YALE SCHOOL OF MANAGEMENT
THE MILLSTEIN CENTER
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Chairing the Board

The Case for Independent Leadership in Corporate North America

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EXECUTIVE SUMMARY

- Independent chairmanship of a public company is now a growing successful model of corporate board leadership in the US and Canada.
- Global experience has shown that the model is a tested instrument of governance. Having an independent chairman is a means to ensure that the CEO is accountable for managing the company in close alignment with the interests of shareowners, while recognizing that managing the board is a separate and time intensive responsibility.
- The independent chair curbs conflicts of interest, promotes oversight of risk, manages the relationship between the board and CEO, serves as a conduit for regular communication with shareowners, and is a logical next step in the development of an independent board.
- A corporate board can mitigate concerns about overlapping responsibilities by clearly spelling out the different responsibilities of the chair and CEO roles to the company and shareowners, agreeing on a definition of independence, effectuating successful strategies and risk management policies, and making careful personnel choices.
- Peer independent chairs believe that lead directors are not considered the equivalent of board chairmen by the board or shareowners, even when such directors are provided with comparable authorities. "He who sits at the head of the table runs the meeting."[1]
- In the context of this economic crisis, boards should adopt independent chairmanship as an important voluntary and proactive element in restoring market trust in enterprise.
- Through this report the Chairmen's Forum is issuing a call on all North American public companies to voluntarily adopt independent chairmanship as the default model of board leadership, upon succession to a combined CEO and chairman. A board could do so, for instance, through bylaw or charter amendments. If corporate directors choose to take a different course, either by combining the two posts or naming a non-independent chair, they should explain to their corporation's shareowners why doing so represents a superior approach to optimizing long-term shareowner value.

To advance the spread of such practices, the Chairmen's Forum will commit to undertake the following steps within the next three months:

- Secure endorsements from additional market institutions and individual leaders for the recommendations in this report;
- Track the take-up among North American listed companies of independent chairmanship;
- Open a new Chairmen's Forum website, through the Millstein Center, to feature documentation and research on non-executive board chairmanship; and
- Convene a Chairmen's Forum roundtable in July 2009 to assess progress and, if appropriate, review additional steps that could further encourage adoption of the independent chair model. Policy options could include a call on the New York Stock Exchange and Nasdaq to adopt listing rules on the matter.

1 *Participants of the Center Chairmen's Forum, February/October 2008*

About the Millstein Center for Corporate Governance and Performance

The mission of the Millstein Center for Corporate Governance and Performance (the "Center") is to serve as a vital contributor to the growing architecture of international corporate governance. The Center sponsors research, hosts conferences, generates global databases, designs training and publishes policy briefings on emerging corporate governance policy issues. *Chairing the Board: The Case for Independent Leadership in Corporate North America* is the fourth installment in a series of Policy Briefings designed to assist policymaking.

The Center Policy Briefings are framed as think tank reports based in part on actual experience and observation rather than empirical research. They include original material and policy analysis in a concise format. Reports serve both as pointers to further detailed empirical research and as a resource for market practitioners.

This report is issued both as part of the Center's Policy Briefing program and as background analysis for the Chairmen's Forum, a group of non-executive chairs from the US and Canada convened under the leadership of Harry Pearce, Non-Executive Chairman of Nortel Networks Corporation and Chairman of MDU Resources Group, Inc. A steering group founded the Forum at a meeting in New York City on February 26, 2008 and the first convening took place on October 7, 2008. A section of this briefing is drawn from peer discussions at these events on the real-world experience of independent chairmanship at North American public corporations.

Chairing the Board was prepared under the supervision of Ira M. Millstein, Senior Associate Dean for Corporate Governance, Yale School of Management, and Stephen Davis, Center Senior Fellow. Contributors were Stephen Alogna, Visiting Research Fellow seconded to the Center by Deloitte & Touche LLP-Corporate Governance Services; Mariana Pargendler, Associate Weil Gotshal and Manges LLP; and Meagan Thompson-Mann, Center Visiting Research Fellow.

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About the Chairmen's Forum

Founded on February 26, 2008, the Chairmen's Forum is an organization comprised of non-executive chairmen of corporate boards whose companies are incorporated and stocks are traded on exchanges in the United States and Canada. Participants meet for the purpose of addressing steps that enhance the accountability of corporations to owners, discussing matters of common interest, promoting deeper understanding of independent board leadership practices and reaching out to the wider market on effective practices of board chairmanship. The Chairmen's Forum intends to help create an international hub of national and regional forums of non-executive chairmen to encourage peer exchanges worldwide.

The founding Chairman is Harry Pearce, Non-Executive Chairman of Nortel Networks Corporation and Chairman of MDU Resources Group, Inc.

INTRODUCTION

The number of non-executive chairmen at companies in North America has been increasing year by year. Recent figures, according to the 2008 Spencer Stuart Board Index[2], indicate that the last decade has seen a growing trend in separating the roles of the Chief Executive Officer (CEO) and the chairman of the board. In 1998, 16% of the S&P 500 featured distinct chairmen. Data shows that in 2008 as many as 39% appoint someone other than the CEO to chair the board. Traditionally, even in companies that split the role, the chairman was not completely independent, but rather commonly the ex-CEO or another related party. During the past four years, Spencer Stuart, a sponsor of the Chairmen's Forum, has tracked the trend of appointing independent chairmen who have no prior relationship with the company. In 2004, just 7.6% of all chairmen were designated as independent of management. In 2007, the figure rose to 13% and climbed to 16% in 2008. A RiskMetrics study, expanded to include S&P Mid and SmallCap companies, shows the appointment of independent non-exective chairmen to be slightly higher at 23% and 27% respectively for 2008, a cumulative increase of 17% from 2006 for the S&P 1500.[3]

Despite this movement toward independent chairmanship, there is little practical advice on what a non-executive chairman does and how the role differs from a chairman with executive powers. Also lacking is guidance on the profile and the ideal attributes of non-executive chairs, or whether appointing a lead director is an adequate alternative to separating the roles of chairman and CEO. Through the following sections, this report seeks to address these and other issues as they relate to the non-executive chairman.

Section 1: Findings of the Chairmen's Forum
The Chairmen's Forum convened by the Center, and chaired by Harry Pearce, took place on February 26, 2008 and October 7, 2008 and are the basis for this section. The sessions were held under Chatham House rules,[4] allowing for candid dialogue between parties and for sentiments to be explored freely, without attribution of any specific idea or quotation.

Section 2: The Argument in Context: Empowering Boards of Directors
This section discusses the historical transformation of board composition, management oversight, the evolution of independent board leadership and the forces that influenced these changes.

Section 3: Independent Chairs around the World
This section takes a brief look at how the world outside North America addresses the issue of a combined or split CEO and chairman.

Section 4: Pros and Cons of Independent Chairs
The reasons companies have chosen to separate or maintain the combined roles of the CEO and chairman are manifold. This section explores the arguments of both proponents and critics.

Research for this report included:

- The Chairmen's Forum.
- Independent research on chairmanship, the lead director and a historical analysis of the treatment of separating the roles of the CEO and chairman of the board.
- Correspondence with chairmen, lead directors and institutional investors.

The Center is grateful to the following bodies and individuals who provided assistance in the Policy Briefing project: The participants of the Chairman's Forum; Weil Gotshal and Manges, LLP; Deloitte & Touche LLP; The Institute of Corporate Directors in Canada; Spencer Stuart, research sponsor, and Milica Boskovic of the Center, Sir Adrian Cadbury, Peter Clapman, CEO of Governance for Owners USA, Maureen Errity and Nicole Sandford of Deloitte for their thoughtful comments. See Appendix A for a full listing of resources used to compile this report. Any positions taken in this Policy Briefing, and any errors within it, are solely the responsibility of the Center.

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2 The Spencer Stuart Board Index is an annual study that examines the state of corporate governance among the S&P 500. The 2008 index looks at how boards have changed in the past 10 years. Among other findings, a key takeaway in the 23rd edition is the increased independence and changing makeup of today's S&P 500 board.

3 *Board Practices: Trends in Board Structure at S&P 1500 Companies*, RiskMetrics Group Issues Report (December 17, 2008).

