Chapter 1

Taking Back the Boardroom: Understanding your Duties as a Director

Directors are like the parsley on fish — decorative but useless.

Irving Olds, former Chairman,
United States Steel, April 1992

This chapter discusses the economic theory of the firm and the agency theoretic foundations for the organization of the boardroom. Appreciation for these fundamentals is critical for a director's understanding of his duties and obligations in the boardroom. I will first deal with the concept of residual claims, which will give directors a perspective on how to deal with competing claims when they arise in the boardroom. I will then discuss the question of control and the various mechanisms of control over management that are available to shareholders. The need and role of the board, as representatives of shareholders, is discussed and debated. The translations of the board's legal responsibilities into director's duties are also discussed, with particular attention to the economic and philosophical rationale for these duties.

How the Firm is Defined and Why is that Important for Directors

There are three broad definitions of the firm that come from economics, law, and sociology. From the perspective of economics, the firm is a production function. Simply put, it is the embodiment of a technological (broadly defined) transformation of inputs (capital, raw materials, human effort, and talent, etc.) into outputs (goods and

services) for which there is an imputed value (price) in the marketplace. This 'production function' can exist in many contexts and forms. For example, one could broadly define a strategic alliance as a production function, in which there is no physical manifestation of an organization as long as it embodies a technology that transforms inputs into outputs for a price. Yet, it is not technically a firm, unless it has a specific legal form. Here, it has to be stressed that the legal definitions of the firm should be treated separately from the economic definitions of the firm. While the former has implications for the fiduciary and statutory duties of directors, the latter has important implications for the *moral* duty of directors.

If the firm is a production function, then it stands to reason that the *raison d'être* of the firm is the transformation of input to output. There can be no other. A firm that produces goods and services for which the imputed value is less than the cost of production is one that is not fulfilling the purpose of its existence. Hence, this conceptualization of the firm takes as its ultimate measure of success the *efficient* transformation of inputs into outputs.

Given that the firm is a creation of the law, its survival depends on its legitimacy conferred by society. As long as society regards the firm as the primary means of wealth creation the maximization of efficiency is the only way the firm can retain that legitimacy. Therefore, in this view of the firm, the moral duty of a director is to ensure the maximally efficient use of the firm's resource.

The second definition of the firm views the firm as a nexus of contracts. This definition embodies the legal manifestation of the firm, which acknowledges that all firms exist in contemplation of the Law. The firm is where the exchange of wages for human effort, capital for return, and technology for money take place. Under this definition, the firm is reducible to a set of contracts so that the main purpose of organization is the assurance of the integrity and discharge of these contracts. One way to fulfill this purpose is for managers of the firm to expend the resources to write complete contingent claims contracts, defined as contracts that cover all possible contingencies to an agreement in all possible future states of the world. However, it is often uneconomical, perhaps even impossible, to specify complete contracts because the information to create

such instruments required may not always be available or may be very costly to obtain. Therefore, it must be possible for parties to *re*-contract, defined as the re-specification of contractual terms given changes in the original conditions of the contract. In order for re-contracting to be possible, there must be an adjudicator that guarantees the integrity of the re-contracting process such that contracting parties are not exposed to the risks of holdup. This *contracting governance* mechanism is the board of directors. In this view of the firm, the law imposes statutory and fiduciary liabilities on directors in recognition of their duties to protect the firm's implicit and explicit contracts and to protect the re-contracting process when necessary.

The third definition of the firm is that of a social organization. There is increasing realization that a firm is a place where people meet to exchange specific information for the purpose of engaging in production. However, given the human dimension of the 'firm', non-economic considerations have become important to the firm's effective functioning. The reality of the merger between home and work has now manifested itself in such organizational innovations as telecommuting, paternal leave, and workplace day care. Sociologists recognize the firm as a community of individuals who collectively create an ethos, which provides the context for production. The idea of the social organization goes beyond the simple idea of a nexus of contracts because contracts assume definable outcomes, delimited time periods, specific geographic boundaries, and calculable payoffs. As a social organization, the firm has a character and a conscience, leading the way to view directors' duties from a moral dimension. In addition, the firm as a social organization also implies that it can only succeed when the stakeholders that comprise this organization are recognized and their claims are met. This last view of the organization has been less popular among those who think about corporate governance in Common Law jurisdictions. However, in countries like Japan and Germany, it is the central view of the firm, leading to a stakeholder approach to corporate governance, where the primary duties of the director is the arbitration of the competing claims of stakeholders to the wealth created by the firm.

In this book, we define the firm *primarily* as a production function, so that its purpose is the efficient transformation of inputs to outputs

for a price, secondly as a nexus of contracts and lastly as a social organization. This is because unlike definitions that can be applied to other forms of organization such as the government, charity or social club, the firm's role as a production function is unique in human society. Thus, the duties of directors can be similarly prioritized according to these definitions. In order to fulfill these purposes, the firm employs technology, contracts with the providers of capital and labor, and identifies market opportunities in which the value of the output can be realized to its maximum.

How does the Firm Perform its Productive Function?

