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Finance 750 Evaluation

Evaluator: Sugato Bhattacharyya
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Ken undertook a Graduate Independent Research Study under my supervision during the summer of 1999. He undertook to study the role for Boards of Directors in various systems of corporate governance. The attached paper has been prepared by him as fulfillment of requirements for the course.

I have awarded Ken a grade of Excellent based on his diligent study of the institution of the Board of Directors in corporations. In the paper he has submitted, Ken first provides an overview of the state of Boards in the United States. In this, he has done a reasonable job in summarizing reports from a variety of places. This summary provides a good starting point for his discussions later in the paper.

Ken goes on to examine various duties that Boards are supposed to discharge under a variety of circumstances, especially in the context of the American corporate governance system. In this section, he does a very good job of collecting together various arguments and presenting them clearly. He also looks at the evolution of these duties in light of recent court judgements.

Ken goes on to comment on the state of Boards in the German and Japanese systems. While his discussion of the German system is not quite comprehensive, his relative familiarity with Japanese corporate governance system allows him to examine differences with the US system with a reasonably critical eye.

Finally, Ken presents an analysis of what Boards should do and what factors should determine their size, composition and extent of duties. Here he presents contrasting arguments well, keeping in mind that these are both topical and hotly debated issues. While he cannot be expected to generate truly original findings in an area where research on the fundamental issues is still an ongoing endeavor, he does manage to bring out the essential points of the debates quite well.

All in all, Ken has demonstrated the signs of concentrated and effective learning in an area where the debate is concerned with a multitude of viewpoints and paradigms. He has also shown an impressive amount of maturity in being able to understand and classify the issues well. While the submitted paper could very well be better exposited in places, I think that, overall, it shows evidence of substantial work at both understanding and presenting issues of critical importance in today's business world.

A Graduate Business School Research Paper, University of Michigan Business School-

JUN 2 6 2000

THE ROLES OF THE BOARD OF DIRECTORS UNDER CORPORATE GOVERNANCE SYSTEMS

by

Ken Ichiro Soma

A research paper submitted in fulfillment of the requirements for 3 0 credits

GRADUATE INDEPENDENT RESEARCH PROJECT Spring/Summer Term 1999,

Professor Sugato Bhattacharyya, Faculty Supervisor.

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INTRODUCTION

The board of directors is the single most important corporate governance mechanism, in principle. At least in the U.S., directors have the legal authority to perform almost every function in governing corporations. However, the boards have historically lacked the appropriate incentives and the procedural mechanisms to elicit the most effective oversight. Accordingly, much of the corporate governance debate revolves around questions about whose interest boards of directors should serve, what they should do, and how they can be best organized to ensure that they carry out their duties.[1] The goal of this paper is to provide necessary considerations to the above three questions.

In the first section of this paper, the reality of the American boards of directors is described, mainly through summarizing surveys of institutional arrangements. The second section deals with the underlying problem in governing modern corporations, and approaches in the U.S., Japan, and Germany are compared. The third to fifth sections deals with the three questions respectively. In considering whose interest boards should serve, shareholders-value principle is revisited and how boards should treat other constituencies are tested, from a view of societies' expectation. In considering what boards should do, the implication of the U.S. corporate law is examined, and boards' appropriate behaviors in both ordinary course of business and extraordinary case of takeover threat are provided. In considering how boards should be best organized, each element of institutional arrangements is tested in accordance with the expected functions of boards.

REALITY OF THE AMERICAN BOARDS

What Boards Are Doing

History in brief. A board is the only formal organization directly chosen by shareholders, and therefore is responsible for managing the affairs of the corporations. To complete this responsibility, for decades the American boards have delegated to managers the daily running of the business, given managers the authority to make business decision, and monitored the performance of the delegated management.

The role of the boards had disappeared in mid-twentieth century, after the separation of corporate ownership from corporate control became virtually complete and professional managers started dominating corporate decision-making. Boards became often cited as "rubber-stamps" for management, with a merely ceremonial function.[2]

However, particularly after late 80's, the rules for corporate boards have been changed. Major drivers include the takeover wave of 80's, the greater scrutiny by both the judiciary and the business press, and activism by the institutional investors that own an ever increasing share of corporate equity.[3] Responding to such pressures, the General Motors set the example of well-functioning boards that address the separation of equity ownership from control. In 1994, the GM issued its Board of Directors Corporate Governance Guidelines, which were widely circulated. The California Public Employees' Retirement System (CalPERS), a typical institutional activist, wrote to the board chairs of

[1] Blair Ownership and Control 1995, pp77-78

[2] Millstein and MacAvoy The Active Board of Directors and Improved Performance of the Large Publicly-traded Corporation 1997. p12

the 300 largest public companies requesting the comparison between the GM guidelines and their own practices, and graded the level of boards' self-developments.[4]

Nowadays, the boards of directors are expected to assume a more engaged role and a greater degree of accountability. Boards' mandate remains unchanged: not running the company, but hiring, monitoring, compensating, and if necessary firing management.[5] It is required for boards to oversee management in a proactive and professional manner.

Legal responsibilities. Having a board of directors, with fiduciary responsibilities for the corporation, is required in state corporate laws. A fiduciary is someone who has legal responsibility to care for something held in trust for someone else. Fiduciary duties impose the duties of loyalty and care. The duty of loyalty prohibits self-dealing transactions at the expense of the corporation and requires to avoid conflicts of interest. The duty of care requires each director to act in good faith, with the care an ordinarily prudent person in a like position would exercise under similar circumstances, and in a manner he/she reasonably believes to be in the best interests of the corporation. The application of these duties is complicated, because corporations are not merely simple trusts. Interests of various constituencies are involved, and the goals of corporations are not clearly defined.[6] Thus, judgements on what directors should do or should not do to fulfill their fiduciary duties depend on the courts' decisions in individual law suites.

However, in practice, so-called business judgement rule keeps the courts out of the affairs of companies. Formally, the business judgement rule is the common law

[3] Davis "Corporate Boards in Times of Turbulent Change" 1998, p278

[4] NACD Report of the NACD Blue Ribbon Commission on Director Professionalism 1996, pp1-2

[5] Davis "Corporate Boards in Times of Turbulent Change" 1998, p286

presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action was in the best interest of the company.[7] The courts have been reluctant to "second-guess" boards or management from outcomes of their business, except in case of gross negligence or willful misconduct like self-dealing.

Boards' loyalty: shareholders-value principle. The first, and probably the most important, premise for the American corporate finance theories is that the goal of corporations is to maximize shareholders' wealth. Stockholders are the owners of the firm, and inherently own the right to control corporations. Thus, the operations of corporations should be managed in line with shareholders' interest. Corporations should, using shareholders' funds and leveraging them by debt when appropriate, make investment to projects with positive net present value. By generating future cash flows through investments, corporations are able to increase shareholders' wealth.

This shareholder-value principle is not merely an academic story, but serves as an important premise in managing corporations. According to the survey reported on the *Chicago Tribune*, American firms rated the importance of Return on Investment as 2.43 on average, on a scale of 0 to 3, 3 being most important. Answers to the same question by Japanese firms averaged 1.24.[8] Shleilfer and Vishny even defined "corporate governance" as "the ways in which suppliers of finance to corporations assure themselves of getting a

[6] Blair Ownership and Control 1995, pp56-58
[7] Bradley and Schipani "The Relevance of the Duty of Care Standard in Corporate Governance" 1989, p23
[8] Miller "Is American Corporate Governance Fatally Flawed?" 1997, p38

return on their investment".'

A current stock price is considered to measure the company's fair market value, and its movement serves as the scorecard of corporate performance.[10] Financial theories suggest that a stock price be quoted as the present value of expected dividends in the future.[11] Another way to put it is that the net present value of all free cash flows in the future should be equal to the corporation's market value, and that by dividing by the number of outstanding shares after subtraction of its debt value, the market price should be determined.[12] Therefore, instead of holding stocks throughout the company's life, shareholders can realize the value created by the company through the sale of stock at market.

Capital markets are assumed, and further encouraged, to allocate capital among firms efficiently. A stock price under well-functioning capital markets not only measures how the company is doing business, but also how it is governed in line with shareholders' interest. According to a survey by McKinsey in 1996, two-thirds of American investors are willing to pay more, on average 16 percent more, for the company with the properly structured and functioning board of directors, all other things being equal.[13]

Ordinary course of business. Again, the main role boards are playing is to oversee management. According to the Korn/Ferry survey, board meetings were held in 1993, excluding sub-committee meetings. Banks and other

9 Shleifer and Vishny "A Survey of Corporate Governance" 1997, p737
10 Prahalad "Corporate Governance or Corporate Value Added" 1997, p46
11 Brealey and Myers Principles of Corporate Finance 1996, pp59-62
12 Brealey and Myers Principles of Corporate Finance 1996, pp423-428
13 Millstein and MacAvoy The Active Board of Directors and Improved Performance of the Large Publicly-traded

financial institutions met most frequently with an average of nine meetings, while insurance companies met least often with six meetings.[14] Issues to be discussed at board meetings can be determined by each company in either its bylaws or other guidelines, in addition to those issues obligated by corporate laws. Boards are commonly supposed to discuss a corporate philosophy and mission, to review and approve management's strategic and business plans, and reviewing corporate performance against the plans.[15] In addition, governing documents of corporations often require boards to authorize major transactions, declare dividends, and authorize the sale of additional securities in accordance with their articles of incorporation.[1]

Boards are also playing a role in selecting, evaluating, compensating, and if necessary replacing the CEO and other senior executives. Interviews with outside directors revealed that these traditional functions staked out for the board are still the greatest source of directors' influence.[17] In the selection process of management succession, 67 percent of boards determines whether to consider external candidates, 63 percent defines qualifications and performance expectations for next CEO, 46 percent identifies potential CEO candidates, 65 percent meets and evaluates CEO candidates, and 64 percent selects CEO successor.[18] In evaluation and compensation, 78 percent of surveyed corporations have a formal process of evaluating the performance of the CEO, either once or twice a year, and CEO compensation is based on the evaluation received in

Corporation 1997, p12
14 Korn/Ferry International Twenty-first Annual Board of Directors Study 1994, p11
15 NACD Report of the NACD Blue Ribbon Commission on Director Professionalism 1996, pp1-2
16 Blair Ownership and Control 1995, p56
17 Davis "Corporate Boards in Times of Turbulent Change" 1998, pp281-282

94 percent of the cases. Other key executives also receive boards' evaluation in 43 percent of overall surveyed companies, and in 58 percent of 5 billion-and-over industrials.

Takeovers. In the U.S., there have been four takeover waves in the 20* century, and the most recent wave was in 80s. At least 143 out of the 500 largest industrial corporations in 1980 had been acquired during the decade. Although the majority was friendly takeovers, which were carried out with the consent of target firms, there were also a substantial number of hostile takeovers, in which the management of target firms fought against bids.[20]

Takeovers are an extraordinary situation with fundamental change of the company's business, and therefore, give different stories to the role of the boards of directors from the ordinary course of business. In friendly mergers, management proposals have to be submitted to shareholder votes, and boards as "gate-keepers" are required to approve the proposed transactions prior to submission to shareholders.[21] In hostile takeovers, most defensive tactics are permitted without shareholders approval, but duties of care and loyalty of boards have been tested at the courts. While the business judgement rule strongly protects boards in the ordinary course of business, board's performance has been challenged in case of such extraordinary cases as takeovers.

