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Neither inside nor outside directors can adequately represent shareholder interests.

BY ROGER L. MARTIN

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THE APPROACH A COMPANY TAKES TO GOVERNANCE—the theories it holds and the structures it builds—can create or destroy real value. For public companies, boards have a particularly tricky task. In many respects, boards lie right at the intersection between the expectations market—in which traders handle stocks and derivatives—and the real market. From that position, over time, boards have come to govern operations in the real market to the benefit of actors in the expectations market. How? Boards attempt to ensure that employees in the real market show proper accountability for their decisions and the operations of the firm; they also attempt to ensure that shareholders in the expectations market have visibility into operations in the real market. In particular, the board's job is to protect shareholders, ensuring that executives are engaged in maximizing the return to the shareholders rather than to the executives themselves.

By and large, it is the independent directors who have been tasked with being the voice and protector of outside shareholders. Most boards are made up of independent, outside directors (individuals who have no connection to the company other than through their board seat) and a few inside directors (executive-owners, like the CEO). Within this structure, the role of shareholder white knight falls to the independent directors because inside directors are considered ill-equipped to perform it, especially to the extent that the

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inside directors have meaningful stock-based compensation. As actors in both the real and expectations markets, inside directors have a powerful incentive to focus on raising expectations, whether or not doing so is in service of the company's long-term, real-market performance. An inside director may attempt to show self-control and not act in accordance with this incentive, but it is a Herculean task.

Therefore, inside directors are not at all well positioned to protect the interests of the outside shareholders, so the burden falls on independent directors, who, unfortunately, aren't well positioned to do it either.

A BOARD OF DIRECTORS is asked to span a wide (and widening) gulf, resolving the tension between two very different markets with very different actors. On the one hand, boards are intended to act on behalf of outside shareholders, who want the greatest possible return for their investment in the expectations market. On the other hand, the board must deal closely with executives, who work in the real market yet are tied by incentives to the expectations market and motivated to maximize their own returns, even at the expense of shareholders. And those executives are in fact in an ideal position to exploit outside shareholders; with deep insider knowledge, they know much better than any outsider could when to buy or sell the company's stock based on the greatest possible differential between expectations and reality.

So, ultimately, the job of directors is to ensure that insiders do not use their preferential access to information to exploit outside shareholders. Unfortunately, it is a job directors can't perform effectively, owing to problems with capabilities, incentives, and selection.

Many jobs are difficult but can be accomplished by dedicated people with the right set of skills and capabilities. One problem with the role we have given to outside directors is that no matter how dedicated the individuals involved, they will be largely incapable of achieving what we have asked of them. Independent directors can't know as much as management does about the operations of the firm. Their very independence puts them at a distinct information disadvantage relative to the inside directors.

Executive management is in a position to provide independent directors with whatever information it sees fit and has the capacity to restrict access to information it doesn't want independent directors to see. No matter how smart and diligent the independent directors, they will never match the knowledge of executives, who, by definition, spend much more time engaged in the business than directors do. The best an independent director can do is to bring to bear broad expertise and insight from other markets that management can utilize if it so desires. But that isn't the task we set out for them; we don't ask them to make use of those capabilities. We ask them to be all-knowing, even when that is impossible.

Many assume that the knowledge deficit can be overcome through the hiring of professionals, principally auditors, by the independent committee of the board. Again, this simply is not the case. In the end, the important audit decisions come down to judgment, and management is always in a better position to argue its case than the auditors are to argue theirs. WorldCom provides an excellent object lesson on this. Its auditors did not discern that management had classified $3.8 billion in expenses as assets in order to inflate earnings.

Because the "assets" in question were various sorts of complicated switching gear in the WorldCom network, management was able to convince the auditors that this equipment would be used as an asset for years to come when, in fact, it was equipment that had been purchased and installed to serve a single client, and had no obvious further use. The equipment should properly have been expensed against the profitability of the client contract, not capitalized and put on the books of WorldCom as an asset. The insiders knew this yet were able to use the information asymmetry to convince the outsiders otherwise.

