The Agency Problem of the Board of Directors

Michael R. Levin

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The contemporary corporate board of directors (BoD) is a rather odd construct, although it should not be. Its dysfunction symbolizes neatly how poorly corporate governance works these days, or at least much worse than it should.

As the BoD works in US corporations today:

- Directors have a much closer relationship with the corporate executives they ostensibly supervise than they have with the shareholders that ostensibly elect them.
- Executives and directors control the BoD nomination and election process, and spend considerable amounts of company money to keep themselves in their positions.
- Directors appoint their own successors, filling vacancies and nominating replacements with the approval of company executives.
- Investors and directors communicate with each other at best indirectly, mediated by executives and legions of attorneys, public relations staff, and other minions and gatekeepers, and at worst never at all.
- Executives, not investors, design and maintain director compensation methods (cash, equity) and amounts, with literally no mechanism for investor approval.
- Directors have their own elaborate professional trappings, with numerous trade, educational, and support groups that train them in “effective” and “collegial” service.

I’ve wondered how CEOs talk about “my” BoD as if they own it; yet in some important respects they rather do. I’ve also wondered about the CEOs who retire from a company only to join the ranks of executives that embark on a second career as a “professional” director. What, exactly, does that profession entail? What do they see, do, and learn at NACD[1] meetings?

More generally, how does a BoD take on its own, independent identity, largely separate from the shareholders that they purport to represent and defend? How does the role of a corporate director turn into a part-time job in which retired CEOs become employees of current CEOs?

Berle and Means[2] do not have this peculiar structure in mind in their classic guide to the distinction between ownership and control. Nor do Jensen and Meckling[3] envision this odd environment would evolve as the way to address agency problems in public companies. These

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[1] National Association of Corporate Directors, one of a number of membership associations for

[2] Adolf Berle and Gardner Means, *The Modern Corporation and Private Property*, 1932

[3] Michael C. Jensen and William H. Meckling, “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure”, *Journal of Financial Economics*, Vol. 3, No. 4 (October 1976), p. 305-360

scholars conceive of a BoD as a way to resolve conflicts of interest and reduce agency costs between investors and executives. Today BoDs have their own unique problems, as a number of activist investors have profitably discovered. What gives?

An awkward, wasteful three-way structure has emerged. BoDs don't devote their loyalty exclusively to shareholders, as representatives elected or appointed to oversee an investment in a corporation. Formally, they have a fiduciary duty to represent shareholder interests. Daily, they have a closer kinship with executives.

Instead of aligning directly and solely with investors, BoDs have their own interests, which align more closely with executives than investors. Today directors and executives alike protect their respective jobs, rather than creating value for investors.

From this close alignment of director and executive interests follows the power that executives have over BoDs. Today, executives have more authority over directors, in terms of monitoring BoDs and creating incentives for BoD performance, than investors do.

This essay seeks to work out some of these relationships. It uses agency theory as a way to understand what drives a BoD these days and how to improve on this dysfunctional environment. Agency theory also helps us investors to evaluate prospective BoD reforms, and even how to assess the performance of directors at a specific portfolio company.

Investors and Executives

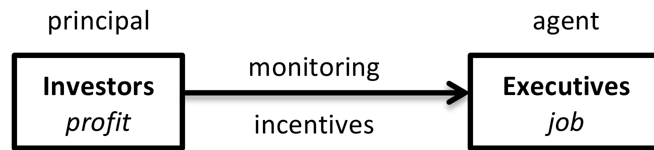
We see three different parties at work. Of course, these three are familiar to anyone who has thought even slightly about public companies. For our purposes here, corporations begin with two of them: investors and executives.

Investors fund a business idea, providing money (or other in-kind assets) for capital goods, employees, etc. They seek a profit on the investment. Jensen and Meckling call them principals.

Executives work directly in the business. They have the specific experience and expertise in the business idea, and devote their efforts to earning the desired profit. Jensen and Meckling call them agents.

