Why Outsiders on Boards Can’t Solve the Corporate Governance Problem

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In two recent trials involving organized crime, it was alleged in one case that $50 million was obtained illegally and in the other that $12 million was stolen. These amounts are “chump change” compared to the sums alleged to be taken if the indictment of Tyco International executives Dennis Kozlowski and Mark Swartz holds up in court. A New York grand jury charged them with a racketeering scheme involving stock fraud, unauthorized bonuses, and falsified expense accounts to extract $600 million that, among other things, was used for apartments in New York City, homes in Florida, jewelry, and a birthday party for Kozlowski’s wife that was held in Sardinia. The Manhattan district attorney contended that

Mr. Kozlowski and Mr. Swartz created an elaborate, covert system beginning in 1995 that he called the “top executives’ criminal enterprise,” which . . . allowed them to spend millions of dollars in company money for personal expenses. The men then covered their tracks by limiting the scope of internal audits and bypassing the company’s legal department when filing disclosure documents with the Securities and Exchange Commission.

At the same time, a Securities and Exchange Commission (SEC) suit charged Tyco made improper loans to Kozlowski of more than $315 million. Another suit filed by the new management of Tyco seeks to recover Kozlowski’s income and benefits since 1997 and the forfeiture of all his severance pay. This amounts to a salary and bonus of about $5 million a year and more than $330 million from exercising stock options and selling stock grants.

The two Tyco executives are only part of the cast of CEOs that include Bernie Ebbers (WorldCom Inc.), Ken Lay and Jeffery Skilling (Enron Corp.), and Gary Winnick (Global Crossing) who have come under heavy criticism for extracting extremely large compensation and fat perquisite packages while their companies were failing. But even CEOs of firms who have not been accused of misleading financial reporting and illegal payments, such as Michael Eisner of The Walt Disney Co. and Jack Welch, the former CEO of General Electric Co., have received a lot of attention for their high levels of pay and perks. As Paul Krugman, who writes financial editorials for the New York Times points out . . . modern CEOs set their own compensation, limited only by the “outrage” constraint—outrage not on the
part of the board, whose members depend on the CEO for many of their perks, but on the part of outside groups that can make trouble. And the true purpose of many features of executive pay packages is not to provide incentives, but to provide “camouflage”—to let CEOs reward themselves lavishly while minimizing the associated outrage.

While many critics of these practices blame boards of directors for not meeting their fiduciary responsibilities and argue that there should be more outside members of boards of directors to stop such excesses and ensure that stockholders are protected, we don’t think this is much of an answer. The facts are that some of the most egregious cases occurred in firms with a majority of outside directors, such as Enron (80 percent outside directors), Tyco (65 percent outside directors), and Disney (60 percent outside directors). Even WorldCom had a large percentage, though not a majority, of outside directors (45 percent). These boards, like others dominated by outsiders, often act like they are members of the emperor’s court, either approving the CEOs’ actions or not being terribly interested in what the CEOs do, so long as they are able to hold on to their board status.

Stockholders are faced with two problems. The first is moral hazard: the CEO may take advantage of his/her position to pursue self-interests rather than shareholders’ interest. The second is information asymmetry: the CEO and the top management team may withhold important information from shareholders and the board of directors. What happened at Enron, Tyco, WorldCom, and many other corporations are perfect illustrations of these two problems. They are not easy problems to solve. The reason is well-stated in the theory of managerial capitalism, which argues that there is no “justification for assuming that those in control of a . . . corporation will also choose to operate it in the interest of the owners,” particularly in the case that stock ownership is widely dispersed.

The core of this argument is that many of the possible constraints on managers are eliminated when ownership is so widely dispersed that the gain to any individual stockholder (through an increase in share value) is substantially offset by the costs to take any action. These firms without large stockholders are called management-controlled firms. They have no individual outside stockholder with a holding of 5 percent or more of the stock. Firms that we have discussed above like Disney, Enron, Tyco, and WorldCom fall into this category. Firms in which there is a 5 percent outside equity holder are called owner-controlled. When a member of management holds 5 percent or more of the outstanding stock, firms are classified as owner-managed.