Increased scrutiny and regulatory changes in the wake of the recent scandals has emboldened auditors, but none of the changes will help them overcome this inherent knowledge deficit.

THE CAPABILITIES CHALLENGE IS STIFF. When the outside shareholders of Enron needed the independent directors to stop illegal accounting, blatant self-dealing, and stunning market exploitation by CEO Jeff Skilling and CFO Andrew Fastow, the independent directors were incapable of doing so. When the outside shareholders of Qwest Communications needed the independent directors to alert them to the fact that insiders were exploiting the mismatch between the expectations market and the real market (unloading $2 billion in stock before the bottom dropped out of the share price), the directors were unable to do so. Independent directors—even bright, capable, and dedicated ones—simply don't have a chance against executives committed to their own self-interest.

But the capability issue is only part of the problem. Not only do independent directors lack the *capability* to effectively serve the interests of outside shareholders—they lack the *incentive* to do so. We know that people respond to incentives. And agency theory tells us that people have self-interested motivations that cause them to maximize their own welfare instead of the welfare of the organization for which they work. So, the argument goes, executives (the agents) will maximize their own rewards at the expense of shareholders (the principals) unless given incentives to do otherwise.

The theory suggests that we can deal with the principal-agent problem by having the board of directors discipline the agents and incent them effectively. But do boards not have exactly the same principal-agent problem? After all, the mem-

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bers of the board of directors are not principals either. They are agents too—hired and paid for by the shareholders—and, as agents, directors have every bit as much interest in maximizing their own welfare as do executives.

It raises the question: *Why would we imagine that the directorial agents would act any differently than the executive agents?* After all, directors and executives are drawn largely from the same pool: Current and former senior executives are highly sought as directors. Yet we choose to apply agency theory to executives and not to directors. We assume that executives will maximize their self-interest but that directors will not. This is a failure of logic. Either the motivational schism between principals and agents is real and is a problem, or it's not.

If it is not a problem, then we don't need directors to keep managers in line. But if it is a problem, then directors will be susceptible to the same incentive issues as executives, and having a board of directors won't do a company a bit of good.

FINALLY, IN ADDITION TO PROBLEMS of capabilities and incentives, boards of directors suffer from a profound selection problem that further prevents them from protecting outside shareholders effectively. Put simply, good governance is something companies tend to have when they don't need it and lack when they do.

At some companies, shareholders have little need for protection. These are the companies, like Procter & Gamble and Johnson & Johnson, that put customers first, focus on the long term, and grow value consistently over time. They have nothing to hide from their shareholders so have no reason not to have great, thoughtful directors, open communication between executives and the board, and full disclosure to directors. Their directors are therefore in the best possible position to keep tabs on wayward executives and to clamp down on them. But since such companies had nothing to hide in the first place, their directors rarely need to discipline the executives; the culture of the company already provides that discipline. Ultimately, while these companies have directors and board relationships that could overcome agency problems, there aren't agency problems to overcome.

Executives of companies with something to hide, on the other hand, will look for weak directors and will seek to obscure the truth. In these companies, executives don't want to enlighten directors or disclose the truth to them. They hide information, obscure facts, and do all they can to keep the directors ignorant of the company's real activities. At Enron and Qwest, for example, directors weren't up to the task of protecting shareholders precisely because they were at a company that so desperately needed them to be up to it. Executives made sure that directors weren't up to the task out of pure self-interest.

So the great irony is that where stellar performance by independent directors is most needed, it is least likely to happen and where great performance is least needed, it is most likely to happen. Essentially, board governance works like a driver's-education course. Careful, dutiful new drivers take driver's-ed courses. Impulsive, bad new drivers don't, and so never improve. This is what economists call an adverse selection bias. Circumstances cause exactly the wrong drivers to select the option of taking a driver's-education course. If we accept that boards exist to protect shareholders, then exactly the wrong companies have great, functioning boards. ■