Leader of the Pack: A Proposal for Disclosure of Board Leadership Structure

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> *Who will watch the managers? Corporate America never has settled on an answer. It has been the unsolved riddle, the missing link in the corporate chain, even long before Dwayne O. Andreas [CEO and chair of Archer-Daniels-Midland] became a poster boy for reformers. . . . If you want to motivate [directors], make them responsible, i.e. guarantee that besmirchment will be the reward for being asleep at the switch.*
>
> — *Roger Lowenstein*[1]

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1. Roger Lowenstein, *Corporate Governance's Sorry History*, WALL ST. J., Apr. 18, 1996, at C1.

I. INTRODUCTION

The boards of directors of a number of America's largest corporations, with household names like American Express, General Motors, International Business Machines, K-Mart, and Westinghouse, have recently responded to poor corporate performance by essentially declaring, "Off with their heads!" and firing their chief executive officers ("CEOs").[2] In many instances, the removal of CEOs has been associated with a significant increase in shareholder wealth.[3] However, boards of directors frequently allow CEOs to engage in activities that destroy shareholder wealth and waste valuable corporate resources before they remove these individuals.[4] As a result, if boards of directors in these situations had fired their company's CEOs earlier or taken other corrective action, they may have been able to avoid the loss of significant shareholder wealth.[5]

The positive relationship between a company's corporate governance policies and the likelihood that the board will remove an underperforming CEO has attracted increasing attention to these policies.[6] By focusing on corporate governance issues pertinent to the companies in which they invest, institutional investors, such as the California Public Employees' Retirement Fund ("CalPERS"), [7] the largest public pension fund in the United States with assets in excess of $95.5 billion,[8] have found that they can significantly enhance their investment returns.[9] As a result, institutional investors have placed

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2. *See* David. J. Denis & Diane K. Denis, *Performance Changes Following Top Management Dismissals*, 50 J. OF FIN. 1029 (1995).

3. *See, e.g.*, Joseph A. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates*, 45 STAN. L. REV. 857, 882-900 (1993).

4. *See infra* text accompanying notes 107-254.

5. *See, e.g.*, *A Survey of Corporate Governance: Watching the Boss*, ECONOMIST, Jan. 29, 1994, at 3 (stating "there is ample evidence of waste that might have been avoided had bosses been on a tighter rein.").

6. Commentators have argued that the "acid test" of a company's corporate governance policies is the willingness of its board of directors to fire an underperforming CEO. Grundfest, *supra* note 3, at 877 (citing Martin Lipton & Jay W. Lorsch, *A Modest Proposal for Improved Corporate Governance*, 48 BUS. LAW. 59, 66 (1992)).

7. *See, e.g.*, *CalPERS Issues Governance Report Cards*, IRRC CORP. GOVERNANCE BULL., Apr.-June 1995 (describing how CalPERS graded its 300 largest portfolio companies based on their responses to its corporate governance survey).

8. Stan Hinden, *The Case of the Unretiring Shareholder*, WASH. POST, Feb. 12, 1996 (Washington Business section) at 27.

9. *See, e.g.*, Steven L. Nesbitt, *Long-Term Rewards from Shareholder Activism: A Study of the "CalPERS Effect,"* CONTINENTAL BANK J. OF APPLIED CORP. FIN., Winter 1994, at 75. *See also* Michael P. Smith, *Shareholder Activism by Institutional Investors: Evidence from CalPERS*, 51 J. OF FIN., 227, 244-48 (1996) (shareholder

increasing importance on corporate governance related activities. In response to the increasing interest of institutional investors in this area, publicly traded companies in the United States have prioritized corporate governance issues.[10]

Although certain companies have made significant improvements with respect to corporate governance issues, others have not adequately addressed these issues.[11] As a result, a number of commentators have made corporate governance proposals[12] that, if implemented, would significantly change the status quo.[13] For example, some commentators, including former Commissioners of the Securities and Exchange Commission ("SEC") Harold Williams[14] and Mary Shapiro,[15] and Professor Jay Lorsch of the Harvard Business School,[16] have recommended that a company should not permit a single individual to serve as both its CEO and chairperson of its board of directors ("chair"). Alternatively, if a company allows a single individual to serve as its CEO and chair, Lorsch and Martin Lipton of the law firm Wachtell, Lipton, Rosen & Katz, among others, have asserted that a company's board of directors should select a senior independent director to lead the independent directors.[17]

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wealth increased for targeted firms that adopted CalPERS's shareholder resolutions or made changes sufficient to warrant a settlement with CalPERS but declined for firms that resisted change; no statistically significant change in operating performance was found across firms).

10. *See, e.g.*, GENERAL MOTORS CORP., GENERAL MOTORS' BOARD GUIDELINES ON SIGNIFICANT CORPORATE GOVERNANCE ISSUES (1994) (describing the position of General Motors on twenty-eight corporate governance issues).

11. Lowenstein, *supra* note 1, at C1.

12. *See, e.g.*, Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 865 (1991).

13. *See, e.g.*, John Daly & Julie Cazzin, *A Collision Course: GM Directors Overthrow Their Chairman and Take Control of a Troubled Corporate Giant*, MACLEAN'S, Nov. 9, 1992, at 90.

14. *See* Harold M. Williams & Irving S. Shapiro, The 1979 Benjamin F. Fairless Memorial Lectures, *Power and Accountability: The Changing Role of the Corporate Board* 18 (Carnegie-Mellon University Press, 1979).

15. *See* Robert Sanford, *SEC Official Favors Shaking Up Boardrooms*, ST. LOUIS DISPATCH, Apr. 24, 1993, at 8C.

16. JAY W. LORSCH & ELIZABETH MACIVER, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS 184-87 (1989).

17. *See, e.g.*, Lipton & Lorsch, *supra* note 6, at 70. Ira M. Millstein of the law firm Weil, Gotshal & Manges proposed designating an outside director for a board leadership role in 1990. Ira M. Millstein, Corporate Governance in the 1990's, Address to the Harvard University School of Government (Apr. 10, 1990). He had previously

This Article proposes that the New York Stock Exchange ("NYSE") and the National Association of Securities Dealers ("NASD") amend their listing policies to require a listed company, in the case of the NYSE, and a NASDAQ/NMS company, in the case of the NASD, to disclose in its proxy statement (1) whether or not there is a separate independent chair, and if there is not, (2) whether or not its board of directors has designated a senior independent director who functions as a leader of its independent directors ("lead director"). For this purpose, a director would not be considered independent were he or she either the retired CEO or not otherwise deemed independent, applying the definitions used in the NYSE and NASD rules requiring an audit committee consisting solely of independent directors.[18]

Our proposal would not require a company to separate the roles of CEO and chair or to designate a lead director. Rather, our proposal would allow a company to select the board leadership structure that it considers optimal. However, if that structure did not include a separate independent chair or lead director, the directors would be required to explain in the proxy statement why they believe it to be in the best interests of the company and its shareholders to have a single individual act as its CEO and chair, or to have a retired CEO or other non-independent person as chair, without the appointment of an independent lead director.[19]

These proposals are designed to encourage directors to select an independent chair or a lead director, thereby increasing the likelihood that a company's independent directors will not be beholden to the CEO and that a company's independent directors will actively monitor and evaluate the performance of the CEO and the company on an on-going

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proposed separating the roles of CEO and chair. Winthrop Knowlton & Ira M. Millstein, *Can the Board of Directors Help the American Corporation Earn the Immortality It Holds So Dear? in* JOHN R. MEYER & JAMES M. GUSTAFSON, THE U.S. BUSINESS CORPORATION: AN INSTITUTION IN TRANSISTION 186 (1988).

18. The status of independent directors would be determined in accordance with the definitions used in the NYSE and NASD rules requiring an audit committee consisting solely of independent directors. *See* NEW YORK STOCK EXCHANGE COMPANY MANUAL § 303.00 (An audit committee shall be "comprised solely of directors independent of management and free from any relationship that, in the opinion of its Board of Directors, would interfere with the exercise of independent judgment as a committee member."). *See also* NASD MANUAL § 5(c), (CCH) ¶ 1812, at 1579 ("[I]ndependent director shall mean a person other than an officer or employee of the company or its subsidiaries or any other individual having a relationship which, in the opinion of the board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director.").

19. Such a rule change would have to be approved by the SEC pursuant to Securities Exchange Act of 1934 § 19(b), 15 U.S.C. §78s(b) (1995), and Rule 19-4 promulgated thereunder. 17 C.F.R. §240.19b-4 (1995).

basis. Implementation of these proposals would enhance the ability of a company's board of directors to make mid-course corrections rather than waiting until the company is in a crisis to act. The use of the listing requirements as an instrument for change provides a practical and easy way to promote the consideration by publicly traded companies of board leadership structure and methods for improving it, without requiring the SEC to amend its proxy rules or states to amend their corporation laws.[20]

This Article consists of five parts. Part II will discuss the rationale for our proposal. This part will analyze the existing board leadership structure and practices in the United States. Part II will also explore the impact that the separation of a company's CEO and chair positions and the appointment of a lead director would have on corporate accountability.

Part III will summarize a recent study, the findings of which suggest that independent directors have no effect on corporate performance as measured by stock price. This part will then discuss the recent research on the relationship between a company separating its chair and CEO positions and its performance in the United States and the United Kingdom.

Part IV will review specific examples of management underperformance in publicly traded U.S. companies. These examples will demonstrate that many independent directors wait until the company is in crisis before removing an underperforming CEO and adopting the board practices needed to prevent the abuses of power that resulted from the CEO's dominance. This part will focus on well-publicized corporate crises, such as the recent allegations of wrongdoing by officers at Archer-Daniels-Midland and precipitous losses at Morrison Knudsen, and will analyze the confluence of power in these situations within a single individual. Moreover, this part will utilize the recent corporate governance initiatives at General Motors to illustrate how a company can

20. Listing requirements have been used before to promote improved corporate governance and responsibility. For example, the NYSE changed its rules in 1977 to require each domestic company with common stock listed on the NYSE to establish and maintain an audit committee comprised solely of independent directors. See NEW YORK STOCK EXCHANGE COMPANY MANUAL §303.00, approved by the SEC in *In re* New York Stock Exchange, Exchange Act Release No. 13,346 (Mar. 9, 1977). The NASD subsequently imposed the same requirement on NASDAQ/NMS issuers. See NASD MANUAL § 5(D), Fed. Sec. L. Rep. (CCH) ¶ 1812, at 1579.

dramatically improve its corporate governance practices and in doing so create shareholder value. Lastly, Part IV will discuss the separation of the roles of CEO and chair at Compaq Computer to illustrate how a company with a separate CEO and chair was able to change course prior to reaching a corporate crisis.

Part V will conclude by discussing the anticipated effect of the implementation of this Article's proposal.

II. THE RATIONALE FOR THE DISCLOSURE OF BOARD LEADERSHIP PROPOSAL

Our proposal involves the use of proxy disclosure as a means of promoting thoughtful consideration of board leadership structure, with the expectation that it will cause more companies to improve that structure by designating an independent chair or a lead director. The use of proxy disclosure as a means of inducing change has been used in the past in the United States.