We studied how CEOs acquire power to manage a firm for their personal interests when stockholders are in a weak position. We propose that CEO power is deeply embedded in the institutionalized structure of corporate governance and decisions that both CEOs and boards make over time. The effect of these decisions is a complicated web within which CEOs are able to protect themselves from attempts by stockholders to have their voices heard. We believe there are four major phases in a CEO’s power consolidation process. They are

1. Negotiating a favorable employment contract;
2. Reducing threats from the board and other senior executives;
3. Implementing corporate strategies that insulate the CEO; and
4. Controlling the CEO compensation processes.

HOW CEOs GET AND USE POWER

First, Negotiate a Favorable Employment Contract

Good CEOs are difficult to find and are in high demand. Finding a new CEO is a critical task, fraught with difficulty and risk because of the complexity involved and the signifi-
cant impact the CEO can have over the firm. When the firm is performing poorly, executive search consultants are asked to find a CEO to resurrect the firm. When the firm is successful, they are asked to find someone with the competencies to maintain it. In either case, the task is neither easy nor simple because of the complicated requirements of the CEO job.

This creates an interesting paradox for potential CEOs. On one hand, firms are usually anxious to fill a vacant CEO position, no matter what the reason for the vacancy. This puts the preferred candidate in a relatively strong position. On the other hand, we know from studies that new CEOs are in a tenuous position during their early years in office. For these reasons alone, it makes perfectly good sense for potential CEOs to try to negotiate an employment contract that protects and solidifies their position from these stakeholders before they accept the job.

During this negotiation, the rational thing for the firm’s representatives is to structure the employment contract in ways that will reduce the CEO’s capacity to take actions that will benefit him or her personally at costs to stockholders. At the same time, the candidate is likely to be seeking more “wiggle room” after the job starts. This creates a bargaining situation in which, in our judgment, the CEO can negotiate a very favorable employment contract in the management-controlled firm.

One reason is that the CEO candidate may withhold information that would have a negative impact on the firm’s decision to employ him or her. This happened in the cases of Al Dunlap when he was hired as CEO at Sunbeam, and of Ronald L. Zarella, the chief executive of Bausch & Lomb. Dunlap failed to inform Sunbeam about two jobs from which he had been fired in the 1970s. Zarella claimed, falsely, that he had received an M.B.A. from New York University. Furthermore, even though certain aspects of the employment arrangements can be very precisely defined (e.g., compensation arrangements, golden parachutes, and nonpecuniary benefits), it is simply impossible to know and cover all contingencies beforehand. After being hired, the CEO can exploit the resultant loopholes in the employment contract. This is particularly true when the CEO, after taking the position, is not subject to appropriate monitoring by the board of directors. The latter is one of the reasons why adding more outside directors to the board, as many have suggested to resolve the governance problem, is not likely to have the effect of controlling the CEO.

Trying to fathom the employment contract is not an easy task. While the law requires that CEO employment contracts be publicly available, they are difficult to access for two reasons. First, it is impossible to track all of the contracts down. Much of this information is not reported in publicly available documents, such as proxy statements or annual reports. Second, firms are reluctant to disclose these contracts. When Nell Minow, the editor of The Corporate Library, a web site that focuses on corporate governance, sent letters to 500 firms asking for their CEO’s employment contract, a presumed public document, she was able to obtain only 124 such contracts (posted at www.thecorporatelibrary.com). Most companies did not even respond to her request; others chastised her for asking (e.g., Occidental Petroleum Corp. and Union Pacific Resources Group Inc.), and several told her, directly, that they would give her nothing (e.g., Apple Computer Inc., Gateway Inc., and Polaroid Corp.).

Given such difficulties, how could we get an idea about what such a CEO employment contract would look like when the CEO candidate is in a relatively strong negotiating position? Instead of trying to examine actual contracts, we analyzed what happened when a new CEO was appointed in management-controlled and owner-controlled firms. Our intuition was that CEOs in owner-controlled firms would have less freedom to construct a strong self-defense strategy, while the contract for CEOs in management-controlled firms would leave them with a range of opportunities to strengthen their position after appointment. Our results showed that those who became CEOs in management-controlled firms were, indeed, able to negoti-
ate employment arrangements with more generous terms than those who became CEOs in owner-controlled firms. For example,

1. Their compensation was higher, and there was less compensation risk, especially when they were also appointed board chair.
2. They were able to acquire enough influence to exert the most control in setting their own compensation.
3. They had more control over appointments to the board of directors after they were appointed.
4. They were able to implement diversification strategies that were more likely to reduce their own employment risk.
5. If they were not also appointed board chair when they initially took the position, they did get the position later in their tenure.

