An Independent Voice on the Board

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On July 8, 2008, the inaugural meeting of the Lead Directors Network took place in New York City, convening a select group of lead directors, presiding directors, and non-executive chairmen of Fortune 500 companies to discuss the changing role and value of the lead director. Representing companies such as Microsoft, Home Depot, Coca-Cola, and Morgan Stanley, the group personifies the emergence of a relatively recent phenomenon in corporate governance within U.S. companies: the presence of the lead director as an important independent voice on a corporation's board of directors. (1)

Spurred by amendments to the New York Stock Exchange listing requirements (specifically §303A.03 of the NYSE Listed Company Manual), the mounting pressure to bolster corporate governance in the wake of Enron's highly publicized collapse, and leadership crises at other corporations, U.S. companies have responded by appointing lead directors to their boards in ever increasing numbers over the last five years. Most American public companies have traditionally employed a corporate governance structure where a single individual fulfilled the roles of both CEO and Chairman, but following the recent corporate scandals, some argued that boards in the United States should be led by an independent chairman instead of a combined Chairman-CEO.

No requirement of a lead director was inserted into the Sarbanes-Oxley Act but in a compromise effort, the New York Stock Exchange in 2002 adopted the requirement that listed companies have a "presiding" director to oversee a once yearly meeting of the independent directors without the presence of management.(2) This requirement, along with continued pressure for greater board independence from those who advocate splitting the Chairman and CEO roles, has led to an explosion in the number of companies employing a lead director.

In mid-2003, only 36 percent of S&P 500 boards had designated a lead director, but by mid-2004, this figure had grown to 85 percent. In 2007, 448 of the S&P 500 companies (94 percent) reported having a lead director.(3) Despite this proliferation of lead directors on the corporate governance landscape, the responsibilities of the position and the roles played by these individuals within the leadership structure remain difficult to define. In this article we seek to elucidate the changing role of the lead director in U.S. corporate governance practices.

One of the difficulties in clearly delineating the role of a lead director in corporate governance arises from the multifarious titles given to individuals who serve in this capacity. Depending on the company, a lead director may be known as a lead independent director, presiding director, or non-executive chairman. In practice, these differences in title generally signal little difference in responsibilities. Lead directors, presiding directors, and non-executive chairmen often have the same duties, with the only consistent distinction being that non-executive chairmen tend to assume a greater role in company and board leadership.

The differences in title do, however, signal subtle disparities in authority to fellow board members. While the title of non-executive chairman seems to convey the greatest degree of leadership since the position requires a strong relationship with the CEO, the title of lead director also appears to carry a greater authority than that of presiding director. While the presiding director title connotes "not so much a leadership position, but more so presiding over the meetings when the chairman is not around," the "lead director" title can create the perception of a two-tiered board that may upset the other directors. (4)

George M.C. Fisher, presiding director at General Motors, warns that "calling someone a 'lead director' potentially singles that person out as a super-director and implies that other directors must communicate through that person to the CEO." (5) To avoid this perception, some companies choose to use the "presiding" label to suggest equality among independent directors even though that person may actually play a lead role. As a result, it seems that the title a company chooses to use for its lead director has more to do with internal board politics and less to do with helping investors assess a company's corporate governance. Only a case-by-case, facts and circumstances analysis can accurately limn the role that each individual plays within the leadership structure. Thus, our use of the term "lead director" encompasses all the titles assigned to individuals serving in such capacity.

CEO and Chairman Roles

Following Enron and the other corporate scandals of this decade, a movement began, particularly among activist shareholders, in favor of splitting the positions of CEO and Chairman. This bifurcation was intended to protect the flow of information to the board against a potentially overbearing CEO, which was perceived to have been one of the root causes of these corporate failures. While such change has been implemented to some degree over the last five years, it has generally been viewed as a more severe break from the traditional corporate governance structure than necessary.

As of 2007, only 35 percent of S&P 500 companies split the roles of Chairman and CEO, and only 13 percent had an independent Chairman. (6) Instead, the popular fashion has become the appointment of a lead director to act as a "counterweight" to the Chairman-CEO. As previously mentioned, the percentage of S&P 500 companies with a lead director has increased from 36 percent in 2003 to 94 percent in 2007. (7) Among companies that have recently experienced crises, such as Tyco, Marsh & McLennan, AIG and Walt Disney, the appointment of a lead director has been made a symbol of a renewed commitment to good corporate governance. (8)

Institutional Shareholder Services' (ISS) best practice recommendations are ambivalent on splitting the Chairman and CEO roles so long as a company effectively employs a lead director. Formally naming or not naming an individual as lead director has no impact on ISS policy. Instead, ISS reviews proxy disclosures of each company in regard to the duties of the directors when assessing whether a company in fact makes use of a lead director. ISS policy on the subject is most significant to a company when it has received a shareholder proposal to split the CEO and Chairman positions. (9)

For most companies, the lead director role was originally created purely for compliance purposes and was defined narrowly. However, over time, the position has grown from encompassing a relatively simple set of responsibilities to a broader and more complicated role. In fact, depending on the conditions at a company at a given time, lead directors feel that the role can "change on a dime." (10) Most of the actual duties of a lead director in practice cannot be found within a company's corporate governance principles, as the tasks of lead directors are constantly growing to reflect each company's needs.

