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Are Independent Board Members Necessarily Credible?

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By the late 2000s, independent directors were in the majority on the boards of almost every type of U.S. organization. While this achievement may have improved corporate governance, it was not the panacea that some had anticipated, as subsequent events like the financial crisis of 2008 brought down even some of the best governed corporations.

The tragic fate of Lehman Brothers, which declared bankruptcy on September 15, 2008, the triggering event of the financial crisis, illustrates the limitations of independent board members. Lehman's board of directors, typical for the time, was made up of independent people, many of whom were ex-CEOs of large corporations like IBM, GlaxoSmithKline, Haliburton, Telemundo Group, and Sotheby's.

The board made its decisions on the basis of the members' experience, which had little relevance to the business of Lehman, an investment bank and a large trading operation that dealt with complex financial products.

The report of the examiner appointed by the bankruptcy court to determine the responsibility of Lehman's board of directors for the bank's collapse (the Jenner & Block Report) is instructive. For the board meeting on March 20th, 2007 at which a fateful decision was made about Lehman's larger financial commitment to the sub-prime mortgage market, the people responsible for preparing a presentation for the president of Lehman exchanged e-mails conveying his expectations. One e-mail read:

> Board is not sophisticated around subprime market- Joe [the president of Lehman] doesn't want too much detail. He wants to candidly talk about the risks to Lehman but be optimistic and constructive – talk about the opportunities that this market creates and how we are uniquely positioned to take advantage of them (Jenner & Block Report, p.90).

Later in the report, the examiner wrote:

> Although Lehman's management did not provide the Board with all available information concerning the risks faced by the firm in 2007 and early 2008, that fact is not surprising given the Board's limited role in overseeing the firm's risk management, and the extraordinarily detailed information available to management. (Jenner & Block Report, p. 185).

Thus, a board made up of independent members with impressive biographies is not *ipso facto* credible. This helps explain why corporate governance falls short at too many organizations.

A board's credibility rests ultimately with management's assessment of the board: does the management feel that the board understands in depth their strategic choices, the *real* drivers of performance, the complexity and ramification of proposed decisions? Do the members of the management team feel that discussions with the board are productive and stimulating, bring out new viewpoints and add value to the decision-making process? A board of directors is only credible to the extent that a significant number of its members are able to interact knowledgeably with management on the multiple factors that influence performance. This type of exchange calls for a board's deep and systemic understanding of the company's business model.

That's why so many experienced, real-world, observers of corporate governance have begun to advocate "specific competence" and "understanding the company's business model." (See, for example, William, 2013; Bailey and Koller, 2014; and Lorsch et al., 2012, *The Future of Governance*).

Having interviewed 78 board members of large U.S. companies, Jay W. Lorsch, professor at the Harvard Business School, reported that they, unanimously or nearly so, said boards must significantly enhance their skills, and lamented "the huge deficits in expertise and understanding of the business."

The more complex a business is, the more important it is that the board can count on directors who are well versed in the arcane aspects of its operations, although it may be at the price of their independence.

Lorsch concludes that "It is difficult, if not impossible, to find directors who possess deep knowledge of a company's process, products, and industries who can also be considered independent."

The current, conventional, approach to selecting board members consists of drawing up a list of the different types of professional expertise that would serve the company well. The search also includes a number of retired or active senior managers from diverse corporations. This process will not necessarily lead to a credible board, because the senior managers selected too often lack experience in the business sectors where the company to be governed operates.

The selection process should begin by identifying industries with characteristics in common with the industry in which the target company operates. Those characteristic should include capital intensity, time horizon of investments, industrial vs. consumer markets, international scope of competition, key success factors, and generic strategies. Executives with experience in such industries will more quickly master the essential aspects of the company while also qualifying as independent, thus reconciling independence with credibility.

This approach should also apply to the selection of a director with, say, an expertise in finance. The selection process should stress that candidates must have experience acquired in an industry with characteristics similar to those of the target company's industry. There is very little transferable expertise, whether in financial management, human resources, risk management, or information technology, among a retail business, a resources company, a financial institution, and a firm in the aerospace/defense industry.

If new board members lack credibility, then the board must determine whether they have committed to investing the time necessary to develop it and, have the necessary education and intellect and whether the board itself has created programs to enhance the credibility of new members.

A board's credibility is the cornerstone of effective governance. Thus, the search for, training, and retention of credible board members has become the dominant issue and inescapable challenge for corporate governance in the 21st century.