In order to engage in production, the firm must make decisions on how it will allocate its resources. The decision process can then be divided into four components. Decision initiation is the process of planning the allocation of resources. This often takes the form of a business or strategic plan or budget. After a plan is formulated, it has to be checked for consistency with the firm's stated mission, which is the process of decision ratification. Ratification ensures that the stated objectives of the firm's mission are reflected in the investment decisions proposed by management. Thus, a firm that is supposed to be in banking should not become distracted as real estate investors unless this business allows the firm to be a better bank. Implementation describes the entire process involved in translating the plan into action. This is an ongoing process and often, directors ignore the limitations that prior implementations of the plan can have on future possibilities contemplated by the plan. Finally, the entire production function has to be monitored. That is, someone has to ensure that actual results are consistent with planned results and deviations are investigated and corrected.

The processes of initiation and implementation are collectively known as decision management. Decision management falls within the preserve of the top management team. These powers are delegated to management by the board of directors by virtue of the specialized knowledge possessed by the management. The processes of ratification and monitoring are collectively known as decision control. Decision control falls within the purview of the board. The board

retains these powers for itself because it is ultimately liable for the decisions taken by top management. Thus, the separation of management and control, which is taken up in more detailed later ensures that specialized knowledge can be applied to the greatest benefit while accountability is maintained.

The Relationship Between Managers and Shareholders

In 1934, Adolph Berle and Gardiner Means articulated an important phenomenon that they observed in the evolution of the modern corporation. They noticed that with the growth of the firm came an increasing need for capital to engage in production. The rise of technology in production ensured great benefits from economies of scale. Thus, those firms that could command the most capital (investments) were more able to compete effectively against those who lacked similar capacity. As the need for more capital increased, the ability for an owner-manager to supply all of the monetary requirements of the firm decreased. This meant that capital had to be accumulated from an increasingly large number of individual investors, leading to dispersion in the concentration of ownership (i.e., more people holding smaller amounts of shares in the firm). The dispersion of ownership led to a condition in which owners of the shares become atomistic and anonymous, thus less able to co-ordinate among themselves to monitor the actions of the management. As a result, the relative discretion of managers over the disposition of the firm's resources increased, making them the *de facto* owners. However, these 'owners' were different from those who truly owned shares in the corporation. The true owners were exposed to the risks inherent in the businesses of the corporations in which they had shares. Thus, they were concerned with the efficient deployment of the firm's assets. These 'manager-owners' were not exposed to such risks since the costs of the decisions they made were borne by the true owners. Therefore, these managers could make self-serving business decisions with impunity. Many of these decisions hurt the shareholder.

What sorts of decisions benefit the management but can hurt the shareholder? More than 35 years of empirical study on how managers

are compensated has resulted in a single conclusion. Management pay is directly related to the size of the firm but never with profitability. We know from similarly well-established empirical research that firm size, regardless of how it is measured (sales, numbers of employees, assets, etc.) is not always positively related to productive efficiency. In fact, every time there has been an economic crisis, such as the 1997 Asian Currency Crisis or the post-9/11 airline industry crisis, we witness the massive downsizing of giant corporations due to the fact that they often have excess capacity, idle assets, and bloated payrolls that create costs without corresponding productive output. The result is the oft-observed phenomenon that managers, because they are free to allocate resources in any way they see fit, tend to accumulate assets beyond their efficient scale, so they can justify ever increasing levels of compensation and perquisites, with asset size as the justification.

Shareholders only gain when the residual value of the firm, defined as the net of cash flows after positive economic value future investments have been made, is maximized. Beyond some efficient scale of production, given by available technology, the size of the firm's assets matter little to the shareholder. Hence, for the shareholder, because efficiency, and not size, translates into wealth gains, the manager's decision to keep accumulating assets (i.e., grow the firm) can ultimately prove very costly. It is how the firm's productive capacity is employed, and whether it generates a net positive profit that determines the residual value. If the residual is small, the owners keep little. If the residual is large, the owners benefit accordingly.

Thus, the crux of the corporate governance problem can be summarized as the continuing struggle between those who manage the capital assets of the corporation and those who are exposed to the underlying risks of mismanagement (i.e., the owners of these assets). More pointedly, whoever controls how the residual is allocated ultimately wins the struggle. It has been the contention of corporate governance thinkers, particularly those in the Anglo-American legal tradition that owners of the capital have been losing in the struggle to the managers of the capital, because of the formers' inability to coordinate their actions to bring pressure to bear on management. This

struggle is known as the agency problem, and defines the continuing relationship between managers and shareholders to this day.

The agency problem

In the agency theory of corporate governance, those who manage the firm's resources act as agents of the shareholders — owners of those resources. A standard agency relationship is governed by contracts. These contracts specify the terms of performance and duties of the contracting party. They may also specify the processes by which performance is to be achieved. Contracts are generally well-defined in terms of timing, scope, and redress for non-performance. However, agency contracts between the shareholder and manager are very costly to write and enforce. Firstly, the managers have the skills and knowledge not possessed by the shareholders. This information asymmetry inevitably leads to the misspecification of performance standards for the managers. Secondly, monitoring is difficult because shareholders are not able to observe everything that a manager does. Thirdly, even when problems are detected, redress is difficult because co-ordinating the actions of all the shareholders, who may be widely dispersed, is very costly. For example, the record of successes in shareholder proxy battles has been dismal. Even shareholders with significantly large blocks of shares have had little success in replacing a poorly performing management team through the proxy battle.