So, from the beginning, in management-controlled firms, CEOs start with an “agreement” that provides them with substantial discretion over areas in which they can craft the protective shield they prefer. There is less monitoring and incentive alignment, exactly in the situation where we think they are needed most to combat the opportunistic CEO. When the deal is completed, the new CEOs in management-controlled firms have set the stage, because they have a contract that provides them with more effective control than the board of directors.

Second, Reduce Threats From the Board and Other Senior Executives

After being appointed, the first thing the new CEO will do is to fortify his or her position against internal threats. These come from two places: the board itself and the top management team.

Managing the board of directors. Because the board of directors is responsible for monitoring managerial decisions and assessing the performance of the CEO, managing the board of directors is a critical move in the CEO’s effort to acquire and institutionalize discretion. There are at least two ways to approach this. One is through the selection of directors and the second is through tactics of interpersonal influence.

Selecting the right directors is one of the first steps. What the new CEO wants is a “rubber-stamp” board that doesn’t outwardly appear to be one. Generally what this means is that the CEO, controlling the appointment of board members, will populate it with the firm’s current or former executives and friends. For example, more than half of the 16 board members at Disney in 1997 had personal or professional ties to CEO Michael Eisner or to the company. They included Eisner’s personal lawyer, the principal of an elementary school that Eisner’s children had attended, a Disney-commissioned architect, three former Disney executives, Michael Eisner himself (as chairman of the board), and three current Disney executives.

Institutional investors and corporate governance activists are trying to curb this practice. They are calling for board reform that will lead to an increase in independent outside or nonemployee directors who have no personal or professional ties with the CEO. This has resulted, we think, in a significant increase in the proportion of outside directors on corporate boards in recent years. Indeed, most corporate boards now seem to be “dominated” by outside directors. However, this doesn’t mean that the board will do any better in protecting shareholder interests. The reason is that CEOs may skillfully manage the director selection process in ways that create an image of board independence, pleasing investors and governance activists, while still having a supportive board that seldom challenges their decisions.

Using some relatively powerful, but subtle political tactics, the CEO can have a board that appears independent of management, but actually promotes the CEO’s discretion and entrenchment. One of these tactics is to nominate outside candidates who have similar backgrounds and experiences as the CEO, especially candidates who are CEOs themselves elsewhere. Because of their similar backgrounds and experiences, these outside directors are likely to identify
with the firm’s management, especially the CEO. Another is for the CEO to examine each candidate’s history as a director and intentionally steer clear of those who have experience on vigilant boards, those who support the separation of the CEO–board chair positions and the use of performance-based CEO compensation. These tactics can result in a board that is less likely to monitor the CEO actively or to challenge the CEO’s decisions and be more willing to grant high compensation to the CEO.

Influencing director selection is even easier if the CEO has negotiated a favorable employment contract as well as obtained the board chair position. The reason is that, even when there is an independent nominating committee composed exclusively of outside directors, it is often the norm of corporate boards that the nominating committee obtains the CEO’s approval for each new board candidate. A well-articulated justification for this practice is that firm leadership and performance will suffer when the CEO and the board cannot work together. While this may be true, it nevertheless gives the CEO great influence over director selection, which makes it difficult for a board to remain truly independent of the management and the CEO.

*Interpersonal influence tactics* are a second way of dominating the board. Suppose that the nominating committee is truly independent, and the CEO has no role in the director selection process. Does this mean that the board will be able to effectively control the CEO and be more effective in corporate governance? Not necessarily. The CEO may resort to interpersonal influence tactics in his or her dealings with board members. Because of the complexity and uncertainty inherent in strategic decision-making, outside directors tend to believe that CEOs have superior firm-specific knowledge and expertise, and CEOs are able to exploit this perception to their own advantage. Studies have shown how this can be done even when there are independent outside directors. In such situations, CEOs communicate more with the directors outside board meetings to explain the rationale and to build support for their strategic decisions. It is also pretty common to see CEOs attribute good firm performance to their leadership and strategy. When firm performance is weak, CEOs may defend themselves by blaming other “incompetent” executives, or external factors out of their control, such as slow market growth and fierce competition.

