REPLACING THE BOARD

Todd Henderson’s New Book Explores the Benefits of Outsourcing Corporate Governance

By Robin I. Mordfin
JP Morgan, one of the world’s largest financial services firms, has grown to more than 30 times the size it was in the Reagan era. It has $2.5 trillion in assets—up from $76 billion in the 1980s—operates in dozens of countries, and has become geometrically more complex.

However, one thing has not changed: the size of its board of directors. Three decades ago, JP Morgan had around a dozen members. Today, it still has around dozen members.

“Ultimately, you end up with 12 people running a business that is far more complex than anyone can imagine. What’s more, they need expertise in so many areas that they end up buying that expertise from other people,” said M. Todd Henderson, the Michael J. Marks Professor of Law. “There is a kind of pressure that boards should increase in size as businesses become bigger. But the efficiency of a board is going to decrease; it’s hard to imagine a group of 400 people making decisions.”

Fortunately, Henderson has a solution. In his new book, Outsource the Board: How Board Service Providers Can Improve Corporate Governance (Cambridge University Press), he and UCLA School of Law Professor Stephen M. Bainbridge propose giving corporations the option of hiring a new kind of firm, a Board Service Provider (BSP), to serve as their boards. Today, corporations hire law firms, accounting firms, and consulting firms to give them the expertise needed to run their highly complicated businesses. So why not a corporate governance firm?

“There is a whole literature that precedes us advocating for professional board members with standards and education,” Henderson said. “But even that plan has shortcomings because it focuses on the individual rather than on the entity. If there were firms that provided board services and that had employees with expertise in all the areas these corporations need, that would be much more efficient than 12 part-time people. The firm could hire all the experts they need and have them down the hall when information is needed.”

The truth is that most directors spend very little time overseeing the corporation to which they are attached. Typically, boards meet only four times a year, but a Board Service Provider would work full-time, throughout the year, providing far more efficient leadership than a corporation like JP Morgan does, with its array of experts on retainer. BSPs would also have the ability to hire notable individuals with important connections.

“When McKinsey hired Chelsea Clinton, they didn’t do it just because they thought she was a smart person. They also hired her because she is politically connected,” Henderson pointed out. “Networking is an important part of what a board does, and a BSP could do that just as effectively as current boards do.”

GREATER ACCOUNTABILITY

Unsurprisingly, hiring big names as directors is not always effective. In 1995, Michael Ovitz was hired as president of Disney, where Oscar-winning actor Sidney Poitier was a director on the compensation committee. When Ovitz was fired a year later, he received more than $140 million for his services. Disney stockholders were enraged and tried to sue individual directors, including Poitier, to recoup the losses. Ultimately, the directors were not held personally accountable.

Judges would be more likely to hold a BSP accountable for its decisions—including errors made while attempting to comply with oversight regulations, the authors said.

Since the Enron debacle of 2007, Congress has passed an enormous amount of oversight legislation in an attempt to curb large-scale fraud. The mandates are time consuming and complex and often require companies to retain outside experts.

“Right now, all that most boards have time for is oversight, but a BSP could spend time on other things because it would be a deeper entity, it would employ all the people it needs, and therefore, could be in compliance at a lower cost,” Henderson observed.
He also explained that BSPs, with their teams of experts, could overcome other corporate problems, such as having to make decisions without full information from management.

“Often directors do not know if they are getting too little information because they don’t have the experience and broad knowledge needed to make such a determination,” Henderson said. “But a full-service BSP would have that expertise and would be able to tell shareholders that management is not effective or is not cooperating and fire them. Individual directors can’t really do that.”

Henderson and Bainbridge also think that the option of a Board Service Provider could make it easier for shareholders to mount their own slates, and for considerably less investment. Rather than having individual candidates mount campaigns, the BSP could do so with greater efficiency and lower cost. Once elected, they could serve for a specific term. If the BSP was successful, it could be reelected. If not, the shareholders could go back to its old board of directors.

Henderson and Bainbridge say a BSP could provide a board of any size—in some cases it could be 12, in others, it could be just one person.

“We are not saying that the Board Service Provider will definitely be better, and we are not saying there is only one way for them to operate,” Henderson said. “We are saying that BSPs should be an option that shareholders and corporations can consider and try.”

**OVERCOMING OBSTACLES**

There is one hurdle: Legally, boards of directors must be composed of natural persons or individual human beings—not corporations. But Henderson said that shouldn’t be a concern—and could be fixed by abolishing the natural person requirement in Delaware, where most of the nation’s corporations are incorporated.

“This is a myth that should be debunked,” Henderson said. “There are only human beings. At the end of the day there are no such things as corporations, they are just fictions. Our BSPs would be composed of human beings, just like the current board. But, using the BSP form, they would be able to cooperate in ways that today’s board members cannot. And to be honest, no one is defending the natural person rule.”

Doing away with Delaware’s natural person rule would give corporations the opportunity to change their charters to allow board to be composed of natural persons unless otherwise stated.

Henderson and Bainbridge hope *Outsourcing the Board* will spark interest in making Board Service Providers an option. Their idea is getting coverage in Bloomberg, the *Economist*, and the *Stanford Law Review*, among other publications, and they are holding a conference in September at the UCLA School of Law.

The way the duo sees it, there may be many different types of BSPs, from large extant consulting firms who create BSP sections to new firms formed just for this opportunity. They will compete for different types and sizes of clients, and they will succeed or fail depending on their abilities and the corporations with which they work.

“It’s a very Chicago approach,” Henderson said, citing the work of Noble laureate and former colleague Ronald Coase as inspiration. “Coase asked why firms arise at all, concluding that they do when the benefits of cooperation within a firm is greater than the cost of individuals contracting with each other. Our idea is just this, for corporate governance services.”

It is important to note that there is currently no way of measuring corporate governance, which could change due to competition. Corporate performance is currently the best proxy for measuring governance, but at Enron—where for several years the board was lauded as the gold standard—that proved to be an ineffective measure. In fact, no one knows the cost of corporate governance, as it is not reported and is not compared.

Perhaps competition can change that, Henderson said. “We have no idea what kind of governance innovations lie on the other side of the natural person requirement,” he said. “What we have now might be as good as we can do. But it is worth seeing if something better is out there.”

**Understanding Classical Liberal Principles**

Professor M. Todd Henderson is also the editor of a new book of essays by lawyers, economists, philosophers, and other experts that takes a fresh look at the classical liberal principles upon which America was founded. The *Cambridge Handbook of Classical Liberal Thought* (Cambridge University Press), which includes contributors from a variety of political perspectives, explores how those classical liberal principles can help us deal with issues such as climate change, immigration, and the alarming rise in prison populations. It was released in August.