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The Professional Board

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*by Ira M. Millstein**

Webster's Ninth New Collegiate Dictionary includes two definitions of professional," both of which convey the sense of this Article: (i) "characterized by or conforming to the ethical standards of a profession"; and (ii) "participating for gain or livelihood in an activity or field of endeavor often engaged in by amateurs."[1] As will be discussed *infra*, it is the author's belief that directorship requires ever increasing time demands, leaves no room for "amateurs," and requires compensation for value given, especially for major corporations. The author emphatically does not mean to recommend, however, that boards of directors be drawn from a cadre of persons whose only function is to serve on corporate boards of directors, an idea emanating from academia which should be rejected.

FREE MARKET SYSTEMS AND CORPORATE GOVERNANCE

The goal of corporate governance in all "free market" systems, systems in which corporations are permitted to operate free of excessive government restraint and regulation, is to provide an oversight mechanism to select, incentivize, and monitor the best managers available to run the corporation and, if necessary, replace poorly performing managers in a timely manner. The oversight mechanism holds managers accountable to shareholders' interests (as each corporation's shareholders define those interests) and ensures that managers do not misuse corporate assets. Within those parameters and governmental mandates, the oversight mech-

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If this Article contributes anything new to the on-going evolution of corporate governance, it is due in part to the regular dialogue in class between the author and his Co-Professor of Corporate Governance at Yale's School of Management, Paul W. MacAvoy, Williams Brothers Professor of Management Studies. Holly J. Gregory, an associate at Weil, Gotshal & Manges, has assisted them.

1. WEBSTER'S NINTH NEW COLLEGIATE DICTIONARY 939 (1983).

anism must, however, allow managers to take risks and innovate in a dynamic environment in which new technologies, global competition, and complex employee and community relations constantly test the corporation's ability to succeed.

In our free market system, the board of directors is the oversight mechanism charged with monitoring management and providing accountability to shareholders, while allowing managers the freedom they need to run the business. While, historically, the U.S. board tended to passivity, in the past decade, boards have become more independent and active, and real oversight has increased. Ideally, meaningful monitoring is aimed at detecting and responding to performance problems before they develop into crises. To do so requires that the board's role expand beyond hiring and removing managers after long-term failure, their traditional form of activation, into more substantive areas, including participation in strategic planning (with performance monitoring vis-á-vis the corporate plan) and creation of incentives linked to corporate performance. This expansion of the board's role increases the demands on directors' time, on their need for information about and education in the business, and on their level of "professionalism."

Directors who respect their responsibilities will come to see themselves as professionals. Increased professionalism in the boardroom is at the core of the important role directors play, not only in the corporation but through the corporation in the wider economy. In market-oriented economies, in which the role of government is to provide the social safety-net and enable markets to operate, private corporate enterprises are the dominant engines of production and employment. These private enterprises face constant pressure to be more efficient and well-managed to meet existing and anticipated worldwide competition, both in the markets for the services and products they provide, and in the capital markets.[2] Since senior management is responsible for the enterprise's efficiency and competitiveness, and boards of directors are responsible for hiring, compensating, monitoring, and planning the succession of senior management, the board is the focal point of the enterprise's perpetuation and success. Viewed from this perspective, boards of directors are not only fiduciaries for their respective owners and, less directly, accountable to other corporate constituents, but they are also responsible, in effect, for their nation's economic well-being. The larger and more pervasive the private enterprise, the greater the responsibility for the national interest.

2. Global capital will flow towards corporations, regardless of location, that are open, well-managed, and maximize long-term shareholder gain. Those major corporations that confine their vision to a purely domestic scope, without considering the impact of financial markets around the world, run the risk of becoming obsolete. Global investors are quite sophisticated and, increasingly, they inspect the corporations in which they invest to determine if they are well-managed. As always, the quality of management is a key to successful investing; quality management generally portends quality performance over the long run.

Through this lens, directorship is no longer an honorarium. It is a major responsibility, which requires the service of professionals.

THE BOARD'S EXPANDING ROLE

In the past three years, a number of high-profile U.S. boards have adopted a more independent and active approach to governance responsibilities as they attempt to revitalize the corporations they serve. Numerous factors have played a role in this "activation" including, among other things: (i) undeniable and apparent performance deficiencies; (ii) prodding from institutional shareholders (primarily large public pension funds); (iii) evolving judicial interpretations of directors' duties; (iv) pressures emanating from the corporate takeovers of the 1980s; (v) the need to "re-invent" the corporate enterprise to meet newly emerging global competition efficiently; and (vi) directors' concern for their own reputations. Remarkably, the actual reordering of boardroom processes to improve directors' abilities to monitor management and corporate performance has been self-made by boards, without government intervention. This reordering is the first sign of professionalism–directors developing for themselves the standards to live by.

Admittedly, many boards that are now active became so in response to serious performance crises. For boards to become more involved at earlier stages, so that in the future red flags and danger signals are detected *before* a crisis occurs, requires a fundamental change in the status quo in which management tends to dominate the board agenda and the flow of information.

