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Illinois Law, Behavior and Social Science Research Papers Series,
Research Paper No. LBSS11-25
Illinois Public Law and Legal Theory Research Papers Series No.
10-37

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NICOLA FAITH SHARPE

ABSTRACT

Following the 2008 financial crisis the federal government made capital investments in more than 650 companies. The government's involvement was not limited to mere financial investment. In many cases, the government became involved with the corporations' board of directors. The Essay examines the pressing corporate governance questions raised by this involvement. The Essay uses an agency theory lens to examine the government's response to the financial crisis of 2008, and explores the government's role as board member. The Essay then takes a step back and discusses how the financial crisis and accompanying federal bailout represent a larger failure in how boards of directors are conceptualized. The Essay provides some preliminary thoughts on the gap between principal-agent analysis, the federal bailout, and the reality of the board of directors as an effective monitoring mechanism. Specifically, the Essay argues that we must reevaluate board composition with an emphasis on the board members' expertise and redefine the function of the board to include involvement in the firm's strategic decision-making process. The Essay concludes that to better understand corporate failure and to truly improve the efficacy of a board's monitoring function, we must first develop a theory that takes better account of the current corporate failures and craft potential solutions that balance the role of the board as monitor with that of executives as managers.

Electronic copy available at: http://ssrn.com/abstract=1856723

NICOLA FAITH SHARPE*

Rethinking Board Function in the Wake of the 2008 Financial Crisis

I. INTRODUCTION

WHAT KIND OF "OWNER" DOES THE UNITED STATES GOVERNMENT plan to be? The recent financial crisis and resulting bailout have moved this question to the forefront of our legal, political, and economic discourse. The federal government has now made capital investments in more than 650 companies,[1] but its involvement is not limited to mere financial investment. In many cases, the government will elect members of the corporations' boards of directors,[2] although it is utilizing trust structures to manage its investment in some of these entities.[3] For example, American International Group, Inc. ("AIG") issued 100,000 shares of Series C Perpetual, Convertible, Participating Preferred Stock to the government's AIG Credit Facility Trust.[4] The shares are convertible to common stock, which represent approximately 77.9 percent of the total shares outstanding, and carry with them the same voting and dividend rights as common stock.[5] The government has been able to exercise

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1. *See* FinancialStability.Gov, Impact, Contracts List, http://www.financialstability.gov/impact/contracts_list.htm (reporting that, as of the site's update on October 2, 2009, the government had made 677 investment contracts with private organizations).

2. *See, e.g.*, *GM's Shot at Survival Starts Now*, GRAND RAPID PRESS, June 1, 2009, at A1 [hereinafter *GM's Shot*] (noting that the government bailout of General Motors meant that "the [Obama] administration will play a role in selecting a majority of the new board of directors"); *see also infra* notes 23–26, 34–36 and accompanying text.

3. *See, e.g.*, Press Release, AIG, AIG Issues Series C Preferred to Trust for the Sole Benefit of the U.S. Treasury (Mar. 5, 2009), *available at* http://media.corporate-ir.net/media_files/irol/76/76115/releases/030509.pdf.

4. *Id.*

5. *Id.*; *AIG: Where Is the Taxpayer Money Going: Hearing on the Collapse and Federal Rescue of AIG Before the Comm. on H. Oversight and Government Reform*, 111th Cong. (2009) (statement of the trustees of the AIG Credit Facility Trust), *available at* http://oversight.house.gov/documents/20090512165555.pdf [hereinafter *AIG Hearing Trustee Testimony*].

its voting rights to elect a new slate of directors to AIG's board.[6] AIG is just one of many examples of increasingly extensive government ownership and involvement in private industry.[7] This trend raises pressing questions about the government's impact on issues of corporate governance.

This Essay begins with a brief discussion of agency theory, one of the most familiar lenses through which we analyze the firm and issues of corporate governance. The Essay uses this lens for an initial examination of the government's response to the financial crisis of 2008, and identifies the ways in which the government's role as board member fits easily into the traditional principal-agent analysis. The Essay then takes a step back and discusses how the financial crisis and accompanying federal bailout represent a larger failure in how boards of directors are conceptualized. This early discussion categorizes the conventional responses to board failure into two broad categories and then provides some preliminary thoughts on principal-agent analysis, the federal bailout, and the reality of the board of directors as an effective monitoring mechanism. Specifically, the Essay argues that we must reevaluate board composition with an emphasis on the board members' expertise and redefine the function of the board to include involvement in the firm's strategic decision-making process. The Essay concludes with questions for future study.

II. DISCUSSION

A. *Agency Background*

One of the most familiar models for understanding the firm, and part of the foundation for traditional corporate governance theory, is the principal-agent model. Under the traditional conception,[8] shareholders are the owners and principals of a firm, and their agents are corporate officers.[9] Principals would like to see the highest return on their investment—hence the common conception that a public cor-

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6. *See* David Goldman, *'Goodbye and Good Riddance' AIG Directors!*, CNNMoney.com, June 30, 2009, http://money.cnn.com/2009/06/30/news/companies/aig_shareholder_meeting/index.htm ("AIG's three trustees, who represent the government's near-80% controlling interest in the company, elected the new directors on behalf of the taxpayers."); *see also infra* notes 24–33 and accompanying text.

