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BLOG

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Why Good Boards Aren't There When You Need Them

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There has been a lot of talk about governance in the wake of the financial crisis. People have been wondering: where were the directors when numerous financial institutions bet the proverbial mortgage on, well, mortgages and their related products? Those directors are supposed to be there to defend the shareholders against self-interested executives trying to maximize their personal compensation by taking excessive risks.

We sort of thought that we had board oversight figured out after the last crisis. We tightened up governance dramatically with Sarbanes-Oxley: more scrutiny, more independent directors, financial experts on the audit committee, etc. With SOX behind them, boards should absolutely be able to do the job. Shareholders should have good protection.

But there's a flawed assumption buried under the logic of SOX, which is that it assumes a relatively random distribution of smart, experienced people smeared across boards like peanut butter. In other words, every board should, on the whole, have at least one or two smart, experienced independent directors. It is worth examining that assumption, because it is the soft underbelly of board governance.

Let's imagine two companies. The first is a widely-held, publicly-traded corporation with a bloody-minded CEO, one who wants to take advantage of shareholders for his own benefit. BM-CEO feels no compunction about putting his own interests ahead of shareholders.

The second has a romantically-inclined CEO who just wants to do the right thing for shareholders because it is the right thing to do. When there is any doubt, RI-CEO thinks first about the shareholders and only second about what's in it for her.

What kind of directors will they attract to their respective boards?

BM-CEO will seek out and recruit directors who aren't inclined to scrutinize carefully and challenge management. They are directors who need the money, who really desire and value the prestige of being on the board, and who are conflict-averse. Of course, these decisions are not BM-CEO's alone, but if he is also Chairman and is diligent about utilizing his power, he can have a big influence on the selection and recruitment process.

After this carefully orchestrated selection process, the BM-CEO will then work assiduously with this pliant group to keep them in the dark as much as possible. He will arrange board meetings to steer clear of weak spots and establish a board culture that discourages challenge. Because they were carefully selected to be vulnerable to manipulation and being in kept in the dark, they will be unlikely to battle against the odds. They will believe the best, hope for the best, and behave themselves while the BM-CEO self-actualizes.

In contrast, RI-CEO will seek out and recruit directors who are inclined to challenge the company to achieve more; to be the very best it can be. They are directors who don't need the money, who want the prestige of working with a great company and are entirely willing to work through some conflict on the way to getting resolution. Once they are on the board, RI-CEO will keep them highly informed and structure meetings to maximize the chance for getting productive feedback and welcome the counsel that they provide — even if it is challenging to follow.

The result, of course, is the sad paradox of board governance: when the shareholders need the directors least, they get them most. And when they need them most, they get them least.

With RI-CEO at the helm, the shareholders actually don't need the directors to provide protection from the RI-CEO. RI-CEO self-polices. But the high-quality of the directors and the board dialogue means that RI-CEO gets lots of helpful advice and counsel to do a better job that she would have done in any event. Shareholders get directors selected to succeed for them — even though they don't really need it.

With BM-CEO at the helm, the shareholders desperately need terrific directors who will stand up to BM-CEO and insist on the protection of their rights and their capital. But

they don't get governance that even approaches average. They don't get a random assortment of directors and a median board culture. They get directors selected to fail them. The failures, of course, are not usually obvious. The cost tends to be in lost opportunities — the company not doing as well as it otherwise could have and the BM-CEO doing better than he should have. But in a minority of cases, it produces spectacular failure; failure that leaves shareholders, regulators and commentators shaking their heads and asking: Where were the directors?

The answer: because they were needed they weren't there. They were in the dark and out of the action — by design. And had they not been needed, they would have been there.

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