That fundamental change is now in process. In the spring of 1994, the General Motors (GM) board issued guidelines setting forth procedures designed to ensure active monitoring of management by an independent board.[3] That act, by a board itself, in the right place at the right time, seemed to legitimize change in the boardroom. The GM guidelines have been widely praised, and the California Public Employees Retirement System has prodded other boards to consider guidelines adapted to their respective enterprises.[4] In the past year alone, the National Association of Corporate Directors (NACD), the Conference Board, and the Business Law Section of the American Bar Association have published treatises on

3. *See* Robert Simison, *GM Board Adopts Formal Guidelines on Stronger Control Over Management*, WALL ST. J., Mar. 28, 1994, at A4.

4. Sixty-five percent of 1000 directors from the largest U.S. public corporations recently surveyed by Korn/Ferry International reported that their boards adopted formal written guidelines. KORN/FERRY INTERNATIONAL, 22ND ANNUAL BOARD OF DIRECTORS STUDY 24 (1995) (on file with *The Business Lawyer*, University of Maryland School of Law) [hereinafter KORN/FERRY SURVEY]. See Judith H. Dobrzynski, *A Quiet Board Room Revolution: Power Shifts to Outside Directors*, N.Y. TIMES, May 25, 1995, at DI (reporting the results found in the Korn/Ferry survey).

various aspects of corporate governance that, if followed, would significantly improve the board's ability and motivation to monitor performance.[5] Indeed, boardroom change is going international as evidenced by the documents outlining "best practices" for boards that have been published in Canada (the Toronto Stock Exchange),[6] the United Kingdom (the Cadbury Committee),[7] and Australia (the Bosch Committee).[8] It seems reasonable to assume that the European continent will not be too far behind.[9]

While company-specific guidelines and more general codes of "best practices" properly leave with management the authority to conduct the day-to-day affairs of the corporation, they nonetheless express a change in the balance of corporate power and an extension of board powers into "grey areas" of authority that were long management's de facto province. Consider the following relatively simple changes addressed in various board guidelines that shift the balance of authority between management and the board:

5. BLUE RIBBON COMMISSION, NATIONAL ASSOCIATION OF CORPORATE DIRECTORS, PERFORMANCE EVALUATION OF CHIEF EXECUTIVE OFFICERS, BOARDS AND DIRECTORS (1994) [hereinafter COMMISSION ON PERFORMANCE EVALUATION]; COMMITTEE ON CORPORATE LAWS, AMERICAN BAR ASSOCIATION, CORPORATE DIRECTOR'S GUIDEBOOK (2d ed. 1994), THE CONFERENCE BOARD, CORPORATE BOARDS: IMPROVING AND EVALUATING PERFORMANCE (1994).

6. TORONTO STOCK EXCHANGE COMMITTEE ON CORPORATE GOVERNANCE IN CANADA, WHERE WERE THE DIRECTORS?: GUIDELINES FOR IMPROVED CORPORATE GOVERNANCE IN CANADA (Dec. 1994) (on file with *The Business Lawyer*, University of Maryland School of Law) [hereinafter TORONTO GUIDELINES].

7. COMMITTEE ON THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE, REPORT OF THE COMMITTEE ON THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE (Dec. 1992) (on file with *The Business Lawyer*, University of Maryland School of Law) [hereinafter CADBURY COMMITTEE REPORT].

8. THE BOSCH COMMITTEE, CORPORATE PRACTICES AND CONDUCT (2d ed. 1993) (on file with *The Business Lawyer*, University of Maryland School of Law).

9. In February 1995, the Organization for Economic Cooperation and Development (OECD) sponsored an international conference in Paris which focused on corporate governance issues. It resulted in a directive issued by the OECD ministers stating that corporate governance should be part of the OECD's agenda. *Meeting of the OECD Counsel at the Ministerial Level*, OECD Press Release, May 24, 1995, at 5. "Ministers invite the OECD to ... examine the significance, direction and means of reform in regulatory regimes, and undertake exploratory work on corporate governance. . . ." *Id*.

Additionally, the Center for Strategic & International Studies, a think tank that has focused for years on geopolitics and strategy, is now turning to comparative corporate governance issues. Letter from John Yochelson, Center for Strategic & International Studies, to John Nash, National Association of Corporate Directors (May 19, 1995) (on file with *The Business Lawyer*, University of Maryland School of Law). Corporate governance reform is penetrating academia in Germany as well. This summer, a group of German think tanks, including the Drager Institute, in conjunction with the University of Chicago Law School, hosted a conference entitled *Corporate Governance: Structural Reforms in the American and German Corporation Law* (June 30–July 1, 1995, Heidelberg, Germany).

(i) separation of the chairman and CEO, or at least the selection–formally or informally–by the board of a "lead director";[10]
(ii) board control over the process of nominating and retaining independent directors;[11] and,
(iii) evaluation of CEO performance by outside directors in meetings solely of outside directors.[12]

Each one of these changes increases the board's independence from the CEO as the board positions itself to gain more information about the corporation and its performance, so that it can identify and understand the early warning signals of "trouble ahead."

