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ARE CHANGING**

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How Corporate Boards Are Changing

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Over the past four years, corporate boards in the U.S. have been under increasing pressure. Stimulated by high-profile scandals, investor dissatisfaction with board performance and questions about the level of executive compensation, regulators have introduced significant reforms in the rules governing boards. First, Congress passed the Sarbanes-Oxley Act, which mandated that only independent directors can serve on the audit committee and also increased the requirements for the financial knowledge of directors, among other changes. Then the New York Stock Exchange and NASDAQ adopted new listing requirements, including implementing stricter rules for board independence and mandating regular executive sessions in which only outside directors meet. And more recently, the Securities Exchange Commission has proposed new reforms that would make it easier for outside shareholders who are disgruntled with a board's performance to nominate their own slate of directors.

Of course, adopting new rules and regulations is one thing; whether the reforms actually change the way boards operate is another. Furthermore, in a period when there are great demands for change, it is important to focus on what changes actually contribute to the effectiveness of boards. There is a real danger that not only will the mandated changes fail to enhance how companies are governed but that they will lead to a number of negative unintended consequences, including very high costs of implementation.

To investigate the impact of recent changes in boards, we conducted a study that compared the board practices and effectiveness of Fortune 1000 companies in 1998 versus 2003. (See "About the Research.") We specifically looked at three areas: board leadership, the conditions governing board membership and the performance evaluations of boards, individual

board members and CEOs. We were particularly interested in determining whether any practices in those three areas were actually related to overall board performance.

Board Leadership

Experts have frequently commented on the type of leadership that a board should have. There is general agreement is that boards should have clearly developed governance standards specifying how they operate, what their roles are and how the board will be led. But there is little consensus regarding whether the chair of the board should be an executive or not. In the U.K. and other countries, the common practice is to have a non-executive chair, whereas in the U.S. the chair is typically also the company's CEO. (See "Should the Chairman and CEO Jobs be Split?" by Jay W. Lorsch and Andy Zelleke.)

The basic argument in favor of a non-executive chair is that such a person can provide the board with independent leadership and prevent any one individual from having too much power. In theory, this should enhance the board's ability to evaluate managerial performance, to choose a new CEO when necessary and to lead in the event of a crisis. An alternative practice is to have an independent board member (often called a lead or presiding director) provide leadership by coordinating the agenda and chairing board meetings. Creating this type of position has very similar advantages to having a non-executive chair, although it may not move the board nearly as much toward independent operation.

In our study, 64% of the companies had formal governance guidelines in 1998. (See "Leadership Practices Implemented by Boards.") That number had increased significantly by 2003, when 87% had formal written guidelines. An even greater proportional increase occurred with respect to the creation of non-executive chairs, albeit from a much lower base. In 1998, only 6% of companies had non-executive chairs, and by 2003 that percentage had more than doubled

to 16%. Thus, although a clear trend exists toward a greater use of non-executive chairs, the practice is still relatively rare among U.S. firms.

The practice of having a lead director has also gained considerably in popularity. Only about a quarter of the boards studied had lead or presiding directors in 1998, but that number rose to almost 50% by 2003. When that percentage is combined with the fraction of companies having non-executive chairs, a clear majority of large U.S. corporations now have boards led by someone other than the company's CEO. This is a major change from 1998, when only a little over 30% of companies were led by non-CEOs.

Interestingly, of the different aspects of board leadership studied, only the adoption of formal corporate governance guidelines was significantly related to board effectiveness. There is no significant relationship between board effectiveness and the practice of having a non-executive chair or that of having an independent person serve as a lead or presiding director.

The link between formal guidelines and board effectiveness is hardly surprising, because guidelines can provide structure for boards and help them be more effective in their deliberations and their decision-making processes. Somewhat surprising is the lack of a connection between non-CEO leadership and board effectiveness, since it runs counter to a number of arguments favoring independent leadership. One explanation could be that because the accepted norm in the U.S. is to have the CEO serve as chair, appointing a different person might be perceived as a last resort of companies in crisis, such as General Motors in the 1980s. Another possibility is that having two leaders blurs accountability and results in internal board conflicts, particularly when the chair is the former CEO of the company.