For example, in 1992, the SEC changed the executive compensation disclosure requirements of Regulation S-K and made further related changes to Schedule 14A and Form 10-K in an attempt to force directors to pay more attention to the area of executive compensation and the relationship between executive pay and corporate performance.[21] For the first time, the SEC required public companies to include in their proxy statement a report from the compensation committee (or the full board if there is no compensation committee) explaining how executive compensation was set and the relationship, if any, between corporate performance and executive compensation.[22] To facilitate a ready comparison of pay and performance, the SEC standardized disclosure of the total compensation (including stock options) provided to certain top executives and required the inclusion of "performance graphs" comparing a company's returns to its shareholders with the returns of the market as a whole and their specific industries.[23]

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21. *See* Executive Compensation Disclosure, Securities Act Release No. 6962, Exchange Act Release No. 31,327, Investment Company Act Release No. 19,032, 57 Fed. Reg. 48,126 (1992) (to be codified at 17 C.F.R. §§ 228, 229, 240, 249), *as corrected in* Executive Compensation Disclosure, Correction, Securities Act Release No. 6966, Exchange Act Release No. 31,420, Investment Company Act Release No. 19,085, 57 Fed. Reg. 53,985 (1992) (to be codified at 17 C.F.R. § 228) [hereinafter Executive Compensation Disclosure]. For a more detailed discussion of these changes and the forces that played a role in the SEC's actions, *see* Tracy Scott Johnson, *Pay for Performance: Corporate Executive Compensation in the 1990s*, 20 DEL. J. CORP. L. 183 (1995).

22. *See* Executive Compensation Disclosure, *supra* note 21.

23. *Id.*

Similarly, our proposal would require NASDAQ and NYSE companies to disclose in their proxy statements their existing board leadership structure and their rationale for having such a structure. By requiring companies with neither an independent chair nor a lead director to explain why they do not consider it to be in the best interests of the company and its shareholders to do so, our proposal will provide an impetus for directors to select an independent chair or a lead director, thereby improving corporate governance. Thus, our proposal falls squarely within the U.S. tradition of using proxy disclosure as a means to induce enhanced corporate and directorial responsibility.

Although this proposal would represent a significant change from the status quo in the United States, precedent in the United Kingdom ("U.K.") supports it. The Report of the Committee on the Financial Aspects of Corporate Governance ("Cadbury Report"),[24] which Sir Adrian Cadbury chaired, stated that in principle the roles of CEO and chair should be separate,[25] but did not mandate a split. Instead the Code of Best Practice included in the Cadbury Report (the "Code of Best Practice") provides that if the roles are combined then there must be a strong and independent element on the board with a recognized senior member.[26] The London Stock Exchange ("LSE") adopted as a requirement the Cadbury Report's recommendation[27] that every listed company domiciled in the United Kingdom disclose in its annual report whether it is in compliance with the Code of Best Practice and explain any areas of non-compliance.[28] Thus, every affected company must disclose whether the same person serves as CEO and chair, and, if so, whether there is a strong and independent element on the board with a

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24. COMMITTEE ON THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE, THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE (1992) [hereinafter CADBURY REPORT].

25. *Id.* at 21.

26. Paragraph 1.2 of the Code of Best Practice provides:

> There should be a clearly accepted division of responsibilities at the head of a company, which will ensure a balance of power and authority, such that no one individual has unfettered powers of decision. Where the chairperson is also the chief executive, it is essential that there should be strong and independent element on the board, with a recognized senior member.

Id. at 58.

27. *Id.* at 17.

28. LONDON STOCK EXCHANGE LISTING REQUIREMENTS § 12.43(j) (1995).

recognized senior member.[29] Any U.K. company that has a single individual serve as CEO and chair but no strong and independent element on the board, with a recognized senior member, must explain why it does not split the roles of CEO and chair or appoint a lead director.[30]

29. *Id.* In mid-1995, the LSE proposed to limit the required certification to just two aspects of the Code of Best Practice included in the Cadbury Report: (1) the auditor's certification of the company's going concern status and (2) the directors' certification of the adequacy of internal controls. Shareholder activists, however, strongly opposed such a change. As a result, it seems unlikely that the LSE will modify this requirement before the successor to the Committee on the Financial Aspects of Corporate Governance issues its report, which is not expected before 1997. *See* Norma Cohen, *A Taste for Cadbury*, FIN. TIMES, June 14, 1995, at 19. *See also* Robert Bruce, *Slow Journey Ahead for Cadbury Mark II*, LONDON TIMES, Dec. 7, 1995, *available in* LEXIS, Nexis Library, CURNWS File.

30. LONDON STOCK EXCHANGE LISTING REQUIREMENTS § 12.43(j) (1995). The LSE disclosure requirement applies to any reporting periods ending after June 30, 1993. REPORT OF THE COMMITTEE ON THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE: COMPLIANCE WITH THE CODE OF BEST PRACTICE 9 (1995). In the period from that date until December 31, 1994, the majority of the largest 1,550 companies listed on the LSE (based on market capitalization) split the roles of CEO and chair. *Id.* at 16. A majority of the companies that combined the roles had a lead director. The distribution by company size, starting with the 100 companies with the largest market capitalization, was as follows:

SIZE	% SEPARATE	% COMBINED WITH A LEAD DIRECTOR	% COMBINED WITHOUT A LEAD DIRECTOR
1-100	82	15	3
101-250	83	15	2
251-500	82	11	7
501-750	73	17	10
751-1000	81	13	6
1001-1250	74	15	11
1251-1550	72	5	23

The Toronto Stock Exchange ("TSE") has adopted a similar proposal. The TSE has promulgated a set of guidelines pertaining to corporate governance and requires companies that do not comply with these guidelines to explain their non-compliance.[31] One of the TSE corporate governance guidelines provides in pertinent part:

> Every board of directors should have in place appropriate structures and procedures to ensure that the board can function independently of management. An appropriate structure would be to (i) appoint a chair of the board who is not a member of management with responsibility to ensure the board discharges its responsibilities or (ii) adopt alternate means such as assigning this responsibility to a committee of the board, such as the governance committee, or to a director, sometimes referred to as the "lead director."[32]

The existence of a separate chair within a company would reduce the CEO's ability to unduly influence and control the board of directors.[33] Commentators have noted that the concentration of power in a single individual, who is a company's CEO and chair, has been a factor in most recent "corporate disasters."[34] If a company has separate individuals serving as the CEO and as the chair, the independent directors will have a recognized leader to guide their performance of such critical tasks as evaluating the CEO, setting executive compensation, and conducting succession planning for the CEO and other members of top management. After consultation with the CEO, a separate chair would also set the agendas for board meetings and preside over board meetings, thereby controlling the timing and pace of board discussions.[35] Along with the

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Id. In contrast, a single individual serves as the CEO and the chair in more than 75% of U.S. companies. JONATHAN P. CHARKHAM, KEEPING GOOD COMPANY: A STUDY OF CORPORATE GOVERNANCE IN FIVE COUNTRIES, 184 (1994).

31. TORONTO STOCK EXCHANGE CORP. COMM. 4-20 (1995).

32. *Id.* at 4-21 to 4-22.

33. The reasoning presented in favor of this proposition has been significantly influenced by LORSCH & MACIVER, *supra* note 16.

34. NATIONAL ASSOCIATION OF CORPORATE DIRECTORS, CORPORATE GOVERNANCE ROUNDTABLE 6 (1995) ("In nearly every recent, major corporate disaster there was one very powerful individual, always the chair and chief executive, but in some cases, chair, chief executive, and a major shareholder as well."). The NACD Blue Ribbon Commission on Director Professionalism recommended that boards consider formally designating a non-executive chair or other independent board leader. NATIONAL ASSOCIATION OF CORPORATE DIRECTORS, REPORT OF THE NACD BLUE RIBBON COMMISSION ON DIRECTOR PROFESSIONALISM 4 (1996).

35. Former SEC Chairman Harold Williams stated that the CEO should not also be chair because "[c]ontrol of the agenda and pace of the meeting is a powerful control."

other directors, a separate chair would also be active in establishing the qualifications for board membership,[36] interviewing candidates, and selecting new directors.[37] Moreover, having a chair who is not also the company's CEO would encourage the directors to engage in more open discussions about current problems and practices.[38] Lastly, the existence of a separate chair serves as a reminder to the CEO that he or she reports to, and serves at the pleasure of, the company's board of directors.[39]

Many executives in the United States oppose the idea of splitting the two roles of CEO and chair.[40] In the United States, promotion to CEO and chair is often viewed as a reward for excellent service and a vote of confidence by the board.[41] Moreover, in the United States, the majority of Fortune 500 companies allow a single individual to serve as their

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Judith H. Dobrzynski, *Chairman and CEO: One Hat Too Many*, BUS. WK., Nov. 18, 1991, at 124.

36. *See* BUSINESS ROUNDTABLE, CORPORATE GOVERNANCE AND AMERICAN COMPETITIVENESS 11-12 (1990).

37. *See* THE WORKING GROUP ON CORPORATE GOVERNANCE, *A New Compact for Owners and Directors*, HARV. BUS. REV., July-Aug. 1991, at 532, 534.

38. This phenomenon occurred at GM after the roles of CEO and chair were split. According to executive vice-president and director Harry Pearce, Paul O'Neil, a GM board member who is also CEO of Alcoa, "is absolutely uninhibited in challenging numbers and our analytical approach--that didn't happen in the past. The signals suggested that it was unseemly behavior to ask questions or to delve into details." Judith H. Dobrzynski, *Jack and John: 2 for the Road at G.M.*, N.Y. TIMES, July 9, 1995, §3, at 11.

39. *See* LORSCH & MACIVER, *supra* note 16.
As part of its annual survey of directors, the executive search firm Korn/Ferry International asked directors to answer the following question: "[I]n what way would the authority of the CEO be limited as a result of separating the two functions [CEO and chair] or in what way has it been limited if already separated?" KORN/FERRY INTERNATIONAL, 22ND ANNUAL BOARD OF DIRECTORS STUDY 26 (1995). The majority of directors indicated that the separation of the CEO and chair roles would result in the CEO exercising less control over board meetings, agendas, committee assignments, and the selection of new directors. *Id.* Moreover, the majority of outside directors indicated that the separation of the roles would reduce the CEO's feeling of "owning the board." *Id.*

40. According to a 1992 survey conducted by Korn/Ferry International, 41% of CEOs believe that separating the roles of CEO and chair would impede management effectiveness. Joann S. Lublin, *Management: Shareholders Campaign to Diffuse Power of Chief Executives by Splitting Top Jobs*, WALL ST. J., Apr. 1, 1992, at B1. Moreover, only 25% of the 653 CEOs surveyed by the National Association of Corporate Executives favored a required separation of the CEO and chair roles. *Id. See also* Dobrzynski, *supra* note 38, at 11 ("I.B.M.'s Louis V. Gerstner Jr. and Allied Signal's Lawrence A. Bossidy are among many who have insisted on having both the chairman and C.E.O. titles before taking top jobs.").

41. James A. Brickley et al., *Corporate Leadership Structure: On the Separation of the Positions of CEO and Chairman of the Board*, Working Paper FR 96-04, William E. Simon Graduate School of Business, University of Rochester (1995) (on file with the authors).

CEO and chair.[42] In most of the companies in the United States that split the roles, the person serving as chair is a former CEO.[43] Even if a company decides that having a separate independent chair is not in its best interests, a company can realize many of the advantages of separating the aforementioned two positions, if its independent directors appoint an independent senior member to serve as lead director.

The lead director should be independent of management, which means that he or she should not be the retired CEO, who often has hand-picked the present CEO.[44] The lead director should also not be affiliated with any firm (such as a customer, supplier, bank, law firm, or consulting firm) that does any material amount of business with the company. To avoid entrenchment and undue affiliation with management, it would be appropriate to impose a limit on the number of consecutive years a person can serve as lead director; a five-year limit would be reasonable.

