Effective Outside Directors

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The board of directors should be a firm's shareholders first and best line of defense against managerial malfeasance. The outside directors on the board should be the backbone of this protection. For this to be the case, outside directors must have the personal qualities, knowledge, and independence necessary to perform their duties. It is widely recognized that outside directors must be financially independent of the firm in order to be effective representatives of the shareholders. However, to be truly independent, outside directors also need to be financially and personally independent of the firm's managers and their relatives. Unfortunately, independence alone is not sufficient to ensure that outside directors perform as the shareholders desire. For example, they must also be of good character and diligent in the performance of their duties. Further, outside directors need to have a sound knowledge of corporate governance issues and structures and a general knowledge what a business is, how they operate, and how to read a firm's financial statements. Deficiencies in any of these areas will reduce the effectiveness of an outside director.

INTRODUCTION

The board of directors of a corporation is the highest level decision making authority in the corporation. Among the duties of the board is to make certain that the managers of the firm operate the firm in accordance with the best interests of the shareholders. In fact, a well functioning board is the shareholders' first and best line of defense against managerial malfeasance. The board is the first line of defense because generally, only the board has the ability to stop managerial malfeasance before it occurs. Since the board usually must approve in advance major investments, policy initiatives, and compensation plans, only they can stop actions that are not in the interests of the firm's shareholders from being promulgated. Regulatory and law enforcement agencies, like the Securities and Exchange Commission (SEC), usually only find out about managerial malfeasance after it has occurred. A well functioning board is also a better defense for shareholders because the board should know more about their company's operations than any outside agency or individual. Regulatory agencies have thousands of companies to monitor and, therefore, are unlikely to know much about the operations any one company. Consequently, the board of directors should be a better monitor of the firm and its managers than any regulatory or law enforcement agency.

Nevertheless, the significant number of corporate governance scandals occurring in recent years has called into question just how effectively boards are performing their managerial monitoring role. It is generally recognized that managers have strong financial incentives to pursue their own interests even if they harm the shareholders of the firm in the process. Consequently, managers who serve on the board are faced with a strong conflict of interest which is unlikely to be resolved in the shareholders' favor. As a result, the outside (nonmanagement) directors on the board are the only board members who can effectively represent the interests of the firm's shareholders (Fama and Jensen, 1983). In the case of Enron, Adelphia, Worldcom, and several other firms, the outside directors clearly have not properly carried out their responsibilities. A number of reasons have been suggested for these outside director failures. These include a lack of financial independence from the firm, a lack of information about the operations of the firm, a lack of diligence, and a reluctance to confront managers ((Sandberg, 2002) and (Kranhold and Schroeder, 2002)).

Most of the focus of those seeking to end these board failures has been on the lack of independence of outside directors. The Sarbanes – Oxley Act of 2002 requires that all directors serving on a firm's audit committee be financially independent from the firm and its subsidiaries. However, the financial independence required by Sarbanes – Oxley is limited and does not apply to outside directors who do not serve on the firm's audit committee. The New York Stock Exchange has proposed changing its listing standards to require that listed companies have a majority of independent directors on their boards (NYSE Corporate Governance Rule Proposals, 2002). The NYSE defines independent directors as having "no material relationship with the listed company." Also, The Conference Board's Commission on Public Trust and Private Enterprise (2003) has recommended that firms have a "substantial majority" of independent directors on their boards but did not provide an explicit definition of independence. Unfortunately, none of these definitions of independence are strong enough to ensure that outside directors are truly independent. Further, independence alone is not sufficient to guarantee that outside directors will be effective shareholder representatives. In this paper, I develop a more comprehensive definition of what director independence should entail and explore some of the other qualities that outside directors must have in order to be truly independent and effective representatives of the shareholders.

INDEPENDENCE

It is widely recognized that outside directors are not likely to be effective representatives of the shareholders of the firm if they have a financial relationship with the firm. In this paper, a firm or business refers to a business and all of its divisions or subsidiaries and any other businesses in which the firm has an ownership interest. Most of the discussion in this regard has related to outside directors or their employers who have provided services, for which they are paid, to the firms on whose boards the outside directors serve. Examples of this type of conflict of interest include accountants who provide auditing or other accounting services to the firm, lawyers who provide legal services to the firm, and bankers who lend money to the firm. Clearly, these outside directors will think twice about taking actions that might irritate the firm's managers and thus jeopardize their financial relationship with the firm, even if these actions benefit the firm's shareholders. However, it is not generally recognized that this same type of conflict of interest also occurs if the outside director or his employer sells goods to the firm on whose board they serve. If the outside director's firm sells raw materials, component parts,

computers, equipment, vehicles, or any other goods to the firm they face the same conflict of interest as outside directors who provide services to the firm. In either circumstance, the director would be unlikely to take the actions necessary to protect the firm's shareholders if those actions might jeopardize the director's other financial relationships with the firm. It appears that the definition of financial independence contained in the Sarbanes – Oxley Act only applies to providers of services to the firm, if that is the case, the Act should be amended to cover providers of goods as well.