4 Under Chatham House rules, content of the meeting may be cited but not attributed to any individual without their explicit agreement

1. FINDINGS OF THE CHAIRMEN'S FORUM

The independent, non-executive chairs who gathered twice in 2008 for Center roundtables in New York discussed in detail the various characteristics and issues of board leadership in the US, Canada and Britain. In this section, we review four major themes on which peers reached broad consensus through the Chairmen's Forum.

1. The responsibilities and personal attributes of an independent chairman are clear and defined—the CEO runs the company, the chairman runs the board.

> *"Management runs the business and the chairman runs the board."*
>
> *"I am chairman of the board, not chairman of the company."*
>
> – Participants of the Chairmen's Forum, February/October 2008.

Critics of the split model argue that the non-executive chair can inadvertently usurp power from the CEO (or vice versa) by diluting the clarity of who leads the company and who leads the board. Furthermore, because the chairman's role has historically been combined in the US with that of the CEO or, when split, has been filled by a former CEO, the market often undervalues the substance of chairmanship as distinct from management leadership. This has arguably contributed as an impediment in the willingness to separate the positions. Unless clearly delineated, the ensuing role confusion can be distracting and sometimes divert attention from the company's mission, as well as potentially erode shareowner value. This can be mitigated by clearly spelling out the individual responsibilities of the chairman of the board and the CEO.

What is the role of the non-executive independent chair? What are his or her responsibilities? What attributes must the non-executive chair possess and what message should be clearly stated to management, the shareowners and the general public? These were some of the questions the participants of the February and October Forums debated at great length.

The responsibilities of managing a complex enterprise are not necessarily the same as those required to lead the board in overseeing management. Moreover, the participants felt it would not be prudent to divert effort from managing the enterprise, given the time and effort required to manage in today's context, to the very different function of leading the board.

A concise summary of the Forum discussions would simply state the CEO runs the company, while the chairman runs the board. But the group further unpacked the question with detail learned from combined peer experiences as current and past CEOs, lead directors and non-executive chairs. A majority of participants has had distinct perspectives from each of the seats at some point during their careers.

What exactly are the primary duties of a non-executive chairman? *"I think it's a little bit like being a conductor. If you think about what conductors do, they never play a note, but they bring out the best in all the players,"* said one Forum participant. Spencer Stuart, in its January 2008 edition of Cornerstone of the Board, states that specific responsibilities fall into four categories: "managing the board, facilitating communication among directors and between the board and management, leading or playing a key role in CEO succession planning, and leading the board evaluation process." Some of the most frequently cited responsibilities are[5]:

- To convene and preside over board meetings and meetings of the independent directors without management present;
- To provide leadership to the board and uphold high corporate governance and ethical standards;
- To establish the processes the board uses in managing the responsibilities of the board and committees;
- To organize and establish board agendas with assistance from the CEO, board committee chairs, and the corporate secretary;

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5 See David W. Anderson, "First Among Equals: The Underappreciated Significance of the Board Chair," *ICD Director*, 136, February 2008, pp. 22–23; "The Non-Executive Chairman," pp. 2-7; Robert F. Felton and Simon C. Y. Wong, "How to separate the roles of chairman and CEO," *McKinsey Quarterly* No.4, 2004; Serge Ezjenberg, "The Role of the 'Non-Executive Chairman'?" Cercle Alexis de Tocqueville website, May 21, 2005; available at http://www.gouverner.net/go/articles/rolenon-executivechairmans.html, amongst many examples.

- To plan the agenda and provide sufficient time for discussion of agenda items;
- To supervise circulation of proper and relevant information to the directors in a timely fashion;
- To ensure contribution from all directors at the meeting;
- To focus the board's attention on relevant matters, limit distraction and discord, and work towards consensus;
- To communicate effectively with management on a regular basis;
- To act as a "sounding board" for the CEO; and
- To take a lead role in board evaluation and succession planning.

These points are not meant to be exclusive. Many boards will find additional duties and responsibilities that are relevant to their particular circumstances. Companies who have split the roles of chairman and chief executive, or are contemplating doing so, should make an effort to clearly document the duties of each role to avoid duplication and prevent potential conflict.

Appointing a non-executive chair involves more than determining the responsibilities of the two specific positions. Careful consideration of the profile of the person in the job is important and instrumental to the model's success. Recognizing that there is a diversity of circumstances unique to individual corporations, the participants of the Chairmen's Forum identified some of the more important attributes that the board, specifically the nomination committee, should consider when searching for a non-executive chairman:

- Is the candidate truly **independent**, not only in actuality, but also in mindedness? Independence does not solely focus on the chairman's relationship to the organization and management, but also the ability to possess "the courage" to ask hard questions and the character and integrity to deal objectively with potential conflicts of interest.
- Does the candidate have organizational **experience**? There was strong consensus among Forum participants that an ideal candidate should have broad familiarity with the company and experience within a similar industry with similar complexity. One of many examples participants identified as suitable candidates are former CEOs who are independent from the company in question. Nominating committees may wish to be broad-minded in the candidates they consider and not simply restrict the search to CEOs.
- Does the candidate bring the level of **commitment** to the job that the company demands? Participants at the Forum agreed that the non-executive chairman role requires a greater time commitment than that of the average director. Under normal circumstances there will be additional time required to handle these added responsibilities. For example an independent chair should ideally have more time to devote to maintaining best corporate governance practices than would a full-time CEO. However, during a crisis, the time commitment can increase exponentially. One participant recalled a crisis situation during which the non-executive chairman's time commitment became a full-time job.
- Does the candidate **communicate** effectively? Does he or she bring **leadership** and **consensus building** to the role? Can the candidate conduct group **collaboration** effectively? Non-executive chairmen, as noted during the February forum are "primus inter pares" (first among equals) and selected by their peers. One Forum participant noted that, "[sustaining and nurturing] the relationship between the board and management, between the chairman and the CEO, and among the board members themselves, [is] the burden of the chairman of the board."
- Does the candidate clearly see the boundaries between his or her role and that of the CEO? Does he or she possess a certain level of **humility**? A key point that came out of the Forums focused on the necessity for the non-executive chairman to view the position as the "end game" rather than as a path to executive leadership. As noted by one of the February Forum participants, "If a director wants the job of chair, he probably shouldn't be the chair. More often than not such people see the role as more expansive than it really is." A retiring non-executive chairman, speaking separately at the October Forum, commented about a potential successor, "I thought he was great, but [the board] agreed he would never be able to resist being more executive…he hadn't yet learned to be non-executive."

2. **It is not always the "right time" to split the roles of CEO and chairman.**

> *"Too often, the decision to adopt the model of the non-executive chair comes in a crisis…when you have a complete failure of governance…or management. And then everyone in a fire-drill ends up [hastily] finding [a] non-executive chair, at least for some period of time to get the ship set right."*
>
> – Participant at the Chairmen's Forum, February/October 2008.

Sweeping changes in corporate governance are often implemented at the pinnacle of a crisis. A look into the not so distant past will illustrate a trend of slow moving governance reforms, followed by rapid, market-wide acceptance as a result of some crisis spurring the demand for immediate action.[6] Recent statistics, as noted in Section Two of this briefing, coupled with the combined experience of the Forum participants, seem to indicate movement to separate the offices of the CEO and chairman is not much different. Often the choice to separate the roles occurs during crises. Ira Millstein discussed a brief history of notable CEO and chairman separations in his speech at the International Corporate Governance Network (ICGN) 2008 Mid-year Event "In Times of Financial Crisis" in Delaware on December 9, 2008. He illustrated how General Motors in the early 1990's replaced their CEO and separated the role of chairman from the CEO. Within months, other high-profile corporations quickly followed suit, splitting the roles and appointing a non-executive chairman. The next decade saw small pockets of this trend with the most recent high-profile separations occurring at financial institutions damaged by the financial crisis that began in 2007.[7]

While crisis may not seem like a natural moment for a board to make a monumental shift to a new structure, peers assert that is precisely the time when an independent and authoritative posture needs to emanate from the board. This is in part because the CEO may be seen as being too close to the problem to gain the trust of regulators, stakeholders and fellow board members. The appointment of a non-executive chairman could send positive signals about the board's independence and integrity.