In defining the scope of board involvement in corporate decision-making, however, a careful line needs to be drawn between board and management responsibility. It is management which must provide both the leadership and creative force in the corporation. This implicates a major element of board professionalism, understanding and defining the limits of the board's role. Lawyers, for example, understand that in most circumstances they render advice, and that taking or leaving that advice is the client's role. The limit is when the lawyer's professional responsibilities require him or her to act when the advice is ignored.

The factors in determining the parameters of the board's role are these: Does the board have access to the same information on performance as management, and does the board have the knowledge of the business to use that information better than, or as well as, management? Will the board take the time, and is it feasible for the board to take the time, to seek out and study the information necessary for informed decision-making? Will board involvement in a particular matter improve overall corporate performance, taking into consideration any relevant costs including the cost of management becoming unnecessarily risk-averse or otherwise unable to react quickly and decisively to certain crises?

Take as a starting example "major policy decisions," which virtually all texts agree are within the board's province to "review," "oversee," "approve," or even, ultimately, to make. Information is critical to the exercise of judgment as to "major" policy decisions which, depending on the corporation and the circumstances, can include: (i) strategic plans, (ii) financial priorities, (iii) buying or selling a business, (iv) a tender offer for the company, (v) a leveraged buyout or management buyout, (vi) a major labor or commercial issue or dispute, and (vii) management succession. The

10. The separation of the chairman and the CEO reflects the CEO's loss of domination over the board and recognition that the CEO is accountable to the board as an independent entity.

11. When directors become the board's choice, rather than management's choice, board members address each other as peer group members not beholden to the CEO.

12. A separate meeting of outside directors alone changes the dynamics of the CEO/board relationship.

board must decide which of these decisions are sufficiently major such that the board must, to discharge its responsibilities, make the decision; which is to be seriously debated but with the decision ultimately left to management; and, which is to be simply reviewed after management decides.[13] Obviously, there are shadings of grey within these parameters.

By whatever means a board is to participate in these "major" policies, it must insist on that level of information, devote that level of time to digest the information, and ask management that level of questions necessary either to satisfy itself of management's diligence or to make the decision itself

Yet the board is at a distinct disadvantage. It can never have management's intimate knowledge of the business, and, in fact, is dependent upon management for the relevant information.[14] Nevertheless, as the board

13. In addition to the board's primary oversight responsibility, state corporate law statutes generally mandate that certain significant corporate actions must be approved by the full board and are non-delegable, even to committees of directors. For example, the board must decide whether to adopt a merger or consolidation agreement, recommend to the stockholders the sale of substantially all of the company's assets, propose the dissolution of the company, or amend the bylaws. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(c) (1994); N.Y. BUS. CORP. LAW §§ 712(a)(1), 712(a)(4), 902, 903, 909 (McKinney 1994). In addition, certain other corporate actions usually require board approval although this requirement may be satisfied through action by committee, such as the issuance of stock. Further, there are a few statutory and regulatory requirements that corporate decisions be made solely by non-management directors. Under the Internal Revenue Code, for example, a company cannot deduct compensation in excess of $1 million dollars paid to the CEO and certain other officers unless, among other things, such compensation is based on predetermined performance goals established by a compensation committee comprised solely of two or more independent directors (as defined by the Code). I.R.C. §§ 162(m)(1), 162(m)(4)(c) (1988 & West Supp. 1995). Decisions made by audit committees of companies listed on the New York Stock Exchange are non-management ones because audit committees must be staffed only with independent directors. NEW YORK STOCK EXCHANGE, LISTED COMPANY MANUAL 3-1 (1991).

In addition, there are two situations which may, depending on the facts, require action solely by the non-management directors. First, under some state corporate law statutes, transactions involving the interests of one or more of the directors must be approved by a majority of the disinterested directors. *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 144 (1994). Thus, in the case of a management buy-out, management directors have an interest in the transaction, which as a practical matter requires approval by a majority of the non-management directors. Second, under the Securities Exchange Act of 1934 (the Exchange Act), as amended, if a company has an employee benefit plan pursuant to which directors and officers are awarded securities, transactions by those directors and officers will be subject to the "short-swing" profit rules of § 16 of the Exchange Act and the rules promulgated thereunder unless, with certain exceptions, the plan is administered by "disinterested" directors, i.e., those directors who were not granted or awarded securities pursuant to the plan. *See* Rule 16b-3(c)(2)(i), 17 C.F.R. § 240.16b-3(c)(2)(i) (1995). Thus, if a company has a plan which awards securities to officers, management directors will be subject to the "short-swing" profit rules unless the plan is administered only by non-management directors.