There was, however, one area in which having a non-executive chair was related to board effectiveness: when boards had independent leadership, they tended to perform better in terms of corporate strategy. This result provides some support for the idea of having a non-executive who leads or presides over the board's operations.

Limits on Board Membership

There are several reasons for establishing limits on the number of boards an individual can be on. First, the workload is increasing for board members, making it more likely that individuals who serve on many boards simply won't have enough time to perform effectively. There is also a less-obvious issue concerning overlap. Many critics have pointed out that a relatively small number of people holding multiple board seats essentially form a closed society of individuals who govern large U.S. corporations. And when the same people sit on each others' boards, they may lose objectivity and independence.

Long tenures are also a potential problem. When people remain on a board for a long time, they can become too close to senior management and lose their objectivity. In essence they may become too comfortable with the status quo. On a related note, failure to have a mandatory retirement age could also be detrimental to board performance in cases where members are allowed to serve even after their advanced ages have substantially diminished their ability to perform effectively.

In our study, we found that a growing number of companies have been placing limits on board memberships. (See "Membership Practices Implemented by Boards.") Specifically, companies are increasingly limiting the number of boards their directors, including their CEOs, can serve on. (That said, it should be noted that most companies still have no such limitations.) Particularly interesting is the greater prevalence of limitations for outside directors. In 1998 only

3% of companies limited the board memberships of their outside directors, whereas in 2003 that number had grown to 17%. Also, an increasing number of companies have been limiting the terms of their directors. In 1998 just 8% of firms had such a policy, whereas in 2003 that number had more than doubled to 20%. Lastly, age limits are in place at more than 75% of companies (this practice declined slightly from 1998 to 2003).

One effect of these limitations on board membership is that turnover among directors will inevitably increase. As a result, companies will have to expend more resources recruiting, training and developing new board members at a time when liability and workload concerns are making it more difficult to find qualified candidates. It also means that the total number of individuals on U.S. corporate boards will likely increase because fewer people will be able to hold multiple board seats. This could result in the appointment of more “professional directors.” (See “Are Professional Board Directors the Answer?” by Eugene H. Fram.) It may also lead to board members having more time to spend on each of the company boards they sit on, which should increase the effectiveness of those individuals.

Two of the practices pertaining to membership show a significant relationship to overall board effectiveness: limiting the number of boards a CEO can serve on and doing likewise for inside directors. There are a number of possible explanations, but perhaps the most obvious is this: if CEOs and inside directors are serving on numerous other boards and the demands of those commitments are significant, they will simply not have as much time to devote to their own companies. A counter argument is that, by allowing CEOs and inside directors to be on other companies’ boards, they will gain valuable experience that will benefit them at their own organizations. Although that is undoubtedly true, a law of diminishing returns might apply, such

that being on more than one, or perhaps two, outside board could easily have an overall negative impact as the time demands outweigh the learning opportunities.

Interestingly, the most popular practice having to do with membership -- enforcing an age limit for board members -- is not significantly related to board effectiveness. This raises the question of whether that practice should be in place at all, particularly given concerns about age discrimination. The same may be true of term limits, which have become increasingly popular even though they are not related to board effectiveness.

Performance Evaluations

The failure of many boards to operate effectively, particularly with respect to the firing of underperforming CEOs, has led to an increased emphasis on how boards evaluate top management as well as themselves. In the case of ineffective CEOs, boards need a process for identifying and addressing the performance shortfalls of those individuals. With respect to their own performance, boards need a mechanism for understanding their weaknesses and for making the necessary adjustments. Lastly, the performance of individual board members is another issue. Without a creditable process for evaluating directors, it may be difficult to obtain the best work from board members and to remove those who perform poorly.