7. *See, e.g.*, *GM's Shot*, *supra* note 2, at A1 (discussing government involvement in GM); Robin Sidel, *Citi Taps Directors with Fix-It Expertise*, Wall St. J., July 25, 2009, at B1, *available at* http://online.wsj.com/article/SB124843702388578869.html (noting the government's thirty-four percent ownership interest in Citigroup).

8. The traditional view of the corporation, often referred to as the separation of ownership and control, can be traced back to Berle and Means. *See generally* Adolf A. Berle & Gardiner C. Means, The Modern Corporation and Private Property (1932). Another view sees shareholders as one constituency, or stakeholder, among several that the board represents. *See* Ronald J. Colombo, *Ownership, Limited: Reconciling Traditional and Progressive Corporate Law via an Aristotelian Understanding of Ownership*, 34 J. Corp. L. 247, 249 (2008).

9. Joan MacLeod Heminway, *Enron's Tangled Web: Complex Relationships; Unanswered Questions*, 71 U. Cin. L. Rev. 1167, 1173 (2003) (stating that corporate officers act as agents of the corporation or its board of directors in the traditional principal-agent model).

poration's primary purpose is to maximize shareholder wealth.[10] In order for shareholders to maximize their wealth, agency costs[11] must be kept to a minimum. The economic and legal literature exploring principal-agent concerns illustrates that reducing agency costs is as important as it is challenging.[12]

One of the most widely discussed and analyzed problems in the agency literature is that the incentives of agents are often not fully aligned with those of the principal.[13] The explanation provided is that agents, like all economically rational beings, are self-interested, which results in the problem of managerial opportunism.[14] Consequently, agents engage in rent-seeking behavior or may shirk—not work as hard or as effectively as the principal would if she were working for herself. As a result, certain monitoring mechanisms are necessary to limit shirking or rent-seeking and confirm that agents are actually working in the best interest of the principal. These monitoring mechanisms help to ensure that the corporation's officers are maximizing shareholder wealth. According to one theory of board governance, the corporation's board of directors functions as one of the primary monitoring mechanisms in a traditional corporation,[15] giving the corporation a corporal form through which it can give effect to its intentions.[16] Agency theory argues that an effective

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10. Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 Va. L. Rev. 247, 249 (1999) ("This principal-agent model, in turn, has given rise to two recurring themes in the literature: First, that the central economic problem . . . is reducing agency costs . . . and second, that the primary goal of the public corporation is—or ought to be—maximizing shareholder's wealth.").

11. Agency costs are the costs incurred when managers (agents) pursue interests that diverge from those of the principal. These costs can be expressed as the sum of monitoring and bonding costs as well as residual loss borne by principals to curb their agent's shirking. One common example is the cost of monitoring. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. Fin. Econ. 305, 308–09 (1976) (defining agency costs and including monitoring costs in the definition and noting that agency costs can include shirking); *see also* Berle & Means, *supra* note 8.

12. Park McGinty, *The Twilight of Fiduciary Duties: On the Need for Shareholder Self-Help in an Age of Formalistic Proceduralism*, 46 Emory L.J. 163, 188 (1997) (stating that reducing agency costs is the "most important and difficult challenge" of corporate law).

13. Jensen & Meckling, *supra* note 11, at 308 ("If both parties to the relationship are utility maximizers there is good reason to believe that the agent will not always act in the best interests of the principal.").

14. Amir N. Licht, *Genie in a Bottle? Assessing Managerial Opportunism in International Securities Transactions*, 2000 Colum. Bus. L. Rev. 51, 52 (describing managerial opportunism as the opportunity of agents in corporate organizations "to take advantage of their position and derive private benefits from 'other people's money'").

15. *See* Principles of Corporate Governance: Analysis and Recommendations § 3.02 cmt. d (Am. L. Inst. 1992) (discussing the board of director's "oversight function"). Additionally, the board of directors is generally not thought of as an agent of the shareholders, but as an extension of them, their principal. Some scholars, such as Professor Donald C. Langevoort, have stated that "the board is not a pure principal either," while recognizing that when the principal's rights and responsibilities "are divided between the board of directors and the shareholders," there is "a strong bias" toward the board "as it relates to running the corporation's affairs." Donald C. Langevoort, *Agency Law Inside the Corporation: Problems of Candor and Knowledge*, 71 U. Cin. L. Rev. 1187, 1191 (2003) (footnotes omitted); *see also* Paul E. Juras & Yvonne L. Hinson, *Examining the Effect of Board Characteristics on Agency Costs and Selected Performance Measures in Banks*, 7 Acad. Banking Stud. J. 87, 87 (2008).