Sometimes investors hire executives to develop a business idea. Sometimes executives seek investment for the idea. Whether investors recruit executives or executives attract investors doesn't matter. Investors own the assets of the business, and executives work in the business to earn the desired profit.

This two-way relationship looks like this:



In this structure, investors supervise executives directly. No BoD or any other mechanism stands in the way.

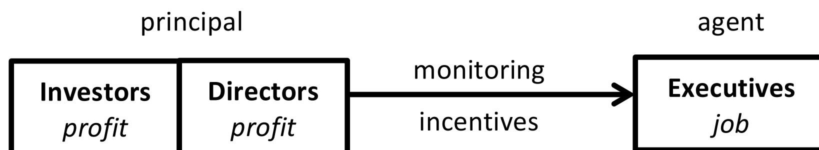
The classic agency problem arises when interests between principals and agents, or investors and executives, diverge. Executives want to maintain their jobs, rather than make a profit for investors. They resist a profitable sale of the company in which they would lose those jobs. They take steps to feed their ego or boost rewards under executive compensation systems, but which don't enhance profitability, such as senseless acquisitions. They incur expenses that make their lives more comfortable, but which also don't enhance profitability, such as corporate jets. We've heard all this many, many times before.

Jensen and Meckling identify two general ways investors can mediate differences between principals and agents: monitoring and incentives. Monitoring entails watching executives closely, measuring their effort and results, and rewarding, punishing, and redirecting them as needed. Incentives entail compensating executives for their work in ways that align their interest with that of investors. The costs associated with designing and maintaining these monitoring and incentive systems, along with any resources wasted as executives pursue personal interests apart from investors', constitute "agency costs".

Enter Directors

Often, investors lack sufficient time and knowledge to run the business. And, in corporations with a public, diversified investor base, it's impractical to solicit views from hundreds, thousands, or more shareholders on how to run the business. So, investors rely on the third party in our story, **directors,** as their representatives in running the business. Thus, in classic agency theory, directors serve as a form of monitoring. Directors also assume responsibility for designing incentives, or setting the structure and amount of executive compensation.

The relationships now look like this:



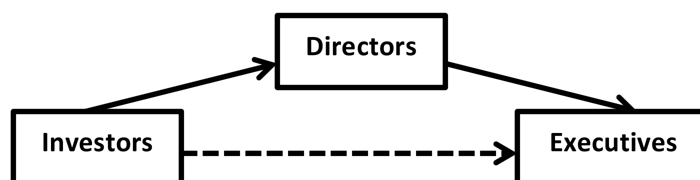
This structure suggests that investors and directors should have the same interests, which together may diverge from the interests of executives. As the delegated representatives of investors, the BoD would design and maintain monitoring and incentives of executives.

Under this structure, investors could serve as directors. In some US corporations, a portfolio manager (or other investor employee) with the time and knowledge to run the business joins the BoD. For various reasons, related to the time commitment or knowledge of the business, or also insider trading restrictions on corporate directors, investors will delegate that responsibility to other people.

Thus the role of an independent director arises. By this we mean, in principle, independent of the executives that run the corporation. But it doesn't work that way these days.

Independent Directors, Truly

Today, most directors don't loyally and exclusively represent investor interest. Instead of the two-part structure in which directors represent investors, we see a curious three-part structure:



In this structure, investors have minimal direct influence over executives. We investors want it and like it that way. Investors can communicate with executives, propose and vote on non-binding resolutions at an annual meeting, and litigate serious matters. That's about it. In lieu of intense oversight, shareholders truly rely on the BoD.

But, so-called independent directors are actually independent of investors, too. Directors have their own interests that create material distance between them and investors. These interests also draw directors closer to the executives that investors need them to monitor.

What are these interests? Much like executives, they want to keep their job and maintain the financial and reputational benefits of their position. As an unfortunate consequence, in most companies executives now have much more control over a director's job than investors do.

Who Works For Whom?

In many ways, directors work for executives, rather than investors. In their pursuit of their own interests, executives have become the principal, and BoDs their agent.