Further, outside directors should not have any financial relationship with the managers of the firm or the managers' relatives. If the outside director has a financial relationship with a manager, or a business in which a manager has a financial interest, they will face the same conflict of interest as outside directors who do business with the firm on whose board they serve. Additionally, it is well known that managers (and others) sometimes try to conceal their financial interests in other businesses by having close relatives, such as spouses, siblings, and children listed as the nominal owners of the businesses. This also creates a conflict of interest for the outside director if they have a financial relationship with one of these businesses. To prevent these conflicts of interest, outside directors should be prohibited from having a financial relationship with a firm's managers and their close relatives and any businesses in which a manager or manager's close relative has a financial interest.

Additionally, no one should be allowed to become an outside director of a company if a manager of that company serves on the board of the firm that employs the prospective director or in which the prospective director has a financial interest. Allowing these interlocking directorships (managers serving on each other's boards) creates a conflict of interest for both managers in their roles as outside directors. For example, if a manager of company A takes an action as an outside director of company B that harms the managers of company B, any manager of company B who serves as an outside director of company A can use their board position as a means to retaliate against the manager of company A. In that circumstance, neither outside director is likely to take an action that will be detrimental to the managers of the firm on whose board they serve, even if that action would benefit the shareholders of the firm.

Outside directors should also not have a personal relationship with any of the firm's managers or managers' close relatives. Outside directors who are personal friends of one or more managers of the firm run the risk that the actions the director takes will harm the interests of their friend/manager and, thereby, damage their friendship with the manager. Undoubtedly, some outside directors would choose not to take actions that benefited the firms shareholders if those actions would damage their friendship with the manager. Outside directors would have a similar, although possibly weaker, conflict of interest if they were personal friends of a close relative of a manager. One implication of this is that outside directors should not be former managers of the firm on whose board they serve as they will probably have close personal relationships with some of the firm's current managers. The only major institution that seems to recognize this conflict of interest is the NYSE, which has proposed that former employees of a firm who serve on that company's board can not be classified as independent directors until at least five years after their employment has been terminated. This prohibition should not extend to outside directors that have professional acquaintances with the firm's managers as these more casual relationships should not cause serious conflicts of interest and would significantly limit the pool of potential outside directors. Only if these professional acquaintances turn into personal friendships should the prohibition apply.

In certain circumstances, the compensation an outside director receives for their board service can also compromise their independence. One of those circumstances is when the outside director derives a large percentage of their total income from their compensation for their board service. This would not usually be the case when the outside director is a highly paid executive of another firm or has a large retirement or investment income. If, however, the outside director has a middle class income, then the board compensation could represent thirty percent or more of their total income. For any director whose board compensation represents a high percentage of their total income, losing their board seat would significantly lower their total income and could create a great financial hardship for them. An outside director in that financial position would likely think twice about doing anything that would jeopardize their board position, like challenging management, even if doing so would benefit the firm's shareholders. Consequently, firms should be cautious about nominating social activists, politicians, or other middle or low income people for board seats or paying unusually high compensation to directors for their board service.

In sum, to be truly independent, outside directors and the firms they work for or have a financial interest in should not have a financial relationship with the firm on whose board they serve or the managers or close relatives of the managers of the firm, nor should they have a personal friendship with any of the firm's managers or the managers' close relatives. Additionally, no interlocking director relationships should be allowed to exist between a company that employs the outside director or in which the outside director has a financial interest and the firm on whose board the outside director sits. These independence requirements should apply to all outside directors, not just those who serve on the firm's audit or other selected committees.

KNOWLEDGE OF CORPORATE GOVERNANCE ISSUES AND STRUCTURES

It is essential that outside directors have a sound knowledge of corporate governance issues, structures, laws, and regulations. A director who does not understand the role of the board and its committees can not hope to effectively carry out their duties. Directors also need to understand the conflicts of interest faced by managers and the types of actions managers can take that would benefit themselves personally yet harm the interests of the firm's shareholders. The training of new directors by outside specialists has been suggested as one way to provide directors with the knowledge they need to perform their duties (Shmukler, 2003). This training can be presumed to be useful only if the training is supplied by third parties that are independent of the firm's managers. If managers are allowed to arrange director training, they have the ability to limit the information directors are given in their training and, thereby, reduce their effectiveness. Consequently, board member training should be arranged solely by the outside directors on the board. Training, however, can only accomplish so much. It may be able to rectify some limited deficiencies in director knowledge but can not make a director with little or no knowledge of corporate governance a competent director. New directors who do not have significant knowledge of corporate governance issues and structures when they begin their board service are unlikely to be effective advocates for the shareholders. Additionally, directors should receive periodic training throughout their service to make certain their are familiar with the latest developments in corporate governance.

