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Are Independent Directors the Answer?
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The seemingly unending stream of corporate governance failures over the last few years – from Enron and Tyco to Disney and the NYSE – has made clear the need for more powerful and effective boards. Most board reform advocates and the many new corporate governance rules that are being issued call for boards to be dominated by independent directors. A number of boards have taken this to heart, and have created boards where the CEO is the only inside director.

The reform advocates are not the only ones who think having independent boards is the answer. A recent survey we conducted with Mercer Delta of directors in *Fortune 1000* companies found that board members themselves feel that of all the proposed board reforms, having boards and audit committees made up of independent directors are by far the most likely to have a positive impact on boards. But, is relying on boards that are made up almost exclusively of independent directors the best way to staff boards?

Creating boards that are entirely made up of independent directors is a simple, straightforward approach, but it overlooks several decades of research on corporate boards that has found no consistent relationship between the percentage of outside directors and company performance. This research shows that increasing the percentage of independent directors does not enhance firm performance and that if anything firms with very few or no inside directors may actually perform more poorly than their peers.

Our research on boards suggests that the reason cutting back on inside directors may not produce better boards is because this approach focuses on just one key element of board design – insuring directors are sufficiently independent of management. It ignores other key dimensions of board effectiveness, such as directors' knowledge and information. The focus on director independence also emphasizes one board role -- as a monitor of company behavior and performance. It neglects other important board roles, such as shaping of long-term strategy and succession planning.

Having a few insiders on the board can add knowledge of the firm's industry and operations to the board both directly, by including individuals with in-depth industry expertise and indirectly, by having inside directors interact with and help educate independent directors. This industry-specific knowledge is unlikely to come from independent directors who typically can't work in the sector due to conflicts of interest. Inside directors can also provide the board with valuable information about how the firm is actually performing, that can enrich the discussion of issues. It may be particularly vital in the event of unethical behavior or other crises, where the board must become more closely involved in company operations. Having a few inside directors also gives outside board members a chance to assess internal candidates to succeed the CEO, while serving as a training ground for future CEOs on how boards operate.

While there are many advantages to having two or three senior executives from a company on the board, it creates the risk that insiders who are trying to please the CEO will dominate board discussions and decision-making, or will be passive board members. There are a number of features that can be built in to board design to provide an effective counter-balance to CEO and insider power:

- Insuring that key board committees (Audit, Compensation and Nominating) are controlled by outside directors
- Having the board, not the CEO, choose new directors

- Having regular executive sessions where only outside directors are present
- Appointing a lead director or chairman who is not a current or former employee of the firm to run board activities.
- Insuring outside directors are truly "independent"

Perhaps the most important feature is having an independent chair or lead director. This feature avoids the problem of CEO dominated boards on which both insiders and outsiders feel they are working for the CEO because the CEO chooses them and runs the meetings.

What should the composition of a board look like, then? Our belief is that it should contain two or three senior executives from the company, an independent board Chair or Lead Director, a few independent directors who are senior executives in other firms, and independent directors who are knowledgeable about key business issues. A board with this composition is much more likely to act independently and be informed about the internal operations of the organization, as well as the external environment than is a board of all independent directors which is headed by the CEO.

Edward E. Lawler III is at the Marshall School of Business, University of Southern California, and David A. Finegold is at the Keck Graduate Institute, a member of the Claremont Colleges. Along with Jay A. Conger, they are the authors of *Corporate Boards: Adding Value at the Top*.