that central agent in the organization even though the many class of agency problems applicable to the modern corporation have been studied from numerous perspectives. For instance, Shleifer and Vishny (1997) survey the research on corporate governance with a focus on the legal protection of investors and of ownership concentration. On the other hand, John and Senbet (1998) survey the empirical and theoretical literature focusing on internal mechanisms of governance, particularly with respect to the board in its role of helping to resolve various classes of agency problems; between managers and equity holders, equity holders and creditors, and capital contributors and other stakeholders. These authors also examine the substitution between internal mechanisms and external mechanisms, particularly the markets for corporate control. There have been as well other strands of the literature from the managerial (Rediker and Seth, 1995) and the legal perspectives (Roe, 1994).

Both of the major surveys of the literature on boards (John and Senbet, 1998; Hermalin and Weisbach, 2000 hereafter H&W) suggest power struggles between boards and CEOs as central to understanding board effectiveness. Benz, Kucher, and Stutzer (2001) find that fat compensation packages by way of stock options can be explained by institutional control; there is a significant correlation between the size of the option granted and the balance of power between the board and the CEO. Substantially lower grants are associated with relatively stronger boards. The authors find statistically support for the hypothesis that CEOs manipulate the board structure and process.

Various authors have argued that pay packages are sometimes the outcome of bargaining skills between the parties but few have been at pains to specify precisely what those skills are. As with numerous studies in this area, the way in which the CEO works its will has not been investigated even though the literature lists the various permutations that have been found crucial. These include size and composition of the board such as inside-outside director ratio, the composition of the compensation committee including whether the CEO is also a member, whether the CEO is also chair of the board, interlocking directors, and fraction of the board appointed by the CEO. Hallock (1997, 1999)

find the incidence of "interlocked" directors too prevalent to be merely coincidental, and CEOs on interlocking boards systematically getting higher compensation packages.

I would argue that observable instrumentalities such as interlocking directorships and loading the board are only half of the story. It does not help explain why once those nominees get on the board they do not acquire a "mind of their own". Our concern is part of a larger concern about incumbency advantages and the problem of altogether too loyal a board—*dysfunctional boards*.6 To illuminate these important questions require innovative research into boardroom processes, focusing on both the formal and informal rules; in other words, getting inside boardrooms.

Inside boardrooms: CEO or deities?

Boards operate through committees. A committee is both a social structure and an economic organization. Therefore, when we learn that a CEOs' representation on the nominating committee of a board is a bargaining advantage (H&W, p. 12; Hallock, 1997, 1999; and Shivdasani and Yermack, 1999), such a lesson serves a very useful purpose. It points us further down the search path.

Furthermore, such findings merely label committee power but do not explain it. It certainly raises the question of why is it the case that once a CEO manages to get on an important committee, that committee is presumed, and in most cases is seen, to defer to the CEO. Stories abound of cases in which boards literarily fall over themselves to please the CEOs. Many of the documented cases create an impression of a bunch of fawners rather than governance institutions. These race-to-please CEOs often manifest in the profile of questionable executive compensation schemes that never cease to elicit public outcry whenever the public cares enough to pay some attention.7

Studies of board room process can illuminate, how all over the world, the *deification* of CEOs happened. However, to underscore the extent of the problem, we borrow Mancur Olson's (1993) lenses to view this deification through the logic of incentives. Viewed thus, the incentives qua incentives heaped on executives can be seen as the creation of a "stationary bandit." De facto, a CEO possesses sufficient power to gain uncontested ownership of the stream of profits generated by the corporation. In the frame work of Olson's thesis, the stationary bandit thereby acquires a stake in the prosperity of that corporation. The stream of income that flows from it becomes part of her endowment, enabling the bandit to prosper.

The alternative, in Olson's phrasing is to be a "roving bandit." The roving bandit possesses little incentive to conserve; the goods she refrains from despoiling will be harvested by others—"the roving bandit will therefore behave like a wolf, the stationary bandit, as a shepherd. Both will consume from the flock, but only the second possesses an incentive to defend and to nurture" (Bates, 1996, p.12). The problem with this view is that it requires quite a stretch of the imagination to accept some of the executive excesses as characteristic of a stationary bandit or to accept that the piling of incentives by a board is a means of either creating a stationary bandit or eschewing a roving one.8