However, corporate America should not wait for a crisis to split the roles, neither should it endeavor to strip the chairman title from the current CEO when all is well. Forum participants predominantly agreed this could be demoralizing and disruptive. Stripping the title of chairman from the present CEO could send the wrong signal. Participants agreed that the more natural and suitable transition, when not forced by an acute event, is to separate the roles during succession. While this method would not produce an immediate overnight change, it would create a broad market-wide movement in the near to medium term. Furthermore, separation during succession provides the company and the board the opportunity to carefully consider candidates and to clarify and document the roles and expectations of each position, all during a period of controlled transition where the company does not need to react hastily. Planning for the transition of the CEO and chairman positions should be undertaken by the board well before it is needed, so as to prevent leaving the company and the board without leadership during an interregnum.

An issue raised during one of the Forums was the potential increased difficulty of recruiting a new CEO without the title of chairman of the board. Are candidates willing to pursue and accept the office of the chief executive without that of the chairman? "There was a time when it was very difficult," noted one participant. "We'd never be able to recruit anybody if you don't give them both titles, but that is changing as noted by the increasing frequency of companies who separate the positions." Another attendee, whose company was currently in the process of prospecting for a new CEO (separate from the chairman), explained they were not experiencing any resistance from potential candidates, perhaps indicating a new and broader acceptance by the marketplace of searches for individuals suitable for the chairman or CEO role rather than both positions.

3. **The differences between a lead director and non-executive chairman are few, but paramount.**

> *"I'm a lead director – and that is a completely different job than being a chairman."*
>
> *"The lead director is better than nothing. But on a scale of 1 to 10, having a [non-executive] chairman is 10, and having a lead director is about a 4."*
>
> *"The lead director does not run the meeting. He who sits at the head of the table runs the meeting."*

6 Consider for example the rapid passage of the Sarbanes-Oxley Act of 2002 and subsequent NYSE and Nasdaq stock exchange governance listing standards and other reform as explored in Section Two of this briefing.

7 The history of the non-executive independent chair is discussed in further detail in Section Two of this briefing.

– Participants of the Chairmen's Forum, February/October 2008.

The participants of the Chairmen's Forum agreed there may be overlap between the general responsibilities of the lead director and the chairman of the board, but in practice the significant impact is not necessarily in the day to day functions, but rather in the comparative effectiveness of the roles. According to RiskMetrics, the number of boards that have a designated lead or presiding director has dropped 4% to 49% in 2008.[8] This decline is the first after rising dramatically in recent years (very few boards had lead directors prior to 2002).

How then is the role of a lead director different from that of a non-executive director? Forum participants debated the distinctions and came to a rough consensus.

Though the lead director model has and continues to work in many situations, Forum participants were near unanimous in contending that the "chairman of the board" title is not meaningless; it remains a strong hierarchical signal of board leadership to fellow board members, management and shareowners alike. Forum members broke down the differences between the chair and lead director into three broad categories: (a) the ability to shape board dialogue; (b) visibility and independent representation of shareowners; and (c) board leadership.

Shaping board dialogue:
The lead director, as described by one Forum attendee, "doesn't have the same sort of effect in terms of shaping the dialogue and moving the strategy forward. And I think that's where the non-executive chair makes a real difference." The ability to structure dialogue is integral to effective board oversight and allows directors to delve into the areas they deem necessary to fulfill their roles as fiduciaries. The lead director can encounter challenges in forming the agenda and steering the meetings, especially if there is confusion as to who leads the board. This was further noted by the experiences of one non-executive chair, "Quite frankly where you've got the two roles combined…management is in charge…from the beginning of setting the agenda, and certainly will shape the discussion when that agenda comes to the board."

8 *Board Practices: Trends in Board Structure at S&P 1500 Companies*, RiskMetrics Group Issues Report (December 17, 2008).

Visibility and independent representation to shareowners:
In the presence of the CEO, lead directors are not often visible to shareowners as independent representatives of their interests. One member of the Forum posited that most shareowners would not be aware of the presence of a lead director, whereas a non-executive chairman plays a more visible role, for example presiding at the annual meeting. The participant went on to state, "[shareowners] view an independent, non-executive chair as the lead representative of the board that is providing the oversight of management to protect their interests."

Board effectiveness:
One member captured the sentiment of many members of the group by saying the differences are "not necessarily in the specific tasks that are performed, because they are very parallel, but it's the effectiveness of running the board meeting. It's the effectiveness that's the real difference." Once again, many participants felt that the lead director is not perceived by their fellow board members as the board leader when in the shadow of the combined CEO and chairman. Another participant, having seen the evolution from a combined chairman and CEO to a lead director to a non-executive chairman – at two separate companies – stressed the point, "I can tell you the minute [he] graduated from lead director to non-executive chairman the whole board changed…it was amazing." Another participant commented that the lead director, at a company on whose board he served, was looked to as someone who stepped forward only during a crisis. "I saw firsthand as a lead director and then a non-executive chairman of the same company, the directors treat the lead director differently than the non-executive chairman," he said.

4. Splitting the roles of CEO and chairman is not a panacea, but independent board leadership is a start.

"People make a mistake when they think the simple act of separating those two roles will yield good governance. It's naïve and will yield failure."

– Participant at the Center Chairmen's Forum, February/October 2008.

One of the participants of the Chairmen's Forum accurately commented that there appears to be an evolutional or generational shift toward independent board leadership. As Section Two of this briefing discusses, over the past 50 years, the boards of large US public companies have slowly evolved

from a composition of 20% independent directors to an average of 75%. This is in no small part due to the combination of regulatory reform and the pressure applied by shareowners in response to repeated scandals and crises during that same period.

Splitting the role of chairman and CEO does not guarantee the application of effective independent oversight. It is no secret that certain companies, featured in some of the most famous corporate debacles, had separate CEOs and chairmen. Although, further examination of some cases conclude that independent board leadership failed to exist[9], it does illustrate the fact that the effective function of structure is not guaranteed. Rather, as participants agreed, the consideration of splitting the roles must be accompanied by delineated responsibilities that are clear to the board, the non-executive independent chair, the CEO and the shareowners in order for the independent chairman to fulfill the important leadership role. Furthermore, attracting and retaining qualified independent directors is a key ingredient.

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9 *See, e.g.,* Malcolm S. Salter, *Innovation Corrupted:* The Origins and Legacy of Enron's Collapse (Harvard University Press, 2008) at 272 (arguing for the complete separation of CEO and board chair roles).

2. THE ARGUMENT IN HISTORICAL CONTEXT: EMPOWERING BOARDS OF DIRECTORS IN THE US

Experiences of the participants in the Chairmen's Forum may be further understood in the context of research into the history of separating the roles of chairman and CEO.

The call for the separation of the roles of chair and CEO stems from the perceived need to reinstate the pivotal role of the board of directors in corporate governance through board empowerment and independence from management. The board of directors has been the focal point of oversight of modern corporations since its inception. This concept can be traced back to colonial enterprises, directed by a council of peers and to the first American corporation established in 1791[10]. Board centrality then proliferated into state corporate law statutes. Today, all US states contain provisions to the effect that the corporation is "managed by, or under the direction of, its board of directors[11]."

Berle and Means famously identified the separation between ownership and control, observed in large US public companies, and the potential for divergence of interests between owners and managers[12]. They argued that managers should administer the corporate assets not in their own interest, or in some form of ambiguous public interest, but as trustees in the best interests of shareowners as the owners of the corporate enterprise[13]. Although Berle and Means' proposal received lip service, scholars, practitioners and regulators progressively came to agree that the imposition of a monitoring function on the board of directors could serve as an effective antidote to what economists dubbed "agency costs"[14] arising out of the separation between ownership and control. Or so the theory went.

In reality, despite the board's prominent standing on paper and the rising recognition of its economic function, for most of the twentieth century, directors were, in practice, no more than decorative figures beholden to the imperial CEO. Scholars have unveiled the sharp discrepancies between "the myths of business literature and the realities of business practice."[15] Historically, in the United States, critics blamed the lack of board oversight for the corporate corruption scandals of the 1970s, for the falling performance and competitiveness of US corporations in the 1980s, and for the accounting scandals of the early 2000s. In the aftermath of each corporate scandal or crisis, the same question emerged: *Where was the board?*

Throughout time, each scandal led to an increased focus on specific board functions distinct from corporate management, and on director independence and skills, as highlighted by participants of the Chairmen's Forum and outlined in Section One of this briefing. Even though Berle and Means' seminal work hardly distinguished directors from executives (they referred to both categories collectively as "managers,"[16]) the evolution of US corporate governance in the twentieth century is marked by the progressive distinction between the role and responsibilities of the board of directors, on the one hand, and corporate officers, on the other. The transformation of corporate boards as a powerful body was indeed a precondition for the effectiveness of an internal corporate system of "checks and balances" against unrestrained management power.