Information inefficiencies faced by shareholders also lead to a decline in transparency and a loss of accountability. When a shareholder cannot accurately determine the point at which the managers stop maximizing the efficiency of the firm, it is not able to take specificaction to halt the erosion in the value of the stock. Even when it becomes apparent that the management is not doing its job, all the shareholder can do is to vote with its feet by selling the stock. By this time, however, the value of the shares would have already declined, and the owner would have lost money in the investment. Further, selling stock is not an effective way of directly dealing with managerial excess unless there is a run on the stock of a company, which is

unlikely in most situations. Selling stock is merely a way to avoid more losses.

A different but related issue to the expropriation of shareholder wealth is observed in emerging or small economies such as China, India, Canada, northern Europe, and South America where ownership is concentrated in the hands of controlling shareholders such as the government, family members, and entrepreneurs. Here, minority shareholders face an even thornier problem. The combination of informational inefficiencies and the inability to co-ordinate effectively can potentially lead to the expropriation of the minority shareholder's wealth *by the controlling shareholder*, leading to what is now known as the 'principal–principal' problem. Because a majority shareholder does not own all of a company's stock capital, it does not bear all of the costs resulting from poor decisions. A proportionate share is borne by other minority shareholders. However, because the controlling shareholder holds sway over the voting stock, it can often force the board of directors to approve inordinately risky decisions, which may generate extraordinary returns in the short run but at the expense of the other bearers of risk, the minority shareholders. During the 1980s and early 1990s, families and individuals controlled many of the banks and financial institutions in Thailand and Indonesia. Several of these banks were publicly listed corporations, but with a minority of their equity stock in the market. During the Asian Crisis of 1997, many of these banks became insolvent, in great part due to the general poor quality of their loans, and to the unsecured loans made to companies owned by their controlling shareholders. The minority shareholders, who had no power over these decisions, ended up paying part of the bill and lost all of their investments. Again, those who control the use of the flow of resources control the use of the residuals stemming from their use. What are the solutions to this problem?

Managing the agency problem

Broadly, there are two categories of solutions for managing the agency problem. In the case of the large, public corporation with dispersed share ownership, the board of directors represents shareholders who

cannot exert influence on management. This is known as an internal mechanism of control. It relies on the expertise and goodwill of corporate watchdogs to protect the interests of shareholders by ensuring that managers abide by the principles of efficiency maximization. The other is external mechanisms of controls. Here, the behavior of managers is indirectly constrained by the workings of competitive markets for product, labor, and capital that punish the company when it systematically deviates from efficiency maximization.

The notion of the separation of ownership and control is the centerpiece of Professors Fama's and Jensen's (1976) seminal article on agency theory and the theory of the firm, in which they stated that such a separation is critical to the efficient functioning of the corporate governance system, because it led to the specialization of risk bearing and managerial expertise. Managers cannot fully diversify their human capital risks from exposure to a firm's systematic risk, defined as risks resulting from non-controllable industry related factors, such as seasonality and technological change. Therefore, managers need to be indemnified against such risks, or they will not take the job of managing companies with high levels of systematic risks. Indemnification usually comes in the form of sufficient basic non-contingent (or fixed) compensation. If managers are not indemnified and they take such jobs, they are likely to make decisions to minimize systematic risks, such as diversifying corporate assets into unrelated businesses, in which they may have little or no managerial expertise, to smooth out the variance in cash flows, a major contributor to risk. The Korean conglomerates or *chaebols* are well known for such 'smoothing' strategies. Hyundai, a family-owned conglomerate, has businesses in numerous industrial sectors ranging from banking to automobile manufacturing, home building, and electronics. In the late 1980s, many of the US conglomerates began a wave of *deconglomerization* that lasted well into the 21st century. Parts of corporations were sold to other companies for which these parts represented core businesses or technologies and were therefore more valuable. Yet others were taken private in transactions known as the leveraged buyout. Yet others were spun-off as free standing public companies through the Initial Public Offering process. Such decisions

resulted from the desire to focus on core competences in the corporations' most important businesses to maximize returns on capital invested.

Owners, on the other hand, can easily diversify their systematic risks by holding on to a portfolio of stocks in unrelated companies. However, they cannot diversify their unsystematic risks, defined as the risks specific to the company, such as those associated with poor management, antiquated technology, and bloated organization. Hence, because they cannot engage in the active management of every company they own, shareowners need to rely on the expertise provided by the professional manager. This system of ownership and control allows the owner to specialize in risk bearing through the diversification of stocks, and the manager can specialize in the deployment of productive resources through his expertise.

In a large and complex firm where the means of production are spread throughout the firm, the knowledge that renders a production technology useful is held in the brains of many people. Therefore, individual employees' claims to the wealth created by the firm are settled via employment contracts and paid out in the form of salaries. The residual, which shows up as cash flows net of obligations and reinvestments belongs to the shareholders (risk bearers) and is usually disbursed in the form of dividends or stock buybacks. In order to ensure that the residual is protected and paid out, rather than squandered on non-value creating ('empire building') projects, the shareholders appoint a board of directors to represent their interests. The board protects the interest of the shareholders by ratifying managerial investment decisions, and acts as a liaison to convey shareholder preferences to management.