14. Shann Turnbull, *Perspectives*, HARV. BUS. REV., May-June 1995, at 169. *See also* Jay W. Lorsch, *Empowering the Board,* HARV. BUS. REV., Jan.-Feb. 1995, at 107. Some commentators have identified the U.S. board's information dependence on management as creating "a systemic competitive disadvantage" as compared to European and Japanese boards, which typically are composed primarily, if not entirely, of members of management.

moves beyond asking questions to more active involvement in corporate decision-making, directors will require, and will seek, more information to provide substantive "oversight," "review," and "approval," and at times preemption of, management's proposed major plans and actions.

All the while, the board must balance its degree of involvement in corporate decision-making with the potential for a negative impact on management performance. Too deep and frequent intervention by the board may make managers risk averse, conditioned to await board guidance. And if a plan is proposed by the board, rather than management, management may not have the same vested interest in carrying it through as it would have if *it* had developed the plan.

Drawing the lines between making the decision, seriously reviewing it, and monitoring requires professionals who consciously understand what they are doing and the consequences of their acts and failures to act. Moreover, any involvement in major policy decisions requires professionals who understand that they need, and are willing to insist upon, the requisite information for each level of involvement, and then spend the requisite amount of time for each level.

These are general observations. Certain specific issues which suggest themselves as warranting a high level of board involvement can now be examined. Which of these issues the board "decides," and which management "decides," is an unnecessary question; the decision, in all likelihood, will ultimately be reached through interaction. When there is serious disagreement, the board will have to decide whether to preempt management, given the concern for engendering inhibition.

While some care is merited in extending board involvement into traditional areas of managerial responsibility, boards can become more active regarding management's proposed plans and actions in three critical respects:

(i) the development of strategy can become more of an interactive board/management exercise;

(ii) the traditional role of monitoring performance against strategic and business plans can be expanded; and

(iii) the board can become more effective by helping to design compensation plans for management, the board, and employees further down the line, aligning, in the same direction, the entire work force with the long-term best interests of its owners.

PARTICIPATING IN STRATEGIC AND BUSINESS PLANNING

Modern organizational theory posits that defining a corporate goal or mission, and defining the strategy to achieve it, are integral to corporate success. The process of developing the corporate mission and designing a strategic plan is ongoing and certainly an appropriate matter for board

and management interaction. Typically, strategic plans are developed by senior management in the divisions, further developed by the CEO's staff and then the CEO, approved by the board, and carried out by senior management at the CEO's direction. Different CEOs vary this mechanism for plan evolution, but, in the end, the CEO and management have the primary responsibility for articulating strategy: they have the greatest knowledge of the firm and its competitive environment, and they must ultimately execute the plan. In contrast, beyond asking questions and approving or disapproving management's proposal, the role of the board as to strategy is ill-defined.[15]

There is growing boardroom interest in assuming a more active role in the strategic planning process.[16] If the board is independently to consider the merits of management's strategic and business plans, including the probability of realizing its components, then board committees or individual board members should, at the least, understand the necessary elements of the strategic planning process and consider whether they have been properly accounted for in the plan. While obviously the necessary elements will vary for individual corporations, generically they are likely to include the following: (i) who are the existing and potential rivals; (ii) what are the enterprise's external environmental factors (economic, social, and political); and (iii) what are the internal characteristics of the organization (goals, assets, liabilities, and structure)?[17] These are the broad elements from which a strategic plan emerges, and a board can inquire into these elements to satisfy itself that management is proposing a well-considered course of action. Any board performing its responsibilities ought to be well-aware of those elements in any event. The board also might, at the same time, identify the benchmarks that would inform it of the plan's progress after a plan is ultimately approved.

The board's involvement in strategic planning, whether aimed at simply understanding and approving the proposal set out by management or aimed at more active participation in devising the plan, may be most effective if it involves director interaction with a broader range of managers than just the CEO in the early stages of plan formulation. But the board must keep in mind the limits: the board cannot write the plan. To do so would be to reduce management's responsibility for carrying out a plan

15. *See, e.g.*, Gordon Donaldson, *A New Tool for Boards: The Strategic Audit*, HARV. BUS. REV., July-Aug. 1995, at 99; John Pound, *Corporate Governance Affects Corporate Strategy*, CORP. BOARD, July-Aug. 1994, at 1; C. Gopinath et al., *Changing Role of the Board of Directors: In Search of a New Strategic Identity?*, 30 MID-ATLANTIC J. BUS. 175 (1994); Chancellor William T. Allen, Redefining the Role of Outside Directors in an Age of Global Competition, Address at the Ray Garrett Jr. Corporate and Securities Law Institute, Northwestern University (Apr. 30, 1992). While strategic planning seems to be more of a developed science, it is suspected that the elements of board involvement in mission development are similarly fuzzy.

16. *See id*.

17. SHARON OSTER, MODERN COMPETITIVE ANALYSIS 5 (2d ed. 1994).

that is the board's and not its own. Again, this requires professionalism and understanding the limits of the profession.