A significant sign of the increasing rise of the board as an independent player in corporate governance was the change in board composition. While in the first part of the past century, directors were typically members of management or other-

10 Stanley C. Vance, *Corporate Leadership:* Boards, Directors, and Strategy 1-5 (McGraw Hill, 1983) (observing that "the Prospectus of the Society for Establishing Useful Manufactures, the first real American corporation established by Alexander Hamilton in 1791, had an up-to-date sounding statement of directorate purpose. *Note:* "The affairs of the company [are] to be under the management of thirteen directors").

11 *See, e.g.,* D.G.C.L., § 141(a) ("[t]he business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation") for the laws of Delaware, and the Model Business Corporation Act (2002), M.B.C.A., § 8.01(b) ("[a]ll corporate powers shall be exercised by or under the authority of the board of directors of the corporation, and the business and affairs of the corporation shall be managed by or under the direction, and subject to the oversight, of its board of directors, subject to any limitation set forth in the articles of incorporation or in an agreement authorized under [the Act]."

12 Adolf A. Berle, Jr. & Gardiner C. Means, *The Modern Corporation and Private Property* (The MacMillan Company, 1933).

13 *Id.* at 248 (arguing that "all powers granted to a corporation or to the management of a corporation, or to any group within the corporation, whether derived from statute or charter or both, are necessarily and at all times exercisable only for the benefit of all the shareholders as their interest appears.")

14 *See* Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, Journal of Law and Economics (June 1983).

15 Myles L. Mace, *Directors:* Myth and Reality (Harvard Business School Press, 1971) at 178. *See, also*, Jay Lorsch & Elizabeth MacIver, *Pawns or Potentates:* The Reality of America's Corporate Boards (Harvard Business School Press, 1989).

16 Berle & Means, *supra* 12.

wise closely linked to management (as lawyers, investment bankers or other advisors of the company), board membership in the twenty-first century reflects a significant majority of independent directors. Once again, only 20% of directors of large public US company boards could be deemed independent in 1950, but by 2005 average independent director representation had reached 75%. [17]

The transformation in board composition, and ultimately board culture and actions, was a gradual one. It resulted from a combination of voluntary action, inspired by heightened expectations of good governance by shareowners and society at large, stock exchange listing standards, judicial decisions and legislation. Nevertheless, each of the changes in the last 30 years shared a common catalyst: a corporate crisis of one sort or another. The combination of board centrality as the "law in the books" and a reality of passivity and rubber-stamping of management decisions turned the board of directors into an obvious target for reform.

Although the balance of power inside corporations has been in flux throughout the century, changes started to take place, in favor of boards, at an accelerated pace starting in the 1970s. Revelations of corporate corruption, after the Watergate scandal, drew public scrutiny to the relationship of corporate directors with management and inspired cries for director independence and oversight. In 1977, this led the New York Stock Exchange (NYSE) to require listed companies to form audit committees composed of "outside directors." It also marked the beginning of a shift from a board whose main role is to support and give advice to the CEO to a position of active oversight and guidance of the CEO, senior management and corporate operations. That is, the board's function changed from an "advisory board" to a "monitoring board."[18] The 1970s wave of reform marked the birth of the concepts "independent director"[19] and "corporate governance"[20]. As a corollary of the shifting role of the board, arguments for the separation of roles of chair and CEO began to surface.[21]

Following the above-mentioned groundbreaking developments, the board of directors remained in the spotlight for the following decade, but for different reasons. In contrast to the focus on corporate social responsibility and legal compliance of the 1970s, the 1980s saw the emergence of concerns about the economic performance of US corporations. The rise of foreign corporations cast doubts on the competitiveness of American companies in an increasingly global economy in the absence of substantial changes in strategy and, perhaps, governance. Critics blamed ineffective and entrenched management, and passive boards, for underperformance. Moreover, the depressed share prices of US corporations in the 1980s, when coupled with financial innovation in the form of "junk bonds," led to the emergence of an era of hostile takeovers, which had significant implications for corporate governance.

These takeovers served as a destabilizing force to the status quo of corporate management. The ensuing judicial decisions on hostile bids, although initially deemed "management-friendly," contributed significantly to consolidate board centrality in corporate governance. On the one hand, the Delaware cases permitting the board to withhold from shareowners the right to sell a company at a premium through the use of "poison pills" was a clear management victory in takeover battles.[22] On the other hand, these cases stressed that boards

17 Jeffrey N. Gordon, *The Rise of Independent Directors in the United States*, 1950–2005: Of Shareholder Value and Stock Market Prices, 59 Stanford Law Review 1465, 1465 (Apr. 2007).

18 *Id.* at 1465.

19 Id. at 1477 (noting that "independent director" entered the corporate governance lexicon only in the 1970s as the kind of director capable of fulfilling the monitoring role. Until then, the board was divided into "inside" and "outside" directors").

20 Luigi Zingales, *Corporate Governance, in*: The New Palgrave Dictionary of Economics and the Law (1997) (stating that "[w]hile some of the questions have been around since Berle and Means 1932, the term 'corporate governance' did not exist in the English language until twenty years ago").

21 Harold M. Williams, *Corporate Accountability and Corporate Power, in:* Harold M. Williams & Irving S. Shapiro, Power and Accountability: The Changing Role of the Board of Directors 19 (Carnegie Mellon University Press, 1979) (arguing that the roles of chairman and CEO "are not the same and can conflict"). *See, also*, Statement of the Business Roundtable, *The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation* 23 (Jan. 1978) (describing that "the critical necessity for an active and independent board which can effectively monitor the financial, social and law compliance performance of operating management has led in some quarters to suggestions that the functions of board chairman and chief executive officer be separated and lodged in two persons each directly responsible to the full board").

22 *Moran v. Household International, Inc.*, 500 A.2d 1346 (Del. Supr. Ct., 1985) (granting the benefit of the business judgment rule to the board's adoption of the "poison pill"). *See, also, Unocal v. Mesa Petroleum,* 493 A.2d 496, 954) (stating that "[w]hen a board addresses a pending takeover bid it has an obligation to determine whether the offer is in the best interests of the corporation and its shareholders" and that "in the broad context of corporate governance, including issues of fundamental corporate change, a board of directors is not a passive instrumentality") and *Revlon v. MacAndrews & Forbes Holdings*, 506 A.2d 173, 179 (Del. Supr. Ct., 1986) (emphasizing that "the ultimate responsibility for managing the business and affairs of a corporation falls on its board of directors and that "[fiduciary duty principles] are the bedrock of our law regarding corporate takeover issues").

were at the apex of the corporate decision-making process, and the judgments contributed to a power shift from management to boards.

Concurrently, when shareowners lost the right to sell at a premium to a raider in the face of management resistance, they started thinking about ways to reduce agency costs and improve performance beyond the "market for corporate control"[23] promoted by hostile takeovers. While institutional investors held only 6.1% of total outstanding US equity in 1950, that amount soared to more than 37% by 1980.[24] In light of the recent concentration of share ownership, institutional shareowners started looking for ways to influence corporate governance and improve performance from *within* the corporation by pushing their elected fiduciaries – the board of directors – to improve performance through enhanced monitoring and strategic guidance of corporate management.