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18 Korn/Ferry International Twenty-first Annual Board of Directors Study 1994, p20
19 Korn/Ferry International Twenty-first Annual Board of Directors Study 1994, p12
20 Shleifer and Vishny "The Takeover Wave of the 1980s" 1997, p98
21 Blair Ownership and Control 1995, p69

How Boards Are Organized

Composition. While the corporate laws in the U.S. allow each company to choose the method of organization, it is quite often the case that shareholders' meeting elects directors by simple majority. Shareholders also often retain the right to remove a director at annual meetings, with or without cause depending on the articles of incorporation, by a simple majority.[22] In reality, however, it is extremely hard for shareholders to remove a director and to nominate a new director. Usually, the boards of directors, occasionally with strong influence from management, nominate the candidates for new directors, and all shareholders can do is to vote or to choose not to vote.[23] According to the Korn/Ferry's survey in 1994, the nominating committee has the basic responsibility for selection of outside directors in 63 percent of surveyed 348 corporations, followed by the CEO with 34 percent. Directors are mainly located through recommendations of other board members (86 percent), recommendations of the chairman (85 percent), and nominating committee within the boards (70 percent). Use of the nominating committee is particularly popular at the largest industrials, 95 percent of $5 billion-and-over-revenue companies. Dependence on the recommendations of institutional investors is only eight percent, though it shows increasing trend.[24]

In the vast majority of the American corporations, one person concurrently serves as the chairman of the board and the CEO. It is worthwhile to note that more than 80 percent boards in the U.K. contrarily have a full-time non-executive chairman, while

22 Fukao Financial Integration, Corporate Governance, and the Performance of Multinational Companies 1995, p98
23 Blair Ownership and Control 1995, p79
24 Korn/Ferry International Twenty-first Annual Board of Directors Study 1994, p11

corporate governance systems in the U.S. and the U.K. demonstrate much similarity and often collectively referred as the Anglo-American system. In the U.S., 80 percent of respondents to the Korn/Ferry survey do not separate the positions of the chairman and CEO.[26] 24 percent of corporations had a lead director role, as a non-management board leadership position, in 1996.

Board members other than the chairman are either part of the management team or drawn from the outside of the firm. The proportion of outside directors is around 75 percent in average, and slightly varies by the industry and size of the firm. For example in 1993, 80 percent is outside directors in banks and other financial institutions, and the largest consumer product companies have 64 percent outsiders. Outside directors are most commonly drawn from the rank of CEOs, COOs, and retired executives of other companies. More than 85 percent of boards include CEOs or COOs of other firms, and each has four of them on average.[28] Other pools for non-executive directors are academicians (58.2 percent of surveyed boards include at least one.), attorneys (56.8 percent), retired officers of the firm (48.7 percent), investment and commercial bankers (36.2 percent), former government officials (31.0 percent), and major shareholders (26.1 percent).[29]

Candidates occasionally decline invitations to serve on boards, and 65 percent of the surveyed firms experienced such decline in 1993. CEOs at billion dollar companies

25 Davis "**Corporate Boards in Times of Turbulent Change**" 1998, p284

26 Korn/Ferry International Twenty-first Annual Board of Directors Study 1994, p7

27 Millstein and MacAvoy The Active Board of Directors and Improved Performance of the Large Publicly-traded Corporation 1997. pp7-8

28 Korn/Ferry International Twenty-first Annual Board of Directors Study 1994, p7

and service firms average three board memberships in addition to their own, and the proportion of those CEOs who declined invitations to boards reached 76 percent in 1993. The main reason to decline invitation is considered time commitment, as 90 percent of surveyed CEOs responded so.[30] Time required to spend on board-related business demonstrated significant increase, to 141 hours for insiders and 157 hours for outsiders on average in 1996.

Sub-committees. Publicly traded companies are increasingly forming sub-committees. One reason is the requirements from outside, such as stock exchanges and tax rulings. Companies listed on the NYSE or NASDAQ are required to have, and those on the ASE are recommended to have, an audit committee comprised of independent directors. It is also becoming popular that boards have independent sub-committee responsible for evaluation and compensation of CEOs, because tax ruling encourage this. Corporate tax deduction for executive compensation package is denied for the portion exceeding $ 1 million a year, unless those packages tie compensation tightly to performance and meet certain other requirements. One of these stipulates that the compensation package be determined by a compensation committee composed entirely of outside directors.[32] Moreover, certain proxy rules and regulation mandate disclosure of certain committee structures and functions, which may encourage the appointment of board nominating and compensation committee. In addition to audit, nominating, and compensations, a few companies have voluntarily formed special social responsibility,

[29] Korn/Ferry International Twenty-first Annual Board of Directors Study 1994, p13
[30] Korn/Ferry International Twenty-first Annual Board of Directors Study 1994, pp11-12, 19
[31] Millstein and MacAvoy The Active Board of Directors and Improved Performance of the Large Publicly-traded

environmental, corporate ethics, or corporate governance committees/

According to the Korn/Ferry survey in 1993, 99.7 percent of surveyed boards had audit committees. 96.6 percent had compensation committees and 67.3 percent had nominating committees. Other surveyed sub-committees included executive (74.9 percent), finance (37.0 percent), public affairs (15.6 percent), corporate ethics (6.7 percent), and science/technology (3.7 percent). Most sub-committees demonstrated increasing trend, and the increase in nominating committee was most significant. The Investor Responsibility Research Center reported that 40.2 percent of large companies have completely independent nominating committees as of 1996.

In case of the GM as of 1995 revision of the guideline, there were six committees: Audit, Capital Stock, Director Affairs, Finance, Executive Compensation, and Public Policy. With the exception of the Finance Committee, all committees consisted of independent directors. Although not mandated, periodic rotations of committee members at about a five-year interval are encouraged.

<u>Size and term.</u> The size of the boards of U.S. companies is reducing. An average board had 14 members in 1987 but only 12 in 1992.[37] As reasonably expected, the size varies with both company size and type of business. In 1993, banks and other financial institutions had the largest boards with average 15 directors, and under-$400million small

<u>Corporation</u> 1997. p5

32 Blair <u>Ownership and Control</u> 1995, p58

33 Blair <u>Ownership and Control</u> 1995, p82

34 Korn/Ferry Internationa] <u>Twenty-first Annual Board of Directors Study</u> 1994, p14

35 Millstein and MacAvoy <u>The Active Board of Directors and Improved Performance of the Large Publicly-traded Corporation</u> 1997, p6

36 NACD <u>Report of the NACD Blue Ribbon Commission on Director Professionalism</u> 1996, p30

37 Blair <u>Ownership and Control</u> 1995, p82

industrials had average 9 directors. For example, the 1995 reviston of GM guideline mentioned:

The Board presently has thirteen members. It is the sense of the Board that a size of fifteen is about right. However, the Board would be willing to go to a somewhat larger size in order to accommodate the availability of an outstanding candidate(s).

Each director generally has one- to three-year term, depending on the articles of incorporation and bylaws. The renewal of election as a board member is rarely restricted. 80 percent of companies had a mandatory retirement age for their directors in 1993. The larger their revenues, the higher the proportion of mandatory retirement ages established. Companies limiting terms of service for directors rather than a stated retirement policy counted 10 percent only.[39] Again as an example, the GM guideline described:[40]

The Board does not believe it should establish term limits. While term limits could help insure that there are fresh ideas and viewpoints available to the Board, they hold the disadvantage of losing the contribution of Directors who have been able to develop, over a period of time, increasing insight into the Company and its operations and, therefore, provide an increasing contribution to the Board as a whole. As an alternative to term limits, the Committee on Director Affairs, in consultation with the Chief Executive Officer and the Chairman of the Board, will formally review each Director's continuation on the Board every five years. This will also allow each Director the opportunity to conveniently confirm his/her desire to continue as a

38 NACD Report of the NACD Blue Ribbon Commission on Director Professionalism 1996, p26
39 Korn/Ferry International Twenty-first Annual Board of Directors Study 1994, p12
40 NACD Report of the NACD Blue Ribbon Commission on Director Professionalism 1996, pp27-28

member of the Board.

According to a survey of the Investor Responsibility Research Center, 57 percent of major listed companies have "staggered" terms of three years. At a three-year staggered board, one-third of the directors is elected each year.[41] The staggered board gained its popularity during the takeover wave in 80's, because it helps prevent the drastic replacement of entire board members in a short period of time.

Compensations for directors. The predominant form of cash compensation for outside director is the combination of an annual fee and per-meeting fees, with 90 percent of corporations' use. 88 percent of companies also pay compensation for sub-committee services. The average total compensation in 1993 was $36,556, including sub-committee fees. Although the annualized increase rate of compensations exceeded the corresponding inflation rate, this increase was not sufficient to compensate for the increase of required time commitments. On average, cash compensation per hour of service slightly declined. Other benefits than cash compensation also included travel expense reimbursement (95 percent), directors' liability insurance (88 percent), the option to defer board fees (67 percent), and pension plans (51 percent). With regard to the level of cash compensation and other benefits, the size of corporation matters significantly. As expected, the larger the company, the higher and the wider the compensations.

An emerging trend in early 90's is to tie directors' compensation with the company's stock. At 55 percent of all companies and at 71 percent of the largest industrials in 1993, board members received additional compensation in the form of

[41] Fukao Financial Integration. Corporate Governance, and the Performance of Multinational Companies 1995, p98

company stock. Stock options were the most popular method with more than a half of the 55 percent, followed by stock grants and restricted grants. In addition, 32 percent of surveyed companies require their directors to own some stocks of the company. By the time of this report, compensations with the company stock have gained further popularity.

When the board' performance is evaluated, the nominating committee within the board plays a role at 69 percent of companies. However, the CEO also often plays a role, at 33 percent.[43]

[42] Korn/Ferry International Twenty-first Annual Board of Directors Study 1994, pp8-10

[43] Korn/Ferry International Twenty-first Annual Board of Directors Study 1994, pp12

INTERNATIONAL COMPARISON

Overview

Issues surrounding corporate governance are inter-related. Although the focus of this paper is the role of boards, merely looking at the boards of directors is not sufficient. Instead, studies need to be made in the context of entire governance systems. Therefore, before we start international comparison, the central issue that every corporate governance system has to address is to be examined.

Although the challenges in governing modern corporations are shared among developed countries, corporate governance systems show significant differences by nations. Accordingly, the roles and optimal arrangements of the board of director differ, depending on the needs from entire governance system. Later in this section, comparison is made among three nations' governance system: namely, American, Japanese, and German. The purpose of comparison is not to determine which is superior to which, but to identify boards' characteristics in each system, which can be implemented in seeking the optimal arrangement for the board of directors.