CEOs recruit directors. They use their own contacts, or retain the same executive search firms that they use to recruit other executives. These are also the same firms that directors retained to recruit the CEO and executives.

Executives determine director compensation. Executives set director compensation, including cash payments and equity grants. The BoD then approves what executives recommend. Shareholders literally have no authority over what directors receive.

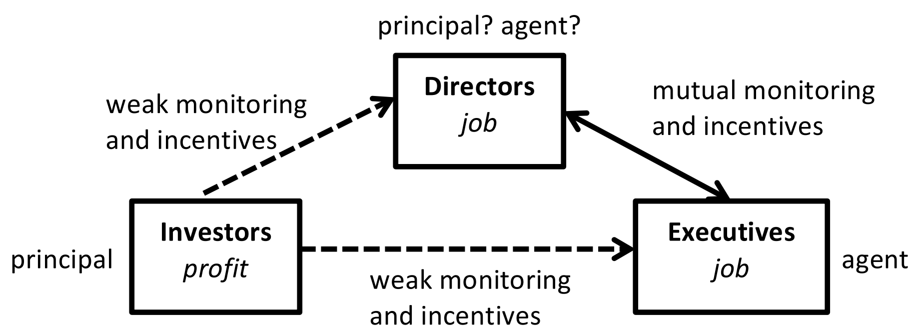
Executives set the rules for the BoD and investors to communicate with each other. This typically entails channeling all contacts through the CEO. Directors have little or no direct contact with the investors that elect them.

The BoD nominates itself. The incumbent BoD creates a nominating committee to decide which directors should continue for another term. With significant input from executives, they essentially nominate themselves.

The Agency Problem of a BoD

The ways in which directors work for executives demonstrate the peculiar agency problem that has emerged. Agency theory explains how interests, monitoring, and incentives all intersect at a BoD. We can use that theory to understand how BoDs fail, and how to improve them.

Today, the relationship looks like this:



The problem begins with divergent interests. Investors want the business to make a profit. Executives want to keep their jobs. Yes, over the past few years we investors have made progress in trying to align these interests. In particular, investors use more sophisticated compensation structures, with more emphasis on equity rewards. Thus, executives now think more about making a profit in the business, and less about merely keeping their jobs. They still don't think as much about the profit as they do job security, but things have improved.

Worse, though, the divergent interests extend to the relationship between investors and directors. Investors remain committed to a profit. Critically, directors don't typically share that goal – instead, they value their job security in the same way as executives. Investor and director interests diverge, while executive and director interests converge. In turn, as investor and BoD interests diverge, the means for investors to monitor and incent the BoD have not evolved.

Earlier we observed that in principle the BoD works for investors. In practice the BoD works for executives. This leads to the perverse situation in which the executives that the BoD needs to monitor and incent instead monitor and incent the BoD.

It's instructive to identify some of the specific monitoring and incentive mechanisms that investors and executives each use to manage a BoD:

	Investors	Executives
BoD Monitoring	• Review qualifications, including other BoD service • Count number of meetings that directors attend • Nominate candidates through a limited, expensive process • Minimal communication	• CEO position on the BoD • BoD advises executives on strategy and operations • CEO controls BoD recruiting, nomination, election, and replacement • Frequent, substantive communication
BoD Incentives	Legal liability for breach of fiduciary duty, with significant insulation through the business judgment rule	Cash and equity in the company, set by the BoD as recommended by executives

Merely asking this question in this way exposes the problem: executives should not monitor and incent a BoD, but rather the BoD should monitor and incent executives. Clearly, the principal-agent relationships have changed, for the worse.

I must note that of course, executives indeed work for the BoD. This essay pertains to how investors and executive influence the BoD, not how the BoD influences investors (a trivial and nonsensical proposition) or how the BoD influences executives. This latter issue is critical, and entails important questions about the best way to monitor (control, audit) and incent (through executive compensation) CEOs and other executives. We leave that issue, though, to other observers, or perhaps a subsequent essay.