It seems that as is commonly the case, loyalty to the Chief is fiercely encouraged (see for example, Woodward 2000) and as has been revealed in many other instances, obedience can be wrought by all sorts of means including ingratiation.9 Even without palliatives, it is well known that boards seem to "have a natural inclination to turn into clubs, and nobody wants to upset the club president" (Economist, 2002a, p.24) which is just as well since CEOs do not tolerate disobedience or disloyalty.10

4. How we can contribute

Inside boardroom: Towards understanding committees

Scholars of politics and corporate governance acknowledge the importance of committees. Within the structure of corporate boards, the nominating committee, the compensation committee and the audit committee, collectively known as monitoring committees are considered crucial to effective control. However, unlike civil governance (see for instance, Fiorina and Plott, 1978; Shepsle and Weingast, 1987), the workings of corporate committees have not been subjected to much systematic analysis, presumably due to the proprietary nature of such proceedings.11 This void can be tackled in two complimentary ways: Advances in theoretical modelling and a bold stakeholder-supported movement to allow accreditation of researchers to board meetings. Stakeholders and researchers must now see eye to eye in order to demystify boardrooms for all.

Why this methodological approach and what can we hope to gain? First, the approach supports rather than rejects the already entrenched use of committee structure which we can justify on the basis of specialization benefits. By permitting composite tasks to be separated into more tractable units to be recombined afterwards, specialization can alleviate cognitive burdens (Simon, 1962). But specialization can result in bureaucratic personalities that are "dysfunctional" (Merton, 1968; Akerlof, 1991). These pros and cons necessarily imply tradeoffs in the structuring of organizations and in the introduction of operating procedures. Therefore, it highlights the tough choices in the industrial organization of corporate boards—designing their structure and process.

Second, it recognizes that in order to make informed choices, relevant information must be available to the architects of the organization. Such requisite information can come from the study of board process. From their perspective of a board as an economic institution, scholars of corporate finance, accountants, lawmakers, and all those interested in outputs may immediately welcome such information for its value in revising corporate law and practices.12 Levine and Plott (1977), and Plott and Levine (1978) are extant theoretical and empirical advances in this area (of *formal rules*). These authors use the method of laboratory experiment to study committee process in a generic setting.

Incorporating informal constraints

But this is only half the story. Institutional economists, psychologists, sociologists, political scientists and all those interested in outcomes understand that a committee is also a social structure. Backed in part by the growing literature from behavioral economics (Thaler, 1997, 2000; Elster, 1998; Rabin, 1998; Loewenstein, 2000; Manski, 2000; Ostrom 2000; Kahneman 2003) we have become more confident that the assumption of universal pursuit of self-interest is the by no means the only motivation that can be logically presumed in serious economic analysis. *Informal rules* such as codes of conduct, sanctions, taboos, and traditions matter as well.

Sugden (1998) explores the theory of normative expectations in which people's behavior is partially conditioned by a distaste of the consequences of violating informal rules. He suggests that this can overwhelm selfish interests and thus can turn into a motive force that affects behavioral outcomes. Using the new institutional economics, Nee (1998) makes a parallel argument. He acknowledges the great strides by the new institutional approach in understanding how informal constraints furnish an alternative facilitating mechanism for economic transactions and argues that the influence of informal constraints on economic organization is more pervasive than is readily acknowledged by economists. Several examples make the point. One is the "group method" employed by workers in the famous Hawthorne plant study (Roethlisberger and Dickson, 1939) to enforce compliance to group norms. The group process for enforcing the agreed upon norms includes subjecting offenders to ruthless ridicule. Conformers enjoyed higher informal rank, reflected in social approval. Habitual nonconformists were ostracized. Social ostracism is brutal particularly if we take the point made in Elstser (1998) that people have been known to take extreme actions when targeted by social ostracism. Elster cites as an example, the case of the Naval Admiral who committed suicide when it was shown that he was not entitled to his honors. Similar examples were described in Akerlof (1991) with regard to the control of dissension within President Johnson's "committee," the Tuesday lunch group:

The president would greet Moyers as "Mr. Stop-the-Bombing"; similar epithets were applied to other dissenters within the group: "our favorite dove," "the in house devil's advocate on Vietnam."...And the measures within the group which were taken to enforce unanimity…were supplemented by more or less voluntary exit as dissenters at different times came to disagree with the policy (p.15)

The above account accords with the observation (The Economist, 2002a, p.24) that "board members rarely challenge the chief executive. If they do, they are often asked to resign, and usually oblige.13" Unfortunately, chief executives may have come to expect this, making it perhaps an example of how institutions shape norms and how norms shape institutions.