Common Challenges in Governing Modern Corporations

Limited liability companies. Modern businesses, both in production and in distribution, are often too large and expensive for an individual to own, and therefore require partial ownership by a number of investors. Investors also prefer to diversify their investment portfolios to mitigate the unique risk of a corporation by making small units of investment into large number of corporations. Furthermore, the limited liability system allows each investor to sell or buy shares, without paying attention to other shareholders. By providing investors with diversification and liquidity of their portfolios, corporations successfully reduce the cost of capital.[44]

However, the limited liability system has disadvantages, and the central issue is the so-called agency problem. The essence of the agency problem is the separation of ownership and control. Owners, or shareholders, cannot be deeply involved in all corporations they invested, and need to delegate day-to-day operation to professional managers. However, it is impossible to specify exactly what managers should do and how profits should be allocated, because most future contingencies are hard to describe and foresee. When managers are allowed to control corporations at their own discretion, they do not necessarily perform as owners originally expected.[45] This agency problem potentially brings about substantial costs, due to the reasons on both shareholders and managers, as described below.

Collective action problem. Shareholders need to monitor and control management, because corporate officers as their agents may execute business in a way that conflicts with shareholders' interest. For shareholders as a whole, it is essential to assure that the invested funds are wisely and prudently used to generate additional cash and are to be returned to investor with dividends in future. However, each small shareholder acting

44 Fukao Financial Integration, Corporate Governance, and the Performance of Multinational Companies 1995, pp9-10
45 Shleifer and Vishny "A Survey of Corporate Governance" 1997, pp740-741

alone is not motivated to serve as a monitor, for the following reasons.

Monitoring requires time and efforts, and every shareholder cannot or is not willing to spend resources. The costs of monitoring can easily exceed the potential benefit, only a small fraction of the gain. Therefore, for many investors who seek diversity and liquidity in their portfolios, required resource commitment for monitoring is inconsistent with their interests.[47] Even if some shareholders were capable of monitoring, they would not like other shareholders to "free-ride" on their time and efforts. Thousands of monitors can never be required for one company, and each shareholder seeks opportunity to free-riding other shareholders as a monitor.

Self-interested opportunism. Because no shareholder is willing to be involved in monitoring or controlling the corporations they invested, managers' discretion over the allocation of investors' fund become significant. Although laws to some extent help limit the occasions that managers simply expropriate cash, get excessive compensation, and benefit from out-of-market transfer pricing, too luxurious offices and company airplanes are commonly observed. More importantly, managers use their discretion to pursue projects that benefit them than shareholders, such as for the private benefits of control or for excessive diversification.

Managers, devoting their time for a corporation, are in a different position from investors in terms of diversification. While investors enjoy liquidity and diversification in their portfolios, managers' personal wealth and human capital is tied to the corporation.

46 R0e Strong Managers Weak Owners 1996, p6

[47] Blair Ownership and Control 1995, p33

[48] Shleifer and Vishny "A Survey of Corporate Governance" 1997, p742

Managers are, by nature, motivated to seek diversification of the corporation by making wide range of investments unrelated to its core business, potentially sacrificing the efficiencies from specialization.[49]

Finally, managers can expropriate shareholders by entrenching themselves and staying on the job, even if they are no longer competent or qualified to run the firm. Some argues that the difficulty in replacing poor managers is the costliest item among the agency problems.

<u>Boards as agents.</u> A collective action problem among shareholders explains the reason why owners are not willing to monitor the appropriate usage of their own wealth. Shareholders, scared with managers' self-interested opportunism, then naturally choose to hire somebody as a collective monitor on their behalf. A collective monitor, instead of deep involvement of numbers of shareholders, saves monitoring costs. In addition, having a collective agent brings about the benefit of coordinating various shareholders' interests, which are not necessarily identical. Risk preference is one example of the source of difference among shareholders, and the intended length of shareholding is the other. If functioning properly, the boards of directors are expected to deliver shareholders' unified voice to management to the best of shareholders' interests as a whole.

However, as easily imagined, boards as agents create another principal-agent problem. The historically typical "rubber stamps" for CEOs are a clear example. Appointment and dismissal as directors are often controlled by CEOs instead of shareholders, and each director is likely to try to secure his/her job by saying nothing to

[49] Miller <u>"Is American Corporate Governance Fatally Flawed?"</u> 1997, pp42-43

management. In line with the manager-shareholder agency problem, board-shareholder relationship should be carefully coordinated. In fact, most protective techniques for the manager agency problem are also applicable to boards.

<u>Common approaches to agency problems.</u> It is found that the well-functioning governance systems around the world show some common characteristics. For example, Shleifer and Vishny conclude that "the U.S., Germany, Japan, and the United Kingdom have some of the best corporate governance systems in the world, and the differences between them are probably small relative to their differences from other countries- According to Shleifer and Vishny, two most common approaches, both of which rely on giving investors some power, are legal protection and concentrated ownership. Good governance systems, as observed in industrialized nations, commonly make the best use of these two approaches.

Legal protection is a relatively direct approach, which assures owners' rights to influence corporate control. Managers' and directors' duty of loyalty supplements the voting rights of shareholders. Laws commonly restrict managerial self-dealings and other conflicting activities with shareholders' interests. Legal systems play an important role especially for minority shareholders, who do not possess other practically effective protections.

Concentrated ownership provides a certain group of shareholders with the incentive to monitor managerial operations. A substantial ownership, leading to large proportion of rights to cash flows, motivates such a shareholder to gather information and

[50] Shleifer and Vishny "<u>A Survey of Corporate Governance</u>" 1997, pp742-743

monitor the management for its own interest. Thus, the substantial shareholder is less concerned about the other small free riders. As importantly, the existence of enough voting control to put pressure to the management discourages managers and directors to act for their own interests instead of shareholders'.[51]

Difference by Nations and Potential Convergence

Market-based vs. relationship-based. Despite the above similarities in broad sense, scholars have more enthusiastically identified substantial differences among the governance systems in developed countries. Comparisons are often made between two representative models: the Anglo-American model and the Japanese/German model. The Anglo-American model, observed in the U.S. and the U.K., is often described as a "market-based" system. Japanese/German model, observed in Japan, Germany, and other continental European nations, is often described as a "relationship-based" model.

In short, the market-based Anglo-American model relies on efficient capital markets with large transaction volume. Stock prices quoted at market are considered the measure of corporate performances, and thus, the value-creation for shareholders is considered the first priority of corporate activities. The markets of corporate control, or takeovers through tender offers, play an important role. Widely dispersed shareholdings, with relatively strong legal protection for minority shareholders, are also important characteristics.[52] Reflecting these, the primary role of boards is an independent monitor of management on behalf of dispersed minor shareholders.

[51] **Shleifer and Vishny "A Survey of Corporate Governance" 1997, pp737-739 and 750-758**

The relationship-based Japanese/German model heavily relies on monitoring and controlling by large shareholders, particularly large banks and inter-corporate holding. These large shareholders, which are creditors or product purchasers at the same time, tend to hold the company stock in the long term, as a token of stable business relationships. Stable large shareholders, which also retain managerial interaction and information sharing within business groups, are expected to serve as effective monitors. Another characteristic of Japanese/German model is the strong representation of employees. As a result, corporate activities do not focus on "pure" shareholders' interest as clearly as the Anglo-American system does. Both relationship investors and employees possess representation of their interests at the boards of directors either directly or indirectly.[53]

Potential convergence. Constant improvement in operational effectiveness is necessary to win the competition, and the corporate governance system is not an exception. Especially when the competition takes place on global basis, relative inefficiency in governance system against other nations makes the costs of necessary resources high throughout the nation, and its economy may suffer a death spiral. The acceleration of studies in governance systems of other nations by American scholars and the success of Japanese/German companies in product competitions, both occurred in late 80's, are not coincidental.

Although global competition somewhat drives studies and implementation of more efficient corporate governance systems both by corporations and by nations, few, if any, believes that the systems are going to converge into one optimal system on global

52 Chew Studies in International Corporate Finance and Governance Systems 1997, pl

basis. That is because each nation or economic block has its own history, culture, and resource constraints, as backgrounds of the current governance system.[54] There have been arguments about the degree of convergence; however, the bottom line is that simply looking for the most effective system around the world and imitating it do never work.

As the governance system as a whole retain differences by economic blocks, the roles of boards in it should be different. However, it is worthwhile to study the advantages of governance systems and corresponding roles of boards, and to consider whether such arrangements fit to the particular economic block in question. Again, various systems around the world have been studied and compared, particularly since late 80's, and these studies identified lots of similarities and differences. Each system has advantages and disadvantages, and no system is regarded ideal. The American system, although generally regarded as working well, possibly have rooms for improvement by implementing advantages of the other governance systems.

The American System

Dispersed ownership. The limited liability system is common in developed countries and not unique to the U.S. What is unique to the U.S. is its high degree of dispersion of equity ownership. The U.K. is the only other major country that demonstrates the same degree of dispersed ownership, and concentrated ownership with influential shareholders is often observed in many other industrial countries like Germany

53 Kester "Governance, Contracting, and Investment Horizons" 1997, pp230-231

and Japan.

Under highly dispersed ownership, the voting power of any individual shareholder is not influential, and formingg groups to enhance collective influence on managemeng is considered difficult and costly.[55] Therefore, the collective action problem among shareholders is substantial, and monitoring and influencing management through the board of directors has an essential role under the governance system.

Financial intermediaries. Even though ultimate fund providers, or owners, are distant individuals, they may be able to influence management through powerful financial intermediaries: namely, banks, insurance companies, mutual funds, and pens.on funds, each holding trillions dollars of assets. However in the U.S., it is not the case. There are a lot of systematic impediments for intermediaries to have influential blocks. Banks have been prohibited from either operating throughout the nation or making stock investment. Mutual funds are discouraged to own control blocks. Insurers can put only a fragment of their investment portfolios into any one from owning any one company's stock. Pension funds are fragmented and securities rules discourage them to act jointly. Various laws or ruling, such as portfolio rules and anti-networking rules, have prohibited or raised the cos. of institutional influence.[56]

There are many examples of banking and securities legislation that discourage or prohibit banks and large investors from supervising corporate management. These laws include the Glass-Steagall Act of 1933, the Securities and Exchange Ac. of 1934, the

54 Coffee The Future as History 1998, pp26-44
55 Blair Ownership and Control 1995, p30
56 Roe Strong Managers Weak Owners 1996, pp21-22

Investment Company Act of 1940, the Bank Holding Company Act of 1956, and the Employee Retirement Income Security Act of 1974.[57] Large institutional investors such as mutual funds have been discouraged their concentrated ownership in a particular company by the Investment Company Act[58] and the Employee Retirement Income Security Act[59].

Roe claims that these restrictions on financial institutions are strongly related to politics affecting lawmakers.[60] Legal and regulatory constraints against the broad oversight authority of financial intermediaries can be largely attributed to a strong populist political undercurrent against Wall Street, which makes the best use of public concerns and the political system.