CEOs may also use ingratiation tactics with outside directors. For example, CEOs may publicly express agreement with directors’ opinions even when they do not agree, or exaggerate how much the directors have contributed to the success of the firms. Further, CEOs may increase director compensation to acknowledge their contributions, or pay directors more in cash than in company stocks to reduce their compensation risks. At some companies, outside directors even get lucrative consulting fees. For example, in addition to his duties as an Enron director, John Urquhart was paid $493,914 in 2000 for providing consulting service to Enron. Interpersonal tactics like this help CEOs build a “good working-relationship” with the directors. Indeed, such CEO interpersonal influence tactics have been found to be positively related to the increase in the firms’ level of diversification and the increase in the CEO’s total compensation, and negatively related to the change in the proportion of long-term incentive grants in CEO compensation, all of which are to the CEO’s advantages.

*Managing senior executives.* Another way for CEOs to institutionalize power is to manage their senior executives who may be significant threats. Inside directors have been recently shown to be the most serious challengers of CEOs. This may appear counterintuitive, because many believe that senior executives are political allies of the CEO—beholden to him or her for their positions within the firm. However, there can be disagreement, interest conflict, and tension between senior executives and the CEO. This is especially true for those senior executives with CEO aspirations. Unlike outside directors, who have limited time
and firm-specific knowledge, senior executives have a much better understanding of the firm’s environment and operations. They may challenge the CEO’s strategies, blow the whistle, and express their discontent with the CEO to the board of directors. These actions could affect the CEO’s authority and diminish his/her discretion.

Probably the most common approach used by CEOs in managing senior executives is to take advantage of their control over executive promotion decisions. Through selectively promoting supportive and loyal executives, CEOs can build a strong coalition at their firms and reduce the risk of challenge from their senior executives. While merit, competence, and performance are often articulated as determinants of promotions, interpersonal relationships are at least of equal importance. CEOs not only tend to promote executives they like, but also may try to force out those who may threaten their leadership positions.

CEOs can also use their control over compensation decisions to gain support of their senior executives. For example, they may increase their senior executives’ compensation without any apparent economic justification. There is evidence that upper-level managers in management-controlled firms were paid, on average, 8.2 percent more than their counterparts in owner-controlled firms. Further, the pay difference between managers at these two types of firms is exaggerated as a function of the managers’ organizational level. That is, the higher the managers’ organizational level, the larger the pay difference between levels. Interestingly, despite the large pay premiums enjoyed by the upper-level managers at firms without large-block shareholders, their firms did not perform better.

There is a more subtle way for CEOs to reduce the threats from senior executives—limit the number of senior executives on the board. The presence of senior executives on the board narrows the power gap between these executives and the CEO. Further, it weakens the CEO’s control over the information to independent outside directors. When there are other senior executives on the board, independent outside directors can get information about the firm without going through the CEO. This can significantly weaken the CEO’s influence over outside directors. Unfortunately, proponents of improving corporate governance often have a negative view of having senior executives, other than the CEO, on the board. Instead, these advocates favor outside directors and oppose promoting senior executives to the board, because they believe these executives are on the CEO’s side. Taking advantage of this belief, CEOs not only can reduce the potential threat from senior executives, but also make themselves look more favorable to shareholders by not promoting senior executives to their boards.

Third, Implement Corporate Strategies That Insulate the CEO

Once the employment contract is in place, and the CEO has also won the political battle that sets the board and top management team in place, the CEO is now in a position to implement strategies that may further enhance his or her position. A firm’s strategies influence its performance, which in turn may have a great impact on the CEO’s job security. Our research suggests that CEOs in management-controlled firms manage early in their tenure to reduce their employment risk by managing the strategic choices of the firm. Following the installation of a new CEO, unrelated diversification is increased in management-controlled firms, while performance-enhancing related diversification is higher in owner-controlled firms. This is probably because related diversification has fewer short-term benefits for the CEO than unrelated diversification.