The external control of the firm

The management of a firm is also disciplined by market-based mechanisms that rely on the operation of an external market for the supply and demand of managerial talent, corporate assets, and goods and services. The business of Business is to transform labor, minerals, and technology, into saleable goods and services. In doing this, Business

adds value to otherwise unusable raw materials. Those who do this at the lowest cost or can add the most value to raw inputs get to do it again (and again). Those who cannot are put out of the game. This competitive process occurs continually, so that when management misreads the market and produces the wrong product for sale or sells at the wrong price, resources are misallocated and shareholder value is destroyed. An example of such mismanagement is the failure of executives in the US automobile industry starting from the 1970s to read the signs broadcasted by the marketplace. They missed watershed customer demands for fuel efficiency, price, and reliability in automobiles; instead choosing to focus only on product design. As a result, billions of dollars of shareholder wealth has been destroyed, and thousands of jobs lost. A typical passenger car made and sold by the Big 3 (Ford, General Motors and DaimlerChrysler's United States division) loses an average of $1,500 (2007 dollars) at retail. Contrast this to the Japanese automakers, most notably Toyota and Honda that turn a profit on every sale. In 2007, the Big 3 planned more than 30% cuts in the US production capacity while Japanese automakers planned to double US capacity. Simply put, it is virtually impossible for firms to succeed when they try to make a product that customers do not want to buy.

The second type of external control is the market for managerial labor. Given that every firm has only one CEO and a small group of top executives, the market for top level managerial labor in any economy is relatively small, and therefore efficient. The performance of a CEO today determines his employability and command over salary tomorrow. Thus, in the long run a CEO that consistently performs poorly will soon lose the ability to become employed in the same position or at the same salary.

The third type of external control is exercised through market competition for the control of corporate assets. When firms fail to operate in a manner that maximizes efficiency, competition in product and factor markets forces the firm to take reduced margins as a way to compensate for lower quality. If these signals are ignored, and management fails to turn the situation around, the market for corporate control initializes a hostile tender offer or takeover. This may

result in change of ownership, the board acting against an existing management team, or a stockholder initiative proxy battle for seats on the board. In 2005, Kirk Kerkorian, well known billionaire activist investor, acquired more than 5% of the stock of General Motors through his investment firm, Tracinda Corporation. The shares of GM jumped when he successfully placed a director on the board to represent the interests of financial investors such as Tracinda. As a result the GM board began a program of restructuring in which product lines were trimmed, plants were closed and workers laid off, in an attempt to make the company profitable. The restructuring continues today, albeit at a slower place when Mr. Kerkorian, impatient with the pace of change, sold all his shares for a small profit.

A more likely scenario is when entrepreneurs in the form of private equity funds are willing to offer large premiums over market prices to gain control of the shares of an under-performing company, because they believe that they can utilize the assets of the corporation much more effectively than the existing management. The very large size of some of the premiums (sometimes in excess of 60% during the 1980s in the US) over share prices that have been offered in takeover situations is clear evidence that firm performance often deteriorates to very low levels before existing management and directors recognize, let alone do anything, about the problems.

Historically, the management of large enterprises seldom feared the possibility of a hostile takeover in Europe and Asia as the illusion of stability due to size masked the significance of such threats. Case studies, such as the record breaking US$25 billion takeover of RJR-Nabisco, and examples from industries as diverse as real estate to retail to airlines teach us that such threats were seldom salient to management when there had been no history of such activities in the industry or the firm. Furthermore, in many parts of the world, including Canada, the pervasiveness of controlling shareholders effectively prevented potential acquirers from obtaining majority stakes in many of these companies. However, these companies' inefficiencies eventually catch up with them in the era of globalized competition, and financial crises. The activities of Mr. Kerkorian and private equity funds, such as Kohlberg, Kravis, Roberts & Co., Blackstone, Clayton Dubilier,

Texas Pacific Group and others, who control hundreds of billions of dollars in buyout capital, have served noticed to corporate boardrooms around the world that no company is too big to be taken over, and no company is too small to be noticed.

In the US, it was not until the advent of the leveraged buyout (LBO) in the 1980s that boards and managers began to realize that they could lose the iron hold they enjoyed over their companies. Nowadays, most boards in the US operate on the premise that their companies are potential takeover targets. In the 1990s, the LBO movement spread to Europe, following the entry of American capital to finance the wave of mergers in telecommunications, airlines, utilities, and manufacturing. With this have come American-style corporate governance and its implications for boardroom behavior and shareholder activism. In Asia, with the entry of foreign institutional capital from the US and Europe to exploit growth opportunities, the pressure for more shareholder-friendly corporate governance is also increasing. Nowadays, a proactive board will often put in place a regular program of share buybacks or special dividends in order to boost the stock price to reduce the threat of takeover. Such strategies are particularly useful for companies that compete in stable, matured businesses where cash flows are predictable and plentiful.

While there has been much written, for and against, the consequences of unfriendly takeovers, empirical research by Michael Jensen of the Harvard School, Stephen Kaplan of the University of Chicago and others generally suggest that when control is taken from an existing group, the result of a change in ownership is usually an increase in value for the shareholders and a more efficient operation of the enterprise. The summary evidence strongly suggests that the market for corporate control, when it operates properly leads to a more effective use of resources within the firm.

External control or the board of directors: which is better?