M&A market for control. It is a common belief that a fairly vigorous M&A market, together with dispersed shareholders, characterizes the American governance system. The takeover wave in 80's helped the U.S. firms achieve the efficiencies of specialization by sharpening the corporate focus. Conglomerates that had diversified beyond rationales were taken over, and their business lines were broken down and sold off to different buyers.[62]

A large number of theories and evidences support that takeovers typically increase the combined value of the target and acquiring firm. The change of control often removes poor-performing managers, leads to distribution of the firms to investors over

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57 Kester "Banks in the Boardroom" 199_, pp68-69
58 Roe "Mutual Funds in the Boardroom" 1997, pp175-178
59 Fukao Financial Integration, Corporate Governance, and the Performance of Multinational Companies 1995, p24
60 Roe Strong Managers Weak Owners 1996, pp48-49
61 Proud "Raiders, Targets, and Politics" 1997
62 Shleifer "The takeover wave of the 1980s" 1997, pp98-100

time, and increase profits afterwards. Even the reasonable threats of becoming a target, supported by a vast liquid capital market, provide managers with pressure to operate the company efficiently and to maintain a stock price high.

The effectiveness of takeovers as a corporate governance mechanism has been questioned, however. First, hostile takeovers are a politically vulnerable mechanism. In fact, managerial lobbies successfully put pressures to obtain state anti-takeover legislation, and contributed to ending the takeover wave of 80s. State officials tend to be inclined more to management and employees in the state as taxpayers than to nation-wide or worldwide investors. Second, takeovers are too expensive to address minor performance failures at earlier stage. When this blunt outside force takes place, managerial problems are too significant and late treatments are accompanied with huge social costs. Nevertheless, the fact that takeovers are the critical element of the American corporate governance system can hardly be questioned.

Economic background. There are several economic reasons that have supported the dispersed ownership particularly in the U.S. Historically, the economies of scale were more substantial in the U.S. due to the size of its market, than in other countries with geographically or politically separated smaller markets. Rapid developments in technologies accelerated benefits from not only scale-efficiencies but also professional management. Selected professional managers, who efficiently manage complicated businesses and devote their time and effort, have been often capable of performing better

[63] Shleifer and Vishny "A Survey of Corporate Governance" 1997, pp756-757

than wealthy owner-managers perform.

Competition in product market, as well as labor and capital, has been enhanced. As a result, managers had only limited opportunities to steal corporate wealth by self-dealing, unless they sacrifice corporate performance and consequently their reputation in managing corporations. Moreover, strict rules of conflict of interests, proxy contests, and takeover respectively served as threats to managers' unreasonable behaviors. The potential costs of dispersed ownership have been reduced, although no solution was complete and perfect.[64]

The fact that net benefit of dispersed ownership is positive is not sufficient. In order to survive in increasing international competition, costs have to be minimized and net benefit has to be maximized. That is why many scholars have devoted to identify systematic problems and to come up with modifications of the governance system.

The Japanese System

Insider-dominated boards Most directors of Japanese corporations are nominated out of senior employees, and approved by a simple majority at shareholders' meetings. Because most board members are concurrently executive officers of the corporation, the expected role of the board has been an execution of business rather than monitoring. The board of directors elects one or more of its members to represent the corporation to deal with third parties, and one of the representative directors is named

[64] Roe Strong Managers Weak Owners 1996, pp7-8

president, the most powerful person equivalent to the CEO and Chairman.[65] All important business decisions are made at senior officers' meeting, and same issues are discussed at the board meeting only when the articles of incorporation require. Consequently, the practical distinction between directors and senior officers is not clear.

The term of a director cannot be longer than two years, and a two-third majority of shareholders can dismiss a director with or without cause. In practice, becoming a director is regarded as a necessary pass to be promoted to a high-tier management officer, under the lifetime employment practice. Therefore, the size of boards, as a pool of candidates for senior officers, has been big as many as 50 in some largest corporations.

Silent shareholders. Shareholders of Japanese corporations are silent at shareholders meeting, although they retain broader voting rights including total compensation for directors and the amount of dividend. The main root lies on the historical view on limited liability corporations. While the American law regards limited liability corporations as a modified form of partnerships and regards shareholders rights as inherent to owners, the Japanese legal structure is not clear regarding the ownership of corporation. The current Japanese commercial laws were prepared in 1950 under the strong influence of the U.S., and shareholders' rights are often considered given by law, as opposed to inherent rights.[66]

There are other systematic reasons of silent shareholding. In addition to the existence of long-term relationship shareholders as described below in detail, racketeers against corporations have historically prevented individual shareholders from active

[65] Fukao Financial Integration, Corporate Governance, and the Performance of Multinational Companies 1995, p99

involvement in shareholders meetings. Even in 1995, the 70-75% of listed Japanese corporations held their annual shareholders' meeting at 10am on June 29. The main purpose of this is to avoid heavy involvement of *sokai-ya*, the racketeers who require unlawful payments from corporations with the threat to disturb shareholders meetings. Including the above example, various preventive systems against *sokai-ya* results in the difficulty for any shareholders to be active.

Main banks and cross-ownership. Most listed Japanese corporations maintain "main bank relationships". This relationship with major commercial banks combines the provision of debt capital and equity ownership, which is often reciprocal. With banks' position as lead lenders and major shareholders, they enjoy preferred status in a wide range of financial services. Main banks have involved themselves deeply in the affairs of their client companies. Detailed disclosure of corporate strategies and investment plans are frequently required, and bank executives occasionally require modification of these plans.

Main banks are also important providers of directors to many Japanese corporations. One or more members of a typical Japanese board are former executives of the corporation's main bank. It is a common practice in Japan that retiring senior managers who failed to be promoted to the banks' own boards are placed in second career as directors of client companies. Moreover, when a corporation faces financial distress or serious managerial difficulties, main-bank involvement in the affairs of the corporation become dramatic. Main banks often send the new president out of their employees, take a

[66] Okushima "Japanese Corporate Governance. Adopting to Globalization" 1996. pp53-54

leadership role in restructuring, and even coordinate mergers.[68]

Same sort of close relationships among industrial corporations are also popular. As a token of stable business relationships between suppliers and purchasers, they reciprocally hold stocks of trade counterparts. Commercial relationships between them are not exclusive, but grant preferred status. The transfers of managers and directors as their second career are also common.

So-called *keiretsus,* or complex group of companies, are formed either horizontally around major banks or vertically around large industrial corporations. Typical characteristics of relationships within each group are implicit contracting, management transfers and human network, extensive information sharing, and selective intervention by core shareholders to force adjustment.[69] Although quite a few of these activities are justified by owning stocks, the capacity of core shareholders is far beyond those of mere shareholders'. Other minor shareholders have historically relied on this systematic monitoring and adjustment, and have not found the necessity of their own activism.

Future perspective. As the Japanese relationship-based system forms closed groups and somewhat disturbs pure competitions, it had served as the barriers against foreign entrants to Japanese market. Foreign nations, particularly the U.S., have put pressure to remove the sources of unfair treatments through the government to government discussion. Meanwhile, since early 90's Japanese economies have been

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67 Kubori "The Latest Movement of Shareholders Meetings, and the Roles of Directors and Auditors" 1996. Pp83-86

68 Kester "Banks in the Boardroom" 199_, pp69-72

69 Kester "Governance, Contracting, and Investment Horizons" 1997, pp230-235

experiencing severe downturns. With greatly declined stock prices, public shareholders came to believe that monitoring and adjustment within *keiretsu* groups and by main banks did not function as expected. It was a natural movement that Japanese policy makers and business communities tried to revisit their governance system.

The long history of neglecting shareholders' rights is currently under adjustment. For example, the stockholder derivative suit is increasing its importance, as the means for minor individual shareholders to influence management. In 1993, Japanese commercial laws were modified and the cost of derivative suits was reduced significantly. While there were only 10 derivative suits for 40 years before 1993 modification, there were 145 cases filed in 1994. ° This movement substantially contributed to educating directors the necessity of accountability in performing their duties.

Business leaders from various Japanese listed companies, including banks and industrial corporations, formed the Corporate Governance Forum of Japan in 1994, and issued reports with recommendations to change in 1997 and 1998. Its recommendations are, in short, highly in line with what the American system has been and is seeking for. They emphasize the accountability of management through disclosure to public, and independent monitoring function of the boards of directors distinguished from business execution. They admit that necessary legal reforms and the development of market for outside directors need time.[71] However, quite a few corporations have already started reforming their institutional arrangements, such as the separation of the executive directors from the corporate decision-making unit.

[70] Sakamaki "Changing Shareholders and Shareholders' Rights" 1996, pp126-127

The German System

Two-tier structure. Unlike the U.S. and Japan, the German commercial law obligates publicly owned and listed corporations to have two-tiered boards. A management board is a decision-making body on most matters, with day-to-day executive authority over the company. Usually five to fifteen full-time members of this board, each having three to five years, are appointed by the supervisory board. This supervisory board is specialized purely overseeing the management and separated from business execution. Employees elect the half of usually 9 to 22 members of the supervisory board, with fixed term of up to five years, and shareholders appoint the other half. These shareholders representatives are commonly elected from the executive ranks of other corporations and banks. Because the firms to which directors belong often have a major stakes in the company, they can practically act as representatives of, and monitors for, other constituencies than shareholders.[72]

No one can be a member of both the management board and the supervisory board of one company. Shareholders meetings determine the compensation for the members of supervisory boards, and supervisory boards determine that for the members of management boards.[73] In this regard, the German system clearly separates the executive function from monitoring by two-tier system, and quite differs from Japanese. However, the important similarity is that boards consist of representatives of employees and other

[71] Corporate Governance Forum of Japan Corporate Governance Principles - A Japanese View - 1998, pp40-58
[72] Kester "Governance. Contracting, and Investment Horizons" 1997, pp236-237
[73] Fukao Financial Integration. Corporate Governance, and the Performance of Multinational Companies 1995, p100

constituencies, instead of purely focusing on shareholders' interest.

Hausbanken. German major banks' influence on corporate affairs is as substantial as Japanese. In addition to their substantial direct shareholding, particularly for largest industrial corporations, the role as depositories leverages banks' voting rights. Banks as depositories are practically permitted to vote on behalf of the depositors.

Hausbanken is comparable to Japanese main banks, with regard to long-term shareholding and long histories of lender-borrower relationships. For example, until the merger with Chrysler, the chairman of the supervisory board of Daimler-Benz came from Deutsche Bank. In fact, Deutsche Bank engineered the merger of the Mercedes and Benz automotive companies, when their financial distress took place.[74]

Cozy community. Germany has a relatively small circle of corporations, and executives dominating large business are closely tied in inter-locking boards. In 1984, 79 percent of the German supervisory boards of largest companies had one or more board members who concurrently served on the management board of other major companies. Eight large banks and insurance companies accounted for more than 45% of inter-locking links. In 1987, Deutsche Bank's 12 management board members served on the supervisory boards of 150 listed companies, and as an extreme case, one bank executive participated in 42 different supervisory boards within 15 years.