Shareowner activists and reformist practitioners soon realized that structural impediments existed to the greater board role that they envisioned, and independent board leadership emerged as a well-defined agenda item. As early as 1969, Sir Walter Puckey, argued that, "It is not desirable for any person to combine [the] duties [of the chairman] with the special duties of the C.E.O. or managing director."[25] Later in 1981, Geoffrey Mills noted that it would be "naïve to expect that a chairman, who is also the chief executive to force the review of management ruthlessly and fire him if the performance is not good."[26] Moreover, he debated the reasonability of expecting a career executive to 'challenge the quality of his bosses' work in an open forum." In 1987, Arch Patton and John C. Baker reasoned that the dual authority of a CEO who is also the chair of the board as "both the stockholders' chief representative and the chief of management" compromised board independence regardless of its composition.[27] In 1988, Ira M. Millstein and Winthrop Knowlton saw in the revitalization of the board of directors, to be led by a non-executive chair, a powerful answer to the performance issues affecting so many US corporations.[28] One year later, Jay W. Lorsch and Elizabeth MacIver proposed the separation of the positions of chair and CEO in order to allow boards to act less like pawns and more like potentates.[29]

However, it was not until 1992 that the adoption of a non-executive chair as a governance reform got traction and publicity through developments in major US corporations. As described in a highly publicized story, the board of directors of General Motors (GM) ousted its chairman and CEO and appointed a non-executive chairman to the board in response to a lack of plan to address its faltering performance and declining market position. The GM board soon had a spillover effect across corporate America. During a two-week period in January 1993, the boards of three other high-profile corporations chose to discharge or accept the resignation of their CEOs and to empower themselves by splitting the roles and installing a non-executive chairman.[30]

In 1994, the GM board published its "Corporate Governance Guidelines" – dubbed a "Magna Carta for Directors" by the media, it would become a watershed document in US corporate governance best practices.[31] The GM Guidelines focused on strengthening the role of an independent board of directors through the adoption of structural improvements ranging from holding regular meetings of independent directors, without management presence, to annual board self-evaluation. Importantly, the GM Guidelines specifically provided for board leadership independent from management in the form of a non-executive chairman or a lead independent director. Another ground-breaking development occurred as a result of shareowners pushing for stronger corporate boards. The California Public Employees' Retirement System (CalPERS), a pioneer in institutional investor activism, began sending let-

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23 According to law-and-economics scholars, hostile takeovers create a "market for corporate control" leading to the replacement of under-performing managers of companies with depressed share prices, thus reducing agency costs. See, Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 The Journal of Political Economy 110 (Apr., 1965).

24 Carolyn Brancato & Stephan Rabimov, *The Conference Board 2008 Institutional Investment Report:* Trends of Institutional Investor Assets and Equity Ownership in US Corporations (Sept. 2, 2008).

25 Sir Walter Puckey, *The Boardroom, A Guide to the Role and Function of Directors*, 107 (Hutchinson of London 1969)

26 Geoffrey Mills, *On the Board*, 114 (Aldershot, Hampshire, England 1981)

27 Arch Patton & John C. Baker, *Why Directors Won't Rock the Boat?*, Harvard Business Review 10 (Nov.-Dec. 1987).

28 Winthrop Knowlton & Ira Millstein, *Can the Board of Directors Help the American Corporation Promote the Immortality It Holds So Dear? in*: The U.S. Business Corporation: An Institution in Transition (Ballinger, 1988) 169-191.

29 Lorsch & MacIver, *supra* note 15, at 185.

30 For a description of the board reforms in IBM, Westinghouse and American Express, *see* Paul MacAvoy & Ira M. Millstein, *The Recurrent Crisis in Corporate Governance* 29-30 (Stanford University Press, 1994).

31 Judith H. Dobrzynski, *At GM, A Magna Carta for Directors*, Business-Week (Apr. 4, 1994) (describing the move which marked "the end of a brief but critical era at the General Motors Corporation").

ters to its portfolio companies asking for information about their compliance with the GM Guidelines.[32] CalPERS would then later award such companies grades from "A+" to "F" based on their responses.

This progress of independent chairmanship was not universally accepted. Whereas the UK and Canada had introduced the concept of independent board leadership into their corporate governance codes subject to a "comply or explain regime,"[33] the US reform initiatives remained subject to voluntary initiatives of companies on an individual basis. Such initiatives proved to be subject to retreat once the initial crisis originating the split of positions was under control.

Although the adoption of independent chairmanship hit the headlines with groundbreaking splits, it failed to achieve widespread support. For instance, in 1995, GM, the early forerunner of independent chairmanship, decided to recombine the roles even in the face of shareowner resistance.[34] In fact, the number of US corporations combining the roles remained largely constant during the 1990s.[35] While the progress of independent chairmanship was slow, the push for board independence continued to intensify. In 1999, the NYSE amended its listing requirements to require that at least three independent directors sit on audit committees. The true momentum toward corporate governance reform would not come until the enactment of the Sarbanes-Oxley Act of 2002 ("SOX") in response to well-publicized instances of accounting fraud. SOX reinforced the oversight and compliance function of corporate boards and required that audit committees be composed exclusively of independent directors subject to stricter independence standards. SOX did not impose any changes to the board's leadership structure, perhaps due to the fact that certain of these companies had already featured a separate CEO and chairman. This would later be criticized as a missed opportunity, since subsequent studies made clear the fact that Enron's chairman could hardly be deemed independent, which was a contributing factor to the company's collapse.[36]

Soon after the enactment of the legislative mandates of SOX, additional stock exchange listing requirements and private sector developments followed in a further attempt to enhance board independence and the functioning of internal control systems.[37] In 2003, the US Securities and Exchange Commission (SEC) approved the new corporate governance standards for NYSE and the National Association of Securities Dealers Automated Quotations (Nasdaq) requiring listed company boards to have a majority of independent directors overall and solely independent directors of the audit committees, compensation and nomination committees, for NYSE-listed companies. The new NYSE listing standards also required boards to meet in regularly scheduled executive sessions without members of management present with the explicit goal of empowering "non-management directors to serve as a more effective check on management." Governance advocates considered the practice of meeting alone, regularly in executive sessions, without the CEO present, was an important movement toward, and symbol of, board independence.[38] In the same year, the NYSE also concluded a far-reaching reorganization of its own internal corporate governance structure to feature a fully independent board of directors and the separation of the role of chair and CEO. This move raised expectations for a new wave of split positions.

The issue of independent board leadership reemerged following SOX. In 2004, Ira M. Millstein and Yale Professor Paul MacAvoy published "The Recurrent Crisis in Corporate Governance," arguing that, in spite of the corporate governance developments in the past years, the underlying reason for the then recent scandals and the "recurring crisis" was the inability to deliver, in practice, the heightened expectations for governance.[39] Millstein and MacAvoy also predicted that if such a void was not filled by finally separating the positions of chair-

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32 Judith H. Dobrzynski, *An Inside Look at CalPERS Boardroom Report Card*, BusinessWeek (Oct. 17, 1994).

33 *See* Section on "Independent Chairs around the World" below.

34 Judith H. Dobrzynski, *Chairman to Step Down in G.M. Shift*, The New York Times

35 Paul Coombes & Simon Chiu-Yin Wong, *Chairman and CEO – one job or two?*, The McKinsey Quarterly n. 2 (2004).

36 *See*, e.g., Malcolm S. Salter, *Innovation Corrupted:* The Origins and Legacy of Enron's Collapse (Harvard University Press, 2008) at 272 (arguing for the complete separation of CEO and board chair roles).

37 In 2002, SEC chair Harvey L. Pitt urged the NYSE and Nasdaq to review their corporate governance and listing standards so as to boost investor confidence. *See* SEC Press Release No. 2002-23 (Feb. 13, 2002) (stating that "[w]hile no set of rules can stop every venal actor determined to put personal interests ahead of those of the companies they manage (…), there are a number of ways that current corporate governance standards can be improved to strengthen the resolve of honest managers and the directors who oversee management's actions.")

38 See e.g. *Running effective executive sessions: when should they be held? How long should they be? Who should lead them? These are among the questions boards must consider to make their executive sessions successful.* Richard Koppes and Heath Rodman, Directors and Boards (Spring 2006)

39 Paul MacAvoy & Ira M. Millstein, *The Recurrent Crisis in Corporate Governance* (Stanford University Press, 1994).

man and CEO, we would see more scandals and more failures.[40] On a side note, American International Group, the Walt Disney Company and Marsh & McLennan, among others all split the roles between 2004 and 2005 in response to corporate governance crises.

In 2004, the US SEC expressly endorsed the importance of an independent chair in response to another crisis, albeit this time in the mutual fund industry. Following a series of 2003 mutual fund scandals, which suggested that weak governance structures were a contributing factor, the SEC amended its rules to require that mutual funds relying on certain exemptions have an independent chair. The adopting release makes reference to the fact that corporate governance experts have opined on the value that an independent chairman brings to a corporate board of directors.[41]

Consistent with the historical precedent of splitting the roles of the chair and CEO in various times of crises, the subprime mortgage meltdown, starting in mid-2007, and resulting financial crisis began to shape corporate governance practices of financial institutions. Starting in 2007 and continuing in 2008, major financial firms such as Citigroup, Bear Stearns, Washington Mutual, Wachovia and Wells Fargo split the two roles. Although most of these firms voluntarily made the change upon succession, triggered by the crisis, the move at Washington Mutual did not occur until a precatory shareowner proposal achieved majority support. Nevertheless, several other affected companies chose to keep the combined roles, even upon succession, including Merrill Lynch.