A company's lead director would function as the leader of the independent directors. In this capacity, the lead director would be able to take an active role in a number of areas of vital importance to the company. For example, Lipton and Lorsch have proposed that the lead director should be actively involved in the following matters: selecting board committee members and chairs; setting board meeting agendas; ensuring the adequacy of information that directors receive; and enhancing the effectiveness of the board meeting process.[45]

The lead director would have the power to convene special and regular meetings of the independent directors, without management present, and would chair such meetings. By having the independent directors meet on a regular basis, the lead director can demonstrate to the CEO that having the independent directors meet in a session without management is not necessarily a sinister event indicating that the independent directors are displeased with management and are contemplating firing

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42. In a 1996 survey of over 1,000 directors, only 19% of the respondents indicated their companies had a non-executive chair. KORN/FERRY INTERNATIONAL, 23RD ANNUAL BOARD OF DIRECTORS STUDY 23 (1996). In addition, three percent of the directors surveyed indicated their boards were considering splitting the functions of CEO and chair. *Id.* Of the directors who served on the boards of companies that had a single individual as CEO and chair, only 27% indicated their boards had a lead director. *Id.*

43. KORN/FERRY INTERNATIONAL, *supra* note 39, at 20.

44. The comments within this paragraph are also applicable to companies that have a non-executive chair.

45. Lipton & Lorsch, *supra* note 6, at 70.

the CEO. A separation of the functions would also increase the likelihood that the board would consider alternative viewpoints and courses of action besides those supported by the CEO and chair.

In addition to increasing the efficacy of routine activities engaged in by a board of directors, a lead director would also be an invaluable asset to a company's other directors in a time of crisis. For example, in the event of the sudden death or incapacity of a company's CEO, a lead director who is a recognized leader on the board of directors could step in and serve as a liaison between the board and the remaining members of management.[46] By conducting regular meetings of independent directors, the lead director also strengthens the relationship among the independent directors and enables them to function more effectively in a time of crisis.

In many boardrooms today, there is already an independent director who is recognized by the management and the independent directors as a leader.[47] Some have argued that selecting an independent director as the leader of the independent directors will "simply legitimate this role."[48] Publicly identifying a person as the leader of the independent directors may also further the goal of providing greater accountability for the company's performance. *The Wall Street Journal* already regularly includes a box naming all of the directors in its articles on corporate disasters.[49] Without a publicly identified leader, it is difficult for the shareholders and the public to hold any particular independent director accountable. On the other hand, if the leader of the independent directors is publicly identified, it is more likely that the leader will be singled out for criticism.[50] Fear of this criticism and the resultant loss of reputation can be a powerful incentive for conscientious board service.[51] As such, publicly designating a lead director provides a

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46. Jay W. Lorsch & Martin Lipton, *On The Leading Edge: The Lead Director*, HARV. BUS. REV., Jan.-Feb. 1993, at 79.

47. *See* Lipton & Lorsch, *supra* note 6, at 71.

48. *Id.*

49. *See, e.g.*, Scott Kilman et al., *An Executive Becomes Informant for the FBI, Stunning Giant ADM*, WALL ST. J., July 10, 1995, at A1, A6; Joan E. Rigdon, *William Agee Will Leave Morrison Knudsen*, WALL ST. J., Feb. 2, 1995, at B1, B10.

50. *See* Lowenstein, *supra* note 1, at C1 ("If you want to motivate [outside directors], make them responsible, i.e. guarantee that besmirchment will be the reward for being asleep at the switch.").

51. *See* PAUL MILGROM & JOHN ROBERTS, ECONOMICS, ORGANIZATION, AND MANAGEMENT 258 (1992) ("[A]n agent whose business opportunities lie with a small group of principals who communicate among themselves must worry that actions that damage his or her reputation will result in the loss of a large volume of possible business."). *See also* Philip E. Tetlock, *Accountability: The Neglected Social Context of Judgment and Choice*, *in* 7 RES. IN ORGANIZATIONAL BEHAV. 297, 308 (L.L. Cummings & Barry M. Staw eds., 1985) (According to H.L. Zetterberg, "[t]he

counter-weight to the often prevailing board culture and norms whereby directors avoid confrontation and only give advice when and if asked by the CEO, considering it "bad form" to push uninvited company business.[52]

We acknowledge that serving as an independent chair or lead director is a big job. To provide a positive incentive to undertake such a role, the company should be prepared to provide the independent chair or lead director extra compensation commensurate with the time, effort, and responsibility involved.[53] This will, for many companies, be an added cost of separating the roles or appointing a lead director.[54]

III. THE EFFECT OF INDEPENDENT DIRECTORS AND BOARD LEADERSHIP STRUCTURE ON CORPORATE PERFORMANCE

This part will discuss a recent study, the findings of which suggest that American corporations need to do more than just place independent directors on their boards to increase shareholder wealth via their corporate governance activities. This part will then analyze the recent research on the relationship between corporate performance and board leadership structure in the United States and the United Kingdom.

A. The Bhagat & Black Study on Independent Directors

Over the past twenty years, the boards of U.S. public companies have undergone a dramatic change in composition.[55] Twenty years ago, inside directors, *i.e.* persons who were company officers or relatives of

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maximization of favorable attitudes from others [is] the counterpart in sociological theory to the maximization of profit in economic theory.").

52. William T. Allen, Corporate Directors in the Dawning Age of Post-Materialism: New Problems and New Solutions, Address at the Stanford University Center for Economic Policy Research Conference on Corporate Governance (May 1, 1992).

53. General Motors, for example, paid independent chair John Smale $300,000 in 1993.

54. For a further discussion of costs involved in splitting the roles of CEO and chair, see Brickley, et al., *supra* note 41, at 7-11.

55. Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 840-41 (1992) ("Twenty years ago, many public company boards were controlled by insiders; today, almost all have a majority of *outside* directors, and many have a majority of *independent* directors . . . .").

officers,[56] controlled many U.S. public companies' boards; today, however, independent directors, *i.e.* persons who have no company related business dealings and are not former company officers,[57] comprise the majority of directors of many U.S. public companies.[58]

The increasing number of independent directors on U.S. companies' boards can be seen as a response to the widely accepted belief that increasing the representation of independent directors on a company's board will improve its performance.[59] As the performance of U.S. companies lagged behind that of their foreign competitors in the 1980s, many commentators argued that to compete successfully with their foreign competitors, U.S. companies needed to change their corporate governance practices.[60] A central tenet of many corporate governance reform proposals espoused in the 1980s was that U.S. companies needed to place more independent directors on their boards to improve their performance.[61] A recently conducted unpublished study by Professor Sanjai Bhagat of the University of Colorado Graduate School of Business and Professor Bernard Black of Columbia Law School suggests that U.S. companies must do more than just place independent directors on their boards to increase shareholder wealth via their corporate governance activities.[62]

The study represented the first large-scale, long-time-horizon analysis of the effect of independent directors on corporate performance.[63] Bhagat and Black analyzed the stock price and accounting performance of 950 large U.S. companies between 1983 and 1993.[64] The authors selected the 950 companies from the Institutional Shareholder Services database, which is comparable to the Fortune 500 database but more inclusive in that it includes companies outside of the areas of manufacturing and mining.[65]

The study found that the proportion of independent directors on a company's board "has no consistent effect on market-adjusted stock

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56. THE ISS PROXY VOTING MANUAL 96-100 (R. Monks et al. eds., Institutional Shareholder Servs., 2d ed. 1991).
57. *Id.*
58. Black, *supra* note 55, at 841.
59. *Id.*
60. Ronald J. Gilson, *Corporate Governance and Economic Efficiency: When Do Institutions Matter?*, 74 WASH. U. L.Q. 327, 328 (1996).
61. *See, e.g.*, AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE (1994).
62. Sanjai Bhagat & Bernard Black, *Do Independent Directors Matter?* (Working Paper, 1996) (on file with the authors).
63. *Id.* at 2.
64. *Id.* at 3.
65. *Id.*

price performance."[66] Moreover, the study found no evidence that the proportion of independent directors on a company's board positively affects its performance across a wide range of accountings measures.[67] The study's findings suggest that independent directors, on average and over time, do not add any more value to the boards on which they serve than that which is added by non-independent directors. One possible explanation for this finding is that independent directors are capable of adding value only if they serve on boards with the appropriate board leadership structure. As a result, this study can be seen as suggesting that American companies need to focus on board leadership structure if they are to increase shareholder wealth through changes in their corporate governance.

B. Recent Research on Board Leadership Structure in the United States

The relationship between U.S. companies separating their chair and CEO positions and their performance has been the subject of only three recently published studies. This section will provide an overview of these three studies. We will also summarize the results of one unpublished study.

A 1991 study analyzed the performance of 250 randomly selected Fortune 500 companies between 1978 and 1983.[68] The study's objective was to compare the multi-year financial performance of companies that had one individual serve as their chair and CEO and those that separated their chair and CEO positions.[69] The study removed companies that changed their structure during the study. As a result, the study's sample consisted of 141 companies, thirty of which had separated their chair and CEO positions during the period from 1978 to 1983.[70] The study found that during each of the years between 1978 and 1983, the companies that separated their chair and CEO positions had significantly higher average returns on investment, average returns on equity, and average profit margins than their counterparts that

66. *Id.*
67. Bhagat & Black, *supra* note 62, at 3.
68. Paula L. Rechner & Dan R. Dalton, *CEO Duality and Organizational Performance: A Longitudinal Analysis*, 12 STRATEGIC MGMT. J. 155 (1991).
69. *Id.* at 156.
70. *Id.*

combined their chair and CEO positions.[71] These findings resulted in the study concluding that companies with separate chair and CEO positions "consistently outperformed" companies with a single individual serving as chair and CEO.[72]

A 1993 study analyzed the effect of board leadership structure within the banking industry.[73] This study analyzed the performance between 1988 and 1990 of a yearly average of 112 banks, nineteen of which on average had a non-chair CEO.[74] The study found that cost efficiency and return on assets are lower for banks where an individual serves as chair and CEO than banks that separate the chair and CEO positions.[75] The study concluded that "on average banks where the CEO is also the chairman of the board underperform those banks where the CEO is not the chairman of the board."[76]

A 1996 study examined the relationship between corporate performance and board leadership structure.[77] This study analyzed each of the Fortune 500 companies as defined at the end of 1990 and then classified them based on their chair and CEO status for each year between 1986 and 1991.[78] Companies that did not use standard managerial titles were removed from the study. As a result, on average, 375 companies were studied for each year.[79] Of the companies studied only twelve had total "nonduality," *i.e.*, they had a separate chair and CEO for each year.[80] This study found that the stock market is unaffected by a company's announcement indicating that it will allow one individual to serve as chair and CEO or separate its chair and CEO positions.[81] Moreover, this study also found that "there is no difference in performance between firms with total nonduality during the period and firms with total "duality" [*i.e.*, firms that had a CEO/chair for each year] . . . ."[82]

71. *Id.* at 158-59.
72. *Id.* at 155.
73. Lynn Pi & Stephen G. Timme, *Corporate Control and Bank Efficiency*, 17 J. OF BANKING AND FIN. 515 (1993).
74. *Id.* at 522.
75. *Id.* at 529.
76. *Id.*
77. B. Ram Baliga et al., *CEO Duality and Firm Performance: What's the Fuss?*, 17 STRATEGIC MGMT. J. 41 (1996).
78. *Id.* at 44-45.
79. *Id.*
80. *Id.*
81. *Id.* at 47.
82. Baglia et al., *supra* note 77, at 49-50.