Effective as markets always are in forcing efficient allocation of resources in the economy, they often are very slow to enforce a remedy. In very large organizations, such as General Motors or IBM, the

possibility that management misuse of resources escapes immediate notice is significant. Large organizations are often able to bury their errors by using up slack resources, naturally accumulated during periods of growth. Additionally, expenditures in diversification, capital expansion, and corporate empire building are easy to justify and make when the firm does not need the public financial markets for help. Finally, dealing with the daily pressures of running a giant corporation often means that executives manage by exception. Indeed, problems are often not discovered and assessed until the loss of market-share, declining earnings and a sharp drop in the market value of shares is so acute that even the most obtuse of directors realize that something must be done.

The empirical research on takeovers has exclusively dealt with the returns to takeovers, not the returns to the *threat of takeovers.* The theory espoused by Michael Jensen of the Harvard Business School is based on the threat of takeovers as a disciplining mechanism. It is this threat, and not the takeover itself, that prevents managers from making self-serving decisions that hurt the shareholders. The takeover is merely a corrective device, which serves to reverse some of the mistakes made by the management. This distinction is important because such market-based mechanisms operate in crude ways. Takeovers are blunt instruments at best; they often come too late because market signals are noisy and can be unreliable, and the eventual corrective measures are often very severe and disruptive to a firm's normal operations. Furthermore, the takeover market has generated a substantial amount of unpopular political fallout, causing an anti-takeover sentiment among legislators in America, which may serve to increase the illusion of invulnerability among firms that have not yet had to face the threat. If the purpose of corporate governance is to maximize the efficient use of resources, then market mechanisms fall short, because they do not prevent or curtail managerial error, but only act to correct it when it becomes too severe, after the losses have already been incurred. At the very least, it disrupts a firm's normal operations and the costs of a takeover often force shareholders to pay heavily for the privilege of exercising their rights of control over the management.

There is no doubt that managers cannot escape from external market mechanisms in the long run. Such mechanisms eventually work to correct the misuse of resources to make firms more competitive. But they are expensive and far from perfect for achieving the desired results. Often, they only correct failings when they have become incredibly severe and after the costs of these failures have already been incurred.

A superior way of assuring efficiency is through the effective governance of the enterprise by the board of directors. Rather than relying on the markets for control to bring efficiency, shareholders should rely on, and expect, effective boards to assure that their firms are operated in an optimally competitive fashion. There are many reasons why this is true but probably the most important is that information is always more complete and reliable within the firm than outside it. Strategic plans are often not revealed in their entirety to market analysts and institutional investors. The probability of success of a research and development (R&D) effort can only be roughly estimated from the outside, whereas scientists working in the firm will have a better grasp of the odds. Finally, many R&D efforts are closely guarded secrets, especially when the payoffs are as great as in, for example, the pharmaceutical industry.

Recognizing this, most stock markets now have in place laws against the trading of company stocks on insider information. In emerging economies, the enforcement of such laws are beginning to be taken seriously by the regulators as they compete for the listing of company stock in their domestic markets. The practical implication of why insider trading laws exist is that financial markets are only able to make judgments about the enterprise as a whole whereas the governing body of an organization can judge individual components of the business. This means that the board and ultimately, management, can take corrective action on those areas of the firm that are not performing, before the market detects the problems. Clearly good management can detect signs of corporate trouble early, address it, and thereby prevent small problems from becoming major ones, which may have to be dealt with through harsher corrective actions, such as executive dismissals, or in battles for control. Furthermore, because internal information is superior, the range of actions that can be taken

is much greater. These actions themselves are finer grained and more discriminating.

In sum, the advantages of a well-functioning board render the monitoring and controlling of the enterprise far less costly for the shareholders, which means they get a higher return for their investments. Shareholders do not need to bear the cost of bankers' and lawyers' fees in a takeover battle. They do not need to pay for the costs of temporary inefficiencies caused by the disruption of routine activities in the enterprise, and finally, they do not need to deal with the costs of negative publicity, adverse reactions of suppliers and customers against uncertainty caused by the takeover, and the costs of government intervention. Thus, it is economically more efficient to have effective boards than effective takeover markets. To have effective boards, boardrooms need effective directors.

The Duties of the Director

So, who are the directors? Where do they come from and what are their roles? Directors have been variously defined as the top echelon of the corporation, the 'controlling mind' of the corporation, and the 'conscience' of the corporation (Gillies, 1992). Within a board, there are two categories of directors. Executive directors or inside directors, as they are known in the US, are those who hold an executive position in the company, such as Chief Executive Officer, Chief Financial Officer, or Chief Operating Officer, in addition to holding a board position. Non-executive or outside directors are those who hold a directorship, but are not involved in the day to day running of the company. Depending on jurisdiction, such as civil law countries, executive, and non-executive directors may have different status under the law. However, in most common law countries, they have the same liability exposures and, therefore, are conferred the same status. Within the general category of non-executives, a controlling shareholder, or significant shareholder may appoint some directors. Known as nominees these directors may also be in the employ of the controlling shareholder. Being in the employ of a third party while acting as a fiduciary for another can lead to potential conflicts of interest — a

problem I will discuss later in the book. In Asia and Europe, some boards are known to have alternate directors, to take the places of the primary directors in meetings when they cannot be there. Under Common and Civil Law, there is no distinction between directors and alternates, as long as they are in the position of directing the affairs of the corporation. Therefore, although an alternate appears to have less power and authority, he does not have less liability.