Significantly, the return of the independent chair as a hot button corporate governance issue in 2008 was not limited to companies affected by the financial crisis. Shareowner activist Bob Monks submitted on behalf of institutional investors and members of the Rockefeller family, a widely-publicized proposal requesting the adoption of an independent chair. The Change to Win (CtW) investor coalition released a statement in favor of the proposal defending the need to "restore adequate checks and balances between the board and management" at ExxonMobil and to position the company "to face up to its need to develop renewable energy programs that address global market changes related to climate change." Ultimately, the proposal received 39.5% support in spite of ExxonMobil's "unprecedented outreach efforts…to solicit votes from institutional and retail investors" and the company's stellar financial performance.[42]

The separation between the roles of chair and CEO also became a central agenda item in a high-profile hedge fund proxy battle. The London-based The Children's Investment Fund (TCI) and Cayman Islands-based 3G Capital Partners used resistance of the split in roles at CSX as one of its main weapons in a broad attack on what they considered to be poor corporate governance practices. While CSX had offered TCI three board seats and a fourth mutually agreed-upon director, the negotiations broke down after CSX required a commitment to maintaining the joint chair-CEO position, which TCI refused to accept.[43] The contest ultimately resulted in a proxy war, following which TCI managed to obtain four board seats, but the combined role remains intact to date.

The significance of shareowner activism with respect to the split in roles in 2008 was not limited to these high-profile cases. According to RiskMetrics, independent board chair proposals obtained record investor support in 2008, averaging 31.3% of the votes cast. Companies in which separate chair proposals achieved more than 40% support include Pfizer, Weyerhaeuser and Time Warner.

The increasing support for a split in roles in 2008 came not only from shareowners, but also from company boards. According to the 2008 Public Company Governance Survey of the US National Association of Corporate Directors (NACD), 72.8% of directors serving on boards with an independent chair stated that companies greatly benefit from an independent chair, while only 6.7% stated that companies do not benefit from this model. These statistics and preferences for separation of the roles were affirmed by the participants of Chairman's Forum.

Where are we today? In light of the financial crisis, which many feel has exposed risk oversight weaknesses on the part of boards, predictions abound that proposals for board reform, including proposals for independent chair, will gain significant momentum in 2009. RiskMetrics has already predicted that the independent

40 *Id.*

41 Securities and Exchange Commission, Release No. IC-26520; File No. S7-03-04, 17 CFR Part 270 (eff. Sept. 7, 2004) (citing the work of Millstein & MacAvoy, *supra* note 39. See, also, Securities and Exchange Commission, Staff Report to the United States Securities Commission, *Exemptive Rule Amendment of 2004:* The Independent Chair Condition (Apr. 2005).

42 *Independent Chair Proposal Falls Short at ExxonMobil*, RiskMetrics Group Risk & Governance Weekly (May 30, 2008).

43 *See* The Children's Fund Management (UK) LLP & 3G Capital Partners, Ltd., *CSX: The Case for Change* (June 2008).

chair will probably be the board issue receiving most attention in shareowner proposals in the next few years. Unions affiliated with the CtW labor coalition are instigating a far-reaching proxy campaign on this issue and are planning to file proposals at more than 40 companies based on the argument that an independent chair is essential to oversee management risk taking, which lies at the heart of the current crisis. [44]

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44 Ted Allen, *A Look Ahead to 2009 Proposals*, RiskMetrics Group Risk & Governance Weekly (Dec. 5, 2008).

3. INDEPENDENT CHAIRS AROUND THE WORLD

The different degree of adoption of the independent chair model in the 1990s gave rise to one of the most significant distinctions within the Anglo-American model of corporate governance. As discussed elsewhere in this briefing, although investors and commentators alike have defended independent chairs in the last 20 years, this practice failed to achieve widespread support in US corporations. Up until the early 2000s, the percentage of the S&P 500 companies with combined roles remained barely unchanged in the previous 15 years, at 80%.[45] Today, approximately 36% of S&P 500 companies have separate chairs and CEOs; this is up from 22% in 2002.[46] However, only 17% of S&P 1500 firms have chairs that can be qualified as independent and the incidence of independent chairs is concentrated on small and mid-cap firms.[47]

This is in sharp contrast to the landscape of other countries. In 1991, the Cadbury Committee (named after its chair, Sir Adrian Cadbury, the former CEO of the confectionary empire) was formed in the UK to address the "financial aspects of corporate governance." The inspiration for the committee came after and during the collapse of high-profile companies such as Maxwell Communication, Pollypeck International and Bank of Credit and Commerce International in the 1980s and early 1990s. Specialists attributed these failures to lax board oversight and the concentration of power in the hands of the CEO. In 1992, the Cadbury Committee released "The Code of Best Practice," which recommended the separation of the positions of board chair and CEO in UK publicly-traded companies. Specifically, the code stated, "There should be a clearly accepted division of responsibilities at the head of a company, which assure a balance of power and authority, such that no one individual has unfettered powers of division."[48] One year later, this recommendation would acquire some teeth when the London Stock Exchange (LSE) required that companies either comply with the Cadbury Code or explain the reasons for their departure from the Code's recommendations in their disclosure documents. The results in the UK were rapid and substantial. Approximately 95% of all FTSE 350 companies adhere to the principle that the roles should be separated,[49] and 79% designate their chairmen as non-executive in their annual reports.[50]

Canadian developments are similar to those in the UK. In 1995, the Toronto Stock Exchange issued corporate governance guidelines recommending the adoption of a non-executive chair or alternate mechanism of board leadership. In 2003, a study showed that nearly two-thirds of 300 Canadian public corporations had split the roles.[51] By 2005, 88% of Canadian directors believed a leadership structure comprised of a CEO and non-executive chairman was appropriate. At that time, 90% of Canadian directors and 91% of Canadian institutional investors said the effect of splitting the roles was generally or very positive.[52] Although progress in Canada was initially slower than compared to the UK, a dramatic rise in independent chairmanship occurred following 2006 – 07 pressure from the Canadian Coalition for Good Governance. Conventional wisdom today among board members is that "chairman and CEO roles are nearly always separated" in the country.[53]

The separation of roles is also the rule in other large economies. All German and Dutch companies have separate chairs and CEOs, since these jurisdictions have two-tier boards which split the roles by definition.[54] Most public firms in Australia, Belgium and Singapore also have separate CEO and board chairs[55], as do most listed companies in Brazil.[56] All listed companies in South Africa split the roles, as required by the Johannesburg Stock Exchange.

Foreign experience with separate chairs thus shows that the model is feasible and an effective governance tool.

45 Paul Coombes & Simon Chiu-Yin Wong, *Chairman and CEO – one job or two?*, The McKinsey Quarterly n. 2 (2004).

46 Joann S. Lublin, *When Chairman and CEO Roles Get a Divorce*, The Wall Street Journal (Jan. 14, 2008) (citing Corporate Library data).

47 Ted Allen, *Wachovia Appoints an Independent Chair,* RiskMetrics Group Risk & Governance Weekly (May 16, 2008).

48 The Cadbury Committee, *Report of the Committee on The Financial Aspects of Corporate Governance* (December 1992)

49 Coombes & Wong, *supra* note 35.

50 Sir Geoffrey Owen & Tom Kirchmaier, *The Changing Role of the Chairman: Impact of Corporate Governance Reform in the UK 1995-2005 on Role, Board Composition and Appointment* (Mar. 2006) at 15.

51 Bernard Simon, *4 Big Canadian Banks Split Jobs of Chairman and Chief*, The New York Times (Sep. 10, 2003).

52 Jiri Maly and David W. Anderson, *Canadian Directors Redefine their Role*, ICD Director, 121, August 2005, pp. 1-5.

53 Beverly Behan, *Splitting the Chairman and CEO Roles*, BusinessWeek (Jan. 10. 2008).

54 Coombes & Wong, *supra* note 35.

55 *Id.*

56 Bernard Black *et al., An Overview of Brazilian Corporate Governance*, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1003059&download=yes (July 2008).