16. Langevoort, *supra* note 15, at 1191 ("To animate and give the corporation a voice, corporate law recognizes the board of directors.").

board will reduce managerial shirking, thereby decreasing agency costs and increasing shareholder wealth.[17]

B. Examining the Government's Response Through an Agency-Theory Lens

The government's bailout of large public corporations and the debate that accompanies it reflect an approach to corporate management based on the principal-agent model, which focuses on maximizing shareholder wealth and curtailing managerial opportunism. Over the years, corporate governance reform has recognized that managerial opportunism can serve as a powerful force for shareholder wealth maximization as long as the incentives of shareholders and managers are properly aligned. Changes in executive compensation—such as performance-based bonuses, options tied to stock price, and more general employee stock ownership plans—are all examples of reforms calculated to align the incentives of agents with those of principals in order to maximize shareholder wealth.[18] Despite the reforms and properly incentivized compensation packages, much of the criticism surrounding corporate failure still blames CEO greed for the downfall and incompetent or irresponsible boards for failing to effectively perform their monitoring function and contain the rampant greed of the chief executive.[19]

As has often been the case after significant corporate failures, in the wake of the recent financial crisis, various board reform measures have been proposed to reduce the likelihood of repeating the failure. After the Enron Corp., WorldCom Inc., and Tyco International Ltd. corporate scandals, many reforms, including Sarbanes-Oxley, advocated greater independence for boards.[20] The media, the public, and scholars often blame these scandals on a failure of the board to effectively serve as a monitoring mechanism for the officers of the corporation.[21] Similarly, media com-

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17. Jensen & Meckling, *supra* note 11, at 308–09; Juras & Hinson, *supra* note 15, at 89.

18. Juras & Hinson, *supra* note 15, at 91 ("[T]he greater the level of stock ownership, the greater the motivation to work to raise the value of the firm." (citing Benjamin E. Hermalin & Michael S. Weisbach, *The Effects of Board Compositions and Direct Incentives on Firm Performance*, J. Fin. Mgmt. Ass'n, Winter 1991, at 101, 101–12)); Jonathan R. Macey, *Externalities, Firm-Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes*, 1989 Duke L.J. 173, 183 n.42 ("Stock ownership, stock option plans, and compensation plans that link management compensation with firm performance all serve to align shareholders' and managers' interests."); *see also* TIAA-CREF, Policy Statement on Corporate Governance 9 (2007) ("Directors should have a direct, personal and meaningful investment in the common stock of the company. We believe that stock ownership helps align board members' interest with those of shareholders.").

19. *E.g.*, Nicholas D. Kristof, *Need a Job? $17,000 an Hour. No Success Required*, N.Y. Times, Sept. 18, 2008, at A35.

20. Lisa M. Fairfax, *Sarbanes-Oxley, Corporate Federalism, and the Declining Significance of Federal Reforms on State Director Independence Standards*, 31 Ohio N.U. L. Rev. 381, 387 (2005) (noting that the abuses of power at Enron and WorldCom contributed to passing Sarbanes-Oxley, which "focused on director independence" and sought to "eliminate those ties that hindered directors ability to objectively monitor corporate officers").

21. *See, e.g.*, *id.* at 382–83 ("Indeed, corporate governance scandals suggested that directors had failed to appropriately monitor corporate officers, and that such failure enabled officers to engage in fraud and other behavior detrimental to shareholders and the markets in general."); Allan D. Grody, Letter to the Editor, N.Y. Times Mag., Jan. 14, 2009, http://www.nytimes.com/2009/01/18/magazine/18letters-t-.html?_r=1 (stating that

mentators have fed public outrage through citing board failure as a significant factor in the demise of the financial and automobile industries.[22] Consequently, in the current bailout, the government's costly stock purchases often require it not only be a shareholder, but also have significant board representation and therefore theoretically play a monitoring function to ensure that taxpayer value is protected and maximized.[23]

AIG is a prime example. The government, as part of the initial $85 billion provided to prevent the company's collapse, established a trust known as the AIG Credit Facility Trust to oversee its interest in AIG.[24] Three trustees[25] manage the trust with the hope that their experience and independence will allow them to act in the best interest of federal taxpayers.[26] Congress has held hearings on the collapse and federal rescue of AIG, the emphasis of which has been their concern with protecting the taxpayer's extraordinary investment.[27] The U.S. House of Representatives' Committee on Oversight and Government Reform asked the three trustees, "is the U.S. taxpayer investment in AIG being adequately protected?"[28] The trustees stated that they have been "charged with exercising the voting rights of the shares held in the Trust in the best interest of the U.S. Treasury and with a view towards maximizing the value of the AIG stock held by the Trust."[29] The trustees note that others, including the U.S. Treasury Department, Congress, and the Federal Reserve Bank, share the same goal of maximizing stock value so that "taxpayers can be paid back for the extraordinary financial assistance given to AIG."[30] Clearly, the 77.9 percent stock ownership and corresponding voting rights provide the government the majority of the control previously enjoyed by the common stockholders. The trustees' duties include "working with senior management and the board of direc-

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the financial crisis was properly blamed on "lack of management oversight and diligence"); Ralph Ward, Editorial, *CEOs Got Grilled, but Let's Hear from Board Leaders, Too*, Detroit Free Press, Dec. 10, 2008, at 15 ("All our corporate disasters of the past decade, from Enron up to the current financial meltdown, have drawn the same question: Where was the board?").