How Investors Can Reclaim the BoD

It doesn't have to work this way. How can investors overcome this curious and harmful (to investors) relationship between directors and management?

Investors need to create an interest for the BoD that exceeds the desire to maintain employment by the company. Right now, a director's overriding interest is in keeping their job, with the attendant financial rewards and prestige. Instead, we investors want the BoD to seek a profitable investment.

Interests can diverge whenever a principal delegates tasks to an agent. This occurs when an investor does not serve as a director, but instead elects or appoints someone else in that capacity. Investors do this in part because trading restrictions and regulations make it impractical for a portfolio manager to become an insider as a director. We should eliminate these trading limits, and encourage portfolio managers to serve as directors.

Investors should also remove the CEO and other company executives from the BoD. A natural conflict arises when the CEO serves as both principal and agent. This of course happens when CEOs serve on the company's BoD, which monitors and incents them. We eliminate the

divergent interests between investors (profit) and executives (job) by precluding executives from even serving as a director, let alone as BoD Chair.

I suggest that investors seek to rremove some of the trappings of "professionalism". Membership in NACD and other similar organizations separates directors from shareholders. We have created a cadre of directors that maintains independence from both executives and investors, when they need strict independence from executives and a strong bias toward investor interests.

Investors also need to take over monitoring and incentives from executives. In numerous ways, shareholders should step in to manage the BoD.

Monitoring

- Investors have always pushed for significant reform of BoD elections and succession. Executives and directors should have no authority over who serves on the BoD. A BoD should not nominate its own members or fill vacancies on its own, so BoD nominating committees need to go. Proxy access is also a meaningful goal.
- Investors should demand direct and substantive communication with directors. We don't need the CEO, other executives, or an investor relations department to mediate relations with the directors that represent our interests.
- Directors should not recommend actions or votes to investors. On any matter that requires a shareholder vote, from routine ones such as approving outside auditors and share issuance for equity compensation plans, to significant ones such as a sale of company assets or the entire company, the BoD needs to remain neutral.
- Directors should provide at most limited advice to executives on strategic and operational subjects. Directors need to redirect their efforts to overseeing (monitor, incent) executives and making material decisions that affect investors.

Incentives

- Investors, not executives, need to design and approve director compensation.
- We should allow an investor to compensate directors that are not employees of that investor. Investors can do this in whatever form (cash, equity) makes most sense. We trust investors will structure director compensation in ways that maximize the investor's interest, in turning a profit.

Agency Theory as a Way to Evaluate BoD Reforms

We can use this structure to consider the impact of various potential improvements to BoD structure and practices. The alignment of interest among investors, executives, and directors, and the subsequent monitoring and incentives needed to protect those interests, guides a critique of three BoD innovations.

Majority voting: For many years, institutional investors have advocated for a system in which directors need to win a majority of the votes cast at an annual meeting in order to remain on

the BoD. Investors have made great progress in achieving this goal, with approximately 40% of the Russell 3000 now having some form of majority voting standard[4]. Agency theory suggests that majority voting represents a means for investors to monitor the BoD. However, the most common forms of majority voting give considerable power to executives and the BoD in replacing directors that fail to win the requisite majority of votes cast. Most of the time, a director that does not gain that majority merely submits a resignation to the BoD, which itself can decide whether to accept it. Directors, rather than shareholders, also fill the vacancy if the BoD accepts the resignation. In these ways, today majority voting does not address adequately the agency problem between investors and directors.

Shareholder engagement: Some recent efforts have promoted closer communication between investors and directors. One, the Shareholder-Director Exchange (SDX), has attracted considerable publicity[5]. Its recent efforts represent another means by which investors monitor directors better. In principle it permits investors to indicate their preferences directly to the BoD, and in turn hear first-hand how the BoD monitors and incents executives. In practice CEOs have too much involvement for this engagement to work well. Four firms that make their living serving CEOs and BoDs, rather than serving investors, sponsor the SDX. Its 22-person Working Group has 13 representatives from among CEOs and professional directors, and only 9 representatives from investors.