Directors are in place to adjudicate the strategic plans of the corporation, ensure that resources are allocated with the view to maximizing the economic value of the corporation, and protect the interests of all shareholders. Thus, they are given full rights to hire and fire management, declare dividends, acquire, and dispose the corporation's assets, and if need be sell or wind up the corporation. Commensurate with these rights are moral and legal duties, from which flow liabilities.

Directors are bound by categories of duties. The first duty, which is a direct result of the agency theory of corporate governance, is the duty of loyalty. The second duty is related to the first, and this is the duty of care. The twin duties of loyalty and care define the duties of a fiduciary. In addition, society may impose additional duties to the directors, for example to protect the environment, human rights, gender rights, etc. These are known as statutory duties. In the Common Law, a director has unlimited liabilities with respect to the assets of the corporation. Thus, a director can be held personally liable for the recovery of taxes, back pay, or criminal action resulting from the company's activities.

However, in recognition of the weight of such liabilities, the law provides for specific ways a director can discharge his duties. Thus, if a director can show due diligence in making a business decision, even when the outcome is negative, the law will generally consider the director to have discharged his duties appropriately. For example, the Delaware Incorporation Act provides relief to directors who can show that they were not intentionally negligent or criminally motivated when failing to discharge their duties. Such relief is popularly known as the Business Judgment Rule, which is a legal stance that the Delaware Chancery Court has taken in which it deems itself incapable

of assessing the *business* decisions of directors and, therefore, can only make judgment on the proper discharge of the directors' fiduciary and statutory duties. By keeping sacrosanct the 'corporate veil', the Delaware Chancery adheres to the long held tradition of 'caveat emptor' — investors have the right to be protected from fraud and misappropriation but not from the inherent risks of investing.

A duty of loyalty demands that a fiduciary shall not engage in practices that directly or indirectly harms the interests of his principal. In legal terms, the duty of loyalty test addresses issues of conflicts of interests, and self-dealing. This precludes fiduciaries from enriching himself at the expense of the principal. Declaring management bonuses and stock options with low or no performance hurdles is an example of self-enrichment. The annual debates over Chief Executive Officer (CEO) compensation in the United States and Britain are indicative of the controversy surrounding the performance of boards in this area. The duty of loyalty also implies that a fiduciary is in a monogamous relationship with the principle. Thus, whenever a person owes fiduciary duties to two parties that transact with each other, he is in a potential conflict of interest. For example, in 1990s case involving Air Canada and Canadian Airlines, two executives from PWA Corporation, the parent of Canadian Airlines, were found to have breached their fiduciary duties because of their positions as nominee directors on Gemini Corporation, a provider of Central Reservations Systems (CRS) for the airline. In this case, PWA was negotiating a merger with American Airlines that would have effectively closed down Gemini. The two executives who knew of the impending move did not inform the board of Gemini. If the nominee directors had informed Gemini, PWA could have taken them to court for violating their fiduciary but because they did not do so, were found guilty of breach of fiduciary to Gemini. Such conflicts are no-win situations for the director. He must either resign from the board before the event or be indemnified by the nominating principal.

The second duty a fiduciary owes is the duty of care. The duty of care is a more stringent test of performance, because it does not only enjoin the fiduciary from self-dealing and adverse action but also demands that it acts in ways to protect and enhance the principal's

position. Therefore, it is not good enough for a board to behave legally, but it should also act beyond the minimum standards of performance to make the very best decisions it is able.

A well-established body of thought, known as the shareholder sovereignty or shareholder capitalism, developed in the late 1990s in the United States is based on this concept of the duty of care. Generally, a fiduciary is defined as a trustee of the company so that in the same manner of a trusteeship, his powers and responsibilities are complete and wide-ranging. The notion of trusteeship, however, can lead to a great deal of ambiguity, because it is unclear to whom the director is responsible for the firm's assets and under whose strictures should the disposition of these assets be made. Hence, in the US, legal scholars and economic theorists have advanced the concept of agency to define and narrow the director's powers and responsibilities (Fama and Jensen, 1976). An agent has a clear duty to represent the interests of the firm's shareholders. Agency theory, as espoused by Jensen and Meckling (1976), places the responsibility for the protection of the shareholders' wealth squarely on the shoulders of the directors.

Discharging the duty of care is critical to the survival of the corporation, because if shareholders no longer have confidence that the board is acting in their best interests, they will no longer invest, with the consequence that capital cannot be accumulated and production will cease. The criticality of confidence is starkly illustrated by the precipitous collapse of stock markets around the world through the 1990s and 2000s whenever investors lost confidence in management to deal with the global exigencies of currency risk, political instability, and energy prices.

Most jurisdictions impose additional duties on directors. These stem from various community and country-specific laws dealing with taxation, environmental protection, labor rights, community citizenship, accounting disclosure, and business practices. In many parts of the world, domestic and international companies are exposed to compliance risks associated with employment health and safety legislation, tax laws, public company listing requirements, financial security legislation, national security and defense acts, and anti-corruption

laws. In the US, for example, directors can be sent to jail under the Corrupt Practices Act, if their companies are found have engage in the bribery of foreign government officials. The directors of Lockheed Corporation were found criminally liable for bribing Japanese officials in a scandal that rocked the defense industry in the 1980s. In Europe (notably Germany), environmental and labor health and safety legislation also impose criminal penalties on directors of corporations found guilty of violations.