BUSINESS KNOWLEDGE

Unless they have a fundamental understanding of what businesses are and how they operate, outside directors can not hope to effectively carry out their roles. Without this knowledge, outside directors would be unlikely to comprehend what the business is doing or what it should be doing. This knowledge should include an understanding of the role of profits in business survival and the role of businesses in supplying goods, services, and jobs for the economy. A fundamental comprehension of the basic principles of management is needed to design compensation and other policies that will properly motivate mangers and other employees to perform in ways that are beneficial to the firm's shareholders. Finally, an ability to read and understand a firm's financial statements is essential to understanding the business and its operations. This knowledge will also be of great use in detecting unusual accounting entries or practices that could indicate managerial malfeasance. Hints of the improper actions that led to many of the corporate governance scandals of recent years were present in the financial statements (and their footnotes) of many of those firms involved, but went undetected or were not acted upon. While it is not necessary for an outside director to be any expert in any field of business, a general knowledge of the items discussed above is important. Deficiencies in knowledge in one or two areas of business can be corrected with further study or training, but a general deficiency in business knowledge will inhibit the performance of any outside director.

CHARACTER

Character is one of the most important qualities that an outside director needs to possess. Although there are many aspects of character, in the context of board service, integrity and fortitude are two of the most relevant. First and foremost, outside directors must have the integrity to maintain their commitment to uphold the interests of the shareholders. Directors can not allow sloth, intimidation, or personal benefit to sway them from this commitment. They must also realize that illegal or unethical conduct is ultimately not in the interest of the firm's shareholders and can not be tolerated. Outside directors must also have the fortitude to ask the tough questions and to say no to managers and other board members when they propose actions that are not in the interest of the shareholders. Knowing that a proposal or action is not beneficial to shareholders is not enough, outside directors must be willing to take the necessary actions to oppose these proposals and actions, including formally voting against them. They must also be able to resist the pressures put on them by managers and other directors not to interfere. An executive quoted in the February 24, 2003 issue of the Wall Street Journal tells of how a CEO recruiting him to become a new board member at the CEO's firm said "new directors were expected to say nothing for the first 12 months" on the board (Hymowitz, 2003). Clearly, the CEO was trying to emasculate the prospective director to keep him from questioning management's actions and proposals. To be effective, outside directors must have the fortitude to resist this type of pressure even if it risks not being renominated for their board position. Directors must also not be swayed by implicit or explicit promises of greater compensation or perks as a reward for going along with management.

DILIGENCE

To be an effective outside director requires more than just showing up at board meetings to collect your attendance fee. A director must put in considerable effort before, during, and after a board meeting to properly discharge their duties. Prior to the meeting, a director should peruse in detail the materials sent to them by the firm. The director should make note of what is said, what needs to be clarified or given greater explanation, what additional information is needed, and what questions the director needs to ask at the board meeting. At the board meeting, the director must bring up the issues that need to be addressed, listen to other officers' and directors' comments, ask for additional information when needed, and cast informed votes. After the meeting, further contemplation of the topics discussed, their implications, and topics that need to be discussed at future board meetings should be made. If the director serves on any board committees, the director must make the same effort to prepare for the board committee meetings as they do for the full board meeting. Further, the directors should study and receive continuing training on corporate governance issues. All in all, considerable diligence is required to be an effective outside director and those who do not exert the requisite effort will not be very useful representatives of the shareholders. Given the significant amount of time and effort it takes to be an effective director, companies should place limits on the number of boards on which their directors may serve. Managers of the company and outside directors with full-time jobs should be limited to serving on a maximum of three boards. Outside directors that do not have full-time jobs should be limited to serving on a maximum of six boards.

SUMMARY

The board of directors should be a firm's shareholders first and best line of defense against managerial malfeasance. The outside directors on the board should be the backbone of this protection. For this to be the case, outside directors must have the personal qualities, knowledge, and independence necessary to perform their duties. It is widely recognized that outside directors must be financially independent of the firm in order to be effective representatives of the shareholders. However, to be truly independent, outside directors also need to be financially and personally independent of the firm's managers and their relatives. Unfortunately, independence alone is not sufficient to ensure that outside directors perform as the shareholders desire. For example, they must also be of good character and diligent in the performance of their duties. Further, outside directors need to have a sound knowledge of corporate governance issues and structures and a general knowledge what a business is, how they operate, and how to read a firm's financial statements. Deficiencies in any of these areas will reduce the effectiveness of an outside director.

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