Few lead directors are still limited to presiding over executive sessions of the board and reporting directors' views to the CEO. Rather, lead directors are taking an increasingly active role in the leadership of corporations. Of the 100 largest U.S. companies as ranked by Forbes Magazine in 2007, 63 reported that their lead directors have responsibilities additional to those detailed in their corporate governance policies. (11) In 2005 and 2006, only 28 and 48 companies, respectively, disclosed such growth in the role of their lead directors. (12) As might be expected given the expansion of the role, lead directors are also spending more time fulfilling their responsibilities. In 2005, lead directors were estimated to be spending over 300 hours per year on board matters, compared to 202 hours for traditional directors. (13)

Duties of Lead Directors

While the duties of lead directors differ across corporations, certain functions seem to predominate. The responsibilities of lead directors frequently include:

- structuring board meetings;
- recommending matters for board consideration;
- coordinating independent directors' activities;
- chairing independent directors' executive sessions;
- setting board meeting agendas with the CEO;
- facilitating communication among the Chairman, CEO, and board;
- serving as an independent liaison to shareholders;
- assigning tasks to board committees;
- providing leadership in crisis situations;
- coordinating the performance evaluation of the Chairman and CEO; and
- overseeing the annual evaluation of the board and its committees.

Lead directors are increasingly responsible for monitoring and improving board performance by guiding board discussions and facilitating the consensus-building process. Lead directors play an important role in improving the performance of the board by focusing members on the larger company issues so as to avoid being bogged down in the operational issues that may regularly confront management but that are not strategically significant. In this manner, lead directors ensure that the board won't be viewed as "meddling in management's day-to-day decision making." (14) Lead directors also can play a critical role in forming consensus between the CEO and the board. In order to avert board dysfunction in a crisis, lead directors must often adopt a viewpoint on an issue and guide board action. When lead directors do so, they must be careful not to seem as though they are promoting their personal agendas. As such, it is critical for lead directors to balance their relationships within the corporate leadership so as to not appear as either an enemy or ally of management.

While lead directors are critical to the consensus-building process, they are also essential to challenging the decisions of management so as to ensure that the corporation is being run in the best interests of shareholders. As shareholder activism increases, lead directors are increasingly playing a significant role in shareholder communication. While management has traditionally handled the job of investor relations, many shareholders now prefer to communicate directly with a lead director. Lead directors are often seen as the flag-bearer for shareholders, since they represent the independent leadership of the corporation. In fact, the role of the lead director is perhaps most important where the actions of management are being opposed by shareholders. In situations such as these, the lead director can prevent unneeded escalation of conflict between shareholders and management by assuaging the concerns of shareholders that management controls the board.

Lead directors are also increasingly involved with the director evaluation process. Lead directors can add value by aiding the CEO and the board in dealing with difficult or underperforming directors. When such problems arise, it is often the job of a lead director to speak to the individual and to suggest that the director resign. By taking such action promptly and not allowing a problematic situation to grow worse until annual board nominations, lead directors can keep the board focused on the business of the corporation.

Lead directors also are playing an important role in providing leadership for corporations during times of crisis. Lead directors often have considerable experience dealing with difficult problems through their previous service as corporate executives. This seasoning allows them to offer insights based on their own experiences when evaluating potential responses to crises ranging from a fight for corporate control to a government investigation. While often these insights will form the basis for collaboration with the CEO, the lead director also must be prepared to lead the charge to replace the CEO where his or her poor performance is the crisis afflicting the company. (15)

Problem of Independence

When the position of lead director was originally conceived and adopted, its pivotal requirement was that the individual who took the seat would be independent from management. Only then would the lead director position serve as a meaningful check on the potential for a domineering CEO to take total control over a corporation. In practice, however, it seems that some lead directors are more tied to management than to shareholders. There are many accounts of companies that employ lead directors with close relationships to the CEOs, often with the lead director and CEO having worked alongside each other in a management capacity at an earlier point in their careers.

In circumstances such as these, one questions whether the appointment of a lead director is more about appearance than true reform. Having a lead director who is beholden to management poses a significant risk to a company in a time of crisis, when strong independent leadership is most needed. Even when times are good, such a lead director is likely to produce little useful debate between the board and management. What shareholders are left with, at best, will be the status quo. At worst, a situation like the one at Tyco under Dennis Kozlowski can occur. There, Frank E. Walsh served as the lead director and also chaired the compensation committee. He also controlled two companies that did significant business with Tyco.

For orchestrating Tyco's 2001 merger with CIT Group, Mr. Walsh received $20 million in compensation, payments which he kept secret. When the payments were disclosed six months later, Tyco dropped nearly $17 billion in market value in a single day. Mr. Walsh resigned and later pled guilty to securities fraud. (16) The problem for companies seeking to employ a truly independent lead director is that the best candidates for the role are those with significant experience and a good relationship with management and the board. Further exacerbating this dilemma is the fact that lead directors need to have a productive relationship with the CEO in order to be effective in the role, and it can often be a slippery slope from establishing a working relationship to simply becoming friends. Lead directors warn that being the CEO's friend and being an effective lead director are in practice mutually exclusive. (17) Accounts such as these lead us to conclude that the lead director title means little if the individual filling the position is not truly independent and invested with the authority necessary to serve as a true counterbalance to management.

Future of the Position

The future of the lead director position is open. Lead directors are engaging in an ever-expanding array of leadership duties. Some believe that this is perhaps the greatest strength of the position currently; it is flexible enough to adapt to changing company needs.18 But if investors who have long clamored for a corporate governance structure that more closely resembles the U.K. model where the Chairman and CEO positions are split finally get their way in the wake of the current financial crises, one wonders if the lead director position will become viewed as duplicative and be cast away as an outdated compromise role.

While the future of the lead director remains unclear, it is certain that lead directors today play a much greater role in corporate governance than was initially envisioned when the NYSE mandated that corporations hold an annual meeting of independent directors with one director presiding. Then, there was little speculation that the responsibilities of the position would extend outside the minimum requirements of the rule. Now, we speculate that the responsibilities of the role may have few bounds so long as bifurcation of the Chairman and CEO roles remains the prevailing norm.

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Endnotes:

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