MONITORING MANAGEMENT PERFORMANCE AGAINST THE STRATEGIC PLAN

The board's monitoring function has been overwhelmingly process-oriented and focused on management presentations, in monthly board meetings, of the current income statement and balance sheet. This information is, in form and content, largely identical to that presented in the annual report. Frequently, the information available to the director is no more current and insightful than that available to stock analysts. Even with extrapolating to future trends, such presentations may not accurately predict problems. Historical and purely financial performance measures may not provide sufficiently sensitive tools for the board to monitor the strategic plan.

If the board is accurately to evaluate management and corporate performance beyond the level of a stock analyst, it needs sharper tools. There is, however, a paucity of academic or other work on just what those tools should be and how the board can obtain them, if they exist.

Some tools for measuring plan performance seem obvious and readily available. If the plan calls for doubling the production of nuts and bolts, count nuts and bolts; if the plan calls for increasing market share, measure market share; if the plan calls for "becoming global," define the term and measure the elements. As to such measurable performance elements, the board needs to itemize them, obtain the relevant information regularly, and then evaluate performance.

But the board cannot rely solely on a rear view mirror: it needs some way to attempt to judge not simply how management has done and how it is doing, but equally important, how management is going to do, and whether management has positioned itself for what may be coming. Failing to care about the future can be disastrous.

Measuring the ability of assets and management to produce future wealth requires increasing sophistication. As recognized in the 1992 report of the Council on Competitiveness, a corporation's future resides in, among other things, its: (i) current activities, (ii) stock of scientific and technical knowledge, (iii) skill base, (iv) reputation with various constituencies, and (v) market position.[18] Boards might endeavor to obtain regular information about such non-financial indicia, if they are somehow quantifiable. The Subcouncil on Corporate Governance of the U.S. Government's Competitive Policy Council echoed this need for a more systematic development of qualitative indicators of corporate performance,

18. COUNCIL ON COMPETITIVENESS, CAPITAL CHOICES: CHANGING WAY AMERICA INVESTS IN INDUSTRY 84 (1992).

including quality of products, customer satisfaction, employee training, and strategic planning.[19] As a recent Conference Board study indicates, some companies already rely on qualitative future value indicators such as: (i) quality of output, (ii) customer satisfaction and retention, (iii) employee turnover and training, (iv) R&D investments and productivity, (v) new product development, (vi) market growth, and (vii) environmental compliance.[20]

Each board can determine what types of qualitative information are relevant to the future of that particular corporation. It is unlikely that one list will fit all. Some of the items mentioned *supra* may be irrelevant or non-quantifiable, others useful. But the board's quest for qualitative indicators of future performance should be a useful exercise in and of itself.

There is "harder" information available that might be useful to a board in discerning the enterprise's future. Production rates, inventories, and shipments indicate the current status of the company; orders, buyer inventories, and forecasts of industry sales allow the board to anticipate changes. Such data can be supplemented by ongoing forecasts of costs and prices, leading to current evaluations of future returns on investments, division by division. The board can indeed go so far as to put itself in the place of an entity investing in the corporation by undertaking an updated present value cash flow analysis of the mainstream operations.

All of this is a long way of explaining that there may be information, both within and outside the corporation, that could help the board anticipate whether management has positioned itself for the future, whether future operations will meet, or fall short of, plan, and whether the plan is currently viable or needs revamping.

This is one professional way of going about the board's business of monitoring management performance. There are surely others for boards to consider.

ALIGNING COMPENSATION OF BOARDS, MANAGERS AND EMPLOYEES

Market economies are based on the assumption that most individuals act in their economic self-interest. An important issue for the board to address is how to align the self-interests of managers, directors, and employees with the interests of shareholders.

Certainly the board can develop strategy as to executive compensation to a greater extent than is found in current practice. To do so, however,

19. SUBCOUNCIL ON CORPORATE GOVERNANCE AND FINANCIAL MARKETS, COMPETITIVENESS POLICY COUNCIL, THE WILL TO ACT 19-24 (Dec. 7, 1992) (on file with *The Business Lawyer*, University of Maryland School of Law).

20. Carolyn K. Brancato, *Performance Measurement to Capture and Enhance Corporate Success*, CONF. BOARD 1995, at 13-21 (draft for comment).

will require less reliance on industry "standards" (what is everyone else paying), and more focus on compensation tied to share price and other indicators of performance unique to the corporation. There are many ways of achieving a package that is tied to corporate performance and more are invented each year by the use of stock options or more sophisticated financial derivatives. What is required is that executive decisions that positively affect shareholder value be rewarded in a systematic process. A professional board will approach this issue by recognizing its importance and its sophistication, and by recognizing that compensation should be tailored, by the board, to fit the unique needs of the corporation at each point of time. For example, if quality improvement is, at a given time, a major corporate imperative to improve shareholder value, why not tie incentives to measurable quality improvement, not just stock price?

Similarly, the board can, and should, compensate its own members to align directors' compensation with corporate performance. The recent Report of the NACD Blue Ribbon Commission on Director Compensation, which suggests compensating directors in at least some part with company stock, is one direction in which to move.[21]

The NACD Commission listed six practices worth considering by boards in determining board compensation, all designed to align director and shareholder interests:

(i) Boards should establish a process by which directors can determine the compensation program in a deliberative and objective way.