Opportunistic behaviors in such a cozy community severely harm the reputation of managers and directors, as a major breach of trust, because the small circle of executives provides opportunities for effective information sharing among them. How a

[74] Kester "Banks in the Boardroom" 199_, pp72-73

businessperson serves as the member of boards, either management or supervisory, is easily observed by other executives sitting at the same boards. Board members with poor performance are dismissed based on widespread information within the community, and vice versa.[75] The close knit of core executives in the German business community helps them monitor the performance as directors one another with a penalty of dismissal, and this provides shareholders and other constituencies with comfort.

75 Kester "Governance, Contracting, and Investment Horizons" 1997, p237

WHOSE INTEREST BOARDS SHOULD SERVE

Revisiting the Shareholder Principle

Backgrounds. Through studies in the governance systems of other industrial nations under the intensified global competition, the overemphasis on stock prices and shareholder returns in the American governance system became questioned. A typical argument includes that the quarter-to-quarter focus of investors pressures American companies into under-investing in relatively intangible assets. A shortsighted, or myopic, feature of corporate management prevents them from long-term investments that was allowing Japanese and German competitors to prevail in the international market place in late 80's and early 90's. These long-term investments include R&D, stronger supplier relationships, market penetration, process improvements, and employee training.[76]

As few claim that the American system is inferior to other nations' governance systems, which have their own disadvantages, the basic idea of the shareholder principle is rarely questioned. However, various modifications to the American systems, incorporating advantages of others, are proposed. Some of them claim that it is beneficial to give constituencies other than shareholders the voice to influence the management of corporations.

In virtually every jurisdiction, it is a common practice that shareholders elect the board of directors under widely dispersed ownership to have directors represent shareholders interests. At the same time, balancing the needs and goals of multiple

[76] Chew Studies in International Corporate Finance and Governance Systems 1997, pp1-2

stakeholders has got to be increasingly expected, to achieve effective political-economic systems in the long run. Some claim that other stakeholders' lack of efficient way to represent their interests indicates the necessity for the boards to take their interests into consideration.[11] As the first step to consider how the boards of directors should function, consideration is made regarding whom boards should be loyal to.

Expectations from societies. In accordance with the corporate laws in most states, a board owes fiduciary responsibilities to the respective corporation as a legal person, as opposed to its shareholders. Because the legal regulation does not define the boards' direct responsibilities to any particular constituencies, it is difficult to objectively determine whose interest corporations should serve.[78] One way to address this question is to consider public expectations. This is partly because the expectations from societies form the base that drives laws and politics. Moreover, corporations and whole economic systems that conflict with societies would face inefficiencies in procuring various necessary resources, and thus lose their competitiveness.

What a society expects for corporations is, in short, to generate economic value for the entire society. The economic value here includes economic profits of the corporations, and spilled-over benefits to the society, such as stable employment and stable business with other entities. We first examine the profit of the corporations, mainly capital providers' concern, and second look at other social benefits, mainly other constituencies' concern.

[77] Weston et al. Takeovers. Restructuring, and Corporate Governance 1997, pp393-394

Equity and Debt

Shareholders. Corporations generate economic profits by making investment in the projects whose rates of return exceed required costs of capital. When corporations successfully add value through investments, capital providers' wealth increases accordingly. The necessary funds can be provided to corporations in essentially two ways, debt and equity. Because debt holders' claim to the corporations is limited to pre-agreed principal repayment and interest, the increase in value of debt is limited. On the extreme assumption that the debt is risk free, all the economic value added is for equity holders. In this case, generating economic profits for the corporations as societies expect is solely for shareholders' interest.

Here, it is important to note that shareholders mean not only those who directly provided corporations with funds but also those who purchased stocks in secondary markets. Ethical obligations of a corporation may be regarded as limited to the direct fund providers. However, unless the corporation commits its responsibilities to secondary shareholders, nobody wants to invest its fund in the secondary market with the danger of its wealth being destroyed. If the secondary market fails to function, the liquidity of stocks initially offered become limited. As a result, the corporation fails to attract investors in the initial offering. Due to this cascade effect, it is unavoidable for every corporation to commit its loyalty to any shareholders in future.

Debt holders. In addition to shareholders, debt holders are also concerned about the corporate activities, in reality. Increase in free cash flows supports the certainty of

[78] Blair Ownership and Control 1995, p58

debt service, decreases financial distress risks and required rate of return, and increases the market value of debts (or, the present value of debt service commitments). More importantly, some corporate activities can cause so-called "uncompensated wealth transfer" from debt holders to equity holders. For example, if a corporation undertakes a riskier project than its existing business with substantial new debt ranked pari passu, the risk of existing debts would increase without compensation. As another, extreme example, a corporation may try to raise a senior debt and to pay all the funds out as dividend to shareholders. The higher the debt ratio is, the more substantial the impact and risk of "wealth stealing" are. These activities should be discouraged, because such wealth transfers never generate overall value to the society and somewhat destroy a sound debt market. Unless debt holders' interests are reasonably protected for the term of debts at least, nobody wants to provide corporations with funds as debts. Consequently, corporations face difficulty to raise funds necessary for profitable investment opportunities, which increase societies' overall wealth. In this regard, the boards' blind loyalty to maximizing shareholders' wealth is problematic.

To determine the degree of necessity to protect debt holders' interest as a role of the boards, there are several factors to be considered, in the context of contractual protections' availability. The first consideration is how debt holders are knowledgeable. In standard practice, the debt contract upon issuance includes negative covenants, which often restrict additional debt raising and excessive dividend payments without prior consent. Upon the breach of covenants, the debt holders can accelerate debt repayments and enforce securities. As long as debt holders have powers and capabilities to include these protections into contracts and to proceed legal settlements, they can retain a much stronger contractual position than shareholders can. Second, the situation of the relevant economy and industry matters. In a stable industry with well-established technologies, the pressure to make investments could be relatively low in general. In this case, corporations are likely to accept strict covenants with debt holders, who consequently are strongly protected by contracts. However, corporations in developing, revolutionary industries are eager to retain their flexibility, so that they can develop competitiveness in timely manners. Too strict covenants, in favor of debt holders' contractual rights, are often unfeasible in practice. For example, the limitation to raise additional funds causes the delay in investment execution. With the strict requirement to disclose business plans, corporations bear substantially high risks that others steal or imitate those business ideas before successfully building the first-mover advantages.

The boards of directors should take debt holders' interest into consideration, because debt holders cannot rely solely on their contract. Even though bankers are knowledgeable enough to impose contractual protections, the costs of losing corporations' flexibility are often not low enough to be justified. In addition, it might be beneficial for other constituencies, too, to include debt holders' representatives in the boards. Debt holders' representatives, highly likely experienced bankers, own expertise to control corporations through their wide knowledge and experience in other industries.

There are several ways to achieve debt holders' representation at the boards. One way is to allow and encourage debt holders to own equity as well, and to have them represent their interest through their status as shareholders. However, their internal conflict of interests, with both caps as debt holders and shareholders, is likely to be an issue. It may be viewed as a mere transfer of the conflict from a corporation to a stakeholder. The other way to achieve debt holders' representation is to include some board members as representatives of debt holders. This notion is simple as a concept, but complicated to implement. For example, there is not a debt holders' meeting relevant to the shareholders' meeting, which elects and dismisses directors.

Other Constituencies

Employees. Societies might expect other benefits to corporations, in addition to profit generation. One example is to generate stable employment. Employees are another group of constituencies of corporations, and will be benefited by job securities. For example in Japan, as already discussed, the implicit contracts between a corporation and its employees are generally in long-term, often the lifetime long. This employment security provides employees with comforts in devoting their time and effort to acquire firm-specific skills. At the same time, this implicit long-term commitment from employees provides corporations with comforts in making investments for employee training and education. This entire system remains efficient, as long as the social preference to such a long-term stable employment is reasonably strong. However, if the social expectation diminishes, the inherent costs of the illiquid market of labor exceed the benefit.

Currently, the costs and benefits of employment securities widely vary by jurisdictions. The cost for corporations, or societies, to commit job securities is to lose flexibility. Labor costs become deemed fixed costs rather than variable costs, and it become more difficult for corporations to stop particular business and to reallocate resources under bearish situations. Although committing to secure employment, instead of jobs, could be easier particularly for corporations diversified in terms of either industries or geographic business portfolio, still certain level of costs is unavoidable. Moreover, the highly diversified form of business is believed to bear the cost of inefficiency in control. On the other hand, the benefits for employees, or societies, depend on historical and cultural backgrounds. When the size of economy is large enough and the liquid labor market is developed as in the U.S., the benefits from job securities are limited. When employees are eager to stay in the small geographic area due to either physical reasons such as language or cultural preference, the small size of economy may prevent societies from absorbing fluctuation in economic situations. In this regard, the levels of costs and benefits are positively correlated. When employees find high benefits of employment securities, corporations' costs to commit employment are also high.

Employees are usually paid pre-determined salaries to compensate their time and efforts, and thus, contractual relationship between corporations and employee is relatively clear. In this regard, it is not necessary for boards to protect employees' interests further, at least in such jurisdictions with liquid markets of employment as the U.S.

Suppliers and customers. A long-term relationships with suppliers and customers, or network externalities for a business community, is another example of spilled-over benefits that society might expect. Long-term relationships help societies keep stable economic activities as well as firm-specific investments, but the same trade-off as job securities applies. Stability can be achieved only at the cost of losing flexibility. In fact, many manufacturers in the U.S. have implemented a part of Japanese-style to facilitate the just-in-time process, and have proved that a strong commitment to suppliers can, at least occasionally, be a more effective system than a heavy reliance on arms-length transactions.[79]

While the commitment to suppliers by corporations can be beneficial to the entire society, it should not be concluded that suppliers should retain influential powers of corporate control. Suppliers' control of a corporation leads to self-dealing, a serious threat against fair competitions. In case of Japan, two kinds of *keiretsu* support its system without unreasonably sacrificing competition. First, the industrial (or vertical) *keiretsu* is accompanied by a substantial cross ownership, which makes suppliers' interests in line with shareholders. Second, the main bank (or horizontal) *keiretsu* provides the third parties who coordinate transactions within the group, particularly a main bank. These third parties are expected to mitigate the threat of self-interested deals, which are likely to occur in case of the direct control. However, such broad systems to reduce the costs of supplier relationships, as represented by Japanese *keiretsu*, are hardly applied to other jurisdictions, because their effects on other parts of governance systems are too significant. Instead, contractual arrangements can be, and actually are, commonly implemented.

It is common and natural for suppliers (or customers) and a corporation to engage formal contracts for their transactions. Any terms and conditions can be agreed, after

[79] Fukao Financial Integration, Corporate Governance, and the Performance of Multinational Companies 1995, pp2-3

arms-length negotiation. If a corporation's investment to build long-term supplier relationship is economically justified, it can engage in with suppliers accordingly. The increasing competition in the technology market, establishment of access to a supplier network, is expected to accelerate the necessity of proper supplier relationship.[81] Whatever the change in supplier/customer relationship is, the bottom line is that suppliers and customers can be easily protected by contracts.