4. PROS AND CONS OF INDEPENDENT CHAIRS

The arguments for separating the roles of chair and CEO are clear. In governance as in government, splitting the roles is ideologically consistent with the view that a system of checks and balances is the best protection against unrestrained power.[57] Proponents of the distinction argue that there are two important conflicts that prevent the CEO from leading the board as effectively as possible:

(i). *Conflict of Interest:* The shift from an advisory board to a monitoring board created the potential for an inherent conflict of interest for a chair who is also the CEO of the company. The difficulties of having someone serve as the leader of the corporate body in charge of overseeing him or herself are rather clear. In this sense, the combination of the roles of chair and CEO is inconsistent with the notion that the board as a group is to act at all times independently and at times critically, of the CEO.

(ii). *Eliminating the Conflict of Function (The Substantial Duties of an Effective Chair of Today's Boards):* The evolution of the role of the board creates a new array of significant duties to the board leader which may be difficult to reconcile with the full-time job and growing demands of managing a publicly-traded company. In addition to presiding at board meetings, key responsibilities of a board chair include working with the CEO in crafting the agenda for board meetings and ensuring there is an adequate and timely information flow from management to the board (see Section One for a full list), to promote deliberation and sensible decision-making. Because boards now have more oversight responsibilities than ever before, they need a leader whose sole job is leading the board and not also managing the company. Combining the role of a chief executive with board chairmanship may generate a strain on time, focus and resources.

Although the logic underlying the defense of independent chairs is compelling, critics have raised various objections to the model.[58]

(i). *"Most US Boards Are Well Served by a Board Structure in Which the CEO Also Serves as Chairman of the Board" (a.k.a. Why Fix What Is Not Broken):* This proposition has been advanced by The Business Roundtable for the last 30 years[59], but it should be viewed in the context of a series of debilitating crises. The board's apparent failure to perform its risk management function is considered by many to be a key contributing factor to the current financial crisis. A brief examination shows the overwhelming majority of financial institutions had combined roles before the crisis erupted.[60] Furthermore, certain foreign institutional investors have expressed to their portfolio companies the view that the combined chairman/CEO model raises risks. They are concerned that oversight may be weaker than it would be under a non-executive independent chairman.[61]

(ii). *Lack of Empirical Evidence that the Separation of Roles Positively Impacts Corporate Performance/Share Price:* There are numerous empirical studies demonstrating positive effects of the separation of roles on value.[62] However, a number of studies exist which negate the causal link between a separate or independent chairman

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57 Ira M. Millstein, *The Two-Headed UK Model Could Work Here, With Fine-Tuning*, 6 Corporate Board Member 62 (Mar./Apr. 2003); David W. Anderson, *The Chair and CEO: Two Leaders, One Vision?* ICD Director, 126, June 2006, pp. 28-30.

58 Ira Millstein in remarks to 2008 International Corporate Governance Network (ICGN) Mid-Year Event In Times of Financial Crisis – What Now for Corporate Governance? Wilmington, Delaware, December 9-10

59 Statement of the Business Roundtable, *The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation* (Jan. 1978) (stating that "the general experience of the Roundtable members has been that the board functions well where the CEO also serves as chairman *and where there is no sharp organizational line drawn between the board and operating management*. It would be a mistake to suppose that the board can perform its mission apart from the chief executive officer or in an adversary relationship with him.") See, *also*, Business Roundtable, Principles of Corporate Governance (2005) (providing that "most American corporations have been well served by a structure in which the CEO also serves as chairman of the board").

60 This list includes Bear Stearns, Lehman Brothers, Citigroup, Merrill Lynch, Washington Mutual, Wachovia, Wells Fargo, Goldman Sachs, JP Morgan Chase, Bank of America and Morgan Stanley, among others.

61 Universities Superannuation Scheme and RAILPEN, two UK based institutional investors, among others, have sent multiple letters to their respective portfolio companies urging leadership to separate the roles of the chairman and CEO.

62 *See*, e.g., Richard Bernstein & Savita Subramanian, *Chairman/CEO Split and Stock Performance,* Merrill Lynch – Quantitative Viewpoint (Oct. 12, 2004); Ira M. Millstein & Paul W. MacAvoy, *The Active Board of Directors and Performance of the Large Publicly Traded Corporation*, 98 Columbia Law Review (June 1998); Lynn Pi & Stephen G. Timme, *Corporate Control and Bank Efficiency*, 17 J. of Banking and Fin. 515 (1993) (finding that "on average banks where the CEO is also the chairman of the board underperform those banks where the CEO is not the chairman of the board"); and Paula L. Rechner & Dan R. Dalton, *CEO Duality and Organizational Performance: A Longitudinal Analysis,* 12 Strategic Mgmt. J. 155 (1991) (concluding that companies with separate chair and CEO positions "consistently outperformed" companies with a single individual serving as chairman and CEO).

and enhanced performance or share price valuation.[63] A more accurate depiction of the literature would be to say that there is *inconclusive empirical evidence* about the effects of the split on value—and this is true, incidentally, with respect to virtually every single corporate governance aspect (from independent directors to staggered boards and poison pills). Moreover, there is no conclusive evidence (or, more accurately, virtually no evidence at all) that splitting roles destroys value. This has led certain advocates to defend the value of independent chairs based on a "chicken soup" type of argument ("it can't hurt, but might help").[64] In any event, the lack of conclusive empirical evidence as to either side is *neutral*,[65] so that any arguments around the subject should focus on experience, common sense and logic rather than regressions alone.

(iii). *Potential for Confusion and Duplication:* Many proponents of independent chairs submit that this concern is a reasonable one, although insufficient to oppose separation. Instead of avoiding the split altogether, companies should ensure that the division of responsibilities between the chair and the CEO is well-delineated and unambiguous so as to avoid overlap. This can prevent confusion and duplication, as well as clarity in the line of accountability; and experience shows this as quite feasible.

(iv). *Potential for Animosities:* Opponents of the split roles cite the potential for adversarial conduct in the boardroom as an important drawback of independent chairs. Indeed, combining the roles fosters a more friendly board environment, just as it encourages more complacent boards. While mindless animosities and ego contests in the boardroom can be counterproductive, directors who applaud and rubberstamp all actions of the CEO without asking difficult questions are not fulfilling their duties. Avoiding the split for this reason would be akin to encouraging absolutism because of branch conflicts generated by the separation of powers. The substantial improvements in the oversight functions of the board far outweigh occasional conflicts between the chair and the CEO. It is, however, important that the personalities of board chair and CEO are generally compatible and work well together. This should be an important concern during the CEO and independent chair selection process.[66]

(v). *Inefficiency in Decision-Making:* If efficiency (here understood as *speed*) in decision-making were the sole priority, it would be difficult to justify the existence of a board of directors at all. One person alone can certainly make decisions faster than a collegiate body, but this does not mean that such decisions would be wiser. Boards of directors exist not to increase the speed of corporate decision-making, but rather its quality through debate and the exchange of different perspectives and experiences. A main function of corporate boards is to provide another set of eyes and minds with respect to key decisions (from strategy and performance to risk and compliance matters). Once a board is in place (as it is in all publicly-traded companies) and fulfills its function, it is unclear why a separate chair would slow down the decision-making process.

(vi). *Cost Considerations:* Another argument against independent chairs is that this new function typically demands a higher pay than that of a regular independent director. Serving as an independent chair means embracing a new and more demanding job, so proportionate pay adjustments seem only reasonable. Still, this does not mean that, in the aggregate, corporate payroll expenses will necessarily increase as a result of the split. In empowering the board, an independent chair can in fact help the board avoid executive compensation excesses and instances of "pay for failure."

(vii). *Potential for Disruption:* Opponents of the split also argue that stripping the CEO of the chair title can be demoralizing and unduly disrupt the governance of the company, a condition the participants of the Chairmen's Forum unanimously agreed could be harmful (See Section One for further details). This does not

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63 *See, e.g.*, James A. Brickley, Jeffery L. Coles & Gregg Jarrell, *Leadership Structure: Separating the CEO and Chairman of the Board*, 3 Journal of Corporate Finance 189 (1997); B. Ram Baliga, Charles Moyer & Ramesh S. Rao, *CEO Duality and Firm Performance:* What's All the Fuss? 17 Strategic Management Journal (1996); Rajeswararao S. Chaganti, Vijay Mahajan & Subhash Sharma, *Corporate Board Size, Composition and Corporate Failures in Retailing Industry*, 22 J. Mgmt. Stud. 400 (1985); and S.V. Berg & S.K. Smith, *CEO and Board Chairman: A Quantitative Study of Dual vs. Unitary Board Leadership,* 3 Directors & Boards 34-37 (1978).