22. Ben Stein, *It's Time to Act Like Grown-Ups*, N.Y. Times, Nov. 11, 2007, at 4 (wondering where were the directors when banks such as Merrill Lynch faced financial disaster); Ward, *supra* note 21 (indicating that a lack of board leadership, which manifested in the form of an inactive board, contributed to General Motors, Ford, and Chrysler reaching "the brink of failure").

23. *See supra* notes 6–7 and accompanying text.

24. *See AIG Hearing Trustee Testimony*, *supra* note 5 ("The trust was established by the FRBNY [Federal Reserve Bank of New York] for the purpose of acquiring, holding and ultimately disposing of approximately 77.9 percent of the voting stock of AIG.").

25. The three trustees are Doug Foshee, Chair of the Board of Directors of the Federal Reserve Bank of Dallas' Houston Branch and Chairman and CEO of El Paso Corporation; Jill Considine, former member of the Board of Directors of the FRBNY and former Chairman of the Depository Trust & Clearing Corporation; and Chester Feldberg, retired non-executive Chairman of Barclays of America and a 36-year employee of FRBNY. *Id.*

26. *Id.*

27. *Id.*

28. *Id.*

29. *Id.*

30. *Id.*

tors to ensure" satisfactory corporate governance procedures and voting the stock at all shareholder meetings or at any other time a shareholder vote is required, "most importantly in connection with the election of directors of AIG."[31] Consequently, the trustees voted the government's controlling interest to elect all but three of the directors up for election at the most recent annual meeting held on Tuesday, June 30, 2009.[32] It is hoped that the six newly elected directors will serve on behalf of the taxpayers.[33]

Similar government involvement in corporate governance is evident with respect to many of the bailout recipients. General Motors ("GM") CEO, Rick Wagoner, was relieved of his responsibility upon President Obama's orders.[34] Additionally, the Obama administration will be involved in selecting a majority of GM's new board.[35] Citigroup Inc., a company in which the government will soon own thirty-four percent of its stock, appointed four new board members in March 2009 and another three members in July.[36] The most recent additions understand regulatory issues as well as what it takes to turn around a financial institution in crisis.[37] The changes are yet another responsive measure to regulatory pressure for "tougher internal oversight."[38]

The government as shareholder and board member has spurred speculation over the role the government will or should play.[39] In President Obama's "First 100 Days" press conference, a reporter asked him "what kind of shareholder are you [the government] going to be?"[40] President Obama's answer to the question is telling.[41] He replied: "[O]ur first role should be shareholders that are looking to get out . . . . like any investor, the American taxpayer has the right to scrutinize what's being proposed and make sure that their money is not just being thrown down the drain."[42] His answer fits well into an agency analysis of corporate governance and is in two ways illustrative of much of the language that has been used to discuss

31. *Id.*

32. Goldman, *supra* note 6.

33. *Id.*

34. *GM's Shot*, *supra* note 2, at A1.

35. *Id.*

36. Sidel, *supra* note 7, at B1.

37. *Id.*

38. *Id.*

39. *See generally* Edmund L. Andrews & David E. Sanger, *U.S. Is Finding Role in Business Hard to Unwind*, N.Y. TIMES, Sept. 14, 2009, at A1 (noting that the government's bailout plans have sparked criticism over what role the government should play); Eamon Javers, *Obama: 'Reluctant Shareholder' in GM*, POLITICO.COM, June 1, 2009, http://www.politico.com/news/stories/0509/23165.html (noting the difficulty the government may have in taking a "hands off approach" and getting out of the auto industry quickly when it is also supposed to be a "good steward of taxpayer money").

40. President Barack Obama, First 100 Days, Address to the American Public (Apr. 29, 2009) (transcript available at http://www.cnn.com/2009/POLITICS/04/29/obama.transcript/index.html).

41. *Id.*

42. *Id.*

corporate governance in the context of the recent financial crisis.[43] Obama's response assumes first that the firm is an entity designed to maximize shareholder wealth, and second that shareholders must monitor the agents, corporate managers, to ensure that money is not "thrown down the drain," which is often a consequence of managerial opportunism.[44]

C. Board Failure in Monitoring Managers and the Government's Flawed Response

The corporate governance approach to board oversight is largely focused on two approaches that draw heavily from legal scholarship and economic literature. The scholarship adopts aspects of agency theory that attempt to improve the efficacy of boards in two ways. The first is through an *ex post* solution that defines successful outcomes of the board review process.[45] The second is through an *ex ante* solution that attempts to create the proper mix of directors to minimize shirking and capture by current executive management.[46] These solutions are incomplete and fail to adequately explain the repeated failures that have plagued the corporate arena for the past several decades.[47] Neither solution properly analyzes the space in between, which can be thought of as the process of how a board functions relative to the larger corporate enterprise. Specifying *ex ante* inputs or *ex post* outputs is a bankrupt framework because the literal functioning of the board in the life of the corporation requires not only a particular mix of members with acceptable goals, but also requires that board members define their responsibilities and perform their duties in a manner that increases the likelihood of the preferred outcomes.