(ii) Boards should set a substantial target for stock ownership by each director and a time period during which this target is to be met.

(iii) Boards should define the desirable total value of all forms of director compensation. This overall level should be set in order to attract and motivate directors.

(iv) Boards should pay directors solely in the form of equity and cash – with equity representing a substantial portion of the total up to 100% – and dismantle existing benefit programs, while avoiding the creation of new ones.

(v) Boards should adopt a policy stating that a company should not hire a director or a director's firm to provide professional or financial services to the corporation.

(vi) Boards should disclose fully in the proxy statement the philosophy and process used in determining director compensation and the value of all elements of compensation.[22]

21. BLUE RIBBON COMMISSION, NATIONAL ASSOCIATION OF CORPORATE DIRECTORS, PURPOSES PRINCIPLES AND BEST PRACTICES 9-18 (1995) [hereinafter COMMISSION ON DIRECTOR COMPENSATION]. *See also* DIRECTOR'S REMUNERATION: REPORT OF A STUDY GROUP CHAIRED BY SIR RICHARD GREENBURY, July 17, 1995, at 40-43 (on file with *The Business Lawyer*, University of Maryland School of Law).

22. COMMISSION ON DIRECTOR COMPENSATION, *supra* note 21, at iii.

Eliminating existing benefit programs and paying directors solely in stock and cash, as recommended in "Best Practice Number 4," is consistent with a pay-for-performance approach. Stock-based remuneration directly links directors' interests to shareholders' interests, so that director compensation increases with improvements to shareholder value. It is not a radical notion. Most companies already include some stock-based component in the director compensation package. According to the Korn/Ferry survey, sixty-two percent of the companies surveyed compensate their directors at least partly in stock.[23] Moreover, the survey found unanimous agreement that at least some stock-based compensation is appropriate: eighty-nine percent said directors should be paid partly in stock and the remaining eleven percent believed directors should be paid *wholly* in stock.[24]

While there are strong arguments for stock compensation for directors, they are not perfect. Such plans have to be refined to motivate successfully directors to longer term growth, and to sharpen their concern for the value added of improved management. Stock grants can be programmatic (800 shares per year for example), but sales restrictions, or even postponement of sales until retirement, can focus the directors to longer-term performance. The most important drawback is that individual stock prices change with stock market performance more frequently, and by larger amounts, than they do because of increasing excellence of the company, relative to others in that market. Sophisticated instruments can be developed which factor out of the company's stock price changes: the co-variance with the market; the size of the company relative to average market capitalization; and other market determinants. The remaining "appreciation" of the share price would then be derived from the value added of improved management.[25] But this involves offering the director not only shares, but a "hedged" position in these shares from a basket of derivatives, an exotic that would give pause to many directors. Moreover, reliance on stock must take account of some desirable directors who will need more cash to induce them to serve (e.g., academics, former government employees, and others similarly situated).

In contrast to stock-based compensation, the traditional compensation package, based on an automatic retainer and attendance fees with generous perks and retirement benefits, is increasingly viewed as out of place.[26] Not only does it fail to provide performance-linked incentives, but it may encourage complacency and a loyalty to current management at the expense of shareholders' interests. Disfavor with elements of traditional compen-

23. KORN/FERRY SURVEY, *supra* note 4, at 17.

24. *Id*. at 22.

25. For the determinants of Stock Prices, see Eugene F. Fama & Kenneth R. French, *Permanent and Temporary Components of Stock Prices*, 96 J. POL. ECON. 246 (1988).

26. *See* COMMISSION ON DIRECTOR COMPENSATION, *supra* note 21, at 29-34.

sation has lead to a number of recent shareholder resolutions challenging director benefits – pensions, charitable contributions, life and health insurance – as having little or no connection to the director's individual performance, while being perceived as creating inappropriate incentives to support the status quo.[27]

How directors address the compensation issue implicates their credibility with shareholders. Directors are in the unusual position of determining their own compensation. It is for this reason that the NACD Commission suggested full disclosure to shareholders of the components of directors' compensation including disclosure of the rationale supporting these components.[28] Disclosure usually provides a valuable "check and balance."

The SEC has indicated in a July 1995 agency release that it is reviewing the NACD Commission Report to determine whether additional disclosure requirements are appropriate.[29] The release contains a proposal aimed at making director compensation information more accessible to shareholders.[30]

Pay-for-performance compensation systems can possibly be extended throughout the corporation, from the boardroom to the factory floor. Doing so pushes authority, responsibility, risk and reward, all attributes of ownership, upward and downward, to directors, managers, and employees alike. It is an approach that emphasizes the importance of the individual's contribution to the company's performance, while creating incentives for every corporate actor to contribute to the overall wealth of the enterprise. Extending the basic elements of compensation alignment from directors and managers on down to the factory floor may be difficult but it is far from impossible. Margaret M. Blair's book, *Ownership and Control*,[31] and Joseph R. Blasi and Douglas L. Kruse's book, *The New Owners*,[32] both describe a variety of means available to make stock performance a part of employee compensation.