64 Constance E. Bagley & Richard H. Koppes, *Leader of the Pack:* A Proposal for Disclosure of Board Leadership Structure, 34 San Diego L. Rev. 149 (1997).

65 Ira M. Millstein, *Viewpoint: Board Leadership*, NACD Director's Monthly (Dec. 2004).

66 David W. Anderson. *Board Chair Succession: Choosy Boards Select Better Chairs*, ICD Director, 137, April 2008, pp. 22-24.

imply a definitive barrier to the adoption of independent chairs, but only a time constraint. Some proponents of the independent chair model agree with this objection and argue that the separation of roles should ideally occur in conjunction with CEO succession. In their view, however, "later" does not mean "never," and the split in roles should become a priority issue with respect to succession planning.

(viii). *Preference of Senior Management for Combined Roles:* In a 2005 article, Jay W. Lorsch and Andy Zelleke argued that "no compelling argument exists for splitting the chairman and CEO jobs, particularly in light of the fact that US senior executives strongly believe that the two positions should remain combined."[67] However, independent monitoring is seen by Forum participants as necessary and efficiency-enhancing, even though it is not likely to be well received by the targets of oversight. Board structure needs to be determined based on reasons other than the interests of any constituency alone.

(ix). *The Independent Chair Model is Just Unworkable in Practice:* The vast experience of foreign companies with independent chairs demonstrates the merits and the practicability of this model. In the US, directors who have experienced this approach weigh overwhelmingly in favor of it. Once again, according to the 2008 Public Company Governance Survey of the National Association of Corporate Directors (NACD), 72.8% of directors serving on boards with an independent chair opined that companies greatly benefit from an independent chair, while only 6.7% stated that companies do not benefit from this model.[68]

(x). *Lead or Presiding Director is an Equivalent (or Superior) Form of Independent Leadership (a.k.a. "Why Focus on the Title?"):* Perhaps the most popular argument against independent chair proposals is that a lead or presiding director with functions somewhat analogous to that of an independent chair, makes the split of titles become immaterial. However, form should not prevail over substance. Although this could be a defensible proposition in theory, the very fact that there is still remarkable management opposition to the separation of roles, but not to the adoption of a lead director, warns against viewing the positions of independent chair and lead or presiding director as equivalent or interchangeable. As discussed in Section One, the participants of the Chairmen's Forum were clear in their assessment of a lead director versus that of a non-executive chairman. In corporate America, there is still some truth to the view that he or she who sits at the head of the table runs the board. If the person at the head of the table is the CEO, the lead director may not able to lead. Therefore, while an improvement, a lead director may not be an adequate substitute for sitting at the head of the boardroom table.

(xi). *Different Board Leadership Structures May Be Appropriate for Different Companies (a.k.a. "One Size Does Not Fit All"):* This is probably the most compelling critique of all. Publicly-traded corporations are a heterogeneous group, and various practices may have an impact on individual corporations differently depending on their particular characteristics and needs. This acknowledgment does not however contradict the principle that the separation of roles should be the default rule. All it does is negate the view that independent board chairs should become a mandatory requirement applicable to all companies. The vast majority of advocates of the separation does not support such a mandate and, in fact, recognizes that specific company conditions may warrant the combination under exceptional circumstances. In these cases, most would agree that companies should explain to shareowners why such an alternative model best serves the long-term interests of the corporation and its investors. For example, a situation in which a company may choose to explain rather than comply with separating the roles may include a family controlled enterprise in which the CEO and chair is the majority shareowner. In Canada for example, some companies seperate the roles but install a representative of the controlling shareholder as board leader. Other circumstances may involve an untimely CEO departure, in which case the chair temporarily assumes CEO responsibilities until a suitable successor is named.

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67 Jay W. Lorsch & Andy Zelleke, *Should the CEO Be the Chairman?* 46(2) M.I.T. Sloan Management Review 71, 74 (2005) (arguing against the split of roles, in contrast to a previous work of one of the authors). See, *also*, Lorsch & MacIver, *supra* note 15.

68 National Association of Corporate Directors, *Public Company Governance Survey* (2008) at 15.

5. WHAT'S NEXT?

The current financial crisis is generating significant momentum for regulatory and corporate governance change. Now, as before, the debacle of major corporations has brought into question the role of the board in overseeing company performance, compliance and, most importantly in this case, risk. This crisis has exposed a board failure in fulfilling its duties and ensuring the existence of an adequate risk management system. As a result, boards are once again a popular target for reform efforts.

The history of corporate governance developments in the United States has been a story of movement away from the model of managerial capitalism which prevailed during a large part of the twentieth century. There has been a shift from an imperial CEO and mode of management which was constrained mainly by *external* forces such as regulation, competition and the market for corporate control, to one which relies also on protecting and enhancing shareholder value through mechanisms of checks-and-balances *within* the corporate structure. These mechanisms include shareowner monitoring and, most importantly, the oversight of boards of directors elected as fiduciaries of shareowners.

Boards of major US corporations have come a long way compared to those in the past. Today they are composed of a substantial majority of independent directors and are more active in compliance matters. Today, by law, only independent directors can serve as members of audit committees. In addition to the exclusive membership of independent directors on other board committees, stock exchange listing standards calling for executive sessions strengthened the board's oversight function. These requirements, when combined with an observable shift in boardroom culture, have made today's boards more independent, professional and active than ever before. Canada has taken a similar path.

Nevertheless, the critical missing piece in this evolutionary path towards more independence, engagement and monitoring, especially in the United States, is the separation of the roles of chair and CEO. Notwithstanding the improvements, boards are still led by the one obvious conflicted person to monitor the CEO and senior management: the CEO. The overall consensus reached at the Center Forums for corporate board chairs in North America, is that without this critical step, the long development towards a monitoring board will remain flawed.

The magnitude of the current crisis is attracting an unprecedented amount of attention to practices of boards of directors and management. The crisis exposed the consequences that deficient risk management practices pose not only to the viability of individual firms, but to the health of the national and global economy. Investors, governments and the public at large can be expected to place a significant amount of focus on boards to improve themselves. The incompatibility between the CEO and board chair positions in the US will become even more conspicuous. The law expects directors, as prudent monitors of the business, to learn from previous crises and adjust behavior accordingly. As scrutiny intensifies, advisors may recommend that it is imprudent for directors to purport to faithfully discharge their oversight functions of management when the chief executive serves as the board chair.

Conclusion

The time has come for independent chairmanship to become the default model of board leadership in corporate North America.

- The economic crisis has fueled strong support among shareowners, directors, the public and legislators for more robust oversight of CEOs by independent minded boards, and more management accountability to investors;
- Independent chairs have demonstrated that the model works successfully in the North American context, as reviewed in Section One;
- There has been a steady rise in the number of truly independent-minded boards faithfully overseeing management and the CEO, as Section Two has outlined;
- The independent chair model has been adopted successfully worldwide as a means to further reassure empowered board independence, as shown in Section Three; and
- Reasons to oppose independent chairmanship are flawed, as discussed in Section Four.

To accelerate board reform, the Chairmen's Forum is calling on all North American public companies to voluntarily adopt independent chairmanship as the default model upon succession to a combined CEO and chairman. A board could do so, for instance, through bylaw or charter amendments. If corporate directors choose to take a different course, either by combining the two posts or naming a non-independent chair, they should explain to their corporation's shareowners why doing so represents a superior approach to optimizing long-term shareowner value.

To advance the spread of such practices, the Chairmen's Forum will commit to undertake the following steps within the next three months:

- Secure endorsements from market institutions and individual leaders for the recommendations in this report;
- Track the take-up among North American listed companies of independent chairmanship;
- Open a new Chairmen's Forum website, through the Millstein Center, to feature documentation and research on non-executive board chairmanship; and
- Convene a Chairmen's Forum roundtable in July 2009 to assess progress and, if appropriate, review additional steps that could further encourage adoption of the independent chair model. Policy options could include a call on the New York Stock Exchange and Nasdaq to adopt listing rules on the matter.

Please submit all comments and endorsements to Stephen Davis, Millstein Center Senior Fellow at stephen.m.davis@yale.edu.

6. APPENDIX A: RESOURCES

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