Discharging your duties as a director

In considering the number and depth of risks to which directors are exposed, it might be reasonable to ask if any director can hope to fully discharge his duties even with the best of intentions. The key to discharging ones duties in the boardroom is to be attentive to the information that flows from the executive. Such information can be strategic (relating to market and competitive position), financial (relating to risk exposures and capital structure), operational (relating to compliance with statutory obligations), and external (relating to shareholder relations, and social responsibility). The director must be seen to be actively dealing with such information by actively seeking it before and during board meetings, evaluating the information during board and committee meetings by asking questions, and acting on the information by actively engaging the management in their decision making and being present to vote on resolutions.

The director is to actively communicate his thoughts regarding the company with the board and its chair. If a director feels that things are not right or that some practices by the company are questionable, he/she has a duty to raise objections and have them reflected in the Minutes of the meeting. This is important, because the Minutes represent the thoughts and intentions of the board, and are often the first place that a court will look to assess a director's attention to his duty. In addition, directors may also keep personal notes during board meetings, including his thoughts at the time the decisions were made. Such notes can be entered into evidence as corroborating evidence.

The director should also expect and comply with formal processes for dealing with contingencies, such as takeover bids, unexpected financial losses, and the loss of important executives. He should be seen to be competent, particularly within his sphere of expertise. Although directors are often treated as a group, a director with a known expertise in a particular area will be called to account at a higher standard of performance. For example, if the case is about a company's breach of duty in the area of financial management, then directors who are financial experts will be asked tougher questions on their performance. The key principle governing such standards of performance is the duty of care. All directors are required to exercise the duty of care, commensurate with his area of expertise and sphere of influence. Thus to discharge his duties, a director must be actively involved in the monitoring of management, and the taking of decisions that lie within the domain of his expertise and general duties as a director.

The Non-Executive Director: Key to Board Independence

The most important role that a director can play on the board is that of monitoring and rewarding the management. The non-executive director is best positioned to play this role simply, because there is a natural conflict of interest when an executive director is called upon to evaluate his Chief Executive. The non-executive director can more easily maintain an arms-length relationship with the CEO, and therefore, act with a greater degree of independent thought. In fact, the effectiveness of the individual director depends on his ability to act independently, which in turn contributes to board effectiveness.

The effective board is an independent board. It operates transparently — a state of affairs in which the decision-making *processes* of the board are easily understood by outside parties. This does not mean that every decision of the board has to be subject to public scrutiny. What it does imply is that over time an intelligent observer can detect the logic behind a board's decisions, and conclude that the logic is internally consistent with the business goals of the corporation.

An effective board is also one that takes full responsibility for its own actions and those of the firm's officers. However, unless the board is independent of the influence of management or the majority shareholder, it cannot make this claim because its decisions would be prejudiced.

$64 million question: So what IS director independence?

Having reviewed the research on corporate governance and consulted with numerous boards on this question, I have concluded that director independence is not solely an issue of boardroom structure or process. Having the right structures *and* processes are important, but it is also critical that directors possess the right personalities and values to *act* independently. Independence consists of the feeling of freedom to express personal views in the boardroom and the freedom from undue influence by the top management team or a controlling shareholder. The feeling of freedom coupled with a willingness to express personal views is particularly critical, because the boardroom is typically small, between 6 and 14 people. In such situations, the probability for a strong willed individual, such as the CEO, to impose himself on the group is high, and this probability is increased when the board meets infrequently and has to rely on management for information before taking decisions.

The willingness to express personal views depends on a director's personality and character of will. In addition, the Chairman must also create a boardroom culture that promotes the feeling of freedom. The role of the Chair is to mentor directors and encourage active participation in boardroom discussions. He does this to mitigate the devastating effects of 'groupthink'. Groupthink is phenomenon in which individuals in a group feel too intimidated, either because of ignorance or lack of preparation, to exercise independent thought, choosing instead to follow presumed group norms. The Nazi regime in post-Weimar Germany, the intelligentsia during the Suharto regime in Indonesia, and the political center during the Tiananmen Massacre in China are all stark examples of groupthink gone awry. A similar situation can often be seen in the boardroom of a company facing a takeover, bankruptcy,

or morally challenging decision. The independence of the board is compromised when individual directors refuse to exercise their legal right to voice concern. Therefore, an effective board must have directors who can think independently because they possess the right knowledge, skills and attitudes toward their fiduciary duties.

Board independence is also achieved through the use of appropriate processes and structures in the boardroom. A worldwide movement has risen to deal with this issue through the development and promulgation of codes of best practices. In these codes, two of which are illustrated in the Appendix (the original Cadbury Code and the OECD Code) independence is defined as boards with effective committee structures, well-defined and formal processes with feedback loops, and performance standards oriented toward maximizing shareholder value.