Conclusion

Priority in boards' loyalty. The boards of directors should be loyal primarily to shareholders, for two reasons. First, societies' expectation to maximize overall wealth can be well interpreted as shareholders' value maximization. Second, shareholders, who can claim residuals only, are the least contractually protected stakeholders. The claims from debt holders and employees are clearly defined, and therefore, rights defined in clear written contracts are easily supported by court. The limited contractual protections for shareholders lead to their necessity of controlling management through the boards.

This does not mean that other constituencies' interests can be completely ignored, however. It can be beneficial to include other constituencies' representation, particularly for debt holders, although the significance of benefits somewhat depends on the background of industry and society. Considerations should be made, first, whether the representation at boards is the best way to take other constituencies' interests in to account. If yes, second considerations are how to have them represent, whether through

[80] Kester "Govemance. Contracting, and Investment Horizons" 1997, pp230-235

holding stocks or through invitation. If the latter applies, shareholders face a trade-off between the dilution of stakes at boards and the benefits from retaining flexibility, and other constituencies face a trade-off between obtaining representation at boards and forgiving some of their direct protections. Systematic decision-making processes, which judge the degree of other constituencies' involvement in boards from individual circumstances of corporations, should be developed.

Answer to the criticism as myopic. The shareholder-value principle, measuring corporations' value creation by stock prices, has been attacked as the reason that the U.S. managers are not willing to make necessary long-term investments compared to German or Japanese. However, the shareholder-value principle or the focus on stock prices is not the source of problems. Instead, how capital markets function in determining stock prices is the issue.

As financial theories suggest, the current market price of a stock should take all available information about the expectation of future cash flow into account. However in history, reported earnings figures have been bluntly used as a short-cut indicator of future cash flows, while value-creating long-term investments create burdens on the current earnings. As a result, the "EPS-enthralled" short-term investors have indirectly forced managers to increase earnings at the cost of long-term investments. Too much focus on current earnings can be the source of an inappropriate conflict of interest among shareholders. If a value-creating long-term investment drives the stock price down, short-term shareholders dislike it and long-term shareholders like it. However, it is impossible

[81] Prahalad "Corporate Governance or Corporate Value Added" 1997, p52

for corporations to distinguish shareholders by their time horizons of shareholding and to treat them differently. This is because, for example, a long-term investor may want to sell stocks tomorrow, after holding them for 10 years. Stock prices should reflect long-term perspective, and then conflicts among investors with different investment horizons disappear.

In fact, stock market participants seem to be easing their emphasis on earnings-related figures, and to be shifting their focus towards corporations' ability to add economic value in the future. For example, the EVA or the Economic Value Added as registered trademarks of Stern Stewart & Co. is increasing its popularity as a tool to measure corporations' and their internal business units' performance, offering and diligently touting a number of advantages.[83]

In summary, the shareholder-value principle is not the source of problem in the governance system, on the condition that capital markets properly takes the long-term effects of business activities into consideration. If capital markets fail to do so, shortsightedness of managers and conflicts among shareholders with different investment horizons become problems. Fortunately, recent trends indicate that the EPS-oriented market is moving towards more sophisticated one, in line with the generally accepted financial theories. Capital markets can function properly as the means for corporations to raise funds from investors, without harming governance systems.

[82] Chew Studies in International Corporate Finance and Governance Systems 1997, p3
[83] Millstein and MacAvoy The Active Board of Directors and Improved Performance of the Large Publicly-Traded Corporation 1997, pp29-32

WHAT BOARDS SHOULD DO

Ordinary Course of Business

Shareholders' direct involvement. Although corporate laws are intended to give shareholders a significant amount of control, the number of matters that must be submitted to shareholder vote is limited. These are election of directors, substantive amendments to the articles of incorporation, and fundamental changes outside of the companies' ordinary business.[84] One way for shareholders to be involved in management is the "proxy contest," which virtually any shareholder can put at the company's expense. Through this attempt by dissident groups of shareholders, they are able to seek to obtain board representation against management proposals. However, communications among shareholders have been strictly restricted, though somewhat eased in 1992 in terms of the number of shareholders contacting, and most contests failed to win a majority.[85] Although some effects on shareholders wealth can be observed regardless of outcome, the present system of proxy contests is charged as inefficient.[86]

Instead of being actively involved, diversified owners choose to exit by selling shares at market if they are not satisfied with management. If enough shareholders exit, the stock price of that company goes down. This signals shareholders' dissatisfaction with current management, and in extreme case triggers replacement of management.

Both proxy contests and exiting pressure admittedly work as reasonable outside

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84 Blair Ownership and Control 1995, p71

85 Fukao Financial Integration, Corporate Governance, and the Performance of Multinational Companies 1995, p106

86 Weston et al. Takeovers, Restructuring, and Corporate Governance 1997, pp402-403

force to have managers act properly; however, reliance on the board as an inside control mechanism is much more significant for most shareholders. Boards have to be proactive in assuring proper control of corporations.

Commitment to delegate. Boards, or management, cannot submit every decision to a shareholder vote, because corporations need to take advantage of investment opportunities as they arise. Spending time to obtain approvals, and sometimes releasing certain kind of information, prevents corporations from building their competitive positions.[87] Boards are appointed to oversee management on behalf of owners, who inherently possess controlling rights. Once shareholders decide to delegate controlling function to boards, shareholders have to commit to follow operational decisions made by boards. Otherwise, potentially frequent challenges to boards' decisions lead to inefficiency.

In this regard, the business judgement rule applied in the U.S. has a rationale. In the long run and for entire societies, the costs of routinely subjecting operational decisions to judicial scrutiny are regarded to exceed the losses from some bad judgements. Here, an important fact to note is that the courts have given managers and boards broad discretion.[88] Shareholders retain only limited capabilities to legally challenge operational decisions made by management and supported by boards. Shareholders have to rely on the power of boards to monitor and influence management properly on behalf of them, together with institutional arrangements that motivate boards in line with shareholders' interests.

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[87] Blair Ownership and Control 1995, pp32-33

Issues to deal with. What boards should NOT do is the day-to-day execution of business. Executive officers should be professionals in managing business with full knowledge of the industry, and boards should concentrate on reviewing what managers do. Otherwise, an executive function is duplicated, and an objective monitoring function is lost. In monitoring and reviewing the ordinary course of business, boards should focus on three things: providing management with their own insights, retaining a sufficient power to influence management, and motivating management to act in line with shareholders interests.

First, boards should provide management with their own insights, through formal approval processes and informal consultations. As a management team is chosen as a group of professionals to execute businesses, directors are chosen as professionals to oversee management. Boards, therefore, are expected to supplement managerial expertise of executive team, in addition to mere double-checking. The sources of additional insight include familiarity to business theories and applications, specialty in law, accounting, and others, and knowledge and experiences in wide range of industries. While all executive officers are required to have industry-specific knowledge and experiences, it is worthwhile to include some directors who can bring something else that the management team is hard to retain. In order to maximize the benefits from diversity of board members, informal consultations should be encouraged, even if the governing documents do not require formal approvals.

Second, boards should retain a sufficient power to influence management. The

[88] Blair Ownership and Control 1995, p58

main source of a power is the right to evaluate and to dismiss poor executive officers including the CEOs, on behalf of shareholders. In order to achieve this, proper empowerment from shareholders and formal procedures for evaluation are necessary. Boards are frequently incapable of oust CEOs quickly enough.[89] Even the boards dominated by outside directors tend to hesitate to remove top managers, unless a true performance disaster happens.[90] It is a natural behavior that boards tend not to replace management until the corporate performance faces real difficulty and the situation becomes hard to recover. Thus, the formal procedures to trigger the replacement of management through evaluation are necessary. Unless the threats to lose managerial positions are reasonably serious, management tends to ignore boards' and shareholders' voices.

Third, boards should motivate management to act in line with shareholders' interests, because it is easier to have management act properly from the first place than to force them change what was decided. Among the ways to achieve this, compensation for management is regarded as most effective. In order to motivate managers to act as owners, aligning managers' self-interest with shareholders' has a significant power. By compensating managers partly by the stock performance, they are encouraged to seek successful moves that benefit shareholders. However, this does not solve the problem entirely. There remains a difference between managers' and shareholders' interests, in terms of diversification. Shareholders in general public have, or at least are able to have, well diversified portfolio, and their stockholding of a particular company is a small part of

[89] Davis "Corporate Boards in Times of Turbulent Change" 1997, p280

their wealth. Contrarily, managers' personal wealth and human capital are largely and inevitably tied to the particular company they are serving. As consequence, risk-averse managers tend to seek corporate diversification, sacrificing the efficiencies from specialization. Stock options, magnifying the upside potential for managers relative to down, may work as a compensation for this risk aversion. A challenge is to determine the suitable level of payoff asymmetry, however. An excessive upside reward tempts managers into excessively risky ventures, because potential losses are mainly not born by managers but shareholders.[91]

Takeovers

Fiduciary responsibilities. Whether good or bad, takeovers are an important and significant feature of the American governance system. Unlike in the ordinary course of business, which the business judgement rule protects boards relatively strongly, board members can be easily attacked at the courts in takeover situations. Again, the boards of directors owe fiduciary responsibilities to corporations, and are required by corporate laws to fulfill the duties of care and loyalty. Legal cases related to takeovers provide a lot of insights about the mandated responsibilities of boards. Issues include what boards are required to do in order to demonstrate their prudent care in decision-making, how boards should react to defensive tactics proposed by management, and to whom boards should be loyal. In the following part, three legal cases in the U.S. are analyzed, and based on the

[90] Shleifer and Vishny "A Survey of Corporate Governance" 1997, p751

[91] Miller "Is American Corporate Governance Fatally Flawed?" 1997, pp42-43

analyses, how boards should react to potential takeovers is considered.

<u>The Trans Union Corporation: duty of care standards.</u> In 1980, the Trans Union Corporation, principally a railcar leasing firm, originally sought for a leveraged buy-out transaction. The management of Trans Union conducted feasibility studies, and figured a feasible range of stock price. Soon after that, the chairman and CEO approached an investor for a cash-out merger, instead of the buy-out, with a proposed price and financing structure. The proposed price, based on LBO feasibility, was approximately 50% higher than a market price, but valuations for the fair value of corporation were not considered. With the agreement with the investor, the chairman and CEO called the board's special meeting. Copies of the proposal failed to be delivered to directors in time to be studied before the meeting. The two-hour board meeting, including a twenty-minute presentation by the chairman and CEO, approved the merger. In line with the recommendation by the board, shareholders approved the merger agreement by a large majority.