An unpublished 1995 study examined the relationship between board leadership structure and accounting performance.[83] This study analyzed 661 firms from the 1989 *Forbes* survey of executive compensation, and then classified them based on their chair and CEO status at the end of 1988.[84] Of the 661-company sample, 535 combined the roles of CEO and chair, ninety-three split the roles, and thirty-three had no chair.[85] This study compared accounting performance for the two subsamples (the 535 companies that combined the roles and the ninety-three that split them) for 1988 and the period from 1989 to 1991. It found that median return on capital in 1988 was higher in firms that combined the roles than in those that split them.[86] Over the period from 1989 to 1991, each subgroup earned essentially the same return on capital.[87] Stock return for the two subgroups in 1988 was not significantly different under one statistical test but was under another.[88] Over the period from 1989 to 1991, the median stock return for firms combining the roles was substantially larger than the median stock return of firms that split the roles.[89] When the study compared accounting and market returns adjusted by industry medians, the differences in both periods across the two subgroups "generally [were] insignificant."[90] This study also found that "changes in leadership structure have no systematic effects on stock prices."[91]

The authors of this study noted that "changes in leadership structure might convey information to the market about cash flows even if the structure itself does not affect performance,"[92] and stated that "[t]he potential for these types of secondary information effects confounds the interpretation of our results."[93] This caution appears well-placed given the authors' proposition, that in the United States, elevating the CEO to the combined roles of CEO and chair is usually a reward for good past

83. Brickley et al., *supra* note 41.
84. *Id.* at 13.
85. *Id.* at 13-14.
86. *Id.* at 26-27.
87. *Id.* at 27.
88. Brickley et al., *supra* note 41, at 27.
89. *Id.*
90. *Id.*
91. *Id.* at 36.
92. *Id.* at 33.
93. Brickley et al., *supra* note 41, at 34.

performance and a vote of confidence.[94] If this is true, then we would expect the market to interpret an announcement that the roles are to be split as an indication that the CEO's performance has not been good, thereby signaling that future cash flows may be lower than the market had expected.

The studies, taken together, suggest that at best separating the roles of chair and CEO positively impacts performance, and at worst it has no effect on performance. As a result, splitting the roles of chair and CEO might be compared to chicken soup: Can't hurt, might help.[95] The lack of definitive empirical data means that we must rely on logic and reason together with anecdotal evidence to support our proposal. The logic has been presented in Part II and can be summarized as follows:

> The function of the chairman is to run board meetings and oversee the process of hiring, firing, evaluating, and compensating the CEO .... Without the direction of an independent leader, it is much more difficult for the board to perform its critical function. Therefore, for the board to be effective, it is important to separate the CEO and chairman positions.[96]

The anecdotal evidence is presented in Part IV.

C. Recent Research on Board Leadership Structure in the United Kingdom

The relationship between U.K. companies separating their chair and CEO positions and their performance has been the subject of one recently published study.[97] This section will provide an overview of this study.

This study analyzed 124 U.K. companies that announced a change in their board leadership structure between January of 1989 and December of 1992.[98] For a company to be included in the survey, it had to announce that it intended to separate, maintain, or create the dual positions of CEO and chair, and the *Financial Times* had to mention this announcement.[99] In addition, companies that had a confounding event, such as the declaration of a dividend within three days of a board

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94. *Id.* at 25.

95. For an analysis of this type of argument in a different context, see Grundfest, *supra* note 3, at 868.

96. Michael C. Jensen, *Presidential Address: The Modern Industrial Revolution, Exit and the Failure of Internal Control Systems*, 48 J. OF FIN. 831, 866 (1993).

97. J. Dahya et al., *The Case for Separating the Roles of Chairman and CEO: An Analysis of Stock Market and Accounting Data*, 4 CORP. GOVERNANCE 71 (1996).

98. *Id.* at 73.

99. *Id.*

leadership announcement, were excluded from the study.[100] As a result, the study only analyzed the effect of seventy-six companies' announcements.[101]

The study found that "a significant positive market reaction . . . followed the separation of the responsibilities of chairman and CEO."[102] The study also found that companies that announced they would separate the chair and CEO positions subsequently performed better than their counterparts based on accounting measures.[103] Moreover, the study found that an announcement that a company would be combining its chair and CEO positions resulted in "the largest negative market response the day after the announcement."[104]

Although this study involved an analysis of a relatively small sample of U.K. companies, its findings support the contention that the separation of the chair and CEO positions can result in the creation of increased shareholder value.[105] Furthermore, the study's findings support the contention that separating the chair and CEO positions can lead to improved performance.[106]

IV. EXAMPLES OF THE EFFECTS OF CORPORATE GOVERNANCE PRACTICES ON SHAREHOLDER VALUE

To illustrate the possible negative consequences of inadequate corporate governance practices on shareholder value, this part examines the stock price effects of several recent, well-publicized examples of management underperformance that have occurred arguably as a direct result of inadequate corporate governance. These examples are intended to illustrate the adverse effects that can occur when a company's management pays inadequate attention to corporate governance issues. This part concludes with a discussion of the recent events at General Motors and Compaq, illustrating the positive effects that can occur when a company's management pays attention to corporate governance issues.

100. *Id.*
101. *Id.*
102. Dayha et al., *supra* note 97, at 76.
103. *Id.*
104. *Id.*
105. *Id.*
106. *Id.*

In presenting these examples we do not mean to suggest that all of the problems could have been solved by inserting an independent chair or lead director. Rather, we maintain that having an independent chair or lead director will, over time, contribute to the creation of a culture in which non-management directors act in an independent manner and fulfill their responsibilities. Such a culture is most likely to result when the separation of the CEO and chair or designation of a lead director is coupled with other generally accepted features of good corporate governance, such as having a predominately outside board, establishing an independent nominating committee that makes nominations based on an articulated statement of director qualifications and does periodic reviews of individual directors' performance, and imposing a retirement age for directors and term limits on committee chairs.[107]

We also do not mean to suggest that all CEOs who are also chairs cannot be trusted and are not doing their jobs. For those who are, our proposal will only add to their credibility and effectiveness, enabling them to make better use of the board by increasing the likelihood that there will be an independent chair or lead director to turn to between meetings, who also will lead the independent directors in a candid evaluation of the CEO's performance and encourage open, frank, and constructive discussion of corporate strategy.

A. Archer-Daniels-Midland

On June 27, 1995, the federal government issued subpoenas for a criminal investigation into possible price-fixing at Archer-Daniels-Midland ("ADM") to a number of the company's senior officers.[108] Federal authorities played excerpts of taped conversations, which the authorities believed had captured ADM executives engaging in illegal price-fixing with several of ADM's competitors, to some of the senior officers who received subpoenas.[109] However, none of ADM's senior officers acknowledged any wrongdoing or agreed to cooperate in the Federal investigation.[110] Within days, ADM received yet another surprise: Mark E. Whiteacre, the head of its bioproducts division and a long-time employee of the company, had been working with prosecutors and the Federal Bureau of Investigation for approximately three

107. John A. Byrne & Richard A. Melcher, *The Best & Worst Boards*, BUS. WK., Nov. 25, 1996, at 82, 104.

108. Kurt Eichenwald, *A Shareholder Rebellion: Investors Demand Answers from Archer-Daniels*, N.Y. TIMES, Oct. 19, 1995, at D1.

109. *Id.*

110. *Id.*

years.[111] Moreover, during these years, Whiteacre had tape-recorded thousands of conversations.[112]

As news of the federal investigation became public, the company's stock declined.[113] While the S&P 500 gained 0.42 percent on June 28, 1995, ADM stock declined by approximately 3.33 percent and closed at $16.44.[114] Moreover, in the three months following the accusations, while the S&P 500 gained 7.55 percent, ADM stock declined by an additional 8.76 percent.[115] This resulted in ADM's shareholder wealth decreasing by approximately $1.0 billion.[116] These events prompted Bonnie Wittenburg, an analyst with the securities firm Dain Bosworth, to assert that "[e]ven in the best case scenario . . . there [would] be a cloud over [ADM's] stock for the next couple of years."[117]

In the months after the public became aware of the federal investigation into ADM, the company's practices became a subject of media attention and public scrutiny. The federal government's price-fixing probe focused on three particular ADM products: high fructose corn syrup, a sweetener used in soft drinks; lysine, a food additive; and citric acid, a product used in everything from detergent to fruit juice.[118] Although ADM had become the subject of much attention, in the months following the public disclosure of the antitrust probe, the company's management "labored mightily to keep analysts and reporters at bay."[119]

In the following months, ADM became the subject of yet another alleged scandal. Allegations that ADM made off-the-books payments, which its senior management approved, began to circulate.[120] These allegations began when ADM fired Whiteacre in August of 1995 for allegedly embezzling $2.5 million, a figure that the company subsequent-

111. *Id.*
112. *Id.*
113. Ronald Henkoff & Richard Behar, *Andreas's Mole Problem is Becoming a Mountain*, FORTUNE, Aug. 21, 1995, at 58.
114. Search of *DATASTREAM*, Equities Library, Time Series File.
115. *Id.*
116. William Patterson & Bartlett Naylor, *Sour Dramas of Poor Corporate Governance*, PENSIONS & INVESTMENTS, Nov. 27, 1995, at 10.
117. Henkoff & Behar, *supra* note 113, at 59.
118. Patricia Commins, *Large Shareholders Continue to Press for Changes in ADM Board*, THE REUTER EUROPEAN BUS. REP., Oct. 20, 1995, *available in* LEXIS, Nexis Library, REUEUB File.
119. Henkoff & Behar, *supra* note 113, at 58.
120. Ronald Henkoff, *Checks, Lies, and Videotape*, FORTUNE, Oct. 30, 1995, at 109.

ly raised to $9.0 million.[121] In his defense, Whiteacre alleged that his supervisors approved the disputed payments and that he did not engage in embezzling.[122]

Following the aforementioned events, ADM's management became the subject of much criticism, which focused on ADM's corporate governance practices. A single individual, Dwayne O. Andreas, age seventy-seven, had served as ADM's chair and CEO since 1972.[123] Moreover, Andreas used his position as chair and CEO to help place directors on ADM's board who had close ties to him.[124] ADM's seventeen member board included twelve directors with direct ties to management.[125] These twelve directors consisted of both current and former ADM executives, two descendants of ADM founders, a relative of an ADM executive other than Andreas, and one of ADM's outside lawyers.[126]

Institutional investors and members of the media criticized ADM's board of directors for its lack of independence. For example, Jon Lukumnik, deputy controller for pensions for the New York City Retirement Systems ("NYCRS"), described ADM's board as "remarkable for its interconnections, friendships and blood ties with the chief executive officer."[127] ADM's directors included Dwayne Andreas; his son, Michael Andreas, vice chair; James Randall, president; John Daniels, retired chair of the board; Ralph Bruce, retired executive vice president; and Lowell Andreas, retired president.[128] The lack of independent directors on ADM's board prompted some critics of its corporate governance practices to suggest that the acronym ADM referred to "All Dwayne's Men."[129]

In response to the situation, institutional investors, who owned approximately forty-eight percent of ADM's stock, placed an unprecedented amount of pressure on ADM.[130] Over thirty institutional shareholders, including CalPERS, withheld their votes with respect to the re-election of ADM's seventeen directors.[131] Although the institutional

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121. *Id.*
122. *Id.*
123. *Id.*
124. Paul Merrion, *Cozy Board Ties Have ADM in Bind: Critics Charge Connections Hurt Credibility*, CRAIN'S CHI. BUS., Aug. 7, 1995, at 3.
125. *Id.*
126. *Id.*
127. Commins, *supra* note 118.
128. *Id.*
129. David Snyder, *Investor Assault on ADM: They Should Know Better*, CRAIN'S CHI. BUS., Nov. 6, 1995, at 13.
130. *Id.*
131. Sharon Walsh, *ADM Chief Thwarts Hostile Shareholders: Board Reelected by More Than 80% Margin*, WASH. POST, Oct. 20, 1995, at B1.

investors' efforts resulted in the withholding of over twenty percent of the votes, they did not affect the election's outcome.[132]

ADM finally responded to these shareholders at its annual shareholders' meeting on October 19, 1995. The meeting started rather cantankerously. When a hostile shareholder representative tried to ask a question, Andreas responded by saying, "This meeting, sir, runs according to my rules."[133] Later, when a representative of a pension fund, which held more than 1.0 million shares of ADM stock, tried to raise a question, Andreas told security personnel to turn off the microphone.[134]

