Leadership

Boards Caused This Mess. Here's How To Fix Them

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Who's responsible for the swift and severe downturn in the economy over the last 18 months? Many groups deserve blame, but the most culpable group of all is boards of directors. They let their organizations leverage up enormously without fully understanding the risks or seriously considering the possibility that housing prices could level off or decline.

The last six years have proved beyond a shadow of a doubt that a tick-the-box legislated attempt to improve corporate governance, like the Sarbanes-Oxley Act of 2002, is just not sufficient; secondly, business leaders don't deserve a free pass to police themselves. We propose a two-part carrot-and-stick process, for both fixing boards and reducing the odds that such a calamitous breakdown in capital markets would happen again.

Politicians have a way of showing up at a crime after the fact (as long as it's serious enough to register with public opinion, that is) to produce legislation they hope will make people think they've done something to prevent the same problem from occurring in the future. Before September 2008, when Washington was forced to come to grips with the vastness of the downturn, politicians hadn't been so interested in business since the dot-com bubble burst eight years ago.

Back then, the drop in stock prices that savaged Americans' 401(k) portfolios was accompanied by revelations of egregious corporate wrongdoing at companies including Enron, WorldCom and Adelphia. Sarbanes-Oxley was the politicians' answer to that bad corporate behavior. It was supposed to make boards more vigilant and accountable for their companies' results. But it was utterly ineffective in preventing this biggest market breakdown since the Great Depression.

We know, from years of research and empirical evidence, that good governance does improve corporate performance and prevent corporate breakdowns. We also know that what makes governance "good" vs. "bad" has nothing to do with most of the "best practice" that finds its way into legislation. A board can be made up mostly of "independent" directors (however you define that); it can have some less tenured members and a chairman who is not also the chief executive officer, but all that has little to do with actual financial results.

The factors that most correlate with better governance and performance, it turns out, are things such as the quality of debate in board meetings, the open-mindedness of the CEO and the directors, whether the board does extensive scenario planning and whether it engages in playing devil's advocate when discussing possible courses of action. None of that is easily measured, so it can't easily be introduced into legislation. Yet it is absolutely critical to good governance.

Business leaders and their apologists at the Business Roundtable and Conference Board criticized Sarbanes-Oxley for years after it passed. They said it was too expensive, bureaucratic and good only for auditors, who got to raise their fees astronomically. They argued that Washington should take a much more hands-off approach. Businesses could police themselves, thank you very much. That point of view has been thoroughly discredited by the econolypse of the last year and a half.
In the two-part carrot-and-stick strategy we propose for improving the functioning of our country’s boards, the carrot is better self-governance. Boards need to regulate themselves more effectively. The Securities and Exchange Commission can’t be a fly on the wall to every board to tell it whether it’s debating issues enough; boards must do that themselves.

The past year’s massive destruction of both real capital and reputational capital at firms like Citigroup and Lehman should send shivers up the spine of every public company director. They should be seeking advice from other directors or consultants who have been successful at improving governance.

We have been involved since 2004 in implementing corporate early-warning systems at the board level to help directors address potential problems in a much more rigorous and systematic way. One basic measure of how a board is doing is whether it has an early-warning system in place. Boards must do everything they can to insulate themselves against failure.

But hoping public companies’ boards will self-regulate is hardly sufficient. In our opinion, there needs to be a stick in place, too. To create it, SEC chairman Mary Schapiro and her commissioners need to swiftly enact something called proxy access. Today, when any shareholder in a public company wants to nominate a candidate for the company’s board of directors, that shareholder must foot the bill and jump over an extraordinary number of hurdles.

The cost is, at minimum, $1 million for lawyers, mailings and proxy solicitors. The candidate must run against the incumbent board member, whose campaign is paid for entirely by shareholders. Imagine the same kind of stacked deck in favor of a one-party system in a political context—we’d call it Venezuela.

Well, U.S. shareholders have been trying to run against Hugo Chavez for years here, with Chavez protected by Delaware court decisions and SEC rules that seek to maintain the status quo (and that also keep the state coffers of Delaware filled, by the way). Proxy access would allow a shareholder who had held shares in the company for some time to nominate one or more board candidates on the company’s own proxy. The challengers wouldn’t have to pay the costs of mailing out proxies. If a challenger can make the case that he or she should be on the board in place of an incumbent, it should happen. May the best directors—not only the friends of the CEO—serve.

Critics of proxy access argue that shareholders who seek to be elected this way will either have extremist views (i.e., groups such as the AFL-CIO or Teamsters may gain more influence than a true majority of shareholders would want, and hijack the process), or "short-termist" views (i.e., shareholders will demand quick fixes for company problems instead of trusting management to do what's best for the long term).

In our view, these criticisms have no merit. Any potential director up for election to a board of directors, incumbent or challenger, needs to make a case for deserving the seat. We trust shareholders to judge for themselves. We believe Capital Research, Legg Mason, Vanguard, and other big investors can tell if a potential director is a crackpot or an extremist—or, on the other hand, a pawn of the CEO who will do nothing more than rubber-stamp his decisions.

We don't believe proxy access, if passed, will cause a major increase in board challenges, but there will be a few, and those could result in a sea change in board effectiveness. If board members are more closely tied to the people they are supposed to represent—the shareholders—they are bound to ask tougher questions. And that will be in everyone’s best interests.

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