

Why corporate boards would be better off with fewer outside CEOs

By Steven J. Toll and Bernard S. Sharfman

Even though it has been eight years since the Enron scandal, recommendations to improve board composition of public companies have not gone much beyond making board members more independent. However, we believe a lot more can be done. One critical recommendation we propose is that there be a limit on the number of outside chief executive officers, current or retired, who can serve on the full board and its major committees. This recommendation is unique because it flies in the face of conventional wisdom that says the more outside CEOs on the board of a public company, the better.

We believe that having a large number of independent directors who have been or are CEOs of large institutions — public or private — creates the potential for *identifying* with executive management and perhaps viewing his or her role on the board as making sure not to get in the way of what executive management wants to do.

This deference toward executive management's position would be in addition to the typical and understandable deference independent board members would normally give to the recommendations of executive management simply because they possess superior information and expertise on any particular corporate issue.

Moreover, we believe that having a board dominated or heavily influenced by outside CEOs, in combination with an executive management that is perceived by the board as being able to do no wrong, may lead to what we refer to as "dysfunctional deference," a regard for the recommendations of board insiders and executive management so pronounced that it stifles deliberation of a corporate board's most important decisions. We believe this is what happened at Enron when the board, without any evidence of significant deliberation, gave its approval for executive management to establish and operate the now infamous LJM private equity funds, even though executive management had clear conflicts of interest in these transactions.

Furthermore, we believe that a heavy reliance on outside CEOs would interfere with what is referred to as a team production approach to board composition. This

approach requires that board composition reflect the main attributes of those key inputs that make up the firm. Based on the scholarly work of Allen Kaufman and Ernie Englander, we recommend that board members of a public company should be selected based on the following criteria:

- *Value Contribution*: those employees who provide critical value added to team production such as engineers or scientists and outside suppliers of research and development such as universities;

- *Unique Risk*: stakeholders such as vendors who have customized their production of goods and services to meet the unique demands of the company; employees and executives of the company who have invested in the learning of non-transferrable skills; providers of unique sources of capital; and the communities where company employment is concentrated and have made infrastructure investments to support this employment; and

- *Strategic Information*: employees, such as executive management, or employees with special skills, such as those with expertise in accounting, finance and marketing, that can provide value added strategic information to board deliberations.

Board members could either be from inside or outside the company, as long as they are representative of the team. For example, the engineers or scientists representative of the critical technologies that create value added can be from either inside or outside the corporation. Given the ability to substitute outside expertise for inside expertise, members of the board that come from outside the firm essentially serve as proxies for the various components of the firm's team production, thereby allowing the board to meet its independence requirements.

The problem with having a significant number of former or current CEOs as independent directors is the potential to overweigh the board with proxies for the current CEO who is already on the board. Of course, each outside CEO on the board will bring to the table different attributes and strategic information than the company's current CEO, but still the risk is that by having too many outside CEOs on the board, it will not be representative of the company from a team perspective. Thus, outside CEOs would be selected to serve on the board only so long as they add value and did not create an imbalance of interests.

This discussion is based on two recent articles we published in the Northwestern University Law Review Colloquy, *Dysfunctional Deference and Board Composition: Lessons from Enron* and *A Team Production Approach to Corporate Law and Board Composition*.

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