After Andreas and ADM President Randall spoke, Brian Mulroney, a former Canadian prime minister and an ADM board member, reported on the work of a special committee, which he chaired, that was overseeing the company's response to the antitrust investigation.[135] Moreover, Mulroney indicated that ADM would appoint a corporate governance committee, which would be co-chaired by Ray Goldberg, a professor of agribusiness at Harvard University, and Glenn Webb, chair of an ADM subsidiary.[136] Mulroney also indicated that the corporate governance committee would "review the company's corporate governance procedures."[137]

On January 3, 1996, a group of sixteen public and union pension funds representing millions of shares of ADM stock wrote a letter to the company's corporate governance committee and recommended that the board be composed of a majority of independent directors and that certain committees be "comprised of solely independent directors."[138] In mid-January, ADM's corporate governance committee came out with its proposal recommending that ADM reduce its board size and reduce the number of inside directors.[139] As a result of the committee's work, Andreas indicated that more outside directors would be added to ADM's

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132. *Id.*
133. *Id.*
134. *Id.*
135. *Id.*
136. Walsh, *supra* note 131.
137. *Id.*
138. Nancy Millman, *ADM's 'All-in-the-Family' Board Faulted: Replacements May Be Recommended at Meeting*, CHI. TRIB., Jan. 15, 1996, at C1.
139. Scott Kilman & Joann S. Lublin, *ADM Panel Recommends Sweeping Changes in Board*, WALL ST. J., Jan. 16, 1996, at A3. *See also* Richard A. Melcher et al., *It Isn't Dwayne's World Anymore*, BUS. WK., Nov. 18, 1996, at 82.

board and board committees at the next annual meeting.[140] Although commentators lauded ADM for taking these steps to improve its corporate governance practices, many commentators also criticized ADM for failing to take all of the necessary steps, such as establishing "a strong 'lead director' as a counterweight to Andreas . . . ."[141]

On October 15, 1996, ADM plead guilty to two criminal charges of price-fixing and agreed to pay a $100 million dollar fine,[142] the largest criminal antitrust fine ever levied.[143] In addition, ADM agreed to help the government build a criminal case against two executives, Michael Andreas and Terrance Wilson.[144] At the annual shareholder meeting on October 17, 1996, eight board members removed themselves from the ADM board, and three more individuals joined ADM's board.[145] As a result, ADM's board now consists of twelve members, three of whom are independent.[146]

Although ADM has taken action to address the inadequacy of its corporate governance practices, the ex-post nature of these actions leaves one pondering how many of ADM's current problems could have been avoided if it had separated its chair and CEO positions or had appointed a lead director. Moreover, one wonders how much of ADM's shareholder wealth would have been preserved if the company had acted proactively to ensure that its corporate governance practices provided it with the normal checks and balances of a corporation of its size and stature.

B. *Morrison Knudsen*

Unlike the board of ADM, the board of Morrison Knudsen ("MK"), an engineering, construction, mining, and rail concern renowned for its construction of the Hoover Dam and San Francisco Bay Bridge, appeared to consist of independent outsiders, such as Peter S. Lynch, former manager of the Fidelity Magellan Fund, and Peter V. Ueberoth, former commissioner of major league baseball, who should have been familiar with what shareholders expect from a public company.[147]

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140. *Id.*

141. Richard A. Melcher & Greg Burns, *Archer Daniels' Cleanup: Don't Stop Now*, BUS. WK., Jan. 29, 1996, at 37. *See also* Byrne & Melcher, *supra* note 107, at 85 (ADM cited as having the worst board in the United States).

142. Melcher et al., *supra* note 139, at 82.

143. *Three Former ADM Executives Indicted*, L.A. TIMES, Dec. 4, 1996, at D3.

144. Mechler et al., *supra* note 139, at 82.

145. *Id.* at 84.

146. *Id.*

147. Diana B. Henriques, *Ties That Bind: His Directors, Her Charity*, , N.Y. TIMES, March 21, 1995, at D1.

However, events that unfolded in 1994 revealed that, like the board of ADM, the board of MK may have benefited from the presence of a lead director or the separation of its chair and CEO positions.

MK earned an annual profit of approximately $35.0 million in 1990, 1991, and 1993 and lost approximately $7.1 million in 1992. MK shocked investors when it unexpectedly lost in excess of $350.0 million in 1994.[148] After MK announced an unanticipated loss of approximately $40.5 million in the second quarter of 1994,[149] its stock price plummeted by approximately thirty percent.[150]

Shortly after this unexpected announcement, MK shareholders filed a class action suit against the company, its CEO and Chair William J. Agee, two other corporate officers, and its outside auditor Deloitte & Touche.[151] The suit claimed that MK had made false and misleading statements and misled investors about the company's future profitability.[152] Subsequently, shareholders filed thirteen additional shareholder derivative suits against Agee and various other board members. These suits repeated the claims alleged in the class action suit and also accused Agee of leading MK to financial ruin via his executive decisions and of misappropriating corporate assets for his personal use.[153] These suits also accused MK's directors of abandoning their oversight responsibilities.[154]

In addition to significantly reducing MK's shareholders' wealth,[155] MK's unexpected loss in 1994 posed a significant threat to MK's future financial viability. To fulfill its contractual obligations, MK required additional sources of cash in 1995.[156] However, because of MK's precarious financial condition and the possibility that it might "seek protection from its creditors under the United States Bankruptcy ..."

148. MORRISON KNUDSEN CORP., 1994 ANNUAL REPORT 28 (1995).
149. Dan Popkey, *SEC Late to the Game*, IDAHO STATESMAN, June 9, 1995, at 8A.
150. *See infra* Exhibit I, APPENDIX for an analysis of MK's stock performance relative to the S&P 500.
151. Robb Mandelbaum, *Big Suits*, AM. LAW., Dec. 1995, at 102.
152. *Id.*
153. *Id.*
154. *Id.*
155. MK stockholders owned equity worth approximately $407.0 million at the end of 1993. However, at the end of 1994, MK stockholders owned equity worth less than $57.7 million. MORRISON KNUDSEN CORP., *supra* note 148, at 28.
156. *Id.* at 20.

Code,"[157] MK's ability to obtain additional financing became uncertain.

As an engineering, construction, mining, and rail concern, MK competed with other firms for various long-term contracts. MK could assess the profitability of many of these contracts only after performing them. In 1994, MK's engineering and construction division lost in excess of $82.0 million, MK's rail subsidiary lost in excess of $31.0 million, and MK's transit division lost in excess of $224.0 million.[158] Critics focused on the process by which MK selected what prices to bid for contracts because cost overruns on allegedly profitable contracts resulted in MK's enormous losses.[159] Moreover, the managerial decisions of Agee, MK's chair and CEO, also became the subject of increasing attention.[160]

MK had submitted bids for many of these long-term contracts that were so low that MK incurred substantial losses fulfilling its contractual obligations.[161] MK officially cited a decrease in new contract awards, postponements of start-ups of previously awarded contracts, write-downs of operating assets and investments, and provisions for anticipated losses on uncompleted contracts as several of the sources of its loss.[162] However, others blamed Agee and accused him of intentionally underbidding certain contracts to ensure that MK received them.[163] For example, Agee reportedly underbid several major transit-car contracts because he thought that doing so would enable MK to solidify its position in this line of business.[164] MK's 1994 financial results and the transit division's 1994 loss of $224.7 million revealed that Agee's strategy had disastrous effects on the company and its shareholders.[165]

Critics of Agee focused not only on his managerial decisions but also on his personal conduct. Although Agee moved to Boise, Idaho, the location of MK's headquarters, in 1988,[166] he sold his Boise residence to MK and began running the corporation from his residence in Pebble

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157. *Id.*
158. *Id.* at 15-17.
159. *See, e.g.*, Allan Sloan, *William Agee: His Record of Disastrous Management Remains Intact*, L.A. TIMES, Feb. 5, 1995, at D2.
160. *Id.*
161. *Id.*
162. MORRISON KNUDSEN CORP., *supra* note 148, at 15-16.
163. Julie Bailey, *MK Acts to Isolate Transit Business*, IDAHO STATESMAN, June 28, 1995, at 5B.
164. *Id.*
165. *See infra* Exhibit I, APPENDIX.
166. Martin Wolk, *Morrison Knudsen Ousts Agee as Chairman*, REUTER BUS. REP., Feb. 10, 1995, *available in* LEXIS, Nexis Library, ARCNWS File.

Beach, California, in the spring of 1994.[167] Moreover, in January of 1994, the MK compensation committee agreed to increase Agee's salary by more than $150,000 after an Internal Revenue Service ("IRS") audit of his taxes for 1990, 1991, and 1992. The IRS found that Agee should have reported income of $56,892 for his wife's use of the MK airplane, $99,383 for company-paid security systems at his houses, and $1,350 for using a company warehouse to store personal items.[168] As a result of the absentee management, the IRS audit, and other activities, Agee developed a reputation as "an out-of-touch executive living a lavish lifestyle at the expense of the faltering company."[169] An editorial in a leading Boise newspaper asked the following question: "Is MK an international construction firm or a posh playground for the rich and famous of Pebble Beach?"[170]

The personal relationships between many of MK's directors and Agee also became an issue during this time period. Nine of MK's eleven directors became directors after Agee had been appointed MK's CEO and chair in 1988.[171] Moreover, Agee also served as a director of MK.

Six of MK's directors had close ties to Agee via the Nurturing Network, a tiny private charity set up by his wife to provide young women with alternatives to abortion.[172] In addition to Agee, Gerard Roche, an MK director, and the wives of five other outside directors had served on the charity's board.[173] On some occasions, the charity's board even met at the same time and location as MK's board. Furthermore, on some of these occasions, the boards shared intimate dinners that spotlighted the charity's work.[174]

Although personal friendships and family socializing are routine among outside directors and CEOs, the nature of these friendships and the extent of the socializing present at MK went beyond the norm. Lorsch stated that he was "quite surprised that there could be this kind

167. Dan Popkey, *Boardroom for Buddies*, IDAHO STATESMAN, June 9, 1995, at 1A.
168. *Id.*
169. Wolk, *supra* note 166.
170. *MK Directors Accountable for Past Mistakes, Future Direction*, IDAHO STATESMAN, Feb. 12, 1995, at 14A.
171. Greg Heberlein, *Gee, Here Is at Least 1 Thank You for Bill Agee*, SEATTLE TIMES, Feb. 5, 1995, at F1.
172. Henriques, *supra* note 147, at D1.
173. *Id.*
174. *Id.* at D4.

of complicated arrangement going on that nobody knows about."[175] He further stated: "I have never seen a situation like this."[176]

The conduct of MK's directors also came under increasing scrutiny after the events of 1994.[177] For example, *Chief Executive* cited MK's board as one of America's worst corporate boards.[178] The magazine criticized MK's board for failing to meet at MK's corporate headquarters for over a year and for paying excessive attention to the CEO's compensation.[179] The magazine also criticized MK's board for failing to take corrective actions as soon as they were necessary.[180]

In late 1994 and early 1995, two new outsiders, William P. Clark and Zbigniew Brzezinski, joined MK's board.[181] In February of 1995, with MK facing immense losses and with the board galvanized by the addition of two new directors, MK's board demanded and received Agee's resignation.[182] Subsequently, in September of 1995, MK settled all but one derivative suit against it.[183] Although the settlement did not include any findings of wrongdoing by MK or any of the individual defendants, the settlement provided for: (1) MK's directors' and officers' liability insurance carriers to pay $35.0 million to plaintiffs, (2) MK to issue over 2.9 million shares of common stock to the plaintiff class, (3) Agee to relinquish certain contractual benefits, and (4) the implementation of certain corporate governance procedures, including reasonable efforts to appoint seven additional non-employee directors to MK's board.[184] In addition to adding these non-employee directors, MK also announced that it would separate the positions of CEO and chair.[185]

When MK announced that it would be merging with Washington Construction Group Inc. in May of 1996, the NYSE halted trading in MK stock.[186] On July 9, 1996, MK filed a pre-packaged Chapter 11

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175. *Id.*

176. *Id.*

177. *See, e.g.*, Robert W. Lear & Boris Yavitz, *The Best and Worst Boards of 1995: Evaluating the Boardroom*, CHIEF EXECUTIVE, Nov. 1995, at 24.