Unrelated diversification is a strategy of acquiring businesses that have little connection with the firm’s current products or markets. When the firm is operating in a single industry, its financial performance is greatly affected by the fluctuations of the industry. In contrast, having a portfolio of businesses in unrelated industries helps stabilize the firm’s
financial returns and provides management with a cushion against the negative impacts of economic downturns in a single industry. These stable returns, while lower than they might have been otherwise, relieve stockholder pressure on the CEO.

In addition to the reduced employment risk and increased job security, the CEO can benefit from this unrelated diversification strategy in several other ways. First, it enables the CEO to increase the firm’s revenues tremendously over a short period of time. By acquiring unrelated businesses, the CEO can easily double or triple the firm’s revenues and then boast of such growth as a major accomplishment. Second, with the increase in the firm’s size and diversification level, the CEO can demand an increase in compensation because he/she can argue legitimately that his/her job of managing the firm has become more complex and difficult. Research has consistently shown that CEO compensation is far more closely correlated with firm size than with firm profits, a topic we will discuss in more detail in the next section.

Third, the CEO may enjoy increased status in the business community, derived from the growth of the firm size. Larger firms generate more publicity for their management, and CEOs reap substantial benefits from being the head of a large organization, such as access to corporate jets or exclusive club membership. In addition, becoming more respected in the business community can lead to more invitations to participate in paid speaking engagements. So, we see that CEOs benefit from growing the firm not only by their compensation schemes but also through reputation and celebrity associated with being the leader of a growing company.

Finally, a more current and in some ways more insidious benefit from running a large firm is the attention of service providers. Among others, investment banks have allocated relatively large numbers of initial public offering (IPO) shares of other firms to a CEO for the prospect of business with his or her firm. For instance, disclosures of IPO allocations to top executives show that Goldman Sachs allocated shares in more than 100 IPOs to eBay Inc.’s chief executive Margaret Whitman.

Unfortunately, this unrelated diversification strategy does not benefit shareholders anywhere near the level it can reward management. First, shareholders can diversify their investment portfolios themselves by investing in firms operating in different industries. This will leave them with more investment choices and opportunities. Second, and more important, research has shown that companies engaging in unrelated diversification strategies under-perform their peer firms. While General Electric, which owns businesses ranging from television networks to jet engines, has enjoyed considerable success with this strategy, it is an exception rather than the norm.

Fourth, Control the CEO Compensation Processes

When the CEOs power is institutionalized, it is reflected in what happens between the CEOs and the boards of directors when the CEO’s compensation is set. We conducted a study of various organizational actors and stakeholders in the CEO compensation processes. What we found helps illuminate the discussion about CEO pay. First, the pay-setting process in management-controlled firms is not as closely monitored by the board, and there is much less pay risk than in owner-controlled firms. Second, in management-controlled firms, the CEOs themselves and management consultants have significantly more influence over their pay than in owner-controlled firms, where the major stockholders are the most influential, followed by the board of directors and the compensation committee. What happened at WorldCom is a good example of CEO compensation in management-controlled firms. According to an interim report prepared by a court-appointed corporate examiner, former CEO Bernard Ebbers used his unusually strong influence over WorldCom’s board to push through lucrative annual compensation
packages for himself worth an average of $25.7 million from 1999 to 2001, as well as personal loans of more than $408 million.

Our findings translate into, we believe, very different approaches to the way that CEOs are evaluated. Our reasoning is based on the fact that the CEO’s task is complex, ranging from making strategic choices that would be reflected in the firm’s financial performance to taking a leadership role in influencing and motivating others in the firm. However, the precise nature of the relationship of the CEO’s decision-making skills and leadership approach to measurable firm outcomes is very difficult to specify. The resulting ambiguity permits room for discretion by boards in choosing which criteria will be used in evaluating the CEO for pay purposes.