In our study, the most common evaluation process is for CEOs. (See “Performance Evaluations Used by Boards.”) In 1998, 71% of the boards evaluated the CEO, and by 2003 that number had increased slightly to 78%. Perhaps the most surprising factor here is not that most boards formally evaluate their CEOs, but that as recently as 2003 more than 20% of corporations still did not. Thus, despite the fact that boards have come under attack for the enormous escalation in CEO compensation during the last decade, and the lack of a relationship between

CEO pay and performance, a significant number of the nation's largest corporations do not evaluate CEO performance.

With respect to board evaluation, 56% of those boards surveyed had a process in place in 2003, substantially up from just 33% five years earlier. Interestingly, that big jump occurred before board evaluation became a requirement of the Sarbanes-Oxley Act.

The evaluation of individual board members has increased only slightly, from 19% in 1998 to 26% in 2003. Companies doing these evaluations relied on three different mechanisms: self-evaluations, written feedback and feedback to the entire board. Of those, self-evaluations occurred in about 50% of the cases in which companies had an evaluation process. The generation of written feedback to individual directors about their performance, often done by an outside consultant based on a survey and/or interviews with other board members and stakeholders, is a common practice at almost half of the boards that conduct member evaluations. Similarly, giving feedback on the results of the evaluation process to the entire board occurs at more than half of the boards that conduct evaluations. The use of all three of these practices greatly increased from 1998 to 2003.

Boards that assess their members and themselves tend to be more effective than those that don't. This finding strongly supports the Sarbanes-Oxley requirement that boards regularly evaluate themselves. In addition, it suggests that, in the future, boards should be required to assess the performance of individual board members, as well as the performance of the board.

Interestingly, CEO evaluations were not related to overall board performance -- a surprising result given the fact that one of the roles of most boards is to assess the CEO's performance, and a formal process is usually the best way to accomplish it. However, this is only one function of the board, so a lack of a relationship is somewhat understandable. Boards that do

conduct CEO evaluations, however, were rated more highly on their strategic performance. One possible explanation for this result that fits with our interviews of board members is that boards use performance reviews to hold CEOs accountable for particular strategic goals and outcomes, thus helping to ensure that strategic decisions are transferred into action.

Future Directions

Corporate boards in the U.S. have indeed been changing, but the big question is whether they've been changing in the right ways. The evidence suggests that, as a general rule, they are. It should be noted that boards are likely just at the beginning of a major transformation. In the not-too-distant future, there will probably be wider adoption of many of the practices studied. Some changes will come about because of legal and regulatory requirements; others simply because boards will be under continuing pressure to improve their performance. There are still a number of important unanswered questions about what makes for an effective board. Further research in this area should help answer those questions, pointing toward increasingly better ways for boards to operate.

About the Research

As part of our research program on corporate governance, we have been collecting longitudinal survey data from board members since 1996. Originally our survey was done in partnership with Korn/Ferry International; in 2003 it was conducted with Mercer Delta. In both 1998 and 2003, our survey data focused extensively on the issues of board leadership, board membership and performance evaluation processes. Thus we can observe the kinds of changes that have occurred over a five-year span.

In the 1998 study, we mailed detailed surveys to all of the directors of the publicly traded Fortune 1000 companies in the U.S. Slightly over 1000 board members responded. The surveys consisted of questions that asked the participants to report on the current governance practices and effectiveness of the boards on which they served. In the 2003 study, we once again surveyed board members in the Fortune 1000, receiving 324 responses. The lower response rate likely reflects the growing workload for directors and the greater number of surveys of board members.

For both studies, we asked the board members to evaluate the overall performance of their boards, as well as its performance, in three major areas: financial monitoring, strategic effectiveness and compliance effectiveness. Within each of those areas, the participants were asked to rate their boards (on a five-point scale from “very ineffective” to “very effective”) with respect to specific functions, for example, the ability to balance the interests of different stakeholders. With that data, we were then able to correlate a board’s use of the key practices studied with its overall effectiveness. Of course, any self-evaluation process can be affected by the biases of the participants involved. Even so, we believe that the overall results of our research do provide valuable insights into which practices tend to lead to greater board effectiveness.

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