178. *Id.*

179. MK's 1993 proxy statement ran 43 pages, 38 of which concerned the compensation programs for Agee and other top officers. *Id.*

180. *Id.*

181. *Id.*

182. Lear & Yavitz, *supra* note 177, at 24.

183. *Morrison Knudsen Settles Securities, Derivative Litigation*, PR NEWSWIRE, Sept. 20, 1995.

184. *Id.*

185. Katy Robinson, *Agee Fiasco Provides Lessons for Other Businesses*, IDAHO STATESMAN, Feb. 9, 1996, at 2A.

186. Ellie Rodgers, *MK's Directors Open New Era Today*, IDAHO STATESMAN, Sept. 12, 1996, at 5B.

bankruptcy plan.[187] Under the term of the agreement, MK's shareholders received one warrant for every thirteen and three-tenths shares of MK stock they owned.[188] Each warrant gave its holder the right to purchase one share of the combined company's stock for $12 over a period of six and one-half years.[189] The combined company assumed the Morrison Knudsen name.[190] On September 12, 1996, shares of the new Morrison Knudsen began trading on the New York Stock Exchange.[191] They closed at $9.63 after their first day of trading.[192]

Although MK's board ultimately took steps to address the problems associated with its CEO and chair, and agreed to take steps that will ultimately result in increasing the efficacy of its corporate governance practices, it did so only after MK shareholders lost a significant amount of their wealth. Between year end 1993 and year end 1994, MK shareholders lost approximately $350.0 million.[193] A shareholder who purchased MK stock on the last trading day of 1993 and sold this stock on the last trading day of 1994 would have lost almost 85.0% of her or his investment.[194]

The events that transpired in 1994 leave one wondering whether they would have occurred if MK had separated the roles of CEO and chair or appointed a lead director at an early stage. The presence of a strong and independent leader on the board would have certainly diminished Agee's control over the board and may have resulted in a course of events that would not have been so disastrous for MK and its shareholders.

187. *Morrison Knudsen Files for Chapter 11 Bankruptcy*, REUTER BUS. REP., June 25, 1996, *available in* LEXIS, Nexis Library, CURNWS File.
188. Ellie Rodgers, *MK Bankruptcy Plan Baffles Investors*, IDAHO STATESMAN, Sept. 23, 1996, at 5B.
189. *Id.*
190. Rodgers, *supra* note 186, at 5B.
191. *Id.*
192. Search of *DATASTREAM*, Equities Library, Time Series File.
193. MORRISON KNUDSEN CORP., *supra* note 148, at 28.
194. *Id.*

C. *General Motors*[195]

In 1981, General Motors ("GM"), the largest American automobile manufacturer, appointed a new chair and CEO, Roger Smith.[196] Smith had spent his entire career at GM, having started work as a general accounting clerk.[197] Soon after the board appointed him chair and CEO, Smith began his attempt to transform GM into an automobile industry leader through the increased use of new processes and technology.[198] For example, between 1981 and 1985, GM spent over $40 billion on high-technology plants equipped with the latest lasers, computers, and robots—an amount of money that exceeded the market valuations of Toyota and Nissan.[199]

Despite these efforts to make GM increasingly competitive via technology, the company remained noncompetitive.[200] GM critics characterized the company's new products as "unexciting, look-alike car models."[201] The "unexciting" nature of GM's new car models partially explains why GM lost market share throughout the 1980s.[202] "During the 1980s, GM's share of North American car sales shrank to about [thirty-five percent] from [forty-five percent] as car buyers switched to smaller, more fuel-efficient Japanese cars."[203] In addition to losing market share, GM became an inefficient and high-cost producer.[204] While GM improved its assembly efficiency by approximately five percent in the 1980s, its two main American competitors, Ford and Chrysler, improved their assembly efficiencies by seventeen percent and thirty-one percent, respectively, during this same period.[205] As a result, while the S&P 500 increased by approximately 227 percent

195. For a more detailed analysis of General Motors, see ROBERT A. G. MONKS & NELL MINOW, CORPORATE GOVERNANCE 327-71 (1995).
196. Stan Hinden, *Corporate Raiders and Company Men*, WASH. POST, May 28, 1989, at X11.
197. *Id.*
198. Adam Wong, *De-Robotising the Car Industry*, NEW STRAITS TIMES, Apr. 9, 1995, *available in* LEXIS, Nexis Library, CURNWS File.
199. *Id.*
200. *See, e.g.*, S.C. Gwynne, *Big Plans for Small Car; New Boss Bob Stempel Aims to Make GM's Latest Model a Hit*, TIME, Aug. 13, 1990, at 53.
201. *Id.*
202. *Id.*
203. Daly & Cazzin, *supra* note 13, at 90.
204. MONKS & MINOW, *supra* note 195, at 361.
205. *Id.*

between 1980 and 1990, GM stock appreciated by only approximately sixty-nine percent during the decade.[206]

During the 1980s, GM's board had developed a reputation for being dominated by Smith.[207] *Fortune* made the following observations about Smith's interactions with the GM board:

> Roger Smith kept the board on a very short leash. He withheld key financial data and budget allocation proposals until the day before meetings and sometimes distributed them minutes before the participants convened. The monthly sessions were rigidly structured and Smith adjourned them promptly at five minutes to noon, leaving little room for discussion. Circumstances and personality enabled Roger Smith to exercise his iron control. Quick to anger, he was intolerant of criticism. Few board members had the ability or desire to take him on.[208]

By engaging in the aforementioned activities, Smith precluded GM's board from assessing the soundness of his executive decisions.

As Smith approached retirement, the subject of who would succeed him as GM's chair and CEO became a source of friction between GM's management and GM's institutional shareholders.[209] Traditionally, GM's chair and CEO chose his successor long before he retired and the former CEO retained a position on the board.[210] However, two of GM's largest shareholders, CalPERS and the New York State Retirement System ("NYSRS"), wrote letters to GM's board indicating their concern that GM's succession process was a source of its current problems.[211] However, GM's directors never responded directly to the concerns of CalPERS or NYSRS and allowed Smith basically to choose his successor.[212]

In August of 1990, GM's directors elected a new CEO and Chair, Robert Stempel.[213] Stempel, who had spent his entire career at GM as an engineer, was the first CEO of GM in over thirty years whose

206. James B. Treece, *Can GM's Big Investors Get It to Change Lanes?*, BUS. WK., Jan. 22, 1990, at 30. *See infra* Exhibit II, APPENDIX for a comparison of the performance of GM versus Ford and Chrysler.
207. *See, e.g.*, Alex Taylor III, *What's Ahead for GM's New Team*, FORTUNE, Nov. 30, 1992, at 59.
208. *Id.*
209. MONKS & MINOW, *supra* note 195, at 362.
210. *Id.*
211. *Id.*
212. Taylor, *supra* note 207, at 58.
213. GENERAL MOTORS CORP., 1990 ANNUAL REPORT 2 (1991).

principal area of expertise involved something other than finance.[214] Although Stempel replaced Smith as GM's CEO and chair, Smith remained a GM director.[215]

After Stempel replaced Smith, the U.S. economy began to stagnate.[216] Because the auto industry is a cyclical industry (*i.e.*, an industry in which profits rise and fall with the economy), and because GM is a major participant in the auto industry, the economic downturn caused GM, in Stempel's own words, to enter into a "kamikaze dive."[217] Although GM had never suffered consecutive annual losses in its history prior to 1990, GM suffered three consecutive annual losses between 1990 and 1992. GM lost approximately $2.0 billion in 1990, $4.4 billion in 1991, and $23.5 billion in 1992.[218]

GM's North American operations accounted for a substantial portion of GM's unprecedented losses.[219] For example, in 1991, GM's North American operations lost in excess of $7.0 billion, which translates "into a loss of $1.0 million every hour, every day of the year."[220] In the early 1990s, GM's North American operations significantly lagged behind those of their competitors in term of cost effectiveness.[221] Experts attributed some of the blame for this situation to Smith's investment in technology.[222] These individuals characterized GM's investment in technology during the Smith era as unjustifiable and unwise.[223]

Stempel unsuccessfully attempted to restore GM to profitability.[224] During the early 1990s, GM launched a major workforce reduction campaign in which it closed numerous plants and terminated thousands of employees.[225] However, these changes did not return GM to profitability.[226] GM also took the following steps in the early 1990s: (1) it issued approximately $2.4 billion in new equity, (2) it increased its debt by approximately $2.4 billion, (3) it reduced its annual stock

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214. MONKS & MINOW, *supra* note 195, at 362.
215. *See* GENERAL MOTORS CORP., *supra* note 213, at 52.
216. Joseph B. White & Paul Ingrassia, *Eminence Grise, Behind Revolt at GM, Lawyer Ira Millstein Helped Call the Shots*, WALL ST. J., Apr. 13, 1992, at A1, A13.
217. *Id.* at A13.
218. GENERAL MOTORS CORP., 1993 ANNUAL REPORT 54 (1994).
219. Warren Brown, *GM Directors Pick Smale as Chairman*, WASH. POST, Nov. 2, 1992, at A1.
220. *Id.*
221. Daly & Cazzin, *supra* note 13, at 94 ("Smith also saddled his successor with the highest production and labor costs in the auto industry . . . .").
222. *Id.*
223. *Id.*
224. *See* GENERAL MOTORS CORP., *supra* note 218, at 54.
225. Taylor, *supra* note 207, at 60-61.
226. *See* GENERAL MOTORS CORP., *supra* note 218, at 54.

dividend from $3.00 to $1.60, (4) it cut its capital spending, and (5) it made questionable assumptions about the rate of return on its pension fund that resulted in the fund being underfunded by approximately $17.0 billion.[227]

These actions and GM's continued losses prompted institutional investors, such as CalPERS, to increase pressure on GM's board, which began to take on an increasingly active role in management.[228] For example, a group of GM's outside directors began to meet secretly on the night prior to board meetings to discuss the ongoing changes at GM.[229] On April 6, 1992, GM's board indicated its displeasure with GM's existing management by replacing GM's president Lloyd Reuss, the head of GM's unprofitable North American operations, with John F. ("Jack") Smith, Jr., the head of GM's profitable international operations, and by demoting Stempel from his post as chair of the executive committee.[230] Moreover, the board announced that John Smale, a GM board member and the former chair and CEO of Procter & Gamble Co., would assume Stempel's position as chair of the executive committee, and that Stempel would be required to report to Smale.[231]

The stock market reacted positively to the board's April 6 announcement.[232] After the announcement, GM's stock price increased by 3.4 percent.[233] This increase resulted in GM's shareholder wealth increasing by approximately $1.4 billion.[234]

After the April 6 announcement, Stempel continued his gradual attempts to streamline and reform GM.[235] However, newspaper articles had begun appearing in mid-October, first in *The Washington Post* and then in other national dailies, indicating that GM's directors planned to remove Stempel.[236] On October 26, Stempel resigned.[237]

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227. MONKS & MINOW, *supra* note 195, at 365.
228. *See, e.g.*, Kathleen Kerwin et al., *Crisis at GM*, BUS. WK., Nov. 9, 1992, at 86.
229. *Id.*
230. Taylor, *supra* note 207, at 60.
231. *Id.*
232. NEW YORK STOCK EXCHANGE, DAILY STOCK PRICE REC. 201 (Apr., May & June, 1991).
233. *Id.*
234. *Id.*
235. Taylor, *supra* note 207, at 58.
236. *Id.*
237. *Id.*