A striking example of this expectation is described in Woodward's account of the process at the Board of Governors of the Federal Reserve System during the later days of Paul Volcker's leadership and of the tenancy of Greenspan's.14

On February 24, 1986, Johnson and three other board members took charge and voted 4 to 3 to lower the discount rate. Volcker found himself in the minority for the first time.

"Good-bye," he announced to the board after the vote was taken. ….Voting down the chairman was an outright rebellion as far he was concerned, an un-Federal Reserve thing to do. It was a staggering breach of club etiquette….

…What was the use of being a chairman of an organization if you couldn't run it? What was leadership if someone else decided the direction?

Baker wanted to remind Volcker, "Look, that's why we have seven governors—why we don't let the chairman decide these things by fiat. It's why it is a democratic vote on the board" (p.18-19)

Boards: dysfunctional, indolent, or bored by design?

Akerlof (1991) extends to cognitive psychology, the range of disciplines required to illuminate economic outcomes. He models the behavior of agents with changing preferences but who may be unaware of those changes. His modeling of "procrastination and obedience" explains how in suitable settings, people behave in unforeseeably time-inconsistent manner such as exhibiting irrational obedience to authority, a trait that is in retrospect extremely distasteful to the perpetrator. To motivate such dysfunctional outcomes, he presents examples of individuals who participate in groups and make regrettable decisions but feel powerless to effect preferred changes. Those who disagree with the action taken by the

group find it disadvantageous to voice their dissent (Akerlof's concept of *natural equilibrium*); group pressure keeps folks in line or at least suppresses vocal dissent.

"Board loyalty to management" should never be a part of the terms of engagement. However, in the event that a CEO demands "loyalty" from the board or from any of its committees and gets it, then in Akerlof's parlance, that board can be labeled dysfunctional. Akerlof's concept of natural equilibrium is typical of corporate board culture in that as noted earlier, those who oppose the CEO are asked to leave and are altogether too willing to oblige. In order to motivate further the proposal that psychology (norms, emotions and values) should be incorporated into the study of corporate governance, particularly board process, I draw on some aspects of the process at the Board of Governors of the Federal Reserve System as described in Woodward (2000), hereafter Woodward. There are two reasons for selecting the Federal Reserve Board (the Fed). One is its preeminence. The other is expediency. As most boardrooms are still shrouded in secrecy, Woodward is one of the few documented accounts that serve as a window into boardroom process. Our first extract illustrates the influence of norms as viewed through the experience of a former vice chairman of the Fed. He also knew that there was tradition at the Fed that members go along with the chairman unless they are uncomfortable, particularly the vice chairman. In Blinder's mind, nobody at the Fed could remember the last time a vice chairman voted differently from the chair. It had become clear to him that voting on the basis of his convictions and economic conclusions wouldn't work at the Fed (p.137).

He left the board subsequently, with words that "After Greenspan, probably that most important force at the Fed was the staff, which had the real power and squelched dissident thoughts or alternative thinking unless Greenspan agreed…." (p.156). In Woodward's account, the chairman had on many occasions emphasized the importance of presenting a united face. Several years later, other members of the board urging similar conduct used the same argument. It had become a "credo" (p.176). The following account of a board session can be an example of how nobody wants to "upset the apple cart", of how directors are reluctant to challenge the CEO, or in Woodward's phrase, "of how other members of the board are equally relieved to be compliant".

The force of Greenspan's personality and his strong desire carried… felt enormous pressure not to oppose him, and as the votes were taken … realized the others felt it, too. … There was frequently a sharp contrast between the hawkish statements of some of the members and their dovish votes to go along with the chairman. If there had been a secret ballot, … Greenspan almost certainly would have lost. … would have voted to raise rates in a secret ballot. But out in the open, … voted with Greenspan. That disturbed her (ibid, p.176-77).

The process described above is consistent with Janis and Mann's (1977) discussion on the feelings of extreme ambivalence and stress that individuals feel in military, political, and economic domains. Similarly, Akerlof's analysis of individuals who participate in groups and make regrettable decisions range from cults to bureaucracies. We make no determination as to the appropriate grouping for boards but Akerlof's thesis on Procrastination and Obedience promises a useful theoretical platform, among others.

5. Summary and conclusions

Recent bold changes in corporate proceedings suggest that business and regulators are ahead of scientists in addressing the role of informal constraints on governance. Boyle (2003) reports that "lead" or "presiding" directors is on the up rise to counterbalance the "corner office." Previously confined to model companies and corporate basket cases, presiding directors run meetings "sans CEO" whereas among other roles, lead directors serve as board ombudsmen.