Our research shows that the choice of criteria, and the justification for the choice, depends upon where the power lies. With strong equity holders, the board is likely to choose risky results-based criteria such as return on assets (ROA), return on equity (ROE), and the value created for stockholders in the equity markets (e.g., earnings per share). When the CEO is powerful, boards tend to focus on less risky behavior-based criteria, like leadership and managerial competencies. If the CEO has created a favorable relationship with the board, it is likely that it will share the CEO’s ideals and strategic vision. This can result in biased performance evaluations. Poor firm performance can easily be attributed to uncontrollable external forces and good performance to the CEO’s leadership. The reason is that these evaluations will follow the positive feelings that the board has for the CEO. Positive outcomes by liked people are attributed to the person, while negative outcomes are attributed to the context, or the situation. This means that a board that has a positive, favorable relationship with a CEO will select criteria favorable to the CEO. The resulting effects on pay are favorable to the CEO. For example, at Bank of America, the board awarded its now-retired CEO Hugh McColl, who sat on three boards with five other Bank of America directors, a $4.3 million compensation package in 2000, a year in which the bank lost 9 percent of its value and announced plans to eliminate 10,000 jobs. One of our studies, as well as others, showed that when CEOs controlled the firm, the size of the firm was more strongly related to CEO pay than was firm performance, and increases in size were related to increases in both total pay as well as bonuses and incentives. On the other hand, in owner-controlled firms, firm performance was the best predictor of CEO pay, and changes in firm performance were more strongly related to changes in CEO pay.

LESSONS LEARNED

Let us be especially clear. We do not believe that many executives enter business intent on bilking their shareholders or duping their boards. Nor do we believe that the general case of CEOs taking advantage of their position in ways that are as egregious as the recent corporate scandals is common. However, it is obviously the case that CEOs require, and perhaps demand, a great deal of autonomy to make and implement the decisions and strategies they develop for a firm. Unfortunately, the more managers obtain autonomy from the board, the weaker the board becomes. This happens as a complex web of factors develops that influences the relationship between the CEO and the board. Over time, the CEO begins to acquire more and more control over the board’s composition, the firm’s strategic direction, and his or her own compensation. To correct this, boards must participate more actively in the operations of the companies they monitor. Encouraging this participation may be very difficult, but we think that some things can be done that will improve the board’s ability to monitor management.

How to Make Boards More Responsive to Shareholders

The mantra for most critics of the current state of corporate governance is the rather
simple suggestion for more outside directors. This, we believe, is not enough because, as we pointed out earlier, these outsiders may be more beholden to the CEO than inside directors. Instead, the real problem is that boards must have representation from real stakeholder–stockholders. Otherwise, it is too easy for CEOs to engage in the sorts of machinations that we have described to secure and institutionalize his or her power. Here are some ways to deal with this:

1. **Require real individual shareholder representation.** To secure the interest of under-represented groups, we recommend that every board have one *de facto* representative appointed to represent individual shareholders. The largest individual shareholder of the firm not involved with the operations of the company or a competitor will hold this position. Selecting the largest of the “small” independent investors will ensure a voice of shareholders on every board.

2. **Institutional shareholder representation.** A second *de facto* position on all boards will represent the largest institutional shareholder. Institutions are often extremely savvy investors, but their guidance is not often heeded. In addition, institutional shareholders have proven themselves to be some of the most involved and active monitors of business decisions. Providing institutions a voice will force managers to explain their strategy to sophisticated investors who monitor business decisions everyday. A stronger vetting process for strategic initiatives will restrict managers from manipulating the corporation for their own gain.

3. **Create a balance of inside/outside members.** Boards and managers tend to prefer to select individuals they know to be competent and easy to work with. However, this can often lead to cronyism and weak monitoring by the board, encouraging the kind of board structure for which Enron and Disney have become known. Despite the call for more outside directors, there is some evidence that says that insiders have positive effects. We advocate a balance of insiders and outsiders that, in concert with the *de facto* appointments above, might lead to a board in which different perspectives can be more fully articulated, evaluated and implemented.

4. **Move some aspects of board selection outside the firm.** Some of the cronyism issues might be resolved if some aspects of selecting board members are externalized, moved outside the organization to an independent firm. A reputable law firm, bank, or consultancy could handle the talent pool of directors and place individuals on boards where their skills will be valued and utilized. This independent firm might increase assurances that knowledgeable people are nominated. It can also manage the election in ways that might prevent the current management from obtaining proxies from indifferent investors that can be used to implement management’s preferences.