A shareholder filed a lawsuit against the directors in between the board meeting and the shareholders meeting, and the later decision by the Delaware Supreme Court gave a complete shock to the business community. The court held that the member of Trans Union boards breached their fiduciary duty to the shareholders. According to its decision, they failed to inform themselves of all available information and disclose all material information to the shareholders. The most significant feature of the decision is that the business judgement rule did not apply, due to the directors' gross negligence. The fact that the Trans Union board was comprised of sophisticated business people, 5 outside directors among 10, did not protect them. The court scrutinized the process for the board to make decision, substituting its own view on the proper procedure for the business decision of the board. Until then, the courts rarely challenged the gross negligence of boards.[92]

The implication of the Trans Union case is the following. Boards are no longer able to blindly rely on the business judgment rule, which has historically protected them. The breach of fiduciary responsibilities can be challenged at the courts, particularly in such extraordinary situations as mergers. In fact, the courts' capability to question the fulfillment of the duty of care is still limited, because only the appearances of decision-making process can be challenged. In case of the Trans Union, two-hour meeting without prior preparations and fair market value estimations clearly demonstrated the lack of prudent care. However, it would have been difficult for the courts to challenge the board, if an investment bank had issued a valuation result at the request of the Trans-Union board. Even if the board in reality completely ignored the opinion from the investment bank, the process might have seen careful enough. The essence of the outcome from the Trans Union case is that directors are obliged to be accountable in their decision-making procedures at least, although the business judgement rule still protect them from second-guessing.

Revion. Inc.: bpards as auctioneers. The hostile takeover battle between Pantry Pride, Inc. and Revlon, Inc. took place in 1985. Revlon rejected Pantry Pride's initial proposal of a friendly acquisition, and used several tactics to fight against the takeover. In addition to the then existing golden parachutes to executive officers, several major

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[92] Bradley and Schipani "The Relevance of the Duty of Care Standard in Corporate Governance" 1989, pp36-42

defensive actions are identified. First, Revlon announced an exchange offer, increasing financial leverage. Revlon intended to stop Pantry Pride by reducing the equity value. Second, after the exchange offer proved no, strong enough to stop Pantry Pride, Revlon started discussion with white knights. Revlon identified more preferable acquirets than Pantry Pride, and had them offer higher price. Third, in the course of raising offered Prices, a management buyout with one of white knights was proposed. Finally, the board approved the white knight's latest offer with a lock-up option, which allowed it to acquire a part of Revlon below fair market value in case someone else acquired 40% of Revlon stock.

After a lawsuit filing by Pantry Pride, Delaware Chancery Court Blocked the acquisition approved by the Revlon board, and the Delaware Supreme Court upheld thrs ruling. The courts ruled that the Revlon board had breached its duty of loyalty to shareholders. The lock-up option, i„ this case, precluded a bid for Revlon by anyone else and retarded the bidding process, although the courts approved all the other defensive tactocs as the maneuvers to protect shareholders from a takeover a, an inadequate price. In general, the implementation of defensive tactics against hostile takeover attempts go against shareholders' interests, because the rise of the stock price ,„ most takeover attempts allows shareholders to realize huge capital gain. Boards' supporting defensive tactics is justified, only when the threat to be acquired a, a too-low price is reasonab;y serious and it is worthwhile to protect shareholders from such an unfavorable deal.

This ruling indicated that the board's proper role changes from a defender against a hostile acqutrer to an auctioneer attempting to secure the highest sales price, once the company is put up for sale.[93] With regard to the appropriate procedure the boards of directors should pursue, considerations are made as follows. In case that an auction becomes unavoidable, boards need to be indifferent to the identity of bidders and to commit fair treatments among them. The boards have to provide sufficient information to potential bidders, and encourage them to come up with the appropriate offer.

Each bidder is expected to do its own valuation of incremental present value of the future cash flows, according to the individual projection of effects on the acquirer. When the purchase price is as high as the incremental present value, the acquirer's expected economic profit by the acquisition is zero. Therefore, all potential acquirers try to bid a price low enough to retain certain economic profit, but high enough to win the deal. The bottom line is that no bidder can offer the price higher than the present value, based on each bidder's valuation. The role of boards as auctioneers is to get the price as close as such a net present value, for the benefit of shareholders. In this regard, ascending bids auctions can be viewed as better procedure than sealed bids, in general. By allowing bidders to look at others' bids and to raise bidding prices, competition among them is enhanced. Each bidder is expected to raise its bidding up to the lower of the current highest bid or the present value.

In order to stimulate proper competitions during ascending bids auctions, it is important that every participant, including an auctioneer, respects the determined deadline for bidding. However, the board might face a difficulty to achieve this. After the board choosing the highest bidder upon the deadline, any other bidders can come back with a

[93] Chen et al. Revlon Inc. Case Study and Analysis Unpublished, pp1-19

higher price. On one hand, if the board ignores such an offer, its loyalty to shareholders can be questioned. On the other hand, if the board accepts such an offer, the bidding deadline becomes meaningless and no bidder is encouraged to respect the deadline.

This dilemma comes from the fact that its role as an auctioneer conflicts with its primary fiduciary duty of loyalty. In order to avoid this, the board had better appoint a third party and delegate its responsibility as an auctioneer. A professional auctioneer, such as an investment bank, is motivated to run an auction properly, because the reputation as an auctioneer matters. Any late bids can be rejected in a professional manner, and the board is no longer able to control the selling process due to its commitment to delegate. It can be hardly challenged that the board decides to delegate its responsibility as an auctioneer, because securing a proper bidding process is in line with shareholders' interest.

Time, Inc.: long-term strategies. In 1989, Time was about to acquire Warner Communications as a friendly deal. Time considered Warner the perfect partner to merge, because it would help Time achieve its mid-term goals without sacrificing its long-term competitive advantages. Time's goals were to expand its business into global and wide aspects of the news and entertainment industry, so that it could retain a desired growth and reduce the cyclical nature of its profit due to strong link to the U.S. economy. At the same time, Time wanted to keep its unique organizational structure and corporate culture that enhances journalistic integrity, and therefore, strongly preferred to be an acquiring body. The boards of Time and Warner respectively approved a stock swap between them.

Paramount Communications, then, came in with a hostile takeover bid to acquire Time. With the belief that Warner was the best partner, Time had several defensive and offensive maneuvers against Paramount. Time even revised the Warner deal into a cash offer with substantial premium on Warner's stock, in order to accelerate the process without a shareholder vote. In its board meetings, the Time management opposed to put Time up for sale. The management believed that it knew better than its shareholders what was best for the company, and putting Time on the auction block was never truly considered. Paramount filed a lawsuit at the Delaware Chancery Court to block the Time-Warner merger. However, the court rejected the Paramount's challenge and upheld Time's validity in desiring to protect its corporate culture. In the ruling, the court declared that evaluating whether the Time-Warner deal is a good deal for shareholders is not the part of the function of the court, because the corporation law does not oblige directors to follow the wishes of a majority of shares. In its view, "Delaware law does recognize that directors, when acting deliberately, in an informed way, and in the good faith pursuit of corporate interests, may follow a course designed to achieve long-term value even at the cost of immediate value maximization…"[94]

At the first glance, the ruling in the Time case seems to go against the shareholders' interests. It went against the legal precedence to put shareholders first and foremost, and at least, Time shareholders surely failed to receive a premium that would have been huge in case of an auction. The competition through the auction procedure as the Revlon case required may be considered the best way to maximize the sales value, and consequently to maximize shareholders' wealth. Combined with the Revlon ruling, the issue is how to define "put up for sale". If the Revlon duty applies, or the corporation is

[94] Buddrius et al. Time, Inc. – Fighting a Hostile Takeover Bid unpublished, pp1-11

put up for sale, the board is obliged to proceed an auction procedure. If not, corporate management and controlling boards have legal standing for strategies to create long-term value, even if their decision is not in line with shareholders' short-term interest. The Time ruling might seem to have given wider discretion to management and boards at the cost of shareholders' interests.

However, upon further reflection, broadly applying the Revlon duty has a side effect. If auction procedures are obligated in any acquisitions, corporations and individuals are discouraged to seek opportunities. Identifying undervalued corporations and planning acquisitions require time and efforts, but public auctions allow other bidders to free ride on them. Even if the original planner can win the bid, it is difficult to retain sufficient profits to make up its effort after tough price competition in bidding. As a result, the number of participants in acquisitions and the chance of high-price takeovers decrease.

This trade-off, namely between proper competitions and motivation for bidders, applies primarily ,,, the business community as a whole. However, it can apply to individual corporations under some circumstances. For example, let's assume tha, a company identified three potential targe, corporations for its strategic acquisition or merger. The company approached the board of one of the potential targets, and offered a friendly acquisition. The potential acquirer has an option to approach other targets. If the board decides to proceed to a pubhc auction, the potential acquirer, with the chance of a high-price offer, is likely to leave. By sucking to an auction procedure, the board may lose an opportunity for shareholders to increase their wealth.

The Time case indicated that friendly mergers or acquisitions as strategic steps do not automatically trigger the Revlon duty, even if the corporation looks as "up for sale". This precedence gives boards lots of flexibility in proceeding the change of control. When a friendly offer is in place, and it is a reasonable threat that competition through auction results in a loss of the M&A opportunity, the board can try to seek takeovers that do not evoke the Revlon duty. This does not deny the benefit of proper competition through auctions, but gives boards the flexibility in determining the best procedure depending on individual situations. The board can judge, with consultation with shareholders when appropriate, what the best way to maximize shareholders' wealth is.

Summary. In summary, boards should react to potential takeover offers in the following steps. Recognizing the business judgement rule principal no longer protects it under extraordinary conditions such as potential change of control, the board has to do its own valuation of the corporation. The board should, then, determine whether the takeover offer is appropriately priced, taking its long-term strategies into account. If under-priced, the board can reject that friendly offer and conduct defensive tactics to prevent the potential hostile takeover, in order to protect shareholders' interest. Although courts are expected to support most defensive tactics in this situation, the board should avoid unequal treatments among bidders after its recognition that the change of control is unavoidable. If the offered price is at or more than the boards' own valuation, the board should proceed it for the sake of corporate value maximization. Here, the board should consider the trade-off between potential higher bids through an auction and the threat to miss this opportunity. The board can either proceed an auction procedure expecting the highest bids possible through competition, or start exclusive discussion as a "strategic step". Throughout the process, the board is likely to face difficulties in performing its duties of care and loyalty by itself, due to conflicting interests or simply lacking capabilities. Therefore, it is often beneficial to hire such specialists as investment banks and to turn over decision-making to shareholders.

HOW BOARDS CAN BEST BE ORGANIZED

Composition

Nomination. In history, boards have been often composed of friends and acquaintances of the CEO, who concurrently serves as a chairman of the board. Management frequently nominates candidates for directors, and shareholders.without altemative ideas, easily approve them.[95] This management-driven nomination of directors has been a major source of passive behaviors of boards. Therefore, it is essential for shareholders to appoint directors without the strong influence of management, so that boards retain sufficient power and influence to perform their monitoring function appropriately. Because not ah sharehoiders are capable of, or are willing to, find candidates who fit the company, needs, it is beneficial that outside board members nominate directors by themselves on behalf of sharehoiders. The use of independent nomination committees should be further emphasized.