"Out of WorldCom's ashes, bold ideas: … The most desirable feature of good governance, argues Mr. Breeden, is a balance of power between shareholders, directors and managers. … Mr. Breeden's solution is to hand more power both to the board and to shareholders.15" Research along the lines suggested here can help to achieve and sustain such a balance of power.

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Endnotes

1. It is encouraging to discover a similarly radical empirical approach advocated in Leblanc (2004)
2. Hollywood has also made a movie called "Other People's Money," affirming the moral hazard endemic to corporations run by insiders on behalf of outsiders who are in comparison less informed about company affairs. Moral hazard is the lack of incentive to take proper care, such as when a decision maker does not bear the full cost of her decisions but receives the full benefits.
3. Recent occurrences that have achieved notoriety include Parmalat, Enron, Arthur Anderson, WorldCom, Vivendi, ABB, Global Crossings, Adelphia Communications and their collateral damages.
4. Malherbe and Segal (2001) examine trends in ownership and concentration in South Africa.
5. Writing about "The Bored Board," Peter Drucker (1981) suggests two different kinds of people for an effective board. "The first kind are representatives of the constituencies—investors, employees, customers, and other groups in the community" (p. 118).
6. In an earlier study of proxy contests, Dodd and Warner (1983) found that dissident shareholders usually fail to obtain a majority of board seats. Other studies have also reached similar conclusions regarding the abiding power of incumbency. Variously, this power has been labeled *failure of internal controls* and/ or *difficulty of takeovers* (see Shleifer and Vishny, 1988; and Ayogu, 2002).
7. For a wide ranging account, see Business Day (2002), Serwer and David (2002), Fox (2002), The Economist (2002b), and Mulholland (2001)
8. Examples of these excesses include ex Tyco chief, Dennis Kozlowski who paid $15,000 for a dog umbrella stand (The Economist, 2002b, p.24; Serwer and David, 2002) and obtained an $18 million New York "crash pad". However, by far the most telling account (at least until John Rigas of Adelphia Communications came along) of an owner that behaved like a "roving bandit" and was unrestrained by the board is that of Armand Hammer of Occidental Petroleum. Adelphia Communications was America's sixth largest cable television provider. For an account of Armand Hammer's escapades, see Milgrom and Roberts (1992), p. 493.
9. In one account reminiscent of the "Godfather," the former WorldCom CEO Bernard Ebbers declined a request from the Chief Operating Officer Ron Beaumont for an advance (on Ron's performance bonus) to save Ron's 3500 cattle ranch. Instead, the CEO offered his beleaguered Chief a loan from his (the CEO's) personal account for $650,000.
10. See for instance the story of "How Al Dunlap Self-Destructed," *Business Week*, 6 July 1998, p. 48. On the same subject of loyalty, The Economist (2002a, p. 25) suggests encouraging robust debate as a way of making boards effective but acknowledges that, "it is a rare boss who has so enlightened a sense of self-interest."
11. The former Chairman and CEO of SonicBlue (maker of the portable MP3 players) was allegedly terminated for "violating the sanctity of boardroom deliberations" (Chmielewski, 2002).
12. For instance, see John and Senbet (198) on optimal design of corporate boards that accounts for debt and equity holders.
13. That this is the norm is corroborated by a finding of the commission of inquiry over the collapse of Regal Treasury Private Bank in South Africa. According to an account, "…not all directors were equally responsible, as several resigned or were fired by Levenstein…" (Business Day, 2002, p. 2).
14. Arguably, the most powerful corporate board in the world, the Board of Governors of the Federal Reserve System, USA, directs open market operations, the primary instrument of monetary policy in the States. It also sets reserve requirements and approves discount rates as part of monetary policy. It oversees the Federal Reserve District Banks (see, www.federalreserve.gov). The seven members of the Board are appointed by the president with advice and consent of the Senate. To promote independence, governors are appointed for a fourteen-year nonrenewable term. Terms are staggered so that at least one new governor must be appointed every two years. The chairman and the vice chairman are named by the president from among the seven governors, subject to Senate confirmation, for a four-year term. They may be reappointed so long as their term as governor has not expired. It is usual for a chairperson who is not reappointed to resign from the Board. The Board is not dependent on congress for budgetary approval.
15. The Economist (2003), p.44. Mr. Breeden is a former Chairman of the Securities and Exchange Commission, USA.