Aligning economic interest and performance is an ideal subject for board prodding. It might yet be the board's most important contribution to the enterprise's success, and there is an enormous amount of thinking yet to be done to achieve this alignment. Professionals are not content with the status quo, but constantly search for better ways.

27. *See id*. at ix.

28. *Id*. at 19-21.

29. Streamlining and Consolidation of Executive and Director Compensation Disclosure, Securities Act Release No. 7184, Exchange Act Release No. 35,894, 59 SEC Docket 1610, 1612 n.17 June 27, 1995).

30. *Id*. at 1611-14.

31. Margaret M. Blair, OWNERSHIP AND CONTROL: RETHINKING CORPORATE GOVERNANCE FOR THE TWENTY-FIRST CENTURY (Brookings 1995).

32. JOSEPH R. BLASI & DOUGLAS L. KRUSE, THE NEW OWNERS (Harper Business 1991).

BOARD PROFESSIONALISM

The role of the board is expanding and is likely to continue to do so in the areas outlined *supra* and in others. This expansion is leading to, and ultimately will require, a more professional board: a board with standards for its own performance, with a sufficient knowledge base and expertise to perform, and with a constant dissatisfaction with status-quo thinking.

More specifically, as boards become more active and involved, the job of director will become more demanding and complex. The board, truly and more appropriately participating, for example, in strategic planning, monitoring management performance against that plan, and setting compensation at all levels to provide appropriate alignment with each other and shareholder interests, will require greater expertise and time-commitment. Directors will need ever-increasing company and industry-specific or other relevant expertise, and improved access to broader information about the corporation, its core industry, and the environment in which it functions. And as directors are required to pay greater attention to and expend more time on boardroom issues and to develop greater expertise about the business of the corporation, greater effort will be required in selecting directors having the requisite time, expertise, and commitment, in creating appropriate incentives for directors, and in providing adequate information and education for directors.

While we should not hear any significant calls for requiring "official" director certification in the United States, many U.S. boards will do their own certification simply through the process of selection and periodic performance reviews. They will seek competent, credible, knowledgeable candidates who are capable of, and willing to, do their homework.[33]

DIRECTOR SELECTION AND INCENTIVES

Board service, as noted, places increased demands on directors to understand the complexities of the corporation and its industry. Time demands on directors are thus increasing and will continue to do so. As a result, the traditional pool of CEOs who are looked to as director candidates may shrink. A CEO running his or her own company should not have the requisite time to commit to any more than one additional board, if that.[34]

As the pool of CEOs available as board candidates shrinks, boards will be required to broaden their search to find outside director candidates.

33. *See* Ronald J. Gilson & Rainier Kraakman, Reinventing the Outside Director: An Agenda for Institutional Investors, Presentation at the Salomon Brothers Center and Rutgers Center Conference on The Fiduciary Responsibilities of Institutional Investors (June 14-15, 1990).

34. But note that, at present, according to the Korn/Ferry survey, only 18% report that they had limited the number of boards on which their CEO could serve, generally to two other boards. *See* KORN/FERRY SURVEY, *supra* note 4, at 24.

Boards, as noted, should consist of "leaders" who are intelligent, energetic, curious, and credible. CEOs clearly fit the bill. And CEOs themselves might identify, as potential board members for other corporations, future leaders in their own corporation. Board service on other corporations for these future leaders can be a rounding experience. Other "leaders" can be found in universities, foundations, religious and financial institutions, the pools of former government officials, politicians, and recently retired CEOs and senior executives, and the "other" professions such as law.[35] All such candidates must be willing, however, actively to participate in the boardroom. There is no longer any room for directors with prestigious backgrounds and titles but who lack the capacity, energy, or interest to engage fully in boardroom deliberations.

A healthy by-product of a deeper and broader search for candidates may be increased diversity and fresher perspectives, as more women, minorities, and younger executives are invited to the boardroom.

As the position of director becomes more demanding, more effort will be required to create appropriate incentives for service. Certainly, the men and women who are of a caliber to be invited, and choose to accept, the challenging role of director are primarily motivated by what Chancellor William T. Allen of the Delaware Chancery Court has termed "soft concepts": pride, self-respect, a sense of service, and an understanding of the legal and social requirements of the governance paradigm.[36] Nonetheless, directors, like all humans, are also motivated by economic self-interest.[37] The Report of the NACD Commission referred to earlier duly recognizes the importance of self-respect and pride as motivating factors for directors' performance, but also recognizes that such factors exist in all professions.[38] Yet, the best in every field expect to receive remuneration commensurate with their skill level, their marketability to other organizations competing for their valuable time and expertise, and their productivity: that is, their ability to contribute to the overall wealth of the organizations which they serve.

As discussed *supra*,[39] directors should be compensated at a level to incentivize them to perform. This is a logical extension of the philosophy underlying the link of CEO pay to corporate performance and underlies the concept of alignment.