In nominating prospective directors, the diversity of boards shouid be carefully considered. As mentioned earlier, insights from directors had better supplement the managers expertise of executive officers,. In thts regard, including academicians, attorneys, and bankers is appropriate. Even though they do not possess deep industry-specific experiences, they can contribute to management through their speitalty. Although business judgement and strategic management are both important functions boards as a whole should retain, the use of CEOs/COOs of other companies seems overemphasized in

[96] Davis"Corporate Boards in Times of "Turbulent Dhange" 1997. p280

the U.S. Extensive use of CEOs/COOs might make sense more in the traditional Japanese/German systems, which deeply rely on human networks and information sharing within either *keiretsus* or the cozy business community. Contrarily in the U.S. with the culture of explicit contracts and the large scale of business community, the merit of overemphasis in managerial professionals is limited.

Ideally, all boards should elect their chairmen independent from the CEOs or senior executives, as seen in most public companies in the U.K. The concept of a lead director might work when the concurrent CEO and chairman is unavoidable for some reasons; however, it is clearly not the best. The CEOs are likely to hesitate to giving up their control of boards, because the truly independent boards may disturb doing their business as the CEOs want and may scare their managerial positions. However, such threat is the essence of the proactive roles of boards. It might take time, but pressures from institutional investors and business presses influential to capital markets are capable of driving the separation of chairmen from CEOs.

<u>Independence.</u> Recognizing the problem that boards act too late and are not accountable for monitoring management, many publications since 70's have emphasized the accountability of boards, particularly the independence from management. Substantial majority of "independent" directors in the boardroom is commonly believed preferable. The idea behind adding more outside and independent directors is that they are likely to be relatively objective critics of management.

However, there is not one publicly accepted definition of independence. Factors to be considered in defining the "independence" include current employment, past employment with certain period of time, relationship with employees or senior officers, compensation other than director fees, employers' business relationship, advisory, grants, or endowments. If strictly defined, "independence" means no affiliation or link to the company other than as shareholders and board members, and excludes union representatives, executives of banks that supply credit, or executives or directors of companies that are major suppliers or customers. Attorneys of law firms that provide professional services, and professors of universities that receive substantial endowments from the company are also excluded. An inter-locked director, that is any executive of the other company for which the CEO of the company serves as a director, is neither considered independent in some definitions. No consensus is made among scholars or reformers of boards, with regard to whether outside directors should also be independent and whether they should or should not represent specific constituencies.[96]

One potential cost of too much emphasis on genuinely "independent" directors is inappropriate selection of board members. Serving as an efficient board member requires the commitment of substantial time and efforts, and it may be difficult to find persons who possess appropriate characteristics and expertise as directors. Strict "independence" requirements limit the ability to use relationship to attract capable individuals, and it becomes more difficult to find those who are willing to serve as directors. Particularly when CEOs nominate candidates as a practical matter, as opposed to the popularly recommended selection processes by independent board members themselves, those who are not capable of active monitoring may be intentionally chosen.

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[96] Blair Ownership and Control 1995, p81

Earlier in this paper, a conclusion is made that it is beneficial to include representatives of other constituencies than shareholders, particularly debt holders. Accordingly, the genuine independence is not considered necessary, for the following reasons. First, while the primary aim of boards is to help increase shareholders' wealth, other constituencies' check not to "steal" wealth might be done at boards most effectively. Second, executives of firms that have business relationship are more likely to devote the time and energy necessary to fulfill the responsibilities, and shareholders should retain flexibility to send them to boards in case alternative "independent" candidates cannot be identified. Third, the use of outside consultants for boards' matters is expected to increase because of requirement to the accountability in boards' decision-making process; these opinions from third parties help modify the biased views of some directors, even if any exists.

Sub-committees

For audit and compensation, sub-committees have already formed at virtually every corporation in the U.S. The increasing use of sub-committee should be further encouraged, at least for the nomination of executives and directors. While it is preferable that boards are consisted of a vast majority of outsiders, the complete exclusion of executive members from boards is not considered a good idea. A few executive directors are able to provide industry-specific knowledge that is inevitable in making judgment, and also serve as liaisons between the management and the board. However, in some sort of issues such as auditing and compensating management, the conflicts of interests become significant. Therefore, it is worthwhile to form smaller groups within boards with outside directors only. The nomination of executives is an issue in the same line, with the great degree of conflict of interests.

In addition to the benefit of fulfilling independence from executives, sub-committees allow directors to develop certain areas of expertise and to focus the responsibility for decisions in those areas on a smaller number of people.[97] Each company should identify the functional areas in which the board needs to retain deep expertise, and allow some directors concentrate on these areas through sub-committees.

Size and Term

Size. In order to cover the functional areas to be represented on the board as a whole, certain numbers of directors are necessary. Boards as a whole should be capable of accounting and finance, business judgement, management, crisis response, industry knowledge, international markets, leadership, and strategic vision.[98] At the same time, too large boards result in less accountability of individual members and discourage active discussions. In fact, reformers of governance structures have often proposed to reduce the size of boards.[99]

The current size of boards, ranging 10-15 members depending on the company's size and industry, seems appropriate. Probably five is too small and 30 is too large; however, the difference of one or two is not a big deal. Instead of determining a fixed

[97] Blair Ownership and Control 1995, p82
[98] NACD Report of the NACD Blue Ribbon Commission on Director Professionalism 1996, pp8-9
[99] Blair Ownership and Control 1995, p82

number as a size of the board, assuring that all necessary functions are covered is important. As long as the all functions are covered without unreasonably heavy workloads on a director, the smaller the better.

Term. Any standardized term limit for individual directors is not recommended, because that limits flexibility in forming the most optimal team of directors to the extent available. Instead, boards should develop effective evaluation processes, which help remove directors when necessary. Companies' circumstances change, and boards should anticipate and respond to company changes by assembling the best mix of people to serve the company effectively at any given time. Moreover, directors' lives are dynamic and the ability of a director to serve effectively may vary with changes in the director's work and personal life.[100] Although the continuity in boards' service is important, frequent renewals of the appointment of an individual director is considered preferable. Choosing not to renew is much easier than dismissing during the term, and upon each renewal shareholders get an opportunity to check the performance of directors. Therefore, a three-year term, most popular in the U.S., might be too long.

The staggered boards are not encouraged, in the same context. The stability of board members given by the staggered structure provides both management and directors with unnecessary comfort. Should management and directors receive too much comfort for their positions, they tend to get discretion to act for their own interests instead of shareholders'. Even if elected frequently and simultaneously, the nomination committee and the shareholders can always choose to renew individual directors' terms and achieve

[100] NACD Report of the NACD Blue Ribbon Commission on Director Professionalism 1996, pp10-13

the necessary stability of boards' service. In addition, the staggered boards gained their popularity as a defensive tactic against hostile takeovers, in which shareholders can potentially increase their wealth by a rising stock price. By making the replacement of boards practically difficult, potential tender offers and thus the shareholders' opportunity to increase their wealth might be lost.

Motivations to Boards

Legal protection. The board of directors is an agent to oversee management on behalf of shareholders. However hard the independence of boards from management is sought, non-executive directors may have interests that are distinct from those of both managers and shareholders.[101] Although such agency costs cannot be completely avoided, providing board members with motivations to perform their duties properly can reduce the costs.

The direct method to have boards act properly is to rely on legal systems. That is to define in corporate laws how boards should act, together with measurement methods by courts. Whenever any stakeholders find the board failed to perform its duties properly, courts judge whether the board should be rectified, including monetary compensation for its failures. If this can be achieved, clear definition in law directly solves the weak contractual protection for shareholders. However, this method has limitation to the degree to apply. That is the conflict with the "commitment to delegate". Unless the certain level of freedom in business operation is granted, monitoring costs by stakeholders become

[101] Davis "Corporate Boards in Times of Turbulent Change" 1997, p281

high.

<u>Self regulation.</u> Another potential way to motivate boards to act properly is to design self-regulatory mechanisms within the business community. An example is seen in the German corporate governance system as the cozy community with reciprocal monitoring and information sharing. In order to build up such a framework, the mechanism should be authorized to penalize boards' malfunction based on case-by-case judgments. If such a mechanism is achieved, shareholders are required to go to courts only in case of "out of norm" situations.

However, the American business community is substantially larger than the German, and the same reciprocal monitoring by directors cannot be expected. Therefore, third parties have to play a role to monitor boards' performance. One candidate for monitors of boards is financial intermediaries that provide stock brokerage services for individual investors. Because public information for investors from them can affect the stock price, they are deemed to possess sufficient powers to penalize boards' mal-functioning. Governmental agencies can potentially play this role, although out of market intervention should be carefully avoided. Whoever the monitors are, the difficulty lies in how to align interests properly. Delegated monitors should have their own incentive to do so and should not be biased due to their own interests.

Reputation, Because the monitoring process by third parties does not exist, the boards commonly evaluate their own performance. It is necessary to develop proper methods to evaluate individual directors, in any way. If conformance with care/loyalty standards of individual directors can be properly evaluated no matter what the corporation's performance is, the reputation as a directors become objective and trustworthy.

In order for the adverse reputation effects to effectively prevent self-interested behaviors of directors, the career as a director has to be attractive enough. One possible way is to set a directorial position as a mandatory career path to reach higher managerial position as seen in the traditional Japanese system, but achieving this without losing the majority of outside directors and small size of the board is a challenge. Instead, high level of compensations, which encourage competition among potential board members based on their reputation, may work.

Compensations for directors. The most practical way, which is easy for individual corporations to implement, is to give board members monetary incentives. The most popular way is to tie the compensation to the corporate performance, through stock options for example. However, as seen in management compensations, the difference between positions of directors and shareholders is left, in terms of the ability to diversity.

CONCLUSION

Adam Smith recognized the problem caused by separation of ownership and control in the public corporation, and Barle and Means forcefully articulated it in 1932.[102] Compared to this long history, necessary changes to achieve proactive functions of the board of directors have taken place quite recently. Following the huge losses recorded by the American corporations in late 80>s, boards by themselves started reforming institutional arrangements to be accountable in overseeing management. The recent movements, mainly driven by emerging activism of institutional investors and by influential business presses, are regarded as generally in the right direction. Effective monitoring of management with sufficient disclosure and accountability to shareholders has been encouraged, and boards have sought for the independence from management.

Boards continue to be expected to play a central role of protecting shareholders from managerial self-opportunism, with a primary loyalty. Because shareholders are required to commit to delegate overseeing functions to the boards, arrangements that encourage and reinforce directors to fulfill their fiduciary duties are inevitable. In addition to further proceeding the independence from management, the following arrangements are recommended. First, the boards should make the better use of other constituencies, such as creditors. Second, the boards should be capable of flexible reforms, so that they can effectively fulfill the requirements from the company and shareholders. Third, the boards

[102] Davis "Corporate Boards in Times of Turbulent Change" 1997. p281

should further improve the evaluation processes of individual directors, so that the effective fulfillment of their duties can make the difference; well-performing directors should be rewarded sufficiently.

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