Given the public outrage and panic over the financial crisis, it is no surprise that the government felt pressure to quickly respond. This is often the case after a crisis

43. *See supra* notes 9–17, 20–23 and accompanying text.

44. *See* Charles M. Elson et al., *Corporate Governance Reform and Reemergence from Bankruptcy: Putting the Structure Back in Restructuring*, 55 Vand. L. Rev. 1917, 1926 (2002) ("When the board fails to monitor effectively, disaster results—executive enrichment and corporate failure ensue. To curb managerial opportunism and protect against disastrous corporate performance, a firm must implement a corporate governance model capable of effectively monitoring the enterprise's operations.").

45. *See* Jerilyn W. Coles et al., *An Examination of the Relationship of Governance Mechanisms to Performance*, 27 J. Mgmt. 23, 26–28 (2001) (reviewing studies that use shareholder returns and other performance benchmarks as indicators of successful board functioning); Paul E. Fischer et al., Investor Perceptions of Board Performance: Evidence from Uncontested Director Elections 1 (unpublished manuscript, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=928843) (calling stock returns and return on assets traditional metrics of board performance).

46. *See, e.g.*, Jeffrey N. Gordon, *"Say on Pay": Cautionary Notes on the U.K. Experience and the Case for Shareholder Opt-In*, 46 Harv. J. on Legis. 323, 328 (2009) ("[T]he initial burst of corporate governance reform energy in the 1970s . . . focused on the composition of the board . . . .").

47. For a discussion of corporate failures from the 1990s to 2004, see generally John C. Coffee, Jr., *What Caused Enron?: A Social and Economic History of the 1990s*, 89 Cornell L. Rev. 269 (2004). For a detailed timeline of the events leading up to the current financial crisis, see Joe Weisenthal, *Financial Crisis: The Complete Timeline*, Bus. Insider, June 25, 2009, http://www.businessinsider.com/financial-crisis-the-complete-timeline-2009-6.

or scandal.[48] The response in this instance, monitoring managers through corporate stock ownership and concomitant board membership, highlights the limits of a traditional regulatory response.[49] What the government failed to do through regulation it has now attempted to remedy through board membership. Proponents of government intervention suggest that regulation may "restore 'investor confidence.'"[50] Given the concern over safeguarding the public's money, regular monitoring through board membership was a quick and visible solution. The response is unsurprising in the face of political pressure to show its involvement in the day-to-day operations of the company, and expedience of a direct intervention in the formerly private business operations of major public corporations.[51] The apparently unattractive alternative is relying on the more burdensome and lengthy process of instituting regulatory control.

Shareholders may view boards as the most obvious and long-recognized monitoring device; but, the abundance of corporate scandals and failures suggest larger systemic imbalances between boards as monitors and corporate executives as managers.[52] It is arguable that these imbalances are beyond the purview of a typical board of directors, thus explaining the failure of boards to properly monitor corporate executives is more complicated than attributing it to self-interested directors and intra-board dynamics. Although it is a small first step toward transforming the discourse on boards as monitoring mechanisms and their role in the success or failure of a corporation, critically examining the institutional limitations characteristic of board and management interaction is crucial to a better understanding of how boards operate within the larger corporate framework. Similarly, broadening the typical inquiry into why boards fail to effectively monitor managers to an in-

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48. Larry E. Ribstein, *Bubble Laws*, 40 Hous. L. Rev. 77, 78 (2003) ("A boom encourages unwarranted trust in markets, leading to the speculative frenzy of a bubble and then to the inevitable bust. The bust, in turn, leads first to the disclosure of fraud and then to the mirror image of the bubble—a kind of speculative frenzy in regulation.").

49. Emma Coleman Jordan, A Fair Deal for Taxpayer Investments 8 (2009), http://www.americanprogress.org/issues/2009/09/pdf/public_directors.pdf ("The accelerating psychology of a severe market panic soon overwhelmed traditional regulatory tools.").

50. Ribstein, *supra* note 48, at 79.

51. *See* Jordan, *supra* note 49, at 19 (explaining that the decision to appoint public directors in the case of AIG was designed "to restore public trust by making government participation in management visible, transparent, and accountable").