BoD outsourcing: Two law professors recently set forth this novel way for investors to populate a BoD[6]. They propose that investors should retain firms to serve as directors, in addition to having individuals serve. They argue that firms monitor and incent directors on behalf of investors better than individuals can. In particular, a firm has the necessary time and knowledge for BoD service that investors lack. If so, a firm lowers investors' agency cost, or cost to design and maintain monitoring and incentives of executives. It follows that investors would compare the cost of retaining a firm relative to electing a group of individuals, and it's not clear that a firm would cost strictly less. In addition, a firm would almost certainly begin with different interests from investors. A firm will want to maximize fees rather than company profits. The authors suggest that investors could compensate the firm for BoD service with company equity, which brings us roughly to the same place investors are now.

Agency Theory as a Way to Evaluate Individual BoDs

I think agency theory also offers a sensible means of assessing the directors of a given portfolio company. We investors today don't really have a logical framework for understanding director performance as our agent. Various BoD professional and trade groups have elaborate nonsense for "board self-assessment" and "effectiveness training". These pointless rituals mostly provide cover for BoDs in their unfortunate work for executives.

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[4] http://www.cii.org/majority_voting_directors

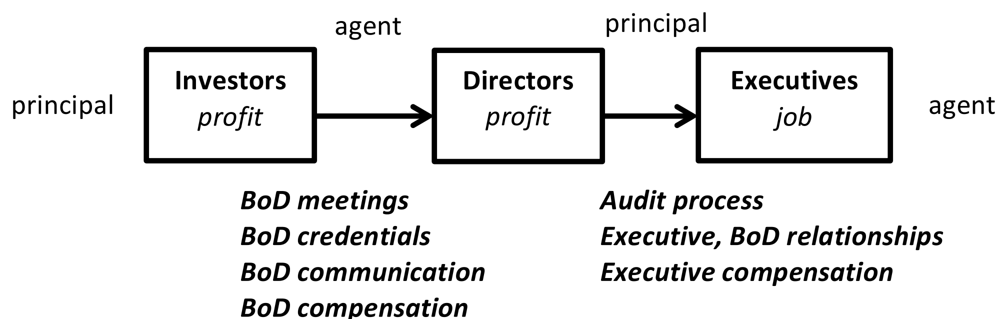
[5] http://www.sdxprotocol.com

[6] Stephen M. Bainbridge and M. Todd Henderson, "Boards-R-Us: Reconceptualizing Corporate Boards", *Stanford Law Review*, Vol. 66 (May 2014), p. 1051-1120

Instead, in a company where portfolio managers do not serve on the BoD, investors should review alignment of interest with directors. Once shareholders assure that directors seek a profitable investment, and not an entrenched job, they can determine the best monitoring and incentives for the BoD of that portfolio company.

In turn, agency theory yields insights into how directors (as principal) should oversee executives (as agent). Again, shareholders can compare the relative interests of directors and executives, and assure that directors work for a profitable investment, rather than executives' (and directors') job security. This stage finally brings us to how BoDs monitor and incent executives, including the nature and extent of proper monitoring, and the structure and amount of executive compensation.

Even better, a company proxy statement provides all the information an investor needs for this purpose:



While far from perfect, proxy statements do provide some information about directors' interests, and monitoring and incentives for directors. Investors can learn about:

- BoD meetings, committees, and overall structure and process
- Director credentials for representing investors
- How to communicate with the BoD
- BoD cash and equity compensation and ownership

Proxy materials also provide information about how the BoD and executives:

- relationships among directors and executives that can lead to common interests between them, and divergent interests with investors.
- monitoring (the audit process)
- incentives (executive compensation).

The BoD today is too distant from shareholders, and too close to executives. Agency theory reveals how to align interests better, and how to design and maintain monitoring and incentives that both keep these interests in alignment, and minimize the costs to investors when these interests diverge.