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Schumpeter

Replacing the board

The case for outsourcing company boards

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CORPORATE boards are among the most important institutions in capitalism. Their job is to police the relationship between shareholders who own companies and managers who run them. This means keeping an eye out for managerial incompetence and fraud. It also means standing back and offering strategic advice on hiring new managers or buying competitors.

Yet their record might politely be described as mixed. The first decade of the 21st century produced an embarrassment of dismal oversight, from the Enron and WorldCom scandals of 2001-02 to the financial crisis of 2007-08. “I actually don’t think risk management failed,” said Larry Fink, the boss of BlackRock, an investment firm. “I think corporate governance failed, because...the boards didn’t ask the right questions.”

Problems have been widespread and deep-rooted. Chief executives have packed boards with cronies: Michael Eisner’s board at Disney once included the former headmistress of his children’s school and the man who designed his house. They have sidelined critics: when a member of the Bank of America’s board criticised the CEO’s compensation in 2000 she was dropped.

The past decade has seen several attempts to bring boards up to date. In America the Sarbanes-Oxley act (2002) and the Dodd-Frank act (2010) forced companies to appoint more independent directors and disclose more information about compensation. Good-governance advocates have pressed companies not just to choose white men as directors, and to publish more data so shareholders can make better informed decisions. But big companies continue to make extraordinary appointments: in 2011 IAC, a media conglomerate chaired by Barry Diller, appointed Chelsea Clinton, then a 31-year-old graduate student, to its board. And some magic bullets have proved to be blanks. Everyone thinks independent directors make better board members but there is no academic evidence to prove it. When Lehman

Brothers went bankrupt, eight of its ten directors were independents.

These reforms have left the basic problem untouched. Companies have almost always been admirably ruthless when it comes to reinventing themselves. They have experimented with every imaginable organisational form and have contracted out everything from manufacturing to strategy-making. Yet when it comes to boards they have been astonishingly conservative.

Boards are almost exactly as they were a hundred years ago: a collection of grey eminences who meet for a few days a year to offer their wisdom. They may now include a few women and minorities. There may be a few outsiders. But the fundamentals remain the same. Board members are part-timers with neither the knowledge nor the incentives to monitor companies effectively. And they are beholden to the people they are supposed to monitor. Boards are thus showcases for capitalism's most serious problems: they are run by insiders at a time when capitalism needs to be more inclusive and are dominated by part-timers at a time when it needs to be more vigilant about avoiding future crises.

In the May edition of the *Stanford Law Review* Stephen Bainbridge of the University of California, Los Angeles, and Todd Henderson of the University of Chicago offer a proposal for fixing boards that goes beyond tinkering: replace individual directors with professional-services firms. Companies, they point out, would never buy legal services or management advice from people only willing to spare a few hours a month. Why do they put up with the same arrangement from board members? They argue for the creation of a new category of professional firms: BSPs or Board Service Providers. Companies would hire a company to provide it with "board services" in the same way that it hires law firms or management consultants. The BSP would not only supply the company with a full complement of board members. It would also furnish it with its collective expertise, from the ability to process huge quantities of information to specialist advice on things such as mergers.

Messrs Bainbridge and Henderson argue that this would require only a simple legal change but could revolutionise the stick-in-the-mud world of boards. It would replace today's nod-and-a-wink arrangements with a market in which rival BSPs compete. It would create a new category of professional director. And it would allow BSPs to exploit economies of scale to recruit the best board members, introduce more rigorous training programmes and develop the best proprietary knowledge. Now, even the most diligent board member can only draw on his or her experience. BSPs would be able to draw on the expertise of hundreds. This would increase the chances that corporate incompetence will be corrected, corporate malfeasance found out and corporate self-dealing, in the form of inflated pay, countermanded.

Back to the drawing board

There are objections to the Bainbridge-Henderson plan. It might deny companies the insights of genuine outsiders—people with a record of producing industry-changing ideas. The very professionalism which will make BSPs better monitors of corporate performance might make them too conservative when advising on strategy. There could be conflicts of interest if, say, rival firms used the same BSP. But all professional-service firms (such as management consultants) have such problems—and ways of dealing with them. The idea might also deprive big shareholders of a chance to nominate board members. These problems could be overcome by creating a hybrid system in which the BSP filled a majority of board positions and a minority were reserved for others. Corporate boards have always been one of the weakest parts of the capitalist system—collections of cuckolds, in Ralph Nader's phrase. Messrs Bainbridge and Henderson have come up with an intriguing idea for keeping companies from straying.

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