### Fix the Compensation Problem

We know that the criticism of excessive CEO compensation is not new to the recent Enron and WorldCom years. It is only the case that in the recent years there were more public and, perhaps, more excessive examples. Simply, the compensation issue must be addressed, not only for CEOs but also for board members.

1. **Readjust director compensation.** Just as managers deserve compensation for their time and effort, so do directors. Typically, directors are part-time overseers of the company who earn only a small percentage of their total income from any one particular board appointment. As a result, management is more involved in the corporation, while the board becomes more and more removed the longer a CEO stays at the top of a firm. We think that the issue is how to increase the active participation of directors, beyond simply attending meetings and rubber stamping management decisions.

   One way to do this is for directors to hold a larger stake in the success and failure of the firms. In too many instances in the largest firms, directors’ fees are excessive and are not linked to their performance or...
the performance of the firm. Lower fixed fees should be the order of the day and the remainder of director compensation based on whether their choices regarding management and strategic direction are correct. This could be done with stock options, arranged so that each year the directors stand to make more from the long-term success of the company than from short-term gains. Progressively increasing option grants is a common way to compensate top executives in a firm, and the technique should be applied to directors as well. Directors bear the ultimate responsibility for a firm’s success, and they should bear the risk of its failure along with the management they hire.

2. Focus CEO compensation. Recently, stock option plans and “incentive” compensation schemes have become the buzzword in management compensation. Compensation committees seem to believe that encouraging managers to increase the stock price means increasing the firm’s value. However, as best shown by many “dot-com” companies, encouraging managers to run up the stock price encourages them to focus on selling the corporation’s stock rather than increasing the firm’s intrinsic value.

Stock options were originally developed to encourage managers to focus on the long-term, but boards have recently begun to give out stock options with exercise dates as close as 2 years away. Stock options are only effective for maximizing shareholder value if the exercise date is far enough into the future and the exercise price is relatively high. We believe that forcing managers to hold their stock options till retirement or some other longer time period will encourage them to pay less attention to short-term stock price responses and focus on long-term performance.

3. Eliminate loans to officers. Using “forgivable” loans to secure the employment of managers was a common practice prior to the disclosure of Tyco’s excessive use of the practice. Companies would offer loans to executives to purchase the company stock or as part of a “signing” package. After a period of time, the board could forgive the loan. This practice gives managers all the wrong incentives, and many executives abused the practice for stock market speculation. Loans to executives give managers no incentive to remain with the company after the loans are “forgiven.” Loans provide the firm only a guarantee that the executive will not quit before the loan is forgiven, rather than a commitment the manager will perform his duties conscientiously. Managers and other executives ought to acquire loans at banks, and the practice of offering loans to employees should be abolished entirely.

Clarify Reporting

The only way to restore investor confidence and prevent the illicit actions of management in the future is through clear and honest financial reporting at all levels of the organization. Mystifying financial reporting only complicates investor’s attempts to assess the competence of management. It allows managers to “game the system.” Current corporate reporting is a mash of footnotes and incomplete truths that only serve to confound investors. While the Federal Accounting Standards Board deserves some blame for the bewildering web of accounting regulations, companies need to remember that good faith-reporting should be done in good faith. It is the responsibility of the board to demand conservative accounting treatment for all transactions in which the company is involved. The board must protect investors from managers who would use loopholes in the accounting system to manipulate performance numbers, and thus the stock market. The best way for a corporation to seem honest is to actually be honest.

CONCLUSION

Managers and board members are human. Sometimes, despite trying to be ethical, they behave in ways that most people would consider unethical. Benefiting at the expense of shareholders who have trusted you to earn
them a return on their investment is unethical. Often times, managers do not intend to behave this way—they behave unethically unintentionally or are reacting to the incentives or the opportunity to act unethically. This drives them to make decisions that are ultimately not in the best interest of the shareholder. Regardless of how many shares an investor owns, every dime that management takes from the company is money that could have been returned to investors.

Recent scandals are only further evidence that boards are frequently unable or unwilling to decide what is appropriate compensation or behavior for management. The corporate governance system needs reform, and we have offered some suggestions to consider in the process.


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