35. If the candidate has provided services to the corporation, however, he or she may not qualify as "independent".

36. Memorandum from Chancellor William T. Allen to the 1993 Tulane Corporate Law Institute, *Corporate Governance: The Internal Environment* 10-11 (on file with *The Business Lawyer*, University of Maryland School of Law).

37. *See* Robert Stobaugh *Director Compensation: A Lever to Improve Corporate Governance*, DIRECTOR'S MONTHLY, Aug. 1993, at 1 (on file with *The Business Lawyer*, University of Maryland School of Law).

38. *See* COMMISSION ON PERFORMANCE EVALUATION, *supra* note 5, at 13.

39. *See supra* notes 21-27 and accompanying text.

INFORMATION AND EDUCATION

As highlighted *supra*, increased involvement by boards in strategic planning and in monitoring and compensating managements' performance will require more expertise and better access to information.[40] Directors will need to rely on more than the information traditionally produced by senior management. Boards will spend more time seeking out additional relevant information about products, customers, suppliers, market conditions, et cetera, whether from corporate employees, institutional investors, or other independent sources. In this regard, a number of board guidelines and "best practices" documents envision directors contacting employees at various levels of the firm to obtain information. Caution is merited, however, because of the danger that employees will become confused about lines of authority. Therefore, it may be wise to keep the CEO apprised of such contacts.

A number of board guidelines and "best practices" documents promulgated both in the United States and elsewhere also call for improving corporations' in-house director orientations. With variations on depth, such programs seek to familiarize, or immerse, outside directors with information about the company's core businesses, competitive posture, and strategic plans and objectives. Such education is a critical component of being a director.

As to "how to" be a director in general, there is a growing industry developing. In the past two years alone, two respected centers of U.S. learning have developed education programs specifically targeted at directors: The Wharton School of Business' Directors Institute and Stanford Law School's Director College. These programs are in addition to the programs run by the National Association of Corporate Directors, and a myriad of other seminars and conferences hosted by consulting firms and publishing houses.

While director associations in Australia, the United Kingdom, and the United States all have programs for director education,[41] only the Australian program offers an accreditation course. A movement to director accreditation has not occurred in the United States, nor is it likely to.

So far, these programs, all part of the growing corporate governance cottage industry, primarily focus on board process: e.g., committee structures, meetings, guidelines, et cetera. In time, it is to be expected that the substantive issues about which more research and thought must be given (e.g., evaluation of future performance, strategic planning, aligning all compensation) will become subjects of organized programs.

40. *See supra* note 14 and accompanying text. *See also* COMMISSION ON PERFORMANCE EVALUATION, *supra* note 5, at 1-5; COMMITTEE CORPORATE LAWS, *supra* note 5, at 19.

41. *See, e.g.*, The Australian Institute of Company Directors (AICD); The Institute of Directors (IOD) in the United Kingdom; and the National Association of Corporate Directors (NACD) in the United States.

CONCLUSION

One practical note: the professionalism of the board can impact the treatment of the corporation in the courts. As the Honorable E. Norman Veasey, Chief Justice of the State of Delaware, stated:

> In the end, the issue is integrity, isn't it? Corporate governance depends on the integrity of directors and their counselors. If one skates close to the edge and a court repudiates either the directors' conduct or that of the lawyer or financial advisor, more than a transaction or a judgment could be lost. A reputation could be irretrievably damaged.
>
> That is why the corporate governance system is largely one of private ordering with its own internal checks and balances. Otherwise, one might expect to see an undesirable regulatory system in its place.[42]

In the United States, where corporate governance is largely left to the self-regulation of individual boards, and courts are willing to defer to the deliberative, independent decisions of boards under the business judgment rule, the movement toward more "professionalism" will surely better protect the corporation in its decision-making on all fronts.

But that is not the main reason, although a good one in this litigation-prone society, for the "professional" director. The author has long suggested that the corporation is a "useful economic institution that adapts reasonably well to changed circumstances, though perhaps not always with optimal promptness," and that "what is wrong with corporate behavior could be corrected with relatively modest evolutionary changes."[43]

Those evolutionary changes have been occurring over the last years, and by all appearances, will continue. As long as they continue to occur, the corporation, as the main engine of our market system, will remain credible and acceptable, as will the market system itself.

It will be the increasing professionalism of directors that keeps the evolution going.

42. The Honorable E. Norman Veasey, The Role of the Candid Counselor in the Empowerment of Independent Directors, Address to the American Society of Corporate Secretaries (Nov. 18, 1994), *in* CORPORATE GOVERNANCE ADVISOR, Jan./Feb. 1995, at 22.

43. John R. Meyer & James M. Gustafson, THE U.S. BUSINESS CORPORATION: AN INSTITUTION IN TRANSITION 227-28 (1988) (referring to Winthrop Knowlton & Ira Millstein, *Can the Board of Directors Help the American Corporation Earn the Immortality It Holds So Dear?*, (appearing in the same volume at 169-91)).