The stock market reacted positively to the rumors that GM's board would remove Stempel.[238] On October 21 and 22, while the S&P declined from 415.480 to 414.900, GM stock increased from $29.75 to $32.88, based on the rumors that GM's board would fire Stempel.[239] This increase in GM's stock price resulted in its shareholder wealth increasing by an amount in excess of $2.0 billion.[240] Moreover, on the day of Stempel's resignation, while the S&P increased from 414.100 to 418.160 (0.98 percent), GM's shares increased from $33.50 to $34.15 (1.87 percent).[241] This increase resulted in GM's shareholder wealth increasing by about $300.0 million.[242]

On November 1, 1992,[243] GM's board of directors replaced Stempel with Jack Smith, who had been GM's president since April, and Smale, who had been chair of GM's executive committee since April.[244] GM's board appointed Smith to serve as GM's CEO and Smale to serve as GM's chair. Smale would be GM's first non-management chair in approximately fifty years.[245]

After GM's board appointed Smale chair, he began working with other board members to improve GM's corporate governance practices to ensure that in the future GM's board would respond quickly to mismanagement.[246] GM's 1992 annual report included the following message from Smale: "During the past year, the General Motors board has reexamined its processes and has established a set of operating guidelines which will ensure that it is performing its responsibilities with the same discipline and dedication that it expects from management."[247]

In 1994, after working on the project for over a year, GM's board publicly announced a twenty-eight-point set of guidelines on significant corporate governance issues facing the company.[248] The guidelines[249] generated considerable positive publicity for GM.[250]

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238. *See* Grundfest, *supra* note 3, at 895-96.
239. Search of *DATASTREAM*, Equities Library, Time Series File.
240. *See* Grundfest, *supra* note 3, at 895-96.
241. Search of *DATASTREAM*, Equities Library, Time Series File.
242. *See* Grundfest, *supra* note 3, at 895-96.
243. Brown, *supra* note 219, at A1.
244. An analysis of the effect of this announcement on GM's market capitalization would be difficult to perform because GM's board also made several other important announcements on this day. For example, the board indicated that GM's dividend would be reduced by 50%.
245. Brown, *supra* note 219, at A1.
246. GENERAL MOTORS CORP., *supra* note 218, at 3.
247. *Id.*
248. *See* GENERAL MOTORS CORP., *supra* note 10.
249. Keith Naughton, *New Guidelines Prove GM's Directors Have Taken the Wheel*, DET. NEWS, March 25, 1994, at A1.

Although GM's guidelines do not express a preference as to whether the CEO and chair should be separate,[251] they specifically provide that if GM's board appoints a GM employee chair, then GM's outside directors will select a lead director who "will assume the responsibility of chairing the regularly scheduled meetings of outside [d]irectors or other responsibilities which the outside [d]irectors as a whole might designate from time to time." [252]

In late 1995, Smale decided to retire as GM's chair.[253] During his tenure as chair, Smale had worked closely with Smith and helped transform GM into a company that earned a profit in excess of $5.0 billion in the first nine months of 1995 from a company that lost in excess of $23.0 billion in 1992.[254] On December 4, 1995, GM's board appointed Smith chair and once again allowed one person to serve as the company's CEO and chair.[255] However, in a move designed in part to reassure major shareholders that GM would not return to its past corporate governance practices, GM's board named Smale the company's lead director.[256] The following statements made by Smith indicated that, as GM's lead director, Smale would remain active in overseeing the company's management:

> The changes announced today will permit [Smale] to continue the leadership role he has played on the GM board, while permitting him to reduce his day-to-day involvement in GM's governance. The fundamental role of GM's directors in overseeing GM's management and affairs will continue.[257]

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250. Martin Dickson, *Policy Codifies Power for Non-Executives—Martin Dickson Considers General Motors' New Guidelines on the Role of Its Board of Directors*, FIN. TIMES, Apr. 6, 1994, at 16 ("It has been variously hailed as a 'Magna Carta for U.S. directors,' 'a very important corporate governance document,' and a 'very commendable example.'").

251. *See* GENERAL MOTORS CORP., *supra* note 10.

252. *Id.*

253. Bradley A. Stertz & Daniel Howes, *GM Names Smith as Chairman: Smale, 68, Stays on as Company's Lead Director, Watchdog*, DET. NEWS, Dec. 5, 1995, at A1.

254. *Id.*

255. *Id.*

256. *Id.*

257. *Id. See also* Judith H. Dobrzynski, *As He Steps Down, G.M. Chairman Looks Ahead*, N.Y. TIMES, Dec. 8, 1995, at D4.

C. Compaq Computer

Unlike ADM, MK, or GM, Compaq Computer ("Compaq"), a designer, manufacturer, and marketer of computers for business and professional users, has had a separate chair and CEO since the company's inception.[258] Since 1983, the year in which Compaq began selling computers, Benjamin M. Rosen, the chair of the venture capital firm that provided Compaq with much of its initial funding, has served as the company's chair.[259] Rosen indicated that his venture capital firm wanted Compaq to have a separate chair and CEO because "the chairman does have a lot more power than just another outside director, and when the chairman and chief executive officer are the same person, the board is often dominated by the C.E.O."[260]

Between 1983 and 1991, Joseph R. Canion, Compaq's founder, served as the company's president and chief executive officer.[261] Between 1983 and 1990, Compaq performed exceptionally well. Compaq's annual sales increased from $111.2 million in 1983 to $3.6 billion in 1990.[262] Moreover, Compaq's net income increased from $4.7 million in 1983 to $454.9 million in 1990.[263] As a result, the value of the shares owned by Compaq shareholders increased from $109.1 million in 1983 to $1.9 billion in 1990.[264]

In 1991, however, Compaq suffered a series of setbacks. For the first time in its history, Compaq's annual sales decreased.[265] Moreover, because Compaq's products cost more to produce than those of many of its competitors,[266] the company's annual net income decreased by $320.1 million in 1991.[267] When Rosen, who was Compaq's chair and a member of the board's compensation, audit, and nominating commit-

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258. COMPAQ COMPUTER CORP., 1983 ANNUAL REPORT 31 (1984).

259. *Id. See also* Byrne & Melcher, *supra* note 107, at 84 (Compaq cited as having the fourth best board in the United States).

260. Steve Lohr, *Pulling Down the Corporate Clubhouse*, N.Y. TIMES, Apr. 12, 1992, § 3, at 5.

261. COMPAQ COMPUTER CORP., 1990 PROXY STATEMENT 2 (1990); Catherine Arnst et al., *Compaq: How It Made Its Impressive Move Out of the Doldrums*, BUS. WK., Nov. 2, 1992, at 146.

262. COMPAQ COMPUTER CORP., *supra* note 258 at 15; COMPAQ COMPUTER CORP., 1990 ANNUAL REPORT 37 (1991).

263. COMPAQ COMPUTER CORP., *supra* note 258, at 15; COMPAQ COMPUTER CORP., 1990 ANNUAL REPORT 37 (1991).

264. COMPAQ COMPUTER CORP., *supra* note 258, at 14; COMPAQ COMPUTER CORP., 1990 ANNUAL REPORT 36 (1991).

265. COMPAQ COMPUTER CORP., 1991 ANNUAL REPORT 17 (1992).

266. *Id.* at 5.

267. *Id.* at 17.

tees,[268] became aware of the company's problems, he began to discuss and investigate them with other board members.[269] Although Rosen and Compaq's other board members reached the conclusion that the company needed to undergo a significant number of changes to continue to be successful, Compaq's management disagreed and thought that the company was merely facing "a short term perturbation."[270]

In October of 1991, after the board realized that it did not agree with management's assessment of the situation, the board replaced Canion, the company's popular CEO and president, with Eckhard Pfeiffer,[271] who was formerly Compaq's chief operating officer and an instrumental figure of the success of the company's European operations.[272] Pfeiffer "redirected the company's product strategy, marketing strategy, and . . . cost-cutting strategy."[273] After Pfeiffer implemented these strategic changes at Compaq, the company's sales, profits, and market capitalization significantly increased.[274]

Unlike its counterparts at ADM, MK, and GM, Compaq's board forced management to make the changes necessary for the company to be successful without waiting for the situation to become a crisis. As Compaq's chair, Rosen played a significant role in the board's decision to investigate and ameliorate the problems that resulted in the company's disappointing sales, profits, and market capitalization in 1991. If Compaq had allowed a single individual to serve as its CEO and chair, its board might not have been able to act so quickly and decisively.[275]

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268. *Id.* at 52.
269. MONKS & MINOW, *supra* note 195, at 159.
270. *Id.*
271. Following this announcement, Compaq's stock price declined by approximately 13.6% over the next two days. However, the termination announcement came only one day after the company announced its first-ever quarterly loss. Thomas C. Hayes, *Compaq Ousts Chief After Loss*, N.Y. TIMES, Oct. 26, 1991, at 33. Compaq's announcement of a quarterly loss generated bad publicity regarding the company in the following days. *See, e.g.*, Louise Kehoe, *Compaq's Ousted CEO a Scapegoat?*, FIN. POST, Oct. 29, 1991, at 10.
272. Bob Francis, *Compaq's New CEO: A Focus on Price*, DATAMATION, Jan. 1, 1992, at 37.
273. MONKS & MINOW, *supra* note 195, at 159.
274. COMPAQ COMPUTER CORP., 1992 ANNUAL REPORT 7 (1993).
275. *For a comparison of the performance of Compaq versus International Business* Machines ("IBM") and Digital Equipment ("Digital"), *see infra* Exhibit III, APPENDIX.

V. CONCLUSION

Although it would be extreme to refer to all directors as "non-performing assets," the label Robert Monks used to describe the directors of Sears, Roebuck in a full-page ad in *The Wall Street Journal* recommending a vote in favor of a variety of shareholder proposals (including one to separate the roles of CEO and chair),[276] there is clearly room for improvement in the boardroom. By requiring boards of directors to consider on a yearly basis whether it would be desirable to split the roles of CEO and chair or to appoint a lead director, the adoption of our proposal would encourage CEOs and directors to focus on the strengths and weaknesses of their board leadership structure. We believe that many boards will conclude that there are substantial benefits to splitting the roles or appointing a lead director. These include the empowerment of the independent directors through the appointment of a recognized leader who will guide their regular evaluation of the CEO and his or her performance[277] and encourage free and open discussions about current problems, practices, and strategies. Yet, our proposal permits boards to keep a unitary CEO-chair structure without a lead director, provided the board explains its rationale to the shareholders in the proxy statement.

Because we believe the arguments for a separate CEO and chair or lead director are compelling, we expect that boards providing for neither may find it difficult to explain their reasoning to shareholders. Unable to defend current practice, directors may conclude that modifying that practice is the only solution. If so, our proposal may provide the impetus necessary to overcome CEO resistance to a change in board leadership structure that will reduce the CEO's power over the board.[278]

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276. WALL ST. J., May 8, 1992, at A7.

277. For a useful discussion of how to conduct a successful CEO performance evaluation, *see* National Association of Corporate Directors, *Report of the NACD Blue Ribbon Commission on Performance Evaluation of Chief Executive Officers, Boards, and Directors* 1-5 (1994). *See also* James E. Sailer, *CEO Evaluation at Dayton Hudson*, Harvard Business School Case No. N9-491-116, March 28, 1991.

278. Shareholder groups in the U.K. strongly support the LSE disclosure requirement because they believe that companies that are otherwise reluctant to comply with the Cadbury Report's Code of Best Practice are embarrassed into compliance by the requirement to publicly state whether they are in compliance and, if not, why not. Cohen, *supra* note 29, at 19.