52. *See* Edward S. Adams, *Corporate Governance After Enron and Global Crossing: Comparative Lessons for Cross-National Improvement*, 78 Ind. L.J. 723, 729–30 (2003) (noting that although boards are theoretically supposed to represent the shareholders' interests, the various complexities of corporate governance, including the relationship between the board and management, creates a gulf between theory and practice). Richard Saliterman, has stated that:

> The corporation, for the most part, has been and presently is governed by a highly theoretical and, arguably, a non-reality oriented framework of perceptions: 1) that shareholders—the principal corporate investors—control the corporations and reflect their shareholder sovereignty by electing boards of directors; and 2) that these boards of directors select or otherwise carefully govern the activities of corporate executives who are subservient to both the board and the shareholders.

Richard Saliterman, *Perceptions Bearing on the Public Policy Dynamics of Corporation Law*, 20 Hamline L. Rev. 261, 261 (1996).

quiry that analyzes the functional dynamic of boards necessitates an investigation into what institutional changes are needed for a board to best fulfill their monitoring obligations. Without this understanding, the government's knee-jerk response is like a Band-Aid over a gaping wound.

The federal government's solution is flawed in that it simply substitutes taxpayers' representatives for former board members. Such a substitution is unlikely to result in a marked improvement in board monitoring and may in fact exacerbate regulatory difficulties.[53] For instance, regulatory agencies such as the Securities and Exchange Commission ("SEC"), also tasked with protecting public investor welfare, may face conflicts of interest when investigating corporations where there is a government ownership and, more complicatedly, possible wrongdoing on the part of government representatives.[54] Before the government bailed out banks such as Citigroup, the SEC was considering bringing "multi-billion dollar suits" against several large financial firms.[55] The SEC's general counsel, Brian G. Cartwright, has acknowledged the conflict of interest and pointed out that it does have "system wide consequence."[56] The conflict is readily apparent where government representatives have assumed control of corporate boards, as one of the SEC's key jobs is to "rule on difficult questions about . . . the decisions of boards of directors."[57] Thus, while having trusted representatives such as the AIG trustees elect skilled and respected board members may pacify the public and appear to protect the large federal investment in the 500 or so corporations it has bailed out,[58] it does not solve the problem of inadequate board monitoring as a contributing factor in corporate ruin and, in fact, creates additional regulatory challenges.[59] This kind of board involvement may even lead to situations where the SEC is forced to "adjudicate be-

53. Zachary A. Goldfarb, *Dueling Public Interests in Policing Rescued Firms; SEC Actions Could Weigh on U.S. Stakes*, Wash. Post, Aug. 4, 2009, at A1, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2009/08/03/AR2009080303028.html.

54. *Id.* (quoting former SEC chairman, Harvey Pit: "It raises a question about how would the SEC protect one of its principal constituencies—namely public shareholders—if it cannot go after the people that led to the conduct that allegedly violated the law . . . . That would raise a very difficult policy conundrum").

55. *Id.*

56. *Id.*

57. *Id.*

58. *See* FinancialStability.Gov, *supra* note 1 (listing more than 600 private companies who have received government funds).

59. Some regulatory concerns include how to oversee the AIG trustees because they "[h]ave virtually absolute discretion to run A.I.G. The trust is unbreakable, and the government has no control over the trustees' actions, so long as their decisions are not contrary to the interests of the government." Steven M. Davidoff, *Short-Term Solutions to Long-Term Problems*, N.Y. Times, Mar. 26, 2009, at F8. Additional concerns stem from "[t]he de facto policy of providing taxpayer support to struggling 'systemically important' companies[, which] has produced an ill-defined terrain of shared governance between financial executives on the one hand and federal regulators who hold both the power of government and the power of ownership on the other." Jordan, *supra* note 49, at 1. Moreover, other sources of difficulty are the public perception that such extraordinary governmental measures are a sign of corporate favoritism, the complexities of regulatory measures imposed on a case-by-case basis, and the standards by which accountability should be measured with respect to each firm. Davidoff, *supra*, at F8.

tween government shareholders and private shareholders."[60] Federal board control is emblematic of the extensive acceptance of how boards currently function within the principal-agent model, which attributes far too much to the power of board control without a critical understanding of board function.

D. *Improving Board Function*

As an initial attempt at unpacking and analyzing board function, this Essay identifies two of the common limitations that hinder boards from optimally functioning. First, many board members lack the expertise to properly evaluate the decisions of managers.[61] Second, the functional tasks performed by board members are not forward-looking mechanisms designed to adequately monitor strategic and business success.[62]

The first of the two problems is not an issue of composition as commonly conceived in the corporate governance literature.[63] Board composition customarily refers to the divide between outside and inside directors, as opposed to the mix of expertise of the board members. These binary classifications assume that outside directors (directors not employed by the corporation) are less susceptible to shirking and therefore in a better position to monitor managers.[64]

While altering board composition has been a popular regulatory response to many corporate scandals and financial failures,[65] its efficacy has been called into question.[66] In addition to their own robust research, Professors Sanjai Bhagat and Bernard Black have analyzed numerous studies that do not find a strong correlation

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60. *See* Goldfarb, *supra* note 53, at A1.