In spite of the external controls imposed on the firm by the marketplace, there should be no question on the central role that directors play in the governance of today's corporations. This role has heretofore been neglected because directors, as a group, have remained largely invisible, preferring to do their work in the background. This has changed dramatically in recent years, largely due to the early 1990s recession in the US, the Asian Crisis in the late 1990s, the Internet bubble collapse in the early 2000s, the advent of cross-border mega mergers (e.g., Daimler-Benz of Germany and Chrysler of the US), and the rise of aggressive private equity investors more recently. In addition, pressures from international institutional investors who only care about making their quarterly profitability targets have increased sharply. Global capital markets that demand an unprecedented degree of transparency in corporate reporting have fueled these pressures. At the same time, there has also arisen a high degree of social activism by community based non-government organizations (NGOs). Additionally, the political elite of Asian economies struggling with recession has sharpened its calls for more restrictions on the activities of global corporations, so that they have to respond socially to the national welfare concerns of these countries.

Taken together, the only way a board of directors can deal with these opposing demands is for it to act independently of managerial

and political influence. The struggle between profit and welfare is the struggle of the board to maximize the shareholder value, and yet be socially responsive. At one level, these demands seem irresolutely conflicted. However, the reality of managing in today's environment, as illustrated by the following case study, requires directors to manage the contradictions and to excel in doing so.

Sarbanes-Oxley Act of 2002

In 2002, the US Congress passed the most sweeping set of changes to corporate law since the 1934 Securities and Exchange Act. Called the Sarbanes-Oxley Act of 2002, this 66-page legislation impacts all US corporations and their worldwide operations, and all foreign corporations doing business in the United States. The legislation is divided into 6 Titles, two of which, Titles 3 and 4 have direct impact on how boards and directors conduct their business in the boardroom.

A major purpose of the 2002 Sarbanes-Oxley Act was to impose ethical standards, and were seen to have been too laxed in the corporations caught in the scandals that rocked corporate America. In the Act, loans or other extensions of credit to a director or executive officer are prohibited with only very minor exceptions. This prohibition continues to be controversial, because it prohibits not only just the abusive loans to executives that have received adverse press coverage but also legitimate loans and extensions of credit that have been used as part of compensatory arrangements. For example, relocation loans seem to be prohibited. However, it is clear that the practice of making loans to executives to purchase shares in order to avoid taxable income was no longer permitted.

Personal accountability

One of the most sweeping changes to securities laws in the world imposed by the Act is the requirement that the CEO and CFO are required to certify the company's annual and quarterly reports

(Forms 10-K and 10-Q) filed with the SEC. Popularly known as Section 404 (the section in the Act in which the provisions occur), the new certification requires each officer to affirm that he has reviewed the report, and to his knowledge, the report is not misleading and that the financial statements fairly present the company's financial condition and results of operations, that the officer is responsible for establishing internal controls, which ensure that material information is made known to the officer and has evaluated and disclosed the effectiveness of the controls, the officer has disclosed to the independent auditor and audit committee all significant deficiencies in the internal controls and any fraud.

In a separate section of the Act, imposing statutory liabilities, CEOs and CFOs are required to certify the company's periodic reports containing financial statements filed with the SEC, with severe criminal penalties imposed for false certifications. This provision differs from Section 404 in that it requires a statement that the periodic reports fully comply with the SEC reporting requirements, in addition that it fairly presents certification required by SEC rule.

If there is a restatement of financial statements due to material non-compliance as a result of misconduct, the CEO and CFO will have to forfeit any bonus, equity-based compensation or profits realized from the sale of stock during the 12 months following issuance of the non-complying financial statements. The restatement does not necessarily have to be due to an officer's misconduct to trigger a forfeit.

Directors and executive officers may not purchase, sell or otherwise transfer stock of the company received in connection with service as a director or employment as an executive officer during pension blackout periods that prohibit purchases, sales or other transfers of the stock by at least half of the plan participants for at least three consecutive business days, with limited exceptions. The company can bring suit to recover any profit realized in violation of this prohibition.

The legislation includes a sense of the United States Senate provision that corporate federal tax returns should be signed by the CEOs. The authority of the SEC bars a person's serving as a director or officer

of a public company is expanded. Substantial increases in other criminal and civil sanctions for violations of the securities laws are imposed. This includes a new crime of securities fraud involving public companies with a maximum penalty of 25 years. Statutes of limitations for securities fraud are also extended, and debts resulting from violation of securities fraud laws are not dischargeable in bankruptcy.

Enhanced disclosure

Officers, directors, and shareholders with at least 10% ownership of a company's stock will have to file Section 16 reports of changes in beneficial ownership of equity securities within two business days of the change rather than within 10 days after the end of the month in which the change occurred as now required. The reports are to be made public by the SEC and on a company's website within one day. In new SEC rules resulting from Sarbanes-Oxley 2002, all material correcting adjustments identified by the independent auditor must be reflected in the financial statements. Annual reports are to contain a management report on the company's internal controls with an assessment of their effectiveness, which is to be attested to by the independent auditor. Companies are required to disclose whether it has adopted a code of ethics for senior financial officers, as well as disclose any changes or waivers to the code.

The following report from the National Association of Corporate Directors lays out three of the most salient issues facing corporate directors in US listed firms today. As you read the discussion, try to understand the reasons for the changes described, and think about whether your company faces the same type of pressures. If so, determine whether your company is prepared to deal with these changes and whether your board has the resources, in terms of expertise, finances, and time to address them in a substantive way. If not, think about how you, as a director, are going to address the challenges facing your company or others that you are familiar with.