Our proposal takes full advantage of the desire of human beings to be approved of and respected.[279] Public identification of the person who is charged with leading the independent directors will give the chair or lead director extra incentive to avoid the embarrassment and loss of reputational capital that will follow if the CEO runs amuck or the company otherwise performs badly on that person's watch. In short, by encouraging boards to select publicly identified leaders, we hope to shift the balance of power in the boardroom from the CEO to the independent directors, and to thereby improve corporate accountability.

We acknowledge that selecting a separate chair or a lead director is no panacea for all corporate ills.[280] Even if a director is nominally independent of the CEO, as the outside directors of Morrison Knudsen were, social ties and the general desire to avoid being characterized as overly contentious or disruptive cause most directors to be loathe to challenge the CEO. RJR Nabisco, for example, had a separate chair—Charles E. Hugel, then CEO of Combustion Engineering—but CEO F. Ross Johnson still wasted corporate funds and tried to buy RJR with a lowball bid.[281] Nonetheless, as we saw with Compaq, having a publicly identified leader of the independent directors increases the likelihood that the independent directors will hold the CEO accountable and promote such changes in corporate strategy and direction as might be needed to avoid a crisis. Such mid-course corrections can not only make major loss of shareholder wealth less likely, but also prevent the devastating dislocation to employees, communities, and suppliers that often accompanies poor corporate performance.[282]

It is ironic that the United States, which in many ways started the current corporate governance movement in 1976 with a letter from the

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279. *See* Tetlock, *supra* note 51, at 308 ("There are many reasons why people seek the approval and respect of those to whom they are accountable, including both symbolic psychological and tangible material rewards and punishments."). *See also* the comments of Ira Millstein *in* Laura Fowlie, *Executive Firings a "Watershed,"* FIN. POST, Feb. 9, 1993, at 6 ("[The boards of Westinghouse, IBM, and American Express] are acting because their reputations, their pride, their fellowship and their self respect demand it.").

280. *See* Dobrzynski, *supra* note 35, at 124 ("Splitting the jobs of chairman and CEO is no panacea.").

281. *Id. See also* BRYAN BURROUGH & JOHN HELYAR, BARBARIANS AT THE GATE: THE FALL OF RJR NABISCO 73-74, 165 (1990).

282. For a satirical but gut-wrenching depiction of the effect of the closing of the General Motors plant in Flint, Michigan, on former GM employees and the community, *see* the film ROGER AND ME (Warner Bros. Inc. 1989).

Chairman of the SEC to the newly appointed president of the New York Stock Exchange, proposing that the NYSE amend its listing requirements to require the appointment of audit committees comprised solely of independent directors,[283] has now fallen behind the U.K. and Canada. We encourage the SEC, the NYSE, and the NASD to regain the initiative by examining board leadership structure as well as other aspects of corporate governance, such as how directors are selected,[284] evaluated,[285] and compensated.

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283. Letter from Roderick M. Hills to William Batten (May 11, 1986) (on file with authors).

284. *See* NACD Blue Ribbon Commission, *supra* note 34, at 7–14, for guidelines on selection of directors.

285. The NACD Blue Ribbon Commission has adopted guidelines for the evaluation of boards and directors. *Id.* at 15–19.

APPENDIX

Exhibit I

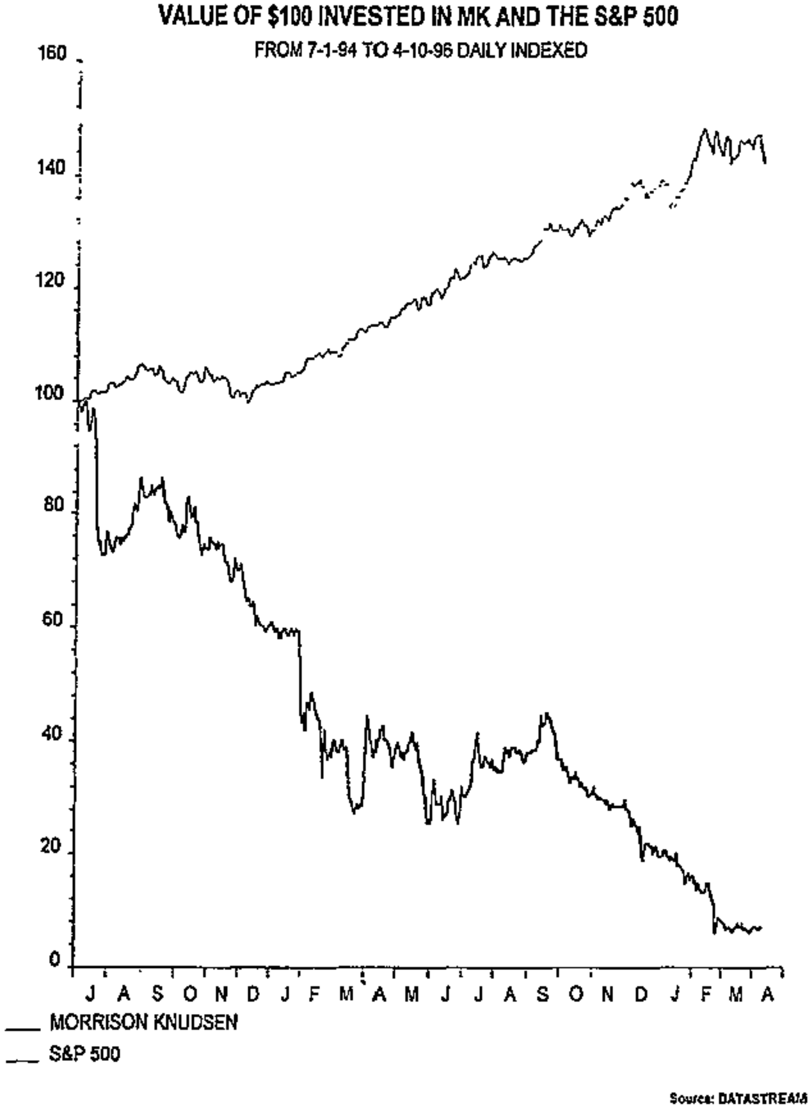
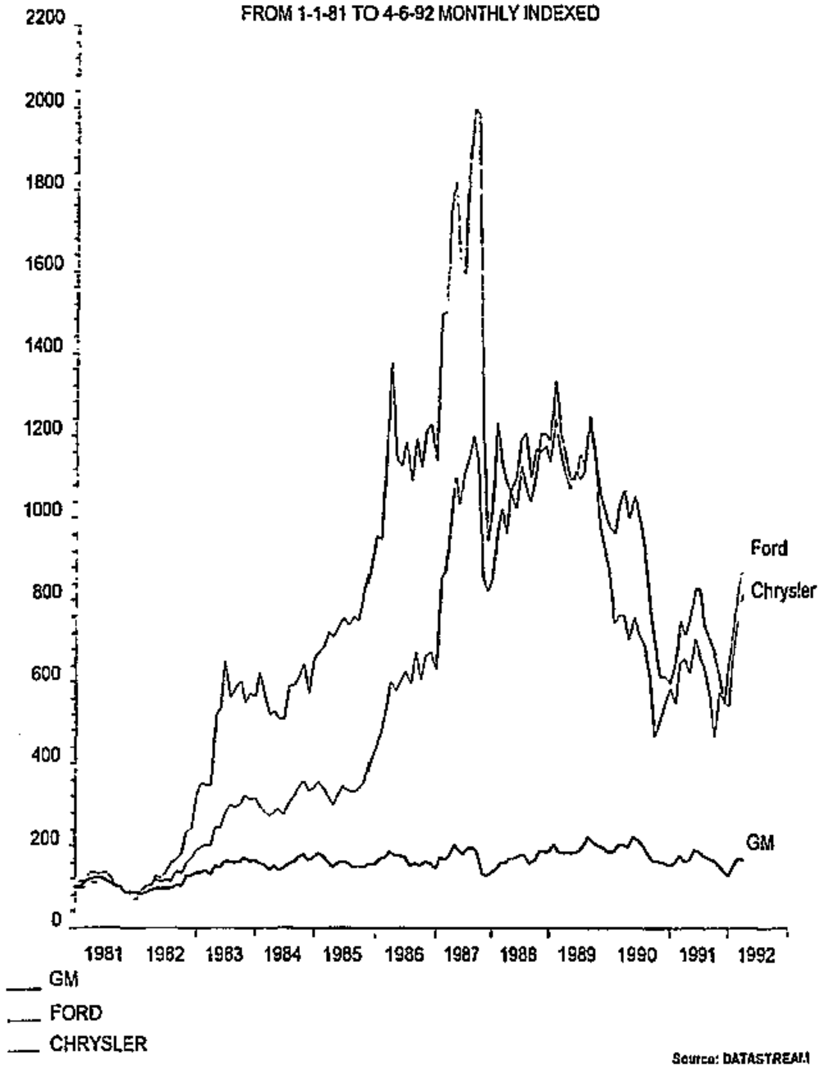


Exhibit II

VALUE OF $100 INVESTED IN GM, FORD, & CHRYSLER

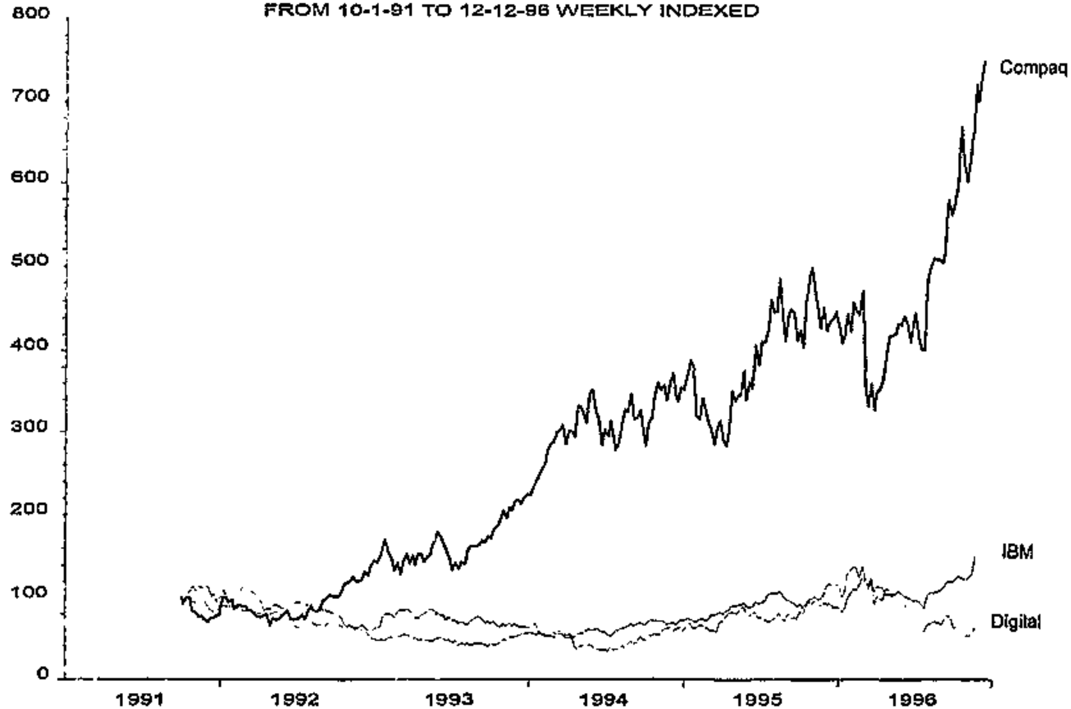
FROM 1-1-81 TO 4-6-92 MONTHLY INDEXED



Source: DATASTREAM

Exhibit III

VALUE OF $100 INVESTED IN COMPAQ, IBM, & DIGITAL
FROM 10-1-91 TO 12-12-96 WEEKLY INDEXED



COMPAQ COMPUTERS
INTL. BUS. MACH.
DIGITAL EQUIP.

Source: DATASTREAM