61. Stein, *supra* note 22, at 4 ("[D]irectors might have been chosen with an eye toward political correctness instead of an eye toward what they knew about finance and accounting.").

62. *See* Jay W. Lorsch, *Empowering the Board*, Harv. Bus. Rev., Jan.–Feb. 1995, at 107, 115 (calling for board empowerment as an answer for more effective monitoring, which can be accomplished by boards "develop[ing] knowledge not only about the company's financial results, which are [only] an indication of past performance but also about the company's progress in accomplishing its strategy").

63. *See* Elizabeth Cosenza, *The Holy Grail of Corporate Governance Reform: Independence or Democracy*, 2007 BYU L. Rev. 1, 21 (noting that many studies have undermined the notion that improved corporate performance results from the composition of the board rather than board expertise); Morten Huse, *Corporate Governance: Understanding Important Contingencies*, Corp. Ownership & Control, Summer 2005, at 41, 47 (explaining that research has traditionally related board composition to corporate financial performance).

64. James D. Westphal & Michael K. Bednar, *Pluralistic Ignorance in Corporate Boards and Firms' Strategic Persistence in Response to Low Firm Performance*, 50 Admin. Sci. Q. 262, 263 (2005).

65. *See, e.g.*, Charles M. Elson & Christopher J. Gyves, *The Enron Failure and Corporate Governance Reform*, 38 Wake Forest L. Rev. 855, 855–56 (2003) (observing that the collapse of Enron and other corporate scandals created "a watershed moment in U.S. corporate governance," which resulted in a "dramatic change in approach to corporate board composition, conduct, and responsibility . . . at the legal and regulatory levels").

66. Westphal & Bednar, *supra* note 64, at 263 ("Yet there is considerable qualitative and anecdotal evidence that boards often fail to check executives' tendencies to persist with failing strategies, regardless of the number of outside directors on the board."); *see also* Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 Bus. Law. 921, 922 (1999) (presenting evidence that overall firm performance was not correlated to the composition of the board and that "[i]ndependent directors often turn out to be lapdogs rather than watchdogs").

between boards composed of a majority of independent directors[67] and firm performance.[68] Examining whether or not the independence of a board is good for a corporation, however, is outside the scope of the current discussion. The Essay instead looks beyond board composition in the strict outside/inside director sense and focuses on another failure in composition—a lack of directors with relevant expertise.

Most corporations have boards where a majority of directors are outsiders;[69] however, these boards often are composed of individuals who are not qualified to assess the strategic viability of the corporations they direct. When a director is unable to effectively evaluate or properly understand the business of the corporation, it makes it difficult for her to be a competent monitor of executive management.[70]

Corporate casualties in the most recent crisis represent instances of board members lacking expertise. In years past, some of Merrill Lynch's board members were leaders of prestigious colleges and universities.[71] However, nothing would indicate that these individuals had meaningful accounting or financial expertise.[72] Their backgrounds and lack of corresponding expertise raise concerns as to their ability to effectively monitor an investment bank such as Merrill. Similarly, Citigroup has been criticized for a board that had a dearth of independent directors with a financial background.[73] Critics have attributed the independent board members' lack of financial skill as a major contributing factor to the company's problems.[74] Specifically, when the 2008 financial crisis hit and the credit markets crashed, the bank held significant numbers of complex securities, which resulted in "billions of dollars in losses."[75] Citigroup is in the process of remedying the problem through appointing new directors with financial expertise.[76]

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67. Independent directors are defined as outside directors without affiliations to the corporation, such as former officers of the corporation or relatives of the corporation's officers. Bhagat & Black, *supra* note 66, at 923.

68. *Id.* at 922.

69. *Id.* at 921 ("In the 1960s, most [American public companies] had a majority of inside directors; today, almost all have a majority of outside directors and most have a majority of 'independent' directors.").

70. Barry Baysinger & Robert E. Hoskisson, *The Composition of Boards of Directors and Strategic Control: Effects on Corporate Strategy*, 15 Acad. Mgmt. Rev. 72, 74 (1990).

71. *See, e.g.*, Merrill Lynch, 2002 Annual Rep. 86 (2003), *available at* http://www.ml.com/annualmeetingmaterials/ar-pdf/2002-annual.pdf (listing board members such as Jill K. Conway, an MIT professor).

72. *Cf.* Stein, *supra* note 22 (opining that, although Merrill Lynch's board members had impressive academic credentials, it would have been "better [for Merrill Lynch] to look for accounting expertise" in a board member).

73. Sidel, *supra* note 7, at B1 ("Citigroup's board for years lacked independent directors with a background in finance, a gap critics say left the bank exposed as it built up massive holdings of complex securities. These holdings produced billions of dollars in losses when the credit crisis hit.").

74. *Id.*

75. *Id.*

76. *See supra* notes 36–38 and accompanying text.

The second problem relates to the functions with which boards are tasked. Of the two problems, this one is far more concerning as the federal government's involvement may be able to improve the first but does not work toward addressing the second issue. Not only do many boards often lack the expertise to fulfill the tasks set before them as previously discussed, the tasks themselves are insufficient to provide the type of oversight necessary to help corporations avoid possible future financial failure.[77] Directors need "knowledge," as opposed to "information."[78] Under the current structure of corporate governance, boards usually are asked to consider financial projections, which are often indicators of past success as opposed to future performance.[79] So while boards are given a significant amount of information about the firm's financial performance, they often lack knowledge about the strategic direction of the firm, which is a better indicator of future success or failure. This type of knowledge, which is necessary to provide proper oversight of executive decisions, is often lacking.[80]

To better understand corporate failure and to truly improve the efficacy of a board's monitoring function, we must first develop a theory that takes better account of the current corporate failures and craft potential solutions that balance the role of the board as monitor with that of executives as managers. In other words, while boards need to operate differently than they currently do, we must be careful to keep their monitoring from morphing into managing. Federal involvement in private enterprise at the board level is a more extreme version of previous reforms targeted at altering board composition in the hopes of improving monitoring.[81] While the government may be an active owner and control significant percentages of various corporate boards, the boards will continue to be constrained by the functional limits often present in the typical corporation.[82] Consequently, the goal of protecting the taxpayers' dollars and maximizing their investment is possibly as unlikely as it was before the financial crisis. Altering the functional role of the board presents better odds of increasing the efficacy of boards' monitoring function.

III. CONCLUSION

This Essay serves as a short introduction to two of the myriad ways in which boards are compositionally and functionally ill-equipped to effectively perform their corporate governance function. Many other factors, such as the part-time nature of

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77. Lorsch, *supra* note 62, at 107–08 (explaining how outside directors must redefine their tasks to guarantee corporate success).

78. *Id.* at 115.

79. *Id.* at 115–16.

80. Baysinger & Hoskisson, *supra* note 70, at 77.

81. *See supra* note 65 and accompanying text.

82. *See supra* Part II.C.

boards,[83] distort incentives driven by the short-term outlook many companies feel forced to adopt due to pressure to continually meet the market's periodic return on investment expectations.[84] This pressure leaves board members in positions where their duties to monitor managers and maximize shareholder value are in conflict.[85]

We should also be critical of the corporate governance literature that utilizes a narrow approach to analyze and explain the problem of corporate failure. Widespread acceptance of this approach has hampered the creation of effective alternatives and has lead to the perpetual use of unsuccessful remedies that likely will give rise to similar market failures in the future.[86] Consequently, we should be wary of proposals that include government representatives on corporate boards as a solution to the problems that have lead to failing firms. The solution is vulnerable to the same structural limitations that existed before the financial collapse. Instead, we should try to explain the inadequacy of boards and suggest solutions by focusing on board function as opposed to board composition in terms of inside and outside directors.

In order to move beyond specific solutions to systemic remedies, we should seriously consider stepping away from familiar constructs and analyze the less explored organizational strategy literature.[87] Such an approach focuses on how to change the functional relationship between the relevant parties in order to better achieve the desired results. In the case of a corporation's board of directors and executive management, the literature provides a framework for proposing functional changes, which helps the board to better monitor the corporation in order to better predict catastrophic financial failure. In other words, financial failure based on faulty strategy should not come as a surprise to a board and the shareholders they represent, but should have been subject to rigorous review and close scrutiny from a board that functions in a manner more consistent with a skilled system of checks on executive management as opposed to a rubberstamp that uncritically accepts management's recommendations.

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83. Lorsch, *supra* note 62, at 111.

84. Cynthia A. Williams, *A Tale of Two Trajectories*, 75 Ford. L. Rev. 1629, 1654–55 (2006) ("[An] aspect of the business environment . . . that can undermine a robust internal perspective, is the pressure that public company managers are under to meet Wall Street's consensus estimates of their company's quarterly results.").

85. *See id.*

86. *See* Lynne L. Dallas, *The Relational Board: Three Theories of Corporate Boards of Directors*, 22 J. Corp. L. 1, 21 (1996) (explaining that studies relying on the connection between board independence and financial performance reflect mixed results).

87. Much of the organizational strategy literature examines the intersection between markets and human behavior. *See, e.g.*, Michael C. Jensen, Foundations of Organizational Strategy 3 fig.1 (1998), *available at* http://www.hup.harvard.edu/adoption/pdf/jenfox.pdf (providing fundamental conceptual building blocks of organizational strategy). Specifically, Harvard Professor Michael Jensen suggests "(1) a system for allocating decision rights among agents in the firm, (2) a system for measuring and evaluating performance in the firm, and (3) a system for rewarding and punishing individuals for their performance." *Id.* at 2. For purposes of future study in the context of the corporation, it should involve an examination of the function of boards, and how to alter that function to best maximize successful outcomes for the firm and its